

RESOLUTION No. 36313

Adopt City of Portland Interest Rate Exchange Agreement Policy.(Resolution)

WHEREAS, the City of Portland is authorized under Oregon Revised Statutes (ORS) 287.014 to 287.029, as amended by Chapter 195, Oregon Laws 2003 to enter into interest rate exchange agreements, commonly known as interest rate swaps; and

WHEREAS, State of Oregon law requires that issuers adopt a formal written policy regarding the use of agreements for the exchange of interest rates (a “Swap Policy”) prior to entering into any such agreement; and

WHEREAS, State of Oregon law specifies that the Swap Policy shall provide a general description of risks related to agreements for exchange of interest rates and the means by which the issuer will address those risks; and

WHEREAS, interest rate exchange agreements can be appropriate interest rate management tools, increase the City’s financial flexibility, and provide opportunities for interest rate savings; and

WHEREAS, there is a need to clearly establish guidelines for the execution and management of the City’s interest rate exchange program; and

WHEREAS, a primary objective of the Interest Rate Exchange Agreement Policy is to ensure that the City Council, management, staff, advisors, and other decision makers adhere to sound financial and risk management practices when evaluating and entering into interest rate exchange agreements.

NOW, THEREFORE, BE IT RESOLVED that the Interest Rate Exchange Agreement Policy, attached hereto as Exhibit I, fulfills all State of Oregon mandated requirements, and is hereby adopted by the City Council.

BE IT FURTHER RESOLVED that the Interest Rate Exchange Agreement Policy is Binding City Policy.

Adopted by the Council, April 27, 2005

Prepared by:

Mayor Tom Potter
Office of Management and Finance
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April 5, 2005

GARY BLACKMER
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Deputy



Exhibit I

City of Portland Interest Rate Exchange Agreement Policy

City of Portland Philosophy Regarding Use of Interest Rate Exchange Agreements

Introduction

Interest rate exchange agreements (“Swaps”) and related financial instruments and derivatives are appropriate interest rate management tools. Properly used, Swaps can increase the City of Portland’s (the “City”) financial flexibility and provide opportunities for interest rate savings.

Swaps are appropriate to use when they achieve a specific financial objective consistent with the City’s overall Swap and Debt Management policies. Swaps may be used, for example, to lock-in a current market fixed rate or create additional variable rate exposure. Swaps may be used to produce interest rate savings or alter the pattern of debt service payments. Swaps may be used to cap, limit or hedge variable rate payments. Options granting the right to commence or cancel an underlying Swap are permitted to the extent the Swap itself is otherwise consistent with this policy.

The authorized Swaps contemplated in this policy are intended to reduce the amount or duration of interest rate risk, or produce a lower cost of borrowing when used in combination with the issuance of bonds.

Rationales for Utilizing Interest Rate Swaps

The use of Swaps and related financial instruments should balance the City’s primary objectives of reducing the cost of capital, minimizing interest rate volatility, and gaining flexibility in structuring and managing its debt portfolio over time with the risks associated with these tools and instruments. Examples of how the City’s debt management objectives can be achieved through the use of Swaps and other financial instruments are described below:

- Reduce borrowing costs at the time of issuance
Create synthetic fixed rate debt through a floating-to-fixed Swap
- Actively manage interest rate risk
Lock-in current market rates through (forward starting) floating-to-fixed Swap
- Optimize capital structure
Sell option to convert variable rate debt to fixed rate debt
- Balance financial risk
Purchase of an interest rate cap
- Achieve appropriate asset/liability match
Create variable rate exposure through fixed-to-floating Swap

Authority for Entering Into Swap Agreements

The purpose of this policy is to integrate the use of Swaps into the City’s overall debt management practice. The use of Swaps will be limited to the City’s outstanding debt, or executed in conjunction with to be issued debt, and do not apply and are therefore not authorized for use in conjunction with the City’s investment portfolio. Swaps will not be used for speculation. The City’s Debt Manager, in consultation with the City Treasurer and the City Controller and subject to the approval of the City’s Chief Financial Officer and/or the Chief Administrative Officer,

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shall be responsible for determining if and when it is in the City's overall best financial interests to enter into a Swap or related financial instruments covered by this policy.

In connection with the use of any Swaps, the City shall comply with all applicable laws and shall notify the State Treasurer as required. The City must receive an opinion acceptable to the market from a nationally recognized firm that the swap contract is a legal, valid, and binding obligation of the City and that entering into such a contract complies with applicable provision of the City Charter and State statutes.

Permitted Instruments

The City may utilize financial instruments that *(i)* lower its interest expense, *(ii)* manage its financial risk, or *(iii)* improve its financial condition.

The City shall not use financial instruments that *(i)* create extraordinary leverage or financial risk, *(ii)* lack adequate liquidity to terminate at market, or *(iii)* provide insufficient price transparency to allow reasonable valuation on an ongoing basis.

The use of derivative financial products should produce a result not otherwise available in the cash market (i.e., lack of advance refunding/non-callable debt), or provide a higher level of net savings compared to conventional financing methods.

Permitted Financial Instruments

The City may expressly utilize the following financial instruments, after identifying the financial objective(s) to be realized and assessing the attendant risks:

- Interest Rate Swaps including, but not limited to: Fixed-to-Floating, Floating-to Fixed, and Forward Starting Interest Rate Exchange Agreements:
Current or forward starting floating-to-fixed rate swaps, designed to reduce a fixed interest rate below that which would otherwise be available through the use of "traditional" fixed rate debt
Fixed-to-floating rate swaps, designed to create additional variable interest rate exposure
- Rate Locks
Cash-settled forward contracts based on indices such as the MMD™ "AAA" scale
- Interest Rate Caps, Floors or Collars
Financial contracts that limit or bound exposure to interest rate volatility
- Options on Variable Rate Indices
Indices could include BMA, LIBOR, etc.
- Options on Swaps ("Swaptions")
Methods used to control the commencement or cancellation of interest rate swaps
- Basis Swaps
Floating-to-floating rate swaps using different variable-rate indices, such as a swap from the BMA index to a percentage of LIBOR

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Approved Swap Transaction Types

Swaps

- Fixed-to-Floating Rate Swap (Synthetic Variable)
- Fixed-to-Floating Rate Cancelable Swap (Synthetic Variable)
- Floating-to-Fixed Rate Swap (Synthetic Fixed)
- Floating-to-Fixed Rate Forward Swap (Bond Issue Anticipation Hedge/Synthetic Forward Refunding)
- Basis Swaps (Floating-to-Floating) on Approved Indices

Swaptions

- Floating-to-Fixed Rate Swaption Sale (Synthetic Forward Refunding)
- Floating-to-Fixed Rate Swaption Sale (Bond Call Option Monetization)
- Other Approved Swaption Purchases and Sales for Asset-Liability Management

Rate Locks

Caps/Floors/Collars

- Interest Rate Caps/Floors Embedded in Approved Swap Transactions
- Purchased Caps
- Purchased Floors
- Purchased Collars (Buy Cap/Sell Floor)

“Exotics” (e.g., Knock-Out Options, Inflation-Indexed Swaps)

Subject to approval based on verifiable savings or achievement of risk reduction benefit targets and consistency with policy requirements regarding price transparency and liquidity. In general, the City will seek to avoid financial products with embedded “digital” risks.

Swap Risk Analysis

The City’s Debt Manager shall evaluate all financial products with respect to the unique risks that they bear. A specific determination must be made that the proposed or expected benefits exceed the identified risks by an adequate margin over those available in the traditional cash market. At a minimum, the Debt Manager shall perform an evaluation of the risks and what steps have been taken to mitigate any risks. The City may retain a swap advisor to assist in assessing these risks. Questions that may arise include the following:

- Market or interest rate risk
Does the transaction hedge or create interest rate volatility?
- Tax Risk
How is the transaction or its benefits affected by a future change in federal income tax policy?
- Termination Risk
Under what circumstances might the transaction be terminated? At what value?

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- Risk of Uncommitted Funding (Put Risk)
Does the transaction create additional financing dependent upon third party participation?
- Rollover Risk
Is the term of the Swap shorter than the term of the underlying hedged debt or financial instrument?
- Legal Risk
Is the transaction expressly authorized?
- Counterparty Risk
What is the creditworthiness of the counterparty?
- Rating Agency Risk
Is the proposed transaction consistent with the City's current ratings and ratings objectives?
- Basis Risk
Do the anticipated payments the City receives match the payments it makes?
- Subsequent Business Conditions
Does the transaction or its benefits depend upon the continuation, or realization, of specific industry business conditions?
- Operational Risk
Does the City have adequate systems, policies, and practices in place to monitor and manage the transaction over its term?

Swap Procurement and Execution

Procurement

The City will not have a fixed policy with respect to the procurement of Swaps and other financial instruments authorized by this policy. However, the City will have a bias toward competitively bidding financial products of a general nature that are widely available in the marketplace. On a product-by-product basis, the City will have the authority to negotiate the procurement of financial instruments that have customized or specific attributes designed on its behalf. The Debt Manager will be responsible for determining the method of procurement for Swaps and related financial instruments. An independent swap advisor may be retained to assist the Debt Manager in evaluating the proposed pricing of Swaps or related financial instruments.

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Swap Execution

The Debt Manager may recommend the use of financial derivative products if they:

1. Provide a specific benefit not otherwise available;
2. Produce greater expected interest rate savings than cash market alternatives;
3. Do not create extraordinary leverage or financial risk;
4. Result in an improved capital structure or better asset/liability match; and
5. Reasonably pass the risk evaluation required by this policy.

Credit Rating Designations

For purposes of this Swap Policy, references to credit ratings will be based on those ratings issued by Moody's Investors Service, Standard & Poor's Corporation, and Fitch Ratings. The credit ratings will reflect the designations assigned by each of these rating agencies for comparable credits, and will be listed for each rating agency in the order shown in the preceding sentence.

Swap Documentation

The City will use standard International Swaps and Derivatives Association ("ISDA") swap documentation including the Schedule to the Master Agreement and a Credit Support Annex.

Terms and Notional Amount of Swap Agreement

The City shall determine the appropriate term for Swaps on a case-by-case basis. The slope of the 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 City's overall financial exposure shall be considered in determining the appropriate term of any Swap agreement. In connection with the issuance or carrying of bonds, the term of the Swap agreement between the City and a qualified swap counterparty shall not extend beyond the final maturity date of existing City debt, or in the case of a refunding transaction, beyond the final maturity of the refunding bonds. At no time shall the total net notional amount of all Swaps, excluding any offsetting Swaps, exceed the total amount of outstanding applicable bonds. Variable rate debt exposure created through the use of Swaps will be consistent with the limitations set forth in the City's adopted Debt Management Policy.

Terms and conditions of any Swap shall be negotiated by the Debt Manager in the best interests of the City subject to the applicable legal provisions and this policy. The Swap agreements entered into between the City and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the Debt Manager, in consultation with City legal counsel and its swap advisor, deems necessary or desirable.

Subject to the provisions contained herein, the City's swap documentation and terms should include the following:

- The downgrade provisions triggering termination should be bilateral
- Governing law for Swaps will be New York, but should reflect Oregon authorization provisions

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- The specified indebtedness related to credit events in the Master Agreement should be narrowly drafted and refer only to specific debt
- Eligible collateral should be limited to Treasuries, Federal Agencies (i.e., City-approved Government Sponsored Enterprises) and any other securities which in the City's sole discretion shall be deemed reasonable and creditworthy
- Collateral thresholds should be set on a sliding scale reflective of credit ratings
- Termination value should be set by "market quotation" methodology
- For counterparties below "Aa2/AA/AA", use of a credit support annex to document swap termination value collateralization procedures
- Downgrade triggers

Policy on Swap Counterparties

The City shall only do business with highly rated counterparties, and will structure swap agreements to protect itself from credit deterioration. All Swap transactions shall contain provisions granting the City the right to optionally terminate a swap agreement at any time over the term of the agreement. Such a provision shall be required even if any termination is at market. In general, exercising the right to terminate an agreement should produce a benefit to the City, either through the receipt of a payment from a termination or, if the termination payment is made by the City, in conjunction with a conversion to a more beneficial (desirable) debt obligation of the City, as determined by the City.

Guidelines on Counterparty Risk

The City should not have an immutable credit standard. However, the City shall attempt to do business with highly rated counterparties with a rating of "Aa2/AA/AA" or better. For lower rated (below "Aa2/AA/AA") counterparties, the City should seek credit enhancement in the form of:

1. Contingent swap counterparty providing support;
2. Collateral;
3. Ratings downgrade triggers; and,
4. Minimum rating threshold of "Baa2/BBB/BBB", below which provisions will allow an assignment or trigger an additional termination event, with the counterparty as the affected party (i.e., the counterparty would pay market based transaction costs).

Qualified Swap Counterparties

The City shall be authorized to enter into interest rate swap transactions only with qualified swap counterparties. The composition of the approved swap counterparties will change from time to time. Qualified swap counterparties must be rated at least "Aa3/AA-/AA-", or equivalent by any two of the nationally recognized rating agencies; or have a "Aaa/AAA/AAA" subsidiary as rated by at least one nationally recognized credit rating agency. In addition, the counterparty must have a demonstrated record of successfully executing swap transactions as well as creating and implementing innovative ideas in the swap market. Each counterparty shall have minimum capitalization of at least \$150 million. The City will not enter into financial products with counterparties rated below "A2/A/A" by any rating agency.

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Limitations on Counterparty Exposure

Guidelines

In order to diversify the City's counterparty credit risk, and to limit the City'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 and proposed swap transaction. The guidelines shown in the following table provide general termination exposure guidelines with respect to whether the City should enter into an additional transaction with an existing counterparty. The City may make exceptions to the guidelines at any time to the extent that the execution of a swap achieves one or more of the goals outlined in these guidelines or provides other benefits to the City. In general, the maximum net termination exposure to any single counterparty should be set so that it does not exceed a prudent level as measured against the gross revenues, available assets or other financial resources of the City.

Such guidelines will also not mandate or otherwise force automatic termination by the City or the counterparty. Maximum net termination exposure is not intended to impose retroactively any terms and conditions on existing transactions. Such provisions will only act as guidelines in making a determination as to whether or not a proposed transaction should be executed given certain levels of existing and projected net termination exposure to a specific counterparty. Additionally, the guidelines below are not intended to require retroactively additional collateral posting for existing transactions. Collateral posting guidelines are described in the "Collateral" section below. The calculation of net termination exposure per counterparty will take into consideration multiple transactions, some of which may offset the overall exposure to the City.

Under this approach, the City will set limits on individual counterparty exposure based on existing as well as new or proposed transactions. The sum of the **current market value** and the **projected exposure** shall constitute the maximum net termination exposure. For outstanding transactions, current exposure will be based on the market value as of the last quarterly swap valuation report provided by the City's swap advisor. Projected exposure shall be calculated based on the swap's potential termination value taking into account possible adverse changes in interest rates as implied by historical or projected measures of potential rate changes applied over the remaining term of the swap. For purposes of this calculation, the City shall include all existing and projected transactions of an individual counterparty and all transactions will be analyzed in aggregate such that the maximum exposure will be additive.

The exposure thresholds, which will be reviewed periodically by the City to ensure that they remain appropriate, will also be tied to credit ratings of the counterparties and whether or not collateral has been posted as shown in the table below. If a counterparty has more than one rating, the lowest rating will govern for purposes of calculating the level of exposure. A summary table is provided below.

Counterparty Credit Exposure Recommended Limits			
Credit Ratings	Maximum Collateralized Exposure	Maximum Uncollateralized Exposure	Maximum Net Termination Exposure
Aaa/AAA/AAA	NA	\$100.0 million	\$100.0 million
Aa2/AA/AA	\$75.0 million	\$20.0 million	\$75.0 million
Aa3/AA-/AA-	\$50.0 million	None	\$50.0 million

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If the exposure limit is exceeded by a counterparty, the City shall conduct a review of the exposure limit per counterparty. The City, in consultation with its bond counsel and swap advisor, shall explore remedial strategies to mitigate this exposure. Irrespective of the guidelines set forth above, for City projects greater than \$100 million, no more than 50% will be funded by financial products backed by a single counterparty.

Benefit Expectation

Financial transactions, using Swaps or other derivative products, intended to produce the effect of a synthetic advance refunding, must generate 25% **greater** savings than the benefit threshold then in effect for fixed-rate bonds as determined by the City's Debt Manager. Such benefit threshold will be determined based on similar call features of the structures being compared.

The higher savings target reflects the greater complexity and higher risk of derivative financial instruments.

In calculating the prospective savings against the target for implementing a fixed-to-variable swap, the cost of remarketing, in addition to the cost of credit and liquidity fees must be added to the variable rate representing the ten-year average of comparable variable rate securities.

Termination Provisions

All swap transactions shall contain provisions granting the City the right to optionally terminate a swap agreement at any time over the term of the agreement. In general, exercising the right to terminate an agreement produces a benefit to the City, either through the receipt of a payment from a termination, or if the termination payment is made by the City, in conjunction with a conversion to a more beneficial (desirable) City debt obligation, as determined by the City.

Collateral

As part of any swap agreement, the City shall require collateralization or other credit enhancements to secure any or all swap payment obligations. As appropriate, the City, in consultation with its legal counsel and swap advisor, may require collateral or other credit enhancements to be posted by each swap counterparty under the following circumstances:

- Each counterparty to the City may be required to post collateral if the credit rating of the counterparty or parent falls below the "Aa2/AA/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 counterparty with the City.
- Collateral shall be deposited with a third party trustee, or as mutually agreed upon between the City and the counterparty.
- 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.
- The market value of the collateral shall be determined on at least a monthly basis.
- The City shall determine the reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.

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- The City shall determine on a case-by-case basis whether other forms of credit enhancement, such as swap insurance, are more beneficial in lieu of the posting of additional collateral.

Monitoring and Reporting

At least once per year, or as requested by the City Council, the Debt Manager shall prepare a report describing the various Swaps and financial arrangements entered into by the City pursuant to this policy that are in effect as of the date of the report's publication. The report shall include the following information:

1. A summary of key terms of the agreements, including notional amounts, interest rates, maturity and method of procurement.
2. The marked-to-market value of each agreement.
3. The full name, description, and credit ratings of each counterparty or the applicable guarantor.
4. The amounts that were required to be paid and received, and any amounts that were actually paid and received.
5. A listing of any credit enhancement, liquidity facility, or reserves and an accounting of all costs and expenses associated with the credit enhancement, liquidity facility, or reserves.
6. The aggregate marked-to-market value for each counterparty and the relative exposure compared to other counterparties.
7. A calculation of the City's value at risk or termination values for each counterparty.
8. A discussion of other risks associated with each transaction.

At the end of each fiscal year, the Debt Manager shall provide to the Controller all information required for financial reporting under GASB as well as any other reporting or disclosure requirements.