



**PENNSYLVANIA
STATE SENATE FINANCE
COMMITTEE HEARING ON
SWAP LEGISLATION**

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SUBSTANTIAL PROGRESS MADE BY BETHLEHEM AREA SCHOOL DISTRICT

1/1/2009

4/1/2010

\$221,085,000

\$125,935,000

Total outstanding principal amount of variable rate debt

\$50,565,000

\$172,670,000

Total outstanding principal amount of fixed rate debt

80%

42%

Percent of total debt principal variable rate

8

4

Number of active swap contracts

\$422,870,000

\$169,505,000

Total notional amount of all active swaps (including overlap)

\$222,140,000

\$169,505,000

Total principal amount of debt attached to swaps

\$73,513,381

\$19,304,725

Cost to terminate all active swaps (net of counterparty spread)

\$372,115,000

\$124,605,000

Notional amount of tax law risk (LIBOR swaps)

137%

42%

Percentage of debt subject to tax law risk (LIBOR swaps)

\$149,975,000

\$0

Principal amount of yield curve risk (constant maturity swaps)

54%

0%

Percentage of debt subject to yield curve risk (CMS swaps)

A

A

S&P Bond Rating (state intercept only)

A3

Baa1/A1

Moody's Bond Rating (underlying/state intercept)

From Public Financial Management Inc. public meeting reports to BASD Board

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Swap termination fees paid/received by BASD since 1/1/2009
(\$12,300,000 payment cited in AG report):

BASD Paid (Fixed Payer)

\$16,008,000

BASD Received (CMS/Basis)

\$3,038,065

From Public Financial Management Inc. public meeting reports to BASD Board

Estimated advisor fees and counterparty spread paid by BASD on swaps:

<u>BASD Paid</u>	<u>Typical</u>	
.09% - .20%	.04% - .10%	Estimated spread (mark-up) charged by swap counterparties (2003 to 2007)
.04% - .10%	.02%	Advisor fees paid per swap transaction (2003 to 2007)

From Public Financial Management Inc. public meeting reports to BASD Board

WHAT HAVE WE OBSERVED SINCE THE ENACTMENT OF ACT 23 OF 2003

(legislation that added swap provisions
to the Pennsylvania Local Government
Unit Debt Act)?

1. THE AMOUNT OF VARIABLE RATE BONDS INCREASED STATEWIDE

- Average School Board member understands interest rate risk
- Fixed payer swaps were marketed as a comprehensive hedge to create “synthetically fixed” rate debt (same as fixed rate bonds but cheaper)
- Synthetically fixed = monthly interest payments on bonds + liquidity fees + remarketing fees + trustee fees + fixed rate swap payments – variable rate swap receipts < fixed rate bond yield
 - All parts had to work as planned (or according to historic norms)
 - Could intentionally introduce tax rate risk if swap was LIBOR based

- **Problems:**

- Optional tender right (“put” option) is required by buyers of “Variable Rate Demand Bonds” (VRDBs) (money market mutual funds, etc.); bondholders could demand that the issuer buy bonds back on 7 days notice
- Standby bond purchase agreements or letters of credit are short-term bank loan commitments (3 to 5 years in 2007, 2 to 3 years now); bank buys bonds that cannot be remarketed – become “bank bonds” at higher interest rates
- 20 year VRDBs (and swap) must assume easy extension or replacement of bank liquidity
- “Liquidity risk” was largely ignored and uncontrollable by the issuer

- Enter the new risk paradigm (loss of cheap and plentiful liquidity)
 - Banks were downgraded or simply abandoned the market
 - Typical liquidity fees increased dramatically from .15% to 1.0%+ today.
- In a low rate environment, swaps forced issuers to maintain their variable rate debt or pay to terminate for swap
 - LGUDA requires swaps to be terminated as the related debt is reduced (or refunded to fixed rate)
- Irony: It was not the swaps that blew up, but rather it was the variable rate debt that had to be maintained to support the swaps

POSSIBLE REGULATIONS/AMENDMENTS:

- **The length of a swap attached to variable rate debt shall not exceed the lesser of (1) the final maturity date of the bond issue, (2) the term (length) of the letter of credit, standby bond purchase agreement or other third party liquidity facility supporting the tender option on such bonds, or (3) the maturity or mandatory tender date of bonds required to be remarketed or refunded in full prior to the final maturity date of the issue.**
- **The required Interest Rate Management Plan (IRMP) shall include:**
 - **if the related bonds are variable rate, a discussion of the risks inherent to the bond structure, as well as the swap, and a fee, cost and payment comparison with conventional fixed rate bonds**
 - **a discussion of the government unit's debt structure illustrating principal amounts and percentages of variable and fixed rate in light of published recommendations by at least one rating agency or bond insurer (distinguishing those recommendations if appropriate)**

2. FORWARD STARTING SWAPS AND SWAPTIONS WERE MARKETED AS HEDGES AGAINST RISING INTEREST RATES (FOR FUTURE CAPITAL PROJECTS AND PROHIBITED ADVANCE REFUNDINGS)

- Forward Starting Swaps (FSS) were put in place years before capital projects were expected to begin construction
- Potential problems:
 - Changes in project timing (must pay swap fee to extend FSS start date)
 - Reduced project costs (bond principal will not match FSS schedule)
 - Assumes a bond counsel opinion can be issued on the future bonds (can tax law spending requirements be met on the swap start date?)
 - BUT compare with common practice of issuing fixed rate bonds before bids, known as “advance funding” (currently high negative earnings (arbitrage) on bond proceeds in construction fund)

- “Swaptions”: up-front payment(s) on forward starting swap in lieu of savings from prohibited advance refunding
 - Now you have to replace existing fixed rate debt with variable rate debt (and live with the consequences)
 - BUT government unit may have already spent the payment to plug a budget hole (though LGUDA says swaps must manage interest rate risk or cost)
 - “Off market” swaps increase the up-front payment in exchange for larger periodic payments on the swap (increases termination payment also)
 - Does this look like “unfunded debt” (which requires court approval)?

POSSIBLE REGULATIONS/AMENDMENTS:

- **The enforceability of a swap shall be conditional on the related bonds being issued within one year of its date.**
- **Any funds received by a government unit as a result of entering into, modifying or terminating a swap shall be used exclusively to pay debt service (current or as a reserve for future debt payments), or to terminate a swap**
- **The financial advisor “fairness” opinion shall be required for swap terminations as well as for new swaps**

3. CASH FLOW SWAPS TIED TO MOVEMENTS IN DIFFERENT INTEREST RATE MARKETS OR TO SIMULATE VARIABLE RATE DEBT

- Since 2003 most “constant maturity swaps” (yield curve risk) and basis swaps (tax rate risk) have resulted in payments to local governments
- Often basis swap was combined with the fixed payer swap used to create synthetic fixed (one reason synthetic fixed looked better than conventional fixed)
- Complex benchmarks - must rely almost entirely on advisors to identify historic anomalies or predict future results (but every presentation includes a disclaimer on predictions)

- Should board members or administration be trained to understand the changing slope of the yield curve?
- What “science” predicts the direction and magnitude of changes in federal income tax rates?
- Historical averages can be tailored to produce a desired result; like the stock market, looking back 20 or 30 years is very different from the past 10 years (or 2 years)
- How do we weigh once in a generation market meltdowns?
- Characterizing a government unit’s swap loss as a win for the counterparty not really accurate:
 - Counterparty makes money (margin or spread) on the initial “trade” (larger + longer = more profitable and risky)
 - Advisors better off if district makes money

- Proper sizing of a swap to hedge average cash balance not addressed anywhere (available debt to attach to cash flow swaps far higher than average cash balances)
- Is a long term contract appropriate for a fluctuating fund balance?
- How much risk gets the job done?

• **POSSIBLE REGULATION/AMENDMENT:**

- **A swap used for asset liability hedging shall not exceed 100% of the total amount held on deposit in the government unit's operating and reserve funds averaged over its past 3 fiscal years (could also use percentage of "Borrowing Base").**

4. RECENT EXPERIENCE WITH CONSEQUENCES OF MULTIPLE RISKS EMBEDDED IN SWAPS AND RELATED VARIABLE DEBT

- Under traditional fixed rate bonds, bondholder assumes all risks and issuer assumes none (though must pay issuance costs to later refund to lower fixed rates)
- Issuer reduces fixed bond refunding costs with “call rights” (ability to prepay fixed rate bonds, typically 5-10 years from issuance); variable rate bonds callable any time (if no swap in place)

- Swaps and variable debt slice various component risks that can be passed on to the issuer
- Examine the risk matrix of a typical interest rate management plan:
 - Interest rate risk
 - Yield curve risk
 - Tax rate (basis) risk
 - Liquidity risk
 - Counterparty risk
 - Swap termination/cross default risk
 - Swap termination payments not covered by usual debt safeguards:
 - Not payable from state subsidy or intercept
 - Not eligible for Act 1 Index exception
 - Federal tax regulations may prevent financing through tax-exempt bonds
 - Currently need a refunding bond issue to finance termination payment (problem if terminating forward starting swap)

POSSIBLE REGULATIONS/AMENDMENTS:

- A swap cannot be approved by formal action of the governing board until at least three (3) calendar days after a public hearing conducted at a board meeting where the financial advisor presents the interest rate management plan and answers questions regarding the transaction
- A swap termination payment can be funded as an eligible project cost independently as well as part of a refunding issue

5. SWAPS CONTAIN DEFAULT AND CROSS-DEFAULT EVENTS IN ADDITION TO NON-PAYMENT

- A common tool (or “remedy”) available to bondholders (and trustees) is the right to “accelerate” the debt so that all principal is payable immediately
 - Likewise, a swap counterparty can demand payment after an “Additional Termination Event” under standard documents
- The LGUDA only discusses remedies for payment defaults, but swaps and some structured loans include non-payment defaults such as:
 - Downgrades on parity debt or other swaps (either rating agency)
 - Insufficient payment coverage from state intercept program
 - Minimum bank deposit relationship (reduced fund balance?)
- Swap cross-default language (contained in swap documents) could accelerate additional debt and/or terminate multiple swaps

POSSIBLE REGULATIONS/AMENDMENTS:

- **In the case of school districts, the counterparty may not terminate a swap prematurely as a result of a credit rating downgrade unless the ratings of both the district making the swap filing and the Commonwealth's subsidy intercept rating fall below a level specified in the swap**
- **The interest rate management plan shall contain a description of the early termination events and cross-default provisions in the proposed swap and loan documents**

6. AMBIGUOUS DISCLOSURE REQUIREMENTS UNDER ACT 23 (WHAT IS A “FEE”?)

- Under Act 23 the independent financial advisor must give written opinion that the “financial terms and conditions” of the swap are “fair and reasonable” to the government unit “as of the date of the award”
- LGUDA only requires the disclosure of “fees” in the interest rate management plan – many counterparties insist (and some financial advisors agree) the spread (counterparty markup) is not a “fee” (though it is the largest charge) and not required to be disclosed (hard for lawyer to argue)
- Fees and spreads disclosed are often expressed as “basis points” (1/100 of one percent) – seemingly small % can turn into very large number in dollars
- Computer required to calculate compensation from basis points
- IRS looking at excessive spreads integrated in bond yield

- Final terms of swap disclosed in a private telephone call and accepted orally on a recorded line; might not mention final spread (basis points or dollars) to be charged (just final rates); who should be on the call?
- No formal DCED approval of swap filings (notice filings can always be legally challenged – unlike debt approvals)
- Legal enforceability opinions must rely on lawyers' interpretation of compliance (not like DCED debt approval) to preclude later lawsuit

POSSIBLE REGULATIONS/AMENDMENTS:

- **DCED should include in readily accessible public swap filing records the identities of the IFA, attorneys and counterparty identified in each IRMP, and include the fees and counterparty spread**
- **The IRMP shall include the following:**
 - **IFA, attorney and other professional fees and expenses associated with the transaction in total (or maximum) dollars**
 - **Maximum acceptable counterparty spread in basis points and resulting dollars**
 - **A certificate signed by the chief financial officer of the LGU outlining and acknowledging the actual or maximum fees and spreads (in dollars) associated with the swap**