10 Questions for bond issuers to ask of other transaction participants, their swap advisor or financial adviser and the swap counterparty:

1 How will the procurement and fair market value of the swap be documented?

Swap transactions are uniformly documented through the use of documents and schedules developed by the International Swap Dealers Association (ISDA) including a Master Agreement and Credit Support Annex. Additionally, cross-references are often required to various bond documents. Issuers must know the compliance and documentation requirements in terms of disclosure and calculations needed to establish the initial value and ongoing determination of fair market value.

2 Many regional dealers are engaged in back-to-back hedging arrangements with a primary dealer. Is this the case with the prospective swap?

If so, the issuer will need to explore the benefits and costs of having a regional dealer involved. The issuer will need to know the dealer fees and how the fee disclosure will be affected.

3 Does the swap have a standard or a non-standard (proprietary) structure?

Whether standard or non-standard, the issuer will need to know how it will be priced, how it will be valued on a periodic basis, and who will provide the periodic valuation. In addition, a termination payment based on market prices should be discussed.

4 If the proposed swap is terminated prior to the maturity date under certain conditions or at one party's option, what is the mechanism for determining the termination cost?

Most swaps may be terminated prior to their stated maturity date. The termination payment is the economic value of the difference between current rates and the contracted swap rate for the remaining life of the swap after adjusting for embedded options or similar features. The issuer should know if the swap allows for an independent valuation for the termination cost.

5 Does the swap document allow us to transfer the swap to another party if we desire?

Under the ISDA Master Agreement, a party to a transaction must obtain the written consent of the other party to the transaction prior to transferring its rights and obligations under that transaction to a third party. Relevant factors in deciding whether to consent to a transfer include credit rating, collateral, netting and tax, operational, accounting and other considerations.

6 Will the swap provider or another entity offer periodic mark-to-market services electronically?

This is an important maintenance tool. Issuer staff or its advisor should monitor and document changes in the swap's value based on changing market conditions.

7 Will the swap provider terminate at the mark-to-market price or add additional commissions?

It is common practice for swaps to be terminated at prices determined by specific procedures different from ones used for mark-to-market purposes. Mark-to-market reports by their nature are not "real time" and do not reflect intraday pricing movements.

8 Will the swap provider agree to collateralize if its credit rating is downgraded?

Downgrades in credit ratings can have a negative impact on the market value of a swap. A swap contract should specify that the swap provider always post collateral with a third party to ensure performance on the agreement.

For additional information or questions contact:
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9 What is the credit rating of the swap provider?

The swap provider's credit rating is the prime indicator of counterparty risk, or risk that the counterparty will not honor its payment obligations under the swap contract because the counterparty has defaulted. If that happens, the issuer no longer receives from or makes payments to the counterparty, thus potentially eliminating any benefits of the swap.

Counterparty risk should be addressed through establishment of guidelines for exposure levels, credit rating thresholds, and, particularly, in the establishment of collateralization requirements. Many entities attempt to mitigate this risk by swapping only with counterparties with certain minimum credit ratings, such as A or AA.

10 Is the swap provider currently, or have they in the past, been involved in litigation with a client regarding a swap?

Past experience can be a precursor of things to come. The market is competitive and there are many providers offering competitive deals. The issuer should always select a swap provider with a strong business record.

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20 Questions for Municipal Interest Rate Swap Issuers

CALIFORNIA DEBT AND INVESTMENT ADVISORY COMMISSION
Phil Angelides, State Treasurer and Chair

CDIAC #05-04

10 Questions for bond Issuer's to ask themselves before transacting an interest rate swap:

1 What financial goals are achieved by the proposed swap?

Management must consider swaps in context to their overall financial plan. Swaps can be used to hedge interest rate risks, change the allocation of fixed to variable rate assets or liabilities to achieve better matching, change the pattern of debt service payments, limit variable rate interest payment fluctuations, or lock-in refinancing savings. Speculation should never be a consideration with regard to implementing an interest rate swap.

2 Are there other ways to achieve the same financial goals?

Management should always consider multiple alternatives to achieving their financial goals. Considerations include cost comparisons to other alternatives and their effectiveness in accomplishing the stated goals. Risk management is a major issue to be addressed in any swap transaction, and its risks should be compared to those of other alternatives that may achieve similar goals.

3 Is there a written swap policy in place?

A swap policy should establish guidelines to be followed and used in the implementation of an interest rate swap program. The policy should be a well-documented commitment from the issuer's management to a sound financial management program. A comprehensive review of the risks, returns, resources and reporting needed to maintain a swap program should be addressed and approved by management.

4 What risks do we retain?

Interest rate swaps carry many types of risk. The issuer must be able to quantify their financial exposure based on interest rates, the probability that the payments made by the issuer on its debt do not match the receipts it receives from the counterparty, in the financial condition of the counterparty that the issuer is swapping with and how a change in their credit quality affect the swap, and events that would terminate the swap.

5 What impact will an interest rate swap have on our credit rating?

The major credit rating agencies consider interest rate swaps when making credit rating decisions. The implementation of an interest rate swap, in isolation, does not necessarily have an impact on ratings, either positive or negative. The rating agencies are most concerned with the issuer's understanding of how interest rate swaps fit within their overall risk management program and the effect of early terminations or collateral calls.

The issuer must be able to explain their overall asset/liability management/policies, the reason for entering into the swap agreement, and the risks and benefits of entering into a swap in simple terms. The issuer should illustrate an understanding of the source of payment under adverse circumstances and the costs, benefits, and risks associated with different interest rate scenarios.

6 Do we have adequate knowledge, resources and commitment to administer a swap program?

Swaps are complex transactions that require active management, monitoring, and reporting. The issuer should provide resources dedicated to the management of the swap program. Staff will need to monitor the swaps closely, including determination of fair market value, cash flows, and changes in risk/return characteristics. Staff should have the knowledge to make decisions on early termination, changing contract length, selling of options, and disclosure.

7 Do we need the help of an outside financial advisor and/or swap advisor?

Given that each swap provider generally has done more swaps than any single bond issuer, a swap advisor may be retained to help level the playing field, and to provide independent structural, procurement, and valuation services. These will assist the issuer in assuring that the swap is obtained at fair market value, all risks are understood, and that the terms have been effectively negotiated on behalf of the issuer. A swap advisor can assist with evaluating the benefits to the issuer of insuring the on-going as well as the termination payments under the swap.

8 What procurement method will be used to obtain the swap?

Swaps can be issued using the following methods: negotiated bid, competitive bid, or a negotiated bid with some competitive bid aspects. The issuer will have to determine which method is most beneficial and that the swap price and terms are fair. In a competitive transaction the issuer will need to determine who will evaluate the bids.

9 How does the issuer guard against speculating in the swap transaction?

Use of swaps should be limited to hedging and reducing an issuer's risks and not for purpose of speculation, leverage, or to bypass the spirit of established debt and investment guidelines. Locking in lower cost of funds or optimizing asset and liability mix are examples of appropriate use.

10 Can the swap provider terminate the swap early?

Unless structured differently, most interest rate swaps can be terminated at any time by giving notice to its counterparty. Typically, the issuer will want to limit the counterparty's ability to terminate based on an issuer's nonperformance or credit deterioration. Gains or losses based on changes in interest rates may become realized if an interest rate swap is terminated in advance of its contractual maturity date. If so, the issuer should know where the money will come from if a termination payment is due to its counterparty. They must also identify the parties who will calculate the termination price. They may also negotiate optional termination by issuer only.

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