## Summary of Policy

The Interest Rate Swap Policy governs the use and management of interest rate swaps as they are used with debt issuances. Its purpose is to reduce the cost of capital with the help of an established financial tool used broadly by municipal governments. It is also intended to guide staff in the management of existing swaps; the existing Debt Policy does not cover interest rate swaps.

The use of interest rate swaps can be beneficial in refunding situations where issuance of traditional fixed rate bonds will not meet the refunding standards in the Debt Policy, as well as in reducing the cost of new money debt issues.

An interest rate swap is a binding agreement between counterparties to exchange periodic interest payments on some predetermined dollar principal, which is called the notional principal amount. For example, after having issued variable rate, long-term bonds, we can swap our interest obligation with another party (counterparty) for a fixed rate. Under the fixed rate, we are insulated from an increase in interest rates and benefits from certainty. However, it does not gain advantage from a fall in interest rates; the party with whom it has swapped does.

The Interest Rate Swap Policy is reviewed and updated annually, and presented to the Board for its approval. The Chief Executive Officer (CEO), Chief Financial Officer (CFO), and Executive Officer-Finance and Treasurer are the designated administrators of the Interest Rate Swap Policy. The Treasurer has the day-to-day responsibility and authority for structuring, implementing, and managing interest rate swaps.

We may enter into interest rate swaps with only qualified swap counterparties. The Treasurer, in consultation with the CEO, CFO, and Legal Counsel, has the authority to select the counterparties, in accordance with the criteria established in the Interest Rate Swap Policy.

As is required, the Interest Rate Swap Policy must be reviewed annually. In June 2006, staff reviewed and proposed updates to the current policy. The bond refunding criteria were enhanced to require greater savings before undertaking a refunding involving a LIBOR interest rate swap. Otherwise, the updates to the policy were primarily editorial revisions to improve the clarity of policy provisions.

As of June 2006, there are seven interest rate swaps subject to the Interest Rate Swap Policy with outstanding notional amounts totaling about $1.1 billion.

## Historical Perspective

In 1992 and 1993 the Los Angeles County Transportation Commission entered into interest rate swaps for notional amounts totaling $300 million, which the Commission approved separately, without adopting an official policy.

As interest rate swaps became more common in the industry – a compression between taxable and tax exempt rates offered substantially greater savings at an incremental risk – the Government Finance Officers Association (GFOA) issued a “best practices” recommendation. It was at this time that the Board decided that it was prudent to adopt a formal policy regarding interest rate swaps.

Staff brought the proposed policy to the Board in May 2003, but it delayed approval until staff had revisited particular sections of the Debt Policy concerning refunding targets. In June 2003, the Board adopted the Interest Rate Swap Policy as staff had presented it, and it reaffirmed the Debt Policy funding targets.

Interest rate swaps have become recognized and established financial tools used by municipal issuers throughout the nation. The GFOA has now adopted an official position, "Recommended Practice" for policy statements governing the use and management of such swaps.

Since the Interest Rate Swap Policy and Debt Policy work together to assist in achieving the lowest possible cost of capital and establish appropriate practices regarding the issuance and management of debt and interest rate swaps, the adoption of the updated Debt Policy was moved forward to coincide with the Interest Rate Swap Policy adoption schedule.

In 2004, there were four interest rate swaps subject to the Interest Rate Swap Policy with outstanding notional amounts that totaled about $690 million.

In June 2005, staff reviewed and proposed updates to the current policy. The updates are primarily editorial revisions in order to improve the clarity of policy provisions.

## Last Board Action

June 22, 2006 – Interest Rate Swap

A. updates to the Debt Policy;

B. updates to the Interest Rate Swap Policy; and

C. receive and file the Annual Report on Interest Swap Rates

## Attachment

Interest Rate Swap Policy

## See Related

Annual Budget

Debt Policy

Financial Standards

Investment

# INTEREST RATE SWAP POLICY

**June 2006**

# Table of Contents

# INTEREST RATE SWAP POLICY

## I. Introduction

The purpose of the Interest Rate Swap Policy of the Los Angeles County Metropolitan Transportation Authority (LACMTA) is to establish guidelines for the use and management of interest rate swaps. The Interest Rate Swap Policy is prepared in accordance with the recommended practices of the Government Finance Officers Association regarding the contents of a derivatives policy published in 2003.

The LACMTA is authorized under California Government Code Section 5922 to enter into interest rate swaps to reduce the amount and duration of rate, spread, or similar risk when used in combination with the issuance of bonds.

## II. Scope and Authority

This Interest Rate Swap Policy shall govern the use and management of all interest rate swaps. While adherence to this Policy is required in applicable circumstances, we recognize that changes in the capital markets, agency programs, and other unforeseen circumstances may from time to time produce situations that are not covered by the Interest Rate Swap Policy and will require modifications or exceptions to achieve policy goals. In these cases, management flexibility is appropriate provided specific authorization from the Board is obtained.

In conjunction with the Debt Policy, the Interest Rate Swap Policy shall be reviewed and updated at least annually and presented to the Board for approval. The Chief Executive Officer, Chief Financial Officer, and Executive Officer - Finance and Treasurer are the designated administrators of the Interest Rate Swap Policy. The Treasurer shall have the day-to-day responsibility and authority for structuring, implementing, and managing interest rate swaps.

The Board shall approve any transaction involving an interest rate swap. The LACMTA shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. The Treasurer, in consultation with the Chief Executive Officer, Chief Financial Officer, and Counsel, shall have the authority to select the counterparties, so long as the criteria set forth in the Interest Rate Swap Policy are met.

## III. Conditions for the Use of Interest Rate Swaps

A. General Usage

Interest rate swaps may be used to lock-in a fixed rate or, alternatively, to create additional variable rate exposure. Interest Rate Swaps may be used to produce interest rate savings, limit or hedge variable rate payments, alter the pattern of debt service payments, or for asset/liability matching purposes.

In connection with the use of any swaps, the Board shall make a finding that the authorized swaps will be used to alter interest rate risk and/or alter the cost of borrowing in a beneficial manner, and when used in combination with new or outstanding bonds, will enhance the relationship between risk and return, or achieve other policy objectives.

B. Maximum Notional Amount

The maximum notional amount for all interest rate swaps shall be limited based on criteria set forth in this Interest Rate Swap Policy regarding the proper management of risks, calculation of termination exposure, and development of a contingency plan in the event of mandatory termination.

C. Liquidity Considerations

The impact on the cost and availability of liquidity support for both new and existing variable rate programs shall be considered when evaluating the issuance of new variable rate bonds requiring liquidity support. It is recognized that there is a limited supply of letter of credit or liquidity facility support for variable rate bonds, and the usage of liquidity support in connection with an interest rate swap may result in higher overall costs.

D. Call Option Value Considerations

When considering the relative advantage of an interest rate swap to fixed rate bonds, the value of the call option that would typically be purchased for the fixed rate bonds shall be compared to the present value of the savings from using a swap. This shall be done to ensure the benefit from use of the swap will provide sufficient compensation to offset the expected value of any foregone future refunding savings. Purchase of a swap cancellation option can mitigate the risk of foregone refunding savings and shall be evaluated for cost effectiveness.

## IV. Interest Rate Swap Features

A. Interest Rate Swap Agreement

Terms and conditions as set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement shall be used as the basis for developing the swap documentation. The swap agreement between the LACMTA and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as the LACMTA, in consultation with its legal counsel, financial advisor and/or swap advisor deems necessary or desirable.

Subject to the provisions contained herein, the terms of any swap agreement shall use the following guidelines:

i. Downgrade provisions triggering termination shall in no event be worse than those affecting the counterparty.

ii. Governing law for swaps will be either New York or California.

iii. The specified indebtedness related to credit events in any swap agreement should be narrowly defined and refer only to indebtedness of the LACMTA that could have a materially adverse effect on its ability to perform its obligations under the swap. Debt should typically only include obligations within the same lien as the swap obligation.

iv. Collateral thresholds stipulating when collateral will be required to be posted by the swap provider are designated in the policy and are based on credit ratings of the swap provider. Collateral requirements setting out the amount and types of collateral will be established for each swap based upon the credit ratings of the swap provider and any guarantor.

v. Collateral should be held by an independent third party.

vi. Eligible collateral should generally be limited to U.S. Treasury securities and obligations of Federal Agencies where the principal and interest are guaranteed by the full faith and credit of the United States government. At the discretion of the Treasurer, other high-quality obligations of Federal agencies, not secured by the full faith and credit of the U.S. government, may be used as collateral.

vii. LACMTA shall have the right to optionally terminate a swap agreement at "market," at any time over the term of the agreement.

viii. Termination value should be set by a "market quotation" methodology, unless LACMTA deems an alternate methodology appropriate.

B. Interest Rate Swap Counterparties

1. Credit Criteria

Qualified swap counterparties will generally be those having a general credit rating of: (i) at least "Aa3" or "AA-" by at least one of the three nationally recognized rating agencies identified in this policy and not rated lower than "A2" or "A" by any of the nationally recognized rating agencies, or (ii) have a "AAA" subsidiary that is appropriately rated by at least one nationally recognized credit rating agency. The nationally recognized rating agencies are Moody's Investors Services, Inc., Standard and Poor's and Fitch Ratings.

For lower rated counterparties whose highest rating from any of the three nationally recognized firms is below "AA-" or "Aa3", additional credit enhancement will be requested in the form of:

i. Contingent credit support or enhancement;

ii. Collateral consistent with the policies contained herein;

iii. Ratings downgrade triggers;

iv. Guaranty of parent, if any.

In addition, qualified swap counterparties must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market.

2. Counterparty Termination Exposure

In order to diversify counterparty credit risk, and to limit credit exposure to any one counterparty, the LACMTA will compute the "Maximum Net Termination Exposure" prior to executing a swap.

*"Maximum Net Termination Exposure"* is the aggregate termination payment for all existing and projected swap transactions that would be paid by or received from a specific counterparty, parent or guarantor. For purposes of this calculation, the aggregate termination payment is equal to: (i) the termination payment based on the market value of all existing swaps as of the first business day of the month prior to the execution of any proposed transaction, plus (ii) the expected worst-case termination payment of the proposed transaction. The expected worst-case termination payment shall be calculated assuming interest rates, as measured by the Bond Buyer Revenue Bond Index, increased (or decreased) by two standard deviations from the sample mean over the last 10 years.

The following chart provides the Maximum Net Termination Exposure to a swap counterparty based on the lowest credit rating assigned by any of the three nationally recognized rating agencies.

| Credit Rating | Maximum Collateralized Exposure | Maximum Uncollateralized Exposure | Maximum Total Termination Exposure |
|---|---|---|---|
| AAA | Not applicable | $40 million | $40 million |
| AA | $30 million | $10 million | $40 million |
| Below AA | $30 million | None | $30 million |

C. Term and Notional Amount

In connection with the issuance or carrying of bonds, the term of the swap agreement shall not extend beyond the final maturity date of the related bonds. The total "net notional amount" of all swaps related to a bond issue should not exceed the amount of outstanding bonds. For purposes of calculating the net notional amount, credit shall be given in situations where there are off-setting fixed rate and variable rate swaps.

D. Collateral Requirements

Terms imposing collateral requirements based on credit ratings of the counterparty, requiring collateralization or other forms of credit enhancements to secure any or all swap payment obligations will be included as part of any swap agreement. The collateral requirements will be determined in consultation with counsel and the financial advisor and/or swap advisor, and may require the counterparty to post securities, surety bonds, letters of credit or other credit enhancement if the highest credit rating of the counterparty, its parent, or guarantor falls below a rating of "AA-" or "Aa2". Additional collateral for further decreases in credit ratings of each counterparty shall be posted by each counterparty in accordance with the provisions contained in the collateral support agreement of the swap agreement.

Threshold collateral amounts shall be determined on a case-by-case basis. Reasonable threshold limits will be established for the initial deposit and for increments of collateral posting thereafter. Collateral shall be deposited with a third party trustee or as mutually agreed upon between the LACMTA and the counterparty. A list of acceptable securities that may be posted as collateral and the valuation of such collateral will be determined and mutually agreed upon during negotiation of the swap agreement with each swap counterparty. The market value of the collateral shall be determined on a monthly basis, or more frequently if the LACMTA determines it is in its best interest given the specific nature of the swap(s) and/or collateral security.

E. Security and Source of Repayment

Generally, the same security and source of repayment (pledged revenues) will secure the interest rate swaps as is used to secure the bonds that are hedged or carried by the swap, if any. The costs and benefits of subordinating the payments under the swap and/or termination payment shall be considered.

F. Cancellation Provisions

The benefit of incorporating the right to cancel the interest rate swap at no cost after a specified period of time, generally 5 to 10 years shall be evaluated. If the cancellation option is cost efficient relative to the cost of obtaining a bond call option for a similar starting period, it will be purchased. A termination provision mitigates some risks of the swap, by allowing a no-cost termination anytime after the exercise date.

G. Prohibited Interest Rate Swap Features

The LACMTA will not use interest rate swaps that: (i) are speculative or create extraordinary leverage or risk, (ii) lack adequate liquidity to terminate without incurring a significant bid/ask spread, (iii) provide insufficient price transparency to allow reasonable valuation, (iv) are used as investments.

## V. Evaluation and Management of Interest Rate Swap Risks

Prior to the execution of any swap transaction, the Chief Financial Officer, Treasurer, financial/swap advisor, and bond counsel shall evaluate the proposed transaction and report the findings to the Board. Such a review shall include the identification of the proposed benefit and potential risks. As part of this evaluation, the Maximum Net Termination Exposure to the proposed swap counterparty shall be calculated.

A. Evaluation Methodology

The following areas of potential risk for new and existing interest rate swaps shall be evaluated:

| Type of Risk | Description | Evaluation Methodology |
|---|---|---|
| Basis risk | The mismatch between actual variable rate debt service and variable rate indices used to determine swap payments. | Review of historical trading differentials between the variable rate bonds and the index. |
| Tax risk | The risk created by potential tax events that could affect the relationship of the swap index with the interest rate on LACMTA's variable rate bonds. | Review of the tax events in proposed swap agreements and evaluation of the impact of potential changes in tax law and the relationship of the swap index with the interest rates on LACMTA's variable rate bonds. |
| Counterparty risk | The failure of the counterparty to make required payments or otherwise comply with the terms of the swap agreement. | Monitor counterparty exposure levels, ratings thresholds, and collateralization requirements. |
| Termination risk | The risk that there will be a mandatory termination of the swap. A termination will almost always result in LACMTA either owing or being due to receive a termination payment. | Compute LACMTA's termination exposure for all existing and proposed swaps at market value and under an expected worst-case scenario. A contingency plan will be periodically updated specifying how we wouldfund or finance a termination payment and/or replace the hedge. |

| | | |
|---|---|---|
| Rollover risk | The mismatch of the maturity of the swap and the maturity of the underlying bonds. | Determine, in accordance with its Debt Policy, the capacity to issue variable rate bonds that may be outstanding after the maturity of the swap. |
| Liquidity risk | The inability to continue or renew a liquidity facility supporting the variable rate bonds that are being hedged. | Evaluate the expected availability of liquidity support for hedged (swapped) and unhedged variable rate debt. |
| Credit risk | The occurrence of an event modifying the credit quality or credit rating of the issuer or its counterparty. | Monitor the ratings of counterparties, insurers, and guarantors. |

1. Refunding Interest Rates Swaps

   For interest rate swaps that are used in combination with refunding bonds, the LACMTA will use the refunding criteria identified in its Debt Policy.

2. Basis Swaps

   The LACMTA may enter into a "basis swap" whereby the LACMTA pays the swap counterparty a rate that is indexed to BMA, and receives a rate that is indexed to LIBOR, in order that the LACMTA can have the potential to receive a net positive cash flow from the transaction. The notional amount of the basis swap must relate to a specific outstanding LACMTA bond issue. The expected present value cash flow savings from a basis swap must be at least 5.0% of the initial notional amount.

3. Options on Interest Rate Swaps

   The LACMTA may sell an option to a counterparty that gives the counterparty the right to put LACMTA into an interest rate swap at a specified time in the future. This transaction, commonly known as a "swaption," would provide the LACMTA with an upfront, non-refundable payment in exchange for selling the option.

   In the event a swaption is exercised by the provider, the LACMTA would be obligated to enter into an interest rate swap and to issue variable rate bonds. Therefore, as part of the evaluation of a swaption, the LACMTA will undertake all appropriate analysis as required by the Debt Policy and Interest Rate Swap Policy relating to the specific type of interest rate swap and bond issue that would be exercised under the option. In particular, for swaptions used as part of a bond refunding, the LACMTA will evaluate, among other things, the estimated present value savings, tax risk, and cost of a cancellation option. Swaptions will generally only be considered for refunding transactions, and not for new money transactions due to the frequent shifts in funding and timing for capital projects.

B. Managing Interest Rate Swap Risks

1. Annual Report to the Board

An annual evaluation of the risks associated with outstanding interest rates swaps will be presented in a written report to the Board. This evaluation will include the following information:

i. A description of all outstanding interest rate swaps, including related bond series, types of swaps, rates paid and received, existing notional amount, the average life and remaining term of each swap agreement, and the current termination value of all outstanding swaps.
ii. Separately for each swap, the actual debt service requirements versus the projected debt service on the swap transaction; and for any swaps used as part of a refunding, the actual cumulative savings versus the projected savings at the time the swap was executed.
iii. The credit rating of each swap counterparty, parent, guarantor, and credit enhancer insuring swap payments, if any.
iv. Actual collateral posting by swap counterparty, if any, per swap agreement and in total by swap counterparty.
v. Information concerning any material event involving outstanding swap agreements, including a default by a swap counterparty, counterparty downgrade, or termination.
vi. An updated contingency plan to replace, or fund a termination payment in the event an outstanding swap is terminated.
vii. The status of any liquidity support used in connection with interest rate swaps, including the remaining term and current fee.

The Interest Rate Swap Policy shall be updated at least annually and submitted to the Board for approval.

2. Contingency Plan for Mandatory Termination

Termination exposure of each swap and for the total swap termination payment exposure shall be calculated at least annually and a contingency plan prepared to either replace the swaps or fund the termination payments, if any, in the event one or more outstanding swaps are terminated. We shall additionally assess our ability to obtain replacement swaps and identify revenue sources to fund potential termination payments.

C. Terminating Interest Rate Swaps

1. Optional Termination

   In consultation with our counsel, financial advisor and/or swap advisor, we may terminate a swap if it is determined that it is financially advantageous, or will further other policy objectives, such as management of exposure to swaps or variable rate debt.

2. Mandatory Termination

   In the event a swap is terminated as a result of a termination event, such as a default or a decrease in credit rating of either the LACMTA or the counterparty, we will evaluate whether it is financially advantageous to obtain a replacement swap, or, depending on market value, make or receive a termination payment.

   In the event it is necessary to make a swap termination payment, LACMTA shall attempt to follow the process identified in its contingency plan for mandatory termination.

## VI. Selecting and Procuring Interest Rate Swaps

A. Financing Team

The services of a nationally recognized municipal bond counsel firm, and qualified financial advisor and/or swap advisor will be utilized for all interest rate swap transactions.

B. Underwriter Selection

In the event bonds are issued in connection with interest rate swaps, the bonds will be priced in accordance with the guidelines set forth in the approved Debt Policy.

C. Counterparty Selection

A competitive bidding process will be utilized to select a swap counterparty and price a swap when that process will provide the lowest financing cost. A negotiated process may be used to select a swap counterparty and price a swap when it is believed that market or competitive conditions justify such a process. The conditions under which a negotiated selection is best used are provided below.

i. Marketing of the swap will require complex explanations about the security for repayment or credit quality.
ii. Demand is weak among swap counterparties.
iii. Market timing is important, such as for refundings.
iv. Coordination of multiple components of the financing is required.
v. Participation from DBE / SBE firms is desired.

vi. The swap has non-standard features, such as being a forward starting swap.

vii. Bond or swap insurance is not available or not offered.

viii. The par or notional amount for the transaction is significantly larger than a typical transaction for that market..

## VII. Disclosure and Financial Reporting

Steps will be taken to ensure that there is full and complete disclosure of all interest rate swaps to the Board, to rating agencies, and in disclosure documents. Disclosure in marketing documents shall provide a clear summary of the special risks involved with swaps and any potential exposure to interest rate volatility or unusually large and rapid changes in market value. With respect to its financial statements, the LACMTA will adhere to the guidelines for the financial reporting of interest rate swaps, as set forth by the Government Accounting Standards Board.

# # # #

<u>Glossary of Terms</u>

**Asset/Liability Matching** Matching the term and amount of assets and liabilities in order to mitigate the impact of changes in interest rates.

**Bid/Ask Spread** The difference between the bid price (at which a market maker is willing to buy) and the ask price (at which a market maker is willing to sell).

**Call Option** The right to buy an underlying asset (e.g. a municipal bond) after a certain date and at a certain price. A call option is frequently embedded in a municipal bond, giving the issuer the right to buy, or redeem, the bonds at a certain price.

**Collateral** Assets pledged to secure an obligation. The assets are potentially subject to seizure in the event of default.

**Downgrade** A negative change in credit ratings.

**Forward Starting Swap** Interest rate swaps that start at some time in the future. Used to lock-in current interest rates.

**Hedge** A transaction that reduces the interest rate risk of an underlying security.

**Interest Rate Swap** The exchange of a fixed interest rate and a floating interest rate between counterparties.

**Liquidity Support** An agreement by a bank to make payment on a variable rate security to assure investors that the security can be sold.

**LIBOR** The London Interbank Offer Rate. Used as an index to compute the variable rate on an interest rate swap.

**Notional Amount** The amount used to determine the interest payments on a swap.

**Termination Payment** A payment made by a counterparty that is required to terminate the swap. The payment is commonly based on the market value of the swap, which is computed using the rate on the initial swap and the rate on a replacement swap.