

## NOTES TO THE FINANCIAL STATEMENTS

## NOTE 7: LONG-TERM LIABILITIES

## A. Changes in Long-Term Liabilities

**Primary Government.** Long-term liability activity for the year ended June 30, 2008, was as follows (dollars in thousands):

	Balance July 1, 2007 (as restated)	Increases	Decreases	Balance June 30, 2008	Amounts Due Within One Year
<b>Governmental activities:</b>					
Bonds and similar debt payable:					
General obligation bonds .....	\$ 5,902,330	\$ —	\$ (368,570)	\$ 5,533,760	\$ 364,495
Special indebtedness:					
Lease-purchase revenue bonds .....	245,045	—	(10,000)	235,045	10,000
Certificates of participation .....	727,640	275,000	(36,760)	965,880	46,295
GARVEE bonds .....	—	287,565	—	287,565	45,745
Less deferred amounts:					
For issuance discounts .....	(369)	—	243	(126)	—
On refunding .....	(92,259)	—	15,336	(76,923)	—
Add issuance premium .....	309,261	21,843	(43,832)	287,272	—
Total bonds and similar debt payable .....	7,091,648	584,408	(443,583)	7,232,473	466,535
Notes payable .....	36,901	7,425	(11,139)	33,187	6,484
Capital leases payable .....	25,740	—	(1,081)	24,659	1,096
Arbitrage rebate payable .....	5,717	2,023	(4,715)	3,025	—
Compensated absences .....	380,821	233,491	(211,063)	403,249	32,259
Net pension obligation .....	814	22,874	(23,166)	522	—
Workers' compensation .....	84,422	10,895	(6,568)	88,749	11,552
Deferred death benefit payable .....	410	155	—	565	285
Court judgment payable .....	—	749,886	—	749,886	—
Cost settlement payable .....	50,300	—	(15,000)	35,300	15,000
Governmental activity					
long-term liabilities .....	<u>\$ 7,676,773</u>	<u>\$ 1,611,157</u>	<u>\$ (716,315)</u>	<u>\$ 8,571,615</u>	<u>\$ 533,211</u>
<b>Business-type activities:</b>					
Compensated absences .....	\$ 3,885	\$ 3,103	\$ (2,306)	\$ 4,682	\$ 260
Business-type activity					
long-term liabilities .....	<u>\$ 3,885</u>	<u>\$ 3,103</u>	<u>\$ (2,306)</u>	<u>\$ 4,682</u>	<u>\$ 260</u>

For governmental activities, the compensated absences, net pension obligation, workers' compensation, and cost settlement liabilities are generally liquidated by the General Fund. Arbitrage rebate payable is generally liquidated by other governmental funds. A portion of compensated absences is also liquidated by the Highway Fund. Internal service funds predominantly serve the governmental funds. Accordingly, long-term liabilities for them are included as part of the above totals for governmental activities. At year-end, \$4.925 million of internal service funds compensated absences are included in the above amounts.

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**Component Units** (University of North Carolina System, North Carolina Housing Finance Agency, and the State Education Assistance Authority). Long-term liability activity for the year ended June 30, 2008, was as follows (dollars in thousands):

	Balance July 1, 2007 (as restated)	Increases	Decreases	Balance June 30, 2008	Amounts Due Within One Year
<b>University of North Carolina System:</b>					
Bonds payable:					
Revenue bonds .....	\$ 2,058,359	\$ 379,390	\$ (97,710)	\$ 2,340,039	\$ 156,218
Certificates of participation .....	35,080	—	(1,945)	33,135	2,010
Less deferred amounts:					
For issuance discounts .....	(44,498)	—	4,467	(40,031)	—
On refunding .....	(26,856)	(345)	1,896	(25,305)	—
Add issuance premium .....	44,155	4,903	(1,400)	47,658	—
Total bonds payable .....	2,066,240	383,948	(94,692)	2,355,496	158,228
Notes payable .....	97,050	12,614	(18,720)	90,944	50,980
Capital leases payable .....	137,182	25,691	(20,094)	142,779	9,405
Arbitrage rebate payable .....	269	48	—	317	42
Annuity and life income payable .....	11,845	4,934	(73)	16,706	1,420
Compensated absences .....	287,769	210,425	(187,858)	310,336	34,516
Liability insurance trust fund payable .....	50,678	14,874	(4,594)	60,958	14,317
Total long-term liabilities .....	<u>\$ 2,651,033</u>	<u>\$ 652,534</u>	<u>\$ (326,031)</u>	<u>\$ 2,977,536</u>	<u>\$ 268,908</u>

Long-term liabilities of nongovernmental component units of the University of North Carolina System are excluded from the above amounts. At June 30, 2008, nongovernmental component unit foundations and similarly affiliated organizations of the University of North Carolina System had total long-term liabilities of \$461.847 million, of which \$19.35 million was due within one year and \$442.497 million was due in more than one year.

	Balance July 1, 2007 (as restated)	Increases	Decreases	Balance June 30, 2008	Amounts Due Within One Year
<b>North Carolina Housing Finance Agency:</b>					
Bonds payable:					
Revenue bonds .....	\$ 1,619,025	\$ 275,000	\$ (324,790)	\$ 1,569,235	\$ 35,635
Less deferred amounts:					
For issuance discounts .....	(19,636)	(2,809)	3,208	(19,237)	—
On refunding .....	(30)	—	30	—	—
Total bonds payable .....	1,599,359	272,191	(321,552)	1,549,998	35,635
Arbitrage rebate payable .....	1,063	542	(41)	1,564	—
Compensated absences .....	740	474	(339)	875	40
Total long-term liabilities .....	<u>\$ 1,601,162</u>	<u>\$ 273,207</u>	<u>\$ (321,932)</u>	<u>\$ 1,552,437</u>	<u>\$ 35,675</u>

	Balance July 1, 2007	Increases	Decreases	Balance June 30, 2008	Amounts Due Within One Year
<b>State Education Assistance Authority:</b>					
Bonds payable:					
Revenue bonds .....	\$ 2,971,726	\$ 1,524,200	\$ (800,989)	\$ 3,694,937	\$ 506,300
Arbitrage rebate payable .....	7,624	—	(1,886)	5,738	—
Compensated absences .....	285	28	(9)	304	8
Total long-term liabilities .....	<u>\$ 2,979,635</u>	<u>\$ 1,524,228</u>	<u>\$ (802,884)</u>	<u>\$ 3,700,979</u>	<u>\$ 506,308</u>

**NOTES TO THE FINANCIAL STATEMENTS****B. Bonds, Certificates of Participation, and Notes Payable**

Bonds, certificates of participation, and notes payable at June 30, 2008 were as follows (dollars in thousands):

	<u>Interest Rates</u>	<u>Maturing Through Year</u>	<u>Original Issue Amount</u>	<u>Outstanding Balance</u>
<b>Primary Government:</b>				
<u>Governmental activities</u>				
General obligation bonds.....	1.30% - 6.90%*	2028	\$ 7,515,769	\$ 5,533,760
Special obligation debt:				
Lease-purchase revenue bonds.....	2.40% - 5.25%	2024	272,045	235,045
Certificates of participation.....	2.50% - 5.25%	2028	1,064,840	965,880
GARVEE Bonds.....	3.75% - 4.00%	2019	287,565	287,565
Notes payable.....	0.00% - 4.00%	2018	44,137	33,187
<b>Component Units:</b>				
<u>University of North Carolina System</u>				
Revenue bonds.....	1.45% - 10.00%*	2038	\$ 2,772,230	\$ 2,340,039
Certificates of participation.....	3.00% - 5.00%	2036	38,745	33,135
Notes payable.....	2.35% - 9.45%*	2033	141,999	90,944
<u>North Carolina Housing Finance Agency</u>				
Revenue bonds.....	2.70% - 8.25%*	2039	\$ 3,589,241	\$ 1,569,235
<u>State Education Assistance Authority</u>				
Revenue bonds.....	0.00% - 9.00%*	2037	\$ 3,788,150	\$ 3,694,937

\* For variable rate debt, interest rates in effect at June 30, 2008 are included. For variable rate debt with interest rate swaps, the synthetic fixed rates are included.

General obligation bonds are secured by the full faith, credit, and taxing power of the State. Certificates of participation (COPs) and lease-purchase revenue bonds, which are also referred to as special obligation debt, are secured by lease and installment payments made by the State and sometimes by a security interest in the leased facilities pursuant to a leasehold deed of trust. The payments on special obligation debt of the State are subject to appropriation by the General Assembly. Other long-term debts of the State and its component units are payable solely from certain resources of the funds to which they relate.

**C. Bonds Authorized but Unissued**

The amount of authorized but unissued debt of the primary government subject to annual appropriation requirements at June 30, 2008 totaled \$1.554 billion as follows: university projects \$725 million, psychiatric hospital \$306 million, correctional facilities \$166 million, guaranteed energy savings contracts \$68 million, youth facilities \$7 million, parks and land \$120 million, and State and other projects \$162 million.

In 2005, the N.C. General Assembly enacted General Statute 136-18(12b) providing for the issuance of Grant Anticipation Revenue Vehicle Bonds (GARVEEs), which are payable from revenues consisting primarily of federal transportation funds, with the proceeds to finance federal-aid highway projects. The GARVEEs are limited obligations of the State payable solely from these funding sources. The total amount of GARVEEs that may be issued is subject to limitations contained in the authorizing legislation tied to the historic and future level of federal transportation funds the State has or is expected to receive.

**D. Demand Bonds**

Included in bonds payable are several variable rate demand bond issues. Demand bonds are securities that contain a "put" feature that allows bondholders to demand payment before the maturity of the debt upon proper notice to the issuer's remarketing or paying agents.

**Component Units****University of North Carolina System**

With regards to the following demand bonds, the issuer has not entered into take-out agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

*The University of North Carolina at Chapel Hill - General Revenue, Series 2001B and 2001C*

In 2001 the University issued two series of variable rate demand bonds in the amount of \$54.97 million (2001B) and \$54.97 million (2001C) that each has a final maturity date of

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December 1, 2025. The bonds are subject to mandatory sinking fund redemption on the interest payment date on or immediately preceding each December throughout the term of the bonds. The proceeds of these issuances were used to provide funds to refund in advance of their maturity the following issues: Ambulatory Care Clinic, Series 1990; Athletic Facilities, Series 1998; Carolina Inn, Series 1994; School of Dentistry, Series 1995; Kenan Stadium, Series 1996; and Parking System, Series 1997C. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the University's Remarketing Agents, Lehman Brothers, Inc (2001B) and UBS Financial Services, Inc. (2001C).

The University entered into a new line of credit agreement in the amount of \$300 million with Wachovia Bank, N.A. on September 21, 2006 and canceled its line of credit in the amount of \$107.46 million with JP Morgan Chase Bank. Under the new line of credit agreement, the University is entitled to draw amounts sufficient to pay the principal and accrued interest on variable rate demand bonds or commercial paper bonds delivered for purchase. Under the new line of credit agreement, the University may request that Wachovia Bank, N.A. increase the commitment by increments of \$25 million for a total commitment of up to \$400 million. A request for increase is subject to the Bank's sole discretion, and the University cannot be in default under the agreement.

The University is required to pay a quarterly facility fee for the line of credit in the amount of .08% per annum based on the size of the commitment. If a long-term debt rating assigned by Standard & Poor's (S&P), Fitch Ratings (Fitch), or Moody's Investors Service (Moody's) is lowered, the facility fee assigned to the lowest rating in the below table shall apply:

S&P	Fitch	Moody's	Facility Fee
AA	AA	Aa2	0.10%
AA-	AA-	Aa3	0.11%
A+	A+	A1	0.14%
A	A	A2	0.18%

In the event that the Bank increases the available commitment prior to the due date for payment of a facility fee, the University must pay a supplemental fee based on the facility fee applied to the amount of the increase at the time of commitment to increase. The University will also pay an accrued interest fee equal to the amount of accrued interest, at the time of purchase of the bonds, multiplied by the prime rate multiplied by the ratio of the number of days from the date of purchase of the bonds until the date of payment of the accrued interest to 365 days.

Under the line of credit agreement, draws to purchase bonds will accrue interest at the prime rate payable on the same interest date as provided in the Trust Agreement for the original bonds. The University is required to begin making a series of ten fully amortizing semi-annual principal payments on bonds held by the Bank six months after the date of purchase.

Commercial paper bonds held by the Bank may be rolled over for a period of 180 days and must be reduced by 1/10<sup>th</sup> of the original amount of the commercial paper bonds for a period of up to 10 rollovers. All outstanding principal and accrued but unpaid interest is due in full at the maturity of the line of credit. At June 30, 2008, no purchase draws had been made under the line of credit.

The line of credit agreement expires on September 21, 2011 and is subject to covenants customary to this type of transaction, including a default provision in the event that the University's long-term bond ratings were lowered to below a BBB- for S&P, BBB- for Fitch, and Baa3 for Moody's.

*North Carolina Central University – Revenue Bonds Series 2003A*

In October of 2003, the North Carolina Capital Facilities Finance Agency issued Student Housing Facilities Revenue Demand Bonds (\$21.48 million Variable Rate Revenue Demand Bonds, Series 2003A) that have a maturity date of October 1, 2034. The issuer, the North Carolina Capital Facilities Finance Agency, loaned the proceeds of the Series 2003 Bonds to the North Carolina Central University Real Estate Foundation, Inc. (Foundation). The Foundation used the proceeds to finance the costs of building a student housing facility at North Carolina Central University, to fund a debt service reserve fund for the 2003A Bonds, to pay a portion of the interest on the bonds during construction of the project, and to pay certain costs of issuance of the bonds. The 2003A Bonds are subject to mandatory sinking fund redemption at the principal amount on the interest payment dates.

The Student Housing Facilities Revenue Demand Bonds (Series 2003) has an Irrevocable Letter of Credit (LOC) for \$21.82 million. The LOC is to secure the payment of the principal and purchase price of interest on the Series 2003 Bonds. The LOC was issued by Wachovia Bank, N.A. and expired on October 15, 2006. The LOC may be extended by request from the Foundation by delivering a notice of extension to the Trustee with a new expiration date. The LOC was subsequently extended until August 31, 2009. At June 30, 2008, the LOC rate for the bonds was 1.4% and the total amount drawn on it was \$966 thousand.

The Foundation paid Wachovia Bank, N.A. a commitment fee of \$109 thousand for the letter of credit on the date the bonds were issued. If the Foundation terminates the letter of credit on or before August 31, 2009, then the Foundation must pay a termination fee of \$25 thousand. The Bonds are not under a take-out agreement; however, in the event of termination 100% of the unpaid principal will be due and payable plus any unpaid and accrued interest.

Under the LOC agreement, the proceeds of each drawing under the LOC to pay the portion of the purchase price of Series 2003 bonds allocable to principal will constitute a tender advance and must be reimbursed as provided in the agreement. The Foundation is required to repay each tender advance to Wachovia Bank, N.A. plus an interest rate of prime plus 1%.

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According to the Reimbursement Agreement Amendment dated May 2008, the amount of any tender advance made is repaid based on the earliest to occur of the date the credit provider bonds purchased pursuant to such tender advances are remarketed, the close of business on the date that is 366 days after the tender was made, and/or the termination date.

The Student Housing Facilities Revenue Demand Bonds (Series 2003) has a remarketing fee. The remarketing fee is an upfront charge to reset the interest rates on a weekly basis. The Remarketing Agent is Wachovia Bank, N.A. for the Series 2003A Bonds. At June 30, 2008, the remarketing fee rate for the bonds was 0.13%.

With regard to the following demand bonds, the issuer has entered into take-out agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

*North Carolina State University - General Revenue Bonds, Series 2003B*

On June 20, 2003 the University issued tax-exempt variable rate revenue demand bonds in the amount of \$45.66 million that have a final maturity date of October 1, 2027. The bonds are subject to mandatory sinking fund redemption that began on October 1, 2004. The University's proceeds of this issuance were used to pay a portion of the costs of certain improvements on the campus of the University, to refund certain debt previously incurred for that purpose, and to pay the costs incurred in connection with the issuance of the 2003B bonds.

While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven days notice and delivery to the paying agent, The Bank of New York Mellon. Upon notice from the paying agent, the Remarketing Agent, Wachovia Bank, N.A., has agreed to exercise its best efforts to remarket the bonds for which a notice of purchase has been received.

Under a Standby Bond Purchase Agreement (Agreement) between the Board of Governors of the University of North Carolina and Bayerische Landesbank, a Liquidity Facility has been established for the Trustee (The Bank of New York Mellon) to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. This Agreement requires a commitment fee equal to 0.13% of the available commitment, payable quarterly in arrears, beginning on July 1, 2003 and on each October 1, January 1, April 1, and July 1 thereafter until the expiration date or the termination date of the Agreement.

Under the Agreement, any bonds purchased through the Liquidity Facility become Liquidity Provider Bonds and shall, from the date of such purchase and while they are Liquidity Provider Bonds, bear interest at the Liquidity Provider rate (the greater of the bank prime commercial lending rate and federal funds rate plus 0.5%). Upon remarketing of Liquidity Provider Bonds and the receipt of the sales price by the Liquidity

Provider, such bonds are no longer considered Liquidity Provider Bonds. Payment of the interest on the Liquidity Provider Bonds is due the first business day of each month in which Liquidity Provider Bonds are outstanding. At June 30, 2008, there were no Liquidity Provider Bonds held by the Liquidity Facility. The original Liquidity Facility expiration date has been extended and is scheduled to expire on November 30, 2015, unless otherwise extended based on the terms of the Agreement.

Upon expiration or termination of the Agreement, the University is required to redeem (purchase) the Liquidity Provider Bonds held by the Liquidity Facility in twelve quarterly installments, beginning the first business day of January, April, July, or October, whichever first occurs on or following the Purchase Date along with accrued interest at the Liquidity Provider rate. In the event the entire issue of \$44.43 million of demand bonds was "put" and not resold, the University would be required to pay \$16 million a year for 3 years under this agreement assuming a 5% interest rate.

*University of North Carolina Hospitals - Revenue Bonds, Series 2001A and Series 2001B*

On January 31, 2001, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of \$55 million (2001A) and \$55 million (2001B) that have a final maturity date of February 15, 2031. The bonds are subject to mandatory sinking fund redemption that began on February 15, 2002. A portion of the proceeds was used to reimburse the Hospitals for \$75 million spent allowing the UNC Health Care System to acquire controlling interest in Rex Healthcare Inc. The remaining proceeds are being used for the renovation of space vacated after the opening of the North Carolina Women's Hospital, North Carolina Children's Hospital, and associated support services. While initially bearing interest in a daily mode, the mode on these bonds may change to a weekly rate, a unit pricing rate, a term rate or a fixed rate.

While in daily mode, the bonds are subject to purchase on any business day upon demand by telephonic notice of tender to the Remarketing Agent on the purchase date and delivery to the bond Tender Agent, Wachovia Bank, N.A. The Hospitals' Remarketing Agents, Merrill Lynch, Pierce, Fenner & Smith Incorporated (Series 2001A) and Banc of America Securities LLC (Series 2001B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to either 0.05% or 0.08% of the outstanding principal amount of the bonds assigned to each agent, depending upon their performance in comparison to an established benchmark.

Under separate Standby Bond Purchase Agreements for the Series 2001A and Series 2001B (Agreements) between the Hospitals and Landesbank Hessen-Thüringen Girozentrale, a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price and accrued interest on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements

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require an adjustable facility fee based on the long-term rating of the bonds, which is calculated as a percentage of the available commitment. Payments are made quarterly in arrears, on the first business day of each July, October, January and April thereafter until the expiration date or the termination date of the Agreements. For the past fiscal year the percentage was 0.25% with the long-term agreement that became effective on July 11, 2005. This agreement has been extended to October 11, 2011 at a percentage of 0.40% effective October 11, 2008.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the formula rate (base rate equal to the higher of the prime rate for such day or the sum of 0.50% plus the federal funds rate) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is due quarterly (the first business day of January, April, July and October) for each period in which Bank Bonds are outstanding. At June 30, 2008 there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take-out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The agreements allow the Hospitals to redeem Bank Bonds in equal quarterly installments, on the first business day of January, April, July and October. The payments will commence with the first business day of any such month that is at least 90 days following the applicable Purchase Date of the Bank Bond and end no later than the fifth anniversary of such Purchase Date. If the take out agreement were to be exercised because the entire outstanding \$102.4 million of demand bonds was "put" and not resold, the Hospitals would be required to pay \$23.27 million a year for five years under the installment loan agreement assuming an 5.0% prime interest rate.

The current expiration date of the Agreements is December 31, 2015. The Liquidity Provider has the option to terminate its commitment on October 11, 2011, or October 11, 2014 by providing adequate notice of its intention. The Hospitals may request additional extensions of at least one year from the previous termination date. Extensions are at the discretion of Liquidity Provider.

*University of North Carolina Hospitals - Revenue Refunding Bonds, Series 2003A and Series 2003B*

On February 13, 2003, the Hospitals issued two series of tax-exempt variable rate demand bonds in the amount of \$63.77 million (2003A) and \$34.25 million (2003B) that have a final maturity date of February 1, 2029. The bonds are subject to mandatory sinking fund redemption that began on February 1, 2004. The proceeds were used to advance refund \$88.33 million of the Series 1996 Bonds. While initially bearing

interest in a weekly mode, the mode on these bonds may change to a daily rate, a unit pricing rate, a term rate or a fixed rate.

While in the weekly mode, the bonds are subject to purchase on demand with seven days' notice to the Remarketing Agent and delivery to the bond Tender Agent, Wachovia Bank, N.A. The Hospitals' Remarketing Agents, Banc of America Securities LLC (Series 2003A) and Wachovia Bank, N.A. (Series 2003B) have agreed to exercise their best efforts to remarket bonds for which a notice of purchase has been received. The quarterly remarketing fee is payable in arrears and is equal to 0.08% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003A and is equal to 0.07% of the outstanding principal amount of the bonds assigned to the Remarketing Agent for Series 2003B.

Under separate Standby Bond Purchase Agreements for the Series 2003A and Series 2003B (Agreements) between the Hospitals and Bank of America, N.A. (Series 2003A) or Wachovia Bank, N.A. (Series 2003B) a Liquidity Facility has been established for the Tender Agent to draw amounts sufficient to pay the purchase price on bonds delivered for purchase when remarketing proceeds or other funds are not available. These Agreements require a facility fee equal to 0.22% of the available commitment for Series 2003A and Series 2003B, payable quarterly in advance, beginning on February 13, 2003, and on each February 1, May 1, August 1, and November 1 thereafter until the expiration date or the termination date of the Agreements.

Under the Agreements, any bonds purchased through the Liquidity Facility become Bank Bonds and shall, from the date of such purchase and while they are Bank Bonds, bear interest at the Bank Bond interest rate (for Series 2003A, the rate equals London Inter-Bank Offered Rate (LIBOR) plus 2.50% for the first 90 days and then equals LIBOR plus 4.00%; for Series 2003B, the rate equals prime rate for the first 90 days and then equals prime plus 1.00%) subject to a maximum rate as permitted by law. Upon remarketing of Bank Bonds and the receipt of the sales price by the Liquidity Provider, such bonds are no longer considered Bank Bonds. Payment of the interest on the Bank Bonds is on the first business day of each month for each period in which Bank Bonds are outstanding. At June 30, 2008 there were no Bank Bonds held by the Liquidity Facility.

Included in the Agreements is a take-out provision, in case the Remarketing Agent is unable to resell any bonds that are "put" within 90 days of the "put" date. In this situation, the Hospitals is required to redeem the Bank Bonds held by the Liquidity Facility. The Series 2003A agreement allows the Hospitals to redeem Bank Bonds in twelve equal quarterly installments beginning on the first February 1, May 1, August 1 or November 1 that occurs at least 90 days following the applicable Purchase Date of the Bank Bond. If the take-out agreement were to be exercised because the entire outstanding \$62.21 million of demand bonds was "put" and not resold, the Hospitals would be required to pay \$22.98 million a year for three years under the installment loan agreement assuming a 6.46% interest rate (LIBOR plus 4%). The Series 2003B

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agreement allows the Hospitals to redeem Bank Bonds in 36 equal monthly installments, on the first business day of each calendar month after the loan date. Payments commence with the first business day of any such month that is at least 120 days following the applicable Purchase Date of the Bank Bond. If the take out agreement were to be exercised because the entire outstanding \$33.43 million of demand bonds was "put" and not resold, the Hospitals would be required to pay \$12.20 million a year for three years under the installment loan agreement assuming a 6.0% interest rate (Prime plus 1%).

The current expiration date of the Series 2003A Agreement is July 1, 2010 and July 31, 2009 for the Series 2003B Agreement. The Hospitals may request additional extensions, which are approved at the discretion of the Liquidity Provider

### State Education Assistance Authority

#### *Guaranteed Student Loan Revenue Bonds, Series 2005A*

With regards to the following demand bonds, the issuer has not entered into take out agreements, which would convert the demand bonds not successfully remarketed into another form of long-term debt.

In October, 2005, the Authority issued Guaranteed Student Loan Revenue Bonds, Series 2005A, in the amount of \$506.3 million consisting of four tranches of tax-exempt bonds totaling \$471.6 million and two tranches of taxable bonds totaling \$34.7 million. This series of bonds matures on September 1, 2035, but \$12.4 million must be retired by mandatory sinking fund redemption on October 1, 2012. The proceeds of this issuance were used to finance student loans, refund the Authority's outstanding Series 1995A bonds, make a deposit into the operating fund, and pay issuance costs. While bearing interest at a weekly rate, the bonds are subject to purchase on demand with seven day's notice to the Tender Agent.

Payment of principal and interest on the Series 2005A bonds is insured by a financial guaranty insurance policy by Ambac Assurance Corporation. The Authority has entered into a standby bond purchase agreement with a commercial bank for each respective tranche. Pursuant to each agreement, the respective bank has agreed to purchase any bonds of that respective tranche that have been tendered for purchase during the term of the agreement.

## E. Interest Rate and Basis Swaps

### Primary Government

#### Governmental Activities

**Objective.** As a means to lower its borrowing costs and increase its savings when compared to fixed-rate refunding bonds at the time of issuance in December 2002, the State entered into two interest rate swaps in connection with its \$499.87 million Variable Rate General Obligation Refunding

Bonds, Series 2002B-F. The intention of the swap agreements was to effectively change the State's interest rate on the bonds to a synthetic fixed rate of 3.28% (Swap 1) and 3.09% (Swap 2). For comparison, the State sold fixed rate bonds on the same day as the swaps, with the same final maturity, at an interest rate of 4.45%.

In March 2005, the State entered into basis rate swap agreements and related swaptions with three separate counterparties to lower its borrowing costs when compared to fixed rate refunding bonds. The swaption component is disclosed and valued in a separate section within this note (see section F). The bonds associated with basis swaps were as follows (dollars in thousands):

Bonds Associated with Basis Swaps	Principal Amount	Average Coupon	Call Date
Public Improvement, Series 2003A	\$ 171,000	4.89%	3/1/2013
Public Improvement, Series 2003B	169,955	4.87%	4/1/2013
Public Improvement, Series 2004A	335,000	4.86%	3/1/2014
Total	<u>\$ 675,955</u>		

**Terms - Swaps 1 and 2.** The bonds and the related swap agreements mature on June 1, 2019 (Swap 1) and June 1, 2017 (Swap 2) and the combined swaps' notional amount of \$499.87 million matches the \$499.87 million variable-rate bonds. The swaps were entered into at the same time the bonds were issued (December 2002). Starting in fiscal year 2012 the combined notional value of the swaps and the combined principal amount of the associated debt begin to decline. Under the swaps, the State pays the counterparties a fixed payment of 3.28% (Swap 1) and 3.09% (Swap 2) and receives a variable payment computed at 64% of the LIBOR. Conversely, the bonds' variable-rate coupons are closely associated with the Securities Industry and Financial Markets Swap Index (SIFMA).

**Terms - 2005 Basis Swaps.** The 2005 basis swap agreements were entered into on March 9, 2005 with an effective date of March 30, 2005. The related bonds have serial maturities with Series 2003A having a final maturity on March 1, 2026; Series 2003B and 2004A have a final maturity on April 1, 2023, and March 1, 2023, respectively. The basis swap agreements mature on March 1, 2026. The swaps combined notional amount of \$675.96 million matches the \$675.96 million fixed rate bonds. Under the terms of the basis rate swap and swaption agreement, the State will pay the SIFMA to the counterparties and will receive 70% of LIBOR plus a fixed spread of 69 basis points (41 attributable to basis swap and 28 basis points for the swaption).

**Fair value.** Because interest rates have declined since execution of Swaps 1 and 2, the swaps have negative fair values of \$6.66 million (Swap 1) and \$4.91 million (Swap 2) at June 30, 2008. The 2005 basis rate swaps had positive valuations at June 30, 2008 of: \$12.7 million (Counterparty 1), \$7.9 million (Counterparty 2), and \$5.1 million (Counterparty 3). The mark-to-market valuations were established by market quotations from the counterparties, representing estimates of the amounts that would be paid for replacement transactions.

## NOTES TO THE FINANCIAL STATEMENTS

**Credit risk.** As of June 30, 2008, the swaps did not expose the State to credit risk because the swaps had negative fair values. However, should interest rates change and the aggregate fair value of the swaps become positive, the State would be exposed to credit risk in the amount of the derivatives' aggregate fair value. The current counterparty ratings for each swap are presented in the table below:

<u>Swap Counterparty</u>	<u>Moody's</u>	<u>S&amp;P</u>	<u>Fitch</u>
Swap 1	Aa1	AA+	AA-
Swap 2	Aaa	AAA	-
Basis Swap Counterparty 1	Aa1	AA	A+
Basis Swap Counterparty 2	A1	A	A+
Basis Swap Counterparty 3	Aaa	AAA	-

To mitigate the potential for credit risk, if the counterparty's credit quality falls to a specified rating, the counterparty will be required to collateralize a portion (up to 100%) of the fair value. For Swap 1, if the counterparty's credit quality falls to A1 as determined by Moody's or A+ as determined by either S&P or Fitch and their exposure exceeds \$5 million, then the swap will be collateralized by the counterparty with cash, U.S. government or agency securities, or other collateral acceptable to the State. For Swap 2, if the credit quality falls to Aa1 (Moody's) or AA+ (S&P) and their exposure exceeds \$10 million, then the swap will be collateralized by the counterparty with cash, U.S. government or agency securities, or other collateral acceptable to the State. For the basis swaps, if the counterparty's credit quality is rated lower than Baa1 (Moody's), BBB+ (S&P), or BBB+ (Fitch) by two of the three rating agencies, then the swap will need to be collateralized by the counterparty with cash, U.S. government or agency securities, or other collateral acceptable to the State (Fitch credit ratings only apply to counterparty 1). If the counterparty is required to collateralize a portion of the derivative, then the collateral will be posted with a third party custodian or secured party.

An additional termination event occurs if the counterparty fails to maintain: for Swap 1, at least two ratings of at least Baa1 (Moody's) or BBB+ (S&P and Fitch); for Swap 2, at least one rating of at least Baa3 (Moody's) or BBB- (S&P). An additional termination event for the basis swaps occurs if counterparty 1 or 3 has one or more issues of rated, unsecured, unenhanced senior debt or long-term deposits outstanding and none of such issues has at least two ratings of at least Baa2 or higher as determined by Moody's, or BBB or higher as determined by S&P or Fitch. For counterparty 2, an additional termination event occurs if it has one or more issues of rated, unsecured, unenhanced senior debt outstanding and none of such issues has at least two ratings of Baa2 or higher (Moody's), BBB or higher (S&P) or counterparty 2 fails to have a rating on long-term, unsecured, unenhanced senior debt.

**Basis risk and termination risk.** Swaps 1 and 2 expose the State to basis risk should the relationship between LIBOR and SIFMA converge, changing the synthetic rate on the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rates of 3.28% (Swap 1) and 3.09% (Swap 2) and the synthetic rates as of June 30, 2008 of

3.25% (Swap 1) and 3.05% (Swap 2). As of June 30, 2008, the average rate on the State's variable rate bonds was 1.54%, whereas 64% of LIBOR was 1.58%. The swaps may be terminated by the State with 15 days notice and the counterparties can only terminate the swaps if the State's credit rating falls below Baa1 (Moody's), or BBB+ (S&P or Fitch) for Swap 1, and on Swap 2, below Baa3 (Moody's) or BBB- (S&P or Fitch), or an Event of Default occurs.

**2005 Basis Swaps:** These swaps expose the State to basis risk should the relationship between the two variable indexes SIFMA and LIBOR converge, which would affect the amount of interest savings realized. The State pays SIFMA and receives 70% of LIBOR plus 69 basis points (28 basis points relate to swaptions) on the notional amounts by counterparty. As of June 30, 2008, there was no basis risk as the State was paying SIFMA equal to 1.55% and receiving 2.41% (70% of LIBOR plus 69 basis points). LIBOR is 2.46% at June 30, 2008. The basis swaps and swaptions may be optionally terminated by the State with two days notice for counterparties 1 and 2 or with five days notice for counterparty 3. The counterparties can only terminate if the State, at any time during the term of the swap transaction, fails to maintain by at least two rating agencies, ratings of at least Baa2 or higher as determined by Moody's, or BBB or higher as determined by S&P or Fitch (Fitch does not apply to counterparty 2).

**Market-access risk/Rollover risk.** Swap 1 and Swap 2 are for the term of the Bonds and therefore there is no market-access risk or rollover risk. The 2005 basis rate swaps terminate at approximately the same time as the associated serial bonds mature (March 1, 2026; March 1, 2023; and April 1, 2023) and thus no rollover risk exists.

## Component Units

### **University of North Carolina System**

*University of North Carolina at Chapel Hill*

#### Swap 1

**Objective.** In order to protect against the risk of interest rate changes, effective October 3, 2000, the University entered into an interest rate swap agreement with Lehman Brothers Special Financing, Inc. (Lehman Brothers) related to \$22 million of The University of North Carolina at Chapel Hill Variable Rate Housing System Revenue Bonds, Series 2000. This series of bonds was refunded in its entirety by the issuance of the University's Variable Rate General Revenue Demand Bonds, Series 2001B (2001B Bonds), and the interest rate swap agreement was amended to reflect the refunding.

**Terms.** Under this amended agreement, Lehman Brothers pays the University interest on the notional amount based on the SIFMA on a quarterly basis. On a semiannual basis, the University pays Lehman Brothers interest at the fixed rate of 5.24%. The notional amount of the swap reduces annually in conjunction with the 2001B Bonds; the reductions began in November 2002 and end in November 2025. The swap

**NOTES TO THE FINANCIAL STATEMENTS**

agreement matures November 1, 2025. As of June 30, 2008, rates were as follows:

	<u>Terms</u>	<u>Rates</u>
Fixed payment to Lehman Bros.	Fixed	5.24%
Variable payment from Lehman Bros.	SIFMA	<u>1.78%</u>
Net interest rate swap payments		3.46%
Variable rate bond coupon payments		<u>1.60%</u>
Synthetic interest rate on bonds		<u>5.06%</u>

**Fair value.** As of June 30, 2008, the swap had a fair value of negative \$3.56 million. The fair value was developed by Lehman Brothers. Their method calculates the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

**Credit risk.** As of June 30, 2008, the University was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the University would be exposed to credit risk in the amount of the derivative's positive fair value. Should the swap have a positive fair value of more than \$1 million, at that point Lehman would be required to collateralize 103% of their exposure. Lehman Brothers Holdings, guarantor of Lehman Brothers Special Financing, Inc., was rated A2 by Moody's, A by S&P, and AA+ by Fitch for unsecured long-term debt.

**Basis risk.** The University receives the SIFMA from Lehman Brothers and pays a floating rate to its bondholders set by the Remarketing Agent. The University incurs basis risk when its bonds begin to trade at a yield above the SIFMA. Basis risk also exists since swap payments are made quarterly while bond payments are made monthly. With the alternative tax structure of the swap, a change in tax law would trigger the swap being converted from a SIFMA swap to a percentage of LIBOR swap. This would introduce basis risk. If the weekly reset interest rates on the University's bonds are in excess of 65% of LIBOR, the University will experience an increase in debt service above the fixed rate on the swap to the extent that the interest rates on the bonds exceed 65% of LIBOR.

**Termination risk.** The swap agreement uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. Termination could result in the University being required to make an unanticipated termination payment. The swap terminates if the University or Lehman Brothers fails to perform under terms of the contract.

Swap 2

**Objective.** The University entered into an interest rate swap agreement with Wachovia Bank, N.A. on December 5, 2006, based on a notional amount of \$100 million effective December 1, 2007, maturing in December 1, 2036. The purpose of the transaction was to hedge the risk of rising interest rates for the

University's planned issuance of long-term bonds in 2007 and 2009. Due to cash market fixed rates remaining at historically low levels at the time of the General Revenue 2007A issuance, the University decided to issue the bonds as traditional fixed-rate bonds. The University took delivery of the Wachovia swap beginning on December 1, 2007 and uses it as a portfolio hedge for its current variable rate debt, which includes General Revenue 2001 B&C bonds and the University's outstanding balance of commercial paper, and for a planned long-term bond issue in 2009.

**Terms.** Under the agreement, Wachovia Bank, N.A. pays the University 67% of the 1-month LIBOR index times the notional amount, payable monthly. The University pays Wachovia Bank, N.A. a fixed rate of 3.31% on the notional amount, payable monthly. The effective date of this swap was December 1, 2007.

	<u>Terms</u>	<u>Rates</u>
Fixed payment to Wachovia	Fixed	3.31%
Variable payment from Wachovia	SIFMA	<u>1.64%</u>
Net interest rate swap payments		1.67%
Weighted average variable rates		<u>1.65%</u>
Synthetic interest rate on bonds		<u>3.32%</u>

**Fair value.** As of June 30, 2008, the swap had a fair negative value of \$1.12 million. The fair value was developed by Wachovia Bank, N.A.. Market value represents the amount that would be paid to (or received from) another swap dealer to assume the payments under the swap.

**Credit risk.** As of June 30, 2008, the University was not exposed to credit risk because the swap had a negative fair value. In the event that the swap carried a positive fair value for the University and in the event of a specified ratings downgrade of Wachovia's unsecured long-term debt, Wachovia Bank, N.A. would be required to post collateral in the amount of the difference between the positive fair value of the swap and the thresholds in the below tables. The University is also subject to the same provisions. Wachovia Bank, N.A. was rated A+ by S&P, A+ by Fitch and A1 by Moody's.

<u>Moody's/S&amp;P Ratings</u>	<u>Threshold</u>
AA3/AA- or above	\$Infinity
A1/A+	\$15 million
A2/A	\$10 million
A3/A- or below	\$0

**Basis risk.** Changes in swap interest rates and tax-exempt bond interest rates may differ, introducing basis risk in the event the swap is unwound and traditional fixed-rate debt is issued. In the event that the University issues variable rate debt to create synthetic fixed rate debt, the University will be paying a rate on the bonds that may not correlate with 67% of the 1-month LIBOR index, altering the "fixed" cost of synthetic debt.

**Termination risk.** The swap agreement uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. Termination could result in the University

## NOTES TO THE FINANCIAL STATEMENTS

being required to make an unanticipated termination payment. The swap terminates if the University or Wachovia Bank, N.A. fails to perform under terms of the contract.

**Future Swap.** The University entered into an interest rate swap agreement with the Bank of New York for \$150 million to be effective December 1, 2009. The University has the option to (1) issue variable rate bonds in December 2009, thereby effectively creating synthetic fixed-rate debt, or (2) unwind the swap, capturing the value of the movement of interest rates from the issuance date and issuing traditional fixed rate bonds.

#### North Carolina State University

**Objective.** In order to protect against the potential of rising interest rates, the University entered into two separate pay-fixed, receive-variable interest rate swaps at a cost anticipated to be less than what the University would have paid to issue fixed-rate debt.

**Terms, fair values, and credit risk.** The University's swap agreements contain scheduled reductions to outstanding notional amounts that are expected to approximately follow scheduled or anticipated reductions in the associated bonds payable category. The terms, fair values, and credit ratings of the outstanding swaps as of June 30, 2008 were as follows (dollars in thousands):

Associated Bond Issue	Notional Amounts	Effective Date	Fixed Rate Paid	Variable Rate Received	Fair Values	Swap Termination Date	Counterparty Credit Rating Moody's/S&P/Fitch
Centennial Campus 1999A General Revenue 2003B	\$ 7,800	10/1/1999	4.57%	67% of LIBOR	\$(727)	12/01/2019	A1 / A+ / A+
	24,655	6/20/2003	3.54%	75% of LIBOR	67	10/01/2027	Aaa / AA+ / AA
Total	<u>\$32,455</u>				<u>\$(660)</u>		

Because rates have changed since the effective dates of the swaps, the 1999A swap has a negative fair value as of June 30, 2008. The negative fair value may be countered by a reduction in total interest payments required under the variable-rate bonds, creating lower synthetic interest rates. Because the coupons on the University's variable-rate bonds adjust to changing interest rates, the bonds do not have corresponding fair value increases. The fair values are the market values as of June 30, 2008.

As of June 30, 2008, the swaps did not expose the University to credit risk since the swaps had a negative fair value, in aggregate. However, should interest rates change and the fair value of the swaps become positive, the University would be exposed to credit risk in the amount of the derivatives' aggregate fair value. The swap agreements require termination should the University's or the counterparty's credit rating fall below either Baa2 as issued by Moody's or BBB as issued by S&P or Fitch. Also, under the terms of the swap agreements, should one party become insolvent or otherwise default on its obligations, provisions permit the nondefaulting party to accelerate and terminate all outstanding transactions. To mitigate the potential for credit risk, if the counterparty's

credit quality falls below A3 as determined by Moody's or A- as determined by S&P, the swap will be collateralized by the counterparty with cash, U.S. government or agency securities. If the counterparty is required to collateralize, then the collateral will be posted with a third party custodian or secured party. The swap agreements entered into by the University are held with separate counterparties. All the counterparties are rated A1 or better.

**Basis risk.** The University is exposed to basis risk on the swaps when the variable payment received is based on an index other than SIFMA. Should the relationship between LIBOR and SIFMA move to convergence, the expected cost savings may not be realized. As of June 30, 2008, the SIFMA rate was 1.55%, whereas 67% of LIBOR was 1.65% and 75% of LIBOR was 1.85%.

**Termination risk.** The University or the counterparty may terminate any of the swaps if the other party fails to perform under the terms of the contract. If any of the swaps are terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination

**NOTES TO THE FINANCIAL STATEMENTS**

the swap has a negative fair value, the University would be liable to the counterparty for that amount.

**Future swaps.** The University has also entered into two future dated interest rate swap agreements; one for \$50 million and one for \$22.4 million to be effective September 1, 2008 and March 1, 2017, respectively, on a General Revenue Bond Issue planned for 2008.

*North Carolina Central University*

In October of 2003, the North Carolina Capital Facilities Finance Agency issued Student Housing Facilities Revenue Bonds (\$21.48 million Variable Rate Revenue Demand Bonds, Series 2003A). The issuer, the North Carolina Capital Facilities Finance Agency, loaned the proceeds of the Series 2003 Bonds to the North Carolina Central University Real Estate Foundation, Inc. (Foundation). The Foundation used the proceeds to finance the costs of building a student housing facility at North Carolina Central University, to fund a debt service reserve fund for the 2003A Bonds, to pay a portion of the interest on the bonds during construction of the project, and to pay certain costs of issuance of the bonds.

**Objective.** As a means to lower its borrowing costs and increase its savings, when compared against fixed-rate refunding bonds at the time of issuance in October 2003, effective March 24, 2004, the Foundation entered into two interest rate swaps with Wachovia Bank, N.A., in connection with its \$21.48 million Variable Rate Revenue Demand Bonds, Series 2003A. The intention of the swap agreements was to effectively change the interest rate on the bonds to a synthetic fixed rate of 3.52% (Swap 1) and 2.71% (Swap 2).

**Terms.** The bonds mature on October 1, 2034, and the related swap agreements mature on October 1, 2024, (Swap 1) and April 1, 2009, (Swap 2) and the combined swaps' notional amount of \$17.18 million hedges 80% of the \$21.48 million variable-rate bonds. The combined notional value of the swaps and the combined principal amount of the associated debt is declining. Under the swaps, the Foundation pays Wachovia Bank, N.A. a fixed rate of 3.52% (Swap 1) and 2.71% (Swap 2) and receives a variable rate at 70% and 100% of LIBOR and SIFMA, respectively. The bonds' variable-rate coupons are closely associated with the SIFMA.

**Fair value.** As of June 30, 2008, the swaps have fair values of negative \$199 thousand (Swap 1) and negative \$43 thousand (Swap 2). The mark-to-market valuations were established by market quotations from Wachovia Bank, N.A. representing estimates of the amounts that would be paid upon terminating the transactions.

**Credit risk.** As of June 30, 2008, the Foundation was not exposed to credit risk because the swaps had a negative fair value.

**Basis risk and termination risk.** Swap 1 exposes the Foundation to basis risk should the relationship between LIBOR and SIFMA converge, changing the synthetic rate on

the bonds. The effect of this difference in basis is indicated by the difference between the intended synthetic rate of 3.52% and the actual rate of 3.27% (Swap 1) at June 30, 2008. As of June 30, 2008, the rate on the Foundation's Bonds was 1.48% whereas 70% of LIBOR was 1.72%. Swap 2 exposes the Foundation to basis risk should the actual rate on the Foundation's Bond vary from the SIFMA. The effect of this difference in basis is indicated by the difference between the intended synthetic rate of 2.71% and the actual rate of 2.64% (Swap 2) at June 30, 2008. As of June 30, 2008, the rate on the Foundation's Bonds was 1.48%, whereas the SIFMA index was 1.55%. Termination could result in the Foundation being required to make an unanticipated termination payment. The swap agreements are terminated if the Foundation or Wachovia Bank, N.A. fails to perform under the terms of the contract.

**Market-access risk/Rollover risk.** Swap 1 and Swap 2 expose the Foundation to market-access and rollover risk when the swaps mature on October 1, 2024 and April 1, 2009 respectively. When Swap 1 and Swap 2 mature, the interest rate on the underlying debt will return to a variable rate.

*University of North Carolina Hospitals*

**Objective.** In order to protect against the risk of interest rate changes, the Hospitals entered into an interest rate swap contract agreement with Bank of America, N.A. (BOA) on February 13, 2003. The agreement covers the Variable Rate Revenue Refunding Bonds, Series 2003A (\$63.77 million) and Series 2003B (\$34.25 million). The 2003 series of bonds partially refunded Fixed Rate Revenue Bonds, Series 1996.

**Terms, fair values, and credit risk.** Under this agreement, BOA pays the Hospitals interest on the notional amount based on 67% of the arithmetic mean of the LIBOR (with a designated maturity of one month) on a monthly basis. Also on a monthly basis, the Hospitals pays BOA interest at the fixed rate of 3.48%. No cash was paid or received by the Hospitals upon initiation of the agreement. The notional amount of the swap reduces annually; the reductions began in February 2004 and end in February 2029.

The swap agreement terminates February 1, 2029. As of June 30, 2008, rates were as follows:

	<u>Terms</u>	<u>2003A Rates</u>	<u>2003B Rates</u>
Fixed payment to BOA	Fixed	3.48%	3.48%
Variable payment from BOA	LIBOR	<u>1.65%</u>	<u>1.65%</u>
Net interest rate swap payments		1.83%	1.83%
Variable rate bond payments		<u>1.55%</u>	<u>1.45%</u>
Synthetic interest rate on bonds		<u>3.38%</u>	<u>3.28%</u>

The swap agreement has a mark-to-market value of negative \$3.39 million as of June 30, 2008. BOA develops the mark-to-market value. Their method calculates the present value of the future net settlement payments required by the swap assuming that the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for LIBOR due on the date of each future net settlement on the swap.

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**NOTES TO THE FINANCIAL STATEMENTS**

As of June 30, 2008, the Hospitals was not exposed to credit risk because the swap had a negative fair value. However, should interest rates change and the fair value of the swap becomes positive, the Hospitals would be exposed to credit risk in the amount of the derivative's fair value. BOA's current long-term ratings are AA- by Fitch, Aaa by Moody's, and AA+ by S&P. At such time that their ratings fall below A3 for Moody's or below A- for S&P, BOA will be required to collateralize a portion of their exposure (up to 100%). The following instruments can serve as eligible collateral: Cash, U.S. Treasury Obligations, U.S. Government Agency Fixed Rate Fixed Maturity Securities, U.S. Government Agency Single Class Mortgage-Backed Securities, U.S. Treasury STRIPS and other U.S. Government Agency Mortgage-Backed Securities. Posted collateral received will be entered in one or more accounts with a domestic office of a commercial bank, trust company or financial institution organized under the laws of the United States (or any state or a political subdivision thereof).

**Basis risk.** The Hospitals receives 67% of 1-month LIBOR-BBA Index from BOA and pays a floating rate to its bondholders set by the Remarketing Agent. The Hospitals incurs basis risk when its bonds trade at a yield above 67% of 1-month LIBOR-BBA Index. If the relationship of the Hospitals' bonds trade to a percentage of LIBOR greater than 67%, the Hospitals will experience an increase in debt service above the fixed rate on the swap.

**Termination risk.** The derivative contract uses the International Swap Dealers Association Master Agreement, which includes standard termination events, such as failure to pay and bankruptcy. The Hospitals or the counterparty may terminate the swap if the other party fails to perform under the terms of the contract. If the swap is terminated, the associated variable-rate bonds would no longer carry synthetic interest rates. Also, if at the time of termination the swap has a negative fair value, the Hospitals would be liable to the counterparty for that amount. Termination could result in the Hospitals being required to make an unanticipated termination payment.

**Future swap.** The University of North Carolina Hospitals entered into a fixed/float swap for \$44.3 million to be effective February 12, 2007, on a General Revenue Bond Issue planned for 2009.

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**NOTES TO THE FINANCIAL STATEMENTS****North Carolina Housing Finance Agency**

**Objective.** The Agency has entered into interest rate swaps in connection with its \$74.69 million variable-rate revenue bonds associated with several series in its 1998 Home Ownership Revenue Bond Resolution as a means to lower its borrowing costs when compared against fixed-rate bonds at the time of issuance. The intention of the swaps was to effectively lower the Agency's interest rate on the long-term bonds to a fixed rate.

**Terms and fair value.** The terms and fair value of the outstanding swaps as of June 30, 2008 were as follows (dollars in thousands).

Series	Counterparty	Counterparty Credit Rating Moody's/S&P	Notional Amount	Date of Swap	Maturity Date of Swap	Fixed Rate	Fair Values
15	UBS AG	Aa2/AA-	\$17,170	5/8/2003	7/1/2032	3.51%	\$ (251)
16	Bank of America, N.A.	Aaa/AA+	17,520	9/16/2003	7/1/2032	3.81%	(625)
17	Bank of America, N.A.	Aaa/AA+	20,000	12/11/2003	7/1/2032	3.73%	(800)
18	Goldman Sachs Mitsui Marine	Aaa/AAA	20,000	4/20/2004	1/1/2035	3.29%	88
			<u>\$74,690</u>				<u>\$ (1,588)</u>

Under all of the swaps, the Agency pays the counterparties a fixed rate and receives a variable payment computed as 63% of the LIBOR plus 30 basis points. The bonds' variable-rate coupons are based on the variable SIFMA, which was 1.70% as of June 30, 2008.

**Fair value.** In total, the swaps have a fair value of negative \$1.59 million as of June 30, 2008. Because the coupons on the Agency's variable-rate bonds adjust to changing interest rates, the bonds do not have a corresponding fair value increase. The fair value was estimated using the zero-coupon method. This method calculates the future net settlement payments required by the swap, assuming the current forward rates implied by the yield curve correctly anticipate future spot interest rates. These payments are then discounted using the spot rates implied by the current yield curve for hypothetical zero-coupon bonds due on the date of each future net settlement on the swap.

**Credit risk.** As of June 30, 2008, the swaps did not expose the Agency to credit risk since the swaps had a negative fair value, in aggregate. However, should interest rates change and the aggregate fair value of the swaps become positive, the Agency would be exposed to credit risk in the amount of the derivatives' aggregate fair value. To mitigate the credit risk to each party to the swap agreement of a decline in credit quality of the other party, each swap agreement provides that collateral must be posted if either party's rating falls below A1 for Moody's and A+ for S&P. The collateral must be posted with a third-party in the form of cash or United States Government Securities. Additionally, each of the swap agreements has termination provisions if ratings fall below certain levels.

**Basis risk and termination risk.** The swaps expose the Agency to basis risk should the relationship between LIBOR and SIFMA converge, changing the synthetic rate on the bonds. For all swaps, collateral thresholds have been established if the counterparty's ratings reach A2 for Moody's or A for S&P. Series 16, 17 and 18 swaps may be terminated if the counterparty's or the Agency's rating falls below Baa2 as issued by Moody's or BBB as issued by S&P. Series 15 swap may be terminated if the counterparty's or the Agency's rating falls below Baa3 as issued by Moody's and BBB- as issued by S&P.

## NOTES TO THE FINANCIAL STATEMENTS

## F. Swaptions

**Objective.** As a means of lowering its borrowing costs on the existing bonds in the table below and increasing its savings when compared to fixed rate refunding bonds, the State entered into basis swap and swaption contracts with three different financial institutions. Swaptions give the purchaser the right, but not the obligation, to enter into an interest rate swap on a specified future date. These swaptions and the related basis rate swap disclosed previously were entered into as an alternative to a synthetic fixed rate refunding. This swaption alternative provides an annuity to the State (69 basis points total – 28 for the swaptions). The swaptions give each counterparty the option to require the State to enter into pay-fixed, receive-variable interest rate swaps at the various call dates. If the swaptions are exercised, the State would then expect to issue variable-rate refunding bonds sufficient to retire the related issue.

Bond Series	Principal or Notional Amount (dollars in thousands)				Call Date / Swaption
	Counterparty 1	Counterparty 2	Counterparty 3	Series Total	Exercise Date
Public Improvement Bonds, Series 2003A	\$ 85,500	\$ 51,300	\$ 34,200	\$ 171,000	3/1/2013
Public Improvement Bonds, Series 2003B	84,977	50,987	33,991	169,955	4/1/2013
Public Improvement Bonds, Series 2004A	167,500	100,500	67,000	335,000	3/1/2014
Total	\$ 337,977	\$ 202,787	\$ 135,191	\$ 675,955	

**Terms.** The swaption agreements were entered into on March 9, 2005 and mature March 1, 2026. The swaption annuity was based on the total notional amount of \$675.955 million and is tied to the respective bond issues noted above. The counterparties have the right to exercise the swaption agreements 90 days prior to the call date for each series. If exercised, the State will pay the counterparties a fixed rate, and the counterparties will pay the State a variable rate (SIFMA) based on a declining notional amount that matches the amortization of the associated bonds by series. If the swaptions are exercised, the State intends to issue variable rate bonds in a principal amount to retire the associated bond series. The terms of the swaptions are listed below, which include counterparty credit ratings as of June 30, 2008.

Counterparty	Based on Respective Notional Amounts			Counterparty Credit Rating Moody's/S&P
	Swaption Annuity Payment Received	Fixed Rate Paid by the State	Variable Rate Received by the State	
Counterparty 1	28 Basis Points	4.8%	SIFMA	Aa1/AA
Counterparty 2	28 Basis Points	4.8%	SIFMA	A1/A
Counterparty 3	28 Basis Points	4.8%	SIFMA	Aaa/AAA

**Fair value.** As of June 30, 2008, the swaptions had fair values of negative \$17.7 million (Counterparty 1), negative \$10.4 million (Counterparty 2) and negative \$6.7 million (Counterparty 3), which were estimated using the mark to market method. This method of valuation was established by market quotations from the counterparties representing estimates of the amounts that would be paid for replacement transactions. These values reflect a decline in interest rates from the prior fiscal year, however, only the State has the option to terminate the swaptions. A replacement transaction would generate net present value savings equal to these fair value amounts.

**Market-access risk.** A small risk exists that the State, for some unforeseen reason, may be unable to issue the variable rate bonds. If the swaptions are exercised and refunding bonds are not issued, the series 2003 A and B and 2004A bonds would not be refunded, the basis rate swaps would continue, and the State would have to pay a termination payment on the swaptions to the counterparties. Termination values will be based on the net present value difference between SIFMA and 4.8% fixed rate.

**NOTES TO THE FINANCIAL STATEMENTS****G. Debt Service Requirements**

The following schedules show the debt service requirements for the primary government (governmental activities) and component units (University of North Carolina System, North Carolina Housing Finance Agency, and the State Education Assistance Authority). The debt service requirements of variable rate debt and net swap payments are based on rates as of June 30, 2008 and assume that current interest rates remain the same for their term. As rates vary, variable-rate bond interest payments and net swap payments will vary.

Annual debt service requirements to maturity for general obligation bonds, certificates of participation, revenue bonds, GARVEE bonds, and notes payable are as follows (dollars in thousands).

**Primary Government**

Fiscal Year Ending June 30	Governmental Activities							
	General Obligation Bonds			Certificates of Participation		Lease-Purchase Revenue Bonds		
	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest	Principal	Interest	
2009	\$ 364,495	\$ 238,367	\$ 8,010	\$ 46,295	\$ 46,677	\$ 10,000	\$ 11,041	
2010	364,385	220,826	8,010	46,985	44,556	10,000	10,615	
2011	364,550	202,819	8,010	47,740	42,393	10,000	10,154	
2012	365,575	184,480	8,010	48,550	40,092	10,000	9,687	
2013	367,510	166,846	7,669	49,395	37,889	10,000	9,220	
2014-2018	1,834,660	600,278	26,224	261,520	152,345	50,000	38,780	
2019-2023	1,424,040	264,697	1,550	283,250	84,911	106,000	21,162	
2024-2028	448,545	36,833	—	182,145	20,770	29,045	820	
Total	<u>\$ 5,533,760</u>	<u>\$ 1,915,146</u>	<u>\$ 67,483</u>	<u>\$ 965,880</u>	<u>\$ 469,633</u>	<u>\$ 235,045</u>	<u>\$ 111,479</u>	

Fiscal Year Ending June 30	Governmental Activities			
	GARVEE Bonds		Notes Payable	
	Principal	Interest	Principal	Interest
2009	\$ 45,745	\$ 13,585	\$ 6,484	\$ 1,074
2010	38,670	11,465	4,736	868
2011	36,245	9,658	3,764	706
2012	24,470	7,939	2,421	590
2013	25,660	6,753	2,369	508
2014-2018	97,120	17,702	13,413	1,215
2019-2023	19,655	907	—	—
Total	<u>\$ 287,565</u>	<u>\$ 68,009</u>	<u>\$ 33,187</u>	<u>\$ 4,961</u>

The general obligation bonds include \$355 million of variable rate debt without interest rate swaps. For this debt, the variable interest rates change on a weekly basis and are based on the rate paid by each bank. The banks base their rate on what they perceive to be the market (7-day) for debt of this type given the credit standing of the unit of government. The general obligation bonds also include \$499.87 million of variable rate debt with interest rate swaps (see Note 7E).

## NOTES TO THE FINANCIAL STATEMENTS

Component Units

University of North Carolina System							
Fiscal Year Ending June 30	Revenue Bonds			Certificates of Participation		Notes Payable	
	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest	Principal	Interest
2009	\$ 78,200	\$ 96,252	\$ 3,299	\$ 2,010	\$ 1,419	\$ 50,980	\$ 2,250
2010	79,685	92,713	3,195	2,075	1,350	23,466	1,124
2011	81,605	89,551	3,157	2,150	1,270	8,388	408
2012	83,770	86,219	3,119	2,230	1,192	1,699	297
2013	84,495	82,931	3,063	2,335	1,086	708	253
2014-2018	423,680	366,461	14,013	4,910	4,465	3,458	882
2019-2023	397,619	288,903	10,032	3,745	3,700	1,050	357
2024-2028	366,480	213,676	3,865	4,650	2,786	470	236
2029-2033	365,460	143,523	89	5,870	1,575	590	111
2034-2038	379,045	30,674	—	3,160	246	135	3
Total	<u>\$ 2,340,039</u>	<u>\$ 1,490,903</u>	<u>\$ 43,832</u>	<u>\$ 33,135</u>	<u>\$ 19,089</u>	<u>\$ 90,944</u>	<u>\$ 5,921</u>

Revenue Bonds					
Fiscal Year Ending June 30	North Carolina Housing Finance Agency			State Education Assistance Authority	
	Principal	Interest	Interest Rate Swaps, Net	Principal	Interest
2009	\$ 35,635	\$ 77,111	\$ 1,289	\$ —	\$ 148,627
2010	39,620	75,566	1,262	—	148,627
2011	40,695	73,878	1,234	—	148,627
2012	42,635	72,069	1,208	—	148,627
2013	44,480	70,074	1,183	—	148,627
2014-2018	234,480	316,725	5,557	176,787	727,717
2019-2023	211,795	260,343	4,756	300,000	691,101
2024-2028	314,455	199,089	3,321	30,000	675,669
2029-2033	361,185	110,094	1,161	1,275,000	664,041
2034-2038	238,150	31,224	21	1,913,150	192,919
2039-2043	6,105	205	—	—	—
Total	<u>\$ 1,569,235</u>	<u>\$ 1,286,378</u>	<u>\$ 20,992</u>	<u>\$ 3,694,937</u>	<u>\$ 3,694,582</u>

For revenue bonds of the University of North Carolina System and the State Education Assistance Authority, the fiscal year 2009 principal requirements exclude demand bonds classified as current liabilities (see Note 7D).

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**NOTES TO THE FINANCIAL STATEMENTS****H. Bond Defeasances**

The State and its component units have defeased certain bonds through current and/or advance refundings. New debt proceeds from current refundings may be used to repay the old debt immediately while new debt proceeds from advance refundings are placed into an irrevocable trust with an escrow agent to provide for all future debt service payments on the defeased bonds. Since these bonds are considered to be defeased, the liabilities for these bonds have been removed from the government-wide statement of net assets.

**Component Units****University of North Carolina System***Appalachian State University*

On April 2, 2008, Appalachian State University issued \$19.23 million in The University of North Carolina System Pool Revenue Bonds with an average interest rate of 4.41%. The bonds were issued for a current refunding of \$19.09 million of outstanding Appalachian State University Utility System Revenue Refunding Bonds with an average interest rate of 5%. The refunding was undertaken to reduce total debt service payments by \$1.53 million over the next 15 years and resulted in an economic gain of \$685 thousand.

**State Education Assistance Authority**

On June 30, 2008, the Authority issued \$1.09 billion in 2008-1 Series Student Loan Revenue Private Placement Bonds with an average interest rate of 3.9%. The refunding component of this issue was used for a current refunding of \$647.4 million of outstanding Taxable Guaranteed Student Loan Revenue Bonds with an average interest rate of 4.7%. The refunding was undertaken to reduce total debt service payments by \$102.71 million over the next 25 years and resulted in an economic gain of \$68.94 million.

**Prior Year Defeasances**

During prior years, the State and certain component units defeased certain general obligation and other bonds. For those defeasances involving advance refundings, the proceeds and any securities purchased with the proceeds were placed in an irrevocable trust with an escrow agent in an amount sufficient to provide for all future debt service payments on the refunded bonds. Accordingly, the trust account assets and the liability for the defeased bonds are not included in the government-wide statement of net assets. At June 30, 2008, the outstanding balance of prior year defeased bonds was \$716.4 million for the primary government and \$160.09 million for the University of North Carolina System (component unit).

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**I. Bond Redemptions**

The bond series resolutions for the North Carolina Housing Finance Agency provide for various methods of redemption. Bonds are redeemed at par from prepayments of mortgage loans securing the issues, from unexpended bond proceeds of the issues, or from funds released via the related decreases in the respective debt service reserve requirements. In addition, various bond issues are redeemable at the option of the Agency with premiums ranging up to 2% for up to 12 years after the date of issue.