

# State of Illinois

## Interest Rate Risk Management Policy

October 2003

### **Introduction**

The General Obligation Bond Act (30 ILCS 330) was amended with the signing of Senate Bill 1601 into law on June 3, 2003 as Public Act 93-9. This new legislation permits the State of Illinois (the “*State*”) to enter into interest rate exchange contracts, and to issue directly or to incur through entering an exchange contract, a mode of variable interest rate payment on a portion of the State’s General Obligation debt.

Pursuant to statute, the Governor’s Office of Management and Budget (the “*GOMB*”) is required to adopt an interest rate risk management policy (the “*Policy*”) prior to the issuance of variable rate bonds or entering into interest rate exchange contracts. In addition to citing certain limitations promulgated in statute, the Policy will establish purposes for which, and procedures by which, the State may enter an exchange contract or issue direct variable rate debt. This document fulfills that requirement, and will be made available on the GOMB’s website at [www.state.il.us/budget](http://www.state.il.us/budget).

The Policy will subsequently become a component of a broader scoped debt management policy governing the State’s continuing practice to finance its continuing capital improvement program (the “*CIP*”) through both fixed and variable rate bonds. Readers of the Policy are encouraged to refer to the “*Defined Terms*” section for further information on certain industry and legal terms used throughout the document.

### **Definition of Variable Interest Rate Position**

The General Obligation Bond Act, as amended, limits the total amount of variable interest rate risk position to a maximum of 20% of the State’s currently outstanding principal amount of General Obligation debt. In the context of balancing risk and efficiencies related to fixed rate debt vis-à-vis other debt management methods, at least 80% of the State’s debt issuance activities in the cumulative aggregate shall continue in the practice of fixed rate issuance.

Included in variable rate position are the following two debt and contract configurations:

1. The outstanding principal amount of debt issued or outstanding as direct variable rate bonds, auction rate securities and commercial paper, in all instances, in which the next interest reset date is less than 365 days.
2. The notional value of an exchange contract on which the State will pay a variable rate of interest.

For purposes of quantifying variable rate position pursuant to the Statute, such position shall not include the following debt and contract structures:

1. The notional value of an exchange contract on which the State will receive a variable rate of interest, when the intention of the State is to create Net Fixed rate debt.
2. Variable rate debt shall also exclude short term borrowing pursuant to the Short Term Borrowing Act (30 ILCS 340), whether such debt is offered in floating rate or short-term fixed rate. Such borrowings are considered self-liquidating since source of repayment comes from defined revenues, fund transfers, and other sources.

The amount of principal subject to variable rate may change from year to year. For example, as principal on variable rate bonds is paid, the remaining variable rate position is reduced. Similarly, the State may enter a floating payer exchange contract which does not take effect until a later date. In such an instance, the principal amount in variable rate does not begin until a forward starting effective date. The State's debt management practice would ensure that, if necessary for compliance with the 20% limit, an adequate amount of variable rate principal would be hedged or amortized prior to incurring additional variable rate debt.

### **Purposes of Interest Rate Exchange Contracts**

All applications of interest rate exchange contracts should balance the State's primary objectives of: (1) reducing cost of capital, (2) minimizing interest rate volatility, and (3) gaining efficiency in restructuring debt as and when needed.

As an illustration, the purpose and implementation of five contemporary debt management techniques involving interest rate exchange contracts are briefly described below.

1. Reducing borrowing cost at time of issuance. The State expects to obtain a reduced Net Fixed rate borrowing cost by entering a fixed payer exchange contract to pay interest on underlying variable rate bonds issued simultaneously in an interest rate exchange.
2. Hedging against adverse interest rate movement prior to issuance. The State anticipates a future borrowing for capital purposes and elects to secure interest rate conditions deemed favorable to the State prior to that borrowing.
3. Managing debt duration in response to yield curve characteristics. The State can gain significant economic advantage by shortening the duration of its debt in a steep yield curve environment, without actually issuing debt having a similarly short stated principal maturity.
4. Capturing the refunding value on callable fixed rate bonds. The State may sell an option to enter a forward starting fixed payer contract, the proceeds of which are the economic equivalent of refunding tax-exempt bonds, where the bonds are otherwise ineligible under Federal rules for advance refunding, or to improve the economic value to the State versus more traditional refunding methods.
5. Matching assets and liabilities. The State can create a match between interest rates of assets invested in various funds against the interest rates of its outstanding variable rate debt,

thereby eliminating interest rate volatility risk by the amount of matched assets and liabilities.

## **Risk Assessment**

All interest rate exchange contracts and debt issuance configurations involving such contracts must be accompanied with a disclosure and discussion of the attendant elements of potential risk to the State.

The following is a brief discussion of the types of risk that will be assessed with each contemplated exchange contract.

1. Interest Rate Risk. The rate of interest paid may increase on direct variable rate bonds or floating payer exchange contracts.
2. Liquidity Risk. When holders of variable rate bonds have a “put” option allowing them to tender their bonds back to the State in exchange for cash, and those bonds cannot be immediately remarketed, the State may pay a higher rate of interest to the financial institution that provides liquidity for the tendered bonds.
3. Rollover Risk. Liquidity provider agreements range from two to ten years, typically shorter than the amortization term of the variable rate bonds for which such facility is required. Two risks exist: (a) the State may incur higher renewal fees when new agreements are negotiated and (b) the liquidity bank market constricts such that it is difficult to find a financial institution willing to provide liquidity at any interest rate.
4. Termination Risk. Termination risk is the cost of replacing the counterparty to an exchange agreement under unexpected circumstances including: a rating downgrade on the part of the State or the counterparty, a covenant violation or default as defined in the State’s bond indenture, or counterparty bankruptcy. Termination risk may be reduced with collateral requirements, or through the purchase of termination risk insurance to cover the cost related to replacing the counterparty.
5. Tax Risk. Tax risk arises from tax-exempt rates increasing relative to Federal taxable rates, as would result from a decrease in the marginal rate of corporate and/or personal income tax rates.
6. Basis Risk. This risk refers to having insufficient receipts from a floating receiver exchange contract to pay interest due on the underlying variable rate debt issued by the State. The mismatch of receipts and payments can also occur to the State’s net benefit.
7. Amortization Risk. The risk that exchange contracts with declining notional value could become mismatched versus the amortization of a particular series of fixed or floating rate bonds around which the contract was structured.
8. Counterparty Risk. The risk that the counterparty does not perform pursuant to the terms of the exchange contract.

9. Operational Risk. The risk that the State or the counterparty may not have adequate systems, polices and monitoring thereof, to avoid potentially costly mistakes involving the legal confirmation of transaction details, cash flow exchanges and collateral provisions.

The State will use contemporary financial management techniques and disciplines to mitigate the risks enumerated above. Techniques include a variety of exchange contract features that adjust in response to changing market conditions. Disciplines include weekly monitoring of counterparty credit ratings, comparison of State experienced interest rates versus national indexes, and maintenance of sufficient interest reserve fund balances.

### **Form of Agreements**

The State shall enter into a written agreement with each approved counterparty based on the generally accepted Master Agreement of the industry and any schedules to the Master Agreement including credit enhancement documentation, credit support annex and collateral requirements. Counsel will be used during the negotiation process to ensure business terms that are desirable to the State.

The State will monitor market developments regarding the standard form of agreements and related practices, and subsequently modifying its market agreement standards as appropriate for and applicable to governmental issuers.

### **Legality**

The State must receive an opinion acceptable to the market from a nationally recognized law firm that the interest rate exchange contract is a legal, valid, and binding obligation of the State, and that entering into such a contract complies with applicable State statutes.

Counsel to each party to an exchange contract shall provide an enforceability opinion stating that the terms of the contract are enforceable under appropriate governing law.

### **Qualified Counterparties and Collateral Provisions**

A counterparty to an exchange contract shall be deemed qualified if: (a) the counterparty has demonstrated experience in successfully executing interest rate exchange contracts with other municipal and/or state entities, (b) it indicates a willingness to accept one way collateral as required by the State, (c) its credit rating by one of the three nationally recognized rating agencies is in the AA category and A+ or better by either of the remaining two agencies furnishing such ratings; or (d) its payments pursuant to the exchange contract are unconditionally guaranteed by an entity with credit ratings that satisfy the criteria set forth in (c).

If a counterparty is downgraded and is no longer deemed qualified, the contract shall be subject to the termination provisions in the master agreement unless the additional risk can be mitigated by a substitute guarantor or the contract is collateralized.

The State may enter into an interest rate exchange contract with a counterparty that does not satisfy the foregoing rating criteria provided that such counterparty shall post collateral in the form of USD cash, US Treasury securities, or agency securities guaranteed by the Treasury, at a level of at least 100% of the net market value of the exchange agreement, but also taking into account the collateral duration.

Collateral, if and as required by the Master Agreement, shall be maintained with a mutually agreeable third party agent or trustee, and shall be marked to market by the agent or trustee at the last day of any month at which time a collateral balance is required. Collateral, if and as required, shall be provided in a manner satisfactory to the State that its interests are: (a) perfected, (b) not a matter of preference, and (c) not subject to a stay in the event of bankruptcy of the exchange contract counterparty. The State shall not be required to provide collateral as party to an exchange contract, unless it is clearly in the best interests of the State.

### **Counterparty Aggregate Position Limits**

As a matter of counterparty risk diversification, the State shall not enter interest rate exchange contracts with a single counterparty (or guarantor thereof) to a cumulative total amount exceeding 25% of its then computed maximum allowable variable rate position. In the event that the State finds it prudent or desirable, the State may increase its aggregate position beyond the 25% limit to a particular counterparty provided that the amount in excess of the aggregate position limit for that counterparty is fully collateralized.

In measuring the State's aggregate position with a particular counterparty, a calculation of net offset is permitted in such circumstances as two exchange contracts in which market values change in opposition to one another.

The State reserves the right to modify this Policy regarding risk diversification, qualified counterparty selection and collateral thresholds at such times and for such purpose as may more effectively advance its prudent debt management objectives.

### **Liquidity Facility**

The State will consider the following factors when determining whether to use a Liquidity Facility, as well as what firm and terms to accept:

1. *Form of the Liquidity Facility.* The State will evaluate different forms of liquidity in order to balance the protection offered against the economic costs associated with each structure. These forms include direct pay letters of credit, standby letters of credit and letters of credit.
2. *Credit Ratings.* The ratings of the liquidity provider will prevail over the State's own short or long-term credit ratings because investors have the right to be repaid in full by that provider. Thus, the State will seek out liquidity providers that have a combination of high short term ratings and the most favorable contractual terms to the State as represented in the negotiated Reimbursement Agreement. This combination of criteria will result in the lowest all-in borrowing cost to the State.

3. Trading Values. Before awarding liquidity facility provider contracts, the State will seek input from market participants, including its financial advisory team on anticipated trading levels and general market acceptance of bonds secured by credit facilities. As such, liquidity providers should be selected using those factors as well as proposed rates or fees by the provider.
4. Costs. The State will include all cost components when selecting and structuring a liquidity facility including the commitment fee, draw fees (if any) and interest rates charged when a draw occurs.
5. Maturity. The State shall select liquidity providers that offer the longest terms possible, given all other factors (i.e., credit ratings, trading values and costs) are the same. If maturity terms vary between liquidity providers, the State shall select the provider that offers the optimum combination of all factors listed above.

### **Monitoring and Reporting**

At the end of each fiscal year, the GOMB shall maintain for its own permanent records and provide to the Comptroller all information required for: (a) financial reporting under GASB as well as other reporting and disclosure requirements, and (b) all necessary information related to interest rate exchange contracts that is required for reporting and disclosure purposes for all exchange contracts in force during the year. Such disclosures should encompass rates, market valuations, payments made or received, termination provisions, collateral, existence of any material events, and any changes to this policy.

### **General Matters**

1. Circumstances of Bidding and Negotiation. The GOMB shall determine whether it is in the best interests of the State to bid or negotiate exchange contracts. It is the policy of the State to obtain and verify assurances of appropriate fair market value. The GOMB may retain the services of an outside expert or advisor to assist in establishing fair market value.
2. Preference for Generic Contract Liquidity. The State may consider exchange contracts with proprietary features that provide unique value with regard to reducing cost of capital in a prudent manner. The benefit of any proprietary product will be weighed against the State's desire for operational efficiency.
3. Preference for Termination Provisions. The State shall avoid entering exchange contracts that do not have termination for fair value provisions at the option of the State. The State shall not enter an exchange contract that has an optional termination feature for the counterparty, except if the State receives a specific and material economic advantage.
4. Protection of Proprietary Structures. The State shall take reasonable steps to assure their proprietary nature of financial instruments and techniques presented to it by financial institutions so as not to discourage the creative idea generation and initiative to bring beneficial ideas to the State. Due diligence will nevertheless be performed including an in-depth risk assessment prior to considering entering into such a contract.

## **Annual Review of Policy**

The GOMB will review and annually update this policy to assure that it meets all regulatory and disclosure requirements as well as attaining the fundamental goal of reducing both borrowing costs and all associated financing risks.

## **Defined Terms**

“BMA”	Bond Market Association Tax Exempt Interest Rate Index
“Collateral”	Cash and certain eligible securities deposited with a third party which secures the State’s economic position in such situations as may be required by the terms of an exchange agreement.
“Counterparty”	The financial institution with whom the State enters an interest rate exchange agreement.
“Fixed Payer”	A contract in which the State agrees to receive a floating rate of interest and pay a fixed rate of interest.
“Fixed Receiver”	A contract in which the State agrees to receive a fixed rate of interest and pay a variable or floating rate of interest.
“Floating Payer”	The interest payment stream due on a “fixed receiver” contract.
“Floating Receiver”	The interest receipt stream from a “fixed payer” contract.
“LIBOR”	London Inter-Bank Offered Rate, Taxable Interest Rate Index.
“Liquidity Facility”	A contract between the State, as issuer, and a bank, insurance company or other financial firm, as Liquidity Facility Provider, to temporarily act as owner of the bonds in the event that holders of the bonds tender the bonds back to the State.
“Master Agreement”	The generally accepted industry standard form of exchange contract agreement.
“Net Fixed”	A combination of a fixed payer contract with a like amount of variable rate bonds issued, interest on which is paid by a the “floating receiver” component of the fixed payer contract.

“Net Variable”	A combination of a fixed receiver contract with a like amount of fixed rate bonds issued, interest on which is paid by the “Fixed Receiver” component of a fixed receiver contract with a “Floating Payer”, resulting in a “floating payer” or “synthetic variable rate obligation.
“Notional Amount”	Principal amount on which exchange contract interest is calculated
“GOMB”	The Governor’s Office of Management and Budget
“Policy”	The Interest Rate Risk Management Policy
“Principal Amount”	Principal as relates to issuance of fixed or variable rate bonds
“Reimbursement Agreement”	An agreement between the State, as issuer, and the financial firm, as Liquidity Facility Provider, that describes the terms in which the liquidity facility provider agrees to temporarily own bonds that are tendered back to the State until the remarketing agent secures another investor.
“State”	The State of Illinois
“Statute”	Statutes of the State, including the General Obligation Bond Act
“The Act”	The General Obligation Bond Act, as amended

**Liquidity Facility Terms**

“Commercial Banks”	The predominant provider of liquidity facilities for variable rate debt offered by government borrowers. These banks are governed by international capital requirements that specify how much capital must be reserved for: (a) each type of credit commitment (line, letter, etc.); (b) each credit quality category (AAA rated, non-rated, etc) and (c) the term of the commitment.
“Commitment Fee”	Typically priced at an annual rate based on the par amount of the facility.
“Credit Ratings”	A direct reflection of the underlying short-term ratings of the liquidity facility provider.
“Direct Pay Letters of Credit”	Pays the investor with cash directly rather than at the direction of the State.

“Letter of Credit”	Enable the provider to exit the transaction and liquidity facilities offered by monoline and other insurance companies and financial intermediaries.
“Standby Letters of Credit”	Any facility where a bank or other provider stands ready to provide funds as and when needed.
“Trading Values”	The true economic cost of a liquidity facility including the fee charged by the provider and the increase or decrease in interest paid by the State as a direct result of that credit facility.