

	<b><i>PENNSYLVANIA TURNPIKE COMMISSION POLICY AND PROCEDURE</i></b>		Number:	7.7
			Approval Date:	4/20/04
			Effective Date:	5/05/04
Policy Subject: Interest Rate Swap Management Policy	<i>This is a statement of official Pennsylvania Turnpike Commission Policy</i>		Revised Date:	
	Responsible Department:		Treasury Management Dept.	

## **I. Introduction**

The purpose of the Interest Rate Swap Policy (“Policy”) of the Pennsylvania Turnpike Commission (“Commission”) is to establish guidelines for the use and management of all interest rate management agreements, including, but not limited to, interest rate swaps, swaptions, caps, collars and floors (collectively “Swaps” or “Agreements”) incurred in connection with the incurrence of debt obligations as authorized by the Commission’s Debt Policy (attached as Exhibit A). The Policy sets forth the manner of execution of Swaps and Agreements, provides for security and payment provisions, risk considerations and certain other relevant provisions as well as being responsive to the proposed 2003 recommended practices of the Government Finance Officers Association regarding the contents of an interest rate swap policy. The failure by the Commission to comply with any provision of this Policy shall not invalidate or impair any Swap or Agreement.

## **II. Scope and Authority**

This Policy shall govern the Commission’s use and management of all Swaps. While adherence to this Policy is required in applicable circumstances, the Commission recognizes that changes in the capital markets, agency programs, and other unforeseen circumstances may from time to time produce situations that are not covered by the Policy and will require modifications or exceptions to achieve policy goals.

The Chief Financial Officer and Director of Treasury Management are the designated administrators of the Commission’s Policy. The Chief Financial Officer shall have the day-to-day responsibility and authority for structuring, implementing, and managing Swaps.

The Commission shall be authorized to enter into Swap transactions only with qualified Swap counterparties. The Commission, in consultation with the Chief Financial Officer, shall select the counterparties, in adherence with the criteria set forth in the Policy.

### **III. Conditions for the Use of Swaps**

#### A. General Usage

The Commission will use Swaps to hedge interest rate movement, basis risk and other risks, to lock-in a fixed rate or, alternatively, to create synthetic variable rate debt. Swaps may also be used to produce interest rate savings, limit or hedge variable rate payments, alter the pattern of debt service payments, manage exposure to changing market conditions in advance of anticipated bond issues (through the use of anticipatory hedging instruments) or for asset/liability matching purposes.

#### B. Maximum Notional Amount

The Commission will limit the total notional amount of outstanding Swaps based on criteria set forth in this Policy regarding the proper management of risks, calculation of termination exposure, and development of a contingency plan. In no event, however, shall the Commission's exposure to any counterparty rated A/A- or lower exceed 50% of the Commission total debt.

#### C. Impact of use of Liquidity

The Commission shall consider the impact of any variable rate bonds issued in combination with a Swap on the availability and cost of liquidity support for other Commission variable rate programs.

#### D. Call Option Value Considerations

When considering the relative advantage of a Swap versus fixed rate bonds, the Commission will take into consideration the value of any call option on fixed rate bonds.

#### E. Qualified Hedges

The Commission understands that, (1) if payments on and receipts from the Agreement are to be taken into account in computing the yield on the related bonds, the Agreement must meet the requirements for a "qualified hedge" under federal tax law (sometimes referred to as an "integrated" Swap); and (2) if one of the goals of entering into the Agreement is to convert variable yield bonds into fixed yield bonds (sometimes referred to as a "super integrated swap"), then certain additional requirements must be met. In both of these situations, the terms of the Agreement and the process for entering into the Agreement must be reviewed and approved in advance by tax counsel.

F. Evaluation of Swap Risks

Prior to the execution of any Swap transaction, Commission Chairman, the Chief Financial Officer, the Director of Treasury Management, and Commission’s Financial Advisor, Swap Advisor and Bond Counsel shall evaluate the proposed transaction and report the findings. Such a review shall include the identification and evaluation of the proposed benefit and potential risks.

Evaluation Methodology:

The Commission will review the following areas of potential risk for new and existing Swaps:

<b>Type of Risk</b>	<b>Description</b>	<b>Evaluation Methodology</b>
Basis risk	The mismatch between actual variable rate debt service and variable rate indices used to determine Swap payments.	The Commission will review historical trading differentials between the variable rate bonds and the index.
Tax risk	The risk created by potential tax events that could affect Swap payments.	The Commission will review the tax events in proposed Swap agreements. The Commission will evaluate the impact of potential changes in tax law on LIBOR indexed Swaps.
Counterparty risk	The failure of the counterparty to make required payments.	The Commission will monitor exposure levels, ratings thresholds, and collateralization requirements.
Termination risk	The need to terminate the transaction in a market that dictates a termination payment by the issuer.	The Commission will compute its termination exposure for all existing and proposed Swaps at market value and under a worst-case scenario.
Rollover risk	The mismatch of the maturity of the Swap and the maturity of the underlying bonds.	The Commission will determine, in accordance with its Debt Policy, its capacity to issue variable rate bonds that may be outstanding after the maturity of the Swap.
Liquidity risk	The inability to continue or renew a liquidity facility.	The Commission will evaluate the expected availability of liquidity support for swapped and unhedged variable rate debt.
Credit risk	The occurrence of an event modifying the credit rating of the issuer or its counterparty.	The Commission will monitor the ratings of its counterparties and insurers.

#### **IV. Award**

The Swap must contain financial terms and conditions that are fair and reasonable to be evidenced in a letter from a qualified independent Swap Advisor.

#### **V. Swap Features**

##### **A. Swap Agreement**

The Commission will use terms and conditions as set forth in the International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement. The Swap agreement between the Commission and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as the Commission, in consultation with its legal counsel and Swap Advisor, deems necessary or desirable.

Subject to the provisions contained herein, the terms of any Commission Swap agreement shall use the following guidelines:

- i. Downgrade provisions triggering termination shall in no event be worse than those affecting the counterparty.
- ii. Governing law for Swaps will be the State of New York. Issues relating to jurisdiction, venue, waiver of jury trial and sovereign immunity will be subject to prevailing law and approval of the Commonwealth Attorney General. Preference will be given to language providing that the counterparty will consent to jurisdiction in the Pennsylvania courts with respect to enforcement of the Agreement.
- iii. The specified indebtedness related to credit events in any Swap agreement should be narrowly defined and refer only to indebtedness of the Commission that could have a materially adverse effect on Commission’s ability to perform its obligations under the Swap. Debt should typically only include obligations within the same lien as the Swap obligation.
- iv. Collateral thresholds for the Swap provider should be set on a sliding scale reflective of credit ratings. Collateral requirements should be established and based upon the credit ratings of the Swap provider or guarantor. The Trustee or an independent third party or the counterparty if so directed should hold collateral.
- v. Eligible collateral should generally be limited to Treasuries and obligations of Federal Agencies where the principal and interest are guaranteed by the United States. The market value of the collateral shall be marked to market no less than Bi-Monthly.
- vi. Commission shall have the right to optionally terminate a swap agreement at “market,” at any time over the term of the agreement.
- vii. Termination value should be set by ”second method” and “market quotation” methodology, unless the Commission deems an alternate appropriate.

## B. Swap Counterparties

### 1. Credit Criteria

The Commission will make its best efforts to work with qualified Swap counterparties that have a general credit rating of: (i) at least “A3” or “A-” by two of the nationally recognized rating agencies and not rated lower than “A3” or “A-” by any nationally recognized rating agency, or (ii) have a “non-terminating” “AAA” subsidiary as rated by at least one nationally recognized credit rating agency. The nationally recognized rating agencies are Moody’s Investors Services, Inc., Standard and Poor’s Rating Services, and Fitch Ratings.

In addition to the rating criteria specified herein, the Commission will seek additional credit enhancement and safeguards in the form of:

Contingent credit support or enhancement;

- i. Collateral consistent with the policies contained herein;
- ii. Ratings downgrade triggers;
- iii. Guaranty of parent, if any.

In addition, qualified Swap counterparties must have a demonstrated record of successfully executing Swap transactions as well as creating and implementing innovative ideas in the Swap market.

### 2. Counterparty Termination Exposure

In order to manage the Commission’s counterparty credit risk, and credit exposure to any one counterparty, the Commission will determine and evaluate its exposure to the proposed counterparty or counterparties. The exposure should be measured in terms of notional amount, mark to market valuation and volatility.

## C. Term and Notional Amount

For Swaps tied to an issued series of bonds, the term of the Swap agreement shall not extend beyond the final maturity date of the related bonds. The total net notional amount of all Swaps related to a bond issue should not exceed the amount of outstanding bonds. In calculating the net notional amount, netting credit shall be given to any Swaps that offset each other for a specific bond transaction.

## D. Security and Source of Repayment

The Commission may use the same security and source of repayment (pledged revenues) for Swaps as is used for the bonds that are hedged or carried by the Swap, if any, but shall consider the economic costs and benefits of subordinating the Commission’s payments and/or termination payment under the Swap. The Commission shall consult with Bond Counsel regarding the legal requirements associated with making the payments under the Swap on a parity or non-parity basis

with outstanding Commission debt.

#### E. Prohibited Agreements

The Commission will not use Agreements that:

- i. Are speculative or create extraordinary leverage as risk;
- ii. Lack adequate liquidity to terminate without incurring a significant bid/ask spread;
- iii. Provide insufficient price transparency to allow reasonable valuation.

### **VI. Managing Ongoing Swap Risks**

#### 1. Annual Swap Report

The Director of Treasury Management, in consultation with the Commission's Financial Advisor, Swap Advisor and Bond Counsel, will evaluate the risks associated with outstanding Swaps at least annually and provide to the Senior Executives and the Commissioners a written report of the findings. This evaluation will include the following information:

- i. A description of all outstanding Swaps, including related bond series, types of Swaps, rates paid and received by Commission, existing notional amount, the average life and remaining term of each Swap agreement, and the current mark to market value of all outstanding Swaps.
- ii. Separately for each Swap, the actual debt service requirements versus the projected debt service on the Swap transaction; and for any Swaps used as part of a refunding, the actual cumulative savings versus the projected savings at the time the Swap was executed.
- iii. The credit rating of each Swap counterparty, parent, guarantor, and credit enhancer insuring Swap payments, if any.
- iv. Actual collateral posting by Swap counterparty, if any, per Swap agreement and in total by Swap counterparty.
- v. Information concerning any material event involving outstanding Swap agreements, including a default by a Swap counterparty, counterparty downgrade, or termination.
- vi. An updated contingency plan to replace, or fund a termination payment in the event an outstanding Swap is terminated.
- vii. The status of any liquidity support used in connection with Swaps, including the remaining term and current fee.

The Director of Treasury Management shall review the Policy at least annually, and suggest revisions or updates as deemed appropriate.

## 2. Contingency Plan

The Director of Treasury Management, in consultation with the Commission's Financial Advisor, Swap Advisor and Bond Counsel, shall compute the mark to market exposure of each of its Swaps and its total Swap mark to market exposure at least annually and prepare a contingency plan to either replace the Swaps or fund the termination payments, if any, in the event one or more outstanding Swaps are terminated. The Director of Treasury Management shall assess the ability to obtain replacement Swaps and identify revenue sources to fund potential termination payments. The Director of Treasury Management shall also evaluate the economic costs and benefits of incorporating a provision into the Swap agreement that will allow the Commission to make termination payments over time.

## 3. Termination Matrix

The Director of Treasury Management, in consultation with the Commission's Financial Advisor, Swap Advisor and Bond Counsel, shall prepare a matrix for each individual Swap and for all Swaps in the aggregate setting forth the termination costs under various interest rate scenarios.

### A. Terminating Interest Rate Swaps

#### 1. Optional Termination

The Commission, in consultation with its Financial Advisor, Swap Advisor and Bond Counsel, may terminate a Swap if it is determined that it is financially advantageous.

#### 2. Mandatory Termination

In the event a Swap is terminated as a result of a termination event, such as a default or a decrease in credit rating of either the Commission or the counterparty, the Director of Treasury Management, in consultation with its Financial Advisor, Swap Advisor and Bond Counsel, will evaluate whether it is financially advantageous to obtain a replacement swap, or, depending on market value, make or receive a termination payment.

In the event the Commission makes a Swap termination payment, the Commission shall attempt to follow the process identified in its Swap contingency plan.

## **VII. Selecting and Procuring Interest Rate Swaps**

### A. Financing Team

The Commission will retain the services of a nationally recognized municipal bond counsel firm, and a qualified financial advisor and Swap advisor for all Swaps.

### B. Underwriter Selection

In the event bonds are issued in connection with Swaps, the Commission will price the bonds according to the guidelines set forth in its Debt Policy.

### C. Counterparty Selection

The Commission may use a competitive or a negotiated process to select a Swap counterparty and price a Swap as it believes business, market or competitive conditions justify such a process. The conditions under which a negotiated selection is best used are provided below.

- i. Marketing of the Swap will require complex explanations about the security for repayment or credit quality.
- ii. Demand is weak among swap counterparties.
- iii. Market timing is important, such as for refundings.
- iv. Coordination of multiple components of the financing is required.
- v. The Swap has non-standard features, such as one way collateral.
- vi. Bond insurance is not available or not offered.
- vii. The par amount for the transaction is significantly larger than normal.
- viii. Counterparties are likely to demand individual changes in bid documents.
- ix. Pricing transparency.

## **VIII. Disclosure and Financial Reporting**

The Commission will ensure that there is full and complete disclosure of all Swaps to rating agencies, and in disclosure documents. Disclosure in marketing documents, including Bond offering documents, shall provide a clear summary of the special risks involved with Swaps and any potential exposure to interest rate volatility or unusually large and rapid changes in market value. With respect to its financial statements, the Commission will adhere to the guidelines for the financial reporting of Swaps, as set forth by the Government Accounting Standards Board or other applicable regulatory agencies.

## **Glossary of Terms**

**Asset/Liability Matching:** Matching the term and amount of assets and liabilities in order to mitigate the impact of changes in interest rates.

**Bid/Ask Spread:** The difference between the bid price (at which a market maker is willing to buy) and the ask price (at which a market maker is willing to sell).

**Call Option:** The right to buy an underlying asset (e.g. a municipal bond) after a certain date and at a certain price. A call option is frequently embedded in a municipal bond, giving the issuer the right to buy, or redeem, the bonds at a certain price.

**Collateral:** Assets pledged to secure an obligation. The assets are potentially subject to seizure in the event of default.

**Downgrade:** A negative change in credit ratings.

**Forward Starting Swap:** Swaps that start at some time in the future. Used to lock-in current interest rates.

**Hedge:** A transaction that reduces the interest rate risk of an underlying security.

**Interest Rate Swap:** The exchange of a fixed interest rate and a floating interest rate between counterparties.

**Liquidity Support:** An agreement by a bank to make payment on a variable rate security to assure investors that the security can be sold.

**LIBOR:** The London Interbank Offer Rate. Used as an index to compute the variable rate on an interest rate swap.

**Notional Amount:** The amount used to determine the interest payments on a swap.

**Offsetting Swap:** Secondary interest rate Swap that is placed in an opposite direction from the primary interest rate Swap. The offsetting Swap is used to minimize Swap risks associated with the use of Swaps and potentially gain monetary value from the transaction.

**Termination Payment:** A payment made by a counterparty that is required to terminate the Swap. The payment is commonly based on the market value of the Swap, which is computed using the rate on the initial Swap and the rate on a replacement Swap.