Variable Rate Demand Notes (VRDNs)

Federated Hermes

A Primer

VRDNs are securities, which may be tax exempt, that require the issuer or a third party, such as a dealer or a bank (the "Demand Provider"), to repurchase the security for its face value on demand. This feature is generally called a "Demand Feature." The day on which the security is purchased after the exercise of the Demand Feature is commonly known as the "Tender Date." VRDNs have interest rates that adjust on set dates (such as daily, weekly, or monthly), and the interest rate adjustment dates generally coincide with the Tender Dates.

After a VRDN is tendered, a remarketing agent for the VRDN tries to resell the VRDN for settlement on the Tender Date. Usually, the remarketing agent also sets the interest rate for the VRDN, which enables it to offer at a rate that will attract a buyer for the tendered VRDN. If the remarketing is successful, the buyer pays the purchase price for the VRDN on the Tender Date, and the remarketing agent delivers the purchase price to the investor tendering the VRDN.

If the remarketing agent can't remarket the VRDN, the tender agent may normally draw on a letter of credit, a standby purchase commitment or other liquidity facility to pay the purchase price to the tendering investor, as described in more detail below.

In order for a money market fund to acquire a VRDN, the VRDN must meet the requirements of Rule 2a-7 under the Investment Company Act of 1940. In addition, we have internal guidelines for the analysis of VRDNs.

Nature of Demand Features

A Demand Feature may be **"unconditional"** or **"conditional."**

- An **"unconditional"** feature indicates no conditions under which the Demand Provider's obligation to repurchase the security can terminate.
- A **"conditional"** feature means that the occurrence of certain events discharges the Demand Provider's obligation to repurchase the security.
  - Rule 2a-7 imposes strict requirements on "conditional" Demand Features. These requirements, which generally relate to the creditworthiness of the security, the circumstances under which the Demand Feature may terminate, and the structure of the Demand Feature itself, are intended to limit the circumstances under which the Demand Feature is not available to the investor.

Credit and liquidity enhancements

VRDNs may be issued with a variety of credit and liquidity enhancements. In some instances where the credit quality of the borrower is very strong, VRDNs are supported by the borrower's own liquidity.

- **Letter of Credit (LOC):** The most comprehensive credit enhancement to VRDNs. A letter of credit normally covers all payments on the bonds, which means that the bank issuing the letter of credit commits irrevocably and unconditionally to pay interest, principal and purchase price on the bonds when those payments come due and when the bonds are tendered at bondholder's option. Bond documents clearly coordinate the responsibilities of the letter of credit provider, the trustee (or tender agent) and the remarketing agent. The bank has to be an "approved bank" and followed on an ongoing basis by a Federated Hermes analyst.
- **Stand-by-Bond-Purchase-Agreement (SBPA):** A bank commits to providing liquidity for the bonds, which means the bank commits to providing the tender price should remarketing proceeds be insufficient to cover the entire amount of bonds tendered. The commitment of the bank to fund purchase price is conditional.
- **Insurance:** For some bonds where a SBPA is chosen to provide liquidity for tender price, a financial guarantor or a monoline insurer is responsible for payment of principal and interest only. The monoline insurer has to be followed by a Federated Hermes analyst and has to meet certain criteria.
- **Self-Liquidity VRDNs:** Under limited circumstances, VRDNs are backed by the borrower's own liquidity. Usually, borrowers using this type of financing have high credit quality and strong liquidity sources. These securities receive intense scrutiny and review by Federated Hermes analysts to verify the creditworthiness and the availability of liquid resources to fund tender price.

Modes of Variable Rate Demand Notes

Daily Resets may be tendered for purchase on a same-day basis (e.g., if the investor gives notice of tender in the morning, the investor will receive the purchase price by that afternoon).

Weekly Resets may be tendered at any time with seven days' notice (e.g., if the investor gives notice of tender on Monday, the holder will receive the purchase price on the following Monday).

Monthly or Quarterly Resets have fixed Tender Dates (e.g., the holder will receive the purchase price on the last business day of the month or quarter, provided the holder gives notice at least seven days before the Tender Date).

Commercial Paper (CP) Mode: Bonds may have a term of up to 270 days, bonds may not be tendered before the end of the CP period but must be tendered at the end of the term.

Tender Option Bonds: Bonds must be tendered at the end of the term, normally a year. Notice of tender must be given no longer than 30 days in advance.

Liquidity and credit substitution

Letters of credit and liquidity facilities typically have a stated expiration date, at which time the borrower would typically supply a substitute liquidity or letter of credit bank. Documents should provide for a mandatory tender for the VRDNs prior to the expiration or termination of the credit or liquidity facility. Payment for this mandatory tender should be provided by the existing bank, rather than the replacement one.

Liquidity facilities and letters of credits may also be substituted before the stated expiration date. In this case, the documents often provide for a mandatory tender prior to the occurrence of the substitution. Rule 2a-7 dictates that at a minimum, a notice of substitution should be sent to bondholders.

When a substitution occurs, the new documents are reviewed and evaluated to ascertain that the new facility conforms to the original one and that the security continues to be suitable for investment in money market funds.

Rule 2a-7 is a rule under the Investment Company Act of 1940 regulating money market funds. Rule 2a-7 imposes various restrictions on the money market fund's portfolio, including regulation related to maturity, credit qualification and diversification.

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