House Legislative Analysis Section

House Office Building, 9 South
Lansing, Michigan 48909
Phone: 517/373-6466

INTEREST RATE "SWAPS", ETC.

Senate Bills 1313 and 1314 as passed by the Senate
Sponsor: Sen. Joanne G. Emmons

House Committee: Tax Policy
Senate Committee: Finance

First Analysis (5-28-02)

THE APPARENT PROBLEM:

Municipalities are permitted by state law to enter into so-called interest rate swaps "for the purpose of more effectively managing . . . debt service". An interest swap is a contractual agreement between two parties, generally speaking, to exchange interest payments on a certain amount of principal for a set period of time. For example, a municipality might exchange variable rate debt payments for fixed rate debt payments, to lock in low interest rates, or it could swap fixed-rate debt for variable rate debt, counting on savings from declines in interest rates. A recent report from Standard & Poor's, the credit rating agency, has pointed out that the "prudent use of variable-rate debt and interest rate swaps can be a part of a municipal bond issuer's risk management program, serving to increase financial flexibility and reduce interest costs". (See *Background Information*.) The report points out, however, that there are risks to this strategy and notes that "because of the risks . . . steps must be taken to ensure that the obligations are structured appropriately and that the issuer has sufficient financial flexibility." The report identifies what it describes as five general risks associated with swaps for municipal bond issuers, including counterparty risk (the reliability of the party with which the municipality is "swapping"); termination risk (caused by ratings downgrades, contract violations, bankruptcies, etc.); rollover risk (that the contract period of the swap is not coterminous with the underlying debt); tax event and basis risk (including the impact on reductions in top marginal federal income tax rates, which lessens the demand for tax-free securities); and amortization risk (where a mismatching of the debt results in payments owed on a swap with no asset to cover the payments). Finance specialists say there are number of ways to quantify and manage this risk through the adoption of municipal debt and swap management plans. Legislation has been proposed that would incorporate these protections into the Revised Municipal Finance Act, the act which governs most municipal borrowing and which specifically authorizes the use of interest rate swaps and similar agreements.

THE CONTENT OF THE BILLS:

Senate Bill 1314 would amend the Revised Municipal Finance Act (MCL 141.2317 et al.) to provide additional regulation of interest rate exchanges, swaps, and hedges by municipalities. Senate Bill 1313 would amend Public Act 108 of 1961 (MCL 388.963a) dealing with the school bond loan fund to specify that interest on qualified bonds under the act would include the amount required for the payment of a school district's "net interest obligation" (see below) under an interest rate exchange or swap, hedge, or other similar agreement entered into under the Revised Municipal Finance Act. (Qualified bonds are general obligation bonds of school districts issued for capital expenditures, including refunding bonds.)

The Revised Municipal Finance Act permits a municipality to enter into an interest rate exchange or swap, hedge, or similar agreement in connection with the issuance of debt or in connection with its outstanding debt. The act says that such an agreement is not to be included within the total debt of a municipality for statutory or charter debt limitation purposes and says that the agreement is payable as a limited tax full faith and credit pledge from general funds or from other money or revenue sources. <u>Senate Bill 1314</u> would specify instead that the agreement would be a limited tax full faith and credit pledge if the agreement had been entered into in connection with debt not approved by the voters or in connection with a refunding of such debt. If the debt had been originally approved by voters, the interest payment obligation under the agreement would be considered additional interest on the debt and would constitute an unlimited tax full faith and credit pledge of the municipality. In that case, the municipality would be required to levy 1) the full amount of taxes required, or in the case of a variable rate obligation the amount reasonably estimated to be required, for the payment of principal and interest on the municipal securities without limitation as to rate or amount and in addition to other taxes the municipality was authorized to levy; 2) the full amount of taxes required (or reasonably estimated to be required, for variable rate debt) for the payment of the municipality's net interest obligation under an interest rate exchange or swap, hedge, or similar agreement. The amounts levied would be reduced by any surplus funds in the debt retirement fund in excess of a reasonable reserve, as determined by the chief financial officer of the municipality. Also, the bill would permit a municipality to issue a short-term municipal security to pay debt service charges or obligations on this kind of voter-approved debt.

Net Interest Obligation. The term "net interest obligation", used above, refers to the amount of interest payable by a municipality in a given year under a swap or similar agreement minus any interest payment received by a municipality from the other party to the agreement in the same period, but not less than zero. Termination payments would constitute interest to the extent that the treatment did not cause the interest rate on the debt to exceed limits established by the Revised Municipal Finance Act.

Conditions for Swap Agreements. Further, the bill would prohibit a municipality from entering into such an agreement unless it had met the following conditions: 1) the municipality's governing body had, by resolution, expressly approved the agreement and acknowledged the potential risks; 2) the counterparty to the agreement had been assigned a rating of "A" or better, or other rating as determined by the Department of Treasury, by a nationally recognized rating agency at the time of the agreement; 3) the length of the agreement did not extend beyond the final maturity date of the debt issued in connection with the agreement; 4) the municipality could not waive its right to a jury trial; 5) the municipality had created a debt management plan; and 6) the municipality had created a swap management plan. An agreement of this kind would have to be described in the municipality's required annual municipal finance report.

Management Plans Defined. A "debt management plan" would refer to a written plan of the municipality that included the total amount of debt of the municipality; the total amount of variable debt of the municipality; an analysis of the effect of rising interest rates on variable rate holdings; and an analysis of risk in maintaining variable risk holdings. A "swap management plan" would refer to a written management plan that included an analysis of the benefits and costs of entering into swap agreements; an analysis of the risk associated with entering into swap agreements; an analysis of early termination, involuntary termination, default, and cost considerations associated with swap agreements; and a system in place to monitor the status of all swap agreements.

BACKGROUND INFORMATION:

An extensive report on this subject by Standard & Poors can be found at the company's web site at www.standardandpoors.com/Forum/R…licFinance/Articles/020602_Impacts.html. The report is entitled "Credit Impacts of Variable Rate Debt and Swaps in Municipal Finance" and contains background information on the various protections that Senate Bill 1314 would put into statute.

FISCAL IMPLICATIONS:

The House Fiscal Agency reports that, as written, the bills would have no significant impact on state revenues. (HFA committee analysis dated 5-21-02)

ARGUMENTS:

For:

Senate Bill 1314 would add to the Revised Municipal Finance Act additional regulations for the use of interest rate exchange or swap agreements to provide protection against the risk associated with such transactions. Notably, the bill would require the adoption of debt management plans and risk management plans so that, generally speaking, a municipality would have to acknowledge, evaluate, and protect itself against the risks of entering into these useful agreements. Finance specialists have said that Senate Bill 1313 would allow schools to also make use of the interest rate swaps in the same way that municipalities do.

POSITIONS:

A representative of USB Paine Webber has indicated support for the bills. (5-24-02)

A representative of Miller Canfield (bond attorneys) has indicated support for the bills. (5-24-02)

Analyst: C. Couch

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.