IFA
ILLINOIS FINANCE AUTHORITY

Governor, Rod R. Blagojevich
Executive Director, Kym M. Hubbard

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February 25, 2008

Dear IFA Borrower:

As you know, there have been important developments in the bond markets over the course of the past few weeks which impact all types of borrowers, especially those with auction rate securities and variable rate demand notes outstanding. At the IFA, we are here to facilitate your borrowing needs and help you to respond to market challenges. As a result, we want to make sure that you are aware not only of recent events but also to outline some of the options that may be available to you should you be struggling with exposure to interest rate risk.

We offer for your consideration the attached commentary: "ARS: Challenges and Potential Strategies" provided by Lois Scott, Sr. Managing Director of Scott, Balice Strategies, and "Auction Rate Market Perspective" provided by Bill Morris, Sr. Vice President, Public Finance of D.A. Davidson & Co., as Financial Advisors to the Illinois Finance Authority.

Several of our borrowers have already begun to take action by converting from auction rate to variable rate demand obligations and substituting credit providers. If you have issued debt through the IFA or its predecessors, and if the Authority can be of help in addressing the options available to you, please contact IFA's Director of Financial Services as soon as possible. We will work with you to streamline our approval processes to the extent possible for responsive, timely service.

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We look forward to serving you and to partnering with you to address your financing needs.

Sincerely,

Kym M. Hubbard

Kym M. Hubbard
Executive Director

February 25, 2008

Commentary:

■ ARS: Challenges and Potential Strategies

Lois A. Scott, Sr. Managing Director, Scott, Balice Strategies

Potential Challenges due to Current Market Conditions

A confluence of market disruptions is causing investor concerns which may expose variable rate borrowers to significant interest rate risk. Debt sold in auction rate mode has been and may continue to be especially susceptible to such market disruptions. In addition, bonds with floating-to-fixed rate swaps may experience a higher than usual degree of basis risk. These bond market events include:

- ***Rating Actions on Monoline Insurers.*** XL, AMBAC and FGIC have been downgraded to AA or A depending on the rating agency, with the market expecting that other bond insurers may follow shortly. MBIA and CIFG, while currently rated AAA, are on negative or developing credit watch by all three rating agencies. As of this writing, FSA and Assured Guaranty remain the only 2 bond insurers with stable outlooks by most of the rating agencies. In the meantime, there is speculation that there may be a federal or state government bailout for the monolines or some form of investment bank bailout plan. Regardless, as the market continues to monitor developments, some insured bonds are trading at or above uninsured levels while other debt, including some FSA insured paper, is trading at levels significantly below the tax-exempt variable rate index (SIFMA).
- ***Disruptions in Auction Rate Markets.*** The recent failures by Piper Jaffrey, Stifel Nicolaus, Morgan Stanley, Bank of America, Goldman Sachs, Citigroup and Merrill, among others, to auction their ARS portfolio have received considerable attention in the financial press, causing market participants to re-evaluate exposure to liquidity risk and borrowers to re-evaluate exposure to basis risk, especially when rating actions on insurers can lead to trigger events in liquidity agreements and swap agreements.
- ***Constraints on Liquidity and Capital Access.*** Insurer downgrades and the underwriting capital needed to service auction rate securities have directly affected the interest rates on variable rate demand notes, and the likelihood of underwriters to put the bonds back to the banks providing liquidity facilities for such debt. Faced with significant funding needs, these banks have become more cautious in offering liquidity and credit facilities to support variable rate debt. While some market participants have said that the constraints on credit and liquidity may reflect a short-term panic by banks, the availability of credit and liquidity must be analyzed. Moreover, the full impact of the sub prime situation and impending resets of adjustable rate mortgages is still being assessed by the market. Write-downs by lending and investment banks and risk-based capital requirements make remarketing agents more reluctant to take their clients' bonds onto their own books, in addition to causing a general tightening in the availability of credit which puts pressure on the costs of borrowing.

Potential Strategies for Consideration

While we do not know how long this problem will persist, we believe that several strategies should be immediately explored by borrowers with ARS debt:

- Minimize size of the auction rate portfolio either through a refunding or by converting a bond issue's interest rate setting or mode.
- Analyze whether to remove insurance from variable rate bonds and remarket the variable rate debt based on your own rating plus a liquidity facility.
- Evaluate the economics of terminating outstanding swaps and issuing fixed rate bonds.
- Consider removing insurance from variable rate bonds and replacing it with a bank letter of credit.

We encourage borrowers to work with their financial advisors and underwriters to evaluate options early and carefully.

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February 25, 2008

Commentary:

■ Auction Rate Market Perspective

Bill Morris, Sr. Vice President, Public Finance, D.A. Davidson & Co.

For the past several weeks, bond issuers with Auction Rate debt have experienced significant increases in their interest rates when the rates are reset every 7, 28 or 35 days. While Auction Rate debt is a small part of the overall municipal bond market, the newly reset interest rates have been dramatically more costly to issuers with such debt. The problems in the Auction Rate market are directly related to the financial crisis created by the sub-prime mortgage issue which has had a negative impact on the national economy.

Auction Rate debt is backed (guaranteed) by bond insurers. In many cases, the bond insurers who are securing the Auction Rate debt held sub-prime mortgages in their investment portfolios and as a result have suffered financial losses which, in turn, has resulted in many – but not all – bond insurers either being placed on "credit watch" or having their bond ratings downgraded. The result has been that buyers of Auction Rate notes (bonds) have shown less confidence in the credits and have either demanded much higher interest rates or, in some cases, decided not to repurchase the bonds when the auction is held. Because of these market dynamics, issuers' interest rates have increased – in some cases, to 9 to 15% depending on the bond documents.

It is important to note that a failed auction does not indicate the bonds are in default, but only that there are not adequate buyers of the bonds for that auction cycle, which forces the investor to own the bonds at the higher interest rates.

The Illinois Finance Authority has some borrowers with Auction Rate debt and Director Kym Hubbard and her Board are working with borrowers of such debt to facilitate whatever corrective action borrowers would like to take.

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