

# **3Q2012 IAC Meeting Materials**

**IAC Meeting – November 20, 2012**

**Swaps Discussion Presentation**

## Swaps: How, Why or Why Not?

### What is a swap and what types of swaps are available?

- A swap is a transaction in which two parties agree to exchange a series of cash flows over a specific period of time
- Types of swaps include: interest rate swaps, equity swaps, fixed-income swaps, currency swaps and credit default swaps

### Why has the SBI not used swaps in the past?

- Historically not allowed by state statutes as swaps have not been traded “on a market regulated by a governmental agency or by a financial institution regulated by a governmental agency” (356A.06 Subd.7(b))
- Swaps trade OTC through individually negotiated bilateral contracts
- No central clearinghouse which subjects both parties to counterparty risk
- No standardized margin requirements
- No transparency in swap prices

### Why is the SBI looking at potentially using swaps now?

- Title VII of the Dodd Frank Wall Street Reform and Consumer Protection Act provides for new federal regulation by the SEC and the CFTC of the swaps market; Details of regulations and timing of implementation are still under discussion
- Standardized swaps to be traded on Swap Execution Facility (SEF) and cleared through central counterparty (CCP) to mitigate, dealer and swap participant counterparty risk
- Standardized margin requirements
- Transparent pricing - central trade repository reporting required

### What can be accomplished with swaps with respect to an investment portfolio?

- Adjust the duration of a fixed income portfolio (interest rate swap)
- Achieve international diversification in equity portfolios (equity swap)
- Change the equity allocation between large, mid and small cap (equity swaps)
- Change overall portfolio asset allocation between equity & fixed income (equity & fixed income swaps)
- Manage exchange rate risk (currency swaps)

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### *Discussion:*

*Historically futures markets have been more liquid and have offered lower transaction costs relative to swap markets:*

- *How might the SBI most appropriately utilize swaps in its management strategies?*
- *What are some of the key pitfalls with the implementation of swaps?*
- *Any additional input from IAC members?*

### *Next Steps*

- *Is legislation needed?*
- *Timing?*