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Cash Academy

Understanding VRDNs

Variable Rate Demand Notes (VRDNs) are a critical asset class in the short-term municipal market, representing approximately 76%[1] of the securities that comprise municipal money market funds in the U.S. In this guide, we will explore VRDNs and how they can augment your liquidity portfolio.

VRDNs are floating rate municipal instruments usually with long maturities (commonly 20 or 30 years), and carry a coupon that resets periodically. VRDNs typically have either a one- or seven-day put option which allows investors to put the security back to a financial intermediary (otherwise known as a Tender Agent) at par[2] with one- or seven-days' notice, respectively. It is this put feature at par that helps these securities be considered liquid investments and therefore eligible for purchase by U.S. money market funds. For an indication of VRDN yield levels, market participants reference the Securities Industry and Financial Markets Association (SIFMA) index, which represents the average yield on a basket of seven-day put option VRDNs. The SIFMA Index resets every Wednesday at 4:00 p.m. Eastern Time.

To help ensure VRDNs can be put at par, these securities usually have an external credit enhancement or liquidity support provided by highly rated banks and financial institutions. The external credit enhancement is primarily through a Letter of Credit (LOC) that supports payment of principal and interest. The liquidity support is provided mainly via a Standby Purchase Agreement (SBPA), which allows the investor to put or sell the security back, thereby enhancing the liquidity of the security.

Municipal money market funds hold the clear majority of outstanding VRDNs; however, other investors such as corporations, bond funds, separately managed accounts and individual investors may also hold these securities.

How VRDNs work

Often, as permitted by the VRDN, holders may put back their notes to the Tender Agent (often a bank trustee department) upon seven days written notice.

Typically though, market participants called Remarketing Agents facilitate the put to the Tender Agent by taking back the VRDNs directly from holders. Rather than sending the VRDN to the Tender Agent, Remarketing Agents generally try to sell the VRDNs within a window period (typically seven days). If the VRDNs are successfully remarketed, the Tender Agent never has to take possession of them. On the other hand, if the VRDNs are not remarketed, the Tender Agent must then take the VRDN into their inventory, thereby facilitating the par payment to the original owner. In this case, the Tender Agent then draws on the LOC or SBPA to pay for the notes if the Remarketing Agent is not able to sell them (see illustration below).

Detailing support features

LOC: A LOC is provided by a third-party bank or financial institution and offers full credit enhancement. If the VRDN has an irrevocable LOC, the primary source of credit and liquidity risk for the investor can be viewed as having substituted from the municipal issuer of the VRDN to the LOC provider, since the LOC provider will step in and pay par to the purchaser if the issuer cannot.

1 As of July 31, 2023. Source: iMoneyNet, Inc.

2 Par value is the face value of a security. In this case, investors could resell the bond at its face value of a dollar price of 100 by giving one or seven days' notice to the Tender Agent.

SBPA: An SBPA is a liquidity facility for a VRDN, but it is conditional, unlike an irrevocable LOC. Monitorable conditions under which an SBPA can typically be terminated may include:

- Underlying obligor falls below investment grade
- A default of the underlying obligor
- A bankruptcy of the underlying obligor
- Underlying bonds become taxable

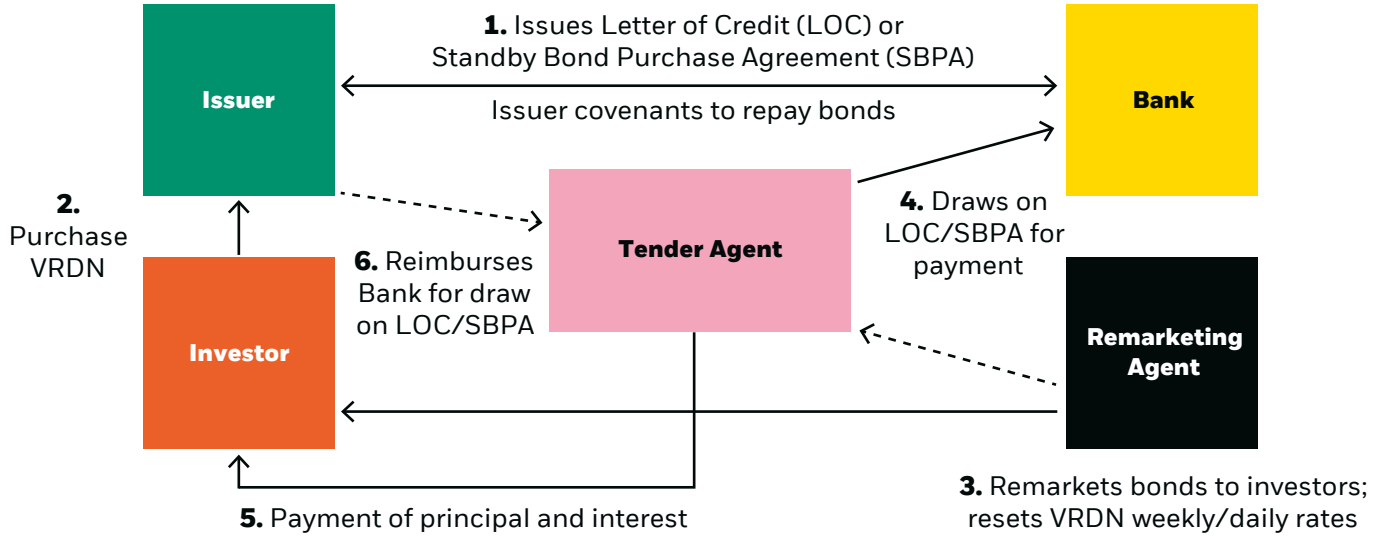
Some VRDNs will have neither a LOC nor an SBPA, leaving the municipality to guarantee principal and interest payments and provide for the par put.

VRDN credit review at BlackRock

At BlackRock, when we purchase VRDNs, we seek to select VRDNs that are supported by well-capitalized financial institutions that meet our credit standards. We purchase VRDNs with hard one- or seven-day put options, which can help increase the liquidity profile of our money market funds since they can be converted to cash within one or seven days respectively.

In our view, the depth and strength of our credit team are critical in supporting our use of VRDNs, as we conduct our own ongoing due diligence rather than relying solely on the opinions of rating agencies. Every VRDN on our credit approved list is vetted through our robust review process, which includes approval from our internal municipal analyst and the internal bank analyst that covers the bank providing the enhancement. Additionally, each VRDN is approved by the BlackRock Cash Management Credit Committee. This three-tiered confirmation process helps BlackRock seek only the highest quality VRDNs to purchase for our money market fund portfolios.

Basics of a VRDN



Source: BlackRock. For illustrative purposes only.

Want to know more?

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Prepared by BlackRock Investments, LLC, member FINRA.

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