

# **WEST BASIN MUNICIPAL WATER DISTRICT**

# **SWAP POLICY**

Updated 2/27/17

**Excerpt from West Basin Administrative Code**

**Part 4. Financial Matters, Chapter 1. Administrative Matters, Article 5. Swap Policy**

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**PART 4. FINANCIAL MATTERS**  
**CHAPTER 1. ADMINISTRATIVE MATTERS**  
**ARTICLE 5. SWAP POLICY**

**4-1.501 POLICY<sup>1</sup>**

The purpose of this Swap Policy (“Policy”) is to establish parameters and provide guidance as to the future use, negotiation, execution, management, and reporting on interest rate swaps and related instruments.

An interest rate swap is an agreement between two parties (“counterparties”) to exchange periodic interest payments. The interest payments are based on a principal amount (“the notional amount”). No principal amount is actually exchanged between the counterparties; only interest is exchanged. As an example, in a common interest rate swap, one party pays interest on the notional amount at a variable or “floating” rate, while the other party pays interest on the notional amount at a fixed rate.

Interest rate swaps and related instruments can be beneficial and effective interest rate management tools in assisting an agency to achieve its financial purpose as further described in Section 4-1.503.

**4-1.502 AUTHORITY<sup>2</sup>**

West Basin Municipal Water District (“West Basin”), either directly or through its financing corporation, is authorized to issue bonds or other obligations and to enter into swaps to better manage its assets and liabilities and take advantage of market conditions to lower overall costs and reduce interest rate risk.

The Board of Directors (“Board”) shall have the final authority for approval of each swap. However, the Chief Financial Officer (“CFO”), subject to Board approval, shall have the authority to enter into each swap. Each swap shall be structured by the CFO and members of the financing team. The CFO shall have the day-to-day responsibility for implementing and managing the swap.

The Policy shall be initially adopted by the Board and reviewed periodically. Future updates, if necessary, to the Policy require the approval by the Board.

West Basin shall be authorized to enter into swaps (including amendments, terminations, novations or other changes) only after certain determinations as required by statute have been made by the Board of Directors. West Basin shall be authorized to enter into swaps only with qualified counterparties. Qualified counterparties shall be determined pursuant to the criteria set forth in this Policy.

#### **4-1.503 PURPOSE**

The issuance of bonds or other obligations involves interest rate payment obligations and risks. A variety of financial instruments are available to reduce, offset or hedge these obligations and risks. It is the policy of West Basin to utilize such financial instruments to better manage its assets and liabilities. West Basin may execute a swap if the transaction can be expected to result in one or more of the following:

- (a) Reduce exposure to changes in interest rates on a particular financial transaction or portfolio of financial transactions.
- (b) Achieve lower net cost of borrowing with respect to West Basin's debt obligations.
- (c) Manage variable interest rate exposure consistent with prudent debt practices and policies adopted by the Board.
- (d) Optimization of capital structure including modification of timing and amounts of scheduled debt service payments.

West Basin may utilize the following financial products after identifying the objectives to be realized and assessing the potential risks:

- (a) Interest rate swaps, including (1) pay fixed/receive floating swaps, (2) pay floating/receive fixed swaps and (3) pay floating/receive floating swaps. Swaps may include option features, such as for the extension, cancellation, or index conversion of the swap.
- (b) Interest rate caps, floors, and collars.
- (c) Stand-alone options to enter into swaps (swaptions) on a particular date, series of dates, or during a particular period of time in the future.

West Basin will only enter into a swap transaction to hedge interest rate risks or lower the carrying cost of debt, and will not enter into any leveraged swaps (leverage means where the index or notional amount is a multiple of a factor greater than one).

#### **4-1.504 CONFORMANCE WITH DODD-FRANK<sup>3</sup>**

West Basin intends that this policy conforms to the requirements relating to legislation and regulations for over-the-counter derivatives transactions under Title VII of the Wall Street Transparency and Accountability Act of 2010, as supplemented and amended from time to time (herein collectively referred to as “Dodd-Frank”). Pursuant to such intent, it is the policy of West Basin that:

- (a) Each swap advisor to be engaged by the Authority will function as the designated qualified investment representative of the Authority, sometimes referred to as the “Designated QIR”;
- (b) Each swap advisor agrees to meet and will continue to meet the requirements specified in Commodity Futures Trading Commission Regulation 23.450(b)(1) or any successor regulation thereto (herein referred to as the “Representative Regulation”);
- (c) Each swap advisor will provide a written certification to West Basin to the effect that such swap advisor agrees to meet and will continue to meet the requirements specified in the Representative Regulation;
- (d) West Basin will monitor the performance of each swap advisor consistent with the requirements specified in the Representative Regulation as further described below;
- (e) West Basin will exercise independent judgment in consultation with its swap advisor in evaluating all recommendations, if any, presented by any counterparty with respect to transactions authorized pursuant to this Swap Policy; and
- (f) West Basin will rely on the advice of its swap advisor with respect to transactions authorized pursuant to this Swap Policy and not rely on

recommendations, if any, presented by any counterparty with respect to transactions authorized pursuant to this Swap Policy.

#### **4-1.505 EVALUATION OF PROPOSED TRANSACTIONS<sup>4</sup>**

When evaluating a proposed transaction involving the use of swaps, West Basin will review and consider the following:

- (a) Assessment of the inherent risks of the transaction.
- (b) Alternate financing options and a comprehensive evaluation of the potential risks and expected benefits of the transaction relative to such other options.
- (c) Procurement process and the suitability of the contemplated counterparties to the swap, taking into account any existing exposure to such counterparties.
- (d) Impact on West Basin's credit and liquidity profile and how other financial obligations, existing or expected, may be impacted.
- (e) Analysis of the impact on the net variable rate interest exposure from the transaction and any potential budgetary impact.
- (f) Cost and availability of on-going resources for the effective operations and risk management of the swap.
- (g) If the transaction includes option components, analysis of circumstances under which the option will likely, or not likely, be exercised and the consequences of each outcome.

West Basin will utilize a qualified independent swap advisor to assist with the evaluation and execution of swap transactions, as well as with the ongoing monitoring and valuation of its portfolio of outstanding swap transactions. West Basin will periodically evaluate the performance and services of its swap advisor. The swap advisor will meet all necessary registration, qualification and other requirements as set by the appropriate rules and regulations relating to the swap markets. The swap advisor will make necessary representations related to its status as a swap advisor to conform to appropriate rules and regulations, including each of the following:

- (a) The swap advisor and its principals and/or senior staff will have a demonstrated specialized experience with respect to swap transactions to allow them to evaluate swap transactions and related risks;
- (b) The swap advisor will have required industry and regulation registrations and/or licenses and will not be subject to any statutory disqualifications related to such registrations;
- (c) The swap advisor will be independent of any swap dealer or a major swap participant that may be acting as a counterparty to West Basin, and as such:
  - (1) The representative of the swap advisor providing advice to West Basin is not, and will not have been within one year of representing West Basin, associated with the counterparty in a capacity that involved solicitation or acceptance of swap transactions or that supervised such activities;
  - (2) There is no principal relationship between the swap advisor and the counterparty;
  - (3) The swap advisor will disclose, in a timely manner, any conflicts of interest that could reasonably affect its judgment or decision-making ability with respect to West Basin's swap transactions and will have policies and procedures designed to manage and mitigate any conflicts of interest;
  - (4) The swap advisor is not affiliated with, is not directly or indirectly controlled by, in control of, or under common control with the counterparty; and
  - (5) The swap advisor was not referred, recommended, or introduced to West Basin by the counterparty within one year of the swap advisor's representation in connection with a swap transaction;
- (d) The swap advisor will agree to undertake a duty to act in the best interest of West Basin, and to meet all of the business conduct rules and

regulations set forth by appropriate regulatory agencies or self-regulatory organizations;

- (e) For each transaction, the Swap Advisor will provide detailed, written materials outlining benefits and risks of the swap transaction and evaluating appropriateness and fair pricing in accordance with any guidelines provided by West Basin; and
- (f) The swap advisor will be subject to restrictions on certain political contributions imposed by appropriate regulatory agencies or self-regulatory organizations.

#### **4-1.506 QUALIFIED SWAP COUNTERPARTIES<sup>5</sup>**

West Basin will be authorized to enter into swap transactions only with Qualified Swap Counterparties. The term “Qualified Swap Counterparties” shall mean any commercial or investment bank or any other financial institution that (1) has a demonstrated record of successfully executing swap transactions, and (2) at the time West Basin enters into the swap, is rated, or has its payment obligations under a Swap Agreement guaranteed by an affiliated entity (parent or subsidiary) which is rated, in each case at least “A1” or “A+”, or equivalent by any two of the nationally recognized rating agencies (i.e. Moody’s, Standard and Poor’s, or Fitch). West Basin will structure interest rate swap agreements to protect itself from credit deterioration of counterparties, including the use of both events-based and ratings-based termination events, collateral posting requirements or other forms of credit enhancement. Such protection shall include any terms and conditions which West Basin deems necessary to protect its interests.

#### **4-1.507 COUNTERPARTY TERMINATION EXPOSURE<sup>6,7</sup>**

In order to diversify West Basin’s counterparty credit risk and to limit its credit exposure to any one counterparty, West Basin will compute the “Maximum Net Termination Exposure” prior to executing a swap.

The “Maximum Net Termination Exposure” is the aggregate termination payment for all existing and projected swap transactions that would be paid by or to an individual

counterparty. The aggregate termination payment is equal to (1) the potential worst-case termination payment based on the market value of all existing swaps as of the first day of the month prior to the execution of any proposed swap transaction, plus (2) the potential worst-case termination payment of the proposed transaction. The potential worst-case termination payment shall be calculated assuming interest rates, as measured by the related index or benchmark interest rates, increased or decreased by two standard deviations from the sample mean over the last 10 years.

West Basin shall not enter into any swap transaction if after giving effect to, and as of the date of entering into, such swap transaction where the Maximum Net Termination Exposure for the swap counterparty would exceed 25% of West Basin's unrestricted cash balance (100% of West Basin's unrestricted cash X 25% per counterparty).

West Basin shall not enter into any swap transaction if after giving effect to, and as of the date of entering into, such swap transaction where the Maximum Net Termination Exposure for all swap counterparties would exceed 100% of West Basin's unrestricted cash balance.

#### **4-1.508 TERMINATION AND ASSIGNMENT PROVISIONS**

West Basin shall consider including in all swap agreements provisions granting West Basin the right to optionally terminate all or a portion of an Agreement at any time over the term of the Agreement and the right to assign an Agreement to a third party. West Basin may exercise its right to optionally terminate a swap agreement if it determines that it will (1) produce a benefit to West Basin, either through receipt of a payment from a termination, or if a termination payment is made by West Basin, in conjunction with a conversion to a more beneficial debt obligation, (2) result in a more beneficial mix of fixed and variable rate debt consistent with prudent debt practices and policies adopted by the Board, or (3) otherwise reduce risk as determined by the CFO.

A termination payment to or from West Basin may be required in the event of early termination of an agreement due to a default or decrease in the credit rating of either West Basin or the swap counterparty and a change in swap rates. If (1) the event

of default or termination event is due to the swap counterparty and (2) a termination payment would be owed by West Basin, before deciding to exercise its right to terminate a swap transaction, the CFO shall evaluate whether it is financially advantageous for West Basin to enter into a replacement swap transaction. Such replacement swap transaction could allow West Basin to avoid making a termination payment or allow a replacement swap counterparty to make an upfront payment to West Basin in an amount that will substantially offset the termination payment that West Basin will be making to the original swap counterparty

The CFO shall make a recommendation to the board regarding the termination, assignment or replacement of an interest rate swap based on the above stated principles and conditions. The board may authorize the CFO to execute any termination and/or deliver on behalf of West Basin any replacement swap transaction so long as the counterparty of such replacement swap transaction is a Qualified Swap Counterparty.

#### **4-1.509 TERM AND NOTIONAL AMOUNT OF SWAP AGREEMENT<sup>8</sup>**

West Basin shall determine the appropriate term and size for an interest rate swap on a case-by-case basis. In connection with the issuance or carrying of bonds, the outstanding notional amount of a swap agreement should relate to the amortization of the related existing or anticipated debt of West Basin and the term shall not extend beyond the latest final maturity date of the related existing or anticipated bond.

The total net notional amount of all swaps related to an issue of bonds should not exceed the amount of the related outstanding bonds or other outstanding variable rate debt. For purposes of calculating the net notional amount, credit shall be given to any swaps that offset a specific bond transaction.

In no case shall West Basin execute an interest rate swap agreement with a term of greater than 10 years.

#### **4-1.510 FORM OF SWAP AGREEMENTS**

Each swap transaction and swap agreement executed by West Basin shall contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement. The agreements shall include payment,

term, security, collateral, default, remedy, termination, and other terms, conditions, and provisions as the CFO deems necessary or desirable. The CFO may use legal counsel and/or outside professional advisors to assist in preparation of the swap documents.

#### **4-1.511 COLLATERAL REQUIREMENTS**

As part of any swap agreement, unless otherwise approved by the Board, West Basin shall require collateralization or other credit enhancement to secure any or all swap payment obligations. As appropriate, the CFO shall require collateral or other credit enhancement to be posted by each swap counterparty with the following considerations:

- (a) Each swap counterparty to West Basin shall be required to post collateral if the credit rating of the swap counterparty or its guarantor is not in the two highest rating categories by at least two of the nationally recognized rating agencies.
- (b) Collateral shall consist of cash, U.S. Treasury Securities, or Agency Securities which are rated at equivalent ratings of U.S. Treasury Securities, by any two of the nationally recognized rating agencies.
- (c) Collateral shall be deposited with a third party custodian, or as mutually agreed upon between West Basin and each swap counterparty.
- (d) 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.
- (e) The market value of the swap and the collateral shall be determined on at least a weekly basis.
- (f) West Basin will determine reasonable threshold limits for the initial deposit and for increments of collateral posting thereafter.
- (g) The CFO shall determine on a case by case basis whether other forms of credit enhancement are more beneficial to West Basin.

**4-1.512 AMENDMENT OR ASSIGNMENT OF SWAP TRANSACTION OR SWAP AGREEMENT<sup>9</sup>**

The CFO may recommend and the board may approve an amendment of any existing swap transaction with the approval and authorization of the board if such amendment does not cause an increase on the effective date of the amendment in the Maximum Net Termination Exposure of West Basin to 1) more than 100% of West Basin's unrestricted cash balance and 2) more than 25% of West Basin's unrestricted cash balance per counterparty, after adjusting for any upfront payments either made or received by West Basin or if such amendment decreases the Maximum Net Termination Exposure.

West Basin shall be authorized to enter into any assignment or novation of a swap transaction from one swap counterparty to another swap counterparty with the approval of the board and if the CFO determines that the swap counterparty to which such swap transaction is assigned is a Qualified Swap Counterparty. West Basin shall be authorized to enter into a swap agreement with the swap counterparty to which any swap transaction is assigned so long as such terms and conditions do not have the impact of increasing on the effective date of such assignment or novation the Maximum Net Termination Exposure of West Basin to 1) more than 100% of West Basin's unrestricted cash balance, 2) more than 25% of West Basin's unrestricted cash balance per counterparty under the assigned or novated swap transaction. West Basin shall be authorized to enter into a swap agreement with the swap counterparty to which any swap transaction is assigned if such assignment decreases the Maximum Net Termination Exposure, and 3) in all material respects, the business terms of the swap transaction are the same or improved.

**4-1.513 REPORTING REQUIREMENTS**

Written records noting the status of all swap transactions will be maintained by West Basin and provided to the Board at least on a quarterly basis and shall include the following information:

- (a) Highlights of all material changes to the swap agreements or new agreements entered into by West Basin and a summary of any agreements that were terminated.
- (b) Basic term sheet containing trade date, effective date and termination date of each of the swap agreements, as well as key terms such as: notional amount, rate paid by each counterparty, day count basis, payment dates, and amortization/accretion schedules. This term sheet will also contain counterparty contact information.
- (c) Mark-to-market valuation and performance of the swap to date, performed by an independent third party advisor.
- (d) For each swap counterparty, shall provide the total notional amount position, the average life of each agreement, the available capacity to enter into a swap, and the remaining term of each agreement.
- (e) The credit rating of each swap counterparty and the guarantor insuring the swap payments.
- (f) Actual collateral posting by the swap counterparty, if any, per agreement and in total by swap counterparty.
- (g) Information concerning any default by a swap counterparty to West Basin and the results of the default, but not limited to the financial impact to West Basin, if any.
- (h) Follow GASB procedures for reporting the swaps on West Basin's annual financial statements, including the provisions of GASB 53.

#### **4-1.514 DEFINITIONS<sup>10</sup>**

- (a) Collateral: Assets pledged to secure an obligation. The assets are potentially subject to seizure in the event of default.
- (b) Counterparty: A principal to a swap or other derivative agreement, as opposed to an agent such as a broker.
- (c) GASB: Governmental Accounting Standards Board
- (d) Interest Rate Cap: An instrument that pays off on each settlement date based on the market value of a reference rate (e.g., SIFMA or LIBOR) and

a specified contract rate; effectively establishing a maximum on a variable rate.

- (e) Interest Rate Collar: An instrument that provides protection within a band of interest rates. (A combination of purchasing an Interest Rate Cap and selling an Interest Rate Floor).
- (f) Interest Rate Floor: An instrument that pays off on each settlement date based on the market value of a reference rate (e.g., SIFMA or LIBOR) and a specified contract rate.
- (g) Interest Rate Swap: A contract between two parties to exchange cash flows over a predetermined length of time. Cash flows are calculated periodically based on a fixed or variable interest rate against a set notional amount. Principal is not exchanged.
- (g) LIBOR: The London Interbank Offer Rate. The rate at which banks will lend Eurodollars to each other over various lengths of time. LIBOR is often used as an index to compute the variable rate on an interest rate swap.
- (h) Notional Amount: The stipulated principal amount for a swap transaction used to determine the interest payments on a swap.
- (i) SIFMA Index: The Securities Industry and Financial Markets Association Municipal Swap Index, produced by Municipal Market Data, is a 7-day high-grade market index comprised of tax-exempt variable rate demand bonds.
- (j) Swap: An agreement between two parties evidenced by a single document in which the parties agree to exchange periodic (net) payments for an agreed period of time based upon a notional amount of principal.
- (k) Swaption: An option on a swap. The swaption purchaser has the right to enter a specific swap for a defined period of time. This option can be exercised on a specific exercise date or series of exercise dates.

**LIST OF CHANGES TO PART 4. FINANCIAL MATTERS,  
CHAPTER 1. ADMINISTRATIVE MATTERS, ARTICLE 5. SWAP POLICY**

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- <sup>1</sup> Section 4-1.501 amended by Resolution 2-17-1057 on February 27, 2017.
  - <sup>2</sup> Section 4-1.502 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>3</sup> Section 4-1.504 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>4</sup> Section 4-1.505 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>5</sup> Section 4-1.506 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>6</sup> Section 4-1.507 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>7</sup> Section 4-1.507 amended by Resolution 2-17-1057 on February 27, 2017.
  - <sup>8</sup> Section 4-1.509 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>9</sup> Section 4-1.512 amended by Resolution 2-16-1027 on February 22, 2016.
  - <sup>10</sup> Section 4-1.514 amended by Resolution 2-17-1057 on February 27, 2017.