CHICAGO TRANSIT AUTHORITY
Debt Management Policy Guidelines

October 2004

I. Introduction

Purpose of Debt Management Policy Guidelines

The purpose of these Debt Management Policy Guidelines (the "Policy Guidelines") is twofold. First, the Policy Guidelines will serve as a management tool to enable the Chicago Transit Authority (the "CTA" or the "Authority") to (a) identify transactions that utilize debt in the most efficient manner and (b) provide for full and timely repayment of all borrowings. Second, the Policy Guidelines will establish guidelines for the appropriate amount and type of debt as a means of (a) achieving the lowest possible cost of capital within prudent risk parameters and (b) ensuring ongoing access to the capital markets.

Authority, Scope and Review

The CTA is a political subdivision, body politic and municipal corporation of the State of Illinois organized and existing under the Metropolitan Transit Authority Act, 70 Illinois Compiled Statutes 3605 (the "Act"). CTA's continuing power to issue revenue bonds is set forth in Section 12 of the Act. Pursuant to Section 7 of the Bond Authorization Act, 30 Illinois Compiled Statutes 305, CTA is also authorized to enter into agreements with counterparties for swaps and similar hedge agreements. All debt obligations of CTA will comply with the requirements of the Act and the Bond Authorization Act as well as all other applicable laws, regulations and Board Ordinances.

CTA will apply these Policy Guidelines to all short and long-term bonds and notes, other long-term lease obligations, and interest rate exchange agreements it considers. These Policy Guidelines, however, will not cover commodity hedging, leveraged leases, long-term operating leases, short-term leases and bank obligation transactions.

The Policy Guidelines will be reviewed no less than every two years and any changes to the Policy Guidelines must be presented to and approved by the Chicago Transit Board (the "Board"). The Policy Guidelines will be made available on CTA's website (www.transitchicago.com).

Administration of Policy Guidelines

The Senior Vice President & Treasurer shall be responsible for managing, implementing and reviewing the Policy Guidelines and recommending appropriate debt offerings to the Board from time to time.

General Best Interests of Authority

While adherence to the Policy Guidelines is desirable, the Board recognizes that deviations from the Policy Guidelines may be appropriate from time to time to address 1) changing financial goals, 2) emerging financial products / debt structures and 3) unique market opportunities. As a result, the general best interests of CTA shall supercede any Policy Guidelines provision.

II. General Debt Issuance Policies

Use of Debt

It is CTA's preference to use a pay-as-you-go funding mechanism for capital projects and other long-term financial needs of the Authority. The financing purpose will guide the type of debt the CTA uses, which may include:

Long-Term Debt: Long-term bonds/notes (i.e., with final maturities greater than thirteen months) are preferred for financing essential capital activities including the acquisition, construction and rehabilitation of major capital assets or to fund other special programs, such as self-insurance, unemployment insurance and unfunded pension liability programs. The CTA may also use long-term lease obligations to finance or refinance capital equipment. Prior to entering into any lease financing, the Authority will evaluate 1) the useful life of assets financed, 2) terms and conditions of the lease and 3) budgetary, debt capacity and tax implications.

Short-Term Debt: CTA may use short-term bonds/notes (i.e., with final maturities of thirteen months or less) as a cash management tool to provide interim financing, to bridge temporary cash flow deficits within a fiscal year, and/or to reduce or hedge interest rate costs. Short-term debt obligations may include commercial paper, grant anticipation notes, working cash notes, variable rate bonds, auction rate bonds, bond anticipation notes as well as any other appropriate instruments.

Variable Rate Debt: In addition to fixed rate debt, CTA may issue bonds/notes with a variable interest rate to 1) diversify its debt portfolio, 2) reduce interest costs, 3) improve its match of assets to liabilities, 4) provide budgetary relief or 5) allow grant funding flexibility to accommodate changes in debt service levels. The aggregate amount of CTA's unhedged long-term variable rate debt, however, should not exceed 20% of its outstanding long-term debt. "Unhedged long-term variable rate debt" means the par amount of variable rate debt that is not offset by a similar amount of variable interest rate assets or hedge agreements. For calculating unhedged long-term variable rate debt outstanding, synthetic fixed rate bonds (i.e., variable rate bonds for which there is a corresponding fixed payer swap) will not be included in the calculation of variable rate debt outstanding. Conversely, synthetic variable rate debt (i.e., fixed rate bonds for which there is a corresponding fixed receiver swap) will be counted in the calculation of unhedged long-term variable rate debt outstanding.

Financing Purposes

The Authority may issue debt for either new money or refunding purposes.

New Money Bonds: New money bonds may be issued to provide additional funding for essential capital activities or other activities suitable for bond financing, as detailed under Use of Debt.

Economic Refunding Bonds: CTA may issue refunding bonds to achieve debt service savings on its outstanding bonds by redeeming high interest rate debt with lower interest rate debt. The CTA may structure the savings from these bonds on a level, accelerated or deferred basis depending on the Authority's financing goals. When identifying potential refunding candidates for economic refundings, the Authority will generally seek a minimum per bond present value savings threshold of 3%. Notwithstanding the above, the 3% savings threshold shall not apply for bonds with a call date between one and three years from their stated maturity, or for small principal maturities and bonds that produce significant negative arbitrage.

Non-Economic Refunding Bonds: In certain instances, it may be advantageous for CTA to issue refunding bonds that do not produce positive economic savings but serve to restructure debt or retire a bond issue in order to remove undesirable bond covenants. Prior to issuing non-economic refunding bonds, the Authority will evaluate the benefits (both intangible and tangible) of issuing such bonds as well as the economic costs.

<u>Credit Ratings</u>

CTA shall have a ratings strategy that is guided by achieving the best economic situation for the Authority. Attaining a proper balance between minimizing borrowing cost and maximizing financial flexibility will be one of the major goals of CTA debt program.

For existing bond programs, CTA shall attempt to maintain or improve current credit ratings without adversely affecting levels of debt that may be issued for any particular program. For new bond programs, CTA will generally seek investment grade ratings from at least two nationally recognized rating agencies. However, CTA acknowledges that as market conditions and financing needs change and evolve, so should the Authority's credit ratings strategy. CTA may accept a lower rating or downgrade (and thus incur a modest financing cost differential) in order to gain the flexibility needed to effect significant policy initiatives. The Authority will periodically review its credit rating strategy to see if market or capital plan developments warrant a revision in the CTA's approach to its ratings.

CTA will strive to communicate regularly and frequently with the rating agencies. To the extent possible, the Authority will forward periodic information to the rating agencies, arrange regular conference calls to update the rating analysts on any significant financial developments and communicate with the rating agencies prior to each CTA bond sale. The CTA will also maintain periodic communication with its credit enhancement providers, updating them on financial developments as a means of facilitating future market participation with the credit enhancement community.

<u>Tax Status</u>

The Authority may issue debt on a taxable or tax-exempt basis. CTA has a preference for issuing debt on a tax-exempt basis to take advantage of the interest costs savings compared to issuing taxable debt.

<u>Credit Enhancement</u>

CTA may secure credit enhancement for all or a portion of each bond issue. Credit enhancement may come in the form of municipal bond insurance or a letter / line of credit. The Senior Vice President and Treasurer shall make the final recommendation to use bond insurance taking into account such factors as the economic benefit of the enhancement, CTA's available insurance capacity with the insurance community and future secondary market trading conditions. CTA will not secure credit enhancement until the final maturity date of a transaction unless it meets the minimum threshold of providing a net economic benefit to the transaction, if the bonds are assumed to remain outstanding until their maturity dates. For municipal bond insurance, or other forms of credit enhancement which are paid for with an upfront premium, CTA will analyze the economic benefit both to the maturity of the bonds, and to the first optional redemption date.

CTA may also use a letter or line of credit ("LOC") to provide credit support for its debt. The Authority shall consider the following criteria when selecting the LOC provider: 1) Long-term ratings at least equal to or better than CTA's; 2) Short-term ratings of P-1 / A-1; 3) Business terms and conditions acceptable to CTA; 4) Representative list of clients for whom the bank has provided credit support; 5) Fees - cost of LOC, draws, bank counsel and other administrative costs; and 6) Trading differential cost. CTA may select a liquidity facility to provide liquidity on variable rate bonds. The same criteria for selecting a LOC provider will apply to selection of a liquidity provider.

<u>Interest Rate Exchange Agreements</u>

Under certain market conditions, the use of alternative financing arrangements (i.e., derivatives) may be more cost effective than conventional short-term, intermediate or long-term financing options. CTA may use interest rate exchange agreements when it will 1) reduce expected interest rate costs, 2) hedge fluctuations in interest rates or 3) gain efficiency in structuring and restructuring debt. More specifically, it may be advantageous to the Authority to use interest rate exchange agreement for the following five purposes:

- Reducing borrowing cost at the time of issuance
- Hedging against adverse interest rate movement prior to issuance
- Managing debt duration in response to yield curve characteristics
- Capturing the refunding value on callable fixed rate bonds
- Matching assets to liabilities

The CTA will analyze the benefits and risks including the following nine forms of risk:

• Interest rate risk	• Termination risk	• Amortization risk
• Liquidity risk	• Tax risk	• Counterparty risk
• Rollover risk	• Basis risk	• Operational risk

To implement an Interest Rate Exchange Agreement, CTA shall enter into a written agreement with each approved counterparty based on generally accepted ISDA Master Agreement of the industry and any schedules to the Master Agreement including credit enhancement documentation, credit support annex and collateral agreements, all in a form acceptable to the Authority's General Counsel.

The Authority will deem a counterparty as qualified if (a) the counterparty has demonstrated experience in successfully executing derivative contracts with other municipal entities, (b) it indicates a willingness to accept one way collateral should the CTA and its advisors so recommend, and (c) (i) its credit rating by one of three nationally recognized rating agencies is in the AA category and A+ or better by either of the remaining two agencies furnishing such ratings or (ii) its payments pursuant to the derivative contract are unconditionally guaranteed by an entity with credit ratings that satisfy the criteria set forth in (c)(i). The CTA will require that if any qualified counterparty is downgraded and no longer deemed qualified, the contract is subject to the termination provisions in the Master Agreement unless the additional risk can be mitigated by a substitute guarantor or the contract is collateralized.

A counterparty that does not satisfy the aforementioned rating criteria shall be required to post an appropriate level of collateral as determined by the Authority. Collateral, if and as required by the Master Agreement and any credit support annex, shall be maintained with a mutually agreeable third party or trustee and shall be periodically marked to market by the agent or trustee. Collateral, if and as required, shall generally be provided in a manner satisfactory to CTA that its interests are: (a) perfected, (b) not a matter of preference, and (c) not subject to stay in the event of bankruptcy of the derivative contract counterparty. CTA shall not be required to provide collateral as party to a derivative contract unless it is clearly in the best interest of the Authority.

CTA's net credit exposure to any single counterparty (or guarantor thereof) generally should not exceed $500 million. CTA may, however, increase its aggregate position beyond this limit to a particular counterparty if the amount in excess of the limit for that counterparty is fully collateralized. In measuring CTA's aggregate position with a counterparty, a calculation of net offset is permitted in such circumstances as two derivative contracts in which the market values offset one another.

The Authority shall determine the best method of selecting counterparties. If the derivative contract is negotiated between the CTA and one or more counterparties, the Authority may verify fair market value for the pricing of any of its derivative contracts by obtaining an opinion from an outside party.

CTA will seek to maximize the benefits and minimize the risks it carries by actively managing its derivative contracts. This will entail frequent monitoring of market conditions by CTA's Financial Advisor and the swap counter party for emergent opportunities and risks. To benefit this analysis, CTA will require the counterparty to provide a mark to market value of their derivative contract(s) on at least a quarterly basis. Active management may require modifications of existing positions including, for example:

- Early termination;
- Shortening or lengthening contract terms;
- Sale or purchase of options:
- Use of basis swaps; or
- Entering into offsetting derivative contract.

III. Method of Sale and Use of Professionals

Method of Bond Sale

The Authority may choose between the following three different bond sale methods: negotiated, competitive and private placement, but prefers the use of negotiated bond sales. Factors which may be considered when determining the most efficient bond sale method include:

• Bond market conditions	• Bond structure	• Market timing

• Credit demand	• Credit acceptance	• Credit ratings
• Use of proceeds	• Bond size	• Financing complexity
• Privacy of financial information	• Credit enhancement participation	• Desire to negotiate bond covenants

Selection of Bond Financing Professionals

The primary members of the financing team shall be selected on a competitive basis, pursuant to Letters of Interest and Qualifications ("LIQ") or Request for Proposals ("RFP") process, based upon such factors as underwriting/advisory experience, reputation of assigned personnel, expertise in transportation financing and knowledge of CTA. In addition to the factors set forth hereinabove, the Authority shall strive for diversity and provide opportunity for DBE Certified and other minority and women-owned firms as part of each financing team. All businesses evaluated and qualified through the LIQ process shall be submitted to the Board for its approval.

CTA requires its financing team to at all times provide the Authority with objective advice and analysis, maintain the confidentiality of CTA financial plans, and be free from any conflicts of interest. All financing team members are required to provide full and complete disclosure, under penalty of perjury, relative to any and all agreements with other financing team members and outside parties that could compromise any firm's ability to provide independent advice that is solely in the best interests of CTA or that could be perceived as a conflict of interest, in violation of the Act, applicable state law or CTA's Ethics Ordinance (Ordinance No. 004-76, as it may be amended from time to time).

IV. Disclosure

With respect to primary disclosure, the Authority will periodically review the requirements of the Municipal Securities Rulemaking Board ("MSRB") and the recommendations of the Government Finance Officers Association ("GFOA") including the GFOA recommendation that financial statements be prepared and presented according to generally accepted accounting principles.

The Authority will also remain in compliance with Rule 15c2-12 by filing its annual financial statements and other financial and operating data for the benefit of its bondholders within 270 days of the close of the fiscal year. CTA will make its financial statements, annual budget and official statements available on its website.

V. Post Issuance Considerations

Investment of Bond Proceeds

Unless otherwise authorized by the Board, CTA shall invest the sale proceeds of its bonds in accordance with the CTA's Investment Policy (passed by Ordinance No. 99-108, as it may be amended from time to time). CTA shall invest bond proceeds in a manner that allows proceeds to be available when needed.

Monitoring Refunding / Escrow Restructuring Opportunities

CTA shall regularly monitor the capital markets to capitalize on unique and / or time sensitive bond market opportunities and to work with the public finance community to keep abreast of market developments, and to periodically analyze its debt portfolio. CTA will also continue to monitor the derivative markets to take advantage of market inefficiencies between the bond and derivative markets.

Arbitrage Rebate

CTA shall retain an arbitrage rebate specialist within two years from the issuance of each series of bonds to perform annual arbitrage rebate calculations. In addition, CTA shall require that calculations are performed within sixty days of the five-year anniversary date of the bonds (or the first computation date for rebate purposes) and every five years thereafter until the bonds are paid in full. Should a liability be owed to the Internal Revenue Service, the Authority shall make every effort to make such a payment in a timely manner to avoid any penalties or sanctions.

Trustee Relationships and Monitoring of Trustee Activities

The Authority shall periodically monitor trustee activities made on behalf of the CTA to ensure the Authority is receiving the best possible service at the most reasonable cost.

Authorization

These Policy Guidelines have been authorized by the Chicago Transit Board by Ordinance No. 004-144.