

City of Philadelphia

Swap Policy

November 2022

I. INTRODUCTION

The purpose of this Swap Policy is to provide a policy for the City of Philadelphia's (the City) use of swaps, cap, floors, collars and other derivative financial products (collectively referred to herein as "swaps") in conjunction with the City's management of its debt.

The swap program managed by the City includes swaps related to general obligation debt, tax-supported service contract debt issued by related authorities, debt of the Water Department, Division of Aviation, and debt of the Philadelphia Gas Works (PGW). Swaps related to debt of the Pennsylvania Intergovernmental Cooperation Authority (PICA), School District of Philadelphia (SDP), and the Philadelphia Parking Authority (PPA) are managed by those governmental entities, respectively, and are therefore not covered by this policy.

The Director of Finance has overall responsibility for entering into swaps. Day-to-day management of swaps is the responsibility of the City Treasurer, and the Executive Director of the Sinking Fund Commission is responsible for making swap payments. The City Treasurer's Office and the City Solicitor's Office coordinate their activities to ensure that all swaps that are entered into are in compliance with applicable federal, state, and local laws.

This policy will address the circumstances when swaps can be used, the risks that need to be evaluated prior to entering into swaps and on an ongoing basis after swaps have been executed, the guidelines to be employed when swaps are used, and how swap counterparties will be chosen. This policy will be used in conjunction with the City's Debt Management Policy. This policy will be reviewed annually and updated as needed.

II. AUTHORITY

Under the Commonwealth constitution, a municipality with a Home Rule Charter can exercise any power not denied by the General Assembly. The First Class City Home Rule Act specifies the limitations on the City's Home Rule powers. One of those limitations is enactment by the General Assembly of a law of general application on a subject. There is no such law in effect relating to swaps. Accordingly, the power to enter into swaps is a home rule power of the City. The City's Home Rule Charter does not specifically address swaps, but states that the City may exercise all powers of local self-government. Authority to enter into swaps must be enacted by an ordinance of City Council, which can be part of an ordinance for bond issuance.

III. PROCEDURE

Before deciding to enter into a swap, the following questions should be answered in a written memo:

- Taking into consideration risks and rewards presented by the proposed transaction, is the transaction appropriate? In this analysis, include:

- A statement of the purpose of the transaction and expected benefits;
 - A description of the transaction structure;
 - A description of the risks it presents; and
 - Any risk mitigation measures.
- What is the legal framework for the transaction? In this analysis, include:
 - The legal framework for the transaction within the context of Pennsylvania law;
 - The City Ordinance that will authorize the transaction;
 - Relevant indenture and contractual requirements (including those contained in credit enhancement agreements); and
 - Any implications of the transaction under federal tax law.
- How does the proposed transaction fit into Section IV “Permitted Uses” on page 3 of this policy?
- After the swap being contemplated has been executed, will the City remain within allowable guidelines set forth in Section V “Guidelines for Swaps” on pp. 3-4 of this policy?
- If the swap or the swap and associated bonds involve two variable interest rates, has the historical relationship been analyzed between the proposed indexes? How would the highest and lowest relationship over the last 10 years impact the budget if this were to occur again? How do these alternative scenarios compare with the expected outcome? Examples of this are a basis swap and a LIBOR¹-based swap associated with SIFMA-based tax-exempt bonds (see Basis Risk under Section VII “Risk Management” on pp. 5-6 of this policy).
- Will this transaction have any impact on areas where the City’s capacity could be limited, either now or in the future, including the use of variable rate debt, bank liquidity facilities or letters of credit, and bond insurance?
- Does the City have the ability to handle the administrative burden imposed by the transaction, including budgeting, accounting, and financial reporting requirements?
- Is the swap structured to include a call option which would permit the City to terminate the swap at no cost? What is the potential termination payment value using a two-standard deviation move in prevailing markets against the City? How would the City pay for this termination payment if it had to terminate?
- Are the swap payments and/or the termination payments insured?
- Do the swap document terms address the three tiered approach to limit counterparty risk set forth in Section VI titled “Counterparty Credit Standards” on pp. 4-5 of the policy?

¹ All references to LIBOR herein shall be understood to mean “LIBOR or any potential successor index”

- Are there any potential effects that the transaction may have on the credit ratings of any City obligations assigned by the rating agencies?
- Is a callable swap available and what are the benefits/considerations of including optionality in this swap?
- Will the swap include a market-based optional termination provision granting the City the right to optionally terminate, at market, at any time over the term of the swap transaction?

Before deciding to either amend or terminate an existing swap, a written memo should be produced that discusses the motivation, benefits, and considerations to execute the proposed transaction. This memo should be reviewed by the City's Swap Consultant.

IV. PERMITTED USES

Swaps must be shown to manage interest rate risk and/or cost of the related debt in order to be considered. Ordinances of the City do not authorize swaps for any other purpose. The City shall not enter into swaps for purely speculative purposes. Permitted uses of swaps include:

- Managing the City's exposure to floating interest rates through interest rate swaps, caps, floors, collars, and other derivative financial products;
- Locking in fixed rates in current markets for use at a later date through the use of forward starting swaps and rate locks;
- Reducing the cost of fixed or floating rate debt through swaps and related products to create "synthetic" fixed or floating rate debt; and
- Managing the City's credit exposure to financial institutions and other entities through the use of offsetting swaps.

Swaps or swaptions with associated upfront payments made to the city, are not allowed unless there is a compelling argument that it is suitable under extreme circumstances.

V. GUIDELINES FOR SWAPS

Swaps must be entered into prudently as they expose the City to risks as described in Section VII titled "Risk Management" on pp. 5-6. The most common type of swap is the floating to fixed rate interest rate swap which is associated with variable rate bonds. For any contemplation of variable rate debt, provisions set forth in the City's Debt Management Policy should be adhered to.

Because of the risks related to issuing variable rate debt and swapping it to fixed rate which were highlighted during the global credit crisis of 2008 and 2009, the amount of hedged variable rate debt should be limited.

	Target
Amount of Hedged Variable Rate Debt as a percentage of Total Debt	15% Maximum

This limitation should be calculated separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. While 15% is the maximum, efforts should be made to keep this percentage well below this for bonds rated below the 'A' category.

In the case where forward starting floating to fixed rate swaps have been entered into but the associated bonds have not been issued yet, the notional amount of the swap and the expected principal amount of the bonds should be taken into consideration. In addition, in the case of a swaption involving a floating-to-fixed rate swap which has not yet been exercised, the notional amount of the swaption should be included in the calculation of hedged variable rate debt.

In addition to floating to fixed rate swaps, there are other types of swaps including basis swaps, constant maturity swaps, and fixed to floating rate swaps. Because of the different types of swaps which can be entered into, it is important to limit the total notional amount of swaps. In the event that one swap directly offsets the cash flows and risks of another swap or swaps with the same counterparty, only the net amount that is not offset should be counted toward the limitation.

When available and economic, callable swaps should be strongly considered.

	Target
Notional Amount of Swaps as a percentage of Total Debt	15% Maximum

This limitation should be calculated separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. While 15% is the maximum, efforts should be made to keep this percentage well below this for bonds rated below the 'A' category.

VI. COUNTERPARTY CREDIT STANDARDS

Swap products can create exposure to the creditworthiness of financial institutions that serve as the City's counterparties on swap transactions. To protect the City's interests in the event of a counterparty credit problem, the City will take a three tiered approach for any future swaps:

- Use of highly rated counterparties: Standards of creditworthiness, as measured by credit ratings and other factors as the City may judge to be appropriate, will determine eligible counterparties. As a general rule, the City will enter into transactions with counterparties whose obligations are rated in the A rated category or better from two nationally recognized rating agencies. Counterparties rated in the A rating category will be required to post collateral, consistent with the schedule described below. In cases where the

counterparty's obligations are rated based on a guarantee or specialized structure to achieve the required credit rating, the City shall thoroughly investigate the nature and legal structure of the guarantee or structure in order to determine that it fully meets the City's requirements.

- Collateralization on downgrade: If counterparty's credit rating is downgraded below a double-A rating category, the City shall require collateral to be posted to a threshold schedule that is appropriate for the expected underlying potential exposure. Exposure should be collateralized at a zero threshold if the counterparty is downgraded to A- or A3.
- Termination: If a counterparty's credit is downgraded below the BBB category, even with collateralization, the City may exercise a right to terminate the transaction prior to its scheduled termination date. The City will seek to require that terminations triggered by a counterparty credit downgrade will occur on the side of the bid-offer spread which is most beneficial to the City, and which would allow the City to go back into the market to replace the downgraded party with another suitable counterparty at no out-of-pocket cost to the City.

In addition to the above three-tiered approach, the City's swap counterparties will be required to notify the City in the event a credit agency takes negative action with regard to the counterparty's credit rating, including both an actual downgrading of the credit rating as well as the publication of a notice by a rating agency that the counterparty's rating is in jeopardy of a downgrading (i.e. being placed on Negative Credit Watch or being assigned a Negative Outlook).

In order to limit the City's counterparty risk, the City will seek to avoid excessive concentration of exposure to a single counterparty or guarantor by diversifying its counterparty exposure over time. Exposure to any counterparty will be measured based on the termination value of any swap contracts entered into with the counterparty. If exposure to one counterparty exceeds 50% of the total termination value of the existing swaps, efforts should be made to not increase potential exposure with that counterparty through additional trades. This should be calculated separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. Aggregate swap termination value for each counterparty should take into account netting of offsetting transactions (i.e. fixed to floating and floating to fixed). The City may require regular mark-to-market valuations of swaps they have entered into from the appropriate counterparties.

VII. RISK MANAGEMENT

The City will manage the risks of its swap exposure separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. Among the risks that the City will track, evaluate, and seek to mitigate are:

- Counterparty Risk: The risk of a failure of one of the City's swap providers to perform as required under a swap contract (See above Section VI "Counterparty Credit Standards").

- **Termination Risk:** The risk that a swap may be terminated prior to its scheduled maturity due to factors outside the City's control. Swaps shall have provisions which permit the City to terminate at no cost after a predetermined period, generally five to ten years. Any longer period must be justified and an analysis must be undertaken to confirm the value of the longer call protection is appropriate.
- **Interest Rate Risk:** The risks that the City's debt service costs associated with variable rate debt increase and negatively affect the budget, coverage ratios, and cash flow margins. Variable rate debt exposure may be created by a swap from fixed to floating. The interest rate risk presented by such a swap may increase as interest rates increase generally.
- **Basis Risk:** The risk that the floating rate received on the swap fails to offset the floating rate on the underlying bonds. Because swaps are generally based on a floating rate index, the chosen index should correlate with the floating rate on the bond, but may not correlate exactly or at all times as we have seen with recent market events. This risk is heightened with LIBOR-based swaps as this may introduce "tax-risk" - the risk of a mismatch between the floating rate on the tax-exempt debt (often tied to the SIFMA index) and the taxable index LIBOR. In addition to heightened volatility between the tax-exempt and taxable indexes, a change in tax law could impact a LIBOR-based swap. Basis risk is also present in a basis swap where there are two variable interest rates in the same swap. The degree of risk should be valued in comparison to the degree of benefit provided.
- **Amortization Risk:** The risk presented by a mismatch between the term of the swap or the notional amount of the swap and the term or principal amount of the underlying bonds being hedged by the swap.
- **Bank Facility Rollover Risk:** When a swap is used in conjunction with puttable floating rate debt, such as variable rate demand bonds, bank facility rollover risk exists if the term of a needed bank liquidity facility or letter of credit on the debt is shorter than the term of the swap which is most often the case. In this situation, the City is at risk to both the availability and the price of successive bank facilities.

VIII. SWAP MONITORING

The City will monitor the swaps it has entered into by regularly evaluating the above risks. A summary of key terms of the agreements will be kept at the Treasurer's Office. This will include notional amounts, interest rates, maturity dates, any embedded optionality, and relevant credit terms including additional termination events. A monthly report will be prepared by the City's swap advisor containing mark-to-market values, the amount of exposure that the City has to each counterparty as measured by aggregate mark-to-market value netted for any offsetting transactions, and the credit ratings for each counterparty (or guarantor, if applicable).

IX. FORM OF SWAP AGREEMENTS

Any swap that is executed by the City shall contain the terms and conditions set forth in the International Swap and Derivative Association, Inc. (ISDA) Master Agreement, including the Schedule to the Master Agreement, any ISDA Credit Support Annex and any Confirmations executed in connection therewith (together, the “ISDA Agreement”). Subject to the credit standards described in Section VI, the ISDA Agreements between the City and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, and provisions as the City deems necessary or desirable.

X. METHOD OF PROCUREMENT

The City will choose counterparties for entering into swap contracts on either a negotiated, invited, or competitive basis. As a general rule, the City will use a competitive or invited selection process whenever the product is relatively standard or if it can be broken down into standard components. An invited procurement is a solicitation of bids from a prequalified pool of counterparties who meet the credit requirements of the City and have approved swap agreements with the City. Negotiated procurement may be used for original products or for original ideas of applying a specified product to a City need, or where the particular facts of the transaction demonstrate that negotiation is in the best interests of the City and such a finding is made.

However, all effort should be made to choose counterparties on a competitive or invited basis. To provide safeguards on all swap transactions, the City should secure outside professional advice to assist in the process of structuring, documenting, and pricing the transaction, and to verify that a fair price was obtained. In any negotiated transaction, the counterparty shall be required to disclose all payments to third parties (including lobbyists, consultants, and attorneys) who had any involvement in assisting the counterparty in doing business with the City. In addition, the counterparty will be required to disclose its aggregate spread from the mid-market level and the City’s swap advisor will be asked to provide separate verification of this, including an estimate of dealer profit.

XI. DODD-FRANK ACT AND RELATED SWAP REGULATION

Each swap advisor selected by the City shall meet the following requirements to be a “Qualified Independent Representative” pursuant to Commodity Futures Trading Commission (“CFTC”) Regulation 23.450, as amended or interpreted by the CFTC, and any comparable requirements set forth by the CFTC or other regulators (collectively, the “Qualified Independent Representative Requirements”). Each of the City’s swap advisors shall:

- (i) have sufficient knowledge to evaluate the swap transaction and risks;
- (ii) not be subject to a statutory disqualification (under the Commodity Exchange Act);
- (iii) be independent of the City’s relevant swap counterparty within the meaning of CFTC Regulation 23.450(c);
- (iv) undertake a duty to act in the best interests of the City;

- (v) makes appropriate and timely disclosures to the City of compensation and all material conflicts of interest that would be sufficient to permit the City to assess the conflict and take steps to mitigate it;
- (vi) evaluate the fair pricing and the appropriateness of the swap transaction; and
- (vii) in addition to any limitations imposed by City regulations or laws, be subject to restrictions on certain political contributions that may be imposed by the CFTC, the United States Securities and Exchange Commission (the “SEC”), or a self-regulatory organization subject to jurisdiction of the CFTC or the SEC.

The City shall undertake annual monitoring of each swap advisor’s performance consistent with the Qualified Independent Representative Requirements and confirm that the particular swap advisor or advisors retained by the City in connection with any swap transaction reasonably appear to satisfy the Qualified Independent Representative Requirements. In undertaking the foregoing, the City may take into account any report or other documentation provided by a swap advisor regarding its satisfaction of the Qualified Independent Representative Requirements.

The City shall obtain and maintain a “legal entity identifier” or such other entity identifier as shall be provided by the CFTC from time to time. Pursuant to CFTC Final Rule Swap Data Recordkeeping and Reporting Requirements: Pre-Enactment and Transition Swaps, 77 Fed. Reg. 35200 (June 12, 2012) and CFTC Final Rule Swap Data Recordkeeping and Reporting Requirements, 77 Fed. Reg. 2136 (January 13, 2012), the City shall keep full, complete and systematic records, together with all pertinent data and memoranda, relating to (a) the final primary business and legal terms, (b) the final confirmation, (c) any valuation, and (d) any modification, amendment, termination or novation (collectively, “Modifications”) of each swap. In order to comply with the foregoing, and subject to any future changes in law or interpretations, the City shall keep copies of: (i) documents and correspondence memorializing final swap terms prepared prior to the execution of a written swap confirmation for the applicable swap, (ii) swap agreements (including all schedules, annexes and confirmations) and any related transaction documents (such as fairness opinions, legal opinions, hedge identification certifications and closing certificates), (iii) valuations prepared by the swap counterparty or the City’s swap advisor during the term of the swap, (iv) documents of the type set forth in the preceding clauses (i), (ii) and (iii) with respect to any Modification, and (v) all agreements, representation letters and information provided in response to a request from a swap counterparty related to the swap counterparty’s compliance with CFTC or similar swap regulations (collectively, the “Swap Information”). The City shall keep the Swap Information with respect to each swap throughout the life of the swap and for a period of at least five years following the final termination of the swap (in either electronic or paper form so long as the information is retrievable within five business days). The City shall maintain in such records any unique swap identifiers assigned by the City’s swap counterparties.