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Interest Rate Swaps in the Post Dodd-Frank World

(Steve Siple)

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Final Session of the Day

Reflection …

Session Format and Disclaimers

Session Format:

Presentation

- Historical Perspective: Local Government Borrowing
- Regulatory Reform
- Debt Alternatives: Risks, Opportunity Costs, Benefits
- Swaps in Today's Economic Environment
- Looking Ahead – What does it Mean for *You*?

Q&A

Disclaimers:

My Personal Opinions and Observations

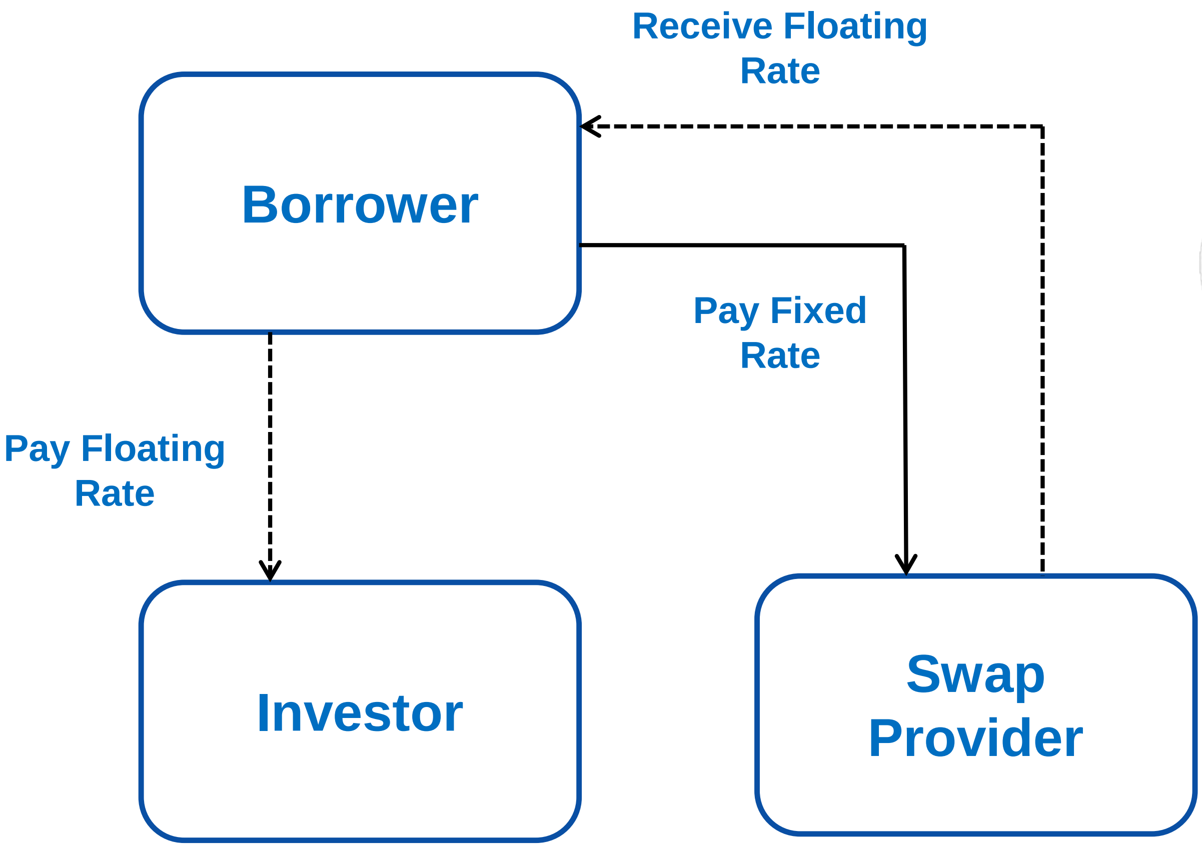
The No Crystal Ball Rule

Goal of our Discussion

To convince you that "swap" is not a four letter word

Presentation Pre-Test

What is a floating-to-fixed interest rate swap?



If You Only Remember One Thing …

There is Inherent Risk in Every Choice We Make:

- **Opportunity Costs-** includes uncertainty and timing of future events
- **Traditional Financial Products**
- **“Exotic” Financial Instruments**

Historical Perspective: Local Government Borrowing

Prior to 1990s

Traditional municipal bond market

- Long Term – Fixed Rate Bond Issues
- Short Term – Fixed Rate Note Issues
- Independent Investment Banks with large Public Finance practice groups

Historical Perspective: Local Government Borrowing (cont.)

1990s to 2007

Development and expansion of…

- Tax-Exempt Commercial Paper *
- VRDOs (Variable Rate Demand Obligations) *
- Bank Direct-Pay Letters of Credit *
- Municipal Bond Insurance *
- **"Synthetic Fixed Rate" Debt** via **Interest Rate Swaps**

* *Debt pricing (interest rate) linked to 3rd party credit support, **not underlying borrower***

Historical Perspective: Local Government Borrowing (cont.)

2008 – Kaboom!

Subprime mortgage bubble burst impacts…

- Bank rating downgrades
- Municipal bond insurer downgrades
- Failed re-marketing events
- Negative “mark to market” on existing floating-to-fixed interest rate swaps
- Flight to quality (U.S. Treasuries & FDIC insured bank deposits)
- Increased Saving, Decreased Borrowing, and Increased Bank Capital Requirements

Historical Perspective: Local Government Borrowing (cont.)

2009-2010

Stimulus Act changed the game and improved capital access…

- Increased "Bank-Qualified" cap from $10MM to $30MM
- De minimis (2%) rule applicable
- Variety of tax credit bonds (BABs, QSCBs, etc.)
- At the same time, large regional banks are searching for high quality borrowers
- Leads to increased participation in **direct municipal lending** from banks/subsidiaries

Historical Perspective: Local Government Borrowing (cont.)

2011 and Beyond

The "New Normal"…

- Stimulus Act provisions sunset in December 2010
- But portions of pre-2008 municipal bond market are not likely to return
- And banks continue to value government "direct placement" debt (loans)
- However, prevalence of **fixed interest rate loans** is likely to decline in the future

But why?...

Historical Perspective: Local Government Borrowing (cont.)

Basic Components of a Bank Balance Sheet

Assets

- Loans (primarily) and investment securities
- Core commercial and consumer loans are **floating interest rate**

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Liabilities

- Deposits (primarily) and borrowings from Fed reserves and/or corporate debt market
- Core deposits and borrowings are **floating interest rate**

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Capital

- Shareholder equity

Regulatory Reform

Major Regulatory Outcome of the Financial Crisis:

Dodd-Frank

Legislation with the lofty goal of ending "Too Big to Fail" (through increased oversight and transparency and expansion of the orderly liquidation process to include certain non-bank players in the financial system that were involved in the Financial Crisis).

Details of the Act are left to be written by the relevant Federal agencies themselves, effectively removing Congress from major changes in legislation.

Jonathan Macey of Yale Law School commented in an article from The Economist:

"Laws classically provide people with rules. Dodd-Frank is not directed at people. It is an outline directed at bureaucrats and it instructs them to make still more regulations and to create more bureaucracies." [1]

Regulatory Reform (cont.)

Major Regulatory Outcome of the Financial Crisis:

Dodd-Frank

Title VII of the law mandates regulators to undertake rulemaking increasing transparency and reducing systemic risk in the derivative (swaps) markets.

Systemic risk represented by swaps was linked primarily to "credit default swaps", instruments used by large financial institutions to hedge against borrower defaults.

SEC has regulatory authority over "security-based swaps" which are defined as… "*swaps based on a single security or loan or events relating to a single issuer of securities*".[2]

Rules released in 2013 require swap providers to have reasonable basis to believe an end user of a swap has engaged an **independent advisor** (an "IRMA" in the event of a municipal borrower) to assist in the evaluation of swap alternatives.

Bottom Line: Engage an IRMA prior to discussing specifics on potential swaps.

Debt Alternatives: Risks, Opportunity Costs, Benefits (cont.)

Traditional Fixed Rate Bond

Risks

- Interest rate fluctuation prior to closing
- Investor appetite

Opportunity Costs

- Higher costs of issuance
- No prepayment flexibility
- No flexibility of interest rates (fixed vs. floating)
- No potential gain from terminating a swap in rising rate environment

Benefits

- Accounting simplicity
- Familiarity

Debt Alternatives: Risks, Opportunity Costs, Benefits (cont.)

Swapped VRDO

Risks

- Interest costs linked to third party credit provider
- Credit enhancement (letter of credit) fee increases
- Re-pricing risk if swap does not go to full term of debt
- Potential for swap termination payment

Opportunity Costs

- Accounting complexity
- Credit enhancement facility does not extend to final maturity of debt

Benefits

- Greater prepayment flexibility
- Flexibility of interest rates (fixed vs. floating)
- Potential for gain when terminating swap in rising rate environment

Debt Alternatives: Risks, Opportunity Costs, Benefits (cont.)

Swapped Direct Placement

Risks

- Re-pricing risk if swap does not go to full term of debt
- Potential for swap termination payment

Opportunity Costs

- Accounting complexity
- Loan tenor may or may not match final maturity of debt

Benefits

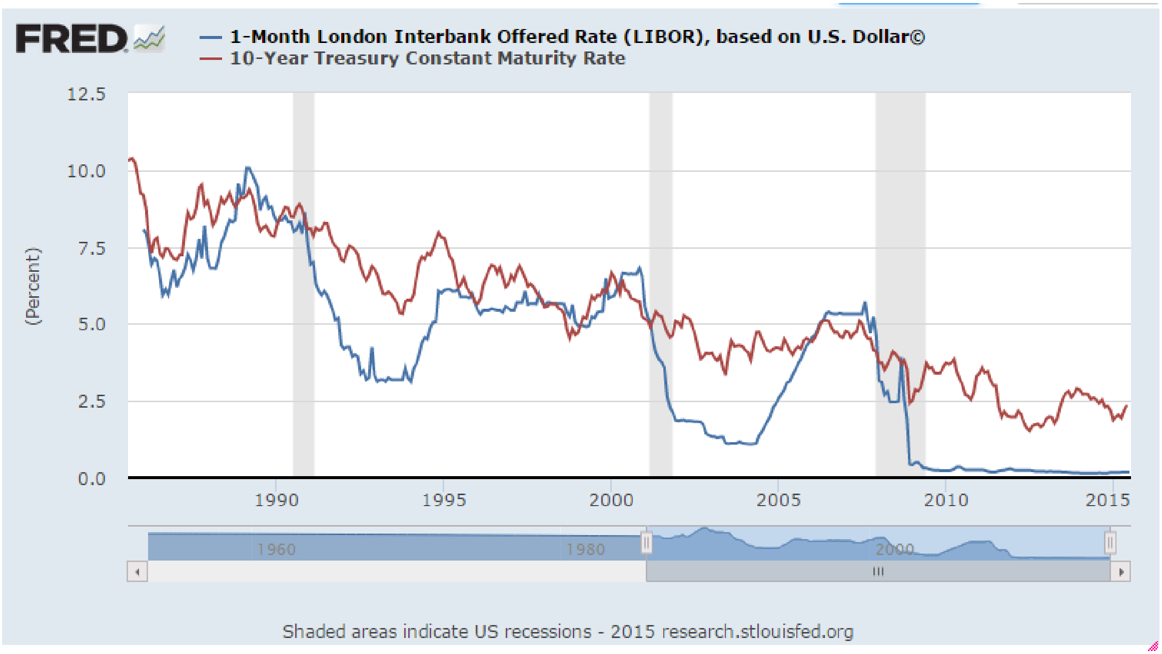
- Lower costs of issuance
- Greater prepayment flexibility
- Flexibility of interest rates (fixed vs. floating)
- Potential for gain when terminating a swap in rising rate environment
- Interest costs not linked to ratings of third party credit provider
- Credit enhancement (letter of credit) fees do not apply

Swaps in Today's Economic Environment

Historical Yield Curves

Which direction are future interest rates most likely to go? ….

One Month LIBOR vs **10 Year UST** (1985-2015): [3]



…. and what happens to a floating-to-fixed swap when they do?

Swaps in Today's Economic Environment (cont.)

What do Industry Associations advise?

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"*When used properly derivative products can be* ***effective interest rate management tools****, which can provide a governmental entity financial flexibility, opportunities for interest rate savings, alter the pattern of debt service payments, create variable rate exposure, or change variable rate payments to fixed rate and otherwise limit or hedge variable rate payments*." [4]

SIFMA

"*Derivatives play an important role in the capital markets and broader economy,* ***allowing businesses [and state and local governments] to manage and hedge risk***." [5]

Additionally… both Associations comment on the important steps that Dodd-Frank took to improve market transparency and provide safe harbors for swap market participants.

Swaps in Today's Economic Environment (cont.)

Finally: What about those Swap Termination Payments?

Three thoughts on the topic …

1. No payment is made to either party unless a swap is terminated.

2. The size of a swap termination payment primarily reflects the value of replacing the swap with fixed interest rates in the current market.

3. Remember that future direction of interest rates question?

Looking Ahead – What does it Mean for *You*?

Endnotes and Additional Resources:

[1] The Economist, “Too big not to fail”, http://www.economist.com/ node/21547784/ (February 18, 2012)

[2] U.S. Securities and Exchange Commission, “Dodd-Frank Spotlight”, http://www.sec.gov/spotlight/dodd -frank/derivatives.shtml

[3] Federal Reserve Bank of St. Louis, FRED Economic Data, https://research.stlouisfed.org/fred2/

[4] Government Finance Officers Association, “Use of Debt-Related Derivatives Products”, http://www.gfoa.org/use-debt-related-derivatives-products

[5] Securities Industry and Financial Markets Association, “OTC Derivatives Resource Center”, http://www.sifma.org/issues/regulatory-reform/otc-derivatives/overview/

Dodd-Frank Act (full text):
http://www.sec.gov/about/laws/wallstreetreform-cpa.pdf

Thank You!

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