County Of Sacramento
Master Swap Policy

Approved by the
Sacramento County Board of Supervisors

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County of Sacramento

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COUNTY OF SACRAMENTO
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1. Introduction

The Master Swap Policy is intended to provide general procedural direction regarding the future use, negotiation and execution of interest rate swaps and swaptions. An interest rate swap is "an arrangement whereby two parties (called counterparties) enter into an agreement to exchange periodic interest payments." The payments are based on a fixed principal amount, called the "notional amount" because no principal amount is actually exchanged between parties; only interest is exchanged. In a typical interest rate swap, one party pays interest on the notional amount at a variable or "floating" rate, which fluctuates over time. The other party pays interest on the notional amount at a fixed rate for the life of the swap. The fixed rate is either bid or negotiated as the swap is executed. Swaps can be negotiated for a variety of terms and are generally not less than two years and not more than 30 years.

Interest rate swaps, and related financial instruments, such as swap options ("swaptions"), can be beneficial interest rate management tools that can assist the County of Sacramento (the "County") as part of its overall debt and investment management program. Swaps may be used to lock-in current market fixed interest rates or to effectively create a variable interest rate portion of the County's debt portfolio.

2. Authority

The County of Sacramento Board of Supervisors (the "Board") may adopt resolutions from time to time authorizing the execution and delivery by the County and any affiliated entities of the County of interest rate swap transactions and related agreements in accordance with the provisions of Section 5922 of the Government Code. Such resolutions will authorize the County to enter into interest rate swaps to 1) prudently reduce the exposure to changes in interest rates by capping variable interest payments; or 2) to achieve a lower net cost of borrowing with respect to such County debt.

In addition, such resolutions will authorize the execution of swaps and related agreements, provide for security and payment provisions, and set forth certain other provisions related to swap agreements between the County and qualified swap counterparties.

3. Purpose and Approval Process

The purposes for which the County may utilize interest rate swaps are specified in Section 5922(a) of the Government Code. The Chief Financial/Operations Officer (the "CFO/O") and Director of Finance (the "DOF") of the County will recommend the use of these products only in a manner consistent with this Master Swap Policy and only if the Board can make the requisite finding(s) required in Section 5922(a) of the Government Code. The purposes for which the County will consider the use of these products are:

a. To prudently reduce the exposure to changes in interest rates by capping variable interest payments; or

b. To achieve a lower net cost of borrowing with respect to such County debt.

As required by the Government Code, no local agency, including the County, can enter into any contracts or arrangements unless its governing body first determines that the contract, arrangement, or program of contracts is designed to reduce the amount or duration of payment, currency, rate, spread, or similar risk or result in a lower cost of borrowing when used in combination with the issuance of bonds or enhance the relationship between risk and return with respect to the investment or program of investment in connection with, or incident to, the contract or arrangement which is to be entered into. When the CFO/O and DOF recommends the use of a swap or other derivative product(s), the County Debt Utilization Committee (the "CDUC") consisting of the CFO/O, DOF, the Administrator of the County Municipal Services Agency, the Director of Airports, and County Counsel shall review such recommendation and present the Board with its written recommendation as to whether or not to proceed. After receiving such written recommendation from the CDUC, the Board may adopt a resolution approving the execution and delivery by the County of the subject swap or other derivative product(s).

4. Form of Swap Agreements

Each interest rate swap executed by the County shall contain terms and conditions as set forth from time to time in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, including any schedules which may contain provisions specific to the swap transactions; Credit Support Annex which may contain provisions regarding credit enhancements such as collateral requirements; and confirmations of negotiated terms and conditions negotiated, as approved in accordance with the resolution adopted by the Board approving such interest rate swap. Any swap agreement between the County and each qualified swap counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, and provisions as the CFO/O and DOF, in consultation with County Counsel, deems necessary or desirable.

5. Qualified Swap Counterparties

The County shall enter into interest rate swap transactions only with qualified swap counterparties. Qualified swap counterparties are financial institutions that are banks and investment banks dealing primarily with raising capital, corporate mergers and acquisitions and securities trades.

6. Credit Requirements of Qualified Swap Counterparties

The qualified counterparties must maintain minimum credit requirements as defined in the governing bond documents; however, initially no lower of the following ratings: "Aa3" by

Moody's, "AA-" by Standard & Poors, and "AA-" by Fitch or "AAA" by a subsidiary of counterparty, absent a determination upon a recommendation of the CFO/O and DOF that a lower rating level is prudent.

For swaps or other hedging transactions involving the County, a swap counterparty must satisfy the requirements for a "Qualified Counterparty" as defined in governing bond documents, between the County, as amended and supplemented from time to time.

When selecting a counterparty, the County may negotiate or competitively bid an interest rate swap transaction based on a review of the market impact to the County of a competitive bid.

7. Termination Provisions

Optional Termination: All swap transactions shall contain provisions granting the County the right to optionally terminate a swap agreement at anytime over the term of the agreement. Exercising the right to optionally terminate an agreement may produce a benefit to County through receipt of a payment from a termination, or if a termination payment is made by County, in conjunction with a conversion to a more beneficial (desirable) debt obligation of the County as determined by the County. The CDUC upon recommendation of the CFO/O and DOF shall determine if it is financially advantageous for the County to terminate a swap agreement. However, the CFO/O and the DOF may terminate a swap without recommendation to CDUC if immediate action is warranted and report to the CDUC of the action taken as set forth below.

Mandatory Termination: A termination payment to or from the County may be required in the event of termination of a swap agreement due to a default or a decrease in credit rating of such County or the counterparty. It is the intent of the County to obtain a replacement counterparty and receive a payment from the replacement counterparty, reflecting the market value of the transaction to the new counterparty, to offset the termination payment owed by the County to the counterparty, as long as the counterparty meets its contractual obligations. The CFO/O and DOF shall evaluate whether it is financially advantageous for the County to obtain a replacement counterparty to avoid making such termination payment.

In the event of default by a counterparty whereby the County would be required to make a termination payment, the County will proceed as follows:

a. In order to mitigate the financial impact of making such payment at the time such payment is due, the County will seek to replace the terms of the terminated transaction with a replacement counterparty. The new or replacement counterparty will make an upfront payment to the County in an amount that would offset or reduce the payment obligation of the County to the original counterparty.

b. If a satisfactory agreement with a replacement counterparty is not reached, the County will be required to make a swap termination payment to the original defaulting counterparty. Funds for such termination payment shall be made from available monies and in accordance with any related governing documents, with respect to termination payments payable by the County. The CFO/O and DOF shall report any such termination payments to a Board at the next Board meeting.

8. Term and Notional Amount of Swap Agreement

The County shall determine the appropriate term for an interest rate swap agreement on a case-by-case basis. The slope of the interest rate swap curve, the marginal change in swap rates from year to year along the swap curve, and the impact that the term of the swap has on the overall exposure of the County shall be considered in determining the appropriate term of any swap agreement. In connection with the issuance or carrying of bonds, the term of a swap agreement between the County and a qualified swap counterparty shall not extend beyond the final maturity date of the bonds.

9. Swap Counterparty Exposure Limits

In order to diversify the County's counterparty risk and to limit the County's credit exposure to any one counterparty, limits will be established for each counterparty based upon both the credit rating of the counterparty as well as the relative level of risk associated with each existing swap transaction. The risk measure will be calculated based upon the mark-to-market (market value)sensitivity of each transaction to an assumed 25 basis point shift in interest rates. Assuming a 25 basis point movement in the swap rate, the maximum net exposure (termination payment) per counterparty shall not exceed the following amounts:

Credit Rating	Maximum Net Exposure (Sensitivity to a 25 Basis Point Shift in the Yield Curve)
Fully Collateralized	$10,000,000
AAA (No collateral required)	$10,000,000
AA (No collateral required)	$ 8,000,000

The maximum net exposure limitations establish guidelines with respect to whether the County should enter into an additional swap agreement with an existing counterparty. For example, assume the County executed a fifteen-year $400 million notional amount swap with an "AAA" rated counterparty. If the yield curve shifted 25 basis points upward or downward, the County could have a significant market exposure to that swap counterparty (i.e., in order to terminate the swap, the County would receive a payment of up to $10 million dollars from the counterparty). The same scenario would apply to a fully collateralized counterparty. If the sensitivity analysis resulted in the maximum net exposure totaling $10 million or more, the CFO/O and DOF would evaluate whether it is prudent and advisable to enter into additional swap transactions with such counterparties in order to mitigate the exposure to such counterparty. For "AA" rated counterparties, the maximum net exposure limitation is reduced to $8 million given its lower credit rating.

The calculation of net interest rate sensitivity per counterparty will take into consideration multiple transactions, some of which may offset market interest rate risk thereby reducing overall exposure to the County. In addition, additional exposure provisions are as follows:

a. The sum total notional amount per counterparty for swaps with the County may not exceed 25 percent of the County's outstanding general fund obligations or in the case of a non general fund entity such as Airports, the amount may not exceed 25 percent of any outstanding respective obligations of that non general fund entity.

b. The appropriate collateral amount will be determined on a case-by-case basis and approved by the CFO/O and DOF in consultation with County Counsel.

If the sensitivity limit is exceeded by a counterparty, the County shall conduct a review of the exposure sensitivity limit calculation of the counterparty. The CFO/O and DOF shall evaluate appropriate strategies in consultation with the County Counsel to mitigate this exposure.

10. Collateral Requirements

As part of any swap agreement, the County shall require collateralization or other credit enhancement to secure any or all swap payment obligations. As appropriate, the CFO/O and DOF, in consultation with the County Counsel, may require collateral or other credit enhancement to be posted by each swap counterparty under the following circumstances:

a. Each counterparty to the County may be required to post collateral if the credit rating of the counterparty or guarantor falls below the “AA” category. Additional collateral for further decreases in credit ratings of each counterparty shall be posted by each counterparty in accordance with the provisions contained in the collateral support agreement to each swap agreement with the County.

b. Collateral shall consist of cash, U.S. Treasury and Agencies’ securities, and Commercial Paper securities rated A-1/P-1.

c. Collateral shall be deposited with a third party trustee or as mutually agreed upon between the County and each counterparty.

d. 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.

e. The market value of the collateral shall be determined on at least a monthly basis.

f. The County will determine reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.

g. The CFO/O and DOF of the County shall determine on a case by case basis whether other forms of credit enhancement are beneficial to the County.

11. Reporting Requirements on Existing SWAP Agreements

A written report providing the status of all interest rate swap agreements will be provided to the Board on a semi-annual basis and shall include the following information:

a. Highlights of all material changes to swap agreements or new swap agreements entered into by the County since the last report.

b. Market value of the County's interest rate swap agreements.

c. The net impact to the County of a 25 basis point movement (up or down) with the appropriate swap index or curve.

d. For each counterparty, the County shall provide the total notional amount position, the average life of each swap agreement, the available capacity to enter into a swap transaction, and the remaining term of each swap agreement.

e. The credit rating of each swap counterparty and credit enhancer insuring swap payments, if any.

f. Actual collateral posting by swap counterparty, if any, per swap agreement and in total by swap counterparty.

g. A summary of each swap agreement, including but not limited to the type of swap, the rates paid by the County and received by the County, and other terms.

h. Information concerning any default by a swap counterparty to the County, and the results of the default, including but not limited to the financial impact to the County, if any.

i. A summary of any planned swap transactions and the impact of such swap transactions on the County.

j. A summary of any swap agreements that were terminated.

The CFO/O and DOF together with the County Counsel shall review this Master Swap Policy on an annual basis and recommend appropriate changes to such Board.

12. Costs

The initial costs of an interest rate swap transaction are paid by the swap provider, per a negotiated interest rate on the swap agreement; e.g., costs for bond counsel, financial advisor, etc. Such costs will be reflected in the fixed swap rate as an increase in the fixed swap rate for transactions where the County is paying fixed and as a decrease in the fixed swap rate for transactions where the County is receiving fixed. Annual-ongoing administrative costs related to the swap transaction are budgeted each fiscal year in the related debt service budget unit(s).

GLOSSARY OF KEY TERMS

Confirmation: A document related to the Master Agreement confirming the exchange between each parties transacting a swap.

Counterparty Risk: The risk that the swap counterparty will not fulfill its obligation as specified under the agreement.

Credit Support Annex: A document related to the Master Agreement containing provisions specific to credit enhancements such as collateral requirements.

Credit Risk: The risk of an occurrence of an event modifying the credit rating of the counterparty.

Interest Rate Risk: The risk associated with changes in general interest rate levels or yield curve.

Interest Rate Swap: The agreement whereby one party typically agrees to exchange a floating rate for a fixed coupon rate. An essential characteristic of swaps is the swapping of cashflows and not principal amounts.

ISDA: The International Swap Dealers Association (ISDA), a global trade association representing participants in the derivatives industry.

International Swap Dealers Association (ISDA) Master Agreement: An agreement developed by the International Swap Dealers Association that contains general terms and conditions related to a swap transaction.

Notional Amount: The stipulated principal amount for a swap transaction. There is no transfer of ownership in the principal for a swap; but there is an exchange in the cashflows for the designated coupons.

Qualified Counterparty: Qualified swap counterparty is a financial institution that is an investment bank dealing primarily with raising capital, corporate mergers and acquisitions and securities trades. The qualified counterparty must maintain minimum credit requirements as defined in the governing bond documents; however, initially no lower of the following ratings: "Aa3" by Moody's, "AA-" by Standard & Poors, and "AA-" by Fitch or "AAA" by a subsidiary of counterparty, absent a determination upon a recommendation of the CFO/O and DOF that a lower rating level is prudent.

Schedule: A document related to the Master Agreement which contains specific provisions regarding the swap transaction.

Swap: A customized financial transaction between two or more counterparties who agree to make periodic payments to one another. Swaps cover interest rate, equity, commodity and currency products. They can be simple floating to fixed exchanges or complex hybrid products with multiple option features.

Swaption: An option on an interest rate swap. The buyer of a swaption has the right to enter into an interest rate swap agreement by some specified date in the future.

Termination Risk: The risk that the swap could be terminated by the counterparty due to any of several events, which may include issuer or counterparty ratings downgrade, covenant violations by either party, bankruptcy of either party, swap payment default by either party and default events as defined in the issuer's bond indenture. The events of default and termination, which could lead to involuntary termination of the agreement would include failure to pay, bankruptcy, merger without assumption of obligations and legality.

Yield Curve: Refers to the graphical or tabular representation of interest rates across different maturities. The presentation often starts with the shortest-term rates and extends toward longer maturities. It reflects the market's views about implied inflation/deflation, liquidity, economic and financial activity and other market forces.