



Michigan's Short-Term Cross-Investment Structure

Under a short-term cross investment structure a state may invest funds from one SRF program to cure a default in the other

A number of states, including New York, Michigan, and Colorado, have already issued bonds to leverage their Drinking Water State Revolving Fund (DWSRF) programs. Recent reports indicate that up to fifteen states are already leveraging or are planning to leverage their DWSRF programs. In designing their leveraged program structures several states have explored the use of pooled bond security enhancements that are new to the State Revolving Fund program: *cross-collateralization* and *short-term cross-investment*. These security enhancements allow the resources of one SRF to be used to secure the repayment of leverage bonds of the other program.

Cross-collateralization was authorized by the Departments of Veteran Affairs and Housing and Urban Development, and Independent Agencies Appropriations Act, 1999 (PL 105-276). Short-term cross-investment is allowed under the "permitted investment provisions" of the Clean Water Act and the Safe Drinking Water Act. To date, New Jersey has received approval for a cross-collateralization structure and New York and Michigan have received approval for short-term cross-investment structures.

Under a short-term cross-investment structure, a state may use available funds from one SRF program to help

cure a default in the other. In the event that a borrower fails to repay a CWSRF or DWSRF loan, the first source to cover the default is the individual program debt service reserve. With a short-term cross-investment structure, as the debt service reserve is depleted, the second revolving fund can "invest" funds to cure the deficiency. The investment is made by the borrower SRF selling a bond to the investing SRF program. The investment is permitted under Section 603(d)(6) of the CWA and Section 1452(f)(5) of the SDWA. The authority for borrowing funds for cross-investment is found in Section 603(d)(4) of the CWA and Section 1452(f)(4) of the SDWA. The bond must be a short-term investment so that the lending SRF is repaid after the borrowing SRF recovers from loan defaults.

The benefit of the cross-investment is that it provides additional security to bond holders which helps to improve the bond ratings given to leveraging bonds and reduce the cost of borrowing to the SRF program. These benefits are accomplished even though the chances of a cross-investment actually occurring are remote due to the extraordinary level of debt service reserves (often 50 percent of bond size) found in many leveraged SRF programs. This report describes the Michigan short-term cross-investment structure.





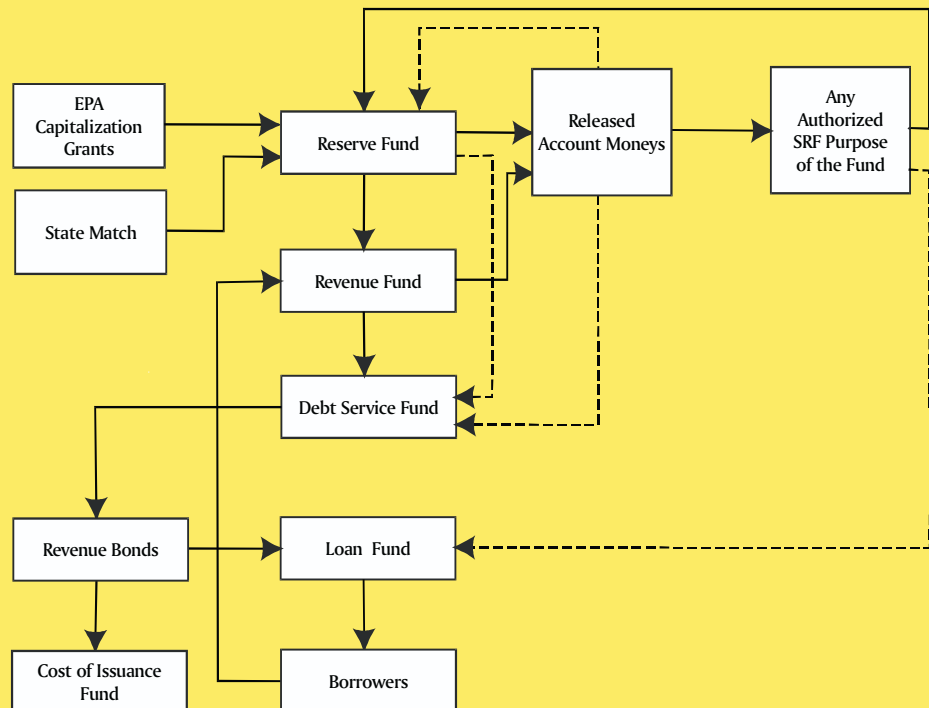
Overview of Michigan's Cross-Investment Structure

Michigan's CWSRF and DWSRF are managed jointly by the Michigan Department of Environmental Quality and the Michigan Municipal Bond Authority. The State has used reserve fund leveraging in the CWSRF since 1992. In order to finance DWSRF loans, Michigan amended its existing master indenture to establish a combined revolving fund financing program while continuing to separately account for all funds associated with the CWSRF and the DWSRF. The first DWSRF bonds funded \$53.2 million in loans to 23 separate government borrowers for 24 different projects.

Exhibit 1 displays Michigan's master indenture flow of funds. The indenture shows that as principal on bonds are repaid moneys from the Reserve Fund are released for other uses. It is possible to release funds and reduce the size of the reserve because as the outstanding bond principal is reduced, the released funds are no longer required to provide security or to generate interest to subsidize the repayment of the bonds. Moneys from the Revenue Fund are also released once it is determined that they are not required for debt service payments.

Michigan's first DWSRF bonds funded \$53.2 million in loans to 23 separate government borrowers for 24 different Projects

Exhibit 1 Michigan's Master Indenture Pooled Project Bonds Flow of Funds



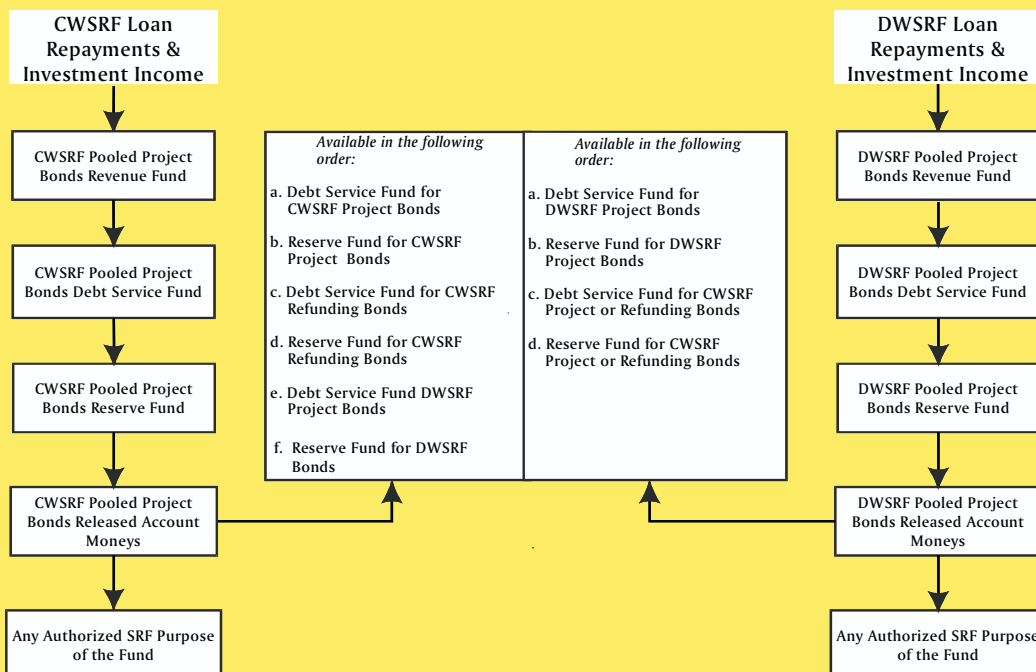
Use of Released Moneys for Cross-Investment

Once the funds are released from the Reserve Fund, Michigan's SRF management reviews the CWSRF and DWSRF to determine whether the released funds are required to cure any fund deficiency resulting from defaults on SRF loan repayment. If the funds are not needed to cure a default, they are then made available for any authorized SRF purpose (i.e., new loans). Exhibit 2 displays the priority order in which the released funds may be applied. The Exhibit shows that the released funds are first used to cure defaults within the Fund of origin before they are made available for cross investment in the other SRF

Released moneys are supplied by both SRF programs and are accounted for separately. If a cross-investment is required to cure a default the investment will be accounted for as a short-term, temporary investment of one SRF in the other and will be evidenced by a subordinate repayment bond. The cross-investment will be repaid with the first moneys available to the borrowing fund, i.e., after payment of debt service on outstanding bonds.

Released funds are first used to cure defaults within the Fund of origin before they are made available for cross-investment in the other SRF fund

Exhibit 2
Priority Use of Released Account Moneys



Summary of Key Features

Michigan's structure is designed to be appealing to bond rating agencies and investors. The State's approach enhances the security structure of Michigan's CWSRF and DWSRF leveraging bonds while complying with federal CWSRF and DWSRF program requirements. The following are key features of Michigan's short-term cross-investment structure:

- The CWSRF and DWSRF accounts remain separate.
- Only moneys released from reserves or revenue accounts may be used for short-term cross-investments.
- Cash draws can not be made for cross-investment purposes.
- Cross-investments cannot be used for state match
- The structure allows short-term cross-investments in either direction between the State's CWSRF and DWSRF programs.
- Short-term cross-investments are made after the borrowing program has depleted all other sources of security in that fund.
- Investments are temporary, short-term bonds that will be repaid with the first available SRF resources.
- Any investments between the CWSRF and DWSRF will be recorded on the SRF balance sheets and evidenced by a subordinated Repayment Bond
- If all funds are viable, the released moneys will immediately be made available to commit to eligible SRF projects.
- The state's approach is detailed in the operating agreements for the DWSRF and CWSRF between the region and the state.
- Funds will not be held in one SRF in anticipation of potential future cross-investment needs.

States interested in further information on short-term cross investment should contact their EPA Regional Office SRF Coordinator. For information on Michigan's program contact the state representatives below.

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