

360 Madison Avenue
New York, NY 10017-7111
Telephone 646.637.9200
Fax 646.637.9126
www.bondmarkets.com

1399 New York Avenue, NW
Washington, DC 20005-4711
Telephone 202.434.8400
Fax 202.434.8456

St. Michael's House
1 George Yard
London EC3V 9DH England
Telephone 44.20.77 43 93 00
Fax 44.20.77 43 93 01



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The municipal derivatives market has grown significantly since the market's inception in the mid-1980's. For state and local governments, health care institutions, universities and other borrowers (each, a "borrower"), derivative transactions have become a key tool in the standard repertoire for reducing borrowing costs, hedging existing assets and liabilities, improving the strategic timing for market access, optimizing the mix of fixed and floating rate debt and investment portfolios, and enhancing investment returns. The most common use for derivatives in the municipal market has been the execution of interest rate swaps and related products to hedge or lower a borrower's expected exposure for new, anticipated, or outstanding debt.

As the use of derivative products has become more widespread in the municipal market, borrowers and their financial and legal advisors have become more familiar with the structure of the transactions, their uses, and the nature of the risks undertaken. The growth of the market has been fostered, in part, by continually improving education, the expansion of sources for publicly available information, the continuing coverage of the market by dealers, press coverage, derivatives presentations at numerous industry conferences, and the proliferation of financial advisory firms specializing in, or able to provide advice on, a range of municipal derivative transactions. Dealers have been active in educating market constituents – borrowers and their counsel and advisors, rating

agencies, credit enhancers, and members of the press – about the risks and benefits of derivatives transactions.

The goal of this release is the further and continued education of the municipal marketplace as to dealer principles and practices. With this release, The Bond Market Association (the “Association”) today reaffirms its adoption of The Principles and Practices For Wholesale Financial Market Transactions, first published on August 17, 1995 (the “Principles and Practices”¹), a copy of which can be accessed at www.ny.frb.org/fxc/fx18.html#Committe_Letter, for municipal market dealers in respect of their derivative activities and, while recognizing that particular practices vary from dealer to dealer, the Association continues to recommend to its Members adherence to its terms. As stated more fully below, this release is just one part of an ongoing effort; the Association and its Members are fully supportive of all efforts to assist the municipal marketplace in improving its understanding of derivatives.

Scope of the municipal derivatives market

The derivatives market for municipal market borrowers is steadily growing. A significant number of state or local governmental entities have executed derivative transactions, ranging from many of the major cities, states, and state-wide issuers to smaller, single-purpose governmental enterprises. In addition, non-profit health care and higher education borrowers of the proceeds of tax-exempt obligations have comprised a

¹ Representatives of the Foreign Exchange Committee of the Federal Reserve Bank of New York, the Emerging Markets Traders Association, the International Swaps and Derivatives Association, the New York Clearing House Association, the Association (formerly known as the Public Securities Association), and the Securities Industry Association participated in the preparation of the Principles and Practices. The preparation of the Principles and Practices was coordinated by the Federal Reserve Bank of New York.

significant component of the municipal derivatives market. In October 2002, it was estimated that activity in the municipal derivatives market totaled approximately \$200-\$400 billion in total notional amount outstanding². At the market's inception, there were no state statutes expressly governing the execution of derivatives transactions by state or local governments; today, approximately 40 states have some form of derivatives legislation expressly permitting local governmental issuers to enter into derivative transactions.³

The dealer community in the municipal derivatives market consists principally of securities firms, commercial banks, and other financial institutions otherwise active in the derivatives market at large; a significant number also have municipal market roles outside of their derivatives businesses, for example, as underwriters, financial advisors or credit enhancers to borrowers. The range of products offered by dealers in the municipal derivatives market generally reflects the characteristics of the debt financing and balance sheet management activities of borrowers. On the other hand, in recognition of the wide differences that characterize borrowers in the municipal market and because derivative products can be tailored to meet a borrower's financial objectives, dealers offer a varied range of products to a varied marketplace of borrowers. The action taken by the Association today, the reaffirmation and readoption of the Principles and Practices for the municipal derivatives market, is predicated on the perceived need to further and

² Moody's Reports: Increased Use of Swaps May Introduce Credit Risks to Municipal Issuers, October 29, 2002.

³ Derivatives legislation is not a prerequisite for all local governmental issuers' execution of derivative transactions; many governmental entities possess the requisite legal authority to engage in derivative transactions without express legislative authority.

continually educate this complex and multi-faceted borrower market as to the principles and practices of dealers.

The Dealer as Principal

The Association believes that the continued growth and success of the municipal derivatives market is dependent upon a clear understanding by borrowers of the rigorous standards and practices adhered to by dealers. The Principles and Practices creates a framework by which a dealer may assess its derivatives business as a whole, as well as each individual transaction it executes, with the principal objective being that a dealer will not subject itself or the marketplace to unmanageable financial or reputation risk. However, as in the derivatives market at large, a Member firm's activities as a dealer in the municipal market – executing transactions and taking risks as principal – are distinct from its roles in its other business lines, such as underwriting and financial advisory work.

Moreover, the role of a dealer, as principal executing a transaction, includes a wide variety of activities such as developing and marketing products and providing borrowers with information about the risks and rewards of particular products and strategies. Dealers have historically been, and are expected to continue to be, helpful to borrowers in a variety of ways, among others, by presenting opportunities in derivatives, detailing the range of products available in the market, and quantifying for borrowers potential outcomes from the implementation of various strategies. It is common practice,

particularly in negotiated transactions, for dealers with ongoing relationships with their borrower clients to assist borrowers by providing information regarding the ongoing management of their derivative portfolios in much the same way. However, as principal in an arms' length transaction, a dealer, when it executes a derivatives transaction (whether municipal or otherwise), and even when it assists its borrower clients as described above, functions entirely as a contract counterparty. In the municipal derivatives market, as in the derivatives market at large, both parties to a derivatives transaction typically have exposures to the other. Therefore, it is common practice in the derivatives markets for contractual agreements to contain terms in which the parties represent to each other and acknowledge that they are not relying on the advice of the other in entering into a particular transaction or transactions and that they have consulted with such advisors as they have deemed necessary to assess the risks and benefits of the transaction.⁴

In the municipal derivatives market, as in the derivatives markets at large, the ability of a dealer to execute transactions as a principal is dependent on its ability to access and execute offsetting, hedging, or reverse positions. The derivatives market depends, in large part, on dealers' ability to take financial positions that are, by definition, distinct from the financial positions of their counterparties. For the market to thrive, dealers must have access to multiple counterparties seeking to take opposing positions on prices, rates, yields, etc. This means that a dealer's ability to offer a rate or price on a municipal derivatives transaction (for example, the rate to be paid or received by a

⁴ Indeed, the International Swaps and Derivatives Association, Inc. ("ISDA") has prepared a standard representation regarding the relationship between parties which can be included in any of ISDA Master Agreements.

borrower in exchange for a different rate to be paid or received by the dealer) is dependent on the dealer's ability to pay that rate or price, profitably, in light of rates or prices otherwise available to the dealer in the market. Since a dealer will simultaneously take opposing positions as to market rates and prices, it is crucial to the functioning of the market that dealers act not as agents of the counterparties with whom they transact, but as principals.

Under the Principles and Practices, the type, nature, and scope of inquiry that a dealer may engage in before executing a particular transaction may vary not only among dealers, but also, with the complexity of the transaction in question as well as the type, sophistication, and financial objectives of the borrower. Borrowers in the municipal market vary widely in size, function, complexity, scope of mandate, governance, legal authority, etc. In the municipal derivatives market, transactions are arranged on both a negotiated and a competitive basis, and while the Principles and Practices may, of course, be adhered to in either context, a dealer's opportunity to review a borrower's financial objectives is naturally greater in the negotiated context than it is in the competitive context.

Recommendations

1. The Association reaffirms its adoption of the Principles and Practices, strongly urges its Members and the municipal derivatives marketplace to carefully review its terms and, while recognizing that particular practices vary from dealer to dealer, urges Members to continue to apply its rigorous standards to activities in the municipal derivatives market.

2. The Principles and Practices encourages a range of action steps on a dealer's part in structuring its derivatives business and a range of determinations to be made by a dealer in considering whether to enter into a particular transaction with a particular counterparty. Dealers will assume that borrowers (i) undertake similar processes in respect of their activities in the market, (ii) determine their own capacity for understanding the quality and nature of the risks they are incurring, in the context of their own fiscal, budgetary, legal, tax, and portfolio constraints, (iii) assess the various risks posed by a particular transaction, and (iv) determine whether they themselves, or, as appropriate, whether they, together with the assistance of qualified financial advisors, are in a position to make such determinations.⁵

3. The Association acknowledges the thoughtful consideration by borrowers of various financing alternatives, carefully drafted documents, exchanges of legal opinions, and the adoption by borrowers of debt policies and authorizing resolutions. The Association supports these steps and believes that maintaining such sound practices will continue to promote sensible market development.

4. The Association recommends that Members continue to provide clear guidance to borrowers as to their role as principal in executing derivative transactions.

Because of the need for legal certainty in defining the nature of the relationship,

⁵ This assumption is consistent with the Governmental Accounting Standards Board Technical Bulletin No. 2003-1 which requires the borrower to understand and disclose the objectives, terms, fair value, risks, and other material facts relating to the derivative instrument(s) to which the borrower has entered into.

the Association is supportive of continued inclusion of “Non-reliance” and similar provisions in derivative documentation.

5. The Association and its Members regard the ongoing education of the municipal marketplace and the derivatives market generally as crucial to the continued and vibrant growth of the market and are committed to continued educational efforts. The Association will continue to support the efforts of issuer groups and other market participants to educate their members about both the opportunities and the risks of executing derivative transactions. The Association recommends that as such groups so request, its Members continue to provide assistance in such efforts.