

**GEORGIA STATE FINANCING AND INVESTMENT COMMISSION
(GSFIC)**

Policy and Procedures, Owner
Commission

Policy Title/Number
**QUALIFIED INTEREST RATE MANAGEMENT AGREEMENTS FOR STATE
AUTHORITIES**

CO-01-01-005

Effective Date: March 26, 2008

Revises Previous Effective Date: December 7, 2007

References: Constitution of the State of Georgia, as amended – Article VII, Section IV,
Paragraph VII
O.C.G.A. §50-17-23(d)
O.C.G.A. §50-17-100 et seq.

Attachments: Appendices I and II

1. Applicability

State Authorities defined in O.C.G.A. §50-17-21(9) (referred to as “State Party” or “State Parties”)

2. Policy Statement

The purpose of this policy is to establish procedures for approving Interest Rate Management Plans¹ and Qualified Interest Rate Management Agreements.

Qualified Interest Rate Management Agreements refer to agreements, including a confirmation evidencing a transaction effected under the ISDA master agreement referred to herein, entered into by the State Party in accordance with, and fulfilling the requirements of, this Policy and the O.C.G.A. §50-17-101 which is designed to manage Interest rate risk or interest cost of the State Party on any debt or lease or installment purchase contract the State Party is authorized to incur, including, but not limited to, interest rate swaps or exchange agreements, interest rate caps, collars, corridors, ceiling, floor, and lock agreements, forward agreements, swaptions, warrants, and other interest rate agreements which, in the judgment of

¹ Capitalized terms are defined in Appendix I.

the State Party, will assist the State Party in managing its interest rate risk or interest cost.

A State Party may enter into Qualified Interest Rate Management Agreements for the following purposes:

- a. to achieve significant savings as compared to other more conventional products available in the bond market, taking into account all applicable fees;
- b. to prudently hedge risk in the context of a particular financing or future financing or overall asset/liability management of the State Party;
- c. to incur floating rate exposure within prudent guidelines; and
- d. to achieve more flexibility in meeting overall financial objectives than available in conventional markets.

A State Party may enter into a Qualified Interest Rate Management Agreement related to all or a portion of any Debt or any Lease or installment purchase contract either issued or anticipated to be issued by the State Party, subject to the requirements herein and the requirements in such State Party's Interest Rate Management Plan.

A Qualified Interest Rate Management Agreement entered into by a State Party in accordance with this policy and O.C.G.A. §50-17-100 et seq. may be used in determining the annual debt service requirements for variable rate debt as provided for in O.C.G.A. §50-17-23(d)(2)(D).

The Georgia State Financing and Investment Commission ("GSFIC") will not approve qualified interest rate management agreements that: (i) are speculative or create extraordinary leverage or risk, (ii) lack adequate liquidity to terminate without incurring a significant bid/ask spread, or (iii) provide insufficient price transparency to allow reasonable valuation.

3. Procedure for Approval

A State Party must receive the approval of the GSFIC before entering into a Qualified Interest Rate Management Agreement. GSFIC approval is a two-part process. For part one, the State Party must submit an Interest Rate Management Plan to the GSFIC. The second part of the approval involves providing GSFIC with details of the particular Interest rate swap transaction. Each part can be submitted separately to the GSFIC or both parts can be combined into one submittal. Once the Interest Rate Management Plan is approved (Part 1), only the submittal containing details of the particular Interest rate swap transaction are required for

subsequent Qualified Interest Rate Management Agreements (Part 2). Both Part 1 and Part 2 must demonstrate compliance with applicable law and this policy.

A State Party considering executing a Qualified Interest Rate Management Agreement shall engage the services of an Independent Financial Advisor experienced in Interest rate swap transactions in order to assist in preparing or reviewing an Interest Rate Management Plan. The Independent Financial Advisor may not be the Counterparty or an affiliate or agent of the Counterparty on the proposed Qualified Interest Rate Management Agreement. State authorities must follow GSFIC Policy No. FI-07-01-001 when seeking the services of a financial advisor.

An Interest Rate Management Plan must include the following:

- a. The State Party's efforts to monitor and minimize the Interest rate risk, basis risk, termination risk, credit risk, market-access risk, and other risks to the State Party set forth in Appendix II of this Policy, including, but not limited to, applying the mitigation techniques set forth in Appendix II;
- b. The State Party's procedure for approving and executing Qualified Interest Rate Management Agreements;
- c. The State Party's qualification requirements and procurement process for counterparties (see Section 5 of this Policy);
- d. The State Party's required document provisions (See Section 7 of this Policy);
- e. The State Party's procedure for monitoring its diversification of exposure to Interest rate swaps and Counterparties;
- f. The State Party's plans for how it will account for payments received under the Qualified Interest Rate Management Agreement; and
- g. Such other provisions as may be required by the Georgia State Financing and Investment Commission, including but not limited to, additional provisions due to changes in market conditions for Qualified Interest Rate Management Agreements.

For approval of a Qualified Interest Rate Management Agreement (referred to as Part 2 above), the State Party must submit the following:

- a. An analysis of the reasonableness of a proposed Interest rate swap transaction in relation to the State Party's overall financial condition;
- b. Draft Documents, including the ISDA 1992 Master Agreement, the Schedule, Credit Support Annex, Confirmation, guarantee agreement, if applicable, term sheet, including the bidding procedure;
- c. Discussion of risks to the Interest rate swap transaction (see Appendix II of this Policy);

- d. Benefits of proposed Interest rate swap transaction;
- e. List of pre-qualified Counterparties and their ratings;
- f. Anticipated pricing levels and parameters for acceptable rate or price;
- g. Discussion of method of procurement;
- h. For a negotiated transaction, the credit and profit spread;
- i. For a competitive transaction, the proposed term sheet and bidding terms;
- j. Listing of all fees directly or indirectly associated with the Interest rate swap transaction; and
- k. Such other provisions as may be required by the Georgia State Financing and Investment Commission, including but not limited to, additional provisions due to changes in market conditions for Qualified Interest Rate Management Agreements.

4. Compliance with Law

The State Party must receive an opinion from a nationally recognized law firm experienced in negotiating Qualified Interest Rate Management Agreements that the Qualified Interest Rate Management Agreement is a legal, valid and binding obligation of the State Party and entering into the transaction complies with applicable law.

In addition, the Counterparty must receive an opinion acceptable to counsel to the State Party that the Qualified Interest Rate Management Agreement is a legal, valid and binding obligation of the Counterparty.

If the related Debt is state debt, the obligations to pay a Counterparty shall be subordinate to the obligations to pay holders of general obligation debt, guaranteed revenue debt, and all payments required under contracts entitled to the protection of the second paragraph of Paragraph I(a), Section VI, Article IX of the Constitution of 1976.

5. Method of Procuring Qualified Interest Rate Management Agreements.

The State Party is to procure a Qualified Interest Rate Management Agreement by competitive bidding with at least three firms solicited. From those firms meeting the Counterparty Selection Criteria in Section 6 of this Policy, the State Party may determine which firms participate in a competitive transaction through a pre-qualification process, whereby only those firms that agree to accept the State Party's terms and conditions for the Qualified Interest Rate Management Agreement in advance of the bid are eligible. The State Party may also accept matching bids in order to decrease Counterparty risk or reward firms for innovative ideas and work performed. The parameters for the bid and selection of Counterparties must be disclosed in writing to all potential bidders.

A State Party may seek an exemption to the competitive bidding requirement. As part of its Interest Rate Management Plan, the State Party must present its rationale for why a negotiated transaction would result in the most favorable pricing and terms (e.g. size or complexity) or that doing so will promote its interests by encouraging and rewarding innovation. GSFIC approval of a negotiated transaction will be made on a case-by-case basis and if approval is granted, the transaction will still be subject to requirement under Section 10 (Fair Market Value) of this Policy for a fair market finding by an Independent Financial Advisor.

6. Counterparty Selection Criteria

A Counterparty must be a bank, insurance company, or other financial institution duly qualified to do business in the State that has, or whose obligations are guaranteed by an entity that has, at the time of entering into a Qualified Interest Rate Management Agreement a long-term unsecured debt rating or financial strength rating in one of the top two ratings categories without regard to any refinement or gradation of rating category by numerical modifier or otherwise, assigned by any two of the following: Moody's Investors Service, Inc., Standard & Poor's Ratings Service, a division of The McGraw-Hill Companies, Inc., or Fitch, Inc.

7. Form and Content of Qualified Interest Rate Management Agreements

The Qualified Interest Rate Management Agreements entered into by the State Party shall be based upon the terms and conditions set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, Local Currency - Single Jurisdiction of 1992, including the schedule, credit support annex and confirmation.

The State Party shall include provisions that permit the State Party to terminate its obligations under the Qualified Interest Rate Management Agreement by transferring such obligations to another party and to optionally terminate the agreement at its market value at any time. In general, the Counterparty shall not have the right to optionally terminate a Qualified interest rate management agreement.

The Agreement shall include the following events of default of Counterparty:

- a. Failure to make payments when due;
- b. Material breach of representations and warranties;
- c. Failure to collateralize in compliance with downgrade provisions; and
- d. Failure to comply with any other provisions of the agreement after a specified notice period.

The State Party will have the right to terminate the Qualified Interest Rate Management Agreement upon an event of default by the Counterparty. Upon such

termination, the Counterparty will be the "Affected Party" for purposes of calculating the termination payment owed.

A termination payment to or from the State Party may be required in the event of termination of a Qualified Interest Rate Management Agreement due to a termination event or an event of default. For payments on early termination or default, the Qualified Interest Rate Management Agreement must provide that the Market Quotation and Second Method (as defined in the ISDA 1992 Master Agreement) will apply, allowing for a two way mark-to-market breakage.

Qualified Interest Rate Management Agreements shall be structured such that only the currency of the United States of America will be used.

A Qualified Interest Rate Management Agreement, including any renewal periods, may not exceed ten years, unless otherwise approved by the GSFIC. Notwithstanding the previous sentence, the term of the agreement cannot exceed the latest maturity date of the bonds, notes, debt, or lease or installment purchase contract referenced in the agreement.

Qualified Interest Rate Management Agreements should spread the benefits over the term of the agreement. Qualified Interest Rate Management Agreements which generate a large upfront payment to the State Party is an exception to this policy and must receive specific GSFIC approval.

The governing law of the agreement shall be the laws of the State of Georgia and any jurisdiction over a State Party in any matter concerning the Qualified Interest Rate Management Agreement shall lie exclusively in the courts of the State of Georgia or in the applicable federal court having jurisdiction and located within the State of Georgia.

The notional amount of any Qualified Interest Rate Management Agreement shall not exceed the outstanding principal amount of the Debt or the aggregate principal payments due under any lease or installment purchase contract to which such agreement relates unless otherwise approved in writing by the GSFIC for any Qualified Interest Rate Management Agreement executed by a State Party.

A State Party may enter into credit enhancement or liquidity agreements in connection with a Qualified Interest Rate Management Agreement containing such terms and conditions as the State Party determines are necessary and desirable, provided that any such agreement has the same source of payment as the related Qualified Interest Rate Management Agreement.

8. Aspects of Risk Exposure Associated with Qualified Interest Rate Management Agreements

Before entering into a Qualified Interest Rate Management Agreement, the State Party shall evaluate all the risks inherent in the transaction. The risks to be evaluated should include: interest rate risk, termination risk, credit risk, market-access risk, rollover risk, tax risk and liquidity risk. The State Party shall endeavor

to diversify its exposure to Counterparties. To that end, before entering into a transaction, it should determine its exposure to the relevant Counterparty or Counterparties and determine how the proposed transaction would affect the exposure. The exposure should be measured by the current market value of the State Party's and State's Interest rate swap portfolio and by how changes in interest rates would affect the State Party's peak exposure. The peak exposure should be based on all outstanding Qualified Interest Rate Management Agreements by the State Party.

9. Provisions for Collateralization

Should the rating of the Counterparty, or if secured, the entity unconditionally guaranteeing its payment obligations, fall below the minimum requirements described in Section 6 above, the obligations of the Counterparty shall be fully and continuously collateralized by general obligations of the United States or of subsidiary corporations of the US government fully guaranteed by such government, or to obligations issued by the Federal Land Bank, Federal Home Loan Bank, Federal Intermediate Credit Bank, Bank for Cooperatives, Federal Farm Credit Banks regulated by the Farm Credit Administration, Federal Home Loan Mortgage Corporation, Federal National Mortgage Association, but excluding (i) interest only and principal only securities and (ii) Collateralized Mortgage Obligations and Real Estate Mortgage Investment Conduits and similar derivative securities. Under no circumstances shall the State Party be required to post collateral.

Collateral requirements can be subject to reasonable threshold and minimum transfer amounts. The specific collateralization requirements shall be set forth in the Credit Support Annex of the Qualified Interest Rate Management Agreement.

10. Fair Market Value

Each Qualified Interest Rate Management Agreement shall be subject to a finding by an Independent Financial Advisor that its terms and conditions reflect a fair market value of such agreement as of the date of its execution, regardless of whether the agreement was entered into on a competitive or negotiated basis.

11. Monitoring

The State Party shall submit a monthly report to the GSFIC staff on its use of Qualified Interest Rate Management Agreements which includes the following:

- a. A description of each Qualified Interest Rate Management Agreement, including a summary of its terms and conditions, the notional amount, rates, maturity and other provisions thereof;
- b. The market value of the Qualified Interest Rate Management Agreement;
- c. A determination of the maximum funds available pursuant to any appropriation of the General Assembly and available to make payments under Qualified Interest Rate Management Agreements if the State

exercises its right to optionally terminate the Qualified Interest Rate Management Agreement;

- d. A determination of any amounts which were required to be paid and received under the Qualified interest rate management agreement, and that the amounts were paid and received;
- e. An assessment of the Counterparty risk, termination risk, basis risk and other risks associated therewith, which shall include the aggregate marked to market value for each counterparty and relative exposure compared to other Counterparties and a calculation of the State Party's peak exposure for each Counterparty:
- f. An evaluation of whether or not each Counterparty is in compliance with its rating requirements;
- g. A determination that all posted collateral, if required, has a net market value of at least the collateral requirements specified in the Qualified Interest Rate Management Agreement; and
- h. A discussion of the procedures for monitoring its Termination exposure for any Qualified Interest Rate Management Agreement which includes a valuation of the amount of Termination exposure on a monthly basis and a calculation of peak exposure or other methodology approved by GSFIC that measure how changes in interest rates would affect the Termination amount.

In addition to the monthly report, an annual report shall be prepared by the State Party in compliance with O.C.G.A. §50-17-102(b) and shall include an analysis of the factors and mitigation techniques listed in Appendix II of this Policy. While the State Party may desire to seek the assistance of its financial advisor in preparation of its annual report, it is not required to do so. The report must be approved by the State Party's governing body and submitted to the Georgia State Financing and Investment Commission for approval within sixty (60) days after the end of each fiscal year. Any State Party that has not submitted such annual report within the time period set forth in the prior sentence shall be prohibited from entering into any new Qualified Interest Rate Management Agreement until such annual report has been delivered to and approved by the Georgia State Financing and Investment Commission.

12. Accounting

A State Party shall reflect the use of a Qualified Interest Rate Management Agreement on its financial statements in accordance with all GASB requirements and regulations. The disclosure requirements include: (1) objective of the Interest rate swap; (2) significant terms of the Qualified Interest Rate Management Agreement; (3) market value of the interest rate swap; (4) debt associated with the Qualified Interest Rate Management Agreement; and (5) the risks associated with the Qualified Interest Rate Management Agreement.

APPENDIX I

GLOSSARY OF TERMS

"Counterparty" means the party entering into a Qualified Interest Rate Management Agreement with the State Party.

"Debt" shall include all debt and revenue obligations that a State Party is authorized to incur by law, including without limitation general obligation debt in the form of bonds or other obligations, guaranteed revenue debt in the form of bonds or other obligations, revenue bonds and other forms of revenue obligations, and all other debt or revenue undertakings, including, but not limited to, bonds, notes, warrants, certificates or other evidences of indebtedness, or other obligations for borrowed money issued or to be issued by any State Party. "Debt" includes any financing lease or installment purchase contracts of any State authority.

"Derivative" means a financial contract, whose value is derived from stocks, bonds, loans, currencies and commodities, or linked to specific events such as changes in interest rates.

"Hedge" means a position taken in order to offset the risk associated with some other position. Most commonly, cash is the initial position and the hedge position involves an Interest rate swap.

"Independent Financial Advisor" means a person or entity experienced in the financial aspects and risks of Qualified Interest Rate Management Agreements that is retained by the State Party to render advice with respect to a Qualified Interest Rate Management Agreement. The independent financial advisor may not be the counterparty or an affiliate or agent of the counterparty on a Qualified Interest Rate Management Agreement with respect to which the independent financial advisor is advising the State Party.

"Interest rate cap" means an instrument that pays off on each settlement date based on the market value of a reference rate (i.e. SIFMA or LIBOR) and a specified contract rate which has the effective of establishing a maximum on a variable rate.

"Interest rate floor" means an instrument that pays off on each settlement date based on the market value of a reference rate (i.e. SIFMA or LIBOR) and a specified contract rate which effectively establishing a minimum on a variable rate.

"Interest Rate Management Plan" means a written plan prepared or reviewed by an Independent financial adviser with respect to Qualified Interest Rate Management Agreements of the State Party.

"Interest rate risk" means the risk that a change in interest rates will cause an increase in debt service costs and negatively impact cash flow margins.

"Interest rate swap" means a contract between two parties to exchange cash flows (but not principal) over a predetermined length of time. In an Interest rate swap, cash flows are typically calculated periodically based on a fixed or variable interest rate against a set notional amount (defined herein).

"LIBOR" means the London Interbank Offered Rate which refers to the rate of interest at which banks borrow U.S. dollars from other banks, in marketable size, in the London interbank market.

"Lease or installment purchase contract" means multiyear lease, purchase, installment purchase, or lease purchase contracts within the meaning of O.C.G.A. §§50-5-64, 50-5-65, and 50-5-77 or other substantially similar or successor Code sections.

"Notional amount" means the dollar amount upon which the fixed and floating Interest rate swap payments are based.

"Qualified Interest Rate Management Agreement" means an agreement, including a confirmation evidencing a transaction effected under a master agreement, entered into by the State Party in accordance with, and fulfilling the requirements of, this Policy and the O.C.G.A. §50-17-101 which is designed to manage interest rate risk or interest cost of the State Party on any debt or lease or installment purchase contract the State Party is authorized to incur, including, but not limited to, interest rate swaps or exchange agreements, interest rate caps, collars, corridors, ceiling, floor, and lock agreements, forward agreements, swaptions, warrants, and other interest rate agreements which, in the judgment of the State Party, will assist the State Party in managing the interest rate risk or interest cost of the State or State authority.

"SIFMA" means an index determined on the basis of the seven-day high grade market index of tax-exempt variable rate demand obligations, as produced by Municipal Market Data and published or made available by the Securities Industry & Financial Markets Association (formerly the Bond Market Association) ("SIFMA") or any organization acting in cooperation with or under the sponsorship of SIFMA and acceptable to the Commission.

"State authority" means any State authority as defined in paragraph (9) of O.C.G.A. §50-17-21, as amended.

"State Party" means the State and any State authority.

"Swaptions" means an option on an Interest rate swap. In a Swaption, the purchaser has the right to enter a specific Interest rate swap for a defined period of time.

"Termination exposure" means amounts that may be due and owing to any Counterparty upon the termination of the Qualified Interest Rate Management Agreement.

APPENDIX II

RISK MANAGEMENT: POTENTIAL EXPOSURE ASSOCIATED WITH QUALIFIED INTEREST RATE MANAGEMENT AGREEMENTS

| Type of Risk | Description | Mitigation Techniques |
|--------------------|---|---|
| Basis Risk | The mismatch between actual variable rate debt service and variable rate indices used to determine payments under the Qualified Interest Rate Management agreement. | The State Party will review historical trading differentials between the variable rate bonds and the index and will budget or provide reserves for potential costs. |
| Tax Risk | The risk that the marginal tax rate will change and that could affect payments made or received. | The State Party will review the tax events in proposed Qualified Interest Rate Management Agreements. The State Party will evaluate the impact of adverse tax consequences and potential changes in tax law on Derivatives. |
| Counterparty Risk | The failure of the Counterparty to meet all of its financial obligations under the Qualified Interest Rate Management Agreement. | The State Party will seek to diversify Counterparty exposure and will monitor Counterparty exposure levels, creditworthiness, ratings thresholds and collateralization requirements. |
| Termination Risk | Premature termination of a Hedge position requiring one Party to the agreement to make a termination payment to the other. | Monitoring Counterparty's ratings and compliance with the Qualified Interest Rate Management Agreement. Evaluate the ability to enter interest rate swaps with other parties or use of other funds to make termination payment. |
| Rollover Risk | The Derivate product expires prior to the underlying bonds of the State Party. | The State Party will monitor the market and analyze whether or not it is feasible to enter into a new Interest rate swap or remain unhedged. |
| Liquidity Risk | The inability to access or renew a liquidity facility when required, such as upon premature termination of the Qualified Interest Rate Management Agreement. | The State Party will evaluate the expected availability of liquidity support for unhedged variable rate debt and any similar instrument. |
| Market-Access Risk | The risk that the State Party will not be able to issue debt or that doing so will become more expensive | State Party will evaluate the availability of forward commitments for credit and liquidity enhancement and related Qualified Interest Rate Management Agreements. |

