

**1. Title**

Interest Rate Swap Policy

**2. Rule and Regulation**

- Sec. 1 Authority. *Texas Education Code*, [Chapter 55](#), including Section [55.13](#), *Texas Education Code*, [Chapter 65](#), including Section [65.461](#), and *Texas Government Code*, [Chapter 1371](#), including Section [1371.056](#), authorize the Board of Regents (Board) of The University of Texas System (U. T. System) to enter into interest rate management agreements and bond enhancement agreements (collectively “swaps”).
- Sec. 2 Purpose. This policy will govern the use of swaps in connection with the U. T. System’s management of its debt programs, including the Permanent University Fund and Revenue Financing System debt programs. By using swaps in a prudent manner, the U. T. System can increase the U. T. System’s financial flexibility, provide opportunities for interest rate savings, allow the U. T. System to actively manage asset and liability interest rate risk, take advantage of market opportunities to lower the overall cost of debt, balance interest rate risk, or hedge other exposures. The use of swaps must be tied directly to U. T. System debt instruments. The U. T. System shall not enter into swaps for speculative purposes.
- Sec. 3 Legality/Approval. Prior to entering into a swap, the U. T. System must receive approval from the Board of Regents (which may include a delegation of authority to an Authorized Representative to enter into one or more swaps) and any required approvals from the Texas Attorney General and the Texas Bond Review Board. The U. T. System will also secure an opinion acceptable to the Authorized Representative from legal counsel that the swap is a legal, valid, and binding obligation of the U. T. System and that entering into the swap complies with applicable State and federal laws.
- Sec. 4 Form of Agreements. Each interest rate swap shall contain terms and conditions as set forth in the International Swaps and Derivatives Association, Inc. (ISDA) Master Agreement, as amended, and such other terms and conditions including schedules, credit support annexes, and confirmations as deemed necessary by an Authorized Representative.

- Sec. 5 Methods of Procuring Swaps. Swaps can be procured via competitive bids or on a negotiated basis with counterparties or its credit support providers having credit ratings of 'A' or 'A2' or better from Standard & Poor's or Moody's, respectively.
- 5.1 Competitive. The competitive bid should include a minimum of three firms. An Authorized Representative may allow a firm or firms not submitting the bid that produces the lowest cost to match the lowest bid and be awarded a specified percentage of the notional amount of the swap.
- 5.2 Negotiated. An Authorized Representative may procure swaps by negotiated methods in the following situations:
- (a) A determination is made by an Authorized Representative that due to the complexity of a particular swap, a negotiated bid would result in the most favorable pricing;
- (b) A determination is made by an Authorized Representative that, in light of the facts and circumstances, a negotiated bid will promote the U. T. System's interests by encouraging and rewarding innovation; or
- (c) A determination is made by an Authorized Representative that a competitive bid would likely create market pricing effects that would be detrimental to the interests of the U. T. System.
- Sec. 6 Counterparty Risk. Counterparty risk is the risk of a failure by one of the U. T. System's swap counterparties to perform as required under a swap. To mitigate this risk, the U. T. System will 1) diversify its exposure among highly rated swap counterparties satisfying the rating criteria set forth in Section 5 above; 2) require collateralization as set forth below; and 3) include an optional termination event if the counterparty (or its credit support provider, if applicable) is downgraded below a second (lower) threshold.
- 6.1 Value Owed by Counterparty. To limit and diversify the U. T. System's counterparty risk and to monitor credit exposure to each counterparty, the U. T. System may not enter into a swap with an otherwise qualified counterparty

unless the cumulative mark-to-market value owed by the counterparty (and its credit support provider, if applicable) to the U. T. System shall be less than or equal to the applicable threshold amount set forth in Section 6.3 below.

6.2 Calculation of Value Owed. The value owed shall be the sum of all mark-to-market values between the subject counterparty and the U. T. System regardless of the type of swap, net of collateral posted by the counterparty. Collateral will consist of cash, U.S. Treasury securities, and Federal Agency securities guaranteed unconditionally by the full faith and credit of the U.S. Government. Collateral shall be deposited with a third party trustee acceptable to U. T. System or as mutually agreed upon between U. T. System and each counterparty.

6.3 Threshold Amounts Based on Credit Rating. Specific threshold amounts by counterparty are based on the cumulative mark-to-market value of the swap(s) and the credit rating of the counterparty or its credit support provider. The threshold amounts are as follows:

(a) AAA / Aaa	\$30 million
(b) AA+ / Aa1	\$25 million
(c) AA / Aa2	\$20 million
(d) AA- / Aa3	\$15 million
(e) A+ / A1	\$10 million
(f) A / A2	\$ 5 million

6.4 Downgraded Rating. If the credit rating of a counterparty or its credit support provider is downgraded such that the cumulative mark-to-market value of all swaps between such counterparty and the U. T. System exceeds the maximum permitted by this policy, the counterparty must post collateral or provide other credit enhancement that is satisfactory to the U. T. System and ensures compliance with this policy.

Sec. 7 Termination Risk. The U. T. System shall consider the merits of including a provision that permits optional termination at any time over the term of the swap (elective termination right). In general, exercising the right to optionally terminate a swap should produce a benefit to the U. T. System, either through

receipt of a payment from a termination, or if a termination payment is made by the U. T. System, a conversion to a more beneficial debt instrument or credit relationship. It is possible that a termination payment by the U. T. System may be required in the event of termination of a swap due to a counterparty default or following a decrease in credit rating.

- Sec. 8 Amortization Risk. The amortization schedules of the debt and associated swap should be closely matched for the duration of the swap. Mismatched amortization schedules can result in a less than satisfactory hedge and create unnecessary risk. In no circumstance may (i) the notional amount of a swap exceed the principal amount of the related debt at any time, or (ii) the term of a swap extend beyond the final maturity date of the related debt instrument, or in the case of a refunding transaction, beyond the final maturity date of the refunding bonds.
- Sec. 9 Basis Risk. Basis risk arises as a result of movement in the underlying variable rate indices that may not be in tandem, creating a cost differential that could result in a net cash outflow from the U. T. System. Basis risk can also result from the use of floating, but different, indices. To mitigate basis risk, any index used as part of a swap shall be a recognized market index, including but not limited to the Securities Industry and Financial Markets Association (SIFMA) Municipal Swap Index, the Effective Federal Funds Rate (EFFR), or the Secured Overnight Financing Rate (SOFR).
- Sec. 10 Tax Risk. Tax risk is the risk that tax laws will change, resulting in a change in the marginal tax rates on swaps and their underlying assets. Tax risk is present in all tax-exempt debt issuances. The U. T. System Office of Finance will continually monitor and evaluate tax risk.
- Sec. 11 Interest Rate Risk. Interest rate risk is the risk that costs associated with variable rate exposure increase as a result of changes in market interest rates. Additional interest rate risk can be created by entering into certain types of swaps. The U. T. System Office of Finance will incorporate the impact of each swap on the overall debt portfolio.
- Sec. 12 Reporting.

- 12.1 The U. T. System Office of Finance staff will report to the Board within 30 days of completion of any swap transaction.
- 12.2 The Annual Financial Report prepared by the U. T. System and presented to the Board of Regents will discuss the status of all swaps. The report shall include a list of all swaps with notional value and interest rates, a list of counterparties (and credit support providers, if applicable) and their respective credit ratings, and other key terms.

Sec. 13 Qualified Independent Representative. In connection with Commodities Futures Trading Commission Rule 23.450(b)(1), an Authorized Representative will select a qualified independent representative (QIR) to advise the U. T. System Office of Finance on derivative transactions, and U. T. System Office of Finance staff will monitor the performance of such QIR on an ongoing basis. The U. T. System Office of Finance will consult with the QIR prior to entering into or modifying any derivative transactions.

### **3. Definitions**

Authorized Representative – includes the Executive Vice Chancellor for Business Affairs, the Vice Chancellor and General Counsel, the Associate Vice Chancellor for Finance, and the Assistant Vice Chancellor for Finance.

Counterparty – a participant in a swap who exchanges payments based on interest rates or other criteria with another counterparty.

Counterparty Long-Term Debt Rating – lowest prevailing rating from Standard & Poor's / Moody's.

Effective Federal Funds Rate (EFFR) – The effective federal funds rate is calculated and published by the New York Federal Reserve Bank based on domestic unsecured borrowings in U.S. dollars by depository institutions. It is a commonly used benchmark for swaps.

Hedge – a transaction entered into to reduce exposure to market fluctuations.

Interest Rate Swap – a swap in which two parties agree to exchange future net cash flows based on predetermined interest rates or indices

calculated on an agreed notional amount. An interest rate swap is not a debt instrument and there is no exchange of principal.

ISDA Master Agreement – the International Swaps and Derivatives Association, Inc. (ISDA), is the global trade association for the derivatives industry. The ISDA Master Agreement is the basic governing document that serves as a framework for all interest rate swaps and certain other types of swaps between two counterparties. It is a standard form used throughout the industry. It is typically negotiated once, prior to the first swap transaction, and remains in force for all subsequent swap transactions.

Mark-to-Market – calculation of the value of a financial instrument (like an interest rate swap) based on the current market rates or prices of the underlying indices.

Maximum cumulative mark-to-market – value of swaps owed to the U. T. System by counterparty (net of collateral posted).

Notional Amount – the size of the swap and the dollar amount used to calculate interest payments.

SIFMA Index – the principal benchmark for floating rate payments for tax-exempt issuers. The index is a national rate based on a market basket of high-grade, seven-day, tax-exempt variable rate bond issues.

Secured Overnight Financing Rate (SOFR) - the Secured Overnight Financing Rate (SOFR) is a broad measure of the cost of borrowing cash overnight collateralized by Treasury securities. It is a commonly used benchmark for swaps to replace LIBOR.

#### **4. Relevant Federal and State Statutes**

*Texas Education Code*, [Chapter 55](#) – Financing Permanent Improvements

*Texas Education Code*, [Chapter 65](#) – Administration of The University of Texas System

*Texas Government Code*, [Chapter 1371](#) – Obligations for Certain Public Improvements

#### **5. Relevant System Policies, Procedures, and Forms**

None

**6. Who Should Know**

Administrators

**7. System Administration Office(s) Responsible for Rule**

Office of Business Affairs

**8. Dates Approved or Amended**

[Regents' Rules Revision History](#)

**9. Contact Information**

Questions or comments regarding this Rule should be directed to:

- [bor@utsystem.edu](mailto:bor@utsystem.edu)