SOUND TRANSIT
STAFF REPORT

RESOLUTION NO. R2004-14

Adoption of Asset Liability Management Framework for Sound Transit

Meeting:	Date:	Type of Action:	Staff Contact:	Phone:
Finance Committee Finance Committee Board	10/7/04 10/21/04 10/28/04	Deferred Discussion/Possible Action to Recommend Board Approval Action	Hugh Simpson, Chief Financial Officer **Brian McCartan, Deputy Chief Financial Officer**	(206) 398-5082 (206) 398-5100

ACTION

- Adopting an Asset Liability Management Framework for agency resources, including Asset Liability Management, Investment, Debt Management, and Debt Swap Policies, and superseding Resolution No. 97.

KEY FEATURES

- Establishes a policy to coordinate the management of the agency's investments and debt on a consolidated basis.
- Establishes debt policies governing the issuance of bonds by the agency.
- Establishes policy for debt swap transactions.
- Supersedes Resolution No. 97, adopted by the Sound Transit Board on September 25, 1997, establishing investment policies for agency resources.
- The policies have been reviewed by the agency's financial advisor, members of the investment banking team, and bond counsel.
- The policies do not authorize issuance of any debt or swap obligations, which must be approved by the Board on a case-by-case basis.

BACKGROUND

The Asset Liability Management (ALM) Framework has four major policies.

1) ALM Policy

The policy establishes that the agency will manage its investments and its debt obligations on a consolidated basis. It establishes liquidity and funds management principles, net interest objectives and ALM roles and responsibilities. Among its key elements are:

- ALM management will be fully consistent with the agency's financial policies and subarea equity.

- The agency will maintain a minimum cash balance equal to two months' operating and maintenance costs, system-wide contingency and Emergency Fund and up to the next three months' forecast of capital outlays.
- ALM strategy will seek to increase interest earnings and decrease debt service through selected use of:
  i. Lengthening term of investments;
  ii. Variable rate debt; and
  iii. Financing mechanisms to lock interest rates at attractive levels.
- Establishes principles for managing and monitoring interest rate risks.
- Staff will report quarterly to the Audit and Reporting Subcommittee on:
  - Investment balances and performance against benchmarks;
  - Status of borrowing program; and
  - Current ALM strategy.

2) Investment Policy

The policy establishes goals for investment objectives, delegation of authority, prudence, ethics and conflicts, authorized dealers, suitable investments, safekeeping, portfolio diversification, maturity structure, internal controls and performance standards and reporting. Its key elements include:

- Primary objectives of Sound Transit's investment activity, in order of priority, are safety, liquidity and return on investment.
- Permitted investments are primarily Treasury and other securities backed by the U.S. Government. Sound Transit may legally invest in any of the securities identified as eligible investments as detailed in the State Treasurer's publication titled "Eligible Investments for Public Funds."
- To the extent possible, Sound Transit will attempt to match its investments with anticipated cash flow requirements and ALM management objectives. Unless matched to a specific cash flow, Sound Transit will generally invest in securities maturing three years or less from the date of purchase.
- Investments with any single securities broker/dealer or financial institution will generally not exceed 50% of the total portfolio, except for the Washington State Treasurer's Local Government Investment Pool, which can be up to 100%.
- Quarterly reports will be provided to Sound Transit's Finance Committee. Included in these reports will be a market versus book analysis, portfolio composition analysis, broker/dealer composition analysis, interest revenue year-to-date analysis, performance standard comparison, market overview, and ongoing investment strategy guidelines.

3) Debt Management Policy

The policy establishes goals for agency borrowing of funds as well as credit objectives, borrowing parameters, and the purposes and uses of debt. Key elements include

- Sound Transit will manage its debt obligations to minimize its net debt service payments consistent with credit objectives, all disclosure and regulatory requirements and highest standard of fiduciary management of public funds.
- Primary objectives are to:
  - Maintain on-going access to the capital markets to facilitate delivery of the Sound Move program;
  - Minimize Sound Transit's debt service within prudent risk parameters;

- Retain the highest practical credit rating consistent with appropriate operating flexibility;
- Ensure timely repayment of principal and interest on debt;
- Comply with State and federal laws and regulations governing the issuance of debt and provisions governing bond documents; and
- Maintain full and complete financial disclosure and reporting.

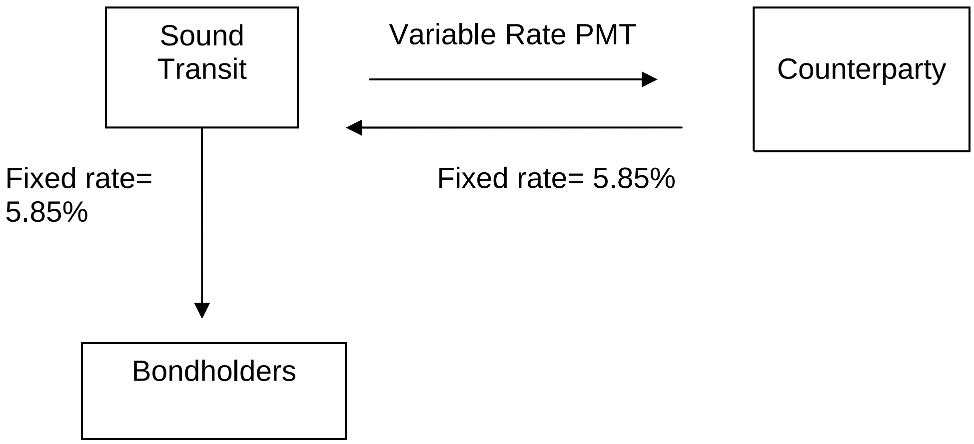
- Sound Transit seeks to maintain the highest possible credit ratings for all categories of short- and long-term debt that can be achieved without compromising delivery of basic Sound Transit services and achievement of adopted Sound Transit policy objectives.
- Sound Transit shall issue second lien or other subordinate debt on a long term basis only if it is financially beneficial to Sound Transit, legally required or consistent with creditworthiness objectives.
- Sound Transit can issue its debt on a competitive (open to all bidders) or negotiated basis (open only to the agency's investment banking team). If a negotiated sale is used, underwriters will be selected through a competitive process and will be required to demonstrate sufficient capitalization and experience related to debt issuance and significant minority and women participation within their firms.
- The amount of unhedged variable rate debt will not exceed 25% of total outstanding debt. For example, if the agency plans to issue $1.5 billion of debt of Phase 1 projects, and does not have a significant cash balance, it is limited to $375 million of variable rate debt (debt whose interest rate varies with interest rate levels, like an adjustable rate mortgage).
- Sound Transit may use derivative instruments on a case-by-case basis, as approved by the Board, and may enter into interest rate management agreements (swaps) as set forth in the Swap Policy. (Derivatives are financial instruments whose values are derived from another underlying financial asset or index).

4) Swap Policy

The Swap Policy establishes guidelines for the use and management of interest rate management agreements, including interest rate swaps, swaptions, rate locks, caps, collars and floors ("swaps"). The policy is prepared in accordance with the proposed 2003 recommended practices of the Government Finance Officers Association. Sound Transit gained the authority to enter into swap agreements during the 2003 legislative session.

Swaps are financial instruments in which two parties agree to trade interest rate payments, usually a fixed-rate payment for a variable-rate payment. For example, if Sound Transit has fixed-rate bonds outstanding, it could enter into a contract with a counterparty (a highly-rated financial institution) to receive a fixed-rate payment equal to its bond payments in exchange for making a variable-rate payment to the counterparty. Sound Transit would effectively be "swapping" its fixed-bond payments for variable-rate payments. There are similar "swaps" for variable- to fixed-rate payments, as well as a variety of other swap instruments.

Notional Swap Transaction



The policy establishes the objectives for uses of swaps, key terms for swap agreements, and credit requirements for swap counterparties. Policy provisions include:

- It is the policy of Sound Transit to on a case-by-base basis utilize swap agreements to manage interest rate risk and/or reduce net borrowing costs, consistent with all legal authority, highest fiduciary standards and the agency's ALM policy objectives.
- Sound Transit will consider the use of swap products as a means of reducing net borrowing costs, and/or hedging interest rate risk .
- Swaps will not be used for speculation – taking additional risks unrelated to Sound Transit's business in an effort to increase returns.
- As protection against counterparty default, the policies require:
  - Swap counterparties have at least AA3/AA- credit rating
  - Collateral (deposits with third party) requirements if the counterparty is below Aa3/AA- category
- Provides for ongoing reporting by staff to the Board on the status and risk of all outstanding swaps on a quarterly basis.

BUDGET IMPACT SUMMARY

There is no action outside of the Board-adopted budget; there are no contingency funds required, no subarea impacts, or funding required from other parties other than what is already assumed in the financial plan.

BUDGET DISCUSSION

This action will have no direct budget impact.

REVENUE, SUBAREA, AND FINANCIAL PLAN IMPACTS

The adoption of the ALM framework has no direct budget or financial impact. However, the goal of ALM is to reduce net interest costs and minimize interest payment volatility which would have a positive impact of the agency's financial status.

BUDGET TABLE

Not applicable to this action.

M/W/DBE – SMALL BUSINESS PARTICIPATION

Not applicable to this action.

PROJECT HISTORY

Finance staff has briefed the Finance Committee several times during 2003 and 2004 on the development of an ALM approach.

Prior Board or Committee Actions and Relevant Board Policies

Motion or Resolution Number	Summary of Action	Date of Action
R-97	Adopting an investment policy for Authority resources.	9/25/97

CONSEQUENCES OF DELAY

The agency is currently evaluating whether a bond sale and/or a swap transaction to lock a portion of the agency's Phase 1 borrowing costs is appropriate at this time. The adoption of the ALM policy, Debt Policy and Swap Policy is a necessary step prior to executing a swap transaction.

PUBLIC INVOLVEMENT

Not applicable to this action.

LEGAL REVIEW

MMB 9/29/04

SOUND TRANSIT

RESOLUTION NO. R2004-14

A RESOLUTION of the Board of the Central Puget Sound Regional Transit Authority adopting an Asset Liability Management Framework for agency resources, including Asset Liability Management, Investment, Debt Management, and Debt Swap Policies, and superseding Resolution No. 97.

WHEREAS, a Regional Transit Authority, hereinafter referred to as Sound Transit, has been created for the Pierce, King and Snohomish County region by action of their respective county councils pursuant to RCW 81.112.030; and

WHEREAS, on November 5, 1996, at a general election held within the Central Puget Sound Regional Transit Authority's district, the voters approved local funding for Sound Move, the ten-year plan for high capacity transit in the Central Puget Sound Region; and

WHEREAS, by Resolution No. 72, adopted May 31, 1996, and pursuant to RCW 81.112.040 and Section 7 of Resolution No. 1 adopted September 17, 1993, the Board adopted as a major decision certain financial policies to guide funding on high capacity transportation services and facilities in the Ten-Year Regional Transit System Plan and to achieve equity among the subareas in the RTA district; and

WHEREAS, by Resolution No. 97, dated September 25, 1997, the Sound Transit Board adopted investment policies for agency resources;

WHEREAS, strong fiduciary management of public funds and minimizing the financing costs for Phase 1 capital investments require the adoption and coordination of investment, debt and swap policies;

NOW, THEREFORE, BE IT RESOLVED by the Board of the Central Puget Sound Regional Transit Authority that:

Section 1. An Asset Liability Management (ALM) framework to coordinate agency management of cash, investments, and debt obligations, including payment agreements, as described in Attachment A "Asset and Liability Management," be adopted. This management approach is divided into four distinct, but coordinated policies that are adopted by the Sound Transit Board, Asset Liability Management, Investment, Debt Management, and Debt Swap policies.

Section 2. ALM Policy applies to all of the agency's unrestricted cash and investment balances, debt obligations and payment agreements. It states that it is the policy of Sound Transit to manage its investment balances (cash and cash equivalents) and debt (short and long-term debt obligations and payment agreements) on a consolidated basis to reduce net interest costs and manage interest rate volatility.

Section 3. Investment Policy applies to all financial resources of Sound Transit except retirement funds. It states that it is the policy of Sound Transit to invest public funds in a manner which will provide the highest investment return with the maximum security, while meeting daily cash flow requirements and conforming to all state and local statutes governing the investing of public funds. It is also the policy of Sound Transit to conduct investment transactions in accordance with Sound Transit's Resolution No. 81, which details the Code of Ethics for Board Members, Officers, and Employees.

Section 4. Debt Management Policy applies to all debt issued by the Sound Transit, including debt guaranteed by Sound Transit. It establishes that Sound Transit will manage its debt obligations to minimize its net debt service payments consistent with credit objectives, all disclosure and regulatory requirements and highest standard of fiduciary management of public funds.

Section 5. The Debt Swap Policy applies to all of the agency's interest rate management agreements, including, but not limited to, interest rate swaps, swaptions, rate locks, forward bond purchase agreements, caps, collars and floors (collectively "Swaps" or "Agreements") incurred in connection with the incurrence of debt obligations (whether or not previously issued or to be issued) as authorized by the Board adopted ALM Policy. It states that the policy of Sound Transit is on a case-by-base basis to utilize swap agreements to manage interest rate risk and/or realize net interest savings, consistent with all legal authority, highest fiduciary standards and the agency's ALM policy objectives.

Section 6. Resolution No. 97, adopted on September 25, 1997, is hereby superseded.

ADOPTED by the Board of the Central Puget Sound Regional Transit Authority at a regular meeting thereof held on October 28, 2004.

John W. Ladenburg
Board Chair

ATTEST:

Marcia Walker

Marcia Walker
Board Administrator

Central Puget Sound Regional Transit Authority

Asset Liability Management Policies

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OVERVIEW

Sound Transit has adopted an Asset Liability Management (ALM) approach to coordinating its management of cash and investments and debt obligations, including payment agreements. These management principles are divided into four distinct, but coordinated policies that are adopted by the Sound Transit Board:

I. ASSET LIABILITY MANAGEMENT POLICY

This policy applies to all of the agency's unrestricted cash and investment balances, debt obligations and payment agreements. It states that it is the policy of Sound Transit to manage its investment balances (cash and cash equivalents) and debt (short and long-term debt obligations and payment agreements) on a consolidated basis to reduce net interest costs and manage interest rate volatility.

II. INVESTMENT POLICY

This policy applies to all financial resources of Sound Transit except retirement funds. It states that it is the policy of Sound Transit to invest public funds in a manner which will provide the highest investment return with the maximum security, while meeting daily cash flow requirements and conforming to all state and local statutes governing the investing of public funds. It is also the policy of Sound Transit to conduct investment transactions in accordance with Sound Transit's Resolution No. 81, which details the Code of Ethics for Board Members, Officers, and Employees.

III. DEBT POLICY

This policy applies to all debt issued by the Sound Transit, including debt guaranteed by Sound Transit. It establishes that Sound Transit will manage its debt obligations to minimize its net debt service payments consistent with credit objectives, all disclosure and regulatory requirements and highest standard of fiduciary management of public funds.

IV. SWAP POLICY

This policy applies to all of the agency's interest rate management agreements, including, but not limited to, interest rate swaps, swaptions, rate locks, forward bond purchase agreements, caps, collars and floors (collectively "Swaps" or "Agreements") incurred in connection with the incurrence of debt obligations (whether or not previously issued or to be issued) as authorized by the Board's ALM Policy. It states that the policy of Sound Transit is on a case-by-base basis to utilize swap agreements to manage interest rate risk lower net borrowing costs, consistent with all legal authority, highest fiduciary standards and the agency's ALM policy objectives.

I. ASSET LIABILITY MANAGEMENT POLICY

1.0 POLICY

It is the policy of Sound Transit to manage its investment balances (cash and cash equivalents) and debt (short and long-term debt obligations and payment agreements) on a consolidated basis to reduce net interest costs and manage interest rate volatility.

2.0 SCOPE

This policy applies to all of the agency's unrestricted cash and investment balances, debt obligations and payment agreements.

3.0 OBJECTIVES

The goal of Asset Liability Management (ALM) is to coordinate management of the agency's financial position, formulate a consistent policy for investments and debt obligations and to effectively manage the agency's interest rate risk.

4.0 CONSOLIDATED CASH MANAGEMENT

4.1 ALM management shall be fully consistent with the principles of subarea equity as established by Sound Move. Allocation of debt to subareas shall be in accordance with subarea equity as defined in Sound Move financial policies and subsequent Board authorization.

4.2 Consistent with Sound Move financial policies that the agency will manage its cash on a consolidated basis, the agency will utilize ALM to help achieve the lowest possible cost for capital projects for all subareas.

4.3 The ALM strategy will be guided by the objectives of the agency's overall cash and debt position and will not generally develop financial or investment objectives for individual projects. However, as some investment or financing options will be unique to a project, the Board may, on a case by case basis, invest or borrow funds for a specific project and the Board may, in its sole determination, allocate debt or investment earnings to a specific project. If specific debt obligations are assigned to a subarea(s) the debt service for that obligation shall be fully paid by that subarea(s). Such actions will require formal Board action.

5.0 LIQUIDITY AND FUNDS MANAGEMENT

The primary goal of the agency's ALM strategy is to insure full access to capital markets, for both investing and borrowing, to insure funding for all its capital requirements at competitive rates with financial prudence consistent with management of public funds. ALM strategy shall manage its cash flow and liquidity requirements to meet these objectives.

5.1 Liquidity Management

The agency's financial policies establish that Sound Transit will "manage the financing of the system plan on a consolidated basis" within the system of subarea equity. The agency's long-term financial plan assumes the agency maintains a minimum $10 million cash balance and two month operating reserve in addition to any budgeted reserve accounts or restricted assets. While this level is sufficient for long-range planning, it is necessary to establish a clearer minimum cash balance goal to guide the agency during execution of the financing of its capital program.

5.2 Minimum Cash Position

5.2.1 The agency's minimum cash position is defined as the minimum amount of cash and cash equivalents that will be maintained with the agency' consolidated account structure, not including any restricted assets (such as debt service reserve funds, collateral for letters of credit, etc.).

5.2.2 The agency's minimum cash position should be made up of the following components:

- **2-Month Operation Reserve:** Under Sound Transit's financial policies, the agency is to maintain a 2-month Operation and Maintenance Reserve. In any given month, the reserve should equal the forecasted next two months of O&M expenses (transit operations, non-capitalizable expenses and regional fund administration expenses).
- **System-wide Contingency:** Equal to annual budgeted amounts for the System-wide Contingency and Emergency Fund.
- **Capital Balances: Up to** the forecasted next three months of construction outlays. Construction activity is determined by a variety of factors, some of which are outside the agency's control. Given that debt issuance can require a 3-6 month lead time, it is prudent for the agency to maintain a level of cash balances that is proportional to the level of construction activity.

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Estimated Minimum Cash Balances Required as of December 31, 2003 ($ M)	
2-Month O&M Reserve	$31
System-Wide Contingency & Emergency Fund	$11
Capital Balances, up to	$100
Total	**$142M**

5.3 Working Balances

In addition to a minimum cash position, the agency shall maintain the flexibility to maintain additional cash balances when the yield on such cash balances is in excess of the true interest cost of marginal debt issuance for any variable rate debt or fixed rate, in full compliance with any IRS arbitrage regulations.

6.0 NET INTEREST OBJECTIVES

The ALM strategy shall seek to minimize agency net interest payments through increasing investment interest earnings and decreasing debt service interest costs. The following strategies may be utilized as appropriate:

- Lengthen investment duration to increase returns over time, consistent with liquidity requirements and investment policy goals regarding preservation of capital;
- Shorten average interest rates on bonds through issuance of variable rate debt;
- Utilize financing mechanisms to lock interest rates at favorable levels; and
- Maintain positive cash balances in excess of minimal required levels if positive net interest position can be improved.

7.0 INTEREST RATE VOLATILITY

ALM strategy shall seek to minimize the agency's net interest rate volatility. The strategy will not attempt to forecast interest rates, but rather develop a consolidated investment and borrowing strategy that, in conjunction, will help hedge interest rate movements.

8.0 ALM ROLES & RESPONSIBILITIES

8.1 Board of Directors:

- All authority consistent with Resolution 78-1
- Approve issuance of all debt obligations over $200,000
- Approve Master and Series Bond Resolutions
- Approve ALM and Investment Policies
- Approve debt lien structure
- Review, through the Finance Committee, investment portfolio performance on a quarterly basis
- Review, through the Finance Committee, the agency's Long-Term Financial Plan

8.2 Chief Executive Officer:

- All authority consistent with Resolution 78-1
- Approves all debt obligations under $200,000
- Reviews and approves for presentation to the Board all ALM related actions requiring Board approval
- Monitors on a quarterly basis ALM performance indicators
- Executes all debt and investment transactions as authorized by the Board of Directors

8.3 Director, Finance and Information Technology Department

- Manages agency debt liabilities and investment assets in accordance with adopted ALM policies
- Approves purchase and sale of all securities, manage Sound Transit investment portfolio
- Negotiates sale of debt obligations
- Monitors outstanding debt obligations in keeping with ALM policies and all regulatory requirements
- Meets all annual disclosure requirements
- Meets all on-going arbitrage requirements
- Updates ALM polices as appropriate in keeping with current statutory requirements and best practices

8.4 Asset/Liability Management Committee (ALCO):

- Develops and maintain asset/liability management process and related procedures
- Maintains and executes a coordinated ALM strategy to meet the objectives of these policies and address the ALM risk objectives (see Risk Objectives)
- Maintains analytic tools and management systems (see Tools) necessary for the ALCO to fulfill its role
- Reviews the annual budget for forecast of interest revenue and debt service
- Documents the current ALM strategy (investment duration, debt issuance and type schedule, liquidity goals and forecast)
- Reviews performance of investment advisors and portfolio performance

9.0 <u>RISK OBJECTIVES</u>

The ALCO shall develop strategies and tactics to minimize the following risks and/or develop mitigation strategies for these risks.

- <u>Interest Rate Risk (IRR) on Earnings</u> – risk that changes in prevailing interest rates will adversely affect interest income and interest expense
- <u>Counter Party Risk</u> – risk that parties who are contractually committed to providing payments or security in the transaction will not be able to meet their contractual obligations
- <u>Valuation/Price Risk</u> – risk that changes in prevailing interest rates will adversely affect the *values* of assets, liabilities, and capital. Valuation/Price risk is the balance sheet valuation effect due to changes in interest rates and other market factors both internal and external to the agency
- <u>Liquidity Risk</u> – risk that insufficient cash will be generated from either assets or liabilities to meet requirements assumed in annual budget, long-term financial plan or emergency requirements
- <u>Credit Risk</u> – risk that some loans and/or investments may not be repaid (default/counter-party risk)
- <u>Compliance Risk</u> – the risk from violations or non-conformance with laws, rules, policies (regulatory or internal), and ethical standards
- <u>Basis Risk</u> – risk that the spread between related instruments of similar maturities will change

- Event Risk – risk that changes in taxes, laws, regulations, or other external factors (such as a disaster) may result in losses

10.0 ALM COMMITTEE (ALCO)

10.1 Meetings

The ALCO will meet no less frequently than quarterly. At each meeting the ALCO shall:

- Review the current and prospective liquidity positions and monitor forecasted revenue and expense/outlays, and monitor short-term cash flow model
- Review outlook for interest rates and the economy at both local and national levels
- Review performance of the investment portfolio
- Review status of the debt portfolio
- Review primary ALM risk objectives and performance indicators
- Update and document the current ALM strategy

10.2 ALCO Membership

Membership on the ALCO Committee will be specified by the CFO and shall include representatives from Accounting, Investment Management and Financial Planning. The agency's financial and investment advisors shall serve the Committee on an advisory basis.

11.0 ALM REPORTING

The ALCO shall report to the CEO and Audit and Reporting Subcommittee of the Board of Directors on a quarterly basis. The Board will be informed of substantive changes to the ALM strategy prior to any new action. The quarterly reports to the Audit and Reporting Subcommittee shall include:

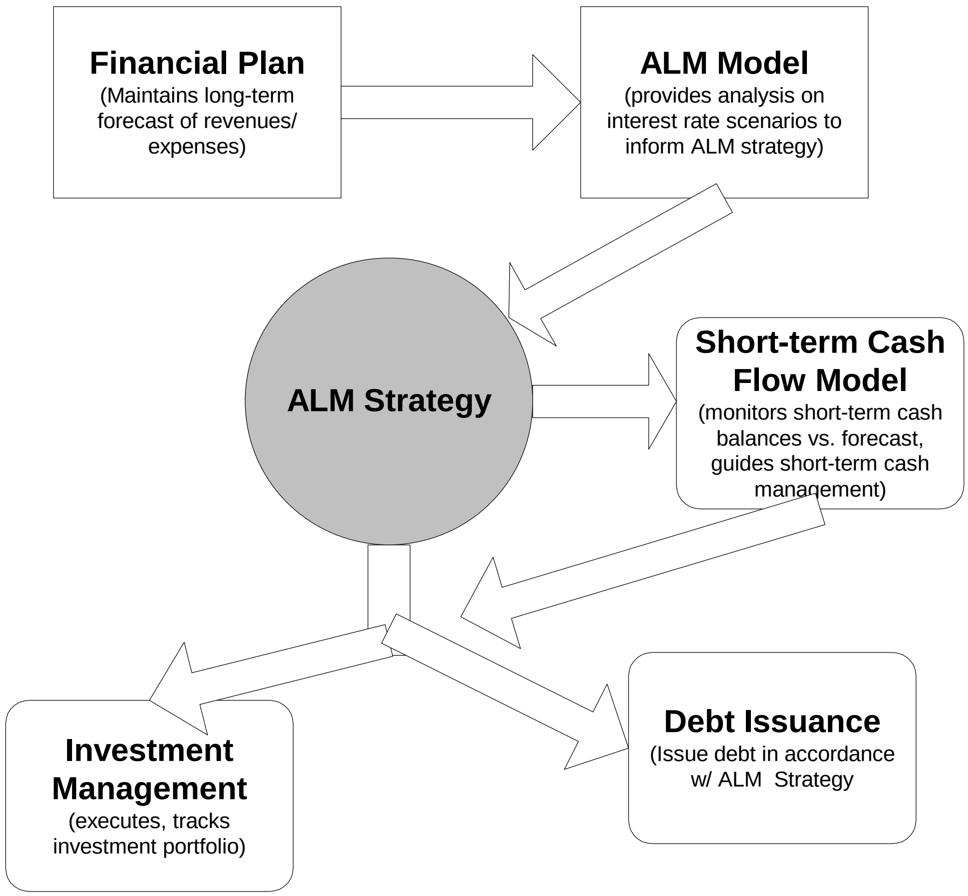
- Investment balances and performance against benchmarks
- Status of borrowing program
- Current ALM strategy

12.0 ALM MANAGEMENT TOOLS

The agency shall maintain the following ALM management tools:

- **Long-Term Financial Plan** (in accordance with FTA guidelines): The plan will be reviewed annually by the Board of Directors and the Citizen Oversight Panel
- **Short-Term Cash Balance Forecast:** A 3- to 5-year model to forecast, on a monthly basis, the agency's net cash position
- **ALM Model**: Long-term model (on annual basis) to produce scenarios and "what ifs" on agency revenues, debt structure, investment structure and interest rate environment. The model will be used to develop and evaluate ALM strategies and quantify risks
- **Investment Software**: Software to track individual securities for entire portfolio (unless held in an approved "pool"), produce analytics on duration, yield, convexity, credit quality and market value

ALM Tools & Process



SOUNDTRANSIT

Central Puget Sound Regional Transit Authority

Asset Liability Management
Investment Policy

II. INVESTMENT POLICY

1.0 POLICY

It is the policy of Sound Transit ("the agency") to invest public funds in a manner which will provide the maximum security with the highest investment return, while meeting daily cash flow requirements and conforming to all state and local statutes governing the investing of public funds.

2.0 SCOPE

Sound Transit financial system is comprised of a single proprietary fund, which is accounted for in the agency's annual Audited Financial Statements. As there are no specifically designated "Funds" used for investment purposes, this Investment Policy applies to all financial resources of the agency with the exception of financial assets managed externally pursuant to insurance policies, fully-defeased lease/leaseback arrangements and retirement plan assets.

3.0 OBJECTIVES

The investment portfolio shall be designed with the objective of attaining a market rate of return throughout budgetary and economic cycles, taking into account the investment risk constraints and liquidity needs and coordinating with the agency's Asset Liability Management (ALM) strategy. Return on investment is of secondary importance compared to the primary objectives of safety and liquidity. The core of investments is limited to relatively low-risk securities in anticipation of earning a fair return relative to the risk being assumed. Securities shall generally be held until maturity with the following exceptions:

- A security with declining credit may be sold early to minimize loss of principal
- A security swap that would improve the quality, yield or target duration in the portfolio
- Liquidity needs of the portfolio that would require that the security be sold

Therefore, the primary and secondary objectives, in order of priority, of the agency's investment activities will be as follows:

3.1 Safety: Safety of principal is the primary objective of Sound Transit's investment program. Agency investments shall be undertaken in a manner that seeks to ensure preservation of capital in the overall portfolio. To obtain this objective, the agency will diversify its investments by investing funds among a variety of securities and financial institutions offering independent returns.

3.2 Liquidity: Sound Transit's investment portfolio will remain sufficiently liquid to enable the agency to meet all operating and capital spending requirements which might be reasonably anticipated.

3.3 Return on Investment: Sound Transit's investment portfolio will be structured with the objective of attaining a benchmark rate of return throughout budgetary and economic cycles, commensurate with the agencies investment risk constraints and the cash flow characteristics of the portfolio.

4.0 PRUDENCE

The Investment Officer(s) shall act responsibly and prudently in order to maintain the safety of the public's funds.

4.1 The standard of prudence that shall be practiced at all times without exception shall be the "Prudent Person Rule" which reads: "Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion, and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived."

4.2 Investment Officer(s) acting in accordance with written procedures, the Investment Policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes. Should any such loss occur, however, the Investment Officer(s) shall report it to the Chief Financial Officer and Controller immediately, who shall then take appropriate action to prevent any future occurrences.

4.3 Purchase of securities shall be made for investment and not speculation.

5.0 DELEGATION OF AUTHORITY

Authority to manage Sound Transit's investment program is derived from Resolution No. 85 which delegates responsibility for the agency's investment program to the Chief Financial Officer as required in RCW 81.112.120.

5.1 Management responsibility for the investment program is hereby delegated to the Chief Financial Officer who shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of subordinate officials and their procedures in the absence of the Chief Financial Officer.

5.2 The Chief Financial Officer will be responsible for delegating authority to Investment Officer(s) and defining their roles.

5.3 Daily operational responsibility for the investment program is hereby delegated to the Controller, who shall establish written procedures for the operation of the investment program consistent with the Investment Policy. Procedures should reference the following: safekeeping, banking contracts, repurchase agreements, wire transfer agreements, depository/custodial agreements, and glossary of investment terms. Procedures shall also include explicit delegation of authority to individuals responsible for investment transactions.

5.4 No one person may engage in an investment transaction except as provided under the terms of this policy and the procedures established by the Chief Financial Officer. The Chief Financial Officer shall be responsible for all transactions undertaken and shall establish a system of controls to regulate the activities of Investment Officer(s) and other employees involved in the accounting for investment activities.

6.0 ETHICS AND CONFLICTS OF INTEREST

It is the policy of Sound Transit to conduct investment transactions in accordance with the agency's Resolution No. 81, which details the Code of Ethics for Board Members, Officers, and Employees. Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or which could impair their ability to make impartial investment decisions. Employees and Investment Officer(s) shall disclose to the Chief Executive Officer and agency Finance Committee any material financial interests in financial institutions that conduct business with the agency, and they shall also disclose any large personal financial/investment positions that could be related to the performance of the agency.

7.0 AUTHORIZED FINANCIAL DEALERS & INSTITUTIONS

7.1 The Controller or their designee will maintain on file a current listing of financial institutions authorized and prepared by the Washington Public Deposit Protection Commission (PDPC) to provide depository services in the state of Washington. In addition, a list will also be maintained of approved security broker/dealers who maintain an office in the state of Washington. From this list, a minimum of four approved security broker/dealers will be selected by the agency to provide investment services in accordance with the evaluation criterion outlined in 7.1. These may include primary dealers, or regional dealers that qualify under Securities and Exchange Commission Rule 15C3-1 (uniform net capital rule) and investment departments of local banks.

Approved security broker/dealers will be selected based on the following criteria:

- financial condition, strength and capability to fulfill commitments,
- regulatory status of the dealer, and
- background and expertise of the individual representative

7.2 Prospective broker/dealers must provide the Controller with the following: National Association of Securities Dealers (NASD) certification, proof of Washington State registration, and written certification that the prospective broker/dealer understands and will adhere to this Investment Policy.

7.3 An annual review of the financial condition and registrations of the selected qualified financial institutions and broker/dealers will be conducted by the Controller. A current audited financial statement is required to be on file for each financial institution and broker/dealer in which the entity invests.

7.4 Sound Transit will strive to use a competitive bid process where its selected NASD broker/dealers will compete for investment transactions but it is recognized that this may not be appropriate for every investment decision.

7.5 Sound Transit reserves the right to remove any broker/dealer from the list of approved broker/dealers if services from them are lacking or if any broker/dealer fails to comply with documentation requirements.

8.0 AUTHORIZED AND SUITABLE INVESTMENTS

8.1 Care must be taken to ensure that the list of instruments includes only those allowed by law and those that local investment officer(s) are trained and competent to handle. Sound Transit is empowered by statute to invest in any of the securities identified as eligible investments as detailed in the Washington State Treasurer's publication titled "Eligible Investments for Public Funds."

Sound Transit chooses to invest in the following types of investments:

- Treasury Securities
- Federal Agency Securities (including mortgage-backed securities)
- Washington State Treasurer's Local Government Investment Pool
- King County Investment Pool
- Non-negotiable Certificates of Deposit
  (Must be with PDPC-qualified public depository)
- PDPC Financial Institution Sponsored Investment Accounts
- Banker Acceptances (Must be Al/P1)
- Repurchase Agreements
- Reverse Repurchase Agreements
- General Obligation Bonds of any state or local government
- Commercial Paper

8.2 Sound Transit may purchase new issue agency securities for a delayed settlement. These securities typically are issued at par and are available from most of the dealers in the new issue market. It will be at the Investment Officer’s discretion to wait to purchase these issues after they “break syndicate” (are “free to trade” at negotiable prices) allowing the agency to ask dealers to offer the securities at a market price that may differ from the initial offering price of par.

8.3 Repurchase agreements and reverse repurchase agreements are subject to the following limitations:

8.3.1 A signed Public Securities Association (PSA) Master Repurchase Agreement is required.

8.3.2 No security will be accepted for repurchase agreement transactions whose market value is not readily available.

8.3.3 Collateral will be required on Repurchase Agreements as described in Section 10.0 of this policy

8.3.4 Investment in reverse repurchase agreements must be approved by the Chief Financial Officer.

8.3.5 Proceeds from a reverse repurchase agreement will be limited to an investment which matures at approximately the same time as the reverse repurchase agreement.

8.4 General obligation bonds of a state or local government must have at the time of investment one of the three highest credit ratings of a nationally recognized statistical rating organization (NRSRO).

8.5 Commercial paper is subject to the following limitations:

8.5.1 Commercial paper must be rated with the highest short-term credit rating of any two NRSROs, at the time of purchase. If the commercial paper is rated by more than two NRSROs, it must have the highest rating from all of the organizations.

8.5.2 Commercial paper holdings may not have maturities exceeding 180 days.

8.5.3 Any commercial paper purchased with a maturity longer than 100 days must also have an underlying long-term credit rating at the time of purchase in one of the two highest rating categories of an NRSRO.

8.5.4 The percentage of commercial paper may not exceed 10 percent of the total assets of the portfolio.

8.5.5 Commercial paper must be purchased in the secondary market and not directly from the issuers.

8.6 Derivatives or securities that derive value and/or yield from an underlying asset or an external index are prohibited unless they fall into one of the following categories: zero coupon treasury instruments, zero coupon agency instruments, agency security obligations that have call features, agency security obligations that have step-up features at pre-determined intervals and agency obligations that float with interest rates or external indexes such as treasury bills, LIBOR, COFI, or the Fed Funds rate, and swap debt obligations only as they pertain to the asset liability management program.

8.6.1 Agency obligation inverse floaters are prohibited.

8.6.2 Derivative securities not previously utilized must be approved by the Chief Financial Officer.

8.7 Sound Transit will only invest in securities when the final maturity date is known at the time of purchase.

9.0 INVESTMENT POOLS

9.1 A thorough investigation of a prospective investment pool is required prior to investing and on a continual basis. Each prospective investment pool will be required to complete a questionnaire that will include information on the following topics:

- a description of eligible investment securities and a written statement of investment policies and objectives,
- a description of interest calculations and how they are distributed and how gains or losses are treated,
- a description of how investments are safeguarded, including the settlement processes, safekeeping of securities, participant parameters, and frequency of pricing, and how the program is audited,
- a schedule for receiving statements and investment listings,
- a fee schedule and when and how it is assessed, and
- whether the pool is eligible for the acceptance of bond proceeds and if it will accept such proceeds.

9.2 Eligible Investment Pools as listed in section 8.0 of this policy must report no less than quarterly a listing of portfolio holdings, average maturity, modified and effective duration and diversification by issuer. Audited annual financial reports must also be provided to Sound Transit.

10.0 COLLATERALIZATION

10.1 Collateral will be required on Repurchase Agreements, and will be limited to treasury, agency and money market securities. Collateral shall be delivered to Sound Transit's safekeeping agent, or through a tri-party arrangement in which the proper documents delineating the responsibilities of the parties have been executed. A clearly-marked evidence of ownership (safekeeping receipt) must be supplied to Sound Transit and retained.

10.2 Any required margin (the amount by which the market value of the securities collateralizing the transaction exceeds the transaction value) will be determined at the time of the transaction, as specified in the Master Repurchase Agreement. Such collateral shall be revalued on a periodic basis, but not less than quarterly, in order to maintain market protection.

11.0 SAFEKEEPING AND CUSTODY

All security transactions, including collateral for repurchase agreements, entered into by Sound Transit will be conducted on a delivery versus payment (DVP) basis. Securities will be held by a third-party custodian designated by the Controller and evidenced by safekeeping receipts with a written custodial agreement.

12.0 DIVERSIFICATION

Sound Transit will diversify its investments by security type, institution and maturity with the intention to minimize risk, as follows:

12.1 Investments with any single securities broker/dealer or financial institution will generally not exceed 50% of the total portfolio except for the Washington State Treasurer's Local Government Investment Pool (LGIP) which can be up to 100%.

12.2 Security limitations by type will follow these guidelines:

Treasury Securities	100%
Federal Agency Securities Individual issues may not exceed 25% of Security portfolio	50%
Washington State Treasurer's Local Government Investment Pool	100%
King County Investment Pool	50%
Non-negotiable Certificates of Deposit (must be with PDPC-qualified public depository)	10%
PDPC Financial Institution Sponsored Investment Accounts	50%
Banker Acceptances (must be A1/P1) Individual banks may not issue more than 50% of security portfolio	10%
Repurchase Agreements Individual banks may not issue more than 50% of security portfolio	25%
Reverse Repurchase Agreements Individual banks may not issue more than 50% of security portfolio	10%
General Obligation bonds of any state or local government	10%
Commercial Paper (must be A1/P1)	10%

13.0 MATURITY STRUCTURE

To the extent possible, Sound Transit will attempt to match its investments with anticipated cash flow requirements and Asset Liability Management objectives. Unless matched to a specific cash flow the agency will generally invest in securities maturing five years or less from the date of purchase. The average maturity of all securities owned should be no longer than three years.

13.1 Collateral for repurchase agreements using longer-dated investments may not exceed five years.

13.2 Reserve funds may be invested in securities exceeding five years if the maturity of such investments is made to coincide as nearly as practicable with the expected use of the funds.

14.0 INTERNAL CONTROL

The Controller shall establish an annual process of independent review by an external auditor. This review will examine internal controls over investment activities for compliance with policies and procedures.

15.0 PERFORMANCE STANDARDS

15.1 The investment portfolio shall be designed with the objective of obtaining a rate of return throughout budgetary and economic cycles, commensurate with the investment risk constraints and the cash flow needs.

15.2 Market Yield (Benchmark): Sound Transit generally follows an active investment strategy in that we monitor market conditions and position the portfolio in response to the current interest rate environment. Given this strategy, the basis used by the Controller in conjunction with the ALM strategy to determine whether market yields are being achieved shall be to identify a benchmark that is comparable to the related portfolio investment duration (for example if the duration of the portfolio is one year, the one-year Treasury yield would be an appropriate benchmark). The Controller shall periodically review portfolio duration and characteristics to ensure selected benchmarks are relevant and where necessary make appropriate changes.

16.0 REPORTING

The Controller will provide the Chief Financial Officer with monthly investment reports coordinated with ALM reporting. Quarterly reports will be provided to the agency's Finance Committee, or its subcommittee, the Audit and Reporting Subcommittee. The quarterly reports will include an executive summary, benchmark comparison, total return and duration analysis, market strategy overview, portfolio performance analysis, interest revenue year-to-date, market versus book analysis, and ongoing investment strategy guidelines.

17.0 INVESTMENT POLICY ADOPTION

Sound Transit's Investment Policy shall be adopted by resolution of the agency's Finance Committee. The policy shall be reviewed by the Chief Financial Officer annually and any significant modification thereto must be approved by the Finance Committee. The CFO is authorized to make any non-material updates to the policies, to keep policies consistent with organization changes and to keep policies consistent with state and federal law and best industry practice.

18.0 **GLOSSARY**

A glossary of investment terms is included as an appendix to these policies.

Central Puget Sound Regional Transit Authority

Asset Liability Management
Debt Management Policy

III. DEBT MANAGEMENT POLICY

1.0 POLICY

It is the policy of Sound Transit to manage its debt obligations to minimize its net debt service payments consistent with credit objectives, all disclosure and regulatory requirements and highest standard of fiduciary management of public funds.

2.0 SCOPE

This Policy applies to all debt issued by the Sound Transit, including debt guaranteed by Sound Transit. Updated debt policies can be an important tool to ensure the use of Sound Transit's resources to meet its commitments under *Sound Move* and to maintain sound financial management practices. In addition to periodic updating, Sound Transit recognizes that changes in the capital markets and other unforeseen circumstances may warrant modifications to the Policy to maintain consistency with *Sound Move*. Therefore, this Policy is a guideline for general use, and may allow for exceptions in extraordinary conditions.

3.0 OBJECTIVES

The primary objectives of debt policies are to:

- maintain on-going access to the capital markets to facilitate delivery of the *Sound Move* program;
- minimize Sound Transit's debt service within prudent risk parameters;
- retain the highest practical credit rating consistent with appropriate operating flexibility;
- ensure timely repayment of principal and interest on debt;
- comply with State and Federal laws and regulations governing the issuance of debt and provisions governing bond documents; and
- maintain full and complete financial disclosure and reporting.

4.0 CREDIT OBJECTIVES

4.1 Objectives

Sound Transit seeks to maintain the highest possible credit ratings for all categories of short- and long-term debt that can be achieved without compromising delivery of basic Sound Transit services and achievement of adopted Sound Transit policy objectives. Sound Transit recognizes that there may be situations where it is appropriate to seek or accept less than the highest rating in order to preserve financing flexibility or capacity.

4.2 Credit Standards

Sound Transit recognizes that external economic, natural, or other events may, from time to time, affect the credit-worthiness of its debt. Nevertheless, the Board is committed to ensuring that actions within their control are prudent and consistent with the highest standards of public financial management, and supportive of the credit-worthiness objectives defined herein.

4.3 Communications

Sound Transit will maintain communication with rating agencies, including periodic conference calls and/or meetings. Sound Transit will also respond to inquiries from investors.

5.0 FINANCIAL DISCLOSURE

Sound Transit is committed to full and complete financial disclosure, and to cooperating fully with rating agencies, institutional and individual investors, other governmental entities and the general public to share clear, comprehensible, and accurate financial information. Sound Transit is committed to meeting secondary disclosure requirements on a timely and comprehensive basis.

Official statements accompanying debt issues, Annual Financial Reports, and continuous disclosure statements will meet (at a minimum) the standards articulated by the Municipal Securities Rulemaking Board (MSRB), the Government Accounting Standards Board (GASB), the National Federation of Municipal Analysts, the Securities and Exchange Commission (SEC), and Generally Accepted Accounting Principles (GAAP). The Department of Finance and Information Technology shall be responsible for ongoing disclosure to established national information repositories and for maintaining compliance with disclosure standards promulgated by state and national regulatory bodies.

6.0 CAPITAL PLANNING

To enhance creditworthiness and prudent financial management, Sound Transit is committed to systematic capital planning, intergovernmental cooperation and coordination, and long-term financial planning. Evidence of this commitment to systematic capital planning will be demonstrated through the annual adoption of a six-year capital plan.

7.0 DEBT LIMITS

Sound Transit will keep outstanding debt within the limits prescribed by State statute and at levels consistent with its creditworthiness objectives. Sound Transit shall maintain debt service coverage ratios consistent with the provisions of Sound Move and governing bond covenants.

8.0 PURPOSES AND USES OF DEBT

8.1 Capital Financing and Use of Debt

Sound Transit will rely on internally generated funds and/or grants and contributions from other governments in addition to debt to finance its capital needs. Sound Transit will consider all other financing alternatives or funding sources for capital projects, including non-debt financing. Debt may be issued to finance capital projects when it is cost-effective and fiscally prudent. Factors to be considered in determining the appropriateness of debt include: the scope, requirements and timing of the budget and capital plan, current and projected interest rate environment, and the relationship between Sound Transit assets and liabilities. Sound Transit recognizes that capital investments have long-term benefits and as such debt can be an appropriate mechanism to allocate costs over a longer beneficiary timeframe.

8.2 Asset Life

Sound Transit will consider long-term financing for the acquisition, maintenance, replacement, or expansion of physical assets (including land) with a useful life of at least five years. Debt will be issued only to finance capital projects and equipment, except in case of emergency. Sound Transit debt will not be issued for periods exceeding the estimated useful life of the project or projects to be financed.

9.0 DEBT GUARANTEES

Sound Transit may consider, on a case-by-case basis, the use of its debt capacity, as legally allowable, for borrowing related to capital projects by public development authorities or other special purpose units of government, so long as the purpose of the financing is consistent with *Sound Move* and that the structure of the financing is consistent with this Policy.

10.0 DEBT COVERAGE

Consistent with *Sound Move* financial policies, the debt service coverage ratio for financial planning purposes will be set at an average coverage ratio of 2.0x for net revenues over annual debt service costs, not to fall below 1.3x in any single year.

11.0 DEBT STANDARDS AND STRUCTURE

11.1 Length of Debt

Debt will be structured for a period consistent with 1) a fair allocation of costs to current and future beneficiaries or users, 2) projected repayment sources, 3) current and projected interest rate environment, and 4) estimated life of assets being financed.

11.2 Debt Structure

Debt will be structured to achieve the lowest possible net cost to Sound Transit given market conditions, the timing of the capital project, the nature and type of security provided, and the repayment of its overall debt to reflect the projected sources of debt service payments.

11.3 Variable Rate Debt

Sound Transit may issue securities that pay a rate of interest that varies according to a pre-determined formula or results from a periodic remarketing of the securities, consistent with state law and covenants of pre-existing bonds, and depending on market conditions. The amount of unhedged variable rate debt will generally not exceed 25% of total outstanding debt.

11.4 Subordinate Lien Debt

Sound Transit shall issue second lien or other subordinate debt only if it is financially beneficial to Sound Transit, legally required or consistent with credit-worthiness objectives. Examples of the use of subordinate lien debt include achieving a goal of minimizing cost or maximizing capacity.

12.0 DERIVATIVES

Sound Transit may utilize derivative products on a case by case basis consistent with state statute and financial prudence if their use lowers net debt service costs or provides other financial or strategic value. Risks inherent in any derivative transaction must be identified and understood. Such risks may include but are not limited to interest rate risk, counterparty risk, termination risk, tax change risk, and basis risk.

13.0 REFUNDINGS

Periodic reviews of all outstanding debt will be undertaken to determine refunding opportunities. Refunding will be considered (within federal tax law constraints) if and when there is a net economic benefit of the refunding, given total agency financial objectives, or the refunding is essential in order to modernize covenants essential to operations and management.

14.0 LEASE FINANCING

Lease obligations may also be considered as appropriate for financing capital. Lease financing should be considered when determined to be more beneficial, either economically or from a policy perspective. Factors to be considered and evaluated include: the useful life of the capital, the terms and conditions of the lease, market convention, and the impact on debt capacity and budget flexibility.

15.0 CREDIT ENHANCEMENTS

Credit enhancement (letters of credit, bond insurance, etc.) may be used when net present value of debt service on the bonds is reduced by more than the costs of the enhancement or when it is required to gain access to the market (i.e. variable rate obligations).

16.0 OTHER FINANCING FACILITIES

The Department of Finance and Information Technology shall, if appropriate, establish and maintain a financing facility that will allow for borrowing on short notice, either in the form of short-term notes or commercial paper, for amounts otherwise not feasible to finance through long term debt. This facility could also be used as an interim financing mechanism when cost effective. Examples of other financing facilities are listed below:

- Commercial Paper: Commercial paper is a cash management tool which can be utilized to provide interim funding for capital expenditures that will ultimately be funded from another source such as a grant or long-term bond.
- Bond and Revenue Anticipation Notes: Borrowing for cash flow purposes through the use of bond or revenue anticipation notes may be used to bridge temporary cash flow deficits or to provide interim financing for capital projects.
- Grant Anticipation Notes: Grant Anticipation Notes to be repaid with the proceeds of State or Federal grants if appropriate for the project and in the best interests of Sound Transit.

17.0 **DEBT ADMINISTRATION AND PROCESS**

The following apply to all Sound Transit debt issuance:

17.1 Agency Debt: No Sound Transit Department or subdivision shall incur debt without proper application of these policies and Board authorization.

17.2 Bond Sales: After obtaining approval by the Board, the requesting Department shall, in conjunction with Sound Transit's Bond Counsel, General Counsel and Department of Finance and Information Technology, produce appropriate resolution(s) for consideration by the Sound Transit Board.

17.3 Investment of Bond Proceeds: Bond proceeds shall generally be invested as part of Sound Transit's consolidated cash pool, unless otherwise specified by the bond legislation or by the lead Department or project manager and approved by the Chief Financial Officer. Investments will be consistent with those authorized by existing state law and by Sound Transit's Investment Policy.

17.4 Debt Service Reserve Fund: Sound Transit will maintain debt service reserve fund for long term debt issuances consistent with bond covenants, market practice, and government regulations. Sound Transit may consider bond insurance or a letter of credit in lieu of providing a debt service reserve fund generated from bond proceeds if such mechanism can be provided at the same or lower cost.

17.5 Costs and Fees: All costs and fees related to issuance of bonds will be paid out of bond proceeds.

17.6 Method of Sale: Sound Transit will issue its debt utilizing the method of sale that is expected to achieve the lowest cost of debt consistent with the Debt Policy objectives, taking into account both short-range and long-range impacts. The CFO and Financial Advisor will advise the Sound Transit Board as to the most appropriate method of sale in light of the prevailing financial, market and transaction-specific conditions.

17.7 Bond Counsel: Sound Transit will retain external Bond Counsel for all debt issues. All debt issued by Sound Transit will include a written opinion by Bond Counsel affirming that Sound Transit is authorized to issue the debt, stating that Sound Transit has met all state constitutional and statutory requirements necessary for issuance, and determining the federal income tax status. Bond Counsel will be selected for a term of up to three year initial contract through a competitive process administered by Sound Transit's Department of Finance and Information Technology. The selection process will require comprehensive municipal debt experience and significant minority and women business participation.

17.8 Underwriter's Counsel: Sound Transit payments for underwriter's counsel will be authorized for negotiated sales by the Department of Finance and Information Technology on a case by case basis depending on the nature and complexity of the transaction and the needs expressed by the underwriters.

17.9 Financial Advisor(s): Sound Transit will retain an external financial advisor(s), to be selected for an initial term of up to three years, through a competitive process administered by Sound Transit's Department of Finance and Information Technology. The utilization of the financial advisor for particular bond sales will be at the discretion of the Department of Finance and Information Technology on a case by case basis and pursuant to the financial advisory services contract. The selection process for financial advisors will require comprehensive municipal debt experience, experience with diverse financial structuring requirements and pricing of municipal securities, and significant minority and women business participation. For each Sound Transit bond sale, the financial advisor will provide Sound Transit with information on pricing and underwriting fees for comparable sales by other issuers.

17.10 Underwriters: Underwriters will be selected through a competitive process and will be required to demonstrate sufficient capitalization and experience related to debt issuance and significant minority and women participation within their firms.

17.11 W/MDBE Participation: For all negotiated sales, unless extraordinary circumstances prevail, underwriting teams will include an appropriate level of participation by women and minority owned enterprises (W/MBE). Sound Transit shall encourage W/MBEs to submit their credentials to serve as lead manager. Sound Transit also shall encourage underwriters to include W/MBE participation in syndicates for competitive sales.

17.12 Fiscal Agents: The Department of Finance and Information Technology will utilize a fiscal agent on all Sound Transit indebtedness. Fiscal agent fees for outstanding bonds will be paid as specified by the Chief Financial Officer.

17.13 Compensation for Services: Compensation for Bond Counsel, underwriter's counsel, financial advisors, and other financial services will be as low as possible, given desired qualification levels, and consistent with industry standards.

17.14 RFP Process: The Chief Financial Officer shall make all final determinations of selection of Bond Counsel, financial advisors and underwriters. The determination will be made following an independent review of competitive bids or responses to requests for proposals (RFPs) and/or requests for qualifications (RFQs). The bids, RFPs, and RFQs will be reviewed by at least three Sound Transit financial professionals. All underwriter bids will also be reviewed by the Sound Transit's financial advisors.

17.15 Other Service Providers: The Chief Financial Officer shall have Sound Transit periodically select other service providers (e.g., escrow agents, verification agents, trustees, arbitrage consultants, etc.) as necessary to meet legal requirements and minimize net Sound Transit debt costs. These services can include debt restructuring services and security or escrow purchases. The Chief Financial Officer may select firm(s) to provide such financial services related to debt without a RFP or RFQ, consistent with Sound Transit and State legal requirements.

17.16 Arbitrage Compliance: The Department of Finance and Information Technology shall maintain a system of record keeping and reporting to meet the arbitrage rebate compliance requirements of federal tax code.

17.17 Financing Proposals: Any capital financing proposal to a Sound Transit Division, Agency or extension of Sound Transit's credit through sale of securities, execution of loans or leases, marketing guarantees, or otherwise involving directly or indirectly the lending or pledging of Sound Transit's credit, shall be referred to the Department of Finance and Information Technology for review.

Central Puget Sound Regional Transit Authority

Asset Liability Management
Swap Policy

IV. SWAP POLICY

1.0 PURPOSE

The purpose of Sound Transit's Swap Policy is to establish guidelines for the use and management of interest rate management agreements. The Policy is prepared in accordance with the adopted 2003 practices of the Government Finance Officers Association.

2.0 POLICY

It is the policy of Sound Transit to, on a case-by-base basis, utilize interest rate management agreements to reduce the amount or duration of its exposure to changes in interest rates or lower net costs of borrowing with respect to related obligations, consistent with all legal authority, highest fiduciary standards and the agency's ALM policy objectives.

3.0 SCOPE

This policy applies to all of the agency's interest rate management agreements, including, but not limited to, interest rate swaps, swaptions, rate locks, caps, collars and floors (collectively "Swaps" or "Agreements") incurred in connection with the incurrence of debt obligations (whether or not previously issued or to be issued) as authorized by the Board's ALM Policy.

4.0 OBJECTIVES

The purpose of the Interest Rate Swap Policy ("Policy") is to establish guidelines for the use and management of all interest rate management agreements. The Policy sets forth the manner of execution of Swaps and Agreements, provides for security and payment provisions, risk considerations and certain other relevant provisions. The failure by the Sound Transit to comply with any provision of this Policy shall not invalidate or impair any Swap or Agreement.

5.0 SCOPE AND AUTHORITY

Sound Transit is authorized to enter into payment agreements under R.C.W. 39.96.

The Chief Financial Officer is the designated administrator of Sound Transit's Swap Policy and shall have the day-to-day responsibility and authority for structuring, implementing, and managing interest rate swaps. The Sound Transit Board (the "Board") shall authorize all swap transactions and documents or delegate execution of documents as appropriate.

6.0 USE OF SWAP PRODUCTS

Sound Transit will consider the use of swap in connection with the issuance of debt obligations and consistent with the overall Asset Liability Management (ALM) as a means of reducing exposure to interest rate fluctuations and/or lower net borrowing costs. Additionally, Sound Transit will strive to only use swap after an analysis of the economic benefit of the interest rate swap market in relation to traditional financing methods has been undertaken and indicates a significant financial economic benefit without excessive or unacceptable levels of additional risk.

Swaps will not be used for speculation – taking additional risks unrelated to Sound Transit's business in an effort to increase returns.

Sound Transit will comply with prevailing state law regarding the use of swap as well as certain disclosure requirements as specified by the Governmental Accounting Standard Board ("GASB"). The GASB recently issued GASB Technical Bulletin No. 2003-1 in June 2003 that requires a governmental entity to provide additional disclosure of derivatives not reported at fair value on the statement of net assets.

7.0 CONDITIONS FOR THE USE OF INTEREST RATE SWAPS

7.1 Maximum Notional Amount

The CFO will recommend to the Board a limit the total notional amount of outstanding interest rate swaps based on criteria set forth in this Policy regarding the proper management of risks and calculation of likely maximum termination exposure.

7.2 Call Option Value Considerations

When considering the relative advantage of an interest rate swap versus fixed rate bonds, the CFO will take into consideration the value of any call option on fixed rate bonds.

7.3 Financial Advisory Opinion

On or prior to the date of execution of any swap agreement, Sound Transit shall obtain a written certification from an independent financial advisor meeting the requirements of RCW 39.96.030 and certifying that (i) the terms and conditions of the payment agreement and any ancillary agreements, including without limitation, the interest rate or rates and any other amounts payable thereunder, are commercially reasonable in light of then existing market conditions; and (ii) the finding and determination contained for purposes of entering into the swap are reasonable and consistent with R.C.W. 39.96 2.030.

8.0 INTEREST RATE SWAP FEATURES

8.1 Interest Rate Swap Agreement

Sound Transit will use terms and conditions as set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement with modifications as appropriate to enhance the security and position of Sound Transit. The swap agreement between Sound Transit and each counterparty shall include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as the agency deems necessary or desirable.

Subject to the provisions contained herein, the terms of any agency swap agreement shall use the following guidelines:

- Any provision triggering termination upon a downgrade of Sound Transit's rating shall not be higher than BBB rating category.
- To the extent not inconsistent with Chapter 39.96 RCW, preference will be given for language that provides that governing law for swaps will be the State of New York, except that the capacity, power or authority of Sound Transit to enter into the Swap and any transaction thereunder shall be governed by and construed in accordance with the laws of the State of Washington. Issues relating to jurisdiction, venue, waiver of jury trial and sovereign immunity will be subject to prevailing law. Preference will be given to language

providing that the counterparty will consent to jurisdiction in the Washington courts with respect to enforcement of the Agreement.

- Collateral thresholds for the swap provider should be set on a sliding scale reflective of credit ratings. Collateral requirements should be established and based upon the credit ratings of the swap provider, credit support provider or guarantor and in compliance with RCW 39.96. These requirements must be consistent with 8.2.2 below.
- Eligible collateral should generally be limited to Treasuries and obligations of Federal Agencies where the principal and interest are guaranteed by the United States
- Sound Transit shall have the right to optionally terminate a swap agreement at “market,” at any time over the term of the agreement.
- Termination value should be set by a “market quotation” methodology, unless the agency deems an alternate appropriate.

8.2 Interest Rate Swap Counterparties

8.2.1 Credit Criteria

Counterparties to a swap agreement must have a rating from at least two nationally recognized credit rating agencies, as of the date of execution of the agreement, that is within the two highest long-term investment grade rating categories without regard to subcategories, or the payment obligations of the party under the agreement are unconditionally guaranteed by an entity that then has the required rating; or

Counterparties to a swap agreement must have a rating from at least two nationally recognized credit rating agencies, as of the date of execution of the agreement, that is within the three highest long-term investment grade rating categories without regard to subcategories, or the payment obligations of the party under the agreement are unconditionally guaranteed by an entity that then has the required rating and;

The payment obligation of the other party under the agreement are collateralized by direct obligations of, or obligations the principal and interest on which are guaranteed by, the United States of America, that (a) are deposited with Sound Transit or an agent of Sound Transit ; and (b) maintain a market value of not less than one hundred two percent of the net market value of the payment agreement to the governmental entity, as such net market value may be defined and determined from time to time under the terms of the payment agreement. In addition to the rating criteria specified herein, Sound Transit may seek additional credit enhancement and safeguards in the form of:

- Collateral consistent with the policies contained herein; and/or
- Ratings downgrade triggers for termination;

8.2.2 Counterparty Termination Exposure

In order to diversify the agency’s counterparty credit risk, and to limit Sound Transit‘s credit exposure to any one counterparty, Sound Transit will evaluate and determine its exposure to the proposed counterparty or counterparties. The exposure should be measured in terms of notional amount, mark to market valuation and volatility.

Sound Transit will measure exposure to a given counter party by mark-to-market exposure and credit rating. Sound Transit in consultation with its Bond Counsel and Swap Advisor, shall evaluate appropriate strategies to mitigate this exposure.

Maximum Net Termination Exposure will be based on the sum of

(i) the market value of existing transactions as of the last day of the month prior to the execution of any new transaction, plus

(ii) the expected worst-case termination value of the new transaction.

For purposes of this calculation, Sound Transit shall include all existing and projected transactions of an individual counterparty and all transactions will be analyzed in aggregate such that the maximum exposure will be additive and netted.

The maximum termination exposure shall be evaluated in relation to the credit rating of a counterparty and whether or not the counterparty has posted collateral against this exposure. For existing transactions, exposure shall be based on the market value as of the last day of the month prior to the execution of any new or proposed transaction. For a new or proposed transaction, maximum exposure will be calculated using an appropriate interest rates index assuming two standard deviations from the sample mean over the last ten years.

The exposure thresholds shall be reviewed periodically to ensure that the thresholds are appropriate. Net Termination exposure will be included in regular reporting as defined in section 12.1. If a counterparty has more than one rating, the lowest rating will govern for purposes of calculating the level of exposure.

8.3 Term and Notional Amount

The notional amount of a swap will not exceed the principal amount of the obligation with respect to which the swap or payment agreement is made. The term of a payment agreement will not exceed the final term of the obligation with respect to which the payment agreement is made.

8.4 Collateral Requirements

All Sound Transit payment agreements shall provide that if a counterparty (or a guarantor to the counterparty) to the agreements falls below the two highest long-term investment grade rating categories without regard to subcategories, the party will under the agreement collateralized the payment obligations by direct obligations of, or obligations the principal and interest on which are guaranteed by, the United States of America, that (a) are deposited with Sound Transit or an agent of Sound Transit and (b) maintain a market value of not less than one hundred two percent of the net market value of the payment agreement to Sound Transit, as such net market value may be defined and determined from time to time under the terms of the payment agreement.

8.5 Security and Source of Repayment

Sound Transit may use the same security and source of repayment (pledged revenues) for interest rate swaps as is used for the bonds that are related to the swap, if any, but shall consider the economic costs and benefits the agency's regularly schedule payments, particularly termination payment under the swap. The agency shall consult with Bond Counsel regarding the legal requirements associated with making the regularly scheduled or termination payments under the Swap on a parity or non-parity basis with outstanding agency debt.

9.0 <u>COUNTERPARTY SELECTION</u>

Sound Transit may use a competitive or a negotiated process to select a swap counterparty and price a swap as it believes business, market or competitive conditions justify such a process, so long as it gives due consideration to proposals from at least two entities. The conditions under which a negotiated selection is best used are provided below.

- Marketing of the swap will require complex explanations about the security for repayment or credit quality
- Demand is weak among swap counterparties
- Market timing is important, such as for refundings
- Coordination of multiple components of the financing is required
- The swap has non-standard features, such as a forward starting swap
- Bond insurance is not available or not offered
- The par amount for the transaction is significantly larger than normal
- Counterparties are likely to demand individual changes in bid documents

10.0 PROHIBITED AGREEMENTS

The Board will not use Agreements that:

- are speculative or create extraordinary leverage as risk;
- lack adequate liquidity to terminate without incurring a significant bid/ask spread; and/or
- provide insufficient price transparency to allow reasonable valuation.

11.0 EVALUATION METHODOLOGY

Prior to Board authorization of a swap transaction, the CFO, the agency's Swap Advisor and Bond Counsel will provide a summary of the risks and benefits of the transactions. As a part of this review, Sound Transit shall compute the Maximum Net Termination Exposure to the proposed swap counterparty. The report will include an evaluation of the following risks and the application of mitigation strategies.

- **Basis risk** is the mismatch between actual variable rate debt service and variable rate indices used to determine swap payments. This risk can be managed through index selection and/or the creation of an interest rate reserve fund or conservative budgeting strategies.
- **Tax risk** is created by potential tax events that could affect swap payments, such as changes in the tax-exempt of interest on Sound Transit debt specifically or municipal tax-exempt debt generally.
- **Counterparty risk** is the potential failure of the counterparty to make required payments under the agreements. This risk can be mitigated through the establishment of exposure limits, ratings thresholds, and collateralization requirements.
- **Termination risk** is the potential for termination of the agreements by the counterparty due to market and other factors. Sound Transit can consider purchasing swap insurance.
- **Amortization risk** is created when there is a mismatch of bond and swap amortization schedules. This risk can be eliminated when swap amortization schedules are built to match the underlying bond amortization.
- **Rollover risk** is the mismatch of the maturity of the swap and the maturity of the underlying bonds, potentially leaving Sound Transit unable to replace the swap on as favorable terms as the original agreement. This risk can be eliminated by making the swap coterminous with the bonds.
- **Market access risk** is the risk that Sound Transit will be unable to access the underlying debt market in the future as may have been assumed when executing some forms of swaps (such as forward swaps). This risk can be mitigated by prudent financial management and potential use of forward bond and swap insurance.

- **Liquidity/Remarketing risk** is the risk that Sound Transit could not secure a cost-effective renewal of a Letter or Line of Credit or suffers a failed auction or remarketing on variable rate bonds that underlying a floating-to-fixed rate swap. A general mitigation technique is the prudent management of financial resources and bank credit facilities.
- **Credit risk** is the occurrence of an event that impacts the credit rating of the issuer or its counterparty. This can be mitigated through minimizing cross defaults, the use of swap insurance, and favorable terms for credit event triggers in the swap documents.
- **Operational risk** is the potential for mismanagement of an outstanding swap obligation for failure to monitor and respond to price changes, interest rate changes, and proper accounting and budgetary treatment. This risk can be mitigated by thorough swap policies and strong reporting to the Board.

12.0 MANAGING INTEREST RATE SWAP RISKS

12.1 Reporting

The CFO will evaluate the risks associated with outstanding interest rate swaps on an ongoing basis at least annually and provide a written report to the Board of the findings. The report will include:

- a description of all outstanding swaps, including notional amount, average life and current termination values;
- the debt service requirements for each swap, versus the projected debt service on the swap transaction; and for any swaps used as part of a refunding, the actual cumulative savings versus the projected savings at the time the swap was executed;
- the credit rating of each swap counterparty, parent, guarantor and credit enhancer insuring swap payments, if any;
- an actual collateral posting by swap counterparty, if any, per swap agreement and in total by swap counterparty;
- information concerning any material event involving outstanding swap agreements, including a default by a swap counterparty, counterparty downgrade or termination;
- an updated contingency plan to replace, or fund a termination payment in the event an outstanding swap is terminated;
- the status of any liquidity support used in connection with interest rate swaps, including the remaining term and current fee.

12.2 Active Management

Sound Transit will seek to maximize the benefits it accrues and minimize the risks it bears by actively managing its swap program. This will entail continuous monitoring of market conditions in conjunction with the swap counterparty and Sound Transit's Financial Advisors for emergent opportunities or risks. Active management may entail modification of existing transactions, including:

- early termination of an agreement;
- shortening or lengthening the term of an agreement;
- sale or purchase of options; and
- application of basis swaps.

13.0 <u>TERMINATING INTEREST RATE SWAPS</u>

13.1 Optional Termination

The Board, in consultation with its Financial Advisor, Swap Advisor and Bond Counsel, may terminate a swap if it is determined that it is financially advantageous and/or is otherwise inconsistent with this Swap policy.

13.2 Mandatory Termination

In the event a swap is terminated as a result of a termination event, such as a default or a decrease in credit rating of the counterparty, the Board will evaluate whether it is financially advantageous to obtain a replacement swap, or, depending on market value, make or receive a termination payment.

14.0 <u>FINANCIAL DISCLOSURE</u>

Sound Transit will ensure that there is full and complete disclosure of all interest rate swaps to rating agencies, and in disclosure documents. Disclosure in marketing documents, including Bond offering documents, shall provide a clear summary of the special risks involved with swaps and any potential exposure to interest rate volatility or unusually large and rapid changes in market value as well as the potential impact of termination payments.

V. GLOSSARY OF TERMS

Accrued Interest – (1) The dollar amount of interest accrued on an issue, based on the stated interest rate on that issue, from its issue date to the date of delivery to the original purchaser. This is usually paid by the original purchaser to the issuer as part of the purchase price of the issue;
(2) Interest deemed to be earned on a security but not yet paid to the investor.

Agency Security Obligations – U.S. Government issued security that was not issued by the Treasury Department. These issues include: Federal Home Loan Bank Bonds (FHLB), Federal National Mortgage Association (FNMA), Federal Farm Credit Bank (FFCB), Federal Home Loan Mortgage Corporation (Freddie Mac), and Student Loan Marketing Association (Sallie Mae).

ALM Management: Integrates Sound Transit's current assets and its liabilities for purposes of financial decision making.

Amortization – Liquidation of a debt through installment payments.

Arbitrage – the difference between interest earned on funds borrowed at a lower tax-exempt rate and interest on funds that are invested at a higher-yielding taxable rate. Under the Tax Reform Act of 1986, with very few exceptions, arbitrage earnings must be rebated back to the federal government.

Ask Price – Price being sought for the security by the seller. Also called the offer.

Asset/Liability Matching – Matching the term and amount of assets and liabilities in order to mitigate the impact of changes in interest rates.

Average Maturity – A weighted average of the expiration dates for a portfolio of debt securities. An income funds volatility can be managed by shortening or lengthening the average maturity of its portfolio.

Bank Wire – A virtually instantaneous electronic transfer of funds between two financial institutions.

Bankers Acceptance (BAs) – Bankers Acceptances generally are created based on a letter of credit used in a foreign trade transaction. They are used to finance the shipment of commodities between countries as well as the shipment of some specific goods within the United States. BAs are short-term, non-interest-bearing notes sold at a discount and redeemed by the accepting bank at maturity for full face value. These notes trade at a rate equal to or slightly higher than Certificates of Deposit (CDs), depending on market supply and demand. Bankers Acceptances are sold in amounts that vary from $100,000 to $1,000,000 or more with maturities ranging from 30 to 270 days. They offer liquidity to the investor, as it is possible to sell BAs prior to maturity at the current market price.

Basis Point – The smallest measure used in quoting yields on bonds and notes. One basis point is 0.01% of yield. For example, a bond's yield that changed from 3.50% to 3.00% would be said to have moved 50 basis points.

Benchmark – A bond whose terms are used for comparison with other bonds of similar maturity. The global financial market typically looks to U.S Treasury securities as benchmarks.

Bid – Price at which a buyer is willing to purchase a security.

Bid/Ask Spread – The difference between the bid price (at which a market maker is willing to buy) and the ask price (at which a market maker is willing to sell).

Bill – A short-term direct obligation of the U.S. Treasury that has a maturity of not more than one year (for example, 13-, 26- or 52-week maturity).

Bond – (1) The written evidence of debt, bearing a stated rate or stated rates of interest, or stating a formula for determining that rate, and maturing on a certain date, on which date and upon presentation a fixed sum of money plus interest is payable to the holder or owner. A municipal bond issue is usually comprised of many bonds that mature over a period of years; (2) Long-term securities with a maturity of greater than one year.

Bond Swap – The sale of a bond and the purchase of another bond of similar market value. Swaps generally are done in order to establish a tax loss, upgrade credit quality, or to extend or shorten duration.

Book Entry – U.S. Government and federal agency securities that do not exist in definitive (paper) form; they exist only in computerized files maintained by the Federal Reserve Bank.

Book Value – The amount at which an asset is carried on the books of the owner. The book value of an asset does not necessarily have a significant relationship to the market value of the security.

Bullet – A security with a fixed maturity and no call feature.

Call Protection – Bonds that are not callable for a defined period of time before their call date.

Call Risk – The risk that declining interest rates may accelerate the redemption of a callable security, causing an investor's principal to be returned sooner than expected. As a consequence, investors may have to reinvest their principal at a lower rate of interest.

Call Option – The right to buy an underlying asset (e.g., a municipal bond) after a certain date and at a certain price. A call option is frequently embedded in a municipal bond, giving the issuer the right to buy, or redeem, the bonds at a certain price.

Callable – A bond that is subject to payment of the principal amount (and accrued interest) prior to the stated maturity date, with or without payment of a call premium. Bonds can be callable under a number of different circumstances, including at the option of the issuer, or on a mandatory or extraordinary basis.

Certificates of Deposit (CDs) – Certificates issued against funds deposited in a bank for a definite period of time and earning a specified rate of return. Certificates of Deposit bear rates of interest in line with money market rates current at the time of issuance.

Collateral – Assets pledged to secure an obligation. The assets are potentially subject to seizure in the event of default.

Collateralized Mortgage Obligation – A derivative security created by dividing the cash flows of a pool of mortgages into obligations having different maturities than the mortgages. CMOs present certain risks because of the relationship between interest rates and mortgage prepayments. When interest rates fall, more mortgages are paid off, impacting the cash flows of CMOs and overall return.

Competitive Quote Process – A process by which two or more institutions are contacted to obtain prices for specific securities.

Convexity – A measure of the change in a security's duration with respect to changes in interest rates. The more convex a security is, the more its duration will change with interest rate changes.

Coupon – The rate of interest payable annually. Where the coupon is blank, it may indicate that the bond is a "zero-coupon," or a new issue where the coupon has yet to be determined, or that it is a variable-rate bond.

Credit Risk – the risk that another party to an investment transaction will not fulfill its obligations. Credit risk can be associated with the issuer of a security, a financial institution holding the entity's deposit, or a third party holding securities or collateral. Credit risk exposure can be affected by a concentration of deposits or investments in any one investment type with any one party.

Credit Spread – A yield difference, typically in relation to a comparable U.S. Treasury security, that reflects the issuer's credit quality. Credit spread also refers to the difference between the value of two securities with similar interest rates and maturities when one is sold at a higher price than the other is purchased.

Current Yield – The ratio of interest to the actual market price of the bond, stated as a percentage. For example, a bond with a current market price of $1,000 that pays $60 per year in interest would have a current yield of 6%.

CUSIP – The Committee on Uniform Security Identification Procedures, which was established under the auspices of the American Bankers Association to develop a uniform method of identifying municipal, U.S. government, and corporate securities. CUSIP numbers are unique nine-digit numbers assigned to each series of securities.

Custodian – An independent third party (usually a bank or trust company) that holds securities in safekeeping as an agent for the entity which purchases investments.

Debenture – An unsecured debt obligation, issued against the general credit of a corporation, rather than against a specific asset.

Defeasance – Termination of the rights and interests of the trustee and bondholders under a trust agreement or indenture upon final payment or provision for payment of all debt service and premiums, and other costs, as specifically provided for in the trust instrument.

Delivery – The providing of a security in an acceptable form to the entity or to an agent acting on behalf of the entity and independent of the seller. Acceptable forms can be physical securities or the transfer of book-entry securities. The important distinction is that the transfer accomplishes absolute ownership control by the purchasing entity.

Delivery vs. Payment – There are two methods of delivery of securities: delivery vs. payment and delivery vs. receipt (also called free). Delivery vs. payment is delivery of securities with an exchange of money for the securities. Delivery vs. receipt is delivery of securities with an exchange or a signed receipt for the securities.

Depository Bank – A local bank used as the point of deposit for cash receipts.

Depository Insurance – Insurance on deposits with financial institutions. For purposes of this policy statement, depository insurance includes: a) Federal depository insurance funds, such as those maintained by the Federal Deposit Insurance Corporation (FDIC) and Federal Savings and Loan Insurance Corporation (FSLIC); and b) the Washington State Public Deposit Protection Commission (PDPC).

Derivative – A financial instrument whose value is based on, and determined by, another security or benchmark.

Discount – (1) Amount (stated in dollars or a percent) by which the selling or purchase price of a security is less than its face amount; (2) Amount by which the amount bid for an issue is less than the aggregate principal amount of that issue.

Discount Note – Short-term obligations issued at a discount from face value, with maturities ranging from overnight to 360 days. They have no periodic interest payments; the investor receives the note's face value at maturity.

Discount Rate **– The rate the Federal Reserve charges on loans to member banks.**

Diversification – The division of available funds among a variety of securities and institutions so as to minimize market risk.

Downgrade – A negative change in credit ratings.

Duration – The weighted maturity of a fixed-income investment's cash flows, used in the estimation of the price sensitivity of fixed-income securities for a given change in interest rates.

Effective Rate – The yield received on a debt security over a period of time taking into account any compounding effect.

Embedded Option – A provision within a bond giving either the issuer or the bondholder an option to take some action against the other party. The most common embedded option is a call option, giving the issuer the right to call, or retire, the debt before the scheduled maturity date.

Event Risk – The risk that an issuer's ability to make principal and interest payments changes dramatically and unexpectedly because of unanticipated factors, such as a corporate restructuring, a regulatory change or a natural disaster.

Face Value – The par value (i.e., principal, or maturity, value) of a security appearing on the face of the instrument; thus, the redemption value at maturity.

Federal Agency Securities – Federal agency securities can be classified by the type of issuer: those issued by Federally Related Institutions, and those issued by Government Sponsored Enterprises.

> <u>Federally Related Institutions</u> are branches of the federal government and generally do not issue securities directly in the marketplace. The major issuers have been the Tennessee Valley Authority (TVA) and the Government National Mortgage Association (Ginnie Mae). With the exception of securities of the TVA and the Private Export Funding Corporation, the full faith and credit of the United States government back these securities.

> <u>Government Sponsored Enterprises</u> (GSEs) are privately owned, publicly chartered entities. They were created by Congress to reduce the cost of capital for certain borrowing sectors of the economy deemed to be important enough to warrant assistance. Today there are five GSEs that issue securities: Federal Farm Credit Bank System (FFCB), Federal Home Loan Bank System (FHLB), Federal National Mortgage Association (Fannie Mae), Federal Home Loan Bank Corporation (Freddie Mac) and the Student Loan Marketing Association (Sallie Mae). These Federal Government-sponsored agencies were established by the U.S. Congress to undertake various types of financing without tapping the public treasury. In order to do so, the agencies have been given the power to borrow money by issuing securities, generally under the authority of an act of Congress. These securities are highly acceptable and marketable for several reasons, though mainly because they are exempt from state and local income taxes. Furthermore, agency securities must offer a higher yield than direct Treasury debt of the same maturity in order to attract investors, partly because these securities are not direct obligations of the Treasury.

Federal Deposit Insurance Corporation – A federal institution that insures bank deposits. The current limit of deposit insurance is $100,000 per deposit.

Federal Funds Rate – The rate of interest at which Federal Funds are traded between banks. Federal Funds are excess reserves held by banks that desire to invest or lend them to banks needing reserves. The particular rate is heavily influenced through the open market operations of the Federal Reserve Board. Also referred to as the "Fed Funds rate."

Federal Reserve System – The central bank of the United States, which has regulated credit in the economy since its inception in 1913. The system includes the Federal Reserve Bank, 12 district banks and the member banks of the Federal Reserve.

Federal Savings and Loan Insurance Corporation (FSLIC) – A federal institution that insures savings and loan deposits. The current limit of deposit insurance is $100,000 per deposit.

Finance Department: As of January 2004, the Department of Finance and Information Technology.

Flexible Repurchase Agreement (Flex Repos) – Similar to a term repurchase agreement, a flex repo is a contractual transfer of U.S. Government securities during the investment period, whereby the Seller agrees to repurchase the collateral securities from the Buyer on the Buyer's demand, subject to provisions of the agreement. The Seller is generally a financial institution such as a securities dealer or a bank. As buyers, most issuers require over-collateralization, marking-to-market of collateral and delivery vs. payment of collateral.

Floating-Rate Bond – A bond for which the interest rate is adjusted periodically according to a predetermined formula, usually linked to an index.

Forward Starting Swap – Interest rate swaps that start at some time in the future. Used to lock-in current interest rates.

General Obligation Bond (GO) – A municipal bond secured by the pledge of the issuer's full faith and credit, and backed by their taxing authority.

Government Security – Any debt obligation issued by the U.S. Government, its agencies or instrumentalities. Certain securities, such as Treasury bonds and Ginnie Maes, are backed by the government as to both principal and interest payments. Other securities, such as those issued by the Farm Credit Bank System and Freddie Macs, are backed by the issuing agency.

Hedge – A transaction that reduces the interest rate risk of an underlying security.

Interest – the compensation paid or to be paid for the use of money, usually expressed as an annual percentage rate. Interest rates change in response to a number of things including revised expectations about inflation, and such changes in the prevailing level of interest rates affects the value of all outstanding bonds.

Inverse Floater – Structured notes or derivatives designed to rise in yield as interest rates fall. Also called a Reverse Floater. These are very volatile securities.

Inverted, or Negative, Yield Curve – The interest rate structure which exists when short-term interest rates are higher than long-term interest rates.

Letter of Credit (LOC) – A commitment, usually issued by a bank, used to guarantee the payment of principal and interest on debt issues. The Letter of Credit is drawn down if the issuer is unable to make the principal and/or interest payments on a timely basis.

Leverage – The use of borrowed money to increase investing power.

LIBOR (London Interbank Offered Rate) – The rate banks charge each other for short-term Eurodollar loans. LIBOR is frequently used as the base for resetting rates on floating-rate securities.

Liquidity – The ease and speed with which an asset can be converted into cash without a substantial loss in value.

Liquidity Support – An agreement by a bank to make payment on a variable rate security to assure investors that the security can be sold.

Local Government Investment Pool (LGIP) – The aggregate of all funds from political subdivisions that are placed in the custody of the State Treasurer for investment.

Long – Securities that are owned by a dealer or investor.

Loss – The excess of the cost or book value of an asset over its selling price.

Market Price – For securities traded through an exchange, the last reported price at which a security was sold; for securities traded “over-the-counter,” the current price of the security in the market.

Market Risk – The risk that the market value of an investment, collateral protecting a deposit, or securities underlying a repurchase agreement will decline.

Marketability – A measure of the ease with which a security can be sold in the primary and secondary market without an undue price concession.

Master Agreement – An agreement which is controlling over all transactions covered by it on an open-ended basis. A new contract is not required for each new transaction.

Maturity Date – The date when the principal amount of a security becomes due and payable, if not subject to prior call or redemption.

Medium-Term Note – A debt security issued under a program that allows an issuer to offer notes continuously to investors through an agent. The size and terms of medium-term notes may be customized to meet investors’ needs. Maturities can range from one year to 30 years.

Modified Duration – The approximate percentage change in a bond’s price for a 100 basis point change in yield *assuming that the bond’s expected cash flows do not change when the yield changes*.

NASD – National Association of Securities Dealers. The largest self-regulatory securities industry organization in the United States.

Negative Convexity – A characteristic of callable or pre-payable securities that causes investors to have their principal returned sooner than expected in a declining interest rate environment or later than expected in a rising interest rate environment. In the former scenario, investors may have to reinvest their funds at lower rates (“call risk”); in the latter, they may miss an opportunity to earn higher rates (“extension risk”).

Net Interest Costs: Total interest earnings on cash and cash equivalents less interest paid on outstanding debt obligations.

Net Interest Exposure; Net interest paid on liabilities (debt service) and interest paid on assets (cash and cash equivalents).

Notes – Short-term promises to pay specified amounts of money, usually secured by specific sources of future revenues, such as taxes, federal and state aid payments, and bond proceeds.

Notional Amount – The amount used to determine the interest payments on a swap.

Off-the-Run Treasuries – Treasury securities sold in the secondary market rather than “on-the-run” Treasury securities, which are the most recently issued securities by the Treasury.

Offer – The price at which a seller will sell a security.

Offsetting Swap – Secondary interest rate swap that is placed in an opposite direction from the primary interest rate swap. The offsetting swap is used to minimize swap risks associated with the use of interest rate swaps and potentially gain monetary value from the transaction.

Option-Adjusted Duration (effective duration) – A measure of the bond’s movement for a shift in the yield curve. For non-callable bonds modified duration and effective duration are the same.

Option-Adjusted Spread (OAS) – The average spread over the AAA spot curve, based on potential paths that can be realized in the future for interest rates. The potential paths of the cash flows are adjusted to reflect the options (puts/calls) embedded in the bond.

Par Value – The nominal or face value of a debt security; that is, the value at maturity.

Performance – An investment’s return (usually total return), compared to a benchmark that is comparable to the risk level or investment objectives of the investment.

Premium – The amount by which a bond sells above its par value.

Primary Dealers – A group of government securities dealers that submit daily reports of market activity and positions and monthly financial statements to the Federal Reserve Bank of New York and are subject to its informal oversight. Primary dealers include Securities and Exchange Commission registered securities broker-dealers, banks and a few unregulated firms.

Prime Rate – The interest rate a bank charges on loans to its most creditworthy customers. Frequently cited as a standard for general interest rate levels in the economy.

Principal – The invested amount on which interest is charged or earned.

Put Bond – A bond that gives the holder the right to require the issuer or the issuer's agent to purchase the bonds at a price, usually at par, at some date or dates prior to the final stated maturity.

Put Option – A put option allows the holder of a bond to "put," or present, the bond to an issuer (or trustee) and demand payment at a stated time before the final stated maturity of the bond.

Qualified Public Depositary – A financial institution which does not claim exemption from the payment of any sales or compensating use or ad valorem taxes under the laws of this state, which has segregated for the benefit of the commission eligible collateral having a value of not less than its maximum liability and which has been approved by the Public Deposit Protection Commission to hold public deposits.

Refunding – Sale of a new issue, the proceeds of which are to be used, immediately or in the future, to retire an outstanding issue by essentially replacing the outstanding issue with the new issue. Refundings are done to save interest cost, extend the maturity of the debt, or to relax existing restrictive covenants.

Registered Bond – A bond whose owner is registered with the issuer or its agent. Transfer of ownership can only be accomplished when the securities are properly endorsed by the registered owner.

Reinvestment Risk – The risk that interest income or principal repayments will have to be reinvested at lower rates in a declining rate environment.

Repricing – The revaluation of the market value of securities.

Repurchase Agreement (Repo) – A Repurchase Agreement is a contractual transaction between an investor and an issuing financial institution (not a secured loan). The investor exchanges cash for temporary ownership of specific securities, with an agreement between the parties that on a future date the financial institution will repurchase the securities at a predetermined price. An "open repo" does not have a specified repurchase date and the repurchase price is established by a formula computation.

Reverse Repurchase Agreement – The opposite of the transaction undertaken through a regular Repurchase Agreement. In a "Reverse Repo", the entity initially owns securities and the bank or dealer temporarily exchanges cash for this collateral. This is, in effect, temporarily borrowing cash at a high interest rate. Most typically a Repo is initiated by the lender of funds. Reverse Repos are used by dealers to borrow securities they have shorted.

Risk – A measure of the degree of uncertainty and/or of financial loss inherent in an investment or decision.

Safekeeping – A service to customers rendered by banks or trust companies for a fee whereby all securities and valuables of all types and descriptions are held in the bank's vaults for protection, or in the case of book entry securities, are held and recorded in the customer's name and are inaccessible to anyone else.

Scenario Analysis – Examining the likely performance of an investment under a wide range of possible interest rate environments.

Secondary Market – Ongoing market for bonds previously offered or sold in the primary market.

Securities – Bonds, notes, mortgages or other forms of negotiable or non-negotiable instruments.

Settlement Date – The day on which payment is due for a securities purchase. Bonds and options normally settle one business day after the trade date. For stocks and mutual funds bought through an investment dealer, settlement is normally five business days after the trade date.

Spread – (1) The difference between the price at which an issue is purchased from an issuer and the price at which it is offered by the underwriters to the first holders. (2) The difference in price or yield between two securities. The securities can be in different markets, or within the same securities market between different credits, sectors or other relevant factors.

Spread to Treasury – The difference between the yield on a fixed-income security and the yield on a Treasury security of comparable maturity. For example, the spread between a 10-year Treasury yielding 5.50% and a 10-year corporate bond yielding 6.25% is 75 basis points.

Step-up Agency Obligation Security – An agency obligation security where the coupon rate increases at pre-determined intervals.

STRIPS – Separate Trading of Registered Interest and Principal of Securities. The Treasury Department's program under which eligible securities are authorized to be separated into principal and interest components, and sold separately.

Swap – A transaction in which an investor sells one security and simultaneously buys another with the proceeds, usually for about the same price.

Syndicate – A group of underwriters formed for the purpose of participating jointly in the initial public offering of a new issue of securities. The terms under which a "syndicate" is formed and operates are typically set forth in an "agreement among underwriters." One or more underwriters will act as manager of the "syndicate" and one of the managers will act as lead manager and "run the books." A "syndicate" is also often referred to as an "account" or an "underwriting account."

Termination Payment – A payment made by a counterparty that is required to terminate the swap. The payment is commonly based on the market value of the swap, which is computed using the rate on the initial swap and the rate on a replacement swap

Third-Party Safekeeping – A safekeeping arrangement whereby the investor has full control over the securities being held. Dealers and/or bank investment departments have no access to the securities being held.

Time Deposit – An interest-bearing deposit at a savings institution that has a specific maturity.

Total Return – Investment performance measure over a stated time period which includes coupon interest, interest on interest, and any realized and unrealized gains or losses.

Trade Date – The date that a trade, or sale and purchase, is consummated, with settlement to be made later (see "settlement date").

Treasury Bills – Treasury Bills are short-term debt obligations of the U.S. Government which are issued at a discount to par value, have no coupon rate and mature at par value. They offer maximum safety of principal since they are backed by the full faith and credit of the United Sates Government. Treasury bills, commonly called "T-Bills" account for the bulk of government financing, and are the major vehicle used by the Federal Reserve System in the money market to implement national monetary policy. T-Bills are issued on a regular basis with initial maturities of 91 days, 182 days, and 364 days. They are more popularly referred to as 3-month, 6-month and 1-year Treasury bills. Because Treasury bills are considered "risk-free," these instruments generally yield the lowest returns of the major money market instruments.

Treasury Notes and Bonds – While T-Bills are sold at a discount rate that establishes the yield to maturity, all other marketable treasury obligations have coupons. These include Treasury Notes, with maturities from one to ten years and Treasury Bonds with maturities of 10 to 30 years. Since Bills, Notes and Bonds are general obligations of the U.S. Government, and since the General Government has the lowest credit risk of all participants in the money market, its obligations generally offer a lower yield to the investor than do other securities with similar maturity structures.

Underlying Securities – Securities transferred in accordance with a Repurchase Agreement.

U.S. Government Agency Securities – A variety of securities issued by several U.S. agencies. Some are issued on a discount basis and some are issued with coupons. Some are backed by the full faith and credit guarantee of the U.S. Government, while others are not.

Volatility – A statistical measure of the variance of price or yield over time. Volatility is low if the price does not change very much over a short period of time, and high if there is a greater change.

When-Issued Trades – Typically there is a lag between the time a new bond is announced and sold, and the time it is actually issued. During this interval, the security trades "WI" – "when, as, and if issued."

Yield – The rate at which an investment pays out interest or dividend income, expressed in percentage terms and calculated by dividing the amount paid by the price of the security and annualizing the result.

Yield Basis – Stated in terms of yield as opposed to price. As yield increases for a traded issue, price decreases and vice versa. Charts prepared on a yield basis appear exactly opposite of those prepared on a price basis.

Yield Curve – The graphical relationship between yield and maturity among bonds of different maturities and the same credit quality. This line shows the term structure of interest rates.

Yield Spread – The variation between yields on different types of debt securities; generally a function of supply and demand, credit quality and expected interest rate fluctuations. Treasury bonds, for example, because they are so safe, will normally yield less than corporate bonds. Yields may also differ on similar securities with different maturities. Long-term debt, for example, carries more risk of market changes and issuer defaults than short-term debt and thus usually has a higher yield.

Yield To Call – A yield on a security calculated by assuming that interest payments will be paid until the call date, when the security will be redeemed at the call price.

Yield To Maturity – The yield on a security calculated by assuming that interest payments will be made until the final maturity date, at which point the principal will be repaid by the issuer. Yield to maturity is essentially the discount rate at which the present value of future payments (investment income and return of principal) equals the price of the security.

Zero-Coupon Bonds – Securities that do not pay interest but are instead sold at a deep discount from face value. They rise in price as the maturity date nears and are redeemed at face value upon maturity.

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SOUND TRANSIT

Amendment #1

Resolution No. R2004-14
Adoption of Asset Liability Management Framework

Amendment #1	
Sponsor	Board Member Jack Start
Amendment	To improve Board oversight and management of agency financial transactions, the following amendments are made to the proposed Central Puget Sound Regional Transit Authority Asset Liability Management Policies. 1. Swap Policy, section 11.0, insert new second/third sentence: "All proposed transactions shall be summarized to the Board on an "all-in" cost basis to include all transaction costs and fees. All such costs and fees, including on-going fees, shall be detailed for the Board for consideration and review." 2. Swap Policy, section 6.0, third paragraph insert new second sentence: "Sound Transit will not undertake unproven swap transactions whose long-term costs and risk are not thoroughly understood and evaluated." 3. Debt Policy, section 12.0, insert new final sentence: "Sound Transit will not undertake unproven debt transactions whose long-term costs and risk are not thoroughly understood and evaluated."