Senate Committee on Local Government
Hon. John H. Eichelberger, Chair
Hon. Rob Teplitz, Democratic Chair
Hearing on SB 901 - 904
Testimony of Nancy Winkler, Treasurer, City of Philadelphia
September 9, 2013

Good morning Chairman Eichelberger, Chairman Teplitz, and members of the Local Government Committee. I am Nancy Winkler, Treasurer of the City of Philadelphia. With me today is Charles Jones, Executive Director of the Sinking Fund Commission and Peter Shapiro, President of Swap Financial Group, the City's Swap Advisor. I want to express our gratitude for the opportunity to appear before you in order to express the City's views at this hearing regarding Senate Bills 901 through 904.

The City strongly opposes SB 904 because it would harm Philadelphia's ability to manage effectively its own financial affairs, including the City's current swap portfolio and investments. This bill would prohibit the City of Philadelphia from entering into "interest rate management agreements", including interest rate swaps and other interest rate hedges, as well as forward and float agreements that allow the City to invest its bond proceeds efficiently. These are important tools to allow the City to generate savings, reduce risks, manage our investments and access the financial markets effectively. Every other major city in the United States has the authority to use these financial instruments to help manage risk and generate savings for their citizens and taxpayers. If SB 904 were to be enacted, Philadelphia would be the only major city in the nation to be prohibited from using swaps. There is nothing in Philadelphia's experience with swaps that warrants this extraordinary measure to deprive Philadelphia of the ability to manage its own fiscal affairs using these important tools. We know from experience that the City of Philadelphia, which is ranked by the Bond Buyer as one of the top 100 issuers of municipal debt in the country, brings the appropriate sophistication and prudence to the use and management of swap agreements. The General Assembly has wisely permitted a reasonable degree of discretion to cities of the first class under the principle of home rule. We urge you to maintain this principle, and to refrain from fixing what is not broken, by setting SB 904 aside.

Philadelphia, like major cities throughout the nation, has historically used swaps to lower financing costs versus traditional tax-exempt fixed-rate bonds. The City issued long term variable rate bonds and at the same time entered into swaps to fix the rate, generating all-in lower costs. During Mayor Nutter's term in office, we have reduced, but not eliminated, our swap exposure. While we have not entered into new swaps, we must retain our ability to do so. We also need to retain our ability to amend or transfer current swaps to other providers in order to improve financial position or reduce risks. As I stated, swaps are used to lower interest costs by accessing a global base of investors. This is particularly important today, because the traditional investor base for municipal bonds is shrinking and interest costs are pressured to rise. In addition, federal proposals to limit the value of municipal tax-exemption are under serious consideration in Congress. A loss or diminution of tax-exemption would add additional increased interest costs. But by offering a way to access global capital as another funding source for our capital programs, swaps are a tool to reduce the impact of these forces.

Until this past year, swaps were very lightly regulated. In light of many actual abuses in the overall financial markets that were revealed in the financial crisis of 2008, Congress passed landmark legislation known as the Dodd-Frank Act. Under this act, all governmental entities, including Philadelphia, are governed by a tight new set of restrictions intended to clamp down on abusive practices. While most of the restrictions in the Act fall upon swap dealers, providing increased protection to the City, the City has moved quickly to be in compliance with the act's requirements on municipalities and the regulations promulgated under it. The new regulatory environment will fundamentally change how the swap market works by requiring increased scrutiny and stronger rules regarding fair business practices, as well as the use of qualified independent advisors. We would ask the Committee to give this process a chance to work, rather than rushing to conclusion with SB 904.

The swaps are not without risks, and they require continuous management supervision by the City's finance staff. But it is precisely by engaging in this close supervision that large cities, such as Philadelphia, are enabled not only to realize the savings offered by swaps, but also to manage the risks responsibly. Swaps must be implemented by managers who understand the swap transactions, and once in place, the transactions must themselves be managed. The City of Philadelphia has both in-house Finance and Treasury expertise as well as external independent advisors to assist with managing and executing swap transactions. We monitor our swaps and related variable rate debt monthly. The City of Philadelphia has a comprehensive swap policy, which is attached to my testimony. This swap policy limits the use of swaps to transactions which would generate interest cost savings versus fixed rate bond transactions, and prohibits some of the types of transactions which, in other communities, have produced abuses. The policy requires the City to consult with an outside swap advisor, and to procure swaps competitively where possible. Swaps should be considered as an option for a portion of a debt program; Philadelphia's current policy provides a guideline that our swaps should not exceed 35% of our total outstanding debt. We believe this is a prudent level given the need to obtain letters of credit and maintain a diversity of debt structures. Currently Philadelphia's swap portfolio is just under 12% of our total outstanding debt. We will not undertake any swaps that do not have call provisions embedded in them, which enables us to eliminate or greatly minimize termination costs. This will substantially reduce the risks related to swaps as the City would minimize any adverse impact of a termination on expected all in debt service costs.

Contrary to stories that have circulated, swaps have not adversely impacted the City's credit rating. The City is currently rated A2 (Moody's), A- (Standard &Poor's) and A- (Fitch). The City attained its A- S&P rating earlier this year, the first time it has been rated in the A category by S&P since 1979. This is the second bond rating upgrade in Mayor Nutter's administration. The rating agencies closely review Philadelphia's use of swaps – as they do all elements of the City's finances. None of the rating agencies cites any concern with the City's use of swaps. Moody's, in its rating report reaffirming the City's ratings on June 12 of this year, cited as a strength the "ongoing improvement in the City's financial operations". Fitch reaffirmed its ratings for the City on the same date, citing Philadelphia's "solid financial management". And Standard and Poor's raised the City's credit rating, saying the City's "financial management is strong, well embedded and likely sustainable", and, in specific, that "Mayor Nutter's administration took proactive actions on spending to restore operational balance" in the face of a deep recession. The report was so favorable that The Philadelphia Inquirer headlined its article on the S&P upgrade with the words "Wall Street Cheers".

When a swap is used as a hedge, it is always a two-part transaction. The first part is the floating rate bonds that the City issues. The second part is the swap used to protect the City against volatility of floating rates. It is wrong – in fact, it is deceptive – to analyze one part of the transaction without analyzing the other. Under Pennsylvania law, the City could not have entered into the swaps unless they were associated with bonds they were hedging. So no bonds, no swaps. Likewise, the City would never have issued floating rate bonds without hedging them with the swaps. The City was not looking to take on, unhedged floating rate risk. The City was not looking to benefit from further declines in interest rates. It was looking to lock in a fixed rate – a lower fixed rate than it would have paid on conventional fixed rate bonds. The fact that floating rates declined was irrelevant to the City. With one exception, (which would no longer be permitted under the City's swap policy) the City's swap transactions consisted of two parts, the swaps and bonds, and the floating rates on each moved in tandem, as intended. While swaps are often characterized as speculative, existing Pennsylvania law rightly prohibits such swap transactions; rather swaps must be used in connection with actual bonds where there is a need for management of interest rate risk. The City supports this eminently sensible existing rule, which is consistent with the City's use of swaps. During the fiscal crisis, the actual part of the transaction that failed was not the swap agreements, but the letter of credit bank products used to secure the variable rate bonds.

My office has undertaken an analysis to estimate the life cycle impact of all the City's swaps. Although such an estimate can never produce perfectly certain results, we concluded that the City's overall experience with swaps versus a fixed rate bond issue through June 30, 2012, ranged between a gain of $35.1 million and a loss of $28.9 million based on the actual cash flows. I reported this estimate to City Council last year. Certain risks were realized during the financial crisis. The greatest of these was the cost of bank letters of credit needed to support the floating rate bonds. For a brief period of time in 2008 and 2009, these costs increased to levels much higher than budgeted, reducing the expected savings on the swap. At one point, given the high cost and limited availability of letters of credit, the City decided to terminate certain of its swaps early, at a cost. Over the past several years, with the banking crisis behind us, the cost of letters of credit have been reduced by up to 400% and our floating rate bond programs are operating well. The costs reported to City Council included the costs, but not the improved pricing we have obtained in the past year.

We have learned some important lessons from the financial crisis. Notably, we now require par call options in swaps, which have the effect of greatly diminishing or entirely eliminating termination costs. The City's swap policy forbids front loading savings, which requires the swaps to generate benefits over the entire life of the transactions. We also require a threshold of benefit for swap transactions above the traditional fixed rate transaction alternative.

In addition to restricting entering into Interest Rate Management Agreement, SB 904 also restricts the City from entering into certain investment vehicles such as forward and float agreements. These agreements, known also as Forward Delivery Agreements or “FDAs”, provide municipalities with a fixed investment rate on required reserve funds and other similar funds for the life of an agreement. These should serve as a critical tool for issuers to manage interest rate risk by providing a predictable rate of return over a long period of time. FDAs are structured in a manner to mitigate credit exposure by delivering securities to an issuer’s account in an amount equal to the contract amount. They can be designed to provide flexibility in drawing down funds. As a strategy for investing long term debt service reserve funds, they provide critical protection from fluctuations in interest rate movements which can negatively impact market values of required reserve funds. Investments can be customized to meet an issuer’s permitted investments constraints and other requirements, and typically include downgrade triggers and protections against non-performance. In terms of budgetary impact, a debt service reserve fund of $10 million could generate an additional $100,000 per year of additional interest earnings for every percentage point a municipality is able to invest these funds in the long term. This is real money.

In summary, we know that swaps come with risk—as does almost any financial transaction. Nevertheless, we are highly conservative and prudent in using them, and vigilant in monitoring them once in place. But we believe that under the right circumstances, they can afford us with needed ways to manage risk and improve Philadelphia’s financial standing. SB 904 would curtail our flexibility and handicap us in the financial markets by denying the City basic financial management tools available to every other major American city.

Thank you, again, for the opportunity to testify today regarding this matter of importance to the City of Philadelphia and I would be happy to answer any questions you may have.

City of Philadelphia
Swap Policy
May 2013

I. INTRODUCTION

The purpose of this Swap Policy is to provide a policy for the City of Philadelphia's (the City) use of swaps, cap, floors, collars and other derivative financial products (collectively referred to herein as "swaps") in conjunction with the City's management of its debt.

The swap program managed by the City includes swaps related to general obligation debt, tax-supported lease and contract debt issued by related authorities, debt of the Water Department, Division of Aviation, and debt of the Philadelphia Gas Works (PGW). Swaps related to debt of the Pennsylvania Intergovernmental Cooperation Authority (PICA), School District of Philadelphia (SDP), and the Philadelphia Parking Authority (PPA) are managed by those governmental entities, respectively.

The Director of Finance has overall responsibility for entering into swaps. Day-to-day management of swaps is the responsibility of the City Treasurer, and the Executive Director of the Sinking Fund Commission is responsible for making swap payments. The Office of the City Treasurer and the City Solicitor's Office coordinate their activities to ensure that all swaps that are entered into are in compliance with applicable federal, state, and local laws.

This policy will address the circumstances when swaps can be used, the risks that need to be evaluated prior to entering into swaps and on an ongoing basis after swaps have been executed, the guidelines to be employed when swaps are used, and how swap counterparties will be chosen. This policy will be used in conjunction with the City's Debt Management Policy. This policy will be reviewed annually and updated as needed.

II. AUTHORITY

Under the Commonwealth constitution, a municipality with a Home Rule Charter can exercise any power not denied by the General Assembly. The First Class City Home Rule Act specifies the limitations on the City's Home Rule powers. One of those limitations is enactment by the General Assembly of a law of general application on a subject. There is no such law in effect relating to swaps. Accordingly, the power to enter into swaps is a home rule power of the City. The City's Home Rule Charter does not specifically address swaps, but states that the City may exercise all powers of local self-government. Authority to enter into swaps must be enacted by an ordinance of City Council, which can be part of an ordinance for bond issuance.

III. PROCEDURE

Before deciding to enter into a swap, the following questions should be answered in a written memo:

- Taking into consideration risks and rewards presented by the proposed transaction, is the transaction appropriate? In this analysis, include:
  - A statement of the purpose of the transaction and expected benefits;
  - A description of the transaction structure;
  - A description of the risks it presents; and
  - Any risk mitigation measures.

- What is the legal framework for the transaction? In this analysis, include:
  - The legal framework for the transaction within the context of Pennsylvania law;
  - The City Ordinance that will authorize the transaction;
  - Relevant indenture and contractual requirements (including those contained in credit enhancement agreements); and
  - Any implications of the transaction under federal tax law.

- How does the proposed transaction fit into Section IV "Permitted Uses" on page 3 of this policy?

- After the swap being contemplated has been executed, will the City remain within allowable guidelines set forth in Section V "Guidelines for Swaps" on pp. 3-4 of this policy?

- If the swap or the swap and associated bonds involve two variable interest rates, has the historical relationship been analyzed between the proposed indexes? How would the highest and lowest relationship over the last 10 years impact the budget if this were to occur again? How do these alternative scenarios compare with the expected outcome? Examples of this are a basis swap and a LIBOR based swap associated with tax-exempt bonds (see Basis Risk under Section VII "Risk Management" on pp. 5-6 of this policy).

- Will this transaction have any impact on areas where the City's capacity could be limited, either now or in the future, including the use of variable rate debt, bank liquidity facilities or letters of credit, and bond insurance?

- Does the City have the ability to handle the administrative burden imposed by the transaction, including budgeting, accounting, and financial reporting requirements?

- Is the swap structured to include a call option which would permit the City to terminate the swap within five years at no cost? What is the potential termination payment value using a two-standard deviation likelihood? How would the City pay for this termination payment if it had to terminate?

- Are the swap payments and/or the termination payments insured?

- Do the swap document terms address the three tiered approach to limit counterparty risk set forth in Section VI titled “Counterparty Credit Standards” on pp. 4-5 of the policy?

- Are there any potential effects that the transaction may have on the credit ratings of any City obligations assigned by the rating agencies?

- Is a callable swap available and what is the benefit of optionality in this swap?

IV. PERMITTED USES

Swaps must be shown to manage interest rate risk and/or cost of the related debt in order to be considered. Ordinances of the City do not authorize swaps for any other purpose. The City shall not enter into swaps for purely speculative purposes. Permitted uses of swaps include:

- Managing the City’s exposure to floating interest rates through interest rate swaps, caps, floors and collars;

- Locking in fixed rates in current markets for use at a later date through the use of forward starting swaps and rate locks;

- Reducing the cost of fixed or floating rate debt through swaps and related products to create “synthetic” fixed or floating rate debt; and

- Managing the City’s credit exposure to financial institutions and other entities through the use of offsetting swaps.

Swaps or swaptions with associated upfront payments are not allowed unless there is a compelling argument that it is suitable under extreme circumstances.

V. GUIDELINES FOR SWAPS

Swaps must be entered into prudently as they expose the City to risks as described in Section VII titled “Risk Management” on pp. 5-6. The most common type of swap is the floating to fixed rate interest rate swap which is associated with variable rate bonds. For any contemplation of variable rate debt, provisions set forth in the City’s Debt Management Policy should be adhered to.

Because of the risks related to issuing variable rate debt and swapping it to fixed rate which were highlighted during the global credit crisis of 2008 and 2009, the amount of hedged variable rate debt should be limited.

Description	**Target**
Amount of Hedged Variable Rate Debt as a percentage of Total Debt.	35% maximum

This limitation should be calculated separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. While 35% is the target, efforts should be made to keep this percentage well below this for bonds rated below the 'A' category.

In the case where forward starting floating to fixed rate swaps have been entered into but the associated bonds have not been issued yet, the notional amount of the swap and the expected principal amount of the bonds should be taken into consideration. In addition, in the case of a swaption involving a floating-to-fixed rate swap which has not yet been exercised, the notional amount of the swaption should be included in the calculation of hedged variable rate debt.

In addition to floating to fixed rate swaps, there are other types of swaps including basis swaps, constant maturity swaps, and fixed to floating rate swaps. Because of the different types of swaps which can be entered into, it is important to limit the total notional amount of swaps. In the event that one swap directly offsets the cash flows and risks of another swap or swaps with the same counterparty, only the net amount that is not offset should be counted toward the limitation.

When available and economic, callable swaps should be strongly considered.

Description	**Target**
Notional Amount of Swaps as a percentage of Total Debt.	35% maximum

This limitation should be calculated separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. While 35% is the target, efforts should be made to keep this percentage well below this for bonds rated below the 'A' category.

VI. COUNTERPARTY CREDIT STANDARDS

Swap products can create exposure to the creditworthiness of financial institutions that serve as the City's counterparties on swap transactions. To protect the City's interests in the event of a counterparty credit problem, the City will take a three tiered approach for any future swaps:

- Use of highly rated counterparties: Standards of creditworthiness, as measured by credit ratings and other factors as the City may judge to be appropriate, will determine eligible counterparties. As a general rule, the City will enter into transactions with counterparties whose obligations are rated in the double-A rated category or better from two nationally recognized rating agencies. In cases where the counterparty's obligations are rated based on a guarantee or specialized structure to achieve the required credit rating, the City shall thoroughly investigate the nature and legal structure of the guarantee or structure in order to determine that it fully meets the City's requirements.

- Collateralization on downgrade: If counterparty's credit rating is downgraded below the double-A rating category, the City shall require that its exposure be collateralized.

Exposure should be collateralized at a zero threshold if the counterparty is downgraded to A- or A3.

• Termination: If a counterparty's credit is downgraded below the A category, even with collateralization, the City may exercise a right to terminate the transaction prior to its scheduled termination date. The City will seek to require that terminations triggered by a counterparty credit downgrade will occur on the side of the bid-offer spread which is most beneficial to the City, and which would allow the City to go back into the market to replace the downgraded party with another suitable counterparty at no out-of-pocket cost to the City.

In addition to the above three-tiered approach, the City's swap counterparties will be required to notify the City in the event a credit agency takes negative action with regard to the counterparty's credit rating, including both an actual downgrading of the credit rating as well as the publication of a notice by a rating agency that the counterparty's rating is in jeopardy of a downgrading (i.e. being placed on Negative Credit Watch or being assigned a Negative Outlook).

In order to limit the City's counterparty risk, the City will seek to avoid excessive concentration of exposure to a single counterparty or guarantor by diversifying its counterparty exposure over time. Exposure to any counterparty will be measured based on the termination value of any swap contracts entered into with the counterparty. If exposure to one counterparty exceeds 50% of the total termination value of the existing swaps, efforts should be made to not increase potential exposure with that counterparty through additional trades. This should be calculated separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. Aggregate swap termination value for each counterparty should take into account netting of offsetting transactions (i.e. fixed to floating and floating to fixed). The City may require regular mark-to-market valuations of swaps they have entered into from the appropriate counterparties.

VII. RISK MANAGEMENT

The City will manage the risks of its swap exposure separately for general fund supported debt, Airport Revenue Bonds, Water and Wastewater Revenue Bonds, and Gas Works Revenue Bonds. Among the risks that the City will track, evaluate, and seek to mitigate are:

• Counterparty Risk: The risk of a failure of one of the City's swap providers to perform as required under a swap contract (See above Section VI "Counterparty Credit Standards").

• Termination Risk: The risk that a swap may be terminated prior to its scheduled maturity due to factors outside the City's control. Swaps shall have provisions which permit the City to terminate at no cost after a predetermined period, generally five years. Any longer period must be justified and an analysis must be undertaken to confirm the value of the longer call protection is appropriate.

• Interest Rate Risk: The risks that the City's debt service costs associated with variable rate debt increase and negatively affect the budget, coverage ratios, and cash flow margins. Variable rate debt exposure may be created by a swap from fixed to floating. The interest rate risk presented by such a swap may increase as interest rates increase generally.

• Basis Risk: The risk that the floating rate received on the swap fails to offset the floating rate on the underlying bonds. Because swaps are generally based on a floating-rate index, the chosen index should correlate with the floating rate on the bond, but may not correlate exactly or at all times as we have seen with recent market events. This risk is heightened with LIBOR based swaps as this introduces "tax-risk" - the risk of a mismatch between the floating rate on the tax-exempt debt and the taxable index LIBOR. In addition to heightened volatility between the tax-exempt and taxable indexes, a change in tax law could impact a LIBOR based swap. Basis risk is also present in a basis swap where there are two variable interest rates in the same swap. The degree of risk should be evaluated in comparison to the degree of benefit provided.

• Amortization Risk: The risk presented by a mismatch between the term of the swap or the notional amount of the swap and the term or principal amount of the underlying bonds being hedged by the swap.

• Bank Facility Rollover Risk: When a swap is used in conjunction with puttable floating rate debt, such as variable rate demand bonds, bank facility rollover risk exists if the term of a needed bank liquidity facility or letter of credit on the debt is shorter than the term of the swap which is most often the case. In this situation, the City is at risk to both the availability and the price of successive bank facilities.

VIII. SWAP MONITORING

The City will monitor the swaps it has entered into by regularly evaluating the above risks. A summary of key terms of the agreements will be kept at the Treasurer's Office. This will include notional amounts, interest rates, maturity dates, and relevant credit terms including additional termination events. A monthly report will be prepared by the City's swap advisor containing mark-to-market values, the amount of exposure that the City has to each counterparty as measured by aggregate mark-to-market value netted for any offsetting transactions, and the credit ratings for each counterparty (or guarantor, if applicable).

IX. METHOD OF PROCUREMENT

The City will choose counterparties for entering into swap contracts on either a negotiated, invited, or competitive basis. As a general rule, the City will use a competitive or invited selection process whenever the product is relatively standard or if it can be broken down into standard components. An invited procurement is a solicitation of bids from a prequalified pool of counterparties who meet the credit requirements of the City and have approved swap agreements with the City. Negotiated procurement may be used for original products or for original ideas of applying a specified product to a City need, or where the particular facts of the transaction demonstrate that negotiation is in the best interests of the City and such a finding is made.

However, all effort should be made to choose counterparties on a competitive or invited basis. To provide safeguards on all swap transactions, the City should secure outside professional advice to assist in the process of structuring, documenting, and pricing the transaction, and to verify that a fair price was obtained. In any negotiated transaction, the counterparty shall be required to disclose all payments to third parties (including lobbyists, consultants, and attorneys) who had any involvement in assisting the counterparty in doing business with the City. In addition, the counterparty will be required to disclose its aggregate spread from the mid-market level and the City's swap advisor will be asked to provide separate verification of this, including an estimate of dealer profit.