

**ADMINISTRATIVE PROCEDURE 6306 INTEREST RATE RISK MANAGEMENT**

Interest rate risk management is incorporated into the framework through which the District undertakes bond financings. Interest rate swap agreements, for example, have been used on a limited basis to successfully manage interest rate risk by hedging a portion of the variable-rate bonds that have been issued, resulting in lower interest costs for the District relative to traditional fixed-rate transactions and providing budgetary certainty.

*Use of Interest Rate Swaps*

Derivatives in the public sector, primarily in the form of interest rate swaps such as those used by the District, became prevalent in the 1990's. Although their use was not as common as it was in the corporate bond market, interest rate swaps became an important debt management tool for many issuers across the country. When used effectively, interest rate swaps can be important risk management tools that have tremendous application for large issuers of municipal debt, such as the District. The potential benefits to public sector issuers include:

- lowering borrowing costs,
- hedging interest rate risk,
- matching assets and liabilities in terms of interest rate risk,
- increasing flexibility in financings, especially when it comes to refundings, and
- reducing reliance on bank liquidity agreements (for variable rate demand bonds)

These potential benefits must be weighed against certain risks that are inherent in swap agreements, including:

- counterparty risk,
- termination risk,
- interest rate risk,
- basis risk, and
- roll-over risk

The District shall pursue swap transactions only with the following strategies in mind. Each swap can achieve one or more of these strategies.

1. Mitigate the effect of fluctuations in variable interest rates.
2. Reduce interest expense from expected benefit resulting from the difference between tax-exempt and taxable rates.
3. Convert a portion of fixed-rate debt to variable in an environment of higher long term fixed rates and lower variable rates, with no ongoing liquidity fees.

*Policy Statement*

The goal of this procedure is to establish interest rate management guidelines and to mitigate risks associated with interest rate swaps that have become pronounced due to recent market conditions and disruptions. This policy incorporates the requirements of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and the business practice requirements of the U.S. Commodities Futures Trading Commission (CFTC). It is also based on the recommended practices of the Government Finance Officers of America (GFOA) and the published criteria of the three major rating agencies Moody's Investor Services, Standard & Poor's, and Fitch Ratings.

While the appropriate use of swaps has been proven to lower borrowing costs and hedge interest rate risk, it is critical that the District consider and evaluate these agreements within its overall financing strategy.

The goal of this procedure is to manage prudently the risks associated with the District's debt obligations so as to balance the following objectives:

- reduce the risk of economic loss,
- match assets and liabilities,
- minimize the cost of capital, and
- mitigate exposure to unexpected market volatility

This swap management procedure also sets forth the manner of execution of swap agreements, provides for their security and payment provisions, the ongoing monitoring of the agreements, and sets forth certain other provisions related to these agreements between the District and qualified swap counterparties. As used throughout this policy, the term "swaps" includes interest rate swaps, basis swaps, caps, floors, collars, options and other related derivative financial products.

#### Purpose

The issuance of debt by the District involves a variety of interest rate and other risks that may be offset, hedged, modified, increased or reduced through the use of interest rate swap agreements. It is the policy of the District to utilize, when prudent, swap instruments to better manage its assets and liabilities. The District may enter into interest rate swap agreements if the transaction can be anticipated to result in one or more of the following:

- Reduce exposure to changes in interest rates on a particular financial transaction or in the context of the management of interest rate risk derived from the District's overall asset/liability balance;
- Result in a lower expected net cost of borrowing with respect to the District's debt as compared to products available in the bond market;
- Manage variable interest rate exposure consistent with prudent debt practices;
- Manage exposure to changing market conditions in advance of anticipated bond issues (through the use of anticipatory hedging instruments);
- Achieve more flexibility in meeting overall financial objectives than can be achieved in using traditional fixed-rate transactions;
- Manage the exposure to the risk of changes in the legal and regulatory treatment of tax-exempt bonds, including changes in federal marginal tax rates and other changes in tax laws that may affect the value of tax-exempt bonds relative to other investment alternatives;
- Manage credit exposure to financial institutions and other entities through the use of offsetting swaps and other credit management products; and
- Strengthen the District's balance sheet.

#### Legal Framework

As a duly constituted and existing unit of local government, body politic, and political subdivision of the State of California, operating under the provisions of the Title 3, Division 7, Part 43 of the Education Code of the State of California, the District, pursuant to Section 5922 of the Government Code of the State of California, is empowered to enter into public finance contracts in connection with, or incidental to, the issuance or carrying of bonds, including contracts commonly known as interest rate swap agreements, in order to manage interest rate risks or levels with respect to its obligations. Specific transactions are authorized by the Board of Trustees by way of a resolution process in connection with the issuance of the underlying bonds before, concurrently with, or after the actual issuance of the bonds.

#### Senior Management Oversight

The District's Vice Chancellor, Finance and Administration ("VCFA") shall review this policy periodically to take into account business and market changes and shall be responsible for ensuring the implementation

of this policy, procedures and proposing amendments to take into consideration, as applicable:

- An analysis of the reasonableness of the proposed activities in relation to the District's overall financial condition, credit and capital levels;
- An analysis of the risks that may arise from the implementation of a swap portfolio;
- An analysis of the performance of existing swap transactions over time as market conditions may change;
- Impact of counterparty exposure as counterparty credit ratings change over time;
- Potential effects that the swap portfolio may have on the credit ratings of any District obligations assigned by the rating agencies;
- The relevant accounting guidelines, including GASB Statements Number 53 and Number 64, any related supplements;
- The relevant tax treatment; and
- An analysis of any changes to legislation authorizing swaps and any new legal restrictions or requirements (state or federal) which may impact the enforceability of the swap obligations and the manner in which swap transactions are entered into and procured.

#### Conditions for the Procurement of Interest Rate Swaps

Recommendations to enter into swap agreements will be made based on analyses performed by the VCFA or a qualified independent representative. Recommendations will consider the following:

- The appropriateness of the transaction for the District based on the balance of risks and rewards presented by the proposed transaction, including a detailed analysis of the transactional structure, a review of the risks and rewards (such as the present value savings of the interest rate swap relative to the value of a fixed-rate call option) and risk mitigation measures;
- The legal framework for the transaction within the context of California state law, relevant indenture and contractual requirements (including those contained in credit enhancement or bank agreements), as well as any implications of the transaction under federal law including tax regulations;
- Potential effects that the transaction may have on the credit ratings assigned by the rating agencies on any of the District's debt obligations;
- The potential impact of the transaction on costs and availability of liquidity support or credit enhancement for new and existing variable rate debt, recognizing the limited sources in the current economic environment;
- The ability of the District to handle any administrative burden that may be imposed by the transaction, including accounting and financial reporting requirements and monthly settlements; and
- Other implications of the proposed transaction as warranted.

Final approval to enter into a swap will be made by the District's Board of Trustees based on a recommendation from the Chancellor.

#### Limitation on Derivatives

The notional amount of interest rate swap transactions resulting in variable interest rate exposure will equal an identified amount of outstanding District bonds, not to exceed 100% of the total District debt outstanding.

### Non-Speculation

While the District may use swaps to increase or decrease the amount of variable rate exposure on its balance sheet, it will not enter into swap agreements under any of the following circumstances:

- The swap will expose the District to extraordinary leverage or risk;
- The swap serves a purely speculative purpose, such as entering into a swap for the sole purpose of trading gains;
- District is unable to reasonably anticipate that it will have sufficient liquidity or financing capacity to terminate the swap at market rates, if it should need to; or
- There is insufficient pricing data available to allow the District and its advisors to adequately value the swap on an ongoing basis.

### Qualified Swap Counterparties

Qualified swap counterparties shall be a bank, insurance company or other financial institution duly qualified to do business in the State of California that is, or whose obligations are guaranteed by an entity that is, at the time of execution of a swap transaction, rated at least 'Aa3' or 'AA-' or equivalent by any one of the nationally recognized rating agencies. Alternatively, the District may consider counterparties rated in the 'A' category by at least two rating agencies, so long as they agree to provide collateral to District in the 'A' category subject to the minimum standards specified below. All such swap counterparties shall have a demonstrated record of executing similar swap agreements and have shown a commitment to acting as counterparty to municipalities in California. Exceptions may be granted if specifically approved by the VCFA, Chancellor and Board of Trustees.

In order to limit the District's counterparty risk, the District will seek to avoid excessive concentration to a single counterparty or guarantor by diversifying its counterparty exposure over time. Exposure to any counterparty or guarantor will be measured by computing the District's Maximum Potential Exposure. Maximum Potential Exposure provides a quantification of the District's worst case swap exposure. It is calculated by applying stress tests to District swaps to show how large the potential termination costs of the swaps could be if markets moved in an extremely adverse manner. Market movements are calculated assuming a two standard deviation change from the sample mean in market rates, based on historic volatilities, to provide better than 95% degree of confidence.

As detailed below, all counterparties will be required to post collateral (subject to threshold amounts) for the District's benefit in the event that they fall below the ratings specified above.

### Procurement

District may choose counterparties for entering into swap agreements on either a negotiated or competitive basis. As a general rule for entering into new swap agreements, a competitive selection process will be used whenever reasonable, if the product is relatively standard and/or if it can be broken down into standard components. Negotiated procurements may be used for original or proprietary products, for original ideas of applying a specified product to a District need, to avoid market-pricing effects or timing delays that would be detrimental to District's interests, to assist in the diversification of counterparty exposure or on a discretionary basis in conjunction with other business purposes. Consideration may be given in negotiated transactions to those counterparties who have provided a high level of service to the District in its capacity as part of District's investment banking team.

To provide safeguards on swap transactions and to comply with applicable state and federal law, the District shall engage a professional financial adviser to assist in the process of structuring, documenting and pricing the swap transactions, to provide representations in accordance with applicable law and to render an opinion that a fair price was obtained.

In all transactions, regardless of procurement method, the counterparty shall represent that no payments were made to third parties (including lobbyists, consultants and attorneys) who had any involvement in assisting the counterparty in securing business with Peralta.

#### Qualified Independent Representative

District will enter into a contract with a firm or firms that have the qualifications to act as a qualified independent representative to the District in accordance with the requirements of CFTC Regulation §23.450 and its related safe harbor provisions and in such contract such firm or firms will make representations and provide agreements to satisfy the requirements and safe harbors of CFTC Regulation §23.450 in a manner satisfactory to the District.<sup>1</sup> Such firm or firms to act as a qualified independent representative to the District will have been selected via a public procurement process.

District will utilize the services of such qualified independent representative when (i) entering into a new swap transaction, (ii) modifying, terminating (in whole or in part), transferring or novating an existing swap transaction, or (iii) discussing the possibility of the transactions in (i) and/or (ii) with a swap counterparty.

District will monitor the continued performance of each qualified independent representative by requesting certifications at least annually from each qualified independent representative restating that the representations and agreements in the contract described above are true and correct and by requiring in the contract described above prompt notice by the qualified independent representative of any failure of a representation or agreement to be true and correct.

#### Form and Terms of Swap Agreement

Each interest rate swap agreement executed shall contain terms and conditions as set forth in the 1992 International Swaps and Derivatives Association, Inc. (ISDA) Master Agreements, including any Schedules to the Master Agreement, Confirmations and Credit Support Annexes, unless otherwise recommended by the District's financial advisor and agreed upon by the District. The swap agreements between District and each qualified swap counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the District deems necessary or desirable.

#### Notional Amount and Term

The term of the swap agreement entered into concurrently with the issuance of bonds shall not extend beyond the final maturity date of the related bonds. The total notional amount of such swap agreements shall not exceed the principal amount of such bonds or notes (as reduced by the amortization schedule). In connection with the execution of a swap transaction, the District shall certify as to the bond or note issuance with which a swap transaction is identified. In certain limited circumstances, the District may modify or take other action with respect to existing swap transactions as may be necessary, including without limitation, transferring the identification of any swap transaction from one bond or note issue to another.

#### Termination Events and Events of Default

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<sup>1</sup> In accordance with CFTC Regulation §23.450(b)(i), the qualified independent representative (i) has sufficient knowledge to evaluate the transaction and risks; (ii) is not subject to a statutory disqualification; (iii) is independent of the swap dealer or major swap participant; (iv) undertakes a duty to act in the best interests of the Special Entity it represents; (v) makes appropriate and timely disclosures to the Special Entity; (vi) evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; and (vii) is subject to restrictions on certain political contributions imposed by the Commission, the Securities and Exchange Commission, or a self-regulatory organization subject to the jurisdiction of the Commission or the Securities and Exchange Commission, provided however, that the representative is not an employee of the Special Entity.

The District shall include in all swap agreements provisions that grant the District the right to optionally terminate a swap agreement at any time over the term of the agreement at market rates or assign that agreement to a third party (subject to counterparty approval). The counterparty shall not generally have a similar optional termination right.

District will require additional termination events (ATE's) if the counterparty (or its credit support provider) fails to maintain at least two ratings of:

1. A credit rating of at least 'Baa2' from Moody's Investors Service; and/or,
2. A credit rating of at least 'BBB' from Standard & Poor's Ratings Services; and/or,
3. A credit rating of at least 'BBB' from Fitch Ratings, Inc.

For the purposes of any termination due to a rating downgrade of the counterparty (or its credit support provider), the counterparty shall be the Affected Party. Recognizing the lower likelihood of default of governmental entities, any ATE's relating to District's credit will be set at appropriately lower ratings thresholds (for example, 'Baa3' from Moody's and 'BBB-' from Fitch Ratings and Standard & Poor's Ratings Services). Alternatives to these ATE ratings thresholds may be utilized subject to confirmation from the District's financial advisor that the alternative levels are more beneficial to the District, including collateralization thresholds.

Payments on Termination

A termination payment to or from the District may be required in the event of termination of a swap agreement due to an optional termination, a termination event or an event of default. Termination amounts shall be calculated pursuant to Market Quotation, Second Method methodology, unless an alternative methodology recommended by the District's financial advisor and demonstrated by such financial advisor to the VCFA to be more beneficial to the District if agreed upon by the District.

Notwithstanding the foregoing, in general the District will seek to avoid making an out-of-pocket termination payment to a counterparty that has defaulted under the agreement. Prior to making any such termination payment, the District shall evaluate whether it is financially advantageous for District to obtain a replacement counterparty to avoid making such termination payment from funds on hand, to finance the termination payment through a long-term financing product or use other techniques to avoid having the counterparty's default create an undesired impact on the District's finances.

Collateral Requirements

As part of any swap agreement, the District will require its counterparty to post collateral or other credit enhancement to secure any or all swap payment obligations. As appropriate, District may require collateral or other credit enhancement to be posted by the swap counterparty under the following circumstances:

- The counterparty will be required to post collateral (subject to threshold amounts set forth below) if its credit rating, or the rating of its credit support provider, falls below 'Aa3' or 'AA-'. Additional collateral for further decreases in credit ratings of the counterparty and for changes in the market value of the collateralized swap agreements shall be posted in accordance with the provisions contained in the collateral support agreement to each swap agreement between Peralta and the counterparty. In the event of split ratings, the lowest rating shall govern.

| <u>Moody's</u> | <u>S&amp;P</u> | <u>Fitch</u>   | <u>Threshold</u> |
|----------------|----------------|----------------|------------------|
| Aa3 and above  | AA- and above  | AA- and above  | Infinite         |
| A1             | A+             | A+             | \$ 20,000,000    |
| A2             | A              | A              | \$ 10,000,000    |
| A3             | A-             | A-             | 0                |
| Baa1 and below | BBB+ and below | BBB+ and below | 0                |

- Collateral shall consist of the following, as determined by the District:

|  | <u>Valuation Percentage</u> |
|--|-----------------------------|
| Cash   | 100%                        |
| Negotiable debt obligations issued by the U.S. Treasury Department (“Treasury Securities”) having a remaining term to maturity of not more than 1 year | 98%                         |
| Negotiable Treasury Securities having a remaining term to maturity of more than 1 year but not less than 5 years                                       | 96%                         |
| Negotiable Treasury Securities having a remaining term to maturity of more than 5 years but less than 10 years   | 94%                         |

- Collateral shall be deposited with a third party trustee, or as mutually agreed upon between the District and each 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 and the collateralized swap agreements shall be determined on at least a weekly basis; and
- District shall determine on a case-by-case basis whether other forms of credit enhancement are more beneficial to Peralta or if the collateral posting thresholds may be modified in order to achieve other benefits on either an individual transaction or on all transactions with a specific counterparty.
- To the extent the District agrees to lower counterparty ATE ratings thresholds, more restrictive collateral posting requirements should be implemented, including, but not limited to, the posting of an Independent Amount.

Collateral posting will be one-way with the District as the secured party. There will be no collateral posted by the District.

Security and Source of Repayment

The obligations of the District pursuant to the swap agreement may only be secured by lawfully available funds subject to the constitutional debt limits of Article XIII of the Constitution of the State of California.

Other Provisions – Transfer, Set-Off, Automatic Early Termination

Set-off - District will provide in its swap agreements that without affecting the provisions of the swap agreement requiring the calculation of certain net payment amounts under such swap agreement, any amount payable under a swap agreement in respect of an early termination date shall not be subject to any set-off. The purpose of this provision is to make clear that obligations between the District and a swap counterparty under other contracts or agreements will not be able to be set-off against termination payments due in connection with a swap agreement.

Transfer –District will modify the transfer restrictions in swap agreements to make clear that a party’s consent to a transfer of the swap agreement or any interest or obligation in or under such swap

agreement (whether by way of security or otherwise) cannot be unreasonably withheld in order to facilitate a transfer if desired by the District.

Automatic Early Termination – The provisions in a swap agreement relating to automatic early termination will not be applicable to the District. The provisions in a swap agreement relating to automatic early termination will not be applicable to the swap counterparty unless otherwise recommended by the District's financial advisor and agreed upon by District.

#### Governing Law

Swap agreements shall be governed by the laws of the State of California.

#### Tax Considerations

If payments on and receipts from an interest rate swap agreement are to be taken into consideration in computing the yield on a related bond issuance (an integrated swap), such swap agreement must meet certain requirements in order to be 'integrated' under federal tax law. If the variable yield on a bond issuance is to be converted into a fixed yield through an interest rate swap agreement (a super integrated swap), certain additional federal tax law requirements must be met. In any case, the terms any such swap agreement and the procurement process must be reviewed in advance by tax counsel.

District shall also consider potential exposure as a result of actual or potential changes in federal tax policy and law.

#### Ongoing Swap Monitoring

For swaps that are being used as hedges, the goal for hedge efficacy is minimal basis mismatch between the bonds and the swaps. District should monitor hedge efficacy on an annual basis. Basis risk should be quantified per swap agreement, on both a cumulative basis and by basis point differential on a periodic basis. Since the remarketing of variable rate demand bonds (VRDBs) can contribute to the basis mismatch variance, the District should also actively monitor the performance of its remarketing agents for each series of VRDBs.

The data collected as part of this monitoring should be used by the District to determine and adopt basis risk tolerance levels. As a guideline, the basis mismatch should be within 25 basis points on average over any given 90 day period. Should basis risk exist in a particular swap, District should investigate the source of the risk to determine whether it is related to the swap or the associated bonds.

District should monitor on an annual basis the overall efficacy of each swap in the context of all other outstanding debt. Termination value/cost should be quantified and evaluated per swap agreement.

District shall engage a financial advisory firm to assist in the monitoring of its swaps on an on-going basis. Financial advisors will provide recommendations consistent with this policy and representations to the District on an annual basis in accordance with the requirements of applicable law.

#### Ongoing Reporting and Recordkeeping Requirements

Written records noting the status of all interest rate swap agreements shall be maintained by the District in both electronic and written form, and disclosed on a regular basis. District shall maintain full records in the manner specified in the Dodd-Frank Wall Street Reform and Consumer Protection Act related to interest rate swap agreements for at least five years following the final termination of each transaction. Such records must be retrievable within five business days. These records shall include the following information:

- ISDA Master Agreements, including associated Schedules, Credit Support Annexes and Confirmations;



- Highlights of all material changes to swap agreements or new swap agreements entered into by District since the last report;
- A summary of each swap agreement, including but not limited to the type of swap, the rates paid by the District and received by District, indices, additional termination event criteria, collateral posting criteria, and other key terms;
- Market values of each of District's swap agreements;
- For each counterparty, the District shall provide the total notional amount position, Maximum Potential Exposure, the average life of each swap agreement, and the available capacity to enter into additional swap transactions (assuming quantitative capacity limits have been established);
- Basis mismatch risk per swap agreement;
- The credit rating of each swap counterparty or credit support provider (where relevant);
- A determination that all posted collateral has a net market value of at least the collateral requirements specified in the applicable credit support annex;
- Information concerning any default by a swap counterparty, and the results of the default, including but not limited to the financial impact to District, if any;
- A summary of any swap agreements that were terminated since the prior report; and
- An annual update of representations from District's financial advisor with respect to swap agreements in accordance with the requirements of applicable law.

District shall file all necessary documentation to comply with ongoing swap reporting requirements under applicable law. District will amend its existing ISDA master agreements with swap counterparties as necessary to comply with requirements of Dodd-Frank, either through completion and distribution of applicable ISDA Protocol documentation and/or through direct negotiation of amendments with individual counterparties.

Each employee or representative of the District that enters into discussions with a swap counterparty regarding a swap transaction or the master agreement (including the related schedule and credit support annex, if applicable) that governs such swap transaction acknowledges and agrees that the discussions will be recorded by the swap counterparty and consents to the recording and agrees to sign an annual acknowledgement form stating that they have notice of and consent to the recording of discussions of swap documentation and transactions.

District shall ensure that it reflects the use of swaps on its financial statements in accordance with GASB requirements, including Technical Bulletin No. 2003-1, and GASB Statements 53 & 64, as applicable. The disclosure requirements include:

- Objective of the Derivative
- A Summary of Key Terms
- Name, Description and Credit Rating of Counterparty/Guarantor
- Mark to Market Value
- Debt Issued in Association with the Swap
- Peak Exposure Risk
- Measurement of Hedge Effectiveness

5%Reference:

Approved by the Chancellor: May 6, 2016