City of Riverside Finance Department

Master Swap Policy

Last Review Date: 5/2013
Prepared by: Financial Resources Division

PURPOSE:

To provide procedural direction to the City of Riverside, California (the "City") regarding the utilization, execution, and management of interest rate swaps and related instruments (collectively, "interest rate swaps").

POLICY:

Interest rate swaps can be effective interest rate management tools in helping the City to achieve its financial and policy objectives. However, the City recognizes that a swap policy is important to minimize risks and maximize the benefits of an interest rate swap program. While adherence to these guidelines is required generally, developments in the financial markets, City circumstances and/or objectives, or other unforeseen events may produce situations not adequately anticipated by this Policy. In these cases, the City will have the flexibility to deviate from these guidelines provided City Council authorization is obtained prior to taking any action that is, or could be reasonably considered, inconsistent with these guidelines. Periodically, but at least annually, the City, together with its advisors and counsel, will review the Policy and shall make modifications as appropriate due to changes in the business environment or market conditions.

These guidelines are not intended to govern other instruments or transactions that the City or its departments may consider, including but not limited to, currency, fuel, power, or other energy-related derivatives. Failure to comply in any manner with this Policy shall not result in any liability on the part of the City to any party.

AUTHORITY AND OVERSIGHT

The City's Chief Financial Officer together with other City staff as designated (the "City's Staff") shall be responsible for interest rate swap activities. In addition, appropriate personnel from any related City departments or enterprises, shall be consulted in the evaluation of and as appropriate, the ongoing management of any interest rate swaps. The City will utilize the services of a swap advisor and legal counsel for the evaluation, execution, and on-going risk management and reporting requirements.

Before entering into an interest rate swap, the City will confirm with its legal counsel, including the City Attorney, that it has the legal authority to enter into such interest rate swap. In addition, if the interest rate swap will be related to existing or anticipated obligations of the City, the City will determine whether an interest rate swap is permitted under the legal documents pertaining to such obligations.

INTEREST RATE SWAP UTILIZATION

The City may utilize interest rate swaps to better manage its interest rate based assets and liabilities and to the extent utilized, interest rate swaps should be considered in the context of the City's overall asset and liability management efforts. **The City shall not utilize interest rate swaps for speculative purposes.**

A. Rationales for Utilization

1 Reduce exposure to changes in interest rates on a particular transaction or portfolio of financial transactions.
2 Achieve lower net cost of borrowing with respect to the City's debt obligations.
3 Achieve a benefit not otherwise available to the City.
4 Optimization of capital structure including modification of the timing and amounts of scheduled debt service payments.
5 Improve asset and liability matching.
6 Achieve optimal fixed rate versus variable rate debt allocations.
7 Better position the City to respond to changing market or other circumstances.
8 Manage the relationship between risk and reward with respect to the City's debt obligations.
9 Manage exposure to changing markets in advance of anticipated bond issuances by locking in borrowing costs (through the use of forward hedging instruments).

B. Permitted Instruments

The City may utilize the following financial products on a current, or forward basis, after identifying the objectives to be realized and assessing the attendant risks.

1 Interest rate swaps, including (i) pay fixed/receive floating swaps (fixed rate swaps), (ii) receive floating/pay fixed swaps (floating rate swaps) and (iii) pay floating/receive floating swaps (basis swaps). Swaps may include option features, such as for the extension, cancellation, or index conversion of the swap.
2 Interest rate caps, floors, and collars.
3 Stand-alone options to enter into swaps (swaptions) on a particular date, series of dates, or during a particular period of time in the future.

EVALUATION OF PROPOSED TRANSACTIONS

The City's Staff shall undertake an evaluation of any proposed transaction. This will include, but not be limited to, consideration of the following:

1 Assessment of all inherent risks of the transaction including, but not limited to those outlined below (see **INTEREST RATE SWAP RISKS**)
2 Alternative financing options and a comprehensive evaluation of the potential risks and expected benefits of the interest rate swap relative to such other options.
3 Security and source of payments, both scheduled and termination, and the integration of the swap into the City's debt program.
4 Procurement process and the suitability of the contemplated counterparties to the swap, taking into account any existing exposure to such counterparties.
5 Impact on City's credit and liquidity profile and how other financial arrangements, existing or expected, may be impacted by the swap.
6 Analysis of impact on the City's net variable rate interest exposure from the contemplated transaction and any potential budgetary impact.
7 Cost and availability of on-going resources for the effective operations and risk management of the swap.
8 Tax, accounting, or other compliance requirements relative to other options.
9 If the transaction includes option components, analysis of circumstances under which the option will likely, or not likely, be exercised and the consequences of each outcome.
10 Volatility Exposure (as outlined herein) for each counterparty for all existing and any proposed transactions.

INTEREST RATE SWAP RISKS

Interest rate swaps may involve several risks of varying degrees, including the following:

1 **Counterparty Risk** – The risk of nonperformance resulting in a payment or other default on a swap by the City's counterparty. If the swap is terminated prior to its scheduled final cash flow date and the City's swap position has increased in value, the City will be owed a termination amount and therefore will have credit exposure to its Counterparty for collection of any such amount.

2 **Termination/Replacement Risk -** The risk that an interest rate swap agreement must be terminated prior to its stated final cash flow date and that the City cannot obtain a replacement transaction with substantially similar terms, including because of deterioration in the City's own credit. In such a circumstance, the City could owe, or be owed, a termination payment and may not be able to effect an assignment of the transaction or enter into a new transaction with substantially similar terms that would preserve the City's economic position.

3 **Collateral Posting Risk –** The risk that the City will be required to secure its payment obligations under the swap. Posted collateral would not be available for the City's expenditure or reserve balance needs, potentially adversely impacting credit ratings and overall liquidity and budgetary efforts.

4 **Basis Risk** – The risk that the payments received (from a floating rate swap or asset) do not match, and in particular are insufficient, to pay the amounts due (on a floating rate swap or liability). In the context of floating rate bonds combined with a fixed rate swap, the risk is experiencing prolonged periods of larger than expected discrepancies between the rate paid by the City to the holders of its underlying bonds and the rate received on the swap over the same period of time (e.g., a tax-exempt variable rate issue paying bondholders an average of 68% of LIBOR while the City receives only 65% of LIBOR pursuant to the associated swap.)

5 **Tax-Exemption Risk** – Related to basis risk, tax-exemption risk is generally the risk of a reduction or elimination in the benefits of tax exemption for municipal bonds (e.g., a reduction in the marginal tax rate) which event would increase the City's tax-exempt floating rate borrowing cost without an offsetting increase in swap receipts.

6 **Liquidity / Remarketing Risk** – In connection with a swap strategy which includes issuance of floating rate bonds that, absent the swap strategy would have been issued as fixed rate bonds, the risk that the City cannot secure a cost-effective renewal of a letter or line of credit or suffers a failed auction or remarketing with respect to the floating-rate bonds.

Before proceeding with a swap transaction, the City must reasonably conclude that the expected benefits of the transaction outweigh the expected risks, that the risks are within acceptable levels, and that the contemplated transaction does not impose risks that threaten the City's ability to perform its core functions. The transaction must be reasonable in relation to the City's overall financial condition and capitalization.

The City shall, with its advisors and legal counsel, structure swap transactions with terms and provisions that will help mitigate such risks to the extent practicable and cost-effective. The City shall have a plan for the on-going monitoring and risk management of swap transactions.

INTEREST RATE SWAP STRUCTURING AND EXECUTION

Swaps may be procured via a competitive process or through negotiation with one or more prospective counterparties. The City's Staff will determine on a case-by-case basis which approach best addresses the City's long-term financial objectives. Regardless of the method of procurement, the City shall obtain a finding from a qualified and independent firm that the terms and conditions of any transaction entered into reflect a fair market value of such transaction as of the date of its execution.

A. Eligible Counterparties

The City will do business only with qualified swap counterparties. Qualified counterparties are institutions whose long term credit rating or whose obligations are guaranteed by a financial institution whose long term credit rating, are at the time the swap is entered into at least as high as "A" or equivalent and that have a demonstrated record of successfully executing swap transactions. The City will structure interest rate swap agreements to protect itself from credit deterioration of counterparties, including the use of ratings-based termination events, credit support annexes or other forms of credit enhancement. Such protection shall include any terms and conditions which the City deems necessary or appropriate to protect its interests.

B. Term and Notional Amount of Swap Agreement

The City shall determine the appropriate term and size for an interest rate swap agreement on a case-by-case basis. In connection with the issuance or carrying of bonds, the outstanding notional amount of a swap agreement should relate to the amortization of the related existing or anticipated debt of the City. While entering into a swap with a term less than the associated bonds may be appropriate, if the intent is to "rollover" the swap, the City will be subject to the uncertainties of entering into a new swap at then prevailing market conditions.

C. Swap Documentation

In connection with each interest rate swap, the City must receive a legal opinion acceptable to the market to the effect that the interest rate swap is a legal, valid and binding obligation of the City. Such opinion must set forth the statutory and/or other provisions that grant the City the capacity and authority to enter into the interest rate swap agreement.

Unless otherwise recommended by the City's Staff and approved by the City Council, the City will use swap documentation based on published ISDA standards, including the Master Agreement, Schedule to the Master Agreement, Credit Support Annex, and Confirmation. The City may modify these standard forms and use additional documentation as, on the advice of counsel and/or its other advisors, it deems necessary and appropriate. Subject to the provisions contained herein, the City's swap documentation and terms should include the following:

1. Appropriately limited definitions of Specified Entity, Specified Transactions, and Specified Indebtedness.
2. Downgrade provisions triggering termination that in no event shall be worse than those relating to the counterparty.
3. Governing law for swaps will be New York State, but should reflect California authorization provisions.
4. The right for the City to optionally terminate the swap at any time (at the then market value), but shall **not** provide this right to the City's counterparty, unless specifically structured to provide the counterparty with cancellation rights.
5. A Credit Support Annex which requires the counterparty to post collateral if rated below "AA", without modifiers, by either S&P **or** Moody's. Threshold amounts will be determined on a case-by-case basis but in all cases shall not permit thresholds in excess of $15,000,000 for entities rated in the "A" category and for entities rated at or below "BBB", the threshold shall be $0. If a counterparty has more than one rating, the lowest rating will govern for purposes of calculating the permitted threshold. If the provisions of the Credit Support Annex are symmetrical, the City will be required to post collateral under the same terms as the City's counterparty. The City shall explore the availability and cost-effectiveness of asymmetrical threshold provisions and/or forms of credit enhancement to secure its swap payment obligations to minimize the City's collateral posting risk.

6. Acceptable security types for collateral purposes shall be limited to those rated 'AAA' and otherwise consistent with the City's investment program. Valuation levels will take

into account the term and liquidity of the investment as well as the valuation frequency. The market value of the collateral shall be determined no less frequently than weekly.

COUNTERPARTY CREDIT EXPOSURE

The City will manage its counterparty credit exposure (i.e., amounts which would become due to the City if the swaps with a particular counterparty were to terminate early pursuant to a default or other similar event) through diversification and active trade management. In order to measure the City's exposure, the City shall periodically calculate and review the current market valuation of all outstanding swaps, subtotaled by counterparty and by security and source of payment (as applicable). In addition, for each counterparty the City will review the then current long-term credit ratings and the ratings outlook, including the date of the last rating update. The calculation of termination exposure per counterparty will be on a net basis by taking into consideration multiple transactions, some of which may offset the overall exposure to the City.

In addition, the City shall estimate the interest rate volatility risk ("Volatility Exposure") of the City's swap portfolio. The purpose of Volatility Exposure is to measure what impact a significant change in interest rates would have on the City's swap portfolio. Volatility Exposure will be calculated assuming (i) an upward shift of 150 basis points in the yield curve and (ii) a downward shift of 150 basis points in the yield curve. The assumed shift will be reviewed periodically to ensure that they remain appropriate.

Example of Counterparty Credit Exposure Information (Illustration Purposes Only)

Counterparty	S&P (Date) Moody's (Date)	Outlook	Market Value of Transactions	Volatility Exposures Market Value
Provider A	A+ (1/1/04)	Stable (1/1/04)	$3 million	$VolExp_{Up}$ $4 million
	A2 (1/1/05)	Negative (4/1/05)		$VolExp_{Down}$ -$1 million

A. Exposure Review of Existing Swaps

While collateralization reduces credit risk, collateralization introduces other risks, principally legal and operational. In order to manage these other risks, the City shall limit the amount of exposure to any one counterparty, regardless of the counterparty credit ratings and threshold levels. If the exposure to a counterparty exceeds $30,000,000, the City shall explore remedial strategies to mitigate this exposure. Credit exposure may be reduced, for example, through a swap termination, in whole or in part, or a restructuring of the swap to an on-market rate with a smaller notional amount accompanied by a cash payment to the City, which could then be used to redeem underlying debt obligations. These counterparty credit risk guidelines will not mandate or otherwise force automatic termination by the City or the counterparty.

B. Exposure Review of Proposed Swaps

Prior to entering into a new swap transaction, the City, as part of its evaluation of the proposed transaction, will compute the Volatility Exposure by treating the proposed swap transaction as an outstanding swap. Such provisions will act only 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. These guidelines are not intended to require retroactively additional collateral posting for existing transactions.

ONGOING RISK MANAGEMENT AND REPORTING REQUIREMENTS

A. Active Management

The City will seek to maximize the benefits and minimize the risks it carries by actively managing its interest rate swap program. This will entail monitoring the adequacy of posted collateral, compliance with accounting requirements, and periodic monitoring of market conditions for emergent opportunities and risks. Active management may require modifications of existing positions including, for example:

1 Early termination;
2 Shortening or lengthening the term;
3 Sale or purchase of options;
4 Basis conversion

B. On-going Reporting

A report providing the status of all interest rate swap agreements entered into by the City will be prepared no less frequently than semi-annually (or on such other basis directed by the City Council) and shall include the following:

1 A description of all outstanding interest rate swap agreements, including project and bonds series, type of swap, rates paid and received by the City, total notional amount, average life of each swap agreement, and remaining term of each swap agreement.
2 Highlights of all material changes to swap agreements or new swap agreements entered into by the City since the immediately preceding report.
3 Market value of each of the City's interest rate swap agreements.
4 The credit rating of each swap counterparty and credit enhancer insuring swap payments, if any.
5 Listing of any credit enhancement, liquidity facility or reserves and accounting of all costs and expenses associated with the credit enhancement, liquidity facility or reserves.
6 The mark to market value for each transaction and the aggregate for each counterparty.

CONFORMANCE WITH DODD-FRANK

It is the intent of the City to conform this Policy to the requirements relating to legislation and regulations for over-the-counter derivatives transactions under Title VII of the Wall Street Transparency and Accountability Act of 2010, as supplemented and amended from time to time (herein collectively referred to as "Dodd-Frank"). Pursuant to such intent, it is the Policy of the City that: (i) each swap advisor engaged or to be engaged by the City will function as the designated qualified investment representative of the City, sometimes referred to as the "Designated QIR"; (ii) each swap advisor agrees to meet and meets the requirements specified in Commodity Futures Trading Commission Regulation 23.450(b)(1) or any successor regulation thereto (herein referred to as the "Representative Regulation"); (iii) each swap advisor provide a written certification to the City to the effect that such swap advisor agrees to meet and meets the requirements specified in the Representative Regulation; (iv) the City monitor the performance of each swap advisor consistent with the requirements specified in the Representative Regulation; (v) the City exercise independent judgment in consultation with its swap advisor in evaluating all recommendations, if any, presented by any counterparty with respect to transactions authorized pursuant to this Policy; and (vi) the City rely on the advice of its swap advisor with respect to transactions authorized pursuant to this Policy and not rely on recommendations, if any, presented by any counterparty with respect to transactions authorized pursuant to this Policy.

PROCEDURE:

Responsibility	Action
Chief Financial Officer or designee	1. Identifies potential opportunities and confirms legality of proposed swap transactions. Obtains council approval for further actions. 2. Evaluates proposed transactions for identified risks and any other situation specific issues relevant to determine if a swap agreement is beneficial. 3. In conjunction with financial advisors, determines procurement basis, develops swap agreement particulars/documentation and obtains required legal opinions for authority and fair market value.
City Council	4. Approves competed swap package.
Finance Department	5. Periodically updates counterparty credit exposure and estimates the interest rate volatility risk of the City's swap portfolio. 6. Reports results to Chief Financial Officer who explores remedial actions if warranted. 7. Prepares semiannual status report for Council on all interest rate swap agreements.