

Policy and Procedures Manual

SUBJECT: BUDGET AND FINANCE

Policy 204: CSUS Board Derivative Policy

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**Procedure**

A. Use of Derivative Products

In connection with the use of any derivative product, the Board must, by affirmative resolution, authorize the use of a swap, option, or other derivative financial product. Such use is limited exclusively to reduce the amount or duration of interest rate risk or result in an expected lower cost of borrowing when used in combination with the issuance of bonds, expected issuance of bonds, or to enhance the relationship between the CSUS's liabilities, assets and its investments or risk profile.

B. Derivatives may be used only for the following purposes:

- To prudently mitigate variable rate exposure on outstanding or proposed debt.
- To achieve significant savings as compared to other products available in the bond market, or to do so with a more acceptable risk profile.
- To achieve more flexibility in meeting overall financial objectives than can be achieved in conventional markets.
- To prudently manage the CSUS's asset/liability matching objectives.

*Derivative financial products shall not be employed solely as investment instruments or for the purpose of speculation. In addition, the CSUS shall not use a derivative for which there is (a) insufficient market liquidity for its transfer or termination at market, or (b) insufficient price transparency to allow realistic valuation of its market value on an ongoing basis.*

C. Evaluation of Risk

Consideration of the potential economic benefits of using any derivative financial product shall include at a minimum each of the following types of risk, as applicable:

- Accounting Risk: the risk that the transaction creates any unanticipated accounting presentation issues on financial statements.
- Basis Risk: the risk that the payments that the CSUS receives from the counterparty are insufficient to completely offset the debt service payments on the underlying bonds.

- Counterparty Risk: the risk that the counterparty is not able or willing to meet its obligations under the agreement.
- Legal Risk: the possibility that the transaction is not expressly authorized by law.
- Liquidity/Remarketing Risk: the risk that the CSUS cannot secure a cost-effective renewal of a letter or line of credit or suffers a failed action or remarketing with respect to its underlying variable-rate bonds.
- Tax Risk: the risk that future tax law changes - through a reduction or elimination of the tax exemption for municipal securities - lead to an increase in the ratio of tax-exempt to taxable yields.
- Termination/Market Valuation Risk: the risk of either (a) the reversion of the transaction to its original status, possibly undermining the CSUS's strategy for entering the transaction, or (b) the liability for a large payment if termination occurs during adverse market conditions.
- Rating Agency Risk: the risk that the proposed transaction may not be consistent with then-current rating agency criteria or guidelines.

#### D. Methods of Soliciting and Procuring Derivatives

In general, the CSUS should procure derivative products through a competitive process. Negotiated bids may, however, be appropriate in situations including but not limited to the following:

1. If the CSUS makes a determination that due to the size or complexity of a particular transaction, a negotiated bid would result in the most favorable pricing.
2. If a derivative embedded within a bond issue is proposed and the financing structure meets the CSUS savings target.
3. To enable diversification and manage the CSUS's exposure with counterparties.
4. If the CSUS determines that doing so will promote its interests by encouraging and rewarding innovation and best financial practices.

In all of the above negotiated situations, the CSUS should use a swap advisor to assist in the price negotiations.

Regardless of the method of procurement, the CSUS shall determine by whatever means is deemed appropriate that the terms and conditions of any derivative entered into reflects a fair market value of such derivative as of the date of its execution.

E. Form and Content of Derivatives

To the extent possible, the derivatives entered into by the CSUS shall contain the terms and conditions set forth in the International Swap and Derivatives Association, Inc. ("ISDA") Master Agreement, including any schedules and confirmation. The schedule should be modified to reflect specific legal requirements and business terms desired by the CSUS.

F. Eligible Counterparties

Qualified counterparties shall demonstrate a record of successfully executing transactions similar in nature to the transaction contemplated by the CSUS. Whenever possible, the CSUS shall use its best efforts to work with qualified counterparties that have, or are guaranteed by a guarantor that has, a long-term senior unsecured credit rating of at least "Aa3" or "AA-" by two of the nationally recognized rating agencies and does not have a rating lower than "A1" or "A+" by any nationally recognized rating agency.

Downgrade Trigger: Subsequent to entering into the agreement, if the rating of the counterparty or guarantor shall fall below the minimum credit thresholds established above, the swap documents will provide that the CSUS shall (a) require the posting of additional collateral or reduce the threshold for posting of collateral from previous levels, and/or (b) have the ability to terminate the agreement at the market.

Events of default of counterparty shall include the following:

- Failure to make payments when due;
- Declaration of bankruptcy;
- Breach of representations and warranties;
- Illegality;
- Failure to comply with downgrade provisions; and
- Failure to comply with any other provisions of the agreement after a specified notice period.

An event of default by the counterparty shall lead to termination of the agreement with the CSUS being the affected party for purposes of calculating any termination payment owed to the CSUS.

G. Provisions for Collateralization

The CSUS will determine the need for collateral posting, the acceptable forms and valuation of collateral, as well as specific triggers, and thresholds by ratings, on a transaction by transaction basis and will detail those provisions in a Credit

Support Annex to the ISDA Master, if deemed appropriate.

#### H. Optional Termination

The CSUS shall consider including a provision that permits it to terminate the agreement at the market value of the agreement at any time. In general, the counterparty shall not have the right to optionally terminate an agreement.

#### I. Accounting Treatment

Prior to execution of an agreement, the CSUS will consult with its external auditors to confirm the appropriate accounting treatment for the product being considered. The CSUS shall reflect such financial products in its financial statements in accordance with generally accepted accounting principles.

#### J. Monitoring and Reporting

The CSUS shall prepare a report to the Board at least annually, which shall include the following information:

1. A summary of key terms of the agreements, including notional amounts, interest rates, maturity, and method of procurement.
2. The mark to market value of each agreement.
3. The full name, description, and credit ratings of each counterparty or the applicable guarantor and, if applicable, a listing of the Acceptable Collateral provided by any counterparty or guarantor as required by this Policy.
4. The amounts that were required to be paid and received and any amounts that were actually paid and received.
5. Listing of any credit enhancement, liquidity facility, or reserves and accounting of all costs and expenses associated with the credit enhancement, liquidity facility or reserves.
6. The aggregate marked to market value for each counterparty and relative exposure compared to other counterparties.
7. Discussion of other risks associated with each transaction.

#### K. Updates and Revisions

The CSUS's Chief Financial Officer shall review this Derivatives Policy at least annually and recommend any changes necessary to ensure that it continues to meet the CSUS's objectives. The policy should also be reviewed as soon as practicable in the event of the turnover of key management or following any material changes to the CSUS's credit rating.

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History: Policy and Procedures Manual effective October 4, 2013 by Board Resolution  
Amended August 2, 2017 by Board Resolution