

Commonwealth of Virginia Treasury Board Guidelines for Ancillary Contracts

1. Authority

These Guidelines are promulgated under the authority of § 2.2-2416 (8) of the *Code of Virginia*, which empowers the Treasury Board to “establish debt structuring guidelines for bonds or other financing arrangements ...” These Guidelines are an appendix to the *Treasury Board Debt Structuring and Issuance Guidelines*.

2. Purpose

These guidelines are intended to provide guidance to agencies, institutions, boards and authorities (“Issuers”) interested in entering into contracts ancillary to debt instruments under §2.2-4517 of the *Code*. Such ancillary contracts may include, but are not limited to, interest rate swaps, floors, caps, swaptions, or other “derivative” products (“Contracts”). These guidelines are further intended to insure that any agency, institution, board or authority has considered and addressed to the extent practical the important issues and risks inherent in any such contractual arrangement. These are guidelines only, and consideration of structures outside of these guidelines may be warranted.

3. Applicability

These guidelines apply to state agencies, institutions, boards and authorities subject to the provisions of §2.2-2416 (8) of the Code of Virginia.

4. Purpose of Contracts

- Contracts should not be used for speculative purposes. Contracts may be considered by Issuers in conjunction with bond issues for the following purposes:
 - To achieve an overall lower cost of funds (net of fees) compared to a product available in the bond market.
 - To prudently hedge interest rate risk.
 - To synthetically advance refund bond issues
 - To increase financial flexibility, and/or access different investor markets.

5. Risks

- Issuers and their governing bodies should understand and be able to address the risks associated with the Contract(s) and strategies to mitigate them. These may include:
 - Counterparty risk,
 - Rollover risk,
 - Basis risk,
 - Tax event risk,
 - Amortization risk, and
 - Termination risk.

6. Approval

- All procurements for services and the approval of the governing body should be obtained prior to seeking Treasury Board approval.
- An opinion from a nationally recognized law firm that the Contract is a legal, valid and binding obligation of the parties should be obtained.
- Documents should be reviewed on behalf of the Issuer by legal counsel (e.g., the Office of the Attorney General) for compliance with state law.

7. Internal Policy

- Managing swaps and other Contracts requires the on going commitment of the Issuer. Prior to entering into a Contract, the governing body of any Issuer should establish and adopt a policy statement and guidelines for managing the Contracts. The following areas should be addressed:
 - The permitted purposes/goals of using Contract(s),
 - Which Contracts or derivative products are eligible to be executed (swaps, swaptions, caps, floors, etc) and their permitted term,
 - Identification of risks and risk limits that the Issuer is willing to assume,
 - Approval
 - Who must approve and how will approval be evidenced?
 - Will the approval vary as a function of size, term, index, manner of procurement, counterparty?
 - Who determines conditions under which the Contract is terminated?
 - Who provides legal review for Issuer and validity opinion?
 - Counterparties and Contract related services
 - How selected?
 - How qualifications or eligibility to be determined?
 - Exposure limitations
 - Structuring
 - Use of standard documents
 - Limitation on indices used
 - Maximum terms
 - Termination provisions
 - Under what conditions can a derivative product be terminated?
 - Does either party have the right to terminate?
 - What are the procedures for termination?
 - How is the termination payment calculated?
 - Management, Monitoring and Oversight
 - How will the Contract be monitored and managed?
 - Who is responsible?
 - Frequency and source of mark-to-market values,
 - What are the plans to monitor net payments, risks under various interest rate scenarios, covenants, collateral coverage, counterparty exposure, rating changes, etc.?
 - What are the reporting requirements?
 - How frequently will the status be reported and to whom?

- Who is responsible for determining and reflecting the use of the Contract on the financial statements in compliance with generally accepted accounting principles?

8. Use of Advisors or Consultants

- The Treasury Board encourages the use of a qualified financial advisor or consultant to perform some or all of the following:
 - Conduct fair market value analysis,
 - Assess and advise on risks,
 - Monitor exposure, mark-to-market, or other ongoing oversight,
 - Assist in the development of policies, procedures and guidelines, and
 - Prepare or review cash-flow analyses.

9. Methods of Procuring Contracts

- Contracts and services related to Contracts should be competitively procured under the Virginia Public Procurement Act either under a competitive sealed bid or competitive negotiation (e.g., RFP) process.

10. Form of Contracts

- Any Contract should be based on and contain the terms and conditions set forth in the International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement.

11. Counterparties

- Counterparties should have at least two, long-term unsecured credit ratings in the double-A category from Fitch, Moody’s or Standard and Poor’s and should have demonstrated experience in successfully executing Contracts. Alternatively, ratings in the single-A category are acceptable so long as the transaction is adequately collateralized .
- In the event of downgrade below the minimal rating standard, the counterparty should be required to (i) provide a substitute guarantor or assign the Contract to an acceptable party meeting the rating criteria, or (ii) provide collateral in accordance with the Contract.
- Issuers should attempt to diversify exposure to counterparties.

12. Collateralization

- If the rating of the counterparty or any entity guaranteeing the counterparty’s payment obligation fall below the required rating, the obligations of the counterparty should be fully collateralized by direct or guaranteed obligations of the United States of America.

13. Credit Facilities

- Selection of providers of any credit enhancement or liquidity facility should be based on relevant criteria, including:
 - Credit rating
 - Capacity and ability to make required payments

- Trading value of the provider's facility
- Experience
- Cost
- Exposure of the Issuer to the provider, and exposure of the market to the provider.

14. Form of Application

Requests for Treasury Board approval of the terms of an ancillary contract should be submitted to the State Treasurer at a minimum of two weeks before the next scheduled meeting. See Attachment A for a summary of the information that should be provided to the Board in consideration of the Contract. The Board or staff may request additional information as needed.

Glossary

Amortization risk	The cost to the issuer of servicing debt or honoring swap payments due to a mismatch between bonds and the notional amount of swap outstanding.
Basis risk	Movement in the underlying variable rate indices may not be perfectly in tandem, creating a cost differential that could result in a net cash outflow from the issuer. Also the mismatch that can occur in a swap with both sides using floating, but different, rates.
BMA Index	The Bond Market Association Municipal Swap Index, the principal benchmark for the floating rate payments for tax-exempt issuers. The index is a national rate based on a market basket of high-grade, seven-day tax-exempt variable rate bond issues.
Counterparty risk	The risk that the other party in the derivative transaction fails to meet its obligations under the contract.
Hedge (1)	A transaction entered into to reduce exposure to market fluctuations.
Interest rate swap	A transaction in which two parties agree to exchange future net cash flows based on predetermined interest rate indices calculated on an agreed notional amount. The swap is not a debt instrument between the issuer and the counterparty, and there is no exchange of principal.
ISDA	International Swap Dealers Association, the global trade association with over 550 members that include dealers in the derivatives industry.
ISDA Master Agreement	The standardized master agreement for all swaps between the Issuer and the dealer, that identifies the definitions and terms governing the swap transaction.
Long-dated swap	A swap with a term of more than ten years. Often used in the municipal market, as issuers often prefer to use a hedge that matches the maturity of the underlying debt or investment.
LIBOR	The principal benchmark for floating rate payments for taxable issuers. The London Inter Bank Offer Rate is calculated as the average interest rate on Eurodollars traded between banks in London and can vary

	depending upon maturity (e.g., one month or six months).
Mark-to-market	A calculation of the value of a financial instrument (like an interest rate swap) based on the current market rates or prices of the underlying index (i.e., the variable on which the derivative is based).
Rollover risk	The risk that a swap maturity contract is not coterminous with the related bonds. In the case of the synthetic fixed rate debt structure, rollover risk means that the issuer would need to re-hedge its variable rate debt exposure upon swap maturity in incur re-hedging costs.
Termination risk	The risk that a swap will be terminated by the counterparty before maturity that could require the issuer to make a cash termination payment to the counterparty. Note: the issuer could have a termination payment even if the termination results from counterparty default.
Tax event risk	The risk stemming from changes in marginal income tax rates due to the tax code's impact on the trading value of tax-exempt bonds. A form of basis risk

Financing Summary of Ancillary Contract Related to Commonwealth Agencies, Institutions, Boards and Authorities

1. Description: Describe the contract/transaction in terms of the type of contract (e.g., fixed to variable swap, cap, etc.), the purpose of the Contract and the underlying bonds to which the transaction relates.
2. Provide a copy of the internal policy statement or guidelines concerning the use of such contracts adopted by the governing board.
 - 2.1. How does this transaction achieve the goals in the Issuer's internal guidelines?
3. Transaction approval – Provide evidence that the transaction has received approval of the governing board/delegated official.
4. Financing Team – What firms will serve in the various roles and what process was used for their selection?
 - 4.1. Counterparty/Dealer
 - 4.2. Legal Counsel
 - 4.3. Financial Advisor
5. Structure
 - 5.1. Term
 - 5.2. Index
 - 5.3. Counterparty
 - 5.3.1. Counterparty Rating:
 - 5.3.2. Rating After Collateral:
 - 5.3.3. Counterparty Exposure - Upon the completion of this transaction, what is the total amount of exposure to this counterparty. What percentage of exposure to counterparties does this particular counterparty represent?
 - 5.4. Termination Provisions
 - 5.5. Collateral Requirements
 - 5.6. Interest Rate Exposure - Upon the completion of the transaction, what is the total amount of exposure to variable rate? What percentage does this transaction represent?
6. Monitoring and Management
 - 6.1. How will the transaction be monitored (e.g., the risks and exposure assessed, changes in collateral coverage, counterparty rating changes, mark-to-market).
 - 6.2. How frequently will this be reported and to whom?