SOUNDTRANSIT

RESOLUTION NO. R2018-24

**Asset Liability Management Policy**

| MEETING: | DATE: | TYPE OF ACTION: | STAFF CONTACT: |
|---|---|---|---|
| Executive Committee<br><br>Board | 07/19/2018<br><br>07/26/2018 | Cancelled<br><br>Final Action | Michael Trzupek, Interim CFO<br>**Jessica Jaeger, Acting Treasurer** |

## PROPOSED ACTION

Adopts a new Asset Liability Management Policy and supersedes Resolution Nos. R2004-14, R2005-17, and R2009-07.

## KEY FEATURES SUMMARY

- The Board initially adopted the Asset Liability Management (ALM) Policy in 2004, and revised it in 2005 and 2009. Revisions in previous years focused on tightening the internal control and due diligence process, improving the efficiency of resources utilization, clarifying the roles and responsibilities, and adjusting the asset allocations and collateral requirements to better manage risks and to diversify the portfolios.
- This action would update the ALM Policy and its components to stay current with the market and regulatory environment, to clarify intent and roles and responsibilities, and to realign practices and process with the agency's current objectives.
- The new policy streamlines and reorganizes the four policies into one larger policy, removing redundancy and unnecessarily administrative and procedural elements, and to reflect changes related to Sound Transit 2 (ST2) and Sound Transit 3 (ST3).

## BACKGROUND

In 2004, the Board adopted the ALM Policy. The policy was revised in 2005 and 2009. Revisions focused on tightening the internal control and due diligence process, improving the efficiency of resources utilization, clarifying the roles and responsibilities, and adjusting the asset allocations and collateral requirements to better manage risks and to diversify the portfolios.

This action would revise the ALM Policy and it's components to stay current with the market and regulatory environment, to clarify intent and roles and responsibilities, and to realign practices and process with the agency's current objectives.

The major additions and revisions are summarized below:

Investment Policy

- The last update to the Investment Policy was in 2009. Since that time there have been changes in the Investment Policy scope, which now includes guidance for strategic allocation of funds.
- Adjusts restrictions and allocation limits on investment instruments to diversify the portfolios and to allow slightly more flexibility in investing in higher return products (i.e. added Corporate Notes / removed Reverse Repurchases) while still minimizing risk.

- Tightens the nationally recognized statistical rating organization (NRSRO) rating for short term investments to require that if a security is rated by all three major NRSRO, it must be rated in the highest short-term rating category.
- Adds security lending as counterparty, allowing for additional source of investment option with restrictive collateral requirements to ensure limited risk exposure.
- Adds maximum maturity and strategic allocation of funds matrixes for more specific and strategic portfolio management & guidance.
- Expands safety objective to specifically call out the goal of mitigating credit risk & interest rate risk.

Debt Management Policy

- The Debt Policy has not been updated since 2004 and there have been changes related to the issuance of variable rate debt, and the Agency's TIFIA loan agreement.
- Updates the debt coverage to be consistent with voter approved Financial Policies.
- Provides more guidance for refunding, including a matrix minimum present value savings to aid in the refunding decision process.
- Expands the types and features of debt to explicitly include common financing tools in the municipal finance space. The new policy contemplates taxable bonds, revenue bonds, private placements, and lines of credit.
- These changes will provide Sound Transit with additional flexibility and options to finance its voter approved capital program while maintaining consistency with the voter approved financial policies.

Swap Policy

- The Swap Policy has not been updated since 2004 and needs to reflect changes in regulations related to Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Expands the swap advisor requirement to reference the Qualified Independent Representative requirements that stem from the Dodd-Frank Wall Street Reform and Consumer Protection Act.
- Provides more guidance on counterparty exposure, including a matrix for the maximum exposure Sound Transit should have to any individual counterparty to mitigate Sound Transit's counterparty risk.

## FISCAL INFORMATION

The policy revisions as described above will have a positive impact fiscally as the agency continues to care and safe guard public funds.

## SMALL BUSINESS/DBE PARTICIPATION, APPRENTICESHIP UTILIZATION, AND TITLE VI COMPLIANCE

Not applicable to this action.

## PUBLIC INVOLVEMENT

Not applicable to this action.

## TIME CONSTRAINTS

There have been many changes in the market, investment practice, and regulations since the Investment Policy was revised in 2009. It is essential to have an updated ALM Policy to provide guidelines in the current market and regulatory environment.

## PRIOR BOARD/COMMITTEE ACTIONS

Resolution No. R2009-07: (1) Amended the Investment Policy of the Asset Liability Management Framework and (2) replaced the Glossary of Terms section of the Asset Liability Management Framework.
Resolution No. R2005-17: Amended Sound Transit's Investment Policy to increase the share of the agency's portfolio that can be invested in Federal Agency securities to 75% and to specify a maximum of 50% of the agency's investment in agency securities can be invested in the securities of a single Federal Agency.
Resolution No. R2004-14: Adopted an Asset Liability Management Framework for agency resources, including Asset Liability Management, Investment, Debt Management, and Debt Swap Policies, and superseding Resolution No. 97.

## ENVIRONMENTAL REVIEW

KH 3/23/2018

## LEGAL REVIEW

AJP 7/12/2018

RESOLUTION NO. R2018-24
**Asset Liability Management Policy**

A RESOLUTION of the Board of the Central Puget Sound Regional Transit Authority adopting an Asset Liability Management Policy and superseding Resolution Nos. R2004-14, R2005-17 and R2009-07.

WHEREAS, the Central Puget Sound Regional Transit Authority, commonly known as Sound Transit, was formed under chapters 81.104 and 81.112 of the Revised Code of Washington (RCW) for the Pierce, King and Snohomish Counties region by action of their respective county councils pursuant to RCW 81.112.030; and

WHEREAS, Sound Transit is authorized to plan, construct and permanently operate a high-capacity system of transportation infrastructure and services to meet regional public transportation needs in the Central Puget Sound region; and

WHEREAS, in general elections held within the Sound Transit district on November 5, 1996, November 4, 2008 and November 8, 2016, voters approved local funding to implement a regional high-capacity transportation system for the Central Puget Sound region; and

WHEREAS, the Board adopted amended financial policies in Resolution No. R2016-16 that took effect upon voter approval on November 8, 2016 to guide funding for the regional high-capacity transportation system; and

WHEREAS, the agency's Asset Liability Management (ALM) Policy covers four coordinated policies on ALM strategy, investment, debt and swap to safeguard the agency's investment assets and prudently manage agency funds and debt obligations; and

WHEREAS, in the interest of maintaining strong fiduciary management of public funds and minimizing the financing costs for capital investments, a revised version of the agency's ALM Policy is required to comply with new regulations, to stay current with the market environment, and to clarify roles and responsibilities.

NOW, THEREFORE, BE IT RESOLVED by the Board of the Central Puget Sound Regional Transit Authority that Resolution Nos. R2004-14, R2005-17 and R2009-07 are hereby superseded with an updated Asset Liability Management Policy, which is hereby adopted as follows:

## 1.0 Scope

1.1 This policy applies to the management of cash, investments and debt obligations, including payment agreements. This management approach includes four coordinated sections covering ALM strategy, investment, debt and swap.

## 2.0 Definitions

2.1 Amortization: Liquidation of a debt through installment payments. The allocation of the premium or discount from 100 on the price of a security from the time of purchase to the maturity date.

2.2 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.

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

2.4 Basis swap: An interest rate swap in which two counterparties exchange floating rate interest payments derived from different indices.

2.5 Benchmark: A basket of securities that are similar to the investment criteria of the investment portfolio that is used to compare total return and yield performance over periods of time.

2.6 Bid: The indicated price at which a buyer is willing to purchase a security.

2.7 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.

2.8 Bond insurance: An insurance policy that guarantees the payment of principal and interest in the event of a default

2.9 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.

2.10 Callable: A bond that is subject to payment of the principal amount (and accrued interest) before 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.

2.11 Call option: The right but not the obligation to buy a security.

2.12 Caps: Derivatives that create a ceiling on a floating interest rate. If market rates move above the cap rate, the buyer will receive the difference between the cap and the underlying interest rate, accrued over the corresponding period.

2.13 Collar: Derivative that is the combination of a cap and a floor.

2.14 Credit risk: The occurrence of an event that impacts the credit rating of the issuer or its counterparty.

2.15 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.

2.16 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.

2.17 Debt: Amount of money borrowed by one party from another to be paid back in the future with interest.

2.18 Defeasance: Method by which an outstanding bond or bond issue can be made void, both legally and financially. Although a defeasance is generally the outcome of a refunding transaction, a defeasance can also be accomplished with cash.

2.19 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.

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

2.21 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.

2.22 Downgrade: A negative change in credit ratings.

2.23 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.

2.24 Effective duration: A measure in years that reflects the price sensitivity given interest rate changes. This measure incorporates probabilities, calls or options on the securities. For bonds, effective duration is also known option-adjusted 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.

2.25 Emergency: Situations involving the risk or likelihood of injury or damage to persons or property, financial loss to the agency, impairment of public service, or financial market disruption and situations involving legal necessity, wherein the customary or established procedures of the Board reasonably cannot be followed or are not applicable.

2.26 Floor: The opposite of a cap. If market rates move below the floor rate, the buyer receives the difference between the floor and the market rate.

2.27 General obligation debt: A common type of municipal debt that is secured by state or local government’s or agencies’ pledge to use legally available resources, including tax revenues to repay bond holders

2.28 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 affect the value of all outstanding bonds.

2.29 Interest rate management agreements: Agreements whose purpose is to help manage interest rate risk and exposure.

2.30 Interest rate risk: The risk that an investment value will change due to a change in the level of interest rates.

2.31 Interest rate swap: An agreement between two counterparties in which one stream of future interest payments is exchanged for another based on a specified principal amount.

2.32 Lease financing: A lease where the owner of an asset gives another party the right to use the asset in return for periodic payments.

2.33 Letter of credit: A commitment, usually issued by a bank, used to guarantee the payment of principal and interest on debt issues.

2.34 Leverage: The use of borrowed money to increase investing power.

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

2.36 Market value: The price at which a security is trading and could presumably be sold.

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

2.38 Maximum net termination exposure: The measure of Sound Transit's exposure to a given counterparty to a swap.

2.39 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.

2.40 Offer: The indicated price at which a seller is willing to sell a security.

2.41 Option: The right but not the obligation to buy or sell a security at a fixed price.

2.42 Par value: The nominal or face value of a debt security at maturity.

2.43 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. The return incorporates both interest earnings and price change over a specified period of time.

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

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

2.46 Private placement: The sale of a bond to a small group of investors, sometimes only one investor rather than as part of a public offering.

2.47 Public offering: The sale of a bond in the public market.

2.48 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 relax existing restrictive covenants.

2.49 Repurchase agreement (Repo): 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.

2.50 Revenue debt: Bonds that are secured with a pledge of a specified revenue source.

2.51 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.

2.52 Secondary market: Ongoing market for bonds previously offered or sold in the primary market.

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

2.54 Securities lending: Loaning securities to an investor or firm. Securities lending requires the borrower to put up collateral, whether cash, security or a letter of credit. When a security is loaned, the title and the ownership are also transferred to the borrower.

2.55 Swap: A transaction in which a public entity exchanges interest payments with a counterparty to achieve a different type of market rate exposure on an underlying security.

2.56 Swaptions: An option giving the right but not the obligation to engage in a swap.

2.57 Taxable bond: A bond whose interest payments are subject to federal income tax and state or local income tax.

2.58 Tax-exempt bonds: A bond whose interest payments are not subject to federal income tax and sometimes also state or local income tax.

2.59 Total return: An investment performance measure over a stated time period, which includes coupon interest, interest on interest, and any realized and unrealized gains or losses.

2.60 Weighted average maturity: A weighted average of the expiration dates for a portfolio.

2.61 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. In the case of bonds or notes, typically refers to the return to an investor expressed as an annual percentage rate assuming that the bond or note is held to its maturity date or, in the case of a premium bond, to its earlier first call date.

2.62 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.

## 3.0 ALM strategy

3.1 The agency manages its cash, investment, debt and payment obligations on a consolidated basis to reduce net interest costs and manage interest rate volatility in compliance with the law. The agency's asset liability management (ALM) strategy prefers managing the agency's overall cash and debt position in lieu of developing financial or investment objectives for individual projects.

3.1.1 The agency maintains a minimum cash position comprised of the reserves established by the Board. The agency maintains additional cash balances to meet liquidity needs and when the yield on such cash balances is in excess of the true interest cost of marginal debt issuance for any variable or fixed rate debt.

3.1.2 The agency seeks to optimize its overall funding strategy and minimize net interest payments through increasing investment earnings and decreasing its cost of borrowing. The agency's ALM strategies include but are not limited to the following:

3.1.2.a Match investment maturities with corresponding liabilities.

3.1.2.b Lengthen investment duration to increase returns over time, consistent with liquidity and other investment requirements as described in section 4.0 of this policy.

3.1.2.c Reduce the agency's cost of borrowing by diversifying the debt portfolio through issuance of variable rate debt.

3.1.2.d Utilize financing mechanisms to lock interest rates at favorable levels.

3.1.2.e Maintain positive cash balances in excess of minimal required levels if positive net interest position may be improved.

3.1.3 The agency uses the long-term financial plan and short-term cash forecast as tools to manage assets and liabilities.

3.2 **Reporting.** The Board receives a quarterly report on the ALM strategy, investment performance, and status of the debt and swap program.

3.3 **Delegation of authority.** The chief financial officer is responsible for managing the ALM program, overseeing all ALM transactions, and establishing and maintaining a system of controls to regulate the activities of ALM officials. The treasurer is accountable for daily operations of the ALM program and may delegate authority for program administration to appropriate individuals. Board authorization is required for all debt and swap transactions.

3.4 **Prudence.** The agency follows the prudent person rule as follows as a standard for managing the ALM portfolio: Execution of the ALM strategy must 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 in regard to speculation but in regard to the permanent disposition of the funds considering the probable income as well as the probable safety of the capital.

3.5 **Ethics.** Sound Transit conducts ALM in accordance with the agency's Code of Ethics for Board members, officers and employees. Board members, officers and employees involved in the ALM process must refrain from any personal business activity that could conflict with proper execution of the ALM program or impair their ability to make impartial investment decisions. Board members, officers and employees must disclose to the Board and the CEO any material financial interests in financial institutions that conduct business with the agency, and they must also disclose any large personal financial or investment positions that could be related to the performance of the agency.

3.6 **Compliance.** All agency investments, debt obligations and payment agreements must conform to federal, state and local statutes governing management of public funds, Generally Accepted Accounting Principles and the Governmental Accounting Standards Board. An external auditor conducts an annual independent review, which includes examining internal controls over investment, debt and swap activities.

## 4.0 Investment

4.1 This section covers the agency's financial resources with the exception of regional fare funds and externally-managed financial assets, such as but not limited to insurance policies, fully-defeased lease-leaseback arrangements and retirement plan assets.

4.2 **Investment objectives.** The agency's investment objectives, in order of priority, are as follows:

4.2.1 **Safety**. The agency undertakes investments in a manner that seeks to ensure preservation of capital in the overall portfolio. To obtain this objective, the agency utilizes highly rated securities and diversifies funds by investing in a variety of securities and sectors. The agency seeks to mitigate credit risk and interest rate risk.

4.2.1.a Credit risk: The agency seeks to reduce the risk of loss due to the financial failure of the security issuer or backer by prequalifying financial institutions, broker-dealers and advisors, diversify the agency's investment portfolio to minimize potential losses on individual securities, and actively monitor investment portfolio holdings.

4.2.1.b Interest rate risk: The agency seeks to reduce the risk that the market value of securities in the agency's portfolio will fall due to changes in general interest rates by structuring its investment portfolio to provide enough liquidity to meet cash flow needs, maintaining a conservative duration target, and structuring the portfolio to consist largely of securities with active secondary or resale markets.

4.2.2 **Liquidity.** The agency's investment portfolio must provide sufficient liquidity to enable the agency to meet all operating, capital and other allowable expenditures that might be reasonably anticipated.

4.2.3 **Return on investment.** The agency's investment portfolio must be structured with the objective of attaining a market rate of return throughout budgetary and economic cycles, commensurate with the investment risk parameters and cash flow characteristics of the portfolio.

4.3 **Investment funds.** The agency maintains an investment portfolio comprised of the following types of funds designated for specific purposes:

4.3.1 Unrestricted: Funds to provide for operating, capital, and other Board-approved expenditures to meet daily liquidity needs.

4.3.2 Internally-restricted: Funds restricted by the Board or internal financial policies to provide for temporary operating and capital expenses in unforeseen events.

4.3.3 Externally-restricted funds: Funds that have an external restriction, whether by statue or otherwise, on the management of the money held within the funds.

4.4 **Permitted investments.** Within its funds, the agency may invest in the following instruments pursuant to chapters 39.58, 39.59 and 43.250 RCW subject to any restrictions contained in external agreements.

4.4.1 U.S. Treasury Obligations: Direct obligations of the United States Treasury.

4.4.2 U.S. Agency Obligations Primary Issuers: U.S. government-sponsored enterprises, which include but are not limited to the Federal National Mortgage Association (FNMA), Federal Home Loan Mortgage Corporation (FHLMC), Federal Home Loan Banks (FHLB), and Federal Farm Credit Banks (FFCB).

4.4.3 U.S. Agency Obligations Secondary Issuers: Other U.S. government sponsored enterprises that are less marketable and considered secondary Government Special Entities and include but are not limited to the Private Export Funding Corporation (PEFCO), Tennessee Valley Authority (TVA), Financing Corporation (FICO) and Federal Agricultural Mortgage Corporation (Farmer Mac).

4.4.4 Supranational Agency Bonds: Institutions that have the U.S. government as its largest shareholder and include but are not limited to the International Bank for Reconstruction and Development (IBRD or World Bank), International Finance Corporation (IFC), Asian Development Bank (ADB) and Inter-American Development Bank (IADB).

4.4.5 Municipal Debt Obligations: Bonds of the State of Washington, any local government in the State of Washington, or General Obligation bonds outside the State of Washington.

4.4.6 Corporate Notes: United States and Canadian notes that adhere to the procedures adopted by the state investment board and are purchased on the secondary market.

4.4.7 Commercial Paper: Short-term promissory notes issued by corporations and purchased on the secondary market.

4.4.8 Banker's Acceptance: Short-term, non-interest bearing notes purchased on the secondary market.

4.4.9 Certificates of Deposit: Non-negotiable Certificates of Deposit from financial institutions that are qualified public depositories.

4.4.10 Public Deposit Protection Commission (PDPC) Bank Deposits: Deposits in banks that are participants in the State of Washington PDPC-approved bank list.

4.4.11 Repurchase Agreements:

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

4.4.11.b Collateral on Repurchase Agreements must be limited to treasury and agency 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.

4.4.11.c 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. Any such required margins shall not be less than 102 percent of the current market value of the collateral. Such collateral shall be revalued on a periodic basis, but not less than quarterly, in order to maintain market protection.

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

4.4.12 Local Government Investment Pool: Investment portfolio managed by the Washington State Treasurer's Office.

4.4.13 King County Investment Pool: Investment portfolio managed by King County.

4.5 **Investment parameters and diversification.** The agency diversifies its investment portfolio by adhering to the constraints in the following table. The agency recognizes Standard and Poor's (S&P), Moody's and Fitch as the major Nationally Recognized Statistical Ratings Organizations (NRSRO). In the case of split ratings, where the major NRSROs issue different ratings, the lower rating shall apply. Minimum credit ratings and percentage limitations apply at the time of purchase and are monitored in accordance with section 4.10.

| Issue type | Maximum % per issue type | Maximum % per issuer | Minimum S&P rating at purchase | Minimum Moody's rating at purchase | Minimum Fitch rating at purchase |
|---|---|---|---|---|---|
| U.S. Treasury Obligations | 100% | None | N/A | N/A | N/A |
| U.S. Agency Obligations Primary Securities (FHLB, FNMA, FHLMC, FFCB) | 75% | 25% | N/A | N/A | N/A |
| U.S. Agency Obligations Secondary Issuance (e.g. FICO, Farmer Mac) | 10% | 5% | AA- | Aa3 | AA- |
| Supranational Agency Bonds | 10% | 5% | AA- | Aa3 | AA- |
| Municipal Debt Obligations | 20% | 5% | AA- | Aa3 | AA- |

<table>
<tr><th>Issue type</th><th>Maximum % per issue type</th><th>Maximum % per issuer</th><th>Minimum S&P rating at purchase</th><th>Minimum Moody’s rating at purchase</th><th>Minimum Fitch rating at purchase</th></tr>
<tr><td>Corporate Notes[1]</td><td rowspan="3">25%</td><td>3% for AA-<br>2% for A-, A, A+</td><td>A-</td><td>A3</td><td>A-</td></tr>
<tr><td rowspan="2">Commercial Paper[2]</td><td rowspan="2">3%</td><td>Short-term: A1</td><td>Short-term: P1</td><td>Short-term: F1</td></tr>
<tr><td>Long-term: A-</td><td>Long-term: A3</td><td>Long-term: A-</td></tr>
<tr><td>Banker's Acceptance</td><td>25%</td><td>5%</td><td>A-</td><td>A3</td><td>A-</td></tr>
<tr><td>Certificates of Deposit</td><td>20%</td><td>5%</td><td>Deposits in PDPC banks</td><td>Deposits in PDPC banks</td><td>Deposits in PDPC banks</td></tr>
<tr><td>PDPC Bank Deposits</td><td>20%</td><td>None</td><td>Deposits in PDPC banks</td><td>Deposits in PDPC banks</td><td>Deposits in PDPC banks</td></tr>
<tr><td>Repurchase Agreements</td><td>10%</td><td>5%</td><td>A-</td><td>A3</td><td>A-</td></tr>
<tr><td>Local Government Investment Pool</td><td>100%</td><td>None</td><td>N/A</td><td>N/A</td><td>N/A</td></tr>
<tr><td>King County Investment Pool</td><td>50%</td><td>None</td><td>N/A</td><td>N/A</td><td>N/A</td></tr>
</table>

[1] No issue may exceed 3% of the cost or 6% of the market value of the total investment portfolio. Corporate notes rated A-, A, or A+ with a negative outlook may not be purchased.

[2] Maturities less than 100 days must have a short-term credit rating by at least two NRSROs. If rated by all three major NRSROs, it must be rated in the highest short-term rating category from all of them. Maturities longer than 100 days must have a long-term senior unsecured credit rating by at least one NRSRO of AA- or higher.

4.5.1 **Maturity requirements across the agency’s investment portfolio.** The agency matches the maturities of its investments with the agency’s anticipated cash flow requirements and ALM objectives. Maturities of certain funds with designated uses must coincide with the expected use of such funds, which in limited situations may exceed the constraints identified in the table below and in section 4.6.

| **Maturity constraints** | **Minimum % of total portfolio** |
|---|---|
| Under 30 days | 10% |
| Under 5 years | 80% |
| Under 20 years | 100% |
| **Security constraints** | **Maximum % of total portfolio** |
| Callable Securities | 25% |
| **Maximum maturity constraints** | **Years** |
| Weighted Average Maturity | 3 |
| Weighted Effective Duration | 3 |
| Single Maturity in Corporate Note Portfolio | 5.5 |
| Duration of Corporate Note Portfolio | 3 |

4.5.2 **Prohibited investments.** Sound Transit will not invest in these investment instruments:

4.5.2.a Directly in asset-backed securities.

4.5.2.b Derivative products.

4.5.2.c Securities that leverage the portfolio or are used for speculation of interest rates such as reverse repurchase agreements.

4.5.2.d Mutual funds.

4.5.2.e Equities.

4.6 **Strategic allocation by funds.** The agency develops investment strategies for each fund based on the specific fund's objectives, liquidity requirements, time horizon and risk tolerance as presented in the table below. These strategies should not be reactive to short-term changes in interest rates, but recognize the benefits to investment performance over a complete market cycle.

| Tier | Tier I – Liquidity | Tier II – Intermediate | Tier III – Long Term |
|---|---|---|---|
| **Fund objective** | Unrestricted operating funds that provide for daily cash flow and certain internally- and externally-restricted funds | Unrestricted operating excess liquidity funds and certain internally-restricted reserves | Internally- and externally-restricted funds with long time horizons |
| **Purpose** | Daily liquidity | Secondary liquidity | Funding of long-term liabilities |
| **Strategy** | Ensure adequate cash for operations through investing in pool funds and high-quality securities. Utilize a benchmark that is consistent with the underlying assets. The liquidity component may be blended with the intermediate component and tracked to a customized benchmark. | Match maturities to known liabilities and match duration exposure based on interest rate risk tolerance. Limit corporate issuer exposure to high quality securities. Utilize an intermediate market benchmark to manage the risk and return of the portfolio. | Utilize a longer term benchmark to manage the risk and return components of the portfolio. Manage corporate and municipal holdings in a manner to control credit and interest rate risk. Bond indentures may restrict the fund further than this policy. Maturities in certain restricted funds may be matched to needs. |
| **Target duration** | 1-24 months | 1 to 3 years | N/A |
| **Single maturity in years** | 2 years | 6 years | 20 years |

4.7 **Safekeeping and custody of investments**

4.7.1 Delivery versus payment. All trades of marketable securities must be executed, cleared and settled on a delivery versus payment basis to ensure that securities are deposited into the agency's safekeeping institution before the release of funds.

4.7.2 External-party safekeeping and banking. The agency must designate all safekeeping and banking arrangements and maintain an agreement of the terms executed in writing. The selection of safekeeping and banking partners must follow the agency's formal procurement process and include an evaluation of the firm's economic viability. The third party custodian is required to provide a monthly statement to the agency listing at a minimum each specific security, description, maturity date, market value, par value, purchase date, and CUSIP number.

4.8 **Investment pools.** A thorough investigation of a prospective investment pool is required before investing and on a continual basis. The agency must gather the following information from each prospective investment pool:

4.8.1 A description of eligible investments and a written statement of investment policies and objectives,

4.8.2 A description of interest calculations, how they are distributed and how gains or losses are treated,

4.8.3 A description of how investments are safeguarded, including the settlement processes, safekeeping of securities, participant parameters frequency of pricing, and audited,

4.8.4 A schedule for receiving statements and investment listings,

4.8.5 A fee schedule and when and how it is assessed, and

4.8.6 Information on whether the pool is eligible for the acceptance of bond proceeds and whether it will accept such proceeds.

4.9 **Authorized counterparties**

4.9.1 Broker-dealer. The agency or its investment advisor must maintain and regularly review a list of all authorized broker-dealers that are approved to transact with the agency for investment purposes. The agency or its investment advisor must maintain documentation of appropriate licenses, professional credentials and financial statements of broker-dealers on the list.

4.9.2 Investment advisors. The agency may contract with an external investment advisor to assist with the management of the agency's investment portfolio in a manner that is consistent with the agency's objectives and this policy. Advisors must be registered under the Investment Advisers Act of 1940 and must act in a non-discretionary capacity, requiring approval from the agency before all transactions. Advisors may be authorized to open accounts on behalf of the agency with broker-dealers on the agency's approved broker-dealer list.

4.9.3 Securities lending agent. Sound Transit may select one or more firms to provide securities lending management services. Securities lending services may be used to ensure that:

4.9.3.a All loans of securities are supported by collateral valued at no less than 102 percent of fair value of the securities.

4.9.3.b Only 20 percent maximum of securities held at the custodial bank may be lent out at any point in time.

4.9.3.c Average maturity of securities on loan and the securities purchased are for 14 days or less.

4.9.3.d Investment of cash collateral must be only in securities and deposits authorized in statute and be in compliance with the investment guidelines found in the contract for securities lending services, next day liquidation for all securities on loan, and monthly accounting, performance, compliance, and management reports.

4.9.3.e The services of a master custodian and securities lending agent will be obtained through evaluation of competitive proposal submitted in response to a regularly issued request for proposals. Securities purchased by the agency must be held by the master custodian acting as an independent party in its safekeeping trust department. Collateral must be similarly held or held by an independent party with whom the agency has a master repurchase agreement.

4.10 **Credit monitoring.** The concentration constraints and minimum credit ratings for each type of investment apply to the initial purchase and do not automatically trigger a sale as the portfolio value fluctuates or in the event of credit rating downgrade.

4.10.1 When a credit rating downgrade occurs, the agency must evaluate the downgrade on a case-by-case situation to determine whether to hold or sell the security after further analysis of the credit rating on an ongoing basis.

4.10.2 Quarterly reports, as required in section 3.2, must address any credit rating downgrade of the securities and any decision regarding actions taken on a downgraded security.

4.10.3 At a minimum, the agency must complete an annual review of credit rating exposure.

4.10.4 The agency must produce a monthly asset allocation report with respect to credit quality that shows the current ratings and identifies any securities that are impacted by the ratings.

4.11 **Competitive transactions**

4.11.1 The treasurer or designee obtains and documents competitive bid information on all investments purchased or sold. Competitive bids or offers should be obtained, when possible, from at least three separate brokers or financial institutions or through the use of a nationally recognized trading platform.

4.11.2 In the instance of a security for which there is no readily available competitive bid or offering on the same specific issue, then the treasurer or designee shall document quotations for comparable or alternative securities.

4.11.3 When purchasing original issue instrumentality securities, no competitive offerings are required, as all dealers in the selling group offer those securities at the same original issue price. The agency is encouraged to document quotations on comparable securities.

4.11.4 If the agency uses an investment advisor to provide investment transaction services, the advisor must retain and provide the agency documentation of competitive pricing execution on each transaction.

4.12 **Security sales.** Securities must generally be held until maturity with the following exceptions:

4.12.1 A security with declining credit may be sold early to minimize loss of principal.

4.12.2 A security exchange that would improve the quality, yield or target duration in the portfolio may be sold early.

4.12.3 Liquidity needs of the portfolio require a security to be sold early.

## 5.0 Debt

5.1 This section covers all debt issued by Sound Transit, including loans and debt guaranteed by Sound Transit. The Board acknowledges that changes in the capital markets may result in unforeseen circumstances that may warrant Board authorization of debt issuances outside the parameters of this policy in emergency conditions to remain consistent with the agency's voter-approved financial policies.

5.2 **Debt objectives.** The agency's debt objectives are as follows:

5.2.1 Maintain ongoing access to the capital markets to facilitate execution of the agency's voter-approved system expansion program.

5.2.2 Optimize the agency's cost of borrowing within prudent risk parameters.

5.2.3 Ensure timely repayment of principal and interest on debt.

5.2.4 Comply with laws governing the issuance of debt and provisions governing bond and loan documents.

5.2.5 Ensure full and complete financial disclosure and reporting.

5.3 **Debt limits.** The agency must keep outstanding debt within the following limits prescribed by state law and at levels consistent with its creditworthiness and the objectives of voter-approved plans and financial policies.

5.3.1 **General obligation debt.** The agency may issue general obligation debt at one and one-half percent of the taxable property within the boundaries of the Sound Transit district and, with the approval of the three-fifths of voters voting within the district, up to five percent of the value of the taxable property within the district's boundaries.

5.3.2 **Revenue debt.** There is no dollar limit for revenue indebtedness. Sound Transit will act with the highest standard of fiduciary management consistent with market standards and the agency's financial policies.

5.4 **Debt coverage.** The agency must maintain debt service coverage ratios consistent with the agency's financial policies and any governing covenants as stated in existing and future bond documents. For long-term planning purposes, Sound Transit agency debt service coverage ratio policy will be set at an average coverage ratio for 2.0x for net revenues over annual debt service costs, not to fall below 1.5x in any single year. However, as voter-approved plans are implemented, prudent changes to the coverage ratios set by the agency's financial policies may be made by the Board as appropriate.

5.5 **Credit standards.** 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 implementation of voter-approved projects and services. There may be situations where it is appropriate to seek or accept less than the current rating to preserve financing flexibility or capacity.

5.5.1 External economic, natural or other events may, from time to time, affect the creditworthiness of the agency's debt. The Board is committed to ensuring that actions within their control are prudent, consistent with the highest standards of public financial management.

5.6 **Disclosure and compliance**

5.6.1 **Issuance and post-issuance disclosure.** Sound Transit is committed to complete financial disclosure and cooperation 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.

5.6.1.a Official statements accompanying debt issues, annual financial reports, and continuing disclosure statements must meet, at a minimum, the standards articulated by the Municipal Securities Rulemaking Board (MSRB), the Government Accounting Standards Board (GASB), the Securities and Exchange Commission (SEC), and Generally Accepted Accounting Principles (GAAP).

5.6.2 **Issuance and post-issuance tax compliance.** Sound Transit complies with requirements of the Internal Revenue Code of 1986, as amended, both at the time of issuance and post-issuance, as necessary to maintain the tax exemption for tax-exempt debt.

5.6.3 **Arbitrage compliance.** Sound Transit maintains a system of record keeping and reporting to meet the arbitrage rebate compliance requirements of federal tax code.

5.7 **Purpose and use of debt.** Sound Transit may issue debt to finance or refinance the cost of capital projects to bridge the gap between the necessary timing of expenditures and permanent financing as a liquidity management tool, to refund outstanding debt or to provide a debt guarantee.

5.7.1 **Long-term debt.** Long-term 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 long-term debt include the scope, requirements, and timing of the budget and capital plan, the 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 may be an appropriate mechanism to allocate costs over a longer timeframe.

5.7.2 **Short-term debt.** Sound Transit considers use of short-term debt financing primarily to bridge the gap between the necessary timing of expenditures and permanent financing. Sound Transit may, if appropriate, establish and maintain a financing facility for borrowing on short notice for liquidity and/or interim financing in the form of short-term notes, commercial paper or short-term bank financing. Examples of other financing facilities are listed below:

5.7.2.a Commercial paper: Commercial paper is a cash management tool that 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.

5.7.2.b 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.

5.7.2.c 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.

5.7.2.d Lines of credit: A loan drawn and repaid as needed.

5.7.3 **Refunding.** The agency periodically reviews all outstanding debt to determine refunding opportunities. The agency considers refunding, within federal tax law constraints to the extent applicable, when there is a benefit to agency financial objectives or the refunding is necessary to modernize covenants essential to agency operations and management. Unless otherwise justified, current refunding and advance refunding requires minimum present value savings as follows:

| **Years to final maturity** | **Current refunding** | **Advance refunding call date <5 years** | **Advance refunding call date > 5 years** |
|---|---|---|---|
| 0-5 | 2% | 3% | N/A |
| 5-10 | 3% | 4% | 4% |
| >10 | 3% | 4% | 5% |

5.7.4 **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 Transit's voter-approved plans and the structure of the financing is consistent with this policy.

### 5.8 Debt structures and features

5.8.1 **Term of debt.** Debt repayment terms take into consideration a fair allocation of costs to current and future beneficiaries or users, projected repayment sources, the current and projected interest rate environment, and the estimated life of assets being financed.

#### 5.8.2 Tax status

5.8.2.a **Tax-exempt bonds.** Sound Transit issues tax-exempt debt unless taxable bonds or loans offers a lower cost or more favorable terms.

5.8.2.b **Taxable bonds.** Sound Transit may issue taxable debt to lower borrowing cost and/or as an option to gain operating flexibility or expand financing options. Sound Transit evaluates the potential benefits to the agency's financial objectives before deciding to issue taxable debt.

#### 5.8.3 Interest rate

5.8.3.a **Fixed rate debt.** Sound Transit may issue bonds that pay a fixed rate of interest.

5.8.3.b **Variable rate debt.** Sound Transit may issue securities that pay a rate of interest that varies periodically. The amount of unhedged variable rate debt will generally not exceed 25 percent of total outstanding debt. The agency evaluates the unique risks and benefits of variable rate debt, such as exposure to interest rate fluctuations and greater flexibility in principal amortization and/or prepayment respectively, to ensure that it achieves the agency's ALM and debt objectives.

#### 5.8.4 Other structural features

5.8.4.a **Redemption features.** For each transaction, Sound Transit evaluates the costs and benefits of call provisions and structures, given the agency's financial objectives.

5.8.4.b **Derivatives.** Sound Transit may utilize derivative products if their use provides anticipated financial or strategic value. Risks inherent in any derivative transaction must be identified and understood. Sound Transit may not undertake transactions when long-term costs and risk are not thoroughly understood and evaluated. (See section 6.0 for more information.)

5.8.4.c **Credit enhancements.** Credit enhancements, such as letters of credit or bond insurance, may be used when the reduction in debt service on the bonds resulting from the credit enhancement exceeds the costs of the enhancement or when required to gain access to the market.

5.8.5 **Private placement.** Private placements may be considered as appropriate for financing if it is determined to be beneficial for the agency, either from an economic or risk perspective.

5.8.6 **Lease financing.** Lease obligations may be considered as appropriate for financing capital. Lease financing should be considered when determined to be more beneficial from an economic or risk perspective than other available financing.

5.8.7 **Defeasance.** Sound Transit may defease outstanding bonds if it is determined that defeasance aligns with agency goals and financial policies.

5.9 **Debt administration and process.** The following apply to all Sound Transit debt issuance:

5.9.1 Investment of bond proceeds: Bond proceeds are invested in compliance with all federal, state, and contractual restrictions regarding the use and investment of bond proceeds and generally invested as part of Sound Transit's consolidated cash pool.

5.9.2 Debt service reserve fund: If necessary to access the market or secure funding through a loan at desired rates and terms or to achieve targeted credit ratings, Sound Transit may establish and fund a debt service reserve fund for portions or all of its debt consistent with bond covenants, market practice, and regulations. Sound Transit may consider bond insurance or a letter of credit in lieu of a debt service reserve funded with cash.

5.9.3 Method of sale: Sound Transit issues debt utilizing the method of sale that is expected to achieve the lowest cost of debt, taking into account short- and long-term impacts and the prevailing financial, market and transaction-specific conditions.

5.9.4 Professional services: Sound Transit may retain external professional services for each debt issuance including but not limited to bond counsel who provides a written opinion affirming that Sound Transit has met all legal requirements to issue the debt, disclosure counsel who provides a written opinion affirming that Sound Transit has made all necessary disclosures, a registered financial advisor(s) to assist with sale of new debt and management of existing debt, and underwriters during a negotiated sale. In addition, it may be necessary for Sound Transit to select other service providers such as escrow agents, verification agents, trustees, and/or arbitrage consultants, necessary to meet legal requirements and minimize Sound Transit's net debt costs. For the ongoing management of debt, Sound Transit utilizes a fiscal agent for all its indebtedness.

## 6.0 Swap

6.1 This section covers guidance for the agency's interest rate management agreements, including but not limited to interest rate swaps, swaptions, caps, collars and floors (collectively swaps), incurred in connection with the issuance of debt obligations whether or not previously issued or to be issued. The failure by the Sound Transit to comply with any provision of this policy shall not invalidate or impair any swap.

6.2 **Purpose and use of swaps.** The agency considers the use of swaps in connection with the issuance of debt obligations consistent with the ALM objectives as a means to reduce exposure to interest rate fluctuations, lower net borrowing costs and/or implement voter-approved plans. The agency strives to only use swaps after an analysis of the economic benefit of the swap market in relation to traditional financing methods has been undertaken and indicates a benefit in either expected interest cost or risk management.

6.2.1 Sound Transit will not use swaps 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.

6.2.2 Sound Transit limits the total notional amount of outstanding swaps based on criteria set forth in this policy regarding the proper management of risks and calculation of likely maximum termination exposure.

6.2.3 The agency must 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 summary of the special risks involved with swaps, any potential exposure to interest rate volatility or unusually large and rapid changes in market value, and the potential impact of termination payments.

6.3 **Swap advisor.** Sound Transit hires an external swap advisor with a proven history of experience with municipal swap transactions to act as a qualified independent representative for all negotiations and transactions. The swap advisor must provide a written certification for all transactions and must comply with laws and regulations.

6.4 **Counterparties**

6.4.1 Counterparty selection. Sound Transit may use a competitive or negotiated process to select a swap counterparty and price a swap as it believes business, market or competitive conditions justify such a process. The conditions under which a negotiated selection is best used are provided below.

6.4.1.a Marketing of the swap requires complex explanations about the security for repayment or credit quality.

6.4.1.b Demand is weak among swap counterparties.

6.4.1.c Market timing is important, such as for refundings.

6.4.1.d Coordination of multiple components of the financing is required.

6.4.1.e The swap has non-standard features, such as a forward-starting swap.

6.4.1.f The par amount for the transaction is significantly larger than normal market volume.

6.4.1.g Counterparties are likely to demand individual changes in bid documents.

6.4.1.h Swap is part of an entire debt proposal, such as a bank loan.

6.4.2 Counterparty termination exposure

6.4.2.a To diversify the agency's counterparty credit risk and limit the agency's credit exposure to any one counterparty, Sound Transit will determine its maximum net termination exposure to a proposed counterparty or counterparties and evaluate appropriate strategies to mitigate exposure before executing a swap.

6.4.2.b The exposure must be measured in terms of notional amount, mark-to-market valuation taking collateral into consideration, credit ratings, and maximum net termination exposure.

6.4.2.c The maximum net termination exposure is calculated as the sum of the market value of existing transactions as of the last day of the month before the execution of any new transactions, plus the expected worst case termination value of the new transaction determined using an appropriate interest rate index assuming one standard deviation from the sample mean over the last ten years. The 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.

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

6.4.2.e The following chart provides the maximum net termination exposure to a swap counterparty based on the lowest credit rating assigned by any of the nationally recognized rating agencies.

| **Credit rating** | **Maximum collateralized exposure** | **Maximum uncollateralized exposure** | **Maximum total termination exposure** |
|---|---|---|---|
| AAA | $40 million | $10 million | $50 million |
| AA | $30 million | $10 million | $40 million |
| Below AA | $30 million | None | $30 million |

6.4.2.f The agency periodically reviews these exposure thresholds to ensure that the thresholds continue to be appropriate. Maximum net termination exposure will be included in regular reporting as defined in section 3.2.

6.5 **Swap terms and conditions.** Sound Transit uses 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 must include payment, term, security, collateral, default, remedy, termination, and other terms, conditions, provisions and safeguards as the agency deems necessary or desirable. The terms of any agency swap must follow these conditions:

6.5.1 Any provision triggering termination upon a downgrade of Sound Transit's or the counterparty's rating may not be higher than the BBB rating category.

6.5.2 To the extent consistent with applicable laws, preference is given to 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 are subject to prevailing law. Preference is given to language providing that the counterparty will consent to jurisdiction in the Washington courts with respect to enforcement of the swap.

6.5.3 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 applicable laws.

6.5.4 Eligible collateral should generally be limited to Treasuries and obligations of federal agencies where the principal and interest are guaranteed by the United States and cash.

6.5.5 Sound Transit shall have the right to optionally terminate a swap agreement at any time over the term of the swap.

6.5.6 Termination value should be set by a market quotation methodology, unless the agency deems an alternate appropriate.

6.6 **Swap features**

6.6.1 Term and notional amount. The notional amount of a swap may not exceed the principal amount or notional amount of the obligation with respect to which the swap is made. The term of a swap may not exceed the final term of the obligation with respect to which the swap is made.

6.6.2 Call option value considerations. When considering the relative advantage of a swap versus fixed rate bonds, Sound Transit must consider the value of any call option on fixed rate bonds, the value of a non-callable swap versus a non-callable bond, and the value of the cost to embed a call option in the swap to provide some potential protection for Sound Transit to manage the termination costs.

6.6.3 Value to embed call option considerations. Sound Transit must evaluate whether or not to include a call option in the swap to match any call options in the bonds. Sound Transit must evaluate the portion of the value in the swap that is being derived from the elimination of the call provision versus the value being derived from the components of the swap transaction. Depending on market conditions, call options in swaps may increase costs which should be evaluated versus the risk reduction obtained.

6.6.4 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 to the agency’s regularly scheduled 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.

6.7 **Evaluation methodology.** Before Board authorization of a swap transaction, the agency must provide the Board with a summary of the risks, benefits and estimated total cost, including ongoing fees, of the proposed transaction. All such costs and fees, including ongoing fees, shall be detailed for the Board for consideration and review. As a part of this review, Sound Transit shall compute the maximum net termination exposure to the proposed swap counterparty. The report includes an evaluation of the applicable risks and the application of mitigation strategies for risks that may include some or all of the following:

6.7.1 Amortization risk: The mismatch of the maturity of the swap and the maturity of the underlying bonds or a mismatch in the amortization of the swap and the bonds.

6.7.2 Basis risk: The mismatch between variable rate debt service and the variable rate index used to determine swap payments. Basis risk can also occur when a divergence arises between the index associated with the bonds and that of the derivative. This divergence could be caused by a number of factors including but not limited to, changes in credit/spreads/trading volumes, tax law changes, absolute levels of interest rate and supply and demand.

6.7.3 Collateral posting risk: The risk that market movements or an issuer downgrade will cause the market value of the swap to be negative enough that the issuer has to post collateral under a Credit Support Annex (CSA).

6.7.4 Counterparty risk: The risk that a counterparty fails to make required payments, experiences rating downgrades, or files for bankruptcy protection.

6.7.5 Credit risk

6.7.6 Interest rate risk

6.7.7 Liquidity/remarketing risk: 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.

6.7.8 Market access risk: The risk that the markets may be closed or that Sound Transit may not be able to enter the credit markets.

6.7.9 Operational risk: 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.

6.7.10 Rollover risk: The underlying variable rate bond related to the swap will typically have a liquidity feature or put feature that will require periodic remarketing, rollover, or renewal. This requires transaction fees and the risk that Sound Transit's credit, or a change in market conditions may economically disadvantage Sound Transit.

6.7.11 Tax risk: 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.

6.7.12 Termination risk: The need to terminate the transaction in a market that dictates a termination payment by one of the counterparties.

6.8 **Interest rate swap management.** Sound Transit seeks to maximize the benefits it accrues and minimize the risks it bears by continuously monitoring market conditions and the swap counterparties for emergent opportunities or risks. Active management may entail modification of existing transactions, including:

6.8.1 Early termination of a swap;

6.8.2 Shortening or lengthening the term of a swap;

6.8.3 Sale or purchase of options; and

6.8.4 Application of basis swaps.

6.9 **Termination of interest rate swaps.** Sound Transit understands the potential for termination costs to change over time in different interest rate environments and should document the sensitivity to these factors. Sound Transit is cautious to ensure that counterparties do not impose excessive fees at termination in excess amounts allowed for in the swap documents.

6.9.1 Optional termination. Sound Transit, 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 policy.

6.9.2 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 may evaluate whether it is financially advantageous to obtain a replacement swap, or, depending on market value, make or receive a termination payment.

**7.0 References**

7.3 Resolution No. R2016-16 Sound Transit 3 Regional Transit System Plan, Appendix B Financial Policies

7.4 Resolution No. R2018-23 Budget Policy

7.5 Resolution No. R2015-32 Asset Management Policy

7.6 Resolution No. 81-2 Code of Ethics

7.7 Resolution No. R2013-25 Declarations of Official Intent to Reimburse Expenditures from Bond Proceeds

7.8 Resolution No. 85 Voucher Approval Procedures and Authorization of Auditing Officer and Treasurer

ADOPTED by the Board of the Central Puget Sound Regional Transit Authority at a regular meeting thereof held on July 26, 2018.

Dave Somers
Board Chair

ATTEST:

Kathryn Flores
Board Administrator