National Federation of Municipal Analysts

White Paper on Disclosure for Swaps

The National Federation of Municipal Analysts (NFMA) is an organization of nearly 1,000 members, primarily research analysts, who evaluate credit and other risks of municipal securities. These individuals represent, among others, mutual funds, insurance companies, broker/dealers, bond insurers, and rating agencies.

One of the main initiatives of the NFMA is to promote timely and complete disclosure of the financial and operating information needed to assess the credit quality and risk of a municipal debt issue. The NFMA's efforts have ranged from global disclosure-related issues to more detailed, sector-specific work. For further information on the NFMA's continuing work in the area of disclosure, please see the "Disclosure Guidelines" and "Position Statements" on the NFMA's web site at www.nfma.org.

The following discussion takes the form of a "White Paper" rather than a "Recommended Best Practice in Disclosure". Current swaps disclosure is in an embryonic state; it is anticipated that this White Paper will catalyze industry discussion as to what improved disclosure practices should entail. In order to develop our Recommended Best Practices in Disclosure, diverse groups of NFMA analysts worked with non-analyst professionals in each sector to develop "best practices" guidelines for certain market sectors. The same process was followed to produce this White Paper that includes descriptions of the specific information needed to help analysts do their jobs. The NFMA believes that the best practice in disclosure will always be the one that provides a steady flow of timely information from borrowers to the entire market.

Following is the White Paper on Disclosure for Swaps. This document is not intended to supplant the amendments to Rule 15c2-12, but to be used in conjunction with the guidance provided in this rule and its amendments. It is important to note that the NFMA's disclosure efforts are a continuing process. This White Paper and the Recommended Best Practices papers are not static documents, and will be revisited and changed as market conditions warrant. We encourage interested parties to submit comments at any time to lgood@nfma.org so that they can be considered in the development of future versions of this White Paper on Disclosure for Swaps.

The recommendations included in this White paper are not intended to be a "one size fits all", and all the information requested may not apply to every transaction in the sector. We encourage the providers of information to indicate when a specific item requested in the White Paper is not applicable to a specific transaction.

INTRODUCTION:

The NFMA Swap Disclosure Task Force was formed to produce a White Paper to identify those issues of concern to analysts regarding the identification of interest rate derivatives, particularly swap and swaption transactions into which bond issuers have entered, as well as the disclosure of the terms of those transactions. The size and breadth of the municipal swap market is difficult to estimate. However, anecdotally it appears to have grown substantially in the last few years, with more issuer participants of varying levels of financial sophistication entering the market as swap counterparties. Regardless of market size, disclosure of swap transactions is uneven. It is the intent of this paper to identify the types of information that analysts need to better evaluate the credit posture of the issuers that are swap market participants. (N.B. The term "swap" is used herein to include swaptions.)

Documentation in the municipal swap market is almost universally accomplished through the negotiation and execution of the forms of documents published by the International Swaps and Derivatives Associations, Inc. (ISDA). Although certain provisions of the ISDA forms have been specially tailored for use by governmental entities (e.g., provisions regarding sovereign immunity), municipal market documents reflect standard ISDA terms. As such, apart from legal issues that are unique to the municipal market because of the nature of governmental entities – the capacity, power and authority of a governmental entity to engage in swap transactions, the credit posture of particular swap transactions within the structure of a governmental entity's financings – any legal issues arising under municipal swap market documentation should mirror the legal issues presented for the general derivatives market at large.

ANALYTIC ISSUES

Key to the credit evaluation process is the analyst's understanding of the bond issuer's financial profile, including its liquidity position and potential claims against that position. A significant component of that analysis is assessing the issuer's overall risk management policies, including its strategies for use of fixed and variable rate debt (whether synthetic or otherwise.) Accordingly, this paper discusses what information is necessary for full disclosure in both the primary and secondary markets, specifically as it relates to the mix of fixed and variable rate debt. In turn, this will assist in understanding the nature and potential volatility of the issuer's financial profile to changing interest rate environments. Comprehensive disclosure of swap transactions, whether entered into to modify the risk of future interest rate changes with respect to any series of bonds or for balance sheet management reasons, helps the analyst more fully develop an overall picture of the issuer's financial operations, asset-liability management philosophy and financial prospects.

Additionally, although analysts for institutional investors and other fiduciaries rely upon tax counsel's opinion and assessment that a particular issue of bonds is tax-exempt, greater transparency with regard to the facts that underlie the tax characterization is desired in order to understand if the swap is included in arbitrage calculations.

Issues of key interest to analysts are:

- Mix of fixed and variable rate debt
- Liquidity
- Required cash flows related to the swaps and the impact those payments have on the financial results.
- Disclosure of how any up-front payment received by an issuer through a swap or in exchange for a swaption has been used to meet the issuer's budgetary or cash flow needs.
- The mechanism for any termination payment that may be ultimately due from the issuer
- If a swap transaction is being integrated for tax yield calculation purposes

DERIVATIVE TRANSACTION DISCLOSURE ISSUES GENERALLY

Municipal issuers have increasingly engaged in the use of derivative transactions, particularly swaps, either to fine-tune their debt strategy or, for more sophisticated issuers, as a component of their asset-liability management policy. Municipal issuers, including municipalities and their agencies, as well as not-for-profit health and higher education institutions, are seeking to reduce their interest expense and minimize interest rate exposure. A convenient means to do so has been through the use of interest rate swaps. Swaptions – i.e. the right for a party to cause the other party to enter into a swap – are another tool used for managing interest rate exposure with respect to an advance refunding or to monetize the value of a call option. As a result, some municipal issuers have received a cash flow benefit from an upfront payment through a swap or swaption transaction – often helpful in providing revenue and budgetary relief to the issuer or for the funding of capital projects.

Despite the rapid growth attributed to the municipal swap market, market disclosure has been inconsistent. Those municipal issuers reporting their financial results under FASB guidelines are now required to follow the accounting and reporting standards of FASB Statement No. 133 (FAS 133) – *Accounting for Derivative Instruments and Hedging Activities*. At the same time, municipal issuers reporting under the guidance of GASB (the larger share of the municipal market) should follow the disclosure requirements of GASB Technical Bulletin No. 2003-1 *Disclosure Requirements for Derivatives Not Reported at Fair Value on the Statement of Net Assets,* effective for fiscal years ending on or after June 15, 2003, the contents of which are incorporated by reference herein. It is assumed that footnote disclosure in the annual report or financial statements consistent with the Technical Bulletin will provide notification of hedges entered into subsequent to debt issuance. The GASB is currently undertaking a broader project on standards for reporting derivatives and hedges, which is currently expected to result in a recommendation during 2005.

SPECIFICS OF SWAPS DISCLOSURE

Below is a listing and discussion of elements analytically significant to the credit evaluation process. It is noted that not all of these elements will be included in the body of a Preliminary Offering Statement (POS), although it is encouraged that an Issuer do so. However, it is further noted that this information should be incorporated into the Issuer's annual audited financial statements, which would be incorporated into its POS.

It is expected, moreover, that as part of the issuer's overall disclosure practices, any material post-audit financial event, including the entry into a swap whether in conjunction with a bond sale or after the initial offering period, would be noted in any subsequent POS. It is further noted that in most instances the existence of a swap is considered to be analytically material.

- ISSUER'S RISK MANAGEMENT
  - Overall risk management policies, including the broad risk management objectives to be achieved, and how they fit into the issuer's debt management plans
  - Process by which swap contracts are evaluated, approved and monitored.

    COMMENT: Analysts have indicated that the existence of a formal swaps management plan is an indicator of management intent and the contents of the plan is an indicator of the entity's risk tolerance.

- ISSUER'S DEBT PROFILE:
  - Mix of variable rate and fixed rate debt
  - Liquidity

    COMMENT: Analysts have indicated a preference that Continuing Disclosure Agreements specifically state that swap information will be included as part of the issuer's annual financial information.

- SWAPS SUMMARY:
  - Objective for swap transactions (i.e. are the swaps used for hedging any investment or debt issues)
  - Listing of each individual swap and a transaction summary
  - Each swap transaction would list the counterparty with their current ratings, the notional amount of the swap, the termination date, and which bond series, if any, the swap is tied to.

- A description of whether or not each swap transaction stands alone or if netting of multiple swap transactions with the same counterparty and from the same source of payment is permitted.
- Collateral requirements – conditions requiring collateral as stated in the Credit Support Annex to the ISDA Master Agreement, as well as the type of collateral permitted and whether it is held in trust.
- Volatility of variable interest rate exposure by combining traditional debt with swaps under various interest rate scenarios.

  COMMENT: Swaps result in an issuer converting variable interest rate costs to a fixed interest rate, fixed interest rate costs to a variable interest rate, or one variable interest rate cost into another variable interest rate (basis swap). As a result, the issuer ends up changing its exposure to interest rate movements.

  Where an issuer is synthetically fixing its variable interest rate costs by entering into a swap where the issuer receives a floating rate and pays a fixed rate some disclosure is appropriate regarding the potential basis risk between the two different floating rates.

  Conversely, where an issuer is converting its fixed rate debt into variable rate exposure by entering into a swap where it receives fixed and pays a floating rate, or is taking on basis risk by entering into a basis swap, additional disclosure should be provided on not only the basis risk between the various floating rates, but also regarding what impact various interest rate movements will have on the issuer's obligations under the swap (e.g. what happens if rates move 100 bps, 200 bps, etc…) and the issuer's financial ability to meet those obligations.

- SWAP ECONOMIC TERMS:
  - Interest rate (variable rate index and fixed rate, if applicable)

    COMMENT: Note that in certain instances of variable rate debt issuance only one offering circular is prepared and interest rate data will not be available although the index upon which the swap will be priced (BMA, LIBOR) is known and can be disclosed.
  - Termination date and notional amounts with amortization, if applicable.
  - Optional termination dates and which counterparty owns the option

    COMMENT: There is general agreement that the above three items are the minimum information to be disclosed where known
  - Fair value at reporting date, as well as method and assumptions used to calculate fair value if other than market quotation (1992 ISDA Master Agreement) or close-out amount (2002 ISDA Master Agreement).Identity of dealer counterparty and related information (e.g. credit rating)

COMMENT: It is noted that there is a reluctance among some of the counterparties to be identified by name in the POS for competitive and/or liability reasons. These counterparties have suggested that a statement that the counterparty will be a "qualified swap party" as defined in the indenture should suffice. "Qualified Swap Party" is often defined to include a minimum rating level by specified NRSROs. At a minimum, the POS should identify the ratings of the qualified counterparties.

Buyers have indicated a preference for identification of the counterparties citing the possibility that their internal credit evaluation of a given counterparty may differ from that defined. It is noted that in the annual audited financial statement, identification of the counterparties is expected although not required under the accounting standards.

Where the indenture or debt management policy includes limitations/requirements as to diversification of counterparties these should be noted.

- OTHER ISSUES:
  - Authorization to enter into swaps

    COMMENT: It is noted that that state statutory authorization to enter into swaps varies greatly. Some states have enacted specific statutes authorizing localities to enter into swaps. Some issuers have grounded their authority on their general power to contract for services. There may be other rationales for entering into swaps, depending upon the relevant statutory client. In all cases, industry practice dictates that an opinion be rendered by an issuer's counsel that the transaction is authorized and that the documentation is valid and binding. It is further noted that where the swap has been entered into apart from a bond transaction, the analytic assumption is that a legality opinion has been rendered.
  - ISDA Standard Events of Default and Early Termination Events.

    COMMENT: Opinions diverge as to whether it is necessary to list ISDA standard events of default. Some Task Force members note however that familiarity with the ISDA documents is currently not widespread in the analytic community and accordingly all Events of Default and Early Termination Events should be included in the documents. Analogy is made to the listing of termination events for Standby Bond Purchase Agreements in offering documents.
  - Events of Default and Early Termination Events if outside ISDA standard terms (e.g. cross default terms and rating triggers)

COMMENT: It is important to note that the Early Termination Event for a downgrade of either party to the swap is individually negotiated. The provision is typically drafted to refer to rating downgrades by one or more NRSROs.

- Disclosure of occurrence of Early Termination Events or Events of Default
- Priority of swap periodic interest payments and termination payment relative to debt service obligations,

COMMENT: This addresses the issue of cross-default between debt service obligations and swaps and payment provisions upon cross-default.

It is further noted that, analytically, the presumption is that inclusion in the indenture of swap payments on parity with debt service payments (the cross-default provision) is factual. Where it is permissive, i.e. where the swap contract places payments lower in the funds flow, it would be to the issuer's advantage to so state.

- Source of payments

COMMENT: The legal basis for the source of revenue used to make parity or termination payments is also a concern. Issuers must ensure that they have not unintentionally created an illegal debt obligation when identifying the source of revenues used to make swap payments.

There is also the need to discuss the reliance of the issuer upon swap payments to make debt service payments (cash flow) and the source of termination payments.

- IF INSURED:
  - Disclosure of insured swap agreement, including if swap payments and/or termination payments are insured and, if so, to what amount.

APPENDIX

DEFINITIONS

- Additional Termination Event – As defined by ISDA, if specified in the Schedule or any Confirmation as applying, the occurrence of an Event at any time with respect to a party is considered a Termination Event and may result in an early termination of the transaction(s).
- Basis Risk – the risk from the mismatch between the interest rate received on an interest rate swap and the interest rate paid on the issuer's bonds. Also, the mismatch that can occur in a basis swap, in which both sides are paying variable rates but based on different indices.
- BMA Index – The Bond Market Association Municipal Swap Index, the principal benchmark for the floating rate payments for tax-exempt issuers. The BMA Index is a national rate based on a market basket of approximately 200 high-grade, seven-day tax-exempt variable rate issues of $10 million or more.
- Breach of Agreement – Failure by the party to comply with or perform any agreements or obligation in accordance with the executed ISDA Master Agreement is an Event of Default.
- Close-out Amount – the single measure of damages standard used to value transactions as defined in the 2002 ISDA Master Agreement. The Close-Out Amount replaces the Market Quotation and Loss methodology used in the 1992 Master Agreement.
- Confirmation – a part of the ISDA agreement that is executed for an individual derivative transaction, itemizing the specific terms and conditions for that transaction.
- Counterparty – a party in a derivative transaction
- Credit Event Upon Merger – If Credit Event Upon Merger is specified in the Schedule to the ISDA Master Agreement and a party merges with or into or transfers all or substantially all of its assets to another entity and it doesn't constitute a Merger Without Assumption but the creditworthiness of the resulting entity is materially weaker than the original party, this is a Termination Event.
- Credit Support – collateral that can be cash and/or marketable securities posted by one party to a swap agreement to reduce the credit exposure of its counterparty.
- Credit Support Annex – a part of the ISDA agreement that states the provisions regarding the mutual posting of collateral, if required, under the ISDA schedule. The need to post collateral is triggered by designated events (e.g. if the credit rating of a counterparty drops below an agreed-to rating level, or if the market value of the swap exceeds a threshold for a given rating level of either the issuer or the counterparty.)
- Credit Support Document – an agreement or instrument that is executed by either a counterparty to a swap or a third party (on a party's behalf) that supports or otherwise provides credit enhancement with respect to the obligations of such party to the ISDA Master Agreement.
- Cross Default – a party's failure to make any payment, or a default or event of default under one or more agreements that have been specified in the Schedule to the Master Agreement, and that the aggregate principal amount of the specified agreements is at or in excess of the specified threshold.

- Default under Specified Transaction – A party or a Specified Entity defaults under a Specified Transaction that was included in the Schedule to the ISDA Master Agreement is an Event of Default.
- Derivative – a financial transaction "derived" from an underlying asset, debt, index or reference rate
- FASB Statement 133 – issued by the Financial Accounting Standards Board (FASB), Statement 133 requires companies that report according to GAAP to include the fair value (i.e. mark-to-market) of their derivative positions on their balance sheets.
- Interest Rate Swap – a contractual agreement between two parties to exchange future net cash flows based on predetermined interest rate indices calculated on an agreed notional amount. The swap is not a debt instrument between the issuer and the counterparty, and there is no exchange of principal.
- ISDA – International Swap Dealers Association, the global trade association with over 575 member institutions representing leading participants in the derivatives industry.
- ISDA Master Agreement – the standardized master legal agreement for all derivative transactions between the Issuer and a counterparty that states standardized definitions, terms and representations governing the swap transaction(s). The 2002 Master Agreement is the new standard for documentation. Note that deals previously documented under the 1992 Master Agreement may or may not have had their documentation/terms modified by execution of an amendment.
- ISDA Standard Events of Default – Events of Default that are applicable to all swap transactions. The standard Events of Default are: failure to pay or deliver; breach or repudiation of agreement; credit support default; misrepresentation; default under specified transaction; cross-default (if specified in the ISDA Schedule to the Master Agreement as applying to the defaulting party); bankruptcy; merger without assumption.
- ISDA Standard Termination Events – Termination Events that are applicable to all swap transactions. The standard Termination Events are: illegality; force majeure event; tax event; tax event upon merger; credit event upon merger; any "additional termination event" if specified in the ISDA Schedule to the Master Agreement as applying to the affected party or affected parties.
- LIBOR – the principal benchmark for floating rate payments for taxable issuers. The London Inter Bank Offer Rate (LIBOR) is calculated as the average interest rate on Eurodollars traded between banks in London and can vary depending upon the maturity (e.g. one month or six months). A percentage of LIBOR can also be used as the floating rate index for tax-exempt swaps instead of the BMA Index.
- Mark-to-market – calculation of the value of a financial instrument (e.g. an interest rate swap) based on the current market rates or prices of the Underlying.
- Merger Without Assumption – If the party consolidates with or merges with or into, or transfers all or substantially all of its assets to, another entity and at the time of the merger the surviving entity fails to assume all obligations of the party under the ISDA Master Agreement, there is an Event of Default.

- Netting – (also known as “Close-out Netting”), the right to net the obligations under different transactions governed by the ISDA Master Agreement into a single amount. As the values of transactions can offset each other, this reduces the credit exposure between the counterparties.
- Notional – the “principal” amount or basis for the calculations of interest payments due.
- Schedule to the Master Agreement – a part of the ISDA agreement that sets out the specific business terms and conditions governing the derivative transaction(s) executed under the agreement.
- Set-off – the ability of the non-defaulting party to seek to garner other assets of the defaulting party (e.g. a deposit account) to reduce the amount owed to it by the defaulting party.
- Swaption – (also know as “Swap Option”). A swaption grants one counterparty the option to begin, cancel, or extend a swap. The fixed rate on the swap that underlies the option is the “strike rate”. A counterparty that sells an option to the other (usually the issuer to a dealer) can receive an up-front cash payment as an option premium, or can receive a more favorable swap rate.
- Termination Risk – the risk that a swap will be terminated by the counterparty before maturity, possibly requiring the issuer to make a cash termination payment to the counterparty.
- Underlying – the variable interest rate, security price, commodity price, or index of prices or rates on which the derivative’s payments are based. A derivative's payment is based on the interaction of the Underlying and the notional amount.