RESOLUTION NO. 20050623-014

BE IT RESOLVED BY THE CITY COUNCIL OF THE CITY OF AUSTIN:

The Council approves the attached Interest Rate Exchange policy related to interest exchange agreements for the City's Debt Management practices; and

The Council further authorizes that the policy be incorporated into the City of Austin's Financial Policies.

ADOPTED: June 23, 2005 **ATTEST:** Shirley A. Brown

Shirley A. Brown
City Clerk

City of Austin Swap Policy

11/16/04

City of Austin Swap Policy

City of Austin Philosophy Regarding Use of Swaps

Introduction

Interest rate exchange agreements ("Swaps") and related financial instruments and derivatives are appropriate interest rate management tools. Properly used, Swaps can increase the City of Austin's (the "City") financial flexibility and provide opportunities for interest rate savings.

Swaps are appropriate to use when they achieve a specific financial objective consistent with the City's overall Swap and Debt Management policies. Swaps may be used, for example, to lock-in a current market fixed rate or create additional variable rate exposure. Swaps may be used to produce interest rate savings or alter the pattern of debt service payments. Swaps may be used to cap, limit or hedge variable rate payments. Options granting the right to commence or cancel an underlying Swap are permitted to the extent the Swap itself is otherwise consistent with this policy.

The authorized Swaps contemplated in this policy are intended to reduce the amount or duration of interest rate risk, or produce a lower cost of borrowing when used in combination with the issuance of bonds.

Rationales for Utilizing Interest Rate Swaps

The use of Swaps and related financial instruments should balance the City's primary objectives of reducing the cost of capital, minimizing interest rate volatility, and gaining flexibility in structuring and managing its debt portfolio over time with the risks associated with these tools and instruments. Examples of how the City's debt management objectives can be achieved through the use of Swaps and other financial instruments are describe below:

- Reduce borrowing costs at the time of issuance
  Create synthetic fixed rate debt through a floating-to-fixed Swap
- Actively manage interest rate risk
  Lock-in current market rates through (forward starting) floating-to-fixed Swap
- Optimize capital structure
  Sell option to convert variable rate debt to fixed
- Balance financial risk
  Purchase of interest rate cap
- Achieve appropriate asset/liability match
  Create variable rate exposure through fixed-to-floating Swap

Authority for Entering Into Swap Agreements

The purpose of this policy is to integrate the use of Swaps into the City's overall debt management practice. The use of Swaps will be limited to the City's outstanding debt, and do not apply and are therefore not authorized for use in conjunction with the City's investment portfolio. Swaps will not be used for speculation on the future direction of interest rates. The City's Treasurer, in consultation with the City's Financial Advisor and subject to the approval of the City's Chief Financial Officer, shall be responsible for determining if and when it is in the City's overall best financial interests to enter into a Swap or related financial arrangement covered by this policy.

City of Austin Swap Policy

In connection with the use of any Swaps, the City shall comply with all applicable State and Federal laws. The City must receive an opinion acceptable to the market from a nationally recognized firm that the swap contract is a legal, valid, and binding obligation of the City and that entering into such a contract complies with applicable provision of the City Charter and State statutes. This should include the review of all aspects of the transaction by the State Attorney General ("AG") as necessary. In accordance with current AG guidelines the governing law of any transaction should be Texas, and jurisdiction for any legal disputes should be the United States District Court for the Western District of Texas, Austin Division.

Permitted Instruments

The City may utilize financial instruments that (*i*) lower its interest expense, (*ii*) manage its financial risk, or (*iii*) improve its financial condition.

The City shall not use financial instruments that (*i*) create extraordinary leverage or financial risk, (*ii*) lack adequate liquidity to terminate at market, or (*iii*) provide insufficient price transparency to allow reasonable valuation on an ongoing basis.

The use of derivative financial products should produce a result not otherwise available in the cash market (i.e., lack of advance refunding/non-callable debt), or provide a higher level of net savings compared to conventional financing methods.

Permitted Financial Instruments

The City may expressly utilize the following financial instruments, after identifying financial objective(s) to be realized and assessing the attendant risks:

- Interest Rate Swaps
- *Immediate or forward starting floating-to-fixed rate swaps, designed to capture current market interest rates*
- *Fixed-to-floating rate swaps, designed to create additional variable interest rate exposure*
- Interest Rate Caps
- *Financial contracts (caps, collars, floors) that limit or bound exposure to interest rate volatility*
- Options on Swaps
- *Sale of options to commence or cancel interest rate swaps*
- Basis Swaps
- *Floating-to-floating rate swaps to manage basis or tax risk*

Approved Swap Transaction Types

Swaps

Fixed-to-Floating Rate Swap (Synthetic Variable)
Fixed-to-Floating Rate Cancelable Swap (Synthetic Variable)
Floating-to-Fixed Rate Swap (Synthetic Fixed)
Floating-to-Fixed Rate Forward Swap (Bond Issue Anticipation Hedge/Synthetic Forward Refunding)
Basis Swaps (Floating-to-Floating) on Approved Indices

Swaptions

Floating-to-Fixed Rate Swaption Sale (Synthetic Forward Refunding)
Floating-to-Fixed Rate Swaption Sale (Bond Call Option Monetization)
Other Approved Swaption Purchases and Sales for Asset-Liability Management

Caps/Floors/Collars

Interest Rate Caps/Floors Embedded in Approved Swap Transactions
Purchased Caps
Purchased Floors
Purchased Collars (Buy Cap/Sell Floor)

Other Non-Traditional Hedging Tools (e.g., Knock-Out Options, Inflation-Indexed Swaps)

Subject to approval based on Verifiable Savings or Risk Reduction Benefit Targets if in the opinion of the City and its Financial Advisor they do not conflict with goals for liquidity and price transparency.

Approved Indices

- LIBOR (London Inter Bank Offered Rate) as published by the British Bankers Association
- BMA (The Bond Market Association Municipal Swap index) published by Municipal Market Data
- Actual Bond Rate – the actual rate paid by the City on its own variable rate bonds
- Another index as deemed appropriate by the City's Treasurer, Chief Financial Officer and Financial Advisor

Swap Risk Analysis

The City's Chief Financial Officer and/or City Treasurer and its Financial Advisor shall evaluate all financial products with respect to the unique risks that Swap transactions bear. A specific determination must be made that the proposed or expected benefits exceed the identified risks by an adequate margin over those available in the traditional cash or fixed rate market. At a minimum, the Chief Financial Officer and/or City Treasurer and its Financial Advisor shall perform an evaluation of the risks and what steps have been taken to mitigate any risks. The City may retain a swap advisor to assist in assessing these risks. Questions that may arise include the following:

- Market or interest rate risk
  Does the transaction hedge or create interest rate volatility?
- Tax Risk
  How is the transaction or its benefits affected by a future change in federal income tax policy?
- Termination Risk
  Under what circumstances might the transaction be terminated? At what value?
- Risk of Uncommitted Funding (Put Risk)
  Does the transaction create additional financing dependent upon third party participation?
- Rollover Risk
  Is the term of the Swap shorter than the term of the underlying hedged asset?
- Legal Risk
  Is the transaction expressly authorized?
- Counterparty Risk
  What is the creditworthiness of the counterparty?
- Rating Agency Risk
  Is the proposed transaction consistent with the City's current ratings and ratings objectives?
- Basis Risk
  Do the anticipated payments the City receives match the payments it makes?
- Subsequent Business Conditions
  Does the transaction or its benefits depend upon the continuation, or realization, of specific industry business conditions?
- Operational Risk

Does the City have adequate systems, policies, and practices in place to monitor and manage the transaction over its term?

Swap Procurement and Execution

Procurement

The City will not have a fixed policy with respect to the procurement of Swaps and other financial instruments authorized by this policy. However, the City may have a bias toward competitively bidding financial products of a general nature that are widely available in the marketplace. On a product-by-product basis, the City will have the authority to negotiate the procurement of financial instruments that have customized or specific attributes designed on its behalf. The Chief Financial Officer and/or City Treasurer will be responsible for determining the method of procurement for Swaps and related financial instruments. An independent swap advisor will be retained to assist the Chief Financial Officer and/or City Treasurer in evaluating the proposed pricing of Swaps or related financial instruments.

Swap Execution

The Chief Financial Officer and/or City Treasurer may recommend the use of financial derivative products if they:

1. Provide a specific benefit not otherwise available;
2. Produce greater expected interest rate savings than cash market alternatives;
3. Do not create extraordinary leverage or financial risk;
4. Result in an improved capital structure or better asset/liability match; and
5. Reasonably pass the risk evaluation required by this policy.

Swap Documentation

The City will use standard International Swaps and Derivatives Association ("ISDA") swap documentation including the Schedule to the Master Agreement and a Credit Support Annex.

Terms and Notional Amount of Swap Agreement

The City shall determine the appropriate term for Swaps on a case-by-case basis. The slope of the swap curve, the marginal change in swap rates from year to year along the swap curve, and the impact that the term of the Swap has on the City's overall financial exposure shall be considered in determining the appropriate term of any Swap agreement. In connection with the issuance or carrying of bonds, the term of the Swap agreement between the City and a qualified swap counterparty shall not extend beyond the final maturity date of existing City debt, or in the case of a refunding transaction, beyond the final maturity of the refunding bonds. At no time shall the total notional amount of all Swaps exceed the total amount of outstanding applicable bonds.

Terms and conditions of any Swap shall be negotiated by the Treasurer in the best interests of the City subject to the applicable legal provisions and this policy. The Swap agreements entered into between the City and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the Treasurer, in consultation with City legal counsel and its swap advisor, deems necessary or desirable.

City of Austin Swap Policy

Subject to the provisions contained herein, the City's swap documentation and terms should include the following:

- The downgrade provisions triggering termination should be bilateral or favorable to the City
- Governing law for Swaps will be Texas per the current requirement of the Texas AG. If the opinion of the AG changes the City may consider using New York law, but documents should reflect Texas authorization provisions
- The specified indebtedness related to credit events in the Master Agreement should be narrowly drafted and refer only to specific debt
- Eligible collateral should be limited to Treasuries, Federal Agencies and any other securities which in the City's sole discretion shall be deemed reasonable and creditworthy
- Collateral thresholds should be set on a sliding scale reflective of credit ratings
- Termination value should be set by "market quotation" methodology
- For counterparties below "AA" use a credit support annex to document swap termination value collateralization procedures

Policy on Swap Counterparties

The City shall only do business with highly rated counterparties, and will structure swap agreements to protect itself from credit deterioration.

Guidelines on Counterparty Risk

The City should not have an immutable credit standard. However, the City shall attempt to do business with highly rated counterparties with a rating of AA or better. For lower rated (below AA) counterparties, the City should seek credit enhancement in the form of:

1. Collateral or;
2. Contingent swap counterparty providing support.

Swap documents should contain ratings downgrade triggers including a minimum rating threshold of "Baa3/BBB-", below which allows assignment or termination at market levels.

Qualified Swap Counterparties

The City shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. The composition of the approved swap counterparties will change from time to time. Qualified swap counterparties must be rated at least "Aa3" or "AA-", or equivalent by any two of the nationally recognized rating agencies (i.e., Moody's, Standard and Poor's, or Fitch); or have a "AAA" subsidiary as rated by at least one nationally recognized credit rating agency. In addition, the counterparty must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. Each counterparty shall have minimum capitalization of at least $150 million. The City will not enter into financial products with counterparties rated below A2 by any rating agency.

Limitations on Counterparty Exposure

Guidelines

In order to diversify the City's counterparty credit risk, and to limit the City's credit exposure to any one counterparty, limits will be established for each counterparty based upon both the credit rating of the counterparty as well as the relative level of risk associated with each existing and proposed swap transaction. The guidelines below provide general termination exposure guidelines with respect to whether the City should enter into an additional transaction with an existing counterparty. The City may make exceptions to the guidelines at any time to the extent that the execution of a swap achieves one or more of the goals outlined in these guidelines or provides other benefits to the City. In general, the maximum Net Termination Exposure to any single Counterparty should be set so that it does not exceed a prudent level as measured against the gross revenues, available assets or other financial resources of the City.

Such guidelines will also not mandate or otherwise force automatic termination by the City or the counterparty. Maximum Net Termination Exposure is not intended to impose retroactively any terms and conditions on existing transactions. Such provisions will only act as guidelines in making a determination as to whether or not a proposed transaction should be executed given certain levels of existing and projected net termination exposure to a specific counterparty. Additionally, the guidelines below are not intended to require retroactively additional collateral posting for existing transactions. Collateral posting guidelines are described in the "Collateral" section below. The calculation of net termination exposure per counterparty will take into consideration multiple transactions, some of which may offset the overall exposure to the City.

Under this approach, the City will set limits on individual counterparty exposure based on existing as well as new or proposed transactions. The sum of the **current market value** and the **projected exposure** shall constitute the Maximum Net Termination Exposure. For outstanding transactions, current exposure will be based on the market value as of the last quarterly swap valuation report provided by the Financial Advisor. Projected exposure shall be calculated based on the swap's potential termination value taking into account possible adverse changes in interest rates as implied by historical or projected measures of potential rate changes applied over the remaining term of the swap.

For purposes of this calculation, the City shall include all existing and projected transactions of an individual counterparty and all transactions will be analyzed in aggregate such that the maximum exposure will be additive.

The exposure thresholds, which will be reviewed periodically by the City to ensure that they remain appropriate, will also be tied to credit ratings of the counterparties and whether or not collateral has been posted as shown in the table below. If a counterparty has more than one rating, the lowest rating will govern for purposes of the calculating the level of exposure. A summary table is provided below.

Counterparty Credit Exposure Recommended Limits			
Credit Ratings	Maximum Collateralized Exposure	Maximum Uncollateralized Exposure	Maximum Net Termination Exposure
Aaa/AAA	NA	$100.0 million	$100.0 million
Aa/AA Category	$70.0 million	$30.0 million	$100.0 million
A/A Category	$50.0 million	$20.0 million	$70.0 million
Below A3/A-	$50.0 million	None	$50.0 million

If the exposure limit is exceeded by counterparty, the City shall conduct a review of the exposure limit per counterparty. The City, in consultation with its Swap Counsel and Financial Advisor, shall explore remedial strategies to mitigate this exposure.

The City's swap exposure to any single counterparty will be limited to 25% of the counterparty's capitalization.

Benefit Expectation

Financial transactions, using Swaps or other derivative products, intended to produce the effect of a synthetic advanced refunding, must generate 1.0% **greater** savings than the benefit threshold then in effect for fixed-rate bonds.

The higher savings target reflects the greater complexity and higher risk of derivative financial instruments, and should include a risk adjustment for other factors. For example, if the bonds are callable and the swap is not, or if tax risk is included in the proposed swap transaction then the comparison should include a risk adjustment for these factors.

Using a refunding situation to illustrate this approach, if the City considers the application of a swap or swaption to refund outstanding callable bonds (either current, forward or advance) the City should apply the following method to evaluate the refunding benefit threshold:

1. Start with the minimum present value savings expected for a traditional refunding, expressed as a percentage of the refunded par amount of the bonds.
2. Add 1% to that number for the added complexity and risks involved with using a swap.
3. Further, add an amount determined to reflect the value of additional risk, especially tax risk and call provisions. The value of the additional risks should be verified by the City's Financial Advisor

In calculating the prospective savings against the target for implementing a fixed-to-variable swap, the cost of remarketing, in addition to the cost of credit and liquidity fees must be added to the variable rate representing the ten-year average of comparable variable rate securities.

Termination Provisions

All swap transactions shall contain provisions granting the City the right to optionally terminate a swap agreement at any time over the term of the agreement. In general, exercising the right to terminate an agreement produces a benefit to the City, either through the receipt of a payment from a termination, or if the termination payment is made by the City, in conjunction with a conversion to a more beneficial (desirable) City debt obligation, as determined by the City.

Collateral

As part of any swap agreement, the City shall require collateralization or other credit enhancements to secure any or all swap payment obligations. As appropriate, the City, in consultation with Counsel, may require collateral or other credit enhancements to be posted by each swap counterparty under the following circumstances:

- Each counterparty to the City may be required to post collateral if the credit rating of the counterparty or parent falls below the "AA" category. 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 to each counterparty with the City.
- Collateral shall be deposited with a third party trustee, or as mutually agreed upon between the City 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 at least a monthly basis.
- The City shall determine the reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.
- The City shall determine on a case-by-case basis whether other forms of credit enhancement are more beneficial.

Monitoring and Reporting

At least once per year, or as requested by the City Council, the Chief Financial Officer and/or City Treasurer shall prepare a report describing the various Swaps and financial arrangements entered into by the City pursuant to this policy that are in effect as of the date of the report's publication. The report shall include the following information:

1. A summary of key terms of the agreements, including notional amounts, interest rates, maturity and method of procurement.
2. The marked-to-market value of each agreement.
3. The full name, description, and credit ratings of each counterparty or the applicable guarantor.
4. The amounts that were required to be paid and received, and any amounts that were actually paid and received.
5. A listing of any credit enhancement, liquidity facility, or reserves and an accounting of all costs and expenses associated with the credit enhancement, liquidity facility, or reserves.
6. The aggregate marked-to-market value for each counterparty and the relative exposure compared to other counterparties.
7. A calculation of the City's value at risk or termination values for each counterparty.
8. A discussion of other risks associated with each transaction.

At the end of each fiscal year, the Chief Financial Officer and/or City Treasurer shall provide to the Controller all information required for financial reporting under GASB as well as any other reporting or disclosure requirements.

The City should receive reports regarding the mark-to-market of each transaction and the current credit rating of each counterparty on a quarterly basis from an independent source. If collateral is being posted in relation to any swap or group of swaps, the City should independently verify the value of swaps and the collateral on at least a monthly basis.