



POLICIES, RULES AND REGULATIONS	
Title: DERIVATIVES POLICY	
Approval Date: April 2018	Effective Date: April 2018
Approved By: Board of Directors	DMS #14892

DERIVATIVES POLICY

1.0 INTRODUCTION

This policy has been developed to guide the Santa Clarita Valley Water Agency (Agency) in its use of derivative financing/interest rate risk mitigation products such as interest rate swaps and other such financing techniques. These derivative financing products can increase the Agency's financial flexibility and provide opportunities for interest rate savings. The use of derivatives should be integrated into the Agency's overall debt and investment management policy. Careful monitoring of such products is required to preserve the Agency's credit strength and budget flexibility.

Derivatives will not be used to speculate on perceived movements in interest rates.

2.0 STATEMENT OF PURPOSE

2.1 PURPOSES FOR WHICH DERIVATIVES WILL BE USED

Derivatives can be structured differently, such as Interest rate swaps to create variable rate exposure through a fixed-to-floating interest rate swap or to create fixed rate exposure through a floating-to-fixed interest rate swap. In any situation, the Agency will only undertake such a financing product to achieve one or more of the following objectives:

- Derivatives may be used to lower interest expense of Agency debt, for a particular financing or for the overall debt portfolio.
- Derivatives may be used to reduce exposure to changes in interest rates.
- Derivatives may be used to achieve an appropriate asset/liability match.

2.2 PURPOSES FOR WHICH DERIVATIVES WILL NOT BE USED

- Derivatives may not be used for speculative purposes.
- Derivatives may not be used where they would create either extraordinary financial leverage or extraordinary financial risk.
- Derivatives may not be used if they present an extraordinary risk to the Agency's liquidity to terminate the agreement due to unforeseen events, or
- Derivatives may not be used if there is insufficient price transparency to allow for fair market valuation.



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3.0 ANALYSIS OF RISK ASSOCIATED WITH DERIVATIVES

The Agency will evaluate all derivatives with respect to the unique risks they present. A specific determination must be made that the proposed or estimated benefits exceed the identified risks by an adequate margin over those available in the traditional cash market. The analysis will assess the risk associated with the following factors:

3.1 Amortization Risk for Interest Rate Swap Agreements

Amortization risk is defined as the mismatch of the expiration of the underlying obligation and its hedge, the swap agreements. Amortization risk is the possibility that, as the result of early redemption of the underlying variable rate bonds, the repayment schedule of the bonds differs from the underlying notional amount of the swap agreements. This risk will only arise if the Agency wants to redeem the variable rate bonds ahead of schedule. This is not expected for the Agency financings.

3.2 Basis Risk

Basis risk refers to the mismatch between the actual variable rate debt service and variable rate index used to determine the derivative payments. Different fixed income market indices will be evaluated as part of the analysis of an interest rate swap agreement. The analysis will identify the amount of basis risk that may result from various indices.

3.3 Credit Risk

Credit risk refers to the credit worthiness of the counterparty. The Agency will only enter into business with highly rated counterparties. The Agency will structure derivative agreements to protect itself from credit deterioration. The Agency will only enter into transactions with counterparties with a credit rating of AA (or equivalent) or better at the time of execution. In the event that the credit rating falls below AA (or equivalent) during the transaction, the derivative documentation shall include protections and remedies. At the time of execution, the Agency should negotiate credit enhancement, subject to market conditions, in the form of:

- Contingent swap counter party providing support
- One-way collateral
- Ratings downgrade triggers



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3.4 Counterparty Risk

Counterparty risk refers to the failure of the counterparty to make its required payments. This risk can be minimized by establishing strong minimum counterparty credit standards and diversifying the Agency's exposure to counterparties.

3.5 Rollover Risk

Rollover risk refers to the potential need to find a replacement counterparty as part of the overall plan of finance if the interest rate swap does not extend to the final maturity of the underlying variable rate bonds. The rollover risk can be minimized through the initial plan of finance by not relying on the execution of future swap agreements.

3.6 Tax Events Risk

Tax events risk is defined as the risk created by potential changes to the Federal and State income tax codes on the interest rates to be paid by the Agency on its variable rate bonds. Tax events risk is a form of basis risk. The evaluation should analyze the potential impact of changes in marginal tax brackets as part of its analysis of basis risk.

3.7 Termination Risk

Termination risk refers to the possibility that, upon a default by the counterparty, the Agency may be required to make a large payment to the counterparty if the swap agreement is terminated prior to its scheduled maturity pursuant to its terms. For certain types of swaps, a payment by the Agency may be required if interest rates have fallen causing the market value of the remaining payments to be in favor of the counterparty.

4.0 INTEREST RATE SWAP FINANCING DOCUMENTATION

The Agency will use standard forms and documentation for derivatives. For interest rate swaps, the Agency will use the International Swaps and Derivatives Association (ISDA) swap documentation including the Schedule to the Master Agreement and a Credit Support Annex. The Agency derivative documentation should include the following terms:

- Downgrade provisions triggering termination of the swap should be bilateral.
- Governing law for swaps will be New York or California, but should reflect California authorization provisions.
- The specified indebtedness related to credit events in the master agreement should be narrowly drafted and refer only to specific debt and in no case provide recourse to the Agency.



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- Eligible collateral should be limited to Treasuries and Federal Agencies.
- Collateral thresholds should be set on a sliding scale reflective of credit ratings.
- Termination value should be set by “market quotation” methodology.

5.0 FINANCIAL CONSIDERATIONS

5.1 Savings Targets

Derivative transactions shall have higher savings targets, due to the greater complexity and higher risk. In calculating the prospective savings for implementing a fixed-to-variable swap, the cost of re-marketing, in addition to the cost of credit enhancement and liquidity fees must be added to the projected average variable rate. The specific targets are as follows:

- Financial transactions, using swaps or other derivative products, intended to produce the effect of a synthetic fixed rate transaction, must generate 8% or greater present value savings compared to standard fixed-rate bonds which have the same optional redemption features.
- The notional amount of all derivative financing products shall not exceed 15% of total Agency outstanding debt.

5.2 Reporting and Accounting

The Agency shall report derivative financing transactions in accordance with Governmental Accounting Standards Board and Financial Accounting Standards Board statements.

5.3 Derivative Procurement

The Agency shall use a professional advisor or designated swap representative (Swap Advisor) to assist in the assessment, structuring, and pricing of proposed or existing interest rate swap agreements. The Agency shall select a Swap Advisor as part of the financing team where a Swap is expected to be executed. The Swap Advisor must meet the following qualifications:

- (1) Has sufficient knowledge to evaluate the swap transaction and risks
- (2) Is not subject to a statutory disqualification
- (3) Is independent of the swap dealer or major swap participant
- (4) Undertakes a duty to act in the best interests of the Agency
- (5) Provides appropriate and timely disclosures to the Agency
- (6) Evaluates fair pricing and the appropriateness of the swap



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The Agency shall obtain an opinion from its Swap Advisor that the terms and conditions of any financial product entered into reflect a fair market value as of the execution date.

The General Manager is authorized to solicit derivative-proposals from firms that meet or exceed the following criteria:

- The derivative transaction provider shall have a credit rating of AA (or equivalent) or better from at least two nationally recognized credit rating agencies.
- The derivative provided shall have a demonstrated record of successfully executing derivative transactions and have a minimum capitalization of \$2 billion.

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