City of Saint Paul

Office of Financial Services

Internal Policy on Derivatives

June 30, 2005

Introduction

In the municipal bond industry, derivatives are contracts whose value is determined by the inter-relation of other underlying financial instruments. They are by their nature complex and often require sophisticated computer modeling and expertise to determine their value at any point in time. They can be used to benefit municipal bond issuers, given a full understanding and adequate, management safeguards in their application. Derivatives in this use are not considered as investment of public funds, but rather as risk mitigation devices for City of Saint Paul, Minnesota ("City") debt instruments.

The credit rating agencies have developed a rating system for issuers using derivatives. These rating systems gauge the risk management practices of the issuer to reduce their derivative risk exposure. The City will seek to obtain the highest possible ratings in derivative risk management. Standard & Poor's specifically has developed its 'Debt Derivatives Profile (DDP), with a rating system of 1 (manageable) to 5 (high risk). If practical, the City will seek an S&P DDP ranking of 1 on all of its derivative issues.

As one part of the City's derivative management program, this Derivative Policy incorporates by reference the Government Finance Officers Association (GFOA) Recommended Practice, "Sale of Derivative Instruments by State and Local Governments."

Considerations for their Use

The City will only consider derivatives in very specific debt applications, and not as a general rule for basic municipal infrastructure funding. In any application, the City will directly address the following areas:

A. The City will generally restrict their application to hedging instruments for variable rate transactions;

B. The City will perform its own analytical review of the derivative application to estimate the benefits to the City;

C. The City will attempt to competitively select the derivative provider;

D. The City will mitigate the derivative's associated risks through a variety of contractual and/or financial guarantees;

   1. The City will analyze the risk of a mismatch of actual debt service obligations with contractual payments (Basis Risk);
   2. The City will review contractual remedies to changes in tax policies (Tax Risk);
   3. The City will evaluate and monitor the ongoing market value (Termination Risk);
   4. The City will require counterparties to have one credit rating from a national rating service in the AA category (Counterparty Risk); and
   5. The City will fully evaluate any other risks specific to the individual derivative under consideration.

The City will obtain third-party opinions, as to the appropriateness of the specific pricing of the derivative.

The City will only proceed with entering into a derivative contract after a full analytical review of the cost-benefits of the derivative option, and its incorporation into well-defined monitoring program.

Ongoing Management and Monitoring Program

The City will maintain an ongoing management program of any derivative contracts. The management program will include monitoring the periodic financial position of the derivatives and presenting their fair market value, as either a note disclosure or on the face of the City's financial statements, in accord with standards of the Governmental Accounting Standards Board (GASB).