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Memorandum

To: Tennessee Comptroller of the Treasury
From: Public Financial Management, Inc.
Re: Guidelines for Interest Rate and Forward Purchase Agreements

As the State's financial advisor, Public Financial Management, Inc. ("PFM") is please to provide comments to the proposed Tennessee State Funding Board's (the "Funding Board") Guidelines on Interest Rate Swap and Forward Purchase Agreements. Given the immeasurable change to market conditions, PFM commends the Funding Board on updating these guidelines. In summary, we have provided comments as well as general suggestions related to the guidelines with the intent of maintaining the apparent goals of the Funding Board. PFM provides independent Swap Advisory and independent Swap Monitoring services to our clients, including multiple Tennessee local governments. When appropriate we will note guidelines that might impact our services and therefore put the reader on notice that our business model might bias our opinion on this particular point.

In general, we agree whole heartedly with the statement at the beginning of the guidelines: "It is the Governmental Entity's responsibility to determine the appropriateness of the transactions and the legal authority to enter into the Agreement." However, we also agree that history supports the proposition that local governmental units do not always have the information they need to make sound judgments, that they are often guided by private vendors with an incentive to make a sale of products that may be more complex or expensive than need be or may expose the Governmental Unit to risks that are either not fully understood by the vendor or minimized by the vendor. While this is an inherent conflict of interest, it is not unique to financial products. However, because of the highly visible nature of these products and their providers, because of the relative magnitude of damage they can do to a community's financial health, and because of the arcane knowledge needed to evaluate these products, the providers of these products (investment bank, investment advisors, commercial banks, etc.) have historically been the subject of state and federal government oversight. The most recent history only validates the need for this oversight.

Given the need for oversight, balanced by the State's desire to allow local governments to make their own decisions, the question becomes how to develop guidelines that accomplish both goals. PFM would suggest the Funding Board put a heavy emphasis on education, policy development, financial planning, assumption of responsibility, full transparency and detailed transaction reporting to the State. PFM believes the vast majority of the problems will be mitigated by requiring policy development, monitoring transactions in light of adopted policies, reporting transaction results to the State and finally by requiring a signed statement that the transaction is in compliance with the community's adopted policies. The Funding Board may further the achievement of its goals by expanding the current State Sponsored training of local finance professionals. This approach avoids

the need to specifically define rules that will either be too restrictive, thereby preventing local communities from managing their financial needs efficiently, or they will not be effective against future market developments.

Based upon this philosophy, we suggest the education, policy development and reporting portion of your guidelines be strengthened and the specific rules (i.e.: rating requirements for counterparties/insurers or savings requirements for use of a particular financial tool) be liberalized or eliminated.

Given the importance and consequences of these updated guidelines, PFM is available to discuss our comments and suggestions with you at length and to assist your staff with revisions you feel are appropriate. Our comments are below.

Section Numbers

II. DEFINITIONS

- 1) “Accountant,” “Chief Financial Officer” or “CFO” and “Monitor”— *Requiring the Accountant to have a bachelor’s degree in accounting, the CFO’s to have (5) years experience in governmental accounting and (3) years governmental experience in Tennessee or the Monitor to have a bachelor’s degree in economics, finance, public administration with a concentration in financial management or accounting and a professional certification such as CPA are too restrictive.*

Before, we proceed with our comments, the question needs to be asked; does the Funding Board have the authority to set minimum educational or experience standards for local governmental employees? And even if the Funding Board has this authority, is it something it wants to undertake?

Many communities in Tennessee hire people to fill these jobs with varied academic and professional back grounds. For example, when Marlin Mosby was hired as CFO for the City of Memphis, he came from a commodity trading company, Dave Goetz came from a public industry association, Rich Reibling (Nashville) was an investment banker and attorney and Hal Canary (Germantown) from public accounting, None of these individuals would have met your standards as an accountant for the smallest town in the state. Many smaller governments hire experienced bookkeepers who do not have any governmental accounting experience or an accounting degree, many larger communities hire middle level finance managers from the private sector with no governmental experience or in some cases retired military officers (Chattanooga) or retired business executives with no direct financial experience. Based upon our experience with local governmental units, PFM finds the requirements as set forth in the Guidelines limiting for the recruitment of new and in some instances, for current CFO’s. For example, by enforcing a requirement of 3 years experience in Tennessee governmental accounting you are preventing a community from hiring someone of national prominence in public finance. Therefore we feel the Guidelines, as written, are potentially limiting Governmental Entities from hiring the most highly qualified candidates for such positions or in the case of many small communities, preventing them from hiring anyone to fill the positions. PFM’s suggestion would be to eliminate the

educational and experience requirements and replace them with an expanded educational and state sponsored certification program.

- 2) “Debt Management Report and Derivative Management Report” – *PFM believes this (these) report(s) can become the cornerstone of the expanded role of the Funding Board.*

Under the current definition, it is unclear whether the State is requiring the report to be completed by (1) all government entities, (2) for all entities that have variable rate debt or (3) for governmental entities that have issued variable rate debt and a swap within the current fiscal period. It is also unclear what role “Debt and Swap Policy Statements” play in these reports.

PFM’s suggestion is to combine the two reports into one report (the “Debt and Derivative Management Report” or, hereafter referred to as the “DDM Report”) and to require the DDM Report from all units with any form of variable rate debt and/or derivative finance structure outstanding at the end of the fiscal year. Further, we would recommend that any Governmental Unit that is required to submit the DDM Report must have a formally adopted (by its governing board) Debt Management and, if a derivative agreement is part of any outstanding debt, a Swap/Derivative Policy. The DDM Report would provide information on the Governmental Unit’s outstanding debt, including but not limited to coupon rates/average yields (variable rate debt), maturity schedules, insurers/guarantors, liquidity providers, remarketing agents, trustees, ongoing fees, etc. Most importantly, the DDM Report would describe how the total outstanding debt stacks up against the Governmental Unit’s adopted Debt/Derivative Policies. The report would be prepared by the Governmental Unit’s CFO, reviewed by the governing board, bond counsel, financial advisor, swap advisor, etc., and transmitted to the State by the Governmental Unit’s CEO. Each Party to this transmittal will acknowledge they have reviewed the DDM Report relative to the Governmental Unit’s Debt and Derivative Policy and certify their belief the Governmental Unit is in compliance with its adopted Policy.

“Independent Swap Advisor and Independent Swap Counsel” *(PFM provides services of Independent Swap Advisor to several Governmental Units in the State of Tennessee)*

While PFM believes all vendors should and can be required to disclose any significant past regulatory or legal findings against the vendor, we do not believe they can or should be required to disclose on-going investigations unless they have been publicly charged with a regulatory or legal wrong-doing.

- 3) “Monitor” – *Can the Monitor be the CFO? Is the requirement of a “Monitor” practical? If so, can this task be outsourced?*

PFM believes the Funding Board’s intent is to require a staff member, in addition to the CFO to “Monitor” any variable rate and swap transactions, however, as the current definition reads this intent is not clearly defined and PFM believes the requirements for this position are excessive. The largest communities in the state would have trouble filling this position given current budgetary restrictions. PFM questions whether these rigorous

Monitor qualifications are practical for any of the State's Governmental Units. Well staffed and sophisticated entities, such as Shelby County, currently do not have the staff in place to provide such detail monitoring and reporting on derivative and variable rate debt financings. Lastly, if the State wants to require this activity, can the monitoring be outsourced to an independent third party to fulfill these duties? *(PFM provides a swap monitoring service called Swap Viewer for a fee.)* For communities that currently do not have staff members in place, PFM believes the cost-benefit of outsourcing this task could greatly benefit entities looking to pursue variable rate and derivative transactions.

PFM suggestion would be to either: (1) allow for this task to be outsourced to independent third parties or (2) define the role of the Monitor function in broad terms and leave the development of the job description to the local Governmental Unit. While PFM understand the State's intent on requiring professionals to possess related academic degrees or respected professional designations, the fact is that many professionals within the financial arena have a bachelor's degree in fields other than economics and finance and very few have CPAs, CFAs, PRMs or other professional certifications.

Rather than defining the position, we believe that the guidelines should focus on the definition of the job responsibilities. "To Monitor" shall mean to internally or externally provide to the CFO monthly reports based upon Generally Accepted Governmental Accounting Standards as to the status of all interest rate agreements that involve variable rate debt or a derivative product. Such report will include but not be limited to the current yield on the agreement, a current estimate of the termination payments on any outstanding derivative product, a list of counterparties, etc. These monthly reports should be transmitted to the CEO by the CFO and filed for future reference. These reports would become the basis for the annual DDM Report to the Funding Board.

III. PROCEDURE FOR SUBMISSION AND COMPLIANCE REPORTING

A. Form of Submission

- 4) *It is not clear when and why this report is filed. Why do conduit issuers and borrowers both have to file separate reports?*

PFM believes requiring both the conduit issuer and the borrower(s) to prepare and submit separate reports of compliance to the Funding Board is redundant and excessive. If the State's intent is to require more prudent financial behavior by conduit issuers, PFM believes this objective can better be achieved by requiring the borrower to submit compliance reports. However, prior to submission, the reports should be reviewed along with the Governmental Units Debt/Swap Management Policies and signed by the conduit issuer with a statement from the conduit issuer the proposed transaction is in compliance with the borrower's existing policies. With this approach the conduit issuer would not be required to submit a separate report of compliance. However, by requiring the conduit issuer to be a party to the borrower's submission and to certify they have received and reviewed the borrower's Debt/Swap Management Policies and in their opinion the proposed transaction was in compliance with said policies, the Funding Board has achieved their goal of getting

complete information on all transactions while at the same time encouraging the conduit issuers to give more thought to the needs of the local Governmental Units.

D. Conditions for Entering into an Interest Rate or Forward Purchase Agreement.

- 5) *In general, PFM believes most of this section should be eliminated. If the Funding Board's goal is to allow local governments based upon their own informed knowledge of the financial products and the risks associated with those products to make financial decisions the most efficient way to fund capital projects, this section is counterproductive and possibly harmful to those communities. For example, to require an average life of debt equal to or less than which would result from "level debt service" maybe a good policy for most general obligation bonds but could be disastrous for a water utility, a convention center or an arena all of which will depend upon future revenue growth to make debt service payments. PFM believes most of your objectives can be achieved by requiring Governmental Units who enter into debt vehicles other than long-term fixed rate debt, sold at competitive sale to prepare and adopt formal Debt/Swap Management Policies and to submit a Compliance Report to the Comptroller prior to the transaction demonstrating the transaction is consistent with their adopted policies. Below are our comments on each individual section.*
- 6) *What is the goal of Number 1.a from Section III.D?*

Why are the guidelines restrictive to "at least level debt service?" What does the State mean by *at least* level debt service? Is this requirement restrictive to general obligation credits? If not, what about revenue bond financings where revenues supporting debt service are growing over the life of the issue? What if a Governmental Unit's intent is to structure towards *aggregate* level debt service? Exactly what is the State's goal by requiring this restriction? PFM believes that by requiring such a condition the Funding Board would be limiting the viable and often most conservative financing options for more complicated issuers or for revenue secured financings. The Funding Board would actually be restricting the possible avenues for issuers to access the capital markets and in some cases potentially increasing the debt burden on issuers by restricting them from entering into interest rate or forward purchases agreements that would be in their best interest.

PFM's suggestion would be to eliminate this requirement or limit it to a final maturity of no more than twenty-five years for general obligation bonds and thirty years for revenue bonds with principal payments starting no later than five years after the completion of the project or projects. In addition, a requirement that the average life of the Governmental Unit's total outstanding debt should not be greater than fourteen years for general obligation bonds or sixteen years for revenue bonds or the average life on a single issue no greater than 65% of the final maturity.

- 7) *Why is the Funding Board requiring Numbers 3, 4 and 5 from Section III.D?*

PFM believes if the State were to require numbers 3 and 4 within Section D that the State would be precluding smaller Government Units from engaging in interest rate and forward purchase agreements. While it may be the case that many smaller governments may not be properly informed about the risk related to interest rate and forward purchase agreements, precluding these entities would be limiting the financing options available to these

communities. Further by implementing numbers 3 and 4 the guidelines limit the ability of these entities from engaging in effective risk management practices. We believe the requirement to have adopted Debt and Derivative Management Policies prior to entering into any variable rate or derivative base transaction will accomplish the same goal and provide those few well managed and knowledgeable communities the freedom to effectively manage their capital funding needs.

PFM agrees wholeheartedly with number III.D.5 (“The Governmental Entity by action of its Governing Body shall have adopted appropriate written enforceable debt and derivative management policies meeting the standard of the model finance truncation management policies developed by the State Funding Board under the authority of Tenn. Code Ann Section 9-21-151.”). This should be the core of your requirements. All Governmental Units who want to issue variable rate debt or enter into a derivative agreement should be required to develop and formally adopt a Debt and Derivative Management Policy. There are numerous models to draw upon. GFOA has a model, ICMA has a model and the rating agencies have published rating criteria. We believe this single act will solve the vast majority of the problems.

In addition, to the requirements above, PFM believes additional minimum requirements are appropriate prior to a Governmental Unit being eligible to issue either variable rate debt or enter into a derivative agreement: (1) minimum outstanding fixed rate debt of at least \$20,000,000, (2) at least one fixed rate bond issue in the past three years, (3) no more than 50% of outstanding net debt be variable rate debt (total debt outstanding minus fully defeased debt minus cash balances in the debt service, revenue, or general funds), (4) a rating at least in the single A category by at least one of the three major rating agencies and finally (5) a certificate from the State that the CFO has passed a certification exam written and given by the State or by the University of Tennessee and sanctioned by the State.

E. Report by Comptroller

8) *Comptroller Waiver Removed*

In the previous version of the Guidelines, there was the ability for the Comptroller to waive certain criteria to allow for Governmental Entities to enter into interest rate and forward purchase agreements. PFM would suggest this waiver be added back to the current version of the Guidelines.

G. Reporting

9) *Inconsistent requirement in Number 4 Section III.G*

Does the State intend for the governmental entity to submit quarterly or monthly reports? The title suggests quarterly, however the paragraph indicates that monthly reports shall be submitted. We took it to mean that the governmental entity would internally prepare monthly reports and present them to the Funding Board quarterly. In either case, we believe a submission prior to each transaction detailing how the proposed transaction is in compliance with the local entity's Debt and Swap Management Policies and an annual report summarizing the performance of all outstanding debt is all that is needed.

IV. GUIDELINES SPECIFIC TO INTEREST RATE AGREEMENTS

This section seems to be redundant with section III.D and should be combined with that section.

A. Conditions to Entering into an Interest Rate Agreement

10) *Size: (We have addressed our comments on the size requirement above in our comments to Section III.D)*

11) *Type: It is unclear what you mean by "Type." Seven day vs. thirty day; VRDBs vs. Auction Rate, market vs. market plus some admin. fee? In any event, it is appropriate that the borrower describe the nature of the financing and disclose all the fees and charges associated with the issue.*

12) *Number 3, Section IV.A: PFM believes this whole section needs to be eliminated.*

As noted above regarding the definition of a "Monitor", PFM questions the current proposed requirements needed for a staff member to qualify as a Monitor. Given the stringent qualifications this would require an additional staff member for many government entities. Because of this we question the practicality of such qualifications.

Furthermore, paragraph 1 of this section, suggests that the Government Unit would be required to receive an opinion from a second independent swap advisor not working on the transaction stating that the Monitor has a basic knowledge of derivatives and the risk entailed with such products. PFM finds this troubling because we believe that an independent swap advisors not involved with the proposed interest rate agreements will be hesitant to provide opinions indicating the competency of the Monitor. In fact, PFM would not provide an opinion as to the competence of any State employee without having the opportunity to work with that employee and to test that employee's knowledge. None of your advisors or legal counsels has the training or tools necessary to formally rule on the competence of a State employee. Lastly, if the Monitor's job is to actually monitor on an ongoing basis the performance of the interest rate agreement, why must the Swap Advisor work with the Monitor? Why not the CFO? The Monitor is an accountant not a policy maker.

13) *Number 4, Section IV.A. The State should clarify its intent of this section.*

PFM finds that the currently stated objectives for variable rate debt as well as fixed rate debt should be simplified as to its intent. By stating that the objective of refunding for a variable rate debt must recognize 100 bps of savings and that creating synthetic variable rate debt must produce a decrease in payments of at least 200 basis points is not clear and impractical. For example, should the saving goals be the same when interest rates are 2% as when they are 14%? What do you mean by “actual fixed-rate?” If you mean the rate the borrower would have incurred if they had issued fixed-rate debt, how is that rate determined? PFM believes the requirement could encourage the wrong kind of behavior and lead to Governmental Units taking on additional risk to ensure all-in cost are below the stated targets. For example, to increase the projected savings the Governmental Unit may choose to enter into a swap with no call feature or they may choose a LIBOR based swap instead of a SIFMA based swap. Both of these examples would improve the projected savings but also increase the borrower’s risk.

PFMs suggestion would be to eliminate the details regarding the savings requirements. Alternatively, we recommend that the Governmental Unit establish and state a well defined percentage based savings goal as a part of their respective Debt and Derivative Management Policies.

14) *Number 5, Section IV.A. Section 5 is too limiting in regards to interest rate agreements*

PFM believes that some of the requirements in this section are too strict regarding the eligibility for entities to enter into interest rate agreements. Below we have highlighted as well as provided our suggestions to changes.

Section B. In regards to the life of the interest rate agreement we believe this requirement should be eliminated as it is counterproductive. If a Governmental Unit is entering into a variable-to-fixed rate swap as an alternative to issuing fixed rate debt the term of the swap should match the term of the bonds. Therefore if the final maturity of the bonds is twenty years the term of the swap should be twenty years. To have a shorter term to the swap would expose the borrower to market rate risk in five years.

Section D. Rather than stating that the market value be \$0.00 we believe this should be “on-market” as, market values will never be exactly zero.

Section F. “The formula used for the payments in a synthetic fixed-rate Interest Rate Agreement can be changed by filing a new request for a report of compliance on the transaction.” This is unclear. If you mean the borrower may negotiate a new Interest Rate Agreement if they file a new Report of Compliance then it is ok. However, if you mean the borrower may unilaterally change its agreement with the counterparty simply by filing a report with the State, that will not work as doing so will require the consent of all parties to the agreement.

Section H. “No Interest Rate Agreement shall be for speculative reasons.” While it may be the case that the examples listed are common agreements used to speculate on future interest rate movements, there may be times in which these examples mentioned would in fact be effective risk management products. By including these as examples within the guidelines the State would be limiting effective risk management products for government entities to employ. As an alternative we would suggest naked or stand-alone swaps not be allowed and all submissions of a Report of Compliance include a description of how the transaction has hedged future interest rate risk.

B. Supporting Analysis

15) *PFM believes separate independent advisors are not needed.*

As noted under Section IV.3.a.1, PFM believes there is not a need for a second independent Swap Advisor. If the first Swap Advisor is a qualified independent advisor there does not appear to us to be a need to seek the opinion of yet another advisor. Either the first advisor is competent or not. What happens when the two independent advisors disagree? How is this mediated? This appears to us to be an unnecessary expense and the potential to introduce a level of complexity that is not needed. *(PFM does provide independent swap advisory services.)*

As we have said before, the Report of Compliance should focus on the current transaction and its relationship to the local Governmental Unit’s adopted Debt and Swap Management Policies. If the Government’s policy states that 35% of their outstanding debt can be in the form of variable rate debt and this transaction falls within those guidelines then it complies, if their policy is 15% and this transaction falls outside those guidelines then it does not comply.

D. Form of Documentation

16) *The Schedule is referred to as the Credit Support Annex.*

In regards to the reference to the supporting documents of any interest rate agreements the paragraph should read:

To document any Interest Rate Agreement, a Government Entity shall utilize the standard documentation prepared by the International Swaps and Derivatives Association, Inc. (“ISDA”), such as the Master Agreement, ***Credit Support Annex*** and Confirmation with such modifications...

F. Standards for Counterparty Selection and Security for Financial Interest.

- 17) *PFM finds these guidelines to be too harsh and precludes competition for Counterparties. Further, given the current market, the guidelines are impractical.*

Given current market conditions, PFM believes that the standards required for Counterparty selection are too harsh. The ratings of counterparties have not been the problem with current variable rate performance, nor do we expect that this will be a problem in the future. Because of this, PFM recommends that the Counterparty be held to a long term rating of “A+” and that the short term rating requirements be removed.

The Funding Board should consider removing the collateral requirement by the counterparty. By requiring this PFM believes 1) the counterparty would require a higher fixed rate and 2) would require similar collateralization from governmental entities when the market value of termination payments are negative. As we have seen in this market, and with some of our clients, it would not be possible for them to post collateral of 102% of the requirement.

G. Credit Enhancement, Liquidity and Reserves.

- 18) *PFM finds this guideline impractical and finds them to be possibly disadvantageous for some entities*

Regarding the use of credit enhancement, the requirement that guarantor or surety provider have a “AAA” rating is not practical in today’s market seeing as there are no insurers that are “AAA” rated by all three rating agencies. Further, what if it makes financial sense for an entity to secure insurance from a guarantor that has an “AA” credit rating or even an “A” credit rating?

H. Financial Monitoring

- 19) *What does the State mean by “financial condition” in numbers 1 and 2.*

PFM is under the impression that credit ratings are both qualitative and objective resources on a firm’s financial condition. If the State wants to require more detailed reporting then it should be clearer as to what it means by “financial condition” and tell the borrowers how they are to go about monitoring the “financial condition” of a publicly held corporation.

20) *The State should provide clarity to its request in number 5.*

Is the intent here for the Independent Swap Advisor to quantify the effectiveness of the swap as a hedge against rising or falling market rates or the effectiveness of the synthetic cost of funds vs. some hypothetical fixed rate issue? This requirement should be more clearly defined

All of our comments above apply to Section V. In particular, we believe the borrower's existing Debt and Swap Management Policies should be the basis for all evaluations.

In summary, PFM hopes the above comments are helpful to the Comptroller, his staff and the Funding Board. As your Financial Advisor, we are prepared to meet with you at anytime to go over our comments and to serve as your sounding board as you further revise these guidelines.

Sincerely,

Lisa Daniel
Andrew McKendrick
Marlin Mosby
Lauren Lowe