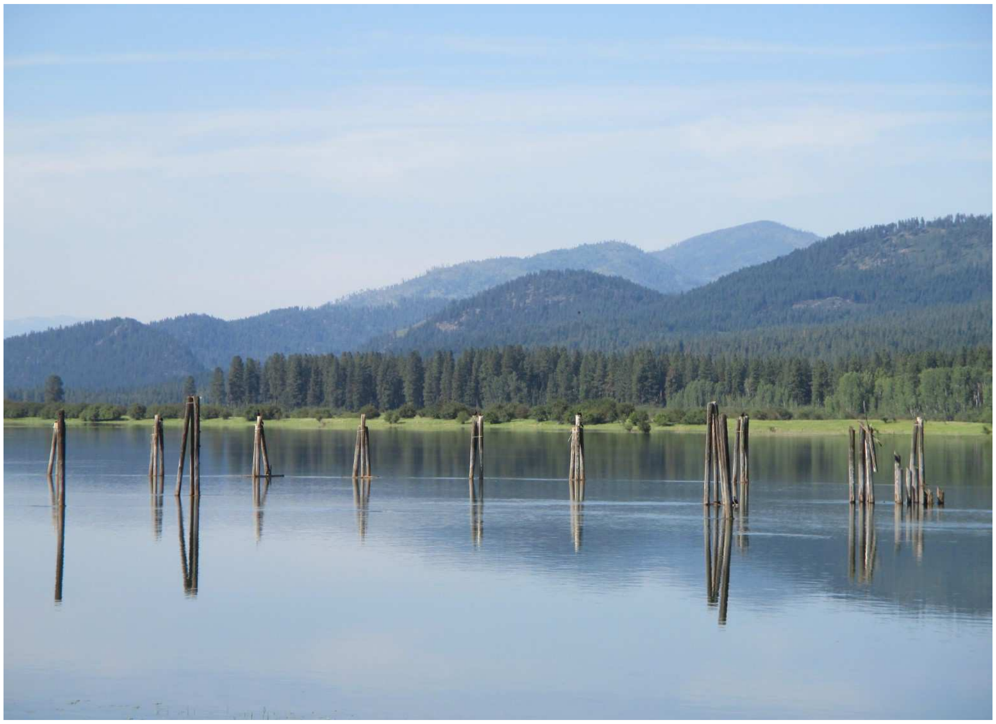

TFA Monthly Newsletter

September 2014

PEND ORIELLE RIVER, USK, WASINGTON NEAR THE KALISPEL TRIBE RESERVATION

Hedging Your Bet: Managing Interest Rate Risk
Cardea Partners Offers Insight on Derivative Strategies

by William Crader, CFA

For over five years we have experienced an extraordinarily low interest rate environment. During this period of low rates most major banks have been promoting the use of derivatives, such as swaps, and in some cases requiring borrowers to use swaps. Why? Since interest rates are so historically low, they have nowhere to go but up. Putting a derivative in place (aka "hedging") could help protect against rising rates. A spike in rates could impact a borrower's ability to make debt service payments - but also banks make money selling these products.

There is no doubt that interest rates will rise in the future. We asked our friends at Cardea Partners, an independent derivative advisory firm, to provide their thoughts on when, why and how hedging strategies can be used to protect against interest rate risk.

TFA: What are your thoughts on when interest rates will begin to rise?

CARDEA: Great question, however it really requires two very different answers for short-term and long-term rates, although they are often connected. Given how most Tribes are financed, short-term rates such as LIBOR are more important, as LIBOR is what most banks use to price their loans. There really is a "crystal ball" for market expectations on when LIBOR is expected to rise. There is a futures market for LIBOR, which is traded on the Chicago Mercantile Exchange, and it is the largest most liquid market in the world (over $1 trillion per day). LIBOR and another short-term target, the Federal Funds rate, are highly correlated. When the Fed moves rates, LIBOR and Prime Rate move in tandem. For example, if the Fed raises the Fed Funds rate by 0.25%, LIBOR and Prime will also rise by 0.25% or so. Currently, this huge futures market for LIBOR is expecting the Fed to start raising short-term interest rates this time next year by about 0.25%. 1-Month LIBOR is expected to be at 1.50% in two years as the Fed is expected to increase short-term interest rates by 1.25% in that time.

Now, if a borrower wants to fix their LIBOR loan for 5 years, how is that rate determined? The 5 year "fixed LIBOR" or "swap rate" is currently 1.65%. This means the market is expecting LIBOR to average 1.65% over 5 years. Think of it this way, ***long-term rates are a predictor of what short-term rates are expected to average over that given period of time***.

The market is fairly good at predicting short-term interest rates out about 18 months, but historically is an extremely poor predictor of long-term interest rates. Consider that two years ago the market expected LIBOR to average 1.65% over 10 years and now the market is expecting LIBOR to average 2.40%.

(continued on Page 2)

IN THE NEWS

Above: TFA team with Tribal Council Member Kevin Bonds, Tule River Reservation, July 2014

Bill to Legalize Internet Poker in California Dropped for 2014
8/6/14 – LATimes.com

Arizona's Historic Tribal Gaming Revenue Top the $1B Mark
8/7/14 – BizJournals.com

New Rules Might Recognize More Tribes, Create New Casinos
8/12/14 – McClatchyDC.com

State Ratifies Gambling Compact with Karuk Tribe
8/19/14 – Times-Standard.com

Tohono O'odham Nation Breaks Ground on New Resort and Casino
8/28/14 – KVOA.com

(continued from page 1)

TFA: When and how should Tribes start considering addressing their interest rate risk?

CARDEA: Managing interest rate risk should be part of the financing process, not an afterthought. **Be pro-active and not re-active.** In our experience, the worst time to put to a hedging strategy in place is when the decision making process is based upon fear. The market has already moved against you and you may be making a decision based on emotion, which often is irrational and costly, especially when fear is the driver. Even though the Fed is telling the market not to expect an increase in short-term rates for a "considerable period of time" doesn't mean you should wait that considerable period of time to start hedging. A big concern of ours is floating rate borrowers in this current low rate environment are being too complacent and taking the "wait and see" approach.

TFA: Recognizing that every situation is unique, is there a particular hedging strategy that Cardea favors under today's market conditions?

CARDEA: We don't favor one strategy over another in today's market environment because we know every Tribal borrower is unique. However, we favor hedging solutions that provide flexibility for opportunistic debt refinancing. Given the current interest rate environment and the changing borrowing needs of Tribes, we favor option-based (interest rate caps) hedging strategies that provide flexibility to refinance and take advantage of low short-term interest rates. Unfortunately, most Tribes or non-Tribal borrowers aren't aware there are alternatives to swaps or how important it is to structure the interest rate hedge to match their specific needs.

TFA: Banks often require borrowers to have hedges put in place. What are your thoughts on this requirement and how should Tribes approach this requirement?

CARDEA: Let us start by stating interest rate swaps are very profitable for the bank. We feel any hedge requirement by the bank needs to be justified and if there is mandatory hedge requirement the parameters should be negotiated.

TFA: Can you discuss the "black box" banks use to price derivative products and how Cardea provides visibility to that pricing process?

CARDEA: This is a very good question. There really is a "black box," but to have your own "black box" means you have to pay for live market prices and the modeling system to customize and generate the price of hedging your exposure. Our "black box" is the same as the banks. It's our biggest expense. By engaging an outside independent derivative consultant, you are basically renting the "black box" and paying an expert to operate the system on your behalf.

TFA: We've often been told the ISDA (International Swaps and Derivatives Association) is a non-negotiable document. Is this true?

CARDEA: The Schedule to the ISDA is negotiable. For example, if a Tribe is quoted a termination cost to unwind a derivative and there is a disagreement as to the termination value, then a fallback is to determine fair market value by following the pre-negotiated optional termination agreement in the schedule to the ISDA. There are other business points which should also be included. Keep in mind that the Schedule to the ISDA is drafted in the bank's favor.

TFA: TFA is always available to discuss a Tribe's financing options and can discuss hedging strategies at a high level. Derivatives are a particular niche within the world of finance and we appreciate Cardea sharing their expertise and thoughts on derivative strategies. For more information about Cardea Partners please visit their website at cardeapartners.com, or contact Rex Evans or Joe Momich at (925) 988-0703.

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