"Swaps" Restrictions
Prime Sponsor: Senator Folmer
Senate Bill 342 of the 2015-2016 Session
Previous Cosponsors: Folmer, Blake, Eichelberger, Teplitz, Vulakovich, Vance, Yudichak, Schwank, Gordner, Boscola, Browne and Scavello

This legislation would restrict government entities from entering into interest rate management agreements, commonly known as "swaps" or "derivatives".

Swaps are contracts under which parties agree to exchange (or swap) cash flow payment obligations. Under current law, a swap is required to relate to specific debt being issued by a local government under the Local Government Unit Debt Act (LGUDA). Swaps are between the local government and a financial institution, commonly referred to as the "counterparty".

The most generic swap structure involves the local government issuing variable rate debt and then entering into a swap under which the counterparty makes a variable rate payment to the local government and the local government makes a fixed rate payment to the counterparty. The goal is to create a "synthetic" fixed rate issue at a lower rate than if the local government issued regular fixed rate debt.

There are many other variations of swaps, such as a "basis swap" in which the local government makes payments to the counterparty based on one type of variable rate, and the counterparty makes payments to the local government based on another type of variable rate. This may produce a winner and a loser at any point in time.

Even more complicated swap structures include "synthetic refundings" or "swaptions" in which a counterparty makes a payment up front to the local government for a refunding that could not be accomplished today and the local government agrees to issue variable rate refunding bonds and enter into a swap at a future date.

Swaps have also been done under which the counterparty pays the local government an upfront payment to give the local government short term cash and the swap is then priced to have the local government pay back the upfront amount over time.

All of these swap structures involve the local government assuming risks it does not assume when it does a normal fixed or variable rate bond issue. Also, if the local government wants to get out of a swap early, it can end up having to pay a large termination fee to the counterparty.

When the Great Recession hit in 2008 and interest rates went low (and stayed low), many of the risks inherent in swap structures became reality and caused multi-million dollar losses for local governments, authorities, and school districts. From October 2003 to June 2009, Pennsylvania local governments, authorities, and schools entered into 626 swaps transactions on $14.9 Billion in debt and a number of them lost millions in taxpayer dollars due to swaps. Taxpayers cannot afford to pay losses incurred by their local governments on risky financial products.

My original plan – introduced in 2012 – would have banned so-called swaps. However, over the course of the last several years, this proposal was changed to restrict – but not ban – swaps. These changes include:

- Removing authorities from the scope of the bill;
- Clarifying required disclosures on consulting, advisory, brokerage, and other fees;
- Requiring swaps payments begin within one year (SB 342 previously required three);
- Providing indexes and bases for calculating swaps payments, and;
- Clarifying the good faith and full and fair disclosure of all required material facts and conflicts of interest required (including provisions under the Dodd-Frank law)

I believe swaps represent gambling with taxpayers' moneys, which is why I propose to:

- **Establish reasonable limits on swaps**:
  - Bar distressed communities from entering into swaps;
  - Require scheduled swaps payments begin one year after the agreement is signed;
  - Constrain local governments' ability to tie up more than 50% of its outstanding debt in swap transactions (there is no current limit);
  - Require swaps payments and termination fees be deposited into an account to ensure moneys are available for required payments;
  - Limit swaps agreements to 10 years maximum;
  - Cap payments to agreed-to schedules and termination requirements;
  - Base payments upon established indexes;

- **Require public disclosures before entering into swaps transactions**:
  - Note consulting, advisory, brokerage, and other fees paid to third parties;
  - Require local governments pass a resolution to authorize and award swaps agreements with at least 10 days advance public notice;
  - Provide information on how the swaps agreement was awarded;
  - Make available information on required payments, swaps covenant agreements, interest rates (including the maximum rate the local government will pay under the swap agreement), principal bond amounts, terms of the agreement, termination provisions, and the maximum interest rate for scheduled swaps payments and interest;
  - Note the source of moneys to cover payment obligations;
  - Explain the actions to be taken if credit ratings of the parties change;
  - Note the relationship to other debts (i.e., whether the swap will be senior or inferior debt);
  - Issue assurances the local government acknowledges and agrees with the terms of the swaps agreement and has complied with applicable rules and regulations (including the federal Dodd-Frank law);
  - Certify the local government has acted in good faith and made full and fair disclosure of all required material facts and any conflicts of interest in entering into the swap;
  - Represent and warrant the rate(s) used to calculate swaps payments are comparable to rate(s) the local government would have received from similar third parties;
  - Assure the local government it will notify the Department of Community & Economic Development of any termination payment under the swaps agreement;
  - Notify the public of how termination payments will be covered and how terminations will be determined (i.e., with cause), and;
  - How other parties to be involved in the swaps process will be selected and agreements executed (which may include an independent financial advisor)