CASE STUDY
The State of Connecticut Municipal Swap

1. Analyze the structure of the variable rate debt described in the case (UPDATES, VRDOs, etc.).
   
   (a) Explain the put, call and cap features and their respective importance.
   
   (b) At what rate should this debt trade? Do you agree with Merrill Lynch’s assessment of J.J. Kenny minus 55bps? How did Merrill arrive at this rate?

2. Compare three forms of debt - fixed rate debt, floating rate debt (with JJK, say) - and explain for each what risks the issuer and investor bear, respectively.

3. Analyze the fixed rate alternatives as proposed by Bankers’ Trust and Merrill Lynch. Which one is more favorable for the State of Connecticut?

4. Analyze the State of Connecticut’s alternatives including a fixed for LIBOR (one or three months) swap with AIG. Assume AIG will quote the rates given in Exhibit 1 of the case. Which one would you recommend?

5. What part of the analysis could benefit from explicit term structure modelling? How would you use a (statistical) model of the term structure of interest rates? What additional information could be gained, what are possible disadvantages?

6. How useful are synthetic fixed-rate debt instruments in your opinion? Why would anybody want to construct such instruments? What are their advantages and disadvantages?

Please note the following ground rules for the case write-ups:

- the maximal group size is 5; every group member receives the same grade;
- at most 2 pages of analysis and 6 pages of technical appendices;
- show your work, staple the pages together and be professional;
- late write-ups will not be accepted for any reason; they are due at the beginning of class for which the discussion is scheduled;
- graded write-ups will be available a week later.