

**TEXAS DEPARTMENT OF HOUSING  
AND COMMUNITY AFFAIRS**

**INTEREST RATE SWAP POLICY**

*As presented to the Board on April 27, 2017*

**2017**

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# **TEXAS DEPARTMENT OF HOUSING AND COMMUNITY AFFAIRS INTEREST RATE SWAP POLICY**

The Texas Department of Housing and Community Affairs (the “Department”) has been duly created and organized pursuant to and in accordance with the provisions of Chapter 2306, Texas Government Code (the “Act”), as amended from time to time, for the purpose of providing a means of financing the costs of residential ownership, development and rehabilitation that will provide decent, safe and sanitary housing for individuals and families of low and very low income and families of moderate income (as described in the Act as determined by the Governing Board of the Department (the “Governing Board”) from time to time) at prices they can afford.

The Act authorizes the Department: (a) to acquire, and to enter into advance commitments to acquire, mortgage loans (including participations therein) secured by mortgages on residential housing in the State of Texas (the “State”); (b) to issue its bonds, for the purpose of obtaining funds to make and acquire such mortgage loans or participations therein, to establish necessary reserve funds and to pay administrative and other costs incurred in connection with the issuance of such bonds; and (c) to pledge all or any part of the revenues, receipts or resources of the Department, including the revenues and receipts to be received by the Department from such mortgage loans or participations therein, and to mortgage, pledge or grant security interests in such mortgages, mortgage loans or other property of the Department, to secure the payment of the principal or redemption price of and interest on such bonds.

## **I. Introduction**

The purpose of this Interest Rate Swap Policy (“Policy”) of the Texas Department of Housing and Community Affairs (the “Department”) 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 issuance of debt obligations. This Policy sets forth the manner of execution of Swaps and provides for security and payment provisions, risk considerations, and certain other relevant provisions.

## **II. Authority**

The Department is authorized by Sections 1371.056 and 2306.351 of the Texas Government Code to enter into Swaps from time to time to better manage assets and liabilities and take advantage of market conditions to lower overall costs and reduce interest rate risk.

This Policy shall govern the Department’s use and management of all Swaps. While adherence to this Policy is required in applicable circumstances, the Department 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 this Policy and will require modifications or exceptions approved or authorized by the Governing Board to achieve policy goals.

The Chief Financial Officer and the Director of Bond Finance are the designated administrators of the Department’s Policy. The Bond Finance Division shall have the day-to-day responsibility for structuring, implementing, and managing Swaps, which includes, with the approval of the Executive Director, the execution of the Department’s right to optional par termination of Swaps to avoid being overswapped (having a higher notional amount of swap outstanding than par amount of related bonds), for economic benefit to the Department, or to achieve other goals of the Department.

The Department shall be authorized to enter into Swaps only with qualified Swap counterparties as defined herein. The Director of Bond Finance, in consultation with the Chief Financial Officer, or a Department designee, shall have the authority to recommend counterparties, so long as the criteria set forth in this Policy are met.

The Chief Financial Officer and the Director of Bond Finance shall review this Policy on an annual basis and recommend any necessary changes to the Governing Board.

### **III. Purpose**

The incurring of obligations by the Department involves a variety of interest rate payments and other risks for which a variety of financial instruments are available to offset, hedge, or reduce. It is the policy of the Department to utilize Swaps to better manage its assets and liabilities. The Department may execute Swaps if the transaction can be expected to result in one of, but not limited to, the following:

- Reduce exposure to changes in interest rates on a particular financial transaction or in the context of the management of interest rate risk derived from the Department's overall asset/liability balance.
- Result in a lower net cost of borrowing with respect to the Department's debt, a higher return on assets, and/or a stronger balance sheet.
- Manage variable interest rate exposure consistent with prudent debt practices.
- Achieve flexibility in meeting overall financial and programmatic objectives that cannot be achieved in conventional markets.
- Lock in fixed rates in current markets for use at a later date.
- Manage the Department's exposure to the risk of changes in the legal or regulatory treatment of tax-exempt bonds.
- Manage the Department's credit exposure to financial institutions.

The Department will not use Agreements that:

- Are purely speculative or incorporate extraordinary leverage;
- Lack adequate liquidity to terminate without incurring a significant bid/ask spread;
- Are characterized by insufficient pricing transparency and therefore make reasonable valuation difficult.

### **IV. Evaluation of Risks Associated with Swaps**

Before entering into a Swap, the Department shall evaluate the risks inherent in the transaction. The risks to be evaluated will include basis risk, tax risk, counterparty risk, credit risk, termination risk, rollover risk, liquidity risk, remarketing risk, amortization mismatch risk, mortgage yield risk, non-origination risk, and PAC band risk. The following table outlines these various risks and the Department's evaluation methodology for those risks.

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| <b>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 Department 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 or their relationship to future bond payments.                   | The Department will review the tax events in proposed Swap agreements. The Department 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 or the occurrence of an event modifying the credit rating of the counterparty.  | The Department 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 Department.                                  | The Department 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 Department will determine its capacity to service variable rate bonds that may be outstanding after the maturity of the Swap.                                      |
| Liquidity Risk             | The inability to continue or renew a liquidity facility, and the risk that the cost of a facility will increase beyond expectations.      | The Department will evaluate the expected availability of liquidity support for swapped and unhedged variable rate debt, if any.                                       |
| Remarketing Risk           | The risk that a remarketing agent may be unable to remarket VRDBs.  | The Department will obtain a standby bond purchase facility to provide the funds necessary to purchase the VRDBs.  |
| Amortization Mismatch Risk | The mismatch of outstanding Swap notional amount versus the outstanding bond principal subject to the hedge.                              | The Department may incorporate one or a combination of the following features: par termination options, PAC or lockout bonds.  |
| Mortgage Yield Risk        | The bond issue may not comply with yield restrictions if the Swap is terminated.  | The Department will obtain legal opinions and or certificates as appropriate.  |
| Non-origination Risk       | The bond proceeds may not originate within the prescribed timeframe and require an unused proceeds call and possible termination payment. | The Department will evaluate bond and mortgage market conditions and quantify the potential termination payment due upon non-origination.                              |

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|-------------------------|---|---|
| PAC Band Break Risk     | The targeted PAC bonds may amortize faster than anticipated based on the PAC amortization schedule.   | The Department will rely upon credit rating agency cashflows to ensure adequate PAC/companion bond structural integrity.  |
| Collateral Posting Risk | The risk that the Department may be required to post liquid collateral to the Counterparty. Inability to post such liquid collateral upon short notice may result in the early termination of a Swap transaction. | The Department will seek to structure Swap Agreements so that the need to post collateral is highly unlikely. This can be accomplished by using high posting thresholds or low rating triggers. |
| Accounting Risk         | The risk that the Department may be required to record changes in fair value of a derivative transaction as a gain or loss in its annual financial statements.  | The Department, when feasible, should aim to structure Transactions that would expect to qualify as effective hedges under GASB 53.   |

The Department will diversify its exposure to counterparties. To that end, before entering into a transaction, the Department will determine its exposure to the relevant counterparty or counterparties and determine how the proposed transaction would affect that exposure. The exposure will not be measured solely in terms of notional amount, but rather how changes in interest rates would affect the Department’s exposure (“Maximum Net Termination Exposure”). For purposes of these limits, “Maximum Net Termination Exposure” shall equal the aggregate termination payment for all existing and projected Swaps that would be paid by an individual counterparty. For purposes of this calculation, the aggregate termination payment is equal to the reasonably expected worse case termination payment of all existing Swaps plus the proposed transaction.

The Department will base the Maximum Net Termination Exposure on all outstanding derivative transactions. Limits will be established for each counterparty as well as the relative level of risk associated with each existing and projected Swap. In order to lessen counterparty risk, the Department will diversify exposure among multiple counterparties and avoid excessive concentration to any one counterparty. In situations where the Department may execute a swap transaction that would result in offsetting counterparty risk with an existing counterparty, the Department should seek to utilize that counterparty.

The Director of Bond Finance shall determine the appropriate term for a Swap on a case-by-case basis. The slope of the Swap curve, the marginal change in Swap rates from year to year along the Swap curve, and the impact that the term of the Swap has on the overall exposure of the Department shall be considered in determining the appropriate term of any Swap. The term of a Swap between the Department and a qualified Swap counterparty shall not extend beyond the final maturity date of the associated debt, or in the case of a refunding transaction, beyond the final maturity date of the refunding bonds.

The Department will review the use of forward-starting swaps and determine the duration based on market condition and the risk associated with using a forward-starting swap. The Department does not have any swaps with a knock-out option which could expose the Department to higher interest rates. The Department will advise the Board prior to entering into either a forward-starting swap or knock-out option.

The Department will inform the Board if the swap is a fixed notional value swap or a declining notional value swap. The Director of Bond Finance will review proposed swaps to ensure that the use of fixed notional value swaps does not place the Department at risk of incurring an incrementally higher expense if the related bond principal is paid off early.

The total “net notional amount” of all Swaps related to a bond issue should not exceed the amount of outstanding bonds, or bonds anticipated to be issued. For purposes of calculating the net notional amount, credit shall be given to any Swaps that offset another Swap for a specific bond transaction.

## **V. Long Term Financial Implications**

In evaluating a particular transaction involving the use of derivatives, the Department shall review long-term implications associated with entering into derivatives, including costs of borrowing, historical interest rate trends, variable rate capacity, credit enhancement capacity, liquidity capacity, opportunities to refund related debt obligations and other similar considerations.

### Impact of Use of Liquidity

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

### Call Option Value considerations

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

### Qualified Hedges

The Department 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.

## **VI. Form of Swap Agreements**

Each Swap executed by the Department shall contain terms and conditions as set forth in the International Swap and Derivatives Association, Inc. (“ISDA”) Master Agreement, including any schedules and confirmations. The Swaps between the Department and each qualified Swap counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions and provisions as the Director of Bond Finance deems necessary, desirable or consistent with industry best practices.

## **VII. Qualified Swap Counterparties**

The Department will make its best efforts to work with qualified Swap counterparties that (i) have, or has a credit support counterparty that has, a general credit rating of at least “A2” with respect to ratings by Moody’s Investors Service or “A” with respect to ratings by Standard and Poor’s Rating Services or Fitch Ratings.

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

- i. Contingent credit support or enhancement;
- ii. Collateral consistent with the policies contained herein; and/or
- iii. Ratings downgrade triggers.

In addition, the Department will take into consideration a Swap counterparty’s track record of successfully executing Swap transactions. The Department will only execute Swap transactions with qualified Swap counterparties.

## **VIII. Termination Provisions**

The Department shall include in all Swaps provisions granting the Department the right to optionally terminate a Swap at any time at market over the term of the Agreement. The Chief Financial Officer and Director of Bond Finance shall determine if it is financially advantageous for the Department to terminate a Swap.

A ratings-based additional termination event shall be included in all of the Department’s Swaps if the provider (or its credit support provider) fails to maintain either:

1. A credit rating of at least Baa2 from Moody’s; or
2. A credit rating of at least BBB from S&P; or,
3. An equivalent rating determined above by a nationally recognized ratings service acceptable to both parties.

A termination payment to or from the Department may be required in the event of termination of a Swap due to a default or a decrease in credit rating of either the Department or the counterparty. If the cause of the termination is a counterparty downgrade, termination payments will be calculated on the side of the bid-offer spread that favors the Department. Additionally, the termination amount of the Swap should seek to compensate the Department, as allowed under the ISDA Agreement, all other costs for creating a replacement transaction of like terms and conditions.

It is the intent of the Department not to make a termination payment to a counterparty that does not meet its contractual obligations. Prior to making any such termination payment, the Chief Financial Officer and Director of Bond Finance shall evaluate whether it is financially advantageous for the Department to obtain a replacement counterparty to avoid making such termination payment or finance the termination payment through a long-term financing product.

For payments on early termination and optional termination, Market Quotation and the Second Method will apply, allowing for two way mark-to-market breakage (assuming the Swaps are documented under the 1992 form of the ISDA Master Agreements).

## **IX. Security and Source of Repayment**

The Department 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 Department's payments and/or termination payment under the Swap. The use of the same security and source of repayment (pledged revenues) is subject to the respective bond indenture's covenants and the prior approval of the Department's bond counsel.

## **X. Specified Indebtedness**

The specified indebtedness related to credit events in any Swap should be narrowly defined and refer only to indebtedness of the Department that could have a materially adverse effect on the Department's ability to perform its obligations under the Swap. Debt should typically only include obligations within the same lien as the Swap obligation.

## **XI. Governing Law**

Governing law for Swaps will be the State of Texas. Issues relating to jurisdiction, venue, waiver of jury trial and sovereign immunity will be subject to prevailing law and approval of the Texas Attorney General Office. Preference will be given to language providing that the counterparty will consent to jurisdiction in the Texas courts with respect to enforcement of the Agreement.

## **XII. Events of Default**

Events of default of a Swap counterparty shall include, but are not limited to the counterparty's:

1. Failure to make payments when due;
2. Breach of representations and warranties;
3. Illegality;
4. Failure to comply with downgrade provisions; and
5. Failure to comply with any other provisions of the Agreement after a specified notice period.

## **XIII. Collateral Requirements**

As part of any Swap, the Department may require the counterparty or the counterparty may require the Department to post collateral or other credit enhancement to secure any or all Swap payment obligations. As appropriate, the Chief Financial Officer and Director of Bond Finance may require collateral or other credit enhancement to be posted by each Swap counterparty under the following circumstances:

- Each counterparty to the Department may be required to post collateral if the credit rating of the counterparty or parent falls below a certain rating threshold, which varies by counterparty. Additional collateral for further decreases in credit ratings of each counterparty shall be posted by each counterparty in accordance with the provisions contained in the credit support annex to each Swap with the Department. At the current time, collateral posting rating triggers by the counterparties would range from A2/A to Baa1/BBB+.
- Collateral shall consist of cash, U.S. Treasury securities, or other mutually acceptable highly liquid securities.



- Collateral shall be deposited with an eligible third party custodian, or as mutually agreed upon between the Department and each counterparty.
- The market value of the collateral shall be determined on at least a weekly basis.
- The Department will determine reasonable threshold limits for increments of collateral posting based on a sliding scale reflective of credit ratings.
- The Chief Financial Officer and Director of Bond Finance shall determine on a case-by-case basis whether a form of credit enhancement in lieu of, or in addition to, collateral is more beneficial to the Department.
- The Department shall seek to not post collateral to the counterparty unless the Department's ratings fall below "A2" or "A".

#### **XIV. Other Criteria**

The Department 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.

- Marketing of the Swap will require complex explanations about the security for payment or credit quality.
- Demand is weak among Swap counterparties.
- Market timing is important, such as for refundings.
- Coordination of multiple components of the financing is required.
- The Swap has non-standard features.
- The par amount is large enough to move the market in a manner adverse to the Department's interests.
- Counterparties are likely to demand individual changes in bid documents.

If a transaction is awarded through a negotiated process, the counterparty will provide the Department with:

- A statement that, in the counterparty's judgment, the difference in basis points between the rate of the transaction and the mid-market rate for a comparable transaction falls within the commonly occurring range for comparable transactions.
- A statement of the amount of the difference as determined by the counterparty.
- If the counterparty does not know of a comparable transaction or mid-market rate, a statement of another suitable measure of pricing acceptable to the counterparty.

The Department will use a swap advisory firm to assist in the price negotiation. Such swap advisory firm shall act as the "qualified independent representative" ("QIR") of the Department for purposes of CFTC Rule 23.450 (b) (1) to advise the Department on swaps, provided that such firm provide certification to the Department addressing why such firm meets the requirements to act as a QIR pursuant to CFTC Regulation 23.450(b)(1). Also, the Department may obtain an opinion from an independent party that the terms and conditions of any derivative entered into reflect a fair market value of such derivatives as of the execution date.

The counterparty must provide to the Department disclosure of any payments the counterparty made to another person to procure the transaction.

Prior to or at execution of any new swap transaction, the swap dealer and/or swap advisor, as the case may be, shall provide information to the Department consistent with the rules and regulations in effect at the time. Such rules would include the Business Conduct Standards for Swap Dealers

and Major Swap Participants as published and enacted by the Commodity Futures Trading Commission. In addition the swap dealer should represent to the Department that it is in compliance with such rules including pay-to-play restrictions.

The Department will determine that the swap transaction will conform to this Interest Rate Swap Policy after reviewing a report of the Director of Bond Finance that identifies with respect to the transaction:

- its purpose;
- the anticipated economic benefit and the method used to determine the anticipated benefit;
- the use of the receipts of the transaction;
- the notional amount, amortization, and average life compared to the related obligation;
- any floating indices;
- its effective date and duration;
- the identity and credit rating of the counterparties;
- the cost and anticipated benefit of transaction insurance;
- the financial advisors and the legal advisors and their fees;
- any security for scheduled and early termination payments;
- any associated risks and risk mitigation features; and
- early termination provisions.

#### **XV. Ongoing Monitoring and Reporting Requirements**

Written records noting the status of all Swaps will be maintained by the Bond Finance Division and shall include the following information:

- Highlights of all material changes to Swaps or new Swaps entered into by the Department since the last report.
- Market value of each of the Swaps.
- The net impact of a 50 or 100 basis point parallel shift or other relevant shift in the appropriate Swap index or curve.
- For each counterparty, the total notional amount, the average life of each Swap and the remaining term of each Swap.
- The credit rating of each Swap counterparty and credit enhancer insuring Swap payments.
- Actual collateral posting by Swap counterparty, if any, in total by Swap counterparty.
- A summary of each Swap, including but not limited to the type of Swap, the rates paid by the Department and received by the Department, indices, and other key terms.
- Information concerning any default by a Swap counterparty to the Department, and the results of the default, including but not limited to the financial impact to the Department, if any.
- A summary of any Swaps that were terminated.

The Department will monitor its Swaps exposure on a periodic basis, as necessary, and will look for ways to reduce the cost of a Swap(s) or the overall Swap exposure.

The Bond Finance Division will monitor the performance of the QIR on an on-going basis.

The Department shall report its Swaps exposure in its annual financial statements and will reflect the use of derivatives in accordance with GASB requirements. With the adoption of GASB 53, the Department will be required to test hedge effectiveness on an annual basis. Any hedge deemed to be ineffective will result in the change in fair value being recorded as a gain or loss. While the long term economic value of the transaction should be more important when structuring a derivative, the Department should seek to structure transactions that are expected to be effective and would not result in changes in fair value affecting net income. For example, while a transaction structured to meet the Consistent Critical Terms method of GASB 53 would ensure hedge effectiveness, the Department should consider the tradeoffs of utilizing a transaction structure that may provide greater expected economic benefits at the expense of potentially not meeting hedge effectiveness. The disclosure requirements include:

1. Objective of the Derivative
2. Significant Terms
3. Fair Value
4. Associated Debt
5. Risks including but not limited to Credit Risk, Termination Risk, Interest Rate Risk, Basis Risk, Rollover Risk, Market Access Risk, Foreign Currency Risk .

With the adoption of GASB 72, the Department will be required to report the fair value of its Swaps in its annual financial statements, as more fully described in GASB 72. The Department will follow these guidelines and may engage a third party to assist in the required calculations.

The Chief Financial Officer and the Director of Bond Finance will review this Policy on an annual basis.

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