#569

Joint Legislative Committee on Performance Evaluation and Expenditure Review (PEER)

Report to
the Mississippi Legislature

A Review of County Governments' Utilization of Bond Interest Rate Swap Instruments

A *bond interest rate swap* is an agreement between two parties to exchange or "swap" cash flow commitments related to a corresponding bond issue for a specified period. A county's intent for entering into a swap is to reduce borrowing costs and improve cash flows, but swaps also have the potential to affect the county's financial position negatively. Mississippi law does not address the requirements or standards that counties must meet when considering interest rate swap agreements. Each county or other local government entity is free to determine, based on its own standards and policies, whether to consider and enter an interest rate swap agreement.

According to the most recent county audits released by the Office of the State Auditor, at the time of those audits, only Harrison and Hinds counties had bond interest rate swap agreements in effect. Since 2002, Harrison County has entered into nineteen such agreements. Since 2005, Hinds County has modified two original bond issues to include swap agreements and these agreements are still in effect, although payments have been suspended until 2015. These counties' utilization of swaps demonstrates that these instruments can yield significantly different results. Since 2002, Harrison County's utilization of swaps has resulted in a net loss of approximately $4.19 million, but Hinds County's utilization of swaps since 2005 has resulted in positive cash flows totaling approximately $6.5 million.

In order to mitigate the risks of bond interest rate swaps, counties should adopt best practices. PEER compiled a list of best practices for using bond interest rate swaps: develop a comprehensive written policy for bond interest rate swap agreements, ensure that individuals managing swaps have appropriate knowledge and expertise, and commit to oversight monitoring.

Prior to their initial swap agreements, neither Harrison County nor Hinds County had all three elements in place of what PEER believes to be best practices. Since that time, both counties have taken steps to improve their processes, but neither has obtained outside financial advisors for bond interest rate swaps through competitive procurement.

February 18, 2013

PEER: The Mississippi Legislature's Oversight Agency

The Mississippi Legislature created the Joint Legislative Committee on Performance Evaluation and Expenditure Review (PEER Committee) by statute in 1973. A joint committee, the PEER Committee is composed of seven members of the House of Representatives appointed by the Speaker and seven members of the Senate appointed by the Lieutenant Governor. Appointments are made for four-year terms, with one Senator and one Representative appointed from each of the U. S. Congressional Districts and three at-large members appointed from each house. Committee officers are elected by the membership, with officers alternating annually between the two houses. All Committee actions by statute require a majority vote of four Representatives and four Senators voting in the affirmative.

Mississippi's constitution gives the Legislature broad power to conduct examinations and investigations. PEER is authorized by law to review any public entity, including contractors supported in whole or in part by public funds, and to address any issues that may require legislative action. PEER has statutory access to all state and local records and has subpoena power to compel testimony or the production of documents.

PEER provides a variety of services to the Legislature, including program evaluations, economy and efficiency reviews, financial audits, limited scope evaluations, fiscal notes, special investigations, briefings to individual legislators, testimony, and other governmental research and assistance. The Committee identifies inefficiency or ineffectiveness or a failure to accomplish legislative objectives, and makes recommendations for redefinition, redirection, redistribution and/or restructuring of Mississippi government. As directed by and subject to the prior approval of the PEER Committee, the Committee's professional staff executes audit and evaluation projects obtaining information and developing options for consideration by the Committee. The PEER Committee releases reports to the Legislature, Governor, Lieutenant Governor, and the agency examined.

The Committee assigns top priority to written requests from individual legislators and legislative committees. The Committee also considers PEER staff proposals and written requests from state officials and others.

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February 18, 2013

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On February 18, 2013, the PEER Committee authorized release of the report entitled **A Review of County Governments' Utilization of Bond Interest Rate Swap Instruments.**

Representative Ray Rogers, Chair

This report does not recommend increased funding or additional staff.

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A Review of County Governments' Utilization of Bond Interest Rate Swap Instruments

Executive Summary

Introduction

The PEER Committee received a legislative request to inquire into counties' use of bond interest rate swaps. In making this request, the legislator referred to an FY 2009 audit report that detailed that a particular county had paid approximately $7.36 million in swap termination fees. The legislator's concern was that county governments might be utilizing these complex financial derivatives without the necessary knowledge and expertise to ensure quality decisionmaking pertaining to such transactions.

The purpose of this review was to determine whether counties have policies and procedures in place to guide decisionmaking regarding entering into bond interest rate swaps, monitoring the swap agreements in effect, and mitigating the inherent risks associated with utilizing bond interest rate swap instruments.

Background

A *bond interest rate swap* is an agreement between two parties to exchange or "swap" cash flow commitments related to a corresponding bond issue for a specified period. The county's intent for entering into bond interest rate swaps is to reduce borrowing costs and improve cash flows. Bond interest rate swaps also have the potential to negatively affect the issuer's net revenues and cash flows, its overall financial position, the relationship between the issuer and third parties, and future debt management options.

Controls and Best Practices for Bond Interest Rate Swaps

What is the regulatory environment for counties' engagement in swap transactions?

While state law contains certain requirements that counterparties must meet in order to participate in interest rate swap transactions involving state-issued debt, Mississippi statutes do not address the requirements or standards that counties, or any other local government entity, must meet when considering the execution of interest rate swap agreements. Each county or other local government entity is free to determine, based on its own standards and policies, whether to consider and enter an interest rate swap agreement.

What standards should counties have relating to the use of interest rate swap agreements?

In order to mitigate the risks of bond interest rate swap utilization, counties should adopt best practices for swap utilization. PEER compiled the following list of best practices for using bond interest rate swaps based on a study by the California Debt and Investment Advisory Commission[1] and a Moody's publication:[2]

- *Develop a comprehensive written policy for bond interest rate swap agreements*--In accordance with generally accepted public finance practices and in order to mitigate the inherent risks associated with bond interest rate swap agreements, any debt issuer considering entering into a bond interest rate swap agreement should adopt and maintain a written comprehensive bond interest rate swap policy.
- *Ensure that individuals managing swaps have appropriate knowledge and expertise*--Counties must have adequate financial expertise to manage swap transactions effectively in order to mitigate the inherent risks associated with bond interest rate swap agreements. If counties do not have staff that possess the technical knowledge and skills to manage and monitor the use of swaps effectively, they should solicit the assistance of professionals with the skills, knowledge, and expertise to do so.
- *Commit to oversight monitoring*--Adequate monitoring and oversight of a bond interest rate swap transaction helps to ensure that the swap's performance continues to affect the county's overall financial position positively and that any changes are effectively communicated to all interested parties.

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[1] *The Fundamentals of Interest Rate Swaps*, California Debt and Investment Advisory Commission, October 2004.
[2] *Evaluating the Use of Interest Rate Swaps by U. S. Public Finance Issuers*, Moody's Investors Service Global Credit Research, October 2007.

If counties choose to use the Mississippi Development Bank (MDB) when issuing bonds, what requirements does MDB have for interest rate swaps?

Counties that utilize the assistance of the Mississippi Development Bank when issuing bonds must have any subsequent interest rate swap transactions for those bond issues approved by MDB's governing board. Although MDB had no standards for the engagement of and/or management of interest rate swaps prior to 2006, it subsequently adopted such policies for counties and counterparties and strengthened them in August 2011. MDB's current derivatives policy requires local governments using MDB for bond issues to submit a uniform credit package and to demonstrate their understanding of the risks associated with swap transactions.

No counties utilizing the MDB's services have sought a bond interest rate swap transaction since MDB revised and adopted its current derivatives policy in 2011. MDB officials assert that if the occasion arises in which a county becomes interested in engaging in a bond interest rate swap transaction, failure to comply with the current derivatives policy would result in a denial from the bank's Credit Review Committee and governing board.

Counties' Use of Bond Interest Rate Swap Transactions

What Mississippi counties have participated in bond interest rate swaps?

According to the most recent county audits released by the Office of the State Auditor, at the time of those audits, only Harrison and Hinds counties had bond interest rate swap agreements in effect. Since 2002, Harrison County has entered into nineteen bond interest rate swap agreements. Since 2005, Hinds County has modified two original bond issues to include swap agreements and these agreements are still in effect, although payments have been suspended until 2015.

What have been these counties' experiences with bond interest rate swaps ?

Harrison and Hinds counties' utilization of bond interest rate swap agreements demonstrates that use of these instruments can yield significantly different results. Since 2002, Harrison County's utilization of bond interest rate swap transactions has resulted in a net loss of approximately $4.19 million. Hinds County's utilization of bond interest rate swap agreements since 2005 has resulted in positive cash flows totaling approximately $6.5 million.

Did these counties comply with the Mississippi Development Bank's standards for their bond interest rate swaps?

At the time that these two counties engaged in their swap transactions, the Mississippi Development Bank had no operable derivatives policy, thus the transactions were not subject to standards of the MDB. However, any future swap transactions related to these particular bond issues would be subject to MDB's 2011 derivatives policy and approval by MDB's Credit Review Committee.

Did these counties follow best practices for their bond interest rate swaps?

Prior to their initial swap agreements, neither Harrison County nor Hinds County had all three elements in place of what PEER believes to be best practices. Since that time, both counties have taken steps to improve their processes, but neither has competitively procured its outside financial advisors for bond interest rate swaps.

- In an FY 2009 audit of Harrison County, the State Auditor noted that the county did not have an adequate, well-informed monitoring process in place for its bond interest rate swaps. The county does not have a comprehensive swap policy and has not used a competitive process to procure its financial advisors, bond counsel, and swap counterparties.
- In an FY 2010 audit of Hinds County, the State Auditor noted that the county lacked adequate procedures to monitor swap agreements and verify the calculations. Hinds County has since hired financial advisors to execute and manage its bond interest rate swaps, but did not utilize a competitive procurement process. The county's financial advisor recently developed a detailed swap policy.

Implications for Potential Government Users of Bond Interest Rate Swaps

Local governmental entities should exercise due diligence by developing and employing precautionary practices before utilizing bond interest rate swap agreements. The best practices described in this report should apply at any level or function of government, including municipalities, school districts, state agencies, or universities. These best practices should be in place to safeguard the governmental entity and taxpayers and mitigate the inherent risks associated with swap agreements, thus reducing the likelihood of large losses of taxpayer funds. However, considering the complexity of these financial instruments, even these best practices will not guarantee successful experiences.

Recommendations

1. In view of the fact that the interest rate swap environment for local governments lacks comprehensive safeguards to ensure that local governments are properly advised on the financial implications of swaps and that counterparties meet certain standards for financial condition, the Legislature should enact legislation to address the following for any interest rate swap or exchange entered into by local governments:
   - credit rating and net worth requirements for any counterparty to an exchange or swap agreement similar to those required of state interest rate swaps found in MISS. CODE ANN. Section 31-18-11 (1972);
   - development of a risk management policy;
   - mandatory counterparty representations regarding pricing unless the counterparty was selected through a competitive process;
   - determination by the governing body that the swap agreement meets the criteria of the swap policy when approving the swap transaction;
   - quarterly monitoring of the swap transaction while it remains effective;
   - biennial reviews of the local government's swap policy as long as the swaps remain in force and effect; and,
   - when necessary, competitive selection of legal and financial professionals to assist in overseeing and monitoring local government swaps.
2. Regardless of any legislative action that might be taken to regulate the utilization of bond interest rate swap instruments by local governments, any local governmental entity considering the use of such instruments should develop comprehensive bond interest rate swap policies that, at a minimum, reflect the best practices put forth in the California Debt and Investment Advisory Commission's October 2004 report entitled *The Fundamentals of Interest Rate Swaps* and Moody's Investors Service Global Credit Research publication from October 2007 entitled *Evaluating the Use of Interest Rate Swaps by U. S. Public Finance Issuers.*

   The three key elements of these best practices are:

   - develop a comprehensive written policy for bond interest rate agreements;

- ensure that individuals managing swaps have appropriate knowledge and expertise (either existing staff or independent, qualified swap advisors, preferably obtained through competitive procurement); and,
- commit to careful oversight and monitoring of the swap.

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A Review of County Governments' Utilization of Bond Interest Rate Swap Instruments

Introduction

Authority

PEER conducted this review of county governments' utilization of bond interest rate swap instruments pursuant to the authority granted by MISS. CODE ANN. Section 5-3-57 et seq. (1972). The Committee acted in accordance with MISS. CODE ANN. Section 5-3-51 et seq.

Problem Statement

The PEER Committee received a legislative request to inquire into counties' use of *bond interest rate swaps*.[1] In making this request, the legislator referred to an FY 2009 audit report that detailed that a particular county had paid approximately $7.36 million in swap termination fees. The legislator's concern was that county governments might be utilizing these complex financial derivatives without the necessary knowledge and expertise to ensure quality decisionmaking pertaining to such transactions.

Scope and Purpose

PEER sought to review counties' utilization of bond interest rate swaps by addressing the following questions:

- What is a bond interest rate swap and what are its benefits and risks?
- What is the regulatory environment for counties' engagement in swap transactions?

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[1]A *bond interest rate swap* is an agreement between two parties to exchange or "swap" cash flow commitments related to a corresponding bond issue for a specified period. The county's intent for entering into bond interest rate swaps is to reduce borrowing costs and improve cash flows.

- What standards should counties have relating to the use of interest rate swap agreements?
- If counties choose to use the Mississippi Development Bank (MDB) when issuing bonds, what requirements does MDB have for interest rate swaps?
- What Mississippi counties have participated in bond interest rate swaps?
- What have been these counties' experiences with bond interest rate swaps?
- Did these counties comply with the Mississippi Development Bank's standards for their bond interest rate swaps?
- Did these counties follow best practices for their bond interest rate swaps?

The purpose of this review was not to critique whether counties should be engaged in interest rate swaps or question any county's decision to enter into the bond rate swap agreements currently in effect. The purpose of this review was to determine whether counties have policies and procedures in place to guide decisionmaking regarding entering into bond interest rate swaps, monitoring the swap agreements in effect, and mitigating the inherent risks associated with utilizing bond interest rate swap instruments.

Method

In conducting this review, PEER:

- reviewed swap transaction information of the Mississippi Development Bank, including swap policies and procedures and board minutes;
- researched applicable information pertaining to best practices for entering, utilizing, and monitoring the utilization of bond interest rate swap instruments; and,
- reviewed the most recent audit reports of the Office of the State Auditor for all eighty-two counties to identify which counties had bond interest rate swaps in effect.

PEER determined that two counties (Harrison and Hinds) had bond interest rate swaps in effect at the time of their most recent county audits. Subsequently, PEER:

- interviewed the Harrison County Administrator and Harrison County Chief Deputy Chancery Clerk regarding the county's use of bond interest rate swaps;
- interviewed the Hinds County Administrator and Hinds County Budget and Accounting Director regarding the county's use of bond interest rate swaps; and,

- reviewed relevant documentation concerning the utilization of bond interest rate swap instruments in Harrison and Hinds counties.

Background

This chapter addresses the following question:

- What is a bond interest rate swap and what are its benefits and risks?

What is a bond interest rate swap and what are its benefits and risks?

A *bond interest rate swap* is an agreement between two parties to exchange or "swap" cash flow commitments related to a corresponding bond issue for a specified period. The county's intent for entering into bond interest rate swaps is to reduce borrowing costs and improve cash flows.

A bond interest rate swap is an agreement between two parties--in this case, a county government and a third party (i. e., *counterparty*)--to exchange or "swap" cash flow commitments related to a corresponding bond issue for a specified period. A county's intent for entering into a bond interest rate swap is to reduce borrowing costs and improve cash flows.

For example, counties may issue bonds with a variable interest rate. Therefore, in order to minimize exposure to higher interest rates in the future, the county may engage in a bond interest rate swap with a counterparty and agree to pay the counterparty a fixed interest rate. In return, the counterparty agrees to pay a variable interest rate based upon an agreed-upon, recognized bond index.

Consequently, if interest rates increase, the county has created a "hedge" against increased interest payments to bondholders due to the higher payments received from the swap counterparty, whose payments are based on the recognized bond index. However, if interest rates decrease or remain stable, the county will continue to pay interest to bondholders and a fixed interest rate to the counterparty. Therefore, the bond interest rate swap agreement increases the county's cost of the variable rate bonds because the fixed rate payments to the counterparty remain the same, while the variable rate payments from the counterparty decrease because of the lower interest rates.

The current value of a bond interest rate swap is based on the specific details of the bond swap agreement and the movement of interest rates since the agreement was made. The value of the agreement will be positive for one party and negative for the other party. If the party whose position has the negative valuation chooses to terminate the bond interest swap agreement, that party will have to

pay a termination fee, usually closely tied to the fair value of the agreement, to the other party.

Benefits of a Bond Interest Rate Swap

Utilizing bond interest rate swaps could potentially help issuers reduce borrowing costs and improve cash flows.

Bond interest rate swaps are flexible financial derivatives that essentially allow issuers (in this case, the county governments) the opportunity to alter the terms of existing cash flow commitments related to the issuance of debt without having an effect on the structure of the debt itself. Effectively utilizing bond interest rate swaps could potentially help issuers reduce borrowing costs and improve cash flows. This increases the resources that will be available for other purposes, such as lowering debt service costs.

Risks of a Bond Interest Rate Swap

Bond interest rate swaps also have the potential to negatively affect the issuer's net revenues and cash flows, its overall financial position, the relationship between the issuer and third parties, and future debt management options.

The utilization of bond interest rate swaps entails inherent risks that must be considered when entering into a bond interest rate swap agreement. Although these are risk factors that are related to bond interest rate swaps, they are not exclusive to these particular financial instruments. These risks should be considered when managing any facet of an issuer's overall debt management profile. The inherent risks involved in bond interest rate swaps could potentially affect:

- the issuer's net revenues and cash flows;
- the issuer's overall financial position;
- the relationship between the issuer and third parties; and,
- the number of debt management options an issuer might have in the future.

Risks That Could Potentially Affect an Issuer's Net Revenues or Cash Flows

- *Basis Risk*--Bond swap interest rates usually correlate to a recognized index such as the London Interbank Offer Rate (LIBOR) or the Bond Market Association (BMA) Index. It is important that the variable rates counties use in their bond deal and those used in the swap are calculated using the same or an equivalent basis. A

significant difference between the bond rate and the swap rate could undermine the hedging effect of a swap, making the deal uneconomical, potentially forcing a termination by the issuer and possibly a termination payment.

- *Tax Risk*--An issuer's debt service costs could increase if marginal tax rates fall or if the tax exemption for municipal debt is eliminated or changed in a manner that reduces its value.
- *Amortization Mismatch*--An issuer's cash flows will be affected if the face value of the bond interest rate swap and the outstanding principal amount of the corresponding debt that will be hedged are no longer equal. This is sometimes caused by events subsequent to the swap agreement such as recovery of bonds prior to maturity or termination of swap prior to bond maturity.

Risks That Could Potentially Affect an Issuer's Financial Position

- *Termination Risk*--Termination risk refers to the risk that a swap agreement will be terminated before its specified maturity date. Termination of a swap agreement results in a termination cash payment. This cash payment is based on the assumption that the non-canceling party will immediately seek a replacement swap that is similar to the original swap's terms. However, the non-canceling party may or may not actually replace the swap. Typically, the terms of a swap agreement dictate that the issuer can terminate the swap at any point, while the counterparty is only allowed to terminate the swap as a result of default of the issuer or a termination event such as bankruptcy or credit rating downgrade of the issuer.
- *Collateral Posting Risk*--In the event that the market value of a bond interest rate swap agreement becomes negative toward the issuer and causes a possible termination event such as a downgrade in its credit rating or bankruptcy, the issuer may be required to post collateral.

Risks That Could Potentially Affect an Issuer's Relationship with the Counterparty

A counterparty's inability to meet its obligation to the swap agreement can expose the issuer to unhedged variable rate risk, which nullifies one of the benefits for entering into swap agreements--avoiding variable rate risks. If the counterparty suffers a bankruptcy or a credit rating downgrade, that usually triggers a termination of the swap agreement. In the event of a termination due to

either one of these events, the issuer may be forced to make a termination payment.

Risks That Could Potentially Affect an Issuer's Future Debt Management Options

- *Market Access Risk*--This is the risk that issuers would be unable to obtain favorable interest rate swap contracts when needed in the future, including new swap agreements upon early or scheduled termination of existing hedges.

- *Rollover Risk*--Rollover risk is when the maturity date of the swap does not match the maturity date of the debt obligation. Bond issuers must understand that if they intend to enter into a new swap agreement at the end of the first agreement, due to the mismatch of maturity date, that the economic benefit might not be the same and the effective interest rate could change, thereby changing the projections on a given swap deal.

The utilization of a bond interest rate swap agreement may offer counties an additional tool to affect their overall financial position positively. However, as mentioned above, swap utilization also adds risks to a county's debt management profile. Therefore, it is important that counties effectively manage the risks associated with swap utilization in order to mitigate the potential for financial loss.

Controls and Best Practices for Bond Interest Rate Swaps

This chapter addresses the following questions:

- What is the regulatory environment for counties' engagement in swap transactions?
- What standards should counties have relating to the use of interest rate swap agreements?
- If counties choose to use the Mississippi Development Bank (MDB) when issuing bonds, what requirements does MDB have for interest rate swaps?

What is the regulatory environment for counties' engagement in swap transactions?

While state law contains certain requirements that counterparties must meet in order to participate in interest rate swap transactions involving state-issued debt, Mississippi statutes do not address the requirements or standards that counties, or any other local government entity, must meet when considering the execution of interest rate swap agreements. Each county or other local government entity is free to determine, based on its own standards and policies, whether to consider and enter an interest rate swap agreement.

When issuing bonds, a county uses an intermediary party, such as an investment bank, to sell the bonds to investors. That county may eventually choose to enter into a bond interest rate swap with a counterparty to reduce borrowing costs and improve cash flows. MISS. CODE ANN. § 31-18-11 (1972) requires that counterparties involved in interest rate swaps involving state-issued debt meet certain standards, such as having an AA credit rating. However, Mississippi law does not address the requirements or standards that counties or other local government entities (e. g., municipalities or school districts) must meet in order to execute interest rate swaps. As a result, each county or other local government entity is free to determine whether to seek execution of an interest rate swap agreement.

If a county decides to enter an interest rate swap agreement at some point after the bonds have been issued, the bond covenants (i. e., the documents that address the legalities and administrative procedures relating to a bond issue) dictate whether the county must use the intermediary party involved in the original bond issuance or whether it is free to use another party in executing the interest rate swap.

In Mississippi, counties have the option of using the services of the Mississippi Development Bank (MDB) or

another intermediary party when issuing bonds. If a county uses the MDB for a bond issue, the MDB requires the county to seek MDB's approval for subsequent interest rate swap agreements. (See pages 15 through 16 for a discussion of the MDB's policies and procedures for approving an interest rate swap.)

Other intermediary parties, such as investment banks, determine the requirements and standards applicants seeking interest rate swap agreements must satisfy. These requirements and standards are based on critical business elements, such as the projected trends for interest rates at the time of the proposal, that each individual intermediary party deems important relative to its business operations and decisions regarding interest rate swap agreements. PEER did not seek to determine those requirements or standards due to the large number of intermediary parties available in the financial market and the potentially proprietary nature of the information PEER would need to review. Unless the intermediary party requires a county to have internal policies and procedures regarding the county's understanding and monitoring of interest rate swap agreements, each county would be responsible for establishing internal policies and procedures to govern the use of interest rate swaps.

Since 2002, Harrison County has entered into nineteen bond interest rate swap agreements. Since 2005, Hinds County has modified two original bond issues to include swap agreements. Hinds and Harrison counties used the MDB when seeking interest rate swaps and were therefore subject to MDB's policies regarding interest rate swaps. Although MDB had no standards for the engagement of and/or management of interest rate swaps prior to 2006, MDB's current policy regarding interest rate swaps requires counties to demonstrate their understanding of the risks associated with swap transactions and requires that counterparties meet certain standards. (See page 15 for a more detailed discussion of MDB's interest rate swap policies and requirements.)

Because Mississippi statutes do not address the use of interest rate swap agreements for counties or other local government entities, it is vital that counties and other government entities have internal policies and procedures relating to the consideration, execution, and monitoring of interest rate swap agreements. Although there are no set standards for such policies and procedures, PEER believes the following represent the minimum standards counties and other government entities should have in place to govern the use of interest rate swaps.

What standards should counties have relating to the use of interest rate swap agreements?

In order to mitigate the risks of bond interest rate swap utilization, counties should adopt best practices for swap utilization that include developing a comprehensive swap policy, ensuring that individuals managing swaps have appropriate knowledge and expertise, and monitoring swap activity on an ongoing basis.

An organization's adherence to sound financial and risk management practices not only assists in limiting its exposure to the risks involved with the utilization of bond interest rate swaps, but also confirms to all stakeholders the leadership's commitment to making prudent decisions concerning its overall financial position.

PEER compiled the following list of best practices for using bond interest rate swaps based on a study by the California Debt and Investment Advisory Commission[2] and a Moody's publication:[3]

- develop a comprehensive written policy for bond interest rate swap agreements;
- ensure that individuals managing swaps have appropriate knowledge and expertise (either existing staff or independent, qualified swap advisors, preferably obtained through competitive procurement); and,
- commit to oversight and monitoring of the swap.

PEER believes these points are not an exhaustive list of the requirements and standards that should be included in an interest rate swap policy. Rather, PEER believes that the above points represent the minimum standards that counties should implement when considering interest rate swap agreements.

Develop a Comprehensive Written Policy for Bond Interest Rate Swap Agreements

In accordance with generally accepted public finance practices and in order to mitigate the inherent risks associated with bond interest rate swap agreements, any debt issuer considering entering into a bond interest rate swap agreement should adopt and maintain a written comprehensive bond interest rate swap policy.

To assure consistency and prudence in practices regarding bond interest rate swaps, entities should adopt comprehensive written policies addressing such instruments.

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[2] *The Fundamentals of Interest Rate Swaps*, California Debt and Investment Advisory Commission, October 2004.
[3] *Evaluating the Use of Interest Rate Swaps by U. S. Public Finance Issuers*, Moody's Investors Service Global Credit Research, October 2007.

Such a policy should be designed to provide guidance as to how the entity will execute and manage its utilization of bond interest rate swaps. The policy should address all elements that issuers should consider when contemplating entering into a bond interest rate swap agreement. Specific elements that should be addressed in a comprehensive swap policy should include a detailed analysis of how swaps work and an assessment of their potential benefits and risks to help decisionmakers understand how the utilization of swap instruments complements an issuer's overall debt management strategy.

The comprehensive bond interest rate swap policy should also detail how an issuer's swap program will be established. It should specifically address minimum standards and selection guidelines for third parties, how the issuer will address the need for independent and necessary knowledge and expertise to administer the swap program, and what will be required to ensure ongoing management and monitoring of its utilization of bond interest rate swap agreements. Management of bond interest rate swap agreements should also include a periodic review of the inherent risks associated with swaps and routine reporting to ensure that the hedges are having a positive effect on the issuer's financial position.

Ensure That Individuals Managing Swaps Have Appropriate Knowledge and Expertise

Counties must have adequate financial expertise to manage swap transactions effectively in order to mitigate the inherent risks associated with bond interest rate swap agreements. If counties do not have staff that possess the technical knowledge and skills to manage and monitor the use of swaps effectively, they should solicit the assistance of professionals with the skills, knowledge, and expertise to do so.

Before engaging in bond interest rate swap agreements, debt issuers should have the financial expertise, capacity, and necessary resources to be able to manage such instruments. County managers should be knowledgeable of the potential benefits and risks associated with swap utilization and the conditions of the environment that could affect future swap performance. They should also be able to evaluate whether the risks associated with bond interest rate swaps are consistent with the county's overall strategic financial goals.

If issuers do not have staff members that possess the technical knowledge and skills to monitor effectively their usage of swaps, they should solicit the assistance of professionals with the skills, knowledge, and expertise to do so. For each swap instrument, advisors must be able to advise issuers independently regarding the various rates

and structures of swaps, market conditions, and swap valuation. The advisors can also assist with the development of a comprehensive swap policy and be responsible for ongoing monitoring of swap instruments.

Management and oversight of swap instruments include making important decisions such as:

- developing policies and procedures for the execution and management of swaps;
- reviewing market values of swaps and determining strategies for possible terminations;
- calculating periodic swap payments;
- determining methods and selection criteria for counterparties; and,
- developing strategies to improve the performance of a county's swap portfolio and periodic review of swap performance.

If a county does not have appropriate knowledge and expertise on staff and chooses to engage the services of an independent, qualified swap advisor, the county should do so through competitive procurement. Competitive procurement of such advisors allows issuers the flexibility to exercise fairness, impartiality, transparency, and to select service providers according to performance standards and measurements that are suitable to both immediate and long-term needs of the issuer.

Full and open competition in procuring swap advisors would provide an incentive for the advisors to provide well-researched and well-founded solutions to an issuer's debt management needs and also for discussions prior to engagement of how their assistance would improve the overall financial position of an issuer's debt management profile. It also would hopefully allow the issuer the opportunity to achieve the best services at the most reasonable cost.

Commit to Oversight Monitoring

Adequate monitoring and oversight of a bond interest rate swap transaction helps to ensure that the swap's performance continues to affect the county's overall financial position positively and that any changes are effectively communicated to all interested parties.

Issuers must be committed to providing ongoing monitoring of bond interest rate swap agreements. The swap policy should detail what process will be needed to ensure real-time management of swaps. The volatility of the interest rate environment and the number of inherent risks involved with swap agreements require consistent oversight of swap performance in order to gauge whether the utilization of the swap is working negatively or

positively for the issuer. It is also important to monitor swap instruments regularly to remain abreast of potential changes in cash flows, particularly the potential for loss.

Management and individuals responsible for the oversight of bond interest rate swap instruments should be knowledgeable regarding current market conditions and potential market opportunities for possible terminations, suspensions, or swap restructurings.

If counties choose to use the Mississippi Development Bank (MDB) when issuing bonds, what requirements does MDB have for interest rate swaps?

Counties that utilize the assistance of the Mississippi Development Bank (MDB) when issuing bonds must have any subsequent interest rate swap transactions for those bond issues approved by MDB's governing board. Although MDB had no standards for the engagement of and/or management of interest rate swaps prior to 2006, it subsequently adopted such policies for counties and counterparties and strengthened them in August 2011.

Although not required to do so by statute, Harrison and Hinds counties used the services of the Mississippi Development Bank for the execution of these two counties' interest rate swap agreements. Although MDB had no standards for the engagement of and/or management of interest rate swaps prior to 2006, it subsequently adopted such policies for counties and counterparties and strengthened them in August 2011.

Availability of the Mississippi Development Bank's Assistance for Local Bond Issues

MISS. CODE ANN. Section 31-25-21 (1972) grants the Mississippi Development Bank the authority to borrow money and issue bonds in order to loan money to local governmental units. Although the bank may exercise this authority at its discretion, counties are not required to utilize the MDB for this service.

MISS. CODE ANN. Section 31-25-3 (1972) created the Mississippi Development Bank (MDB) as an independent body given full power to borrow money and issue its bonds in order to establish more favorable borrowing terms for local and state governmental entities. The intent of the Mississippi Development Bank is to foster and promote adequate access to capital markets, as well as to facilitate borrowing money in order to finance infrastructure improvements and other public purposes from the proceeds of bonds. MDB also works to reduce costs of indebtedness to taxpayers and residents of the state by encouraging investor interest in the purchase of such bonds as sound and preferred securities.

By acting as a "conduit issuer," MDB provides county governments with greater access to bond market expertise than they would have by acting alone. The security for this type of issuance is usually based on the credit of the counties and their ability to generate revenues from the projects that will be financed due to the issuance of the bonds. The "conduit borrower"--the county government--receives the proceeds of the bond sale and is subsequently responsible for making interest and principal payments until the bond reaches its maturity date.

MISS. CODE ANN. Section 31-25-27 (1972) empowers and authorizes local governmental units to contract with MDB with respect to the purchase of the local governmental unit's securities, in this case bond interest rate swap agreements.

MDB's Standards for Interest Rate Swaps, 2006-2011

MDB adopted its first derivatives policy in 2006 and revised the policy between March 2006 and June 2007.

Prior to 2006, the Mississippi Development Bank did not maintain any standards or uniform policies pertaining to the engagement of and/or management of derivatives, specifically bond interest rate swap transactions. On March 14, 2006, the Mississippi Development Bank adopted its first derivatives policy. The policy stated that any county interested in engaging in the utilization of a swap transaction should use a counterparty with at least an AA credit rating.

Between March 2006 and June 2007, the board of the Mississippi Development Bank revised its derivatives policy. The revised policy addressed permitted derivative instruments, how to evaluate and manage risks, suggested qualifications for swap counterparties, approved methods of counterparty solicitation and procurement, and swap termination provisions. Except for the initial requirement of engaging a swap counterparty with an AA credit rating, this revised policy consisted of recommendations and was not mandatory. During this time, the development bank took the position that because a county resolution is needed to seek approval of a swap transaction, it was the county's responsibility to ensure that it had adequate knowledge of the swap transaction and how such a transaction would potentially affect the overall debt management strategy of the county. In short, the bank expected the county governments to exercise sufficient due diligence before engaging in a swap transaction.

MDB's Current Standards for Interest Rate Swaps

The Mississippi Development Bank again revised its derivatives policy in 2011. MDB's current derivatives policy requires local governments using MDB for bond issues to submit a uniform credit package and to demonstrate their understanding of the risks associated with swap transactions.

The Mississippi Development Bank again revised its derivatives policy on August 10, 2011. This policy not only required that all derivative transactions be engaged with a counterparty with at least an AA credit rating, it also defined the responsibilities of the local governmental agencies and the development bank's Credit Review Committee, which was given the primary responsibility of reviewing swap transactions. The policy also set certain requirements for counterparties.

Requirements for Counties

For bond interest swap transactions, the requirements for counties are as follows:

- The highest elected county government official must submit a letter to the MDB explicitly stating his/her understanding of the swap transaction, the risks associated with the transaction, and verification of county-level approval.
- The counties must provide written opinions from (1) a nationally recognized bond counsel firm stating that the derivative contract is a legal, valid, and binding obligation of MDB and that entering into the derivative contract complies with applicable state and federal laws, including federal income tax requirements; (2) counsel to the counterparty, verifying the same.
- The local governmental unit shall demonstrate that it has reviewed and evaluated the inherent risks in the proposed transaction.
- The local governmental unit shall demonstrate various components of the derivative contract in a letter to the Executive Director outlining the following:
    - objectives of the derivative contract;
    - understanding of the risks involved;
    - costs associated with the derivatives contract;
    - expected interest rate exposures and basis risk;
    - mitigating strategies in connection with basis risk; and,
    - credit ratings of any counterparty.

The Mississippi Development Bank's derivatives policy states that local government units have the option to either utilize competitive bidding or a negotiated process when selecting a counterparty and setting a price for the derivative transaction. Regardless of the procurement process selected, the derivative contract itself may be subject to review by the bank's Credit Review Committee. The bank wants to ensure that the terms and conditions of any such contract reflect a fair market value of such an agreement.

Requirements for Counterparties

For bond interest swap transactions, the requirements for counterparties are as follows:

- Regardless of the security or credit rating of the underlying transaction, a qualified counterparty shall have and maintain a credit rating from at least one nationally recognized statistical rating agency that is within the two highest investment grade categories and any ratings that are obtained from any other nationally recognized statistical rating agencies shall also be within the three highest investment grade categories.

  If the credit rating of the counterparty or guaranteeing entity falls below the required rating, the obligations of the counterparty shall be collateralized by the principal and interest that are guaranteed by the United States with a net market value of at least 102 percent of the net market value of the derivative contract.

- The counterparty must either have a net worth of at least $100 million or a person or entity having a net worth of at least $100 million must guarantee the counterparty's obligation under the derivative contract.
- Counties should make an effort to diversify exposure to single-entity counterparties.

No counties utilizing the MDB's services have sought a bond interest rate swap transaction since MDB revised and adopted its current derivatives policy in 2011. MDB officials assert that if the occasion arises in which a county becomes interested in engaging in a bond interest rate swap transaction, failure to comply with the current derivatives policy would result in a denial from the bank's Credit Review Committee and governing board.

Conclusion Regarding Controls and Best Practices for Interest Rate Swaps

Careful deliberation prior to entering interest rate swap agreements and vigilant monitoring of ongoing interest rate swaps are crucial to the prudent management of taxpayer resources.

It is vitally important that counties and other government entities understand the potential role an interest rate swap agreement would play in debt management policy and the risks associated with swap utilization. Utilizing individuals with appropriate knowledge and expertise (either staff members or independent, qualified swap advisors) to manage bond swaps to advise the county or other government entity during the consideration, execution, and ongoing monitoring of interest rate swap agreements could increase government officials' understanding of swap agreements and the risks involved in such agreements.

Although an interest rate swap has the potential to improve cash flow, it may also decrease cash flow and prove costly to terminate. Careful deliberation prior to entering interest rate swap agreements and vigilant monitoring of ongoing interest rate swaps are crucial to the prudent management of taxpayer resources.

Counties' Use of Bond Interest Rate Swap Transactions

This chapter addresses the following questions:

- What Mississippi counties have participated in bond interest rate swaps?
- What have been these counties' experiences with bond interest rate swaps?
- Did these counties comply with the Mississippi Development Bank's standards for their bond interest rate swaps?
- Did these counties follow best practices for their bond interest rate swaps?

What Mississippi counties have participated in bond interest rate swaps?

According to the most recent county audits released by the Office of the State Auditor, at the time of those audits, only Harrison and Hinds counties had bond interest rate swap agreements in effect.

As noted on page 1, in making this request, the legislator referred to an FY 2009 audit report that detailed that a particular county had paid approximately $7.36 million in swap termination fees. The legislator's concern was that county governments might be utilizing these complex financial derivatives without the necessary knowledge and expertise to ensure making quality decisions pertaining to such transactions.

To determine the extent to which counties have participated in bond interest rate swaps, PEER reviewed the most recent county audit reports released by the Office of the State Auditor to identify which counties had bond interest rate swaps in effect. At the time of their most recent audits, two counties (Harrison and Hinds) had bond interest rate swaps in effect.

As noted on page 9, since 2002, Harrison County has entered into nineteen bond interest rate swap agreements. Since 2005, Hinds County has modified two original bond issues to include swap agreements and these agreements are still in effect, although payments have been suspended until 2015.

What have been these counties' experiences with bond interest rate swaps ?

Harrison and Hinds counties' utilization of bond interest rate swap agreements demonstrates that use of these instruments can yield significantly different results.

Harrison County's Bond Interest Rate Swap Experience

Since 2002, Harrison County's utilization of bond interest rate swap transactions has resulted in a net loss of approximately $4.19 million.

Since 2002, Harrison County has entered into nineteen bond interest rate swap agreements. As noted earlier, bond interest rate swap agreements contain risks that are outside of the county's control and that have the potential to have a negative affect on county cash flows and net revenues. During the first quarter of FY 2010, several of Harrison County's bond interest rate swap agreements had a negative fair market value. This negative effect on the county's derivatives resulted in termination payments totaling $7,366,000. The large amount of termination payments was due to a credit downgrade of the county's counterparty and bond insurer, creating a less stable bond environment and exposing the county to high variable interest rates.

Subsequently, due to restructured swap agreements and current bond interest rate swap exchanges, the county has had some positive cash flows as a result of swap utilization totaling $3,176,231. This resulted in a net loss of approximately $4.19 million for bond interest swaps.

In 2008 and 2009, Harrison County participated in eight swaps, three of which are still in effect. Those swap agreements were attached to bond issues in 2008 and 2009 that were utilized to restructure and refinance outstanding debts of the county.

Hinds County's Bond Interest Rate Swap Experience

Since 2005, Hinds County's utilization of bond interest rate swap agreements has resulted in positive cash flows totaling approximately $6.5 million.

Hinds County has entered into two bond interest rate swap agreements since 2005. Hinds County modified two bond issues, intended to be used for public infrastructure improvements, to include the swap agreements. These two agreements are still in effect, but payments on the county's two bond interest rate swap agreements have been suspended until 2015, which was requested by the

counterparty due to changes in variable interest rates that would result in positive cash flows for the county. Since 2006, Hinds County has received bond swap interest payments totaling $6,537,228.

According to information submitted by Hinds County, that county has never suffered a loss from the utilization of its bond interest rate swap contracts. Hinds County has utilized cash flows resulting from swap agreements to assist with budget expenditures. To date, Hinds County has expended approximately $4.62 million of swap payment proceeds for county operations.

Did these counties comply with the Mississippi Development Bank's standards for their bond interest rate swaps?

At the time that these two counties engaged in their swap transactions, the Mississippi Development Bank had no operable derivatives policy, thus the transactions were not subject to standards of the MDB. However, any future swap transactions related to these particular bond issues would be subject to MDB's 2011 derivatives policy and approval by MDB's Credit Review Committee.

As noted previously, since 2002, Harrison County has entered into nineteen bond interest rate swap agreements, three of which are still in effect. Since 2005, Hinds County has modified two original bond issues to include swap agreements and these are still in effect. The Mississippi Development Bank assumed the role of a "conduit issuer" for the bonds associated with the swap transactions in Hinds and Harrison counties. As noted on page 14, the Mississippi Development Bank had no operable derivatives policy at the time that these two counties engaged in their swap transactions. Thus the transactions were not subject to standards of the MDB.

However, MDB revised its derivatives policy in 2011 and the current derivatives policy requires local governments using MDB for bond issues to submit a uniform credit package and to demonstrate their understanding of the risks associated with swap transactions (see page 15). Because both Harrison and Hinds counties facilitated bond issues through the Mississippi Development Bank, any future bond interest rate swap transaction related to one of these bond issues will be subject to approval by the Mississippi Development Bank's Governing Board. According to MDB officials, if the occasion arises in which a county becomes interested in engaging in a bond interest rate swap transaction, failure to comply with the 2011 derivatives policy would result in a denial by the bank's Credit Review Committee and governing board.

Did these counties follow best practices for their bond interest rate swaps?

Prior to their initial swap agreements, neither Harrison County nor Hinds County had all three elements in place of what PEER believes to be best practices. Since that time, both counties have taken steps to improve their processes, but neither has competitively procured its outside financial advisors for bond interest rate swaps.

As noted on page 10, PEER compiled the following list of best practices for using bond interest rate swaps:

- develop a comprehensive written policy for bond interest rate swap agreements;
- ensure that individuals managing swaps have appropriate knowledge and expertise (either existing staff or independent, qualified swap advisors, preferably obtained through competitive procurement); and,
- commit to oversight and monitoring of the swap.

While PEER knows of no legal requirement for counties to follow these or any other prescribed best practices in utilizing bond interest rate swaps, it is incumbent upon all public entities to make the most prudent, effective, and economical use of public funds. Following best practices would help to ensure that public funds are used wisely when utilizing such financial instruments.

The following sections address whether Harrison and Hinds counties followed best practices in their bond interest rate swap transactions.

Harrison County

In an FY 2009 audit of Harrison County, the State Auditor noted that the county did not have an adequate, well-informed monitoring process in place for its bond interest rate swaps. The county does not have a comprehensive swap policy and has not used a competitive process to procure its financial advisors, bond counsel, and swap counterparties.

In the FY 2009 audit of Harrison County, the State Auditor found that the county personnel lacked the necessary training and qualifications to monitor effectively its bond interest rate swap agreements and had not established an adequate periodic monitoring process. PEER notes that the county did not have a comprehensive bond interest rate swap policy at the time of entering into its swap agreements and did not have one at the time of this review.

Harrison County utilizes outside advisors to administer its swap program. The advisors are responsible for executing, managing, monitoring, and reporting on utilization of the county's bond interest rate swap agreements. The county

did not use a competitive bidding process to hire its outside swap and financial advisors. Although MDB does not require counties to utilize a competitive procurement process when contracting for professional services, considering the risks involved with the utilization of bond interest rate swaps and the potential to suffer a loss of taxpayer funds, it would be prudent public policy to utilize a competitive procurement process to hire swap and financial advisors, bond counsel, and counterparties.

Hinds County

In an FY 2010 audit of Hinds County, the State Auditor noted that the county lacked adequate procedures to monitor swap agreements and verify the calculations. Hinds County has since hired financial advisors to execute and manage its bond interest rate swaps, but did not utilize a competitive procurement process. The county's financial advisor recently developed a detailed swap policy.

In an FY 2010 audit of Hinds County, the State Auditor found that the county lacked adequate procedures to monitor swap agreements and verify the calculations. The auditor found that the county did not appear to have anyone in county management that understood or was able to quantify the financial risks the instruments posed to the county. The auditor recommended that the county assign responsibility for monitoring these agreements to a qualified independent party or person who would report the status of such swaps regularly to managers and the board of supervisors. The county has since hired an outside financial advisory firm to handle the execution and management of its bond interest rate swap agreements. However, when procuring its financial advisor for bond interest rate swaps, Hinds County did not utilize a competitive process. Again, although there presently exists no legal requirement to do so, PEER believes that in order to safeguard taxpayers, the county should utilize a competitive procurement process when engaging outside assistance.

Hinds County also did not have a comprehensive bond interest rate swap policy prior to its initial engagement in bond interest rate swap agreements. However, in 2010, Hinds County paid its financial and swap advisory firm to develop the county's swap policy, which specifically details the execution and management of its utilization of bond interest rate swap agreements. Hinds County's Interest Rate Exchange Agreement Policy (i. e., swap policy) now includes the purpose for utilizing a swap instrument, how swap proceeds are to be used, counterparty selection criteria, provisions for collateralization, long-term implications, and standards for county monitoring.

Implications for Potential Government Users of Bond Interest Rate Swaps

Local governmental entities should exercise due diligence by developing and employing precautionary practices before utilizing bond interest rate swap agreements. These practices should be in place to safeguard the governmental entity and taxpayers and mitigate the inherent risks associated with swap agreements, thus reducing the likelihood of large losses of taxpayer funds.

PEER takes no position on whether county governments should utilize bond interest rate swap agreements or whether Hinds or Harrison counties' current or past bond interest rate swap agreements were successful endeavors.

PEER encourages the use of proper policies and procedures in order to ensure that government officials have the information and knowledge necessary to make an informed decision regarding a county's interest in executing a bond interest rate swap agreement.

The best practices described in this report should apply at any level or function of government, including municipalities, school districts, state agencies, or universities. These best practices should be in place to safeguard the governmental entity and taxpayers and to mitigate the inherent risks associated with swap agreements, thus reducing the likelihood of large losses of taxpayer funds. However, considering the complexity of these financial instruments, even these best practices will not guarantee successful experiences.

Recommendations

1. In view of the fact that the interest rate swap environment for local governments lacks comprehensive safeguards to ensure that local governments are properly advised on the financial implications of swaps and that counterparties meet certain standards for financial condition, the Legislature should enact legislation to address the following for any interest rate swap or exchange entered into by local governments:

   - credit rating and net worth requirements for any counterparty to an exchange or swap agreement similar to those required of state interest rate swaps found in MISS. CODE ANN. Section 31-18-11 (1972);
   - development of a risk management policy;
   - mandatory counterparty representations regarding pricing unless the counterparty was selected through a competitive process;
   - determination by the governing body that the swap agreement meets the criteria of the swap policy when approving the swap transaction;
   - quarterly monitoring of the swap transaction while it remains effective;
   - biennial reviews of the local government's swap policy as long as the swaps remain in force and effect; and,
   - when necessary, competitive selection of legal and financial professionals to assist in overseeing and monitoring local government swaps.

2. Regardless of any legislative action that might be taken to regulate the utilization of bond interest rate swap instruments by local governments, any local governmental entity considering the use of such instruments should develop comprehensive bond interest rate swap policies that, at a minimum, reflect the best practices put forth in the California Debt and Investment Advisory Commission's October 2004 report entitled *The Fundamentals of Interest Rate Swaps* and Moody's Investors Service Global Credit Research publication from October 2007 entitled *Evaluating the Use of Interest Rate Swaps by U. S. Public Finance Issuers.*

   The three key elements of these best practices are:

   - develop a comprehensive written policy for bond interest rate agreements;

- ensure that individuals managing swaps have appropriate knowledge and expertise (either existing staff or independent, qualified swap advisors, preferably obtained through competitive procurement); and,
- commit to careful oversight and monitoring of swaps.

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