

NEW JERSEY EDUCATIONAL FACILITIES AUTHORITY
SWAP AND DERIVATIVE POLICY

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NEW JERSEY EDUCATIONAL FACILITIES AUTHORITY

SWAP AND DERIVATIVE POLICY

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NEW JERSEY EDUCATIONAL FACILITIES AUTHORITY

SWAP AND DERIVATIVE POLICY

A. GENERAL

1) Scope and Purpose

The New Jersey Educational Facilities Authority (the “Authority”) is adopting this Swap and Derivative Policy (the “Policy”) to define and describe guidelines for approaching, using, monitoring and managing various types of swaps and other Interest Rate Management Agreements (the “Swaps” or “Agreements”). This Policy is designed to supplement, and to be in conformity with, the various legal requirements applicable to the Authority’s use of Agreements.

The Authority recognizes that changes in the capital markets and other unforeseen circumstances may produce situations that are not covered by this Policy or that make guidelines in this Policy inapposite. The Authority charges the staff, in such circumstances, to conform, to the extent possible, with the purposes of this Policy.

When the Authority discusses a potential financing with a client, it shall review with the clients and the client’s advisors all the various financing options. Such options include Agreements to manage interest rate risk or other financing risks, or to reduce the interest cost on debt. Examples include: locking-in a fixed rate on variable rate debt, or creating synthetic variable rate exposure for the purpose of producing interest rate savings, limiting or hedging variable rate payments, altering the pattern of debt service payments, modifying its variable rate exposure within prudent guidelines, hedging risks in the context of a particular financing, or for asset/liability matching purposes. Examples of Agreements include: interest rate swaps, basis swaps, futures, options, swaptions, caps, collars and floors.

The Authority is a conduit issuer, meaning that it issues bonds and notes on behalf of its clients. Such bonds and notes are special, limited obligations of the Authority, in that they are payable not from the general funds of the Authority, but only from defined revenues receivable from its clients. The obligations to pay the Authority’s debt are therefore ultimately those of its clients, and all decisions regarding long-term obligations with respect to any particular issue of bonds are made in conjunction with the client for whose benefit the bonds are issued.

Similarly, decisions regarding managing the risks of particular long-term obligations must be undertaken in conjunction with, and with the understanding and agreement of, the client that bears such obligations.

In situations where it is appropriate because of legal, structuring or other concerns, the Authority will, upon request of a client after thorough review and analysis, enter into

Agreements in respect of such client's bonds. Such Agreements are called "Authority Agreements". Those Agreements entered into directly by clients are called "Client Agreements".

All financial obligations, all collateral obligations and all obligations dealing with the condition or affairs of a client undertaken by the Authority under an Authority Agreement must be supported by such client. Similarly, the payment obligations of the Authority under an Authority Agreement must be special and limited, payable not from the general funds of the Authority, but only from revenues receivable from the client on behalf of which the Authority entered into such Agreement.

The Authority has determined to engage one or more advisors to help the Authority carry out the purposes of this Policy. One such advisor shall be the Swap Advisor, and its role shall be to help the Authority analyze Swap proposals, educate its clients, negotiate the terms of and procure Swaps and perform such other duties as requested by the Authority. Another advisor shall be the Swap Monitor, and its role shall be to monitor Swaps under both Authority and Client Agreements for the benefit of both the Authority and its clients and to report to the Authority and its clients as described herein. The Authority may also engage additional advisors, as appropriate, to assist in implementing this Policy.

2) Education

Prior to helping a client structure and procure a Client Agreement or to entering into any Authority Agreement on behalf of a client, the Authority will review with the client the long-term implications associated with entering into such Agreement. The Authority and its Swap Advisor will use their best efforts to make sure that the client understands the risks and rewards of the Agreement, is able to evaluate the various options presented to it in structuring the Agreement and is prepared to manage its ongoing responsibilities under the Agreement for its term.

The Authority will not recommend that a client use or not use any particular Agreement. A decision to use an Agreement is a risk-management decision as are the particular structuring decisions inherent in any Agreement, and the Authority's clients have better perspectives from which to assess their risks and to determine how much of any particular risk is acceptable and how much is not.

The Authority and its Swap Advisor will, upon request, assist clients that wish to develop derivative policies of their own.

The Authority will always recommend that its clients consult with their own legal advisors.

3) Conditions for the Use of Agreements

Any transaction involving an Authority Agreement shall be submitted to the members of the Authority for their approval. The Authority may designate one or more officers ("Authorized Officers") to select the counterparties and make other necessary business

and structuring decisions associated with Authority Agreements on behalf of the Authority.

4) Qualified Hedges

The Authority, in consultation with the appropriate Client and legal counsel, will determine whether it is advisable to treat each Agreement as a Qualified Hedge within the meaning of Section 1.148-4 of the Internal Revenue Code of 1986, as amended (the “Code”). If the Authority determines to do so, the Agreement will be structured to satisfy the requirements of the Code and the regulations thereunder. The current federal tax requirements include:

- (i) The Agreement must be entered into to reduce the risk of interest changes and must have no significant investment element;
- (ii) The Agreement must be entered into between the Authority or the Client, as applicable, and an unrelated party;
- (iii) The Agreement must cover all of one or more groups of substantially identical bonds in the issue (*i.e.*, all of the bonds having the same interest rate, maturity and terms) or the same specific identifiable interest payments on each of the substantially identical bonds of the issue;
- (iv) Changes in the value of the Agreement must be primarily interest rate based;
- (v) The Agreement must not hedge an amount larger than the risk with respect to interest rate changes on the hedged bonds;
- (vi) Payments to the Authority under the Agreement must closely correspond, in both time and amount, to the specific interest payments being hedged on the bonds;
- (vii) Payments on the Agreement must not accrue earlier than the sale date of the hedged bonds and must not accrue longer than the hedged interest payments on the hedged bonds;
- (viii) Payments (if any) to the hedge provider must be reasonably expected to be made from the same source of funds that, absent the hedge, would be reasonably expected to be used to pay principal of and interest on the hedged bonds; and
- (ix) The Qualified Hedge must be identified by the Authority on its books and records maintained for the hedged bonds on or before three (3) days from execution of the Agreement and be noted on all forms filed with the Internal Revenue Service for the bond issue after the date the Agreement is entered into.

5) Legality

Prior to entering into an Authority Agreement, the Authority must receive an opinion acceptable to the market from a nationally recognized law firm that the Agreement is a legal, valid and binding obligation of the counterparty and that entering into the transaction complies with applicable law. The Authority will recommend that each client receive such an opinion in connection with a Client Agreement.

6) Fairness

Prior to entering into an Authority Agreement, the Authority must also receive a “fairness” opinion from the Swap Advisor in connection with such Agreement to the effect that the terms and conditions of such Agreement represent fair market value for such transaction as of its date. The Authority will recommend that a client receive such a fairness opinion before any Client Agreement is executed.

B. FEATURES OF THE AGREEMENTS

1) Form of Agreements

Generally, Agreements will be based on the terms and conditions set forth in the International Swaps and Derivatives Association, Inc. (ISDA) Master Agreement. Authority Agreements may contain such modifications as an Authorized Officer, with the advice of the Swap Advisor, shall determine to be appropriate. Each Authority Agreement shall include terms specifying the amount and timing of payments, maturity, security, collateral, defaults, remedies, termination and such other terms, conditions, provisions and safeguards as the Authority, in consultation with the client or clients on whose behalf the Agreement is to be executed, legal counsel and Swap Advisor, deems necessary or desirable.

2) Terms of Authority Agreements Relating to Interest Rate Swaps

The terms of any Swap should refer to the following guidelines:

Downgrade provisions triggering terminations shall in no event be worse for the Authority’s client than those affecting the counterparty.

Governing law will be the laws of the State of New Jersey.

The specified indebtedness related to credit events in any Agreement should be narrowly defined and should refer only to indebtedness of the Authority’s client that could have a materially adverse effect on such client’s ability to perform under the swap.

Collateral thresholds for the swap provider should be set on a sliding scale reflective of credit ratings, size and directional market risk of the transaction. Collateral requirements should be established and based upon the credit ratings of the counterparty or guarantor.

Eligible collateral should generally be limited to U.S. Treasury securities and obligations of Federal Agencies unless otherwise specifically authorized by an Authorized Officer for a particular Agreement.

The Authority should generally have the right to *optional termination* of an Agreement at “market”, at any time over the term of such Agreement.

Termination value should be set by utilizing Market Quotation, Second Method, unless an Authorized Officer deems an alternate method is appropriate.

3) Qualified Counterparties

The Authority shall not enter into an Agreement with a counterparty that does not have (1) (a) a general credit rating of at least “A1” or “A+” from one of the nationally recognized statistical rating organizations, as recognized by the Securities and Exchange Commission, or (b) a subsidiary rated “AAA” by at least one nationally recognized statistical rating organization, (2) a minimum capitalization of at least \$100 million and (3) a demonstrated record of successfully executing municipal swap transactions. For each Authority Agreement, an Authorized Officer shall determine whether to require a higher credit standing from qualified counterparties, after consultation with the client or clients on whose behalf the Agreement is to be executed.

In addition to the rating criteria specified herein, the Authority, where appropriate, will seek additional credit enhancement and safeguards in the form of:

- Contingent credit support or enhancement;
- Collateral consistent with the policies enumerated above;
- Ratings downgrade triggers; or
- Guaranty of parent, if any.

The Authority will recommend that each client obtain similar protections in connection with a Client Agreement.

4) Methods of Soliciting and Procuring Swaps

Agreements can be procured via competitive bids or on a negotiated basis. The competitive bid should include a minimum of three firms with counterparty ratings determined as set forth herein. The Authority, in special circumstances, may allow a firm or firms not submitting the winning bid to match such bid and be awarded no greater than 50% of the notional amount of an Authority Agreement.

The Authority may procure Agreements on a negotiated basis when the Authority makes a determination that:

- (i) Due to the size, complexity or credit features of a particular financing, a negotiated bid would result in the most favorable pricing; or
- (ii) In light of the facts and circumstances, doing so will promote the Authority’s interest by encouraging and rewarding innovation.

5) Counterparty Exposure

The Authority shall endeavor to diversify its clients' exposure to counterparties. To that end, before entering into an Agreement, it will determine its client's exposure to the relevant counterparty or counterparties and determine how the proposed transaction would affect the exposure. The exposure should be measured in terms of notional amount, mark to market valuation and volatility. The Authority shall also take into account its client's exposure to any related entities of a particular counterparty as well as other credit facilities outstanding between such client and the counterparty.

6) Term and Notional Amount

In most cases, the appropriate term for an Agreement shall be the same as for the bonds it is being used to hedge. Similarly, the notional amount of an Agreement should amortize at least as quickly as do the bonds it is being used to hedge.

7) Pledging of Collateral

As part of any Authority Agreement, the Authority may, based on credit ratings of the counterparty, require collateralization or other forms of credit enhancements to secure any or all payment obligations under the Agreement. As appropriate, the Authority, in consultation with its legal counsel and Swap Advisor, may require collateral or other credit enhancement to be posted by the counterparty subject to the collateral threshold amounts specified for such Agreement. Additional collateral for decreases in credit ratings of each counterparty and/or increases in threshold mark to market exposure shall be posted by each counterparty in accordance with the provisions contained in the Agreement. Collateral shall be deposited with a third party trustee, or as mutually agreed upon between the Authority and the counterparty. The market value of the collateral shall be determined on not less than a weekly basis, or more frequently if the Authority determines it is in its best interest given the specific collateral.

When the bonds relating to an Authority Agreement are insured, the Authority will generally require that regularly scheduled payments due from a client in respect of an Agreement are also insured.

8) Prohibited Agreements

The Authority will not use Agreements that:

- (i) Are purely speculative in nature or create extraordinary leverage or risk;
- (ii) Lack adequate liquidity to terminate without incurring a significant bid/asked spread; or
- (iii) Provide insufficient price transparency to allow reasonable valuation.

C. EVALUATION AND MANAGEMENT OF THE AGREEMENTS

1) Evaluation

The Authority, along with its Swap Advisor, will review with the client or clients, and its or their advisors, for which an Agreement is to be executed the following areas of potential risk. The Authority and the Swap Advisor will work with each client to have in place procedures to evaluate and understand the risks and to overcome or mitigate them, in the event that unfavorable situations occur:

Interest Rate Risk:

Interest rate risk is the risk that interest costs on a bond or an Agreement will increase and cost more than the rates associated with a fixed-rate obligation.

The Authority will monitor rates on all variable rate bonds and fixed-to-floating Swaps.

The Authority will work with its clients to minimize interest rate risk. Examples include using variable rate debt or Swaps to hedge floating rate assets, budgeting variable rate costs conservatively and providing the ability to convert to fixed rate payments at the client's option.

Basis Risk:

Basis risk is the risk of a mismatch between the actual variable interest rate on the Authority's debt and the variable interest rate on the Index from which any payments under an Agreement are received.

Prior to entering into any Agreement, the Authority will review with the client or clients on whose behalf the Agreement is to be executed the historical relationships and trading differentials between the variable rates on similar bonds and the Index. After entering into any Agreement with basis risk, the Authority will monitor any such mismatch and evaluate opportunities to reduce or eliminate basis risk at attractive prices.

Termination Risk:

Termination risk occurs when there is a need to terminate an Agreement in an interest rate environment that dictates a termination payment by the Authority or a client to the counterparty.

The Authority will structure each Authority Agreement such that the counterparty's right to early termination is limited and such that the counterparty has no optional termination rights. Further, the Authority will require that a termination payment will be based on an Agreement's market value, giving the Authority the best chance to recover such market value from a replacement counterparty.

Counterparty Risk:

Counterparty risk occurs when there is the failure of a counterparty to make required payments under an Agreement.

The Authority and the Swap Monitor will monitor exposure levels, ratings thresholds and collateralization requirements and will take action to enforce remedies when appropriate. The Authority will also consider termination of any counterparty the ratings on which fall below the minimum required for entering into an Agreement with the Authority.

Credit Risk:

Credit risk occurs when an event modifies the credit rating of a counterparty.

The Authority and the Swap Monitor will monitor the ratings of its counterparties and their credit enhancers, and in the event of a downgrade will immediately review available remedies, such as collateralization and additional credit enhancement, and take appropriate enforcement action.

Liquidity Risk:

Liquidity risk occurs when there is an inability to renew a liquidity facility on a floating rate bond issue.

The Authority will evaluate the expected availability of liquidity support for variable rate debt. The Authority encourages frequent discussions with all potential liquidity facility providers.

Tax Risk:

Tax risk is created by potential changes in the tax laws that could affect payment under an Agreement.

The Authority, its Swap Advisor and legal counsel will review the tax events in proposed Agreements with its client or clients. The Authority and the Swap Advisor will discuss with its client or clients the impact of potential changes in tax law on payments under each Agreement based on taxable indices.

2) Monitoring

The Authority will make the services of the Swap Monitor available to its clients for each Swap related to Authority bonds. The Swap Monitor will monitor the terms, market value, accruals, collateralization, ratings and other critical terms of each such Swap. For each such Swap, the Swap Monitor will report regularly, and as requested, to the Authority and to the client that entered into, or for whose benefit the Authority entered into, such Swap. Such reports will also include various sensitivity analyses.

The Authority will advise and assist clients, if requested, in making use of the services of the Swap Monitor.

3) Managing Agreement Risks

Reports to the Authority:

The Authority staff and the Swap Monitor will analyze the risks associated with outstanding Authority Agreements at least annually and as requested by the Authority,

and report their findings to the Authority. This evaluation will include the following information:

- (1) A description of all outstanding Authority Agreements, including related bond series, types of Agreements, rates paid and received under Agreements, notional amounts, average life and remaining term, and the current termination value of all such Agreements.
- (2) The credit rating of each Authority Agreement counterparty, parent, guarantor, and credit enhancer insuring payments, if any.
- (3) Actual collateral postings by counterparty, if any.
- (4) Information concerning any material event involving outstanding Authority Agreements, including a default by a counterparty, a downgrade, or termination.
- (5) The status of any liquidity support used in connection with Authority Agreements, including the remaining term and current fee.

Updates to the Policy:

The Authority staff, along with the Swap Advisor, shall review this Policy at least annually, and the Executive Director shall submit any suggested updates to the Authority for approval.

3) Terminating Agreements

Optional Termination:

The Authority, in consultation with its Swap Advisor and legal counsel, and only with the approval of the appropriate client or clients, may terminate an Authority Agreement if it is determined that it is financially advantageous or otherwise appropriate under the circumstances to do so.

Mandatory Termination:

In the event that an Authority Agreement is terminated as a result of a termination event, such as a default or a decrease in credit rating of either a client or the counterparty, the Authority along with its client and the Swap Advisor will evaluate whether it is financially advantageous or otherwise appropriate to obtain a replacement Agreement, or, depending on market value, make or receive a termination payment. In the event that a Client Agreement is terminated as a result of a termination event, the Authority and the Swap Advisor will assist the Client, if requested to do so, in making the foregoing evaluation.

D. DISCLOSURE AND FINANCIAL REPORTING

The Authority will take steps to ensure that there is full and complete disclosure of all Authority Agreements to the Authority, to rating agencies, and in disclosure documents. With respect to its financial statements, the Authority will adhere to the guidelines for the

financial reporting of Agreements, as set forth by the Government Accounting Standards Board. If requested, the Authority and the Swap Advisor will assist each Client in making similar disclosure of both Authority and Client Agreements and in its financial reporting.