<u>The State of North Carolina</u>

Interest Rate Exchange Agreement Policy

This policy will govern the use by the State of North Carolina of interest rate exchange agreements. "Interest rate exchange agreement" shall mean a written contract entered into in connection with the issuance of State debt or in connection with State debt already outstanding with a counterparty to provide for an exchange of payments based upon fixed and/or variable interest rates. Practices recommended by the Government Finance Officers Association of the U. S. and Canada for the use of swaps will be considered. The failure by the State to comply with any provision of this policy will not invalidate or impair any Interest Rate Exchange Agreement.

The Conditions Under Which Interest Rate Exchange Agreements May Be Entered Into

Purposes

Interest Rate Exchange Agreements may be used for the following purposes only:

1. To achieve significant savings as compared to a product available in the bond market. Significant savings shall be calculated after adjusting for (a) applicable fees, including takedown, remarketing fees and credit enhancement fees and (b) call options that may be available on the bonds. Examples may include synthetic fixed rate debt and synthetic variable rate debt. Alternatively, significant savings are deemed to occur if the use of derivatives helps to achieve diversification of a particular bond offering.
2. To enhance investment returns within prudent risk guidelines.
3. To prudently hedge risk in the context of a particular financing or the overall asset/liability management of the State. Examples may include buying interest rate caps and entering into delayed start swaps.
4. To incur variable rate exposure within prudent guidelines, such as buying interest rate caps or entering into a swap in which the State's payment obligation is floating rate.
5. To achieve more flexibility in meeting overall financial objectives than available in conventional markets. An example may include a swaption with an upfront annuity payment.

Legality

The State must receive an opinion acceptable to the market from a nationally recognized law firm that the Interest Rate Exchange Agreement is a legal, valid and binding obligation of the State and entering into the transaction complies with applicable law as authorized in G.S. 159-193 through 159-200, or as may be modified in future legislation.

Speculation

Interest Rate Exchange Agreements shall not be used for speculative purposes. Associated risks will be prudent risks that are appropriate for the State to take.

Methods by Which Contracts May be Solicited and Procured

In general, the State should procure Interest Rate Exchange Agreements by competitive bidding. The competitive bid can limit the number of firms solicited to no fewer than three. The State shall determine which parties it will allow to participate in a competitive transaction. In situations in which the State would like to reward a particular firm or wishes to achieve diversification of counterparty exposure, the State may allow a firm or firms not submitting the bid that produces the lowest cost to match the lowest bid and be awarded up to a specified percentage of the notional amount of the Interest Rate Exchange Agreement. In addition, to encourage competition, the State may allow bidders to match the winning bid up to a specified amount of the notional amount as long as their bid is no greater than a specified spread from the winning bidder. The parameters for the bid must be disclosed in writing to all potential bidders.

Notwithstanding the above, the State may procure Interest Rate Exchange Agreements by negotiated methods in the following situations:

1. The State makes a determination that, due to the size or complexity of a particular swap, a negotiated transaction would result in the most favorable pricing and terms. If appropriate, the State should use a financial advisory firm to assist in the price negotiations, in the development of terms and in risk assessment.
2. The State makes a determination, in light of the facts and circumstances, that doing so will promote its interests by encouraging and rewarding innovation.

If procured through negotiation, the State shall obtain an independent opinion that the terms and conditions of the Interest Rate Exchange Agreement reflect a fair market value of such agreement as of the date of its execution.

Form and Content of Interest Rate Exchange Agreements

To the extent possible, the Interest Rate Exchange Agreements entered into by the State 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 State.

The State shall consider including provisions that permit the State to assign its rights and obligations under the Interest Rate Exchange Agreement and to optionally terminate the agreement at its market value at any time. Unless specifically noted in the Interest Rate Exchange Agreement, the counterparty shall not have the right to assign without the consent of the State or optionally terminate an agreement.

Events of Default

Events of default of a counterparty shall include the following:

1. Failure to make payments when due,
2. Material breach of representations and warranties,
3. Illegality,
4. Failure to comply with downgrade provisions, and
5. Failure to comply with any other provisions of the agreement after a specified notice period.

The State will have the right to terminate the agreement upon an event of default by the counterparty. Upon such termination, the counterparty will be the “defaulting party” for purposes of calculating the termination payment owed.

Aspects of Risk Exposure Associated with Such Contracts

Before entering into an Interest Rate Exchange Agreement, the State shall evaluate all the risks inherent in the transaction. These risks to be evaluated could include counterparty risk, termination risk, rollover risk, basis risk, tax event risk and amortization risk. The State shall endeavor to diversify its exposure to counterparties. To that end, before entering into a transaction, it should determine its exposure to the relevant counterparty or counterparties and determine how the proposed transaction would affect the exposure.

Counterparty Selection Criteria

The State may enter into an Interest Rate Exchange Agreement if the counterparty has at least two long term unsecured credit ratings in the double A category from Fitch, Moody’s, or S&P and the counterparty has demonstrated experience in successfully executing Interest Rate Exchange Agreements. If after entering into an agreement the ratings of the counterparty are downgraded below the ratings required by any one of the rating agencies, then the agreement shall be subject to termination unless (a) the counterparty provides either a substitute guarantor or assigns the agreement, in either case, to a party meeting the rating criteria reasonably acceptable to the State or (b) the counterparty (or guarantor) collateralizes the Interest Rate Exchange Agreement in accordance with the criteria set forth in this Policy and the Interest Rate Exchange Agreement.

Provisions for Collateralization

Should the rating of the counterparty, or if secured, the entity unconditionally guaranteeing its payment obligations not satisfy the requirements of the Counterparty Collateralization Criteria, then the obligations of the counterparty shall be fully and continuously collateralized by direct obligations of, or obligations the principal and interest on which are guaranteed by, the United States of America and such collateral shall be deposited with the State or an agent thereof. In the case of an Interest Rate Exchange Agreement, such collateral posted by the counterparty shall have a net market value of at least 100%.

Standards for Procurement of Credit Facilities

The selection of the provider of the credit enhancement or liquidity facility in connection with an Interest Rate Exchange Agreement should be based on the following criteria:

1. Credit Rating,
2. Capacity of the provider,
3. Ability of provider to make required payments,
4. Duration of the Interest Rate Exchange Agreement,
5. Terms of the agreement,
6. Trading value of the provider’s facility,

7. Prior experience with provider,
8. Cost, relative to other proposals and potential savings versus unenhanced obligations,
9. Overall exposure of the State to the provider,
10. Overall exposure of market to provider, and
11. Ability to accept terms and condition proposed.

The procurement of any liquidity and credit enhancement facilities shall be in compliance with applicable State law.

Long-Term Implications

In evaluating a particular transaction involving the use of Interest Rate Exchange Agreements, the State shall review long-term implications associated with entering into Interest Rate Exchange Agreements, including costs of borrowing, historical interest rate trends, sensitivity analysis, variable rate capacity, credit enhancement capacity, opportunities to refund related debt obligations and other similar considerations.

Methods to be Used to Reflect Such Contracts in the State's Financial Statements

The State shall reflect the use of Interest Rate Exchange Agreements on its financial statements in accordance with generally accepted accounting principles and shall include appropriate information about the market value, risk and legal authority regarding such agreements. Such disclosure in the State's financial statements will provide appropriate information to rating agencies, investors and the secondary market.

Monitoring

The State's use of Interest Rate Exchange Agreements shall be monitored on a continuing basis. Responsibility for such monitoring will be assigned to the State and Local Government Finance Division of the Department of State Treasurer and will include the following:

1. Preparing a description of each contract, including a summary of its terms and conditions, the notional amount, rates, maturity and other provisions thereof;
2. Determining any amounts which were required to be paid and received, and that the amounts were paid and received in a timely manner.
3. Determining that each counterparty is in compliance with it rating requirements;
4. Determining that each counterparty is in compliance with the downgrade provisions, if applicable (See Counterparty Selection Criteria); and
5. Determining, at least quarterly, that all posted collateral, if required, has a net market value of at least 100% of the net market value of the agreement to the State. (See Provision for Collateralization).

6. Taking appropriate action to limit undesirable exposures.

7. Developing a contingency plan in the event that early termination of the agreement is determined to be desirable or warranted.

Approved by: ______________________________
Richard H. Moore
State Treasurer

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Date