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AN UPDATE ON SWAPS

WHAT'S DIFFERENT AND WHAT TO DISCLOSE?

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AN UPDATE ON SWAPS

WHAT'S DIFFERENT AND WHAT TO DISCLOSE?

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INTRODUCTION

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SWAPS OVERVIEW

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Background

- ▣ **Title:** Title VII of the Dodd-Frank Act, known as the *Wall Street Transparency and Accountability Act of 2010*, passed in July 2010
- ▣ **Purpose:** To provide increased transparency to the derivatives markets and reduce systemic risk through enhanced exchange trading and central clearing, reporting and recordkeeping of transactions and margin/capital requirements, as well as the application of external business conduct standards to swap dealers.

Background

- Overview of Implementation of the Dodd-Frank Act
 - ▣ Definitions of “Swap”, “Swap Dealer” and “Special Entity”
 - ▣ Central Clearing
 - ▣ Reporting
 - ▣ Recordkeeping
 - ▣ Margin Requirements
 - ▣ External Business Conduct Requirements

Definitions

□ What is a Swap?

- Broadly defined by the Act to include, *inter alia*, interest rate swaps, caps and floors, credit default swaps, total return swaps, weather swaps, energy swaps, equity swaps, equity index swaps, agricultural swaps, commodity swaps and any “agreement, contract, or transaction that is, or in the future becomes, commonly known to the trade as a swap.”
- Primary regulatory authority over swaps is granted to the Commodity Futures Trading Commission (CFTC)

Definitions

- **Who is a Swap Dealer?**
 - ▣ Holds itself out as a dealer in swaps;
 - ▣ Makes a market in swaps;
 - ▣ Regularly engages in the purchase and sale of swaps in the ordinary course of business; or
 - ▣ Engages in any activity causing the person to be commonly known in the trade as a dealer or market maker in swaps.

****** The CFTC expected that approximately 125 entities would register as Swap Dealers. Currently, 94 have registered.***

Definitions

□ What is a “special entity”?

- “Special Entities” are defined to include:
 - Federal agencies;
 - States, State agencies, cities, counties, municipalities or other political subdivisions of a State;
 - employee benefit plans and governmental plans under ERISA; and
 - endowments (including organizations described in section 501(c)(3) of the Internal Revenue Code of 1986, as amended).
- Dodd-Frank increased the discretionary investment threshold for governmental entities to qualify as “eligible contract participants” (generally, entities permitted to enter into swaps outside of a regulated exchange) to \$50 million from \$25 million.

Central Clearing

□ General

- CFTC may determine that a group, category, type, or class of swap must be centrally cleared by a derivatives clearing organization (“DCO”)
- Generally, swaps for which a clearing determination has been made must be submitted for clearing unless:
 - no DCO accepts the swap for clearing;
 - the “end-user exception” applies; or
 - another exemption applies.
- CFTC made the initial clearing determination in December 2012 for certain interest rate swaps and index credit default swaps
 - compliance with the clearing determination occurred in 3 phases over 9 months, and was dependent on type of entity (called “Categories”)

Central Clearing

□ End-User Exception

- generally available to a party that: (i) is not a "financial entity"; (ii) is using the swap to hedge or mitigate commercial risk; and (iii) notifies the CFTC how it generally meets its financial obligations associated with entering into uncleared swaps
 - the additional information may be provided by the electing party either in an annual filing or, through the reporting party (*i.e.*, the swap dealer counterparty), on a swap-by-swap basis
- “financial entity” includes “a person predominantly engaged in activities that are in the business of banking, or in activities that are financial in nature, as defined in section 4(k) of the Bank Holding Company Act of 1956”
 - State and Local Governments: “predominantly engaged” test
- “Hedging or mitigating commercial risk” guidance

Reporting

□ Dodd-Frank:

- Both cleared and uncleared swaps, including historical swaps, must be reported to a registered “swap data repository”
- Legal Entity Identifiers

□ CFTC final rules:

- if a swap is executed on an exchange or other trading platform, then that facility (and not the swap counterparties) must report the swap to an SDR, as soon as “technologically practicable”; and
- if a swap is not executed on an exchange or other trading platform, reporting must be done by:
 - if only one party is an SD, that party;
 - if both parties to a swap are non-SDs and only one party is a U.S. person, that party; or
 - for any other swap, the counterparties are to agree as a term of the swap as to the reporting party.

Recordkeeping

- What must be maintained:
 - Swaps entered into on or after April 10, 2013: comprehensive records in paper or electronic form
 - Swaps entered into before April 10, 2013:
 - If the swap existed on or after July 21, 2010, information and documents relating to the terms of the swap possessed on or after October 14, 2010 or December 17, 2010 (depending on when the swap was entered into)
 - If the swap existed on or after April 25, 2011, minimum economic information as well as any swap documentation in possession on or after such date
- Retention:

Swap records must be maintained throughout the life of the swap and for a period of at least five years from the final termination of the swap
- Retrieval:
 - Swap records generally must be retrievable within five business days throughout the period during which they are maintained
- Inspection:
 - Swaps records retained are open to inspection by the CFTC

Margin

- **Uncleared Swaps Margin** (proposed rules of CFTC and prudential regulators (April 2011)):
 - “financial end-users” (either “high-risk” or “low-risk”) vs. “non-financial end-users”
 - With respect to non-financial end-users, different approaches proposed:
 - CFTC – proposes that some “credit support arrangement” exist with a swap dealer (but maintains the right to require end-users to deliver margin)
 - Prudential Regulators – propose delivery of initial margin and weekly variation margin above credit-based thresholds set by swap dealers, not subject to any floors but reviewable by the regulator
 - segregation of initial (but not variation) margin
 - not expected to apply retroactively

Extraterritoriality

- Title VII does not apply to foreign activities (including swaps entered not between persons outside of the U.S.) unless those activities either:
 - ▣ have a direct and significant connection with activities in, or effect on commerce of the United States; or
 - ▣ contravene such rules or regulations as the CFTC may prescribe or promulgate as are necessary or appropriate to prevent the evasion of any provision of the Act

External Business Conduct Requirements

- Swap dealers must disclose to counterparties material risks, fees, and conflicts of interest
- Swap dealers must provide daily mid-market marks to counterparties on uncleared swaps
- Swap dealers must notify counterparties that they have the right to request a scenario analysis (and must provide such a scenario analysis upon request)
- With respect to “special entities,” swap dealers must:
 - have a reasonable basis to believe that the special entity has an “independent representative” that has specified qualifications; and
 - before the initiation of any transaction, disclose to the special entity in writing the capacity in which the swap dealer or major swap participant is acting.

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NEW SWAP REGULATIONS

New Business Conduct Standards and
Clearing Requirements Impact on Swap
Transactions

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Amending Swap Documentation to Comply with the Business Conduct Standards and Clearing Requirements

If you are a Special Entity, what do you need to do?

19

- Before executing any transaction with a swap dealer, you will need to:
 - ▣ Amend your swap transaction to make the disclosures and representations necessary to enable the swap dealer to comply with the business conduct standards and the clearing requirements; and
 - ▣ Take the steps necessary to have a Qualified Independent Representative (“QIR”) in place; and
 - ▣ Determine if third party consent is needed for amendments to be effective.

Amending your swap transactions

20

- There are two ways to amend your swap transactions:
 - ▣ ISDA has published a set of protocol documents that allow for counterparties and swap dealers to effect the necessary amendments; or
 - ▣ The counterparties and swap dealers can use their own documents.

- Both methods are pretty common.

If you are going to use the protocol documents:

21

- You will need to:
 - ▣ Execute an adherence letter.
 - This is done through ISDA's website
 - Costs \$500
 - ▣ Exchange protocol questionnaires with your swap dealers
 - This is where you provide the disclosures that are specific to you, identify your entity as a Special Entity and identify which sections of the protocol documents apply to your transaction.
 - These questionnaires have a number of very important elections and representations that need to be looked over to be sure that they are accurate and intentional.

If you are not going to use the protocol documents:

22

- The process is still somewhat the same.
- The swap dealers have their own forms of documents that should be substantially similar to the protocol documents.
- Involves completing a questionnaire like the protocol questionnaire.

What are some of the important provisions of the questionnaires?

23

- You need to declare your entity as an eligible contract participant
- If you are a Special Entity:
 - You need to state that you are a Special Entity; and
 - You need designate your QIR.
- You need to make your mandatory clearing requirement elections
 - Special Entities should be able to qualify for the end-use exception; and
 - The questionnaire prompts you to make the representations that validate that you qualify for the exception.

Qualified Independent Representative

24

- What is a Qualified Independent Representative? A representative of the Special Entity who:
 - ▣ has sufficient knowledge to evaluate the transactions and risks;
 - ▣ is not subject to a statutory disqualification;
 - ▣ is independent of the swap dealer;
 - ▣ undertakes a duty to act in the best interests of the Special Entity it represents;
 - ▣ makes appropriate and timely disclosures to the Special Entity;
 - ▣ evaluates, consistent with any guidelines provided by the Special Entity, fair pricing and the appropriateness of the swap; and
 - ▣ in the case of a governmental Special Entity, is subject to SEC/CFTC restrictions on political contributions, provided that this shall not apply if the representative is an employee of the Special Entity.

Qualified Independent Representative (Continued)

25

□ Independent means:

- the representative is not and, within one year of representing the Special Entity in connection with the swap, was not an associated person of the swap dealer;
- there is no principal relationship between the representative of the Special Entity and the swap dealer;
- the representative: (i) provides timely and effective disclosures to the Special Entity of all material conflicts of interest that could reasonably affect the judgment or decision making of the representative with respect to its obligations to the Special Entity and (ii) complies with policies and procedures reasonably designed to manage and mitigate such material conflicts of interest;
- the representative is not directly or indirectly, through one or more persons, controlled by, in control of, or under common control with the swap dealer; and
- the swap dealer did not refer, recommend or introduce the representative to the Special Entity within one year of the representative's representation of the Special Entity in connection with the swap.

Qualified Independent Representative (Continued)

26

- What does this mean that a Special Entity needs to do?
 - Make sure that it has a swap advisor and that the swap advisor meets the requirements of the rules;
 - Enter into a QIR Agreement with the swap advisor so that the swap advisor is providing the necessary representations concerning its qualifications and other requirements; and
 - Adopt policies and procedures that govern the relationship of the QIR and the Special Entity.

27

Things you may need to be doing

Things you may need to be doing because of these rules

28

- How will these rules apply to you?
 - ▣ Do you plan on entering into new swaps or amending, novating or terminating existing swaps?
- Questions to consider to amend your documents:
 - ▣ Do you need a QIR?
 - ▣ Do you have authority to amend your swap documents or do you need board approval?
 - ▣ Do you have authority to modify your internal policies and procedures or do you need board approval?
 - ▣ Do you need third party consent for amendments?

Things you may need to be doing because of these rules (Continued)

29

- Be prepared to execute ISDA Protocol Documents or some other agreement to comply with business conduct standards
 - If you are going to execute the ISDA Protocol Documents, you need to be sure to:
 - Execute an adherence letter
 - Be prepared to exchange questionnaires
 - If you are going to work outside of the ISDA Protocol Documents, you should contact your swap dealer to understand how that process will work.

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GASB 53

**ACCOUNTING AND FINANCIAL REPORTING
FOR DERIVATIVE INSTRUMENTS**

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Refresher

□ GASB 53

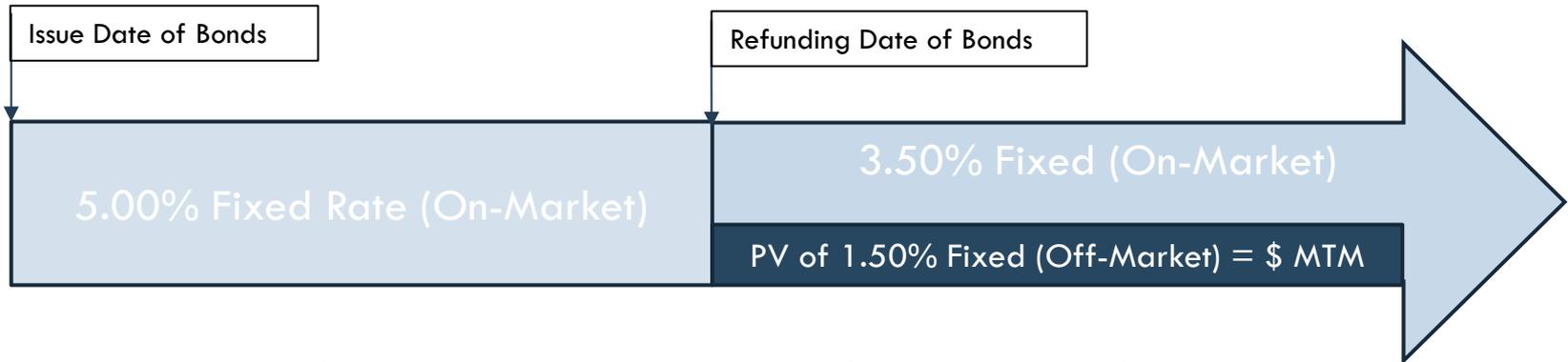
- Objective: Enhance the usefulness and comparability of derivative instrument information reported by state and local governments (“Issuers”)
- Derivative instruments include interest rate swaps (“Swaps”), and commodity hedges but not investments such as GICs.
- GASB 53 Requirements
 - Test each Swap for “hedge effectiveness”
 - Record the change in fair value within the statement of net assets
 - Provide summary of activities, summary of Swaps, including the terms and risks associated with each, in the Financial Statement Notes
- Effective for Fiscal Years beginning on and after June 15, 2009

Focus: Terminations of Hedge Accounting

- Issuers should be aware of the circumstances that can cause “terminations of hedge accounting”, and the impact on financial reporting as a result
- Examples
 - The bonds hedged by the swap are refunded.
 - Result: Balance in the deferral account \$0, offset by similar amount to carrying cost of old debt. Eligible for new hedging relationship
 - Modification or restructuring of the swaps
 - Result: Balance in the deferral account \$0, offset by similar amount to investment revenue. Eligible for new hedging relationship
 - Assignment or novation of the swap
 - Result: Balance in the deferral account \$0, offset by similar amount to investment revenue. Eligible for new hedging relationship
 - GASB 64 assignment or novation of the swap
 - Result: Non-event. Continuation of existing hedging relationship
 - GASB 64 accommodation limited to assignments and novations resulting from an ISDA Termination Event (e.g., counterparty downgrade).

Termination of Hedge Accounting Example

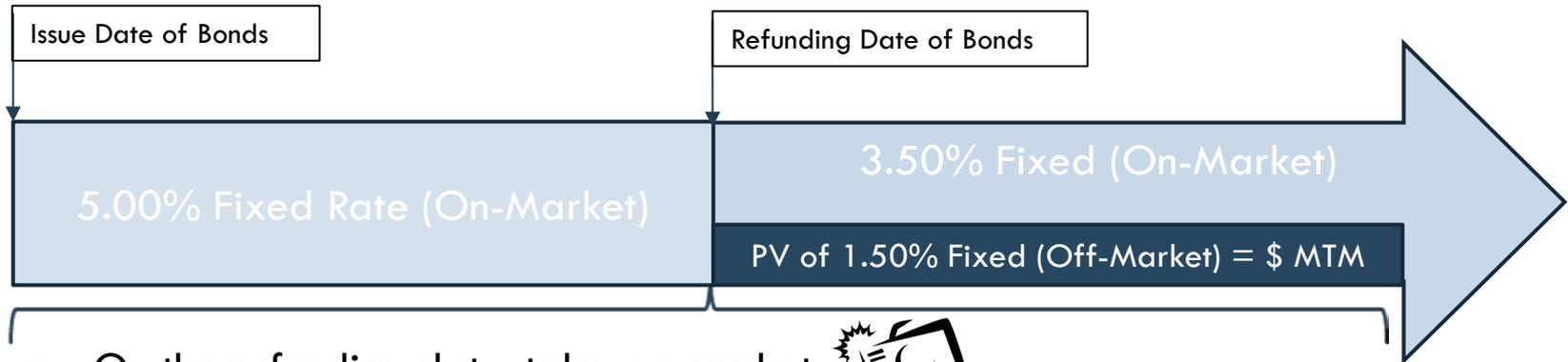
Swap Timeline



- Issue Date of Bonds
 - VRDO bonds swapped to fixed
 - Fixed rate on swap is 5.00%. No upfront payments
MTM = \$0 on trade date
 - Swap is determined to be an effective hedge
- Refunding Date of Bonds
 - VRDO bonds refunded with LIBOR direct purchase bonds
 - No change or modification made to swap
 - Nevertheless, this is a termination of hedge accounting event

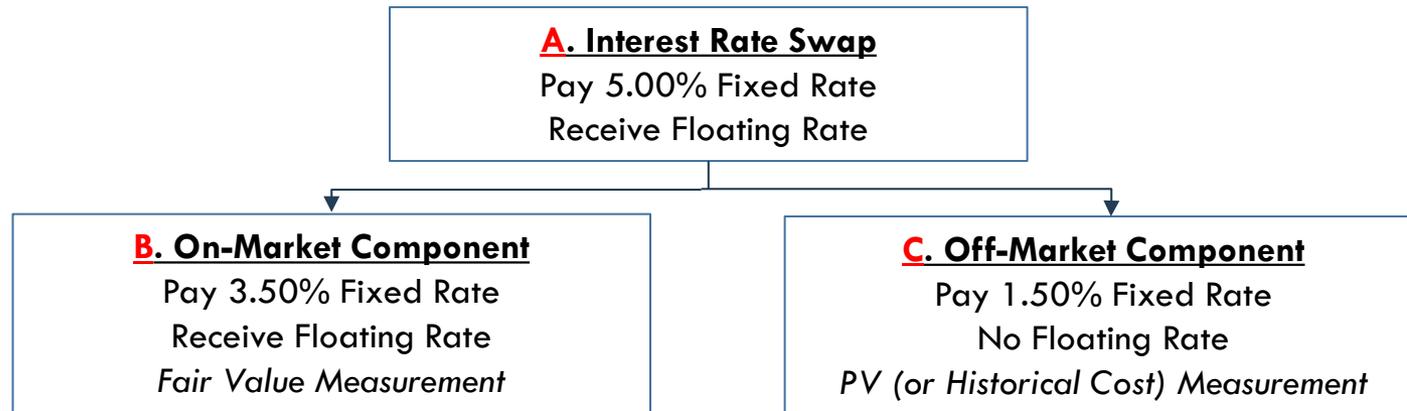
Bifurcation of the Swap: Off-market and On-market components

Swap Timeline



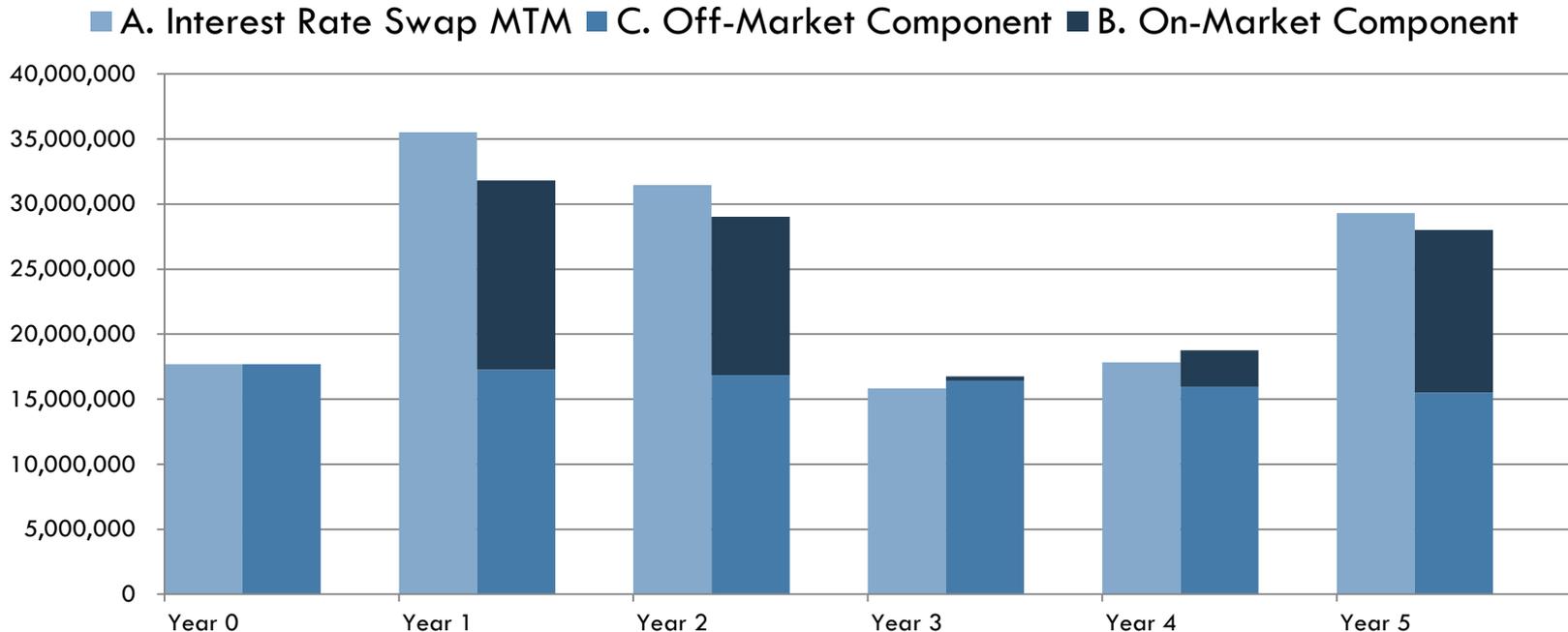
- On the refunding date, take a snapshot: 
 - The value, or mark-to-market value (“MTM”), of the swap is recorded in the carrying amount of the old debt. (This amount is then amortized over the remaining life of the swap, or the refunding bonds, whichever is shorter). At the same time, the balance in the deferral account becomes \$0.
 - Swap is bifurcated into two components, the off-market portion (i.e., 1.50%) and the on-market portion (i.e. 3.50%)
 - A new hedging relationship can then be established between the on-market portion of the swap and the refunding bonds.

Swap Component Values: $1 + 1 \neq 2$?



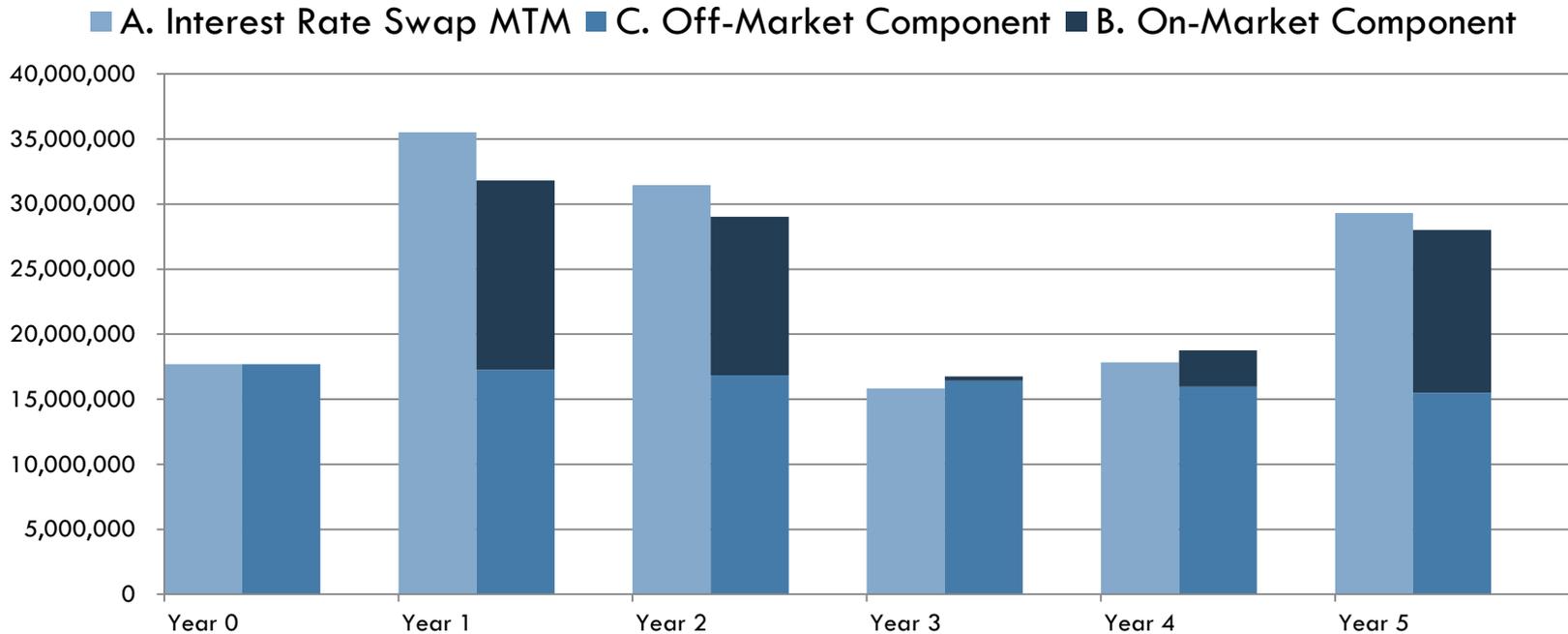
- At the end of each fiscal year, two values are recorded:
 - ▣ On-Market Component: Fair value of the hypothetical 3.5% swap. If effective, then deferred inflow/outflow.
 - ▣ Off-Market Component: Present value of the off-market component using a constant yield derived from the snapshot. Often referred to as the “borrowing” or “loan” balance since mechanically, treated as a fixed rate liability.
- There is often confusion about how A, B, & C are related
 - ▣ Intuition suggests that $A = B + C$
 - ▣ This intuition is reinforced by MTM valuation statements provided by counterparties.

Swap Component Values: $1 + 1 \neq 2$?



- In Year 0, the MTM of the swap and the off-market component are the same, as expected, since the on-market swap has a \$0 value at inception (i.e. the refunding date)
- In subsequent years, the GASB 53 accounting values are represented by the stacked bar. However, Issuers may receive MTM valuation statements from counterparties represented by the first bar.

Swap Component Values: $1 + 1 \neq 2$?



- Which one is correct?
 - The stacked bar is correct for accounting purposes
 - The single colored bar more closely approximates the cost to terminate the swap at that time.
 - The difference arises from valuing the off-market component on a constant yield basis (i.e. from the refunding snapshot) and not the then market value.

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SWAPS AND FLOATING RATE DEBT IN A POST-CRISIS WORLD

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Interest rate outlook

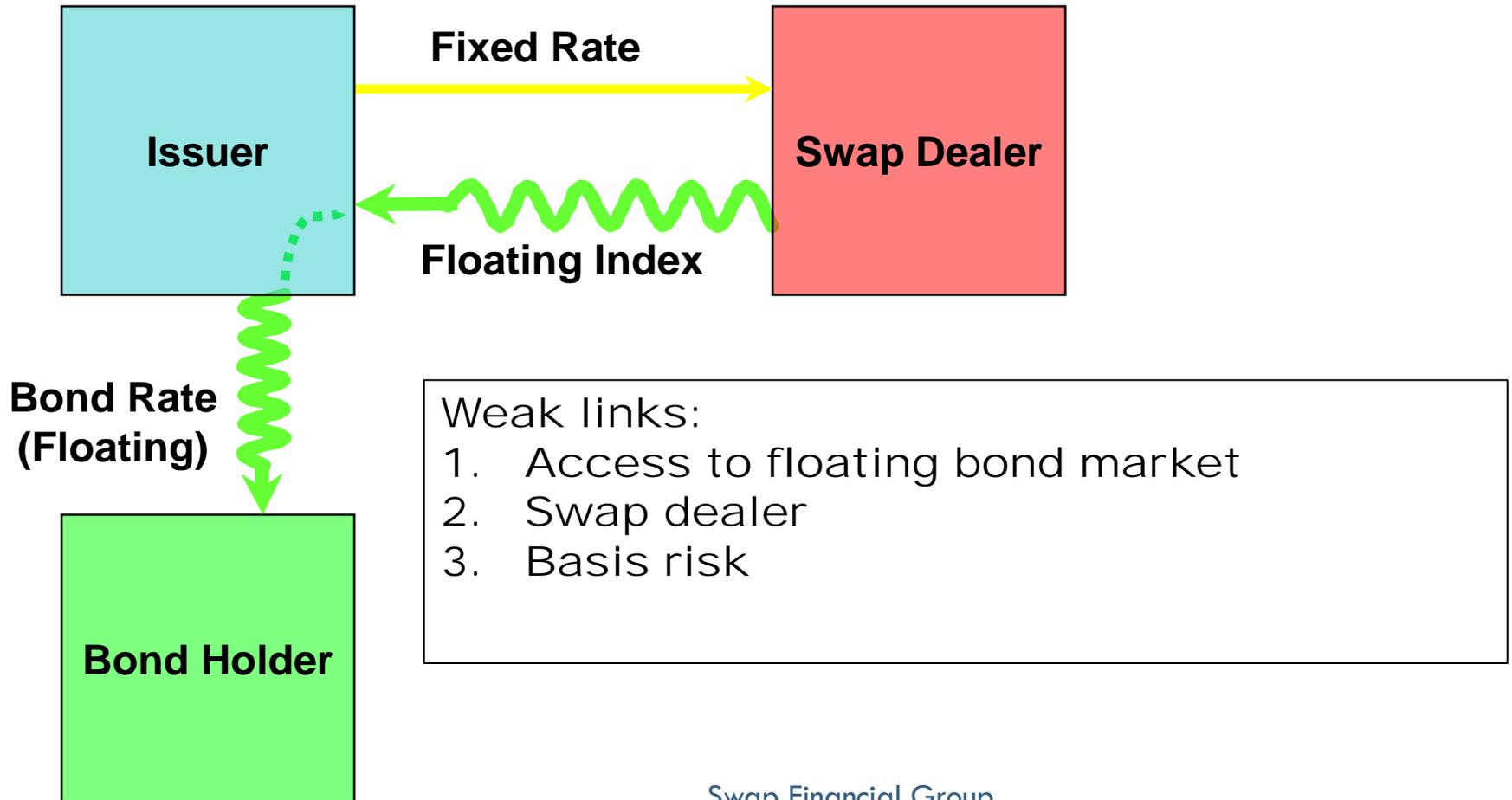
39

The era of lowest rates in modern history is ending

1. Fixed rates have already risen more than 100 bps
 - ▣ As the Fed reduces its bond-purchasing program (AKA “quantitative easing”), fixed rate will continue to rise
2. Floating rates will remain ultra low for at least another year
 - ▣ Fed “forward guidance”: Fed Funds will remain “extraordinarily low” for “an extended period”
 - ▣ Tax-exempts get extra kick from supply-demand imbalance
3. As economy continues to heal, both types of rates will move up:
 - ▣ First, higher fixed rates, steeper yield curve
 - ▣ Second, higher floating rates, normal yield curve

Typical swap – ‘synthetic fixed’

40



Factor 1: Floating debt

41

Crisis: Achilles heal was LOC rollovers

- Subprime > Insurer failures > ARS collapse > Flood of bonds seeking LOC's
- Subprime > Bank failures/downgrades > VRDO puts > Little healthy bank capacity
- Rollover terror: Cost, term, availability

Today:

- LOC's: New players, availability, lower cost
- Alternative floating rate products

Floating rate products today

42

1. VRDO's – LOC rates much lower; self-liquidity for high-rated, cash-rich issuers
2. Index products – Private: Direct Purchases, Public: FRN's – have exploded
 - ▣ Get good terms, esp. re tax law and regulatory capital changes
3. New products – i.e. Barclays VRO's (30 year product)
4. Most borrowers are too heavily weighted to fixed (both natural and synthetic)
 - ▣ Floating pays long term
 - ▣ Natural enterprise hedge

Factor 2: Swap dealers

43

Crisis:

- Lehman failed, others downgraded, nationalized
- Terminations and replacements, mostly managed effectively and at low cost

Today:

- Bank weakness continues
- Some strong banks remain, emerging players

Before and after

44

	Pre-Crisis	Today
Triple A	Citi, JPM, ML UBS	None
Double A	GS, MS	BNY, RBC , TD, Wells, US Bank
Split	Lehman	JPM, Sumitomo
Single A	Bear	Barclays, Deutsche, GS
Triple B (one rating)		Citi*, ML*, MS
Gone		Bear, Lehman, UBS**

*Commercial banking entities (Citibank N.A. and Bank of America N.A.) are single A.

** Exited swap business. Also: AIG, Ambac, Depfa, Dexia

Factor 3: Basis risk

45

Crisis:

- Floating rate paid (ARS, VRDO's with bad banks) exceeded floating rate received (SIFMA or % of LIBOR)

Today:

- Most bonds trading well
- % of LIBOR swaps doing extremely well (SIFMA averaging less than 50% of LIBOR)

Swap Savings – Pre-Crisis Herd

30-yr muni bond
vs.
67% Libor swap
(28 bps of costs)

Average 'Herd
Market' Savings:
30 bps



Swap Savings – Now

30-yr muni bond
vs.
67% Libor swap
(100 bps of
costs)

Savings today:
170 bps



Give yourself call flexibility

Traditional No-Call Swap

- 30-year rate : 170 bps lower than bonds
- Early termination can be costly: On \$100 million notional, a 175 bp drop in 3 years can create a termination cost of more than \$30 million
- No refinancing opportunities

Callable Swap

- With 5-year call: 128 bps lower
- Lower MTM risk: a 175 bps drop in 3 years moves MTM by only \$7 million
- For refinancings, even better than conventional fixed-rate bonds

Who should do swaps?

49

Swaps are not suitable for many issuers

- Risk: Benefit and risk go together – you must understand and evaluate the trade-off, and be sure you can handle the risks
- Financial flexibility: Things can go wrong – you should have ability to manage “wiggle room”, i.e. some degree of variability in expected results, as well as possible disruptions
- Administrative burden: Swaps must be managed - unlike conventional bonds, you can't get the deal done and stick it on the shelf
- Understanding: Excessive reliance on an advisor or banker is a red light – if you don't understand the deal well enough to explain to your board without assistance, don't do it

Key Take-Aways

50

1. Reduce risk, increase flexibility with calls
2. Assume a conservative “carrying cost” for floating rate debt
3. Understand and take advantage of new products – and negotiate hard
4. Plan on active management of rollover risk – LOC rollover, product shift, etc.
5. Be very cautious if your ratings are low single-A or BBB
6. Learn the lessons of behavioral finance – don’t be afraid to move differently than the herd

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QUESTIONS AND ANSWERS

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