



MASSACHUSETTS BAY TRANSPORTATION AUTHORITY

Master Derivatives Policy

June 2022

1) Purpose

The purpose of this Derivatives Policy is to provide a framework for the Massachusetts Bay Transportation Authority's ("MBTA" or the "Authority") use of swaps, caps, floors, collars, options and other hedges or derivative financial products (collectively referred to herein as "Derivatives") in conjunction with the Authority's management of its assets and liabilities. The policy is intended to serve as a source of information and guidance on the use and ongoing monitoring of Derivatives for the professional staff of the Authority, its Board of Directors, and the rating agencies, as well as the general public and financial institutions wishing to do business with the Authority.

2) Scope

The policy describes the circumstances and methods by which Derivatives will be used, the guidelines to be employed when Derivatives are used and who is responsible for carrying out these policies.

3) Authority

The MBTA's legal authority for using Derivatives is based on the Authority's general contractual powers and statutory authority as contained in Chapter 161A of Massachusetts General Laws. Under this authority, the Authority may enter into Derivatives as authorized by the Board of Directors in connection with or incidental to the issuance or payment of obligations, including without limitation, debt obligations, before, concurrently with, or after the actual incurrence of an obligation or issuance of the debt.

4) Procedure

The Authority shall consider entering into Derivative transactions based on the following analysis:

- (i) The appropriateness and suitability of the transaction based on the balance of cost, risks and rewards presented including a detailed description of the transactional structure and risk mitigation measures, where applicable;
- (ii) The legal framework for the transaction within the context of Massachusetts statutes, Authority authorization, and relevant indenture and contractual requirements (including those contained in credit agreements), as well as any implications of the transaction under federal tax regulations;
- (iii) Credit rating implications, including the potential effects that the transaction may have on the credit ratings of any Authority obligations;
- (iv) The potential impact of the transaction on any areas where the Authority's capacity is limited, now or in the future, including the use of variable-rate debt, bank liquidity facilities, letters of credit and bond insurance;
- (v) The administrative burden that may be imposed by the transaction, including accounting and financial reporting requirements;
- (vi) Other implications of the proposed transaction as warranted; and
- (vii) Whether there would be sufficient price transparency, as a result, for example, of unusual structures or terms, to permit the Authority and a Derivative advisor to reasonably determine the fair-market value of the Derivative.

5) Permitted Uses

While the MBTA may use Derivatives for managing risk and other business reasons listed above, the Authority does not and will not enter into Derivatives for purely speculative purposes. The Authority will consider the following, as applicable in the context of the risk being hedged, in evaluating and entering into Derivative transactions:

- (i) Managing the Authority's exposure to floating and fixed interest rates, through interest rate swaps, caps, floors, collars, other option products and forward delivery products;
- (ii) Hedging floating rate and/or spot market risk with caps, collars, basis swaps and other instruments;
- (iii) Locking in fixed rates in current markets for use at a later date, through the use of forward swaps, swaptions, rate locks, options and forward delivery products;

- (iv) Reducing the cost of fixed or floating rate debt, through swaps and related products to create “synthetic” fixed or floating rate debt;
- (v) Accessing the capital markets more rapidly than may be possible with conventional debt instruments;
- (vi) Managing the Authority’s exposure to the risk of changes in the legal and regulatory treatment of tax-exempt bonds, including changes in federal marginal tax rates and other changes in regulations or tax laws that may affect the value of tax-exempt bonds relative to other investment alternatives;
- (vii) Managing the Authority’s credit exposure to financial institutions and other entities through the use of offsetting swaps and other credit management products; and
- (viii) Mitigate the volatility of fuel and electricity prices to increase budgeting certainty.

6) Documentation Guidelines

The MBTA will use one of the forms of the International Swaps and Derivatives Association, Inc. (“ISDA”) Master Agreement as a framework for Derivatives documentation. The Derivatives agreement between the Authority and each counterparty shall include payment, term, security, collateral, default, remedy, termination, as well as other terms, conditions, provisions and safeguards as the Authority, in consultation with a Derivatives advisor and legal counsel, deems necessary or desirable.

Subject to the provisions contained herein, the terms of any Derivatives agreement shall adhere to the following guidelines:

- (i) Ratings-based downgrade provisions shall be included, where appropriate, and should reflect the relative credit strength of the Authority in comparison with the Derivatives Provider. This comparison should give weight to the prevailing greater credit strength of public sector entities as compared with for-profit corporations and financial institutions;
- (ii) The Authority will strive to minimize cross default provisions. The specific indebtedness related to credit events in any Derivatives agreement should be narrowly defined and refer only to indebtedness of the Authority that could have a materially adverse effect on Authority’s ability to perform its obligations under the Derivatives. Debt should only include obligations within the same or superior lien as the Derivatives obligation;
- (iii) Collateral thresholds for the Derivatives provider should be set on a sliding scale reflective of credit ratings. Collateral requirements should be established and based upon the credit ratings of the Derivatives provider or its guarantor;
- (iv) Eligible collateral should generally be limited to cash or Treasuries and obligations of

Federal Agencies where the principal and interest are guaranteed by the United States. At the discretion of the Authority, other highly liquid, high quality obligations of Federal agencies that are not secured by the full faith and credit of the U.S. government, may be used as collateral;

- (v) The Authority shall have the right to optionally terminate a Derivatives agreement “at market,” at any time over the term of the agreement. The Derivatives provider should have no similar right.

7) Counterparty Credit Standards

Derivatives products can create for the Authority a continuing exposure to the creditworthiness of financial institutions that serve as the Authority’s counterparties on Derivatives transactions. To protect the MBTA’s interests in the event of a counterparty credit problem, the Authority will adhere to the following standards:

- (i) Use of highly-rated counterparties: Standards of creditworthiness, as measured by credit ratings, will determine eligible counterparties. Differing standards may be employed depending on the term, size, and interest-rate sensitivity of a transaction, types of counterparties and potential for impact on the Authority’s credit ratings. In cases where the counterparty’s obligations are rated based on a guarantee or specialized structure to achieve the required credit rating, the Authority shall thoroughly investigate the nature and legal structure of the guarantee or structure in order to determine that it fully meets the Authority’s requirements.
- (ii) Collateralization on downgrade: If a counterparty’s credit rating is downgraded below agreed-upon levels, the Authority shall generally require that its exposure to the counterparty be collateralized; and
- (iii) Downgrade Notice: The Authority should require that its Derivatives counterparties notify the Authority in the event of a credit ratings downgrade. The Authority or a Derivatives advisor should independently monitor all ratings agency actions with respect to its counterparties.

In order to limit the MBTA’s counterparty risk, the Authority will seek to avoid excessive concentration of exposure to a single counterparty or guarantor by diversifying its counterparty exposure over time. Exposure to any counterparty will be measured based on the termination value of any Derivatives contract entered into with the Counterparty, as well as such other measurements as the Authority may deem suitable to measure potential changes in exposure, such as “value at risk” or “peak exposure.” Termination values shall be monitored on at least a monthly basis, based on a mark-to-market calculation of the cost of terminating the Derivatives contract given the market conditions on the valuation date.

Derivative termination value for each counterparty should take into account netting of offsetting transactions (i.e., fixed-to-floating vs. floating-to-fixed). As a matter of general principle, the

Authority may require counterparties to provide regular mark-to-market valuations of Derivatives they have entered into with the Authority, and should seek regular, periodic valuations from an independent third party professional.

As of the date of execution of any Derivative, the aggregate maximum net termination exposure for all of the Authority's then existing and proposed Derivatives with all counterparties, as determined in conjunction with a Derivatives advisor, shall not exceed the sum of available cash or investments and unutilized capacity of commercial paper or other debt.

8) Method of Procurement

The Authority may select counterparties for entering into Derivatives contracts on either a negotiated, competitive basis or by some combination of each method. Negotiated procurement may be used for original or proprietary products, original ideas of applying a specified product to an Authority need or if it is in the Authority's best interest based on the Authority's and its advisors' judgment, such as when executing the termination of Derivatives on a negotiated basis to ensure better coordination in conjunction with the simultaneous issuance of bonds.

If it is determined that a Derivative should be competitively bid, the Authority may employ a hybrid structure to reward unique ideas or special effort by reserving a specified percentage of the Derivative to the firm presenting the ideas on the condition that the firm match or improve upon the best bid.

Each Derivative entered into by the Authority shall be subject to an independent review and analysis by a Derivatives advisor. This review and analysis shall include a detailed description of the derivative product; a description of risks/benefits; and a finding that its terms and conditions reflected a fair market value as of the date and time of its execution. All Derivative contacts shall be approved by the Board of Directors and (per 976 CMR 2.00) presented to the State Finance and Governance Board for review.

9) Risk Management

Because of the size and complexity of the assets and liabilities of the MBTA and its established financial systems and controls, the Authority will manage the risks and rewards of the Derivatives program alongside its overall financial risks and rewards. As part of the risk management process, the Authority will evaluate the aggregate Derivative exposure as measured by value at risk, peak exposure and/or realistic worst-case scenarios.

Among the risks that the Authority will monitor, evaluate, and seek to mitigate, are:

| Type of Risk | Description | Evaluation Methodology | Mitigation |
|---------------------|--|--|---|
| Counterparty Risk | The risk of a failure of one of the Authority’s Derivative providers to perform as required under a Derivative contract. | The Authority will evaluate the Derivative providers’ credit ratings and existing exposure on other transactions, including commodity and other transactions across the organization. | The Authority will diversify its exposure, impose minimum credit rating standards and require protective documentation provisions. (See above Sec. 7, “Counterparty Credit Standards”) |
| Termination Risk | The risk that a Derivative may be terminated prior to its scheduled maturity due to factors outside the Authority’s control. | The Authority will review potential sources of early termination, including those resulting from documentation provisions and the likelihood of credit downgrade that could precipitate an early termination. | The Authority will use protective documentation provisions and will evaluate sources of liquidity and market access that could be used in the event a termination payment were required to be made. |
| Interest Rate Risk | The risk that the Authority’s costs associated with variable- rate exposure increases can negatively affect budgets, coverage ratios and cash flow margins. Variable- rate exposure may be created by a Derivative from fixed to floating, or a Derivative that otherwise creates some type of floating-rate liability. The interest rate risk presented by such a Derivative may be increased as interest rates increase generally, as intra-market relationships change, or because of credit concerns relating to the Authority or a credit enhancer. | Prior to taking on interest rate risk, the Authority will measure its capacity for floating rate exposure, based on policy targets for its mix of fixed and floating rate debt and taking into consideration future variable rate needs. | The Authority will maintain floating rate exposure within policy limits, and will make use of interest rate hedges, like caps and collars on an as-needed basis. |

| Type of Risk | Description | Evaluation Methodology | Mitigation |
|---------------|---|---|--|
| Basis Risk | <p>The risk that the floating rate on the Derivative fails to offset the floating rate on the underlying asset or liability. Because Derivatives are generally based on a floating-rate index, the chosen index should correlate closely, but may not correlate exactly. A common type of basis risk is often referred to as “tax risk,” or the risk of a mismatch between the floating rate on tax-exempt debt and a Derivative index, based on a taxable index (i.e., SOFR). The correlation between the SOFR-based rate and the bond rate may change based on changes in tax law or other market events.</p> | <p>The Authority will measure and review the historic variation between the floating rate index used in the Derivative and the underlying floating rate debt it is hedging. In the absence of a sufficient history of underlying debt, it will use relevant comparable floating rate debt. The degree of risks should be evaluated in comparison with degree of benefit provided.</p> | <p>The Authority will consider mitigation techniques as warranted, including maintaining a cushion between the floating rate index and the expected trading level of the floating rate debt, creating a reserve to cover potential basis risk mismatches, and including provisions for optional termination.</p> |
| Rollover Risk | <p>When a Derivative is used in conjunction with underlying puttable floating-rate debt, bank facility rollover risk exists if the term of a needed liquidity or credit facility on the debt is shorter than the term of the Derivative. The Authority is at risk as to both the availability and the price of successive bank facilities.</p> | <p>The Authority will evaluate the likelihood of unavailability of bank facilities based on the underlying credit of the debt as well as the general market for liquidity facilities.</p> | <p>The Authority may use any of the following mitigation techniques: purchasing longer-term facilities for credits where rollover risk is greatest and staggering the maturity dates of different liquidity facility programs to diversify points of market re- entry.</p> |
| Pricing Risk | <p>The risk that the Derivative may not be priced competitively in comparison to the market for comparable Derivatives transactions.</p> | <p>Prior to entering into a Swap, the Authority will make a determination that the transaction can be priced with reasonable transparency and confidence.</p> | <p>The Authority will not enter into overly complex or illiquid transactions where competitive pricing cannot be ascertained. Where it meets Authority objectives (as outlined above in Section 8 “Method of Procurement”), it will use a competitive process. For negotiated transactions, it will seek independent price verification through appropriate professional advice.</p> |

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| Regulatory Risk | The risk that broad market regulation changes require existing derivatives to be re-priced or otherwise modified before termination. | Prior to entering into a Swap, the Authority will make a determination as to any pending regulatory changes that could affect the valuation or risk-profile of the Swap going forward. | The Authority will monitor on an ongoing basis pending or potential regulatory changes that could affect the valuations of its derivatives. |
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The Authority will measure and evaluate the effect of leverage contained within any Derivative on the magnitude of any of the above-mentioned risks.

10) Monitoring and Reporting

The MBTA will track and regularly report on the financial implications of the Derivatives it enters into and may engage a professional swap advisor to assist with such monitoring. An annual report will be prepared for the General Manager, Chief Administrator, Chief Financial Officer and Treasurer, including:

- (i) A summary of key terms of the agreements, including notional amounts, interest rates, maturity and method of procurement, including any changes to Derivatives agreements since the last reporting period;
- (ii) The mark-to-market value (termination value) of its Derivatives, as measured by the economic cost or benefit of terminating outstanding contracts at specified intervals;
- (iii) The amount of exposure that the Authority has to each specific counterparty, as measured by aggregate mark-to-market value, netted for offsetting transactions;
- (iv) The credit ratings of each counterparty (or guarantor, if applicable) and any changes in the credit rating since the last reporting period; and
- (v) Any collateral posting as a result of Derivative agreement requirements.

In addition, the Authority will perform such monitoring and reporting as is required by the rating agencies and for compliance with GASB requirements.

11) Governing Law and Jurisdiction

Swap agreements shall be governed by the laws of the Commonwealth or the State of New York with a preference to Massachusetts as the governing jurisdiction. Except when deemed otherwise acceptable or appropriate in light of the overall transaction, jurisdiction for any claims against the MBTA shall be limited to Massachusetts courts.

12) Dodd-Frank Act and Regulatory Compliance

The MBTA will comply with all federal regulatory requirements promulgated under the Dodd Frank Act, or by the Commodity Futures Trading Commission and other applicable regulations as may be implemented during the period covered by this policy. This includes evaluating all financing proposals, including Derivative proposals, under the framework set forth under these regulations, following all registration protocols, and appointing a qualified party to serve in the role as Derivatives advisor (known as a “Qualified Independent Representative” under the federal regulations) to the Authority.

The MBTA will also comply with all regulatory and reporting requirements of the Commonwealth including those of the Finance and Governance Board of Massachusetts or its successors related to derivative transactions as defined by regulations adopted by that board and as may be amended during the period covered by this policy.