HILLSBOROUGH
California

HILLSBOROUGH
California

Financial Advisory Committee Meeting

LIBOR Phase Out Review

June 3, 2021

Executive Summary

Introduction

LIBOR for the Town's 2006 swap is sunsetting June 30, 2023

Analysis was conducted to determine the potential risk to the Town

Mitigation strategies were evaluated with experts - financial/swap advisor and bond attorney

Presenting several options for FAC to consider for recommendation to the City Council

- **Address LIBOR Risk** - Four options to improve LIBOR risk
- **Look At Opportunity to Reduce All Swap Risk** -With the low interest rate environment, the Town could explore refinancing all COPs/terminating all swaps to improve the long-term financing position, eliminate LIBOR and all other swap risks, and streamline the complex arrangement currently in place

Executive Summary

Situation – LIBOR Risk

- Three of the Town's variable rate COPs are swapped to synthetic fixed rate via fixed payor/floating receiver swap agreements.

- One of the Town's three variable rate COPs is swapped to a synthetic fixed rate where the swap's variable leg is tied to a % of LIBOR (a taxable short-term proxy) while the other two are tied to SIFMA (a tax-exempt short-term proxy). Our LIBOR swap, like many legacy swap contracts, does not contain sufficient "successor" (or "fallback") rate language in case LIBOR resets are discontinued.

- 1 month LIBOR (the Town's tenor) is **scheduled to <u>sunset</u>** after 6/2023. The financial industry has generally agreed that SOFR will be the successor rate for US dollar LIBOR (the Town's currency). However, the Town's swap contracts do not expressly provide for the use of SOFR when LIBOR is discontinued.
  - While it is strongly anticipated that the Town's swap counterparty, JP Morgan, will apply SOFR after 6/2023, it is not expressly written for that to occur.
  - While unlikely for JP Morgan to apply any other floating rate index, any other index (including a now "dormant" LIBOR) could introduce basis exposure for the Town.

Executive Summary

Situation – Overall Swap Risk

The Town's swaps are intended to protect against a raising interest rate environment on the variable rate COPs, and at the time of financing, for affordability and driven by the bond rating.

Terminating the swap(s) and refinancing the COPs to "true" fixed rate eliminates risks on the swaps and may improve long term financing position, but has costs

- The termination cost of a fixed payor swap moves **inversely** from interest rates – i.e. when interest rates fall, the cost to terminate the swap increases and when interest rates rise, the cost to terminate the swap decreases
- Therefore, although interest rates are low (providing a low cost to borrow to refund the COPs), the Town also has to borrow more to fund the termination payment. This results in lower interest rates, but larger borrowing.
  - If interest rates rise, the cost to terminate the swap goes down and the full borrowing size goes down, but the interest cost goes up.
- The swap has a current approximate termination value (payable from the Town to JP Morgan) of $1.57 million
- Risks associated with synthetic swaps (outside of reset of LIBOR issue) include counterparty risk (JP Morgan), termination risk, and potentially basis risk
- Current swapped debt structure is complex to administer (frequent payments, standby credit support, maintenance and renewal of SBPA, remarketing, swap valuation requirements)

HILLSBOROUGH
California

Risk Mitigation versus Cost & Level of Effort

	(1) Keep Swap Without Any Changes	(2) Keep Swap and Negotiate Fallback Language	(3) Modify Swap to SIFMA	(4) Terminate LIBOR Swap and Issue Fixed Rate Debt	(5) Terminate ALL Swaps and Issue Fixed Rate Debt
Eliminates LIBOR Risk/Improves Other Risks	No/No	Yes/No	Yes/Yes	Yes/Yes+	Yes/Yes+
Cost	No change, but possible uncertainty	No Change	NPV Cost ($166k)	NPV Cost ($514k)	NPV Cost ($970k)
Level of Effort to Implement	None	Low	Medium	High	High
Level of Effort On-Going	High	High	High	Low	Low

Aligning Approach With Town Goals

Two options are recommended as being the best fit, depending on which policies the FAC recommends to the City Council:

1. **Adopt Fallback Language Option** is best fit to meet the following objectives for mitigating LIBOR risk:
   - Sunset of LIBOR has little to no economic impact to the Town
   - Low cost and effort solution absent significant benefits from other options
2. **Refinance All COPs/swaps to Fixed Rate Debt Option** is best fit to meet the following long-term Town objectives:
   - Minimize future financial risk (Town goal – Long Term Financial Health)
     - Eliminates unknown future impacts of swaps by eliminating all swap risk
     - Fixed rate debt is predictable
   - Streamlines administrative time spent on debt management (Town goal – Efficient Daily Operations)

Action Requested

1. FAC provides recommendation on which strategy to deploy to mitigate risk on the 2006A LIBOR based interest rate swap.
   a. Keep swap without any changes – ("Do Nothing") - not recommended
   b. Keep swap and negotiate fallback language
   c. Modify swap to SIFMA (to be consistent with 2000 and 2003 swaps)
   d. Terminate 2006 swap/refund 2006 COP and issue fixed rate debt

2. FAC provides recommendation on whether the Town should conduct analysis for a full refinancing of the current COP/swap debt structure. If further evaluation is recommended, FAC to provide specific recommendation on approach, objectives and outcomes for this evaluation