

# Pennsylvania House Finance Committee-Swap Discussion

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March 3, 2010

# Why Do Issuers Use Swaps

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- ❑ Federal Tax Code restricts issuers to one advance refunding. Swaps allow issuers to take advantage of lower interest rates, when a traditional refunding doesn't work for tax or economic reasons.
- ❑ Issuers take advantage of short-term market rates to reduce their overall cost of capital.
- ❑ Issuers can convert fixed rate debt to a variable rate, without the need to refinance bonds and without the need to obtain credit from a bank. Since the credit market implosion in the fall of 2008, the cost of bank credit has increased 3 to 4 times.
- ❑ And, Issuers avoid the risk of remarketing agent performance.
- ❑ Realize economic benefit from market opportunities (flat or inverted yield curve, high tax-exempt to taxable ratios, etc...).

# Swap Structures

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- Variable to fixed rate swaps.
  - Allow issuers to convert variable rate debt to a fixed rate without incurring refunding/remarketing transaction costs.
  - Typically, takes less time to execute a swap than to complete a refunding/remarketing transaction.

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- Fixed to variable swaps.
    - Allow issuers to convert fixed rate debt to a variable rate.
    - Many issuers prefer a combination of fixed and variable rate debt.
    - Can be accomplished without a refunding transaction (bonds might not be callable).
    - Avoids credit costs for liquidity.
      - Since the credit market collapse in 2008, the cost of bank credit has increased 3x to 4x and terms are more onerous.
      - Issuer is not subject to Remarketing Agent performance or expense.

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## Basis Swap

- Issuer receives a taxable index rate and pays a tax-exempt index rate.
- Allows issuers to manage their cost of capital, with historically positive outcomes.
- Many issuers have taken advantage of the changes in market conditions to realize significant cash or cash flow benefit.

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## □ Constant Maturity Swap

- Issuers entered into CMS when the yield curve was flat.
- Were able to realize positive cash flow as the yield curve returned to a more normal positive slope. Historically, yield curves flatten at the point the FRB is close to the end of short-term rate increases and the market expects inflation and economic activity to moderate. As the FRB then reduces short-term rates, the yield curve typically returns to a positive slope.

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## □ Interest Rate Caps

- Allow issuers to cap their exposure to variable rates.

# SGA Practice

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- We meet with Business Manager, Treasurer or Director of Finance.
- We do not meet with Board members.
- After initial meeting, we allow client to discuss the swap proposal before meeting again.
- If, after 2<sup>nd</sup> meeting, we believe the client understands the risks and rewards and the economic benefit meets the objectives, we schedule a 3<sup>rd</sup> meeting, at which time the client can act upon the proposal.
- Some clients have taken several months to make a decision. Other clients, with some experience, are able to make a decision within a few meetings.
- Not all proposals are acted upon, based upon client's reaction, or market changes.
- Fees, including the swap providers margin, are fully disclosed early in the process. We require any and all consultant fees to be disclosed by vendors.
- We strongly discourage clients from using up-front swap payments for operating shortfalls.
- Preferably, swap proceeds finance capital assets, or add to reserves.
- Every client is directed to establish an interest rate reserve account to establish reserves for periods where cash flow is negative for the client.



# Bethlehem School District-What Went Wrong

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- ❑ As the Auditor General's report indicates, there was "no wrongdoing" at Bethlehem SD.
- ❑ In fact, the preponderance of damage was done by the failure of the bond insurers and liquidity providers.
- ❑ Bethlehem SD determined to exit their swaps at a time of extreme volatility and negative valuations.
- ❑ Other issuers that were in similar straits, substituted better and acceptable credit providers, or waited for the market volatility to subside before exiting their swaps.

# What Could Have Helped BASD?

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- Limits, similar to the Borrowing Base limits on aggregate debt, would limit any and every issuer's exposure.
- While we are not questioning the presentation of risks and rewards at BASD and the level of understanding of the administration and board of directors, assurance that issuers have time to think and respond to any proposal could help (i.e., a cooling off period after a proposal is made).

# Summary

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- From our experience, interest rate swap products have served our clients extremely well. We do not favor the repeal of Act 23.
- Revisions to ensure suitability would help issuers, advisors and swap providers. With few exceptions, in our opinion, financial and legal advisors are cautious about swaps and the appropriateness for their clients.
- As in any industry, some individuals and some firms will enter into transactions for the wrong reasons. That should not be a reason to eliminate a very valuable finance tool for municipalities.
- With all due respect to the Auditor General's recommendation to eliminate swaps for municipal entities, we suggest a broader sampling of the market and discussions with financial advisors, bond counsel and other swap providers would provide valuable insight into the due diligence, client suitability and responsibility and further investigation would suggest that ACT 23 has worked very well and should continue to be a valuable finance tool.

# The Other Side

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- I am a School Board Director at Central Dauphin SD.
- Early in 2009, after several meetings to review and discuss a basis swap proposal, the Board determined to enter into a Basis Swap, with a highly rated counter-party (we considered two).
- By June, 2009, the ratios had declined to a level that allowed the Board to establish a \$3,000,000 minimum payment threshold to terminate the swap. Within 2-3 months, the School District realized a one-time payment of approximately \$3,000,000.
- There was some delay in terminating the swap as we negotiated the final terms and fees.
- At this time, the CDSB Board is considering another, but different swap structure in an effort to manage our cost of capital and, ultimately, burden on the taxpayers.