Possible Actions Related to City/Financing Authority's Variable Rate Bond Program

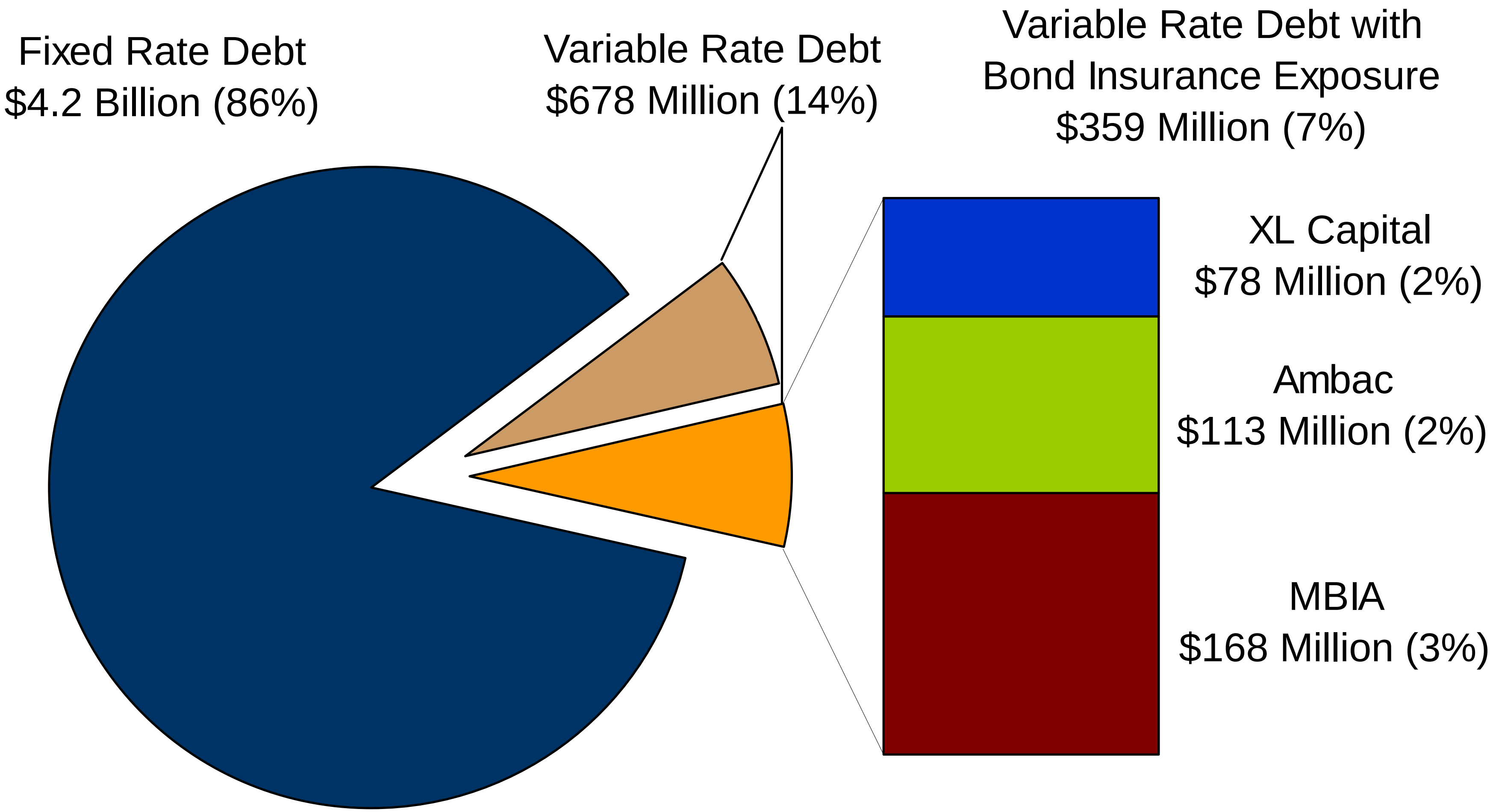
Special City Council/City of San José
Financing Authority Meeting

Finance Department
February 15, 2008

Background

- Continued market disruption due to global reaction to sub-prime mortgages
- Investor confidence shaken due to downgrades by rating agencies of several bond insurers, who insure mortgage backed securities in addition to municipal bonds
- Investors *either* demanding higher interest rates for bonds insured by these bond insurers, or “putting” variable bonds back into the market due to liquidity concerns
- *Some of the City’s variable rate bonds have been impacted by this market disruption*
- No impact on the City’s outstanding fixed rate bonds

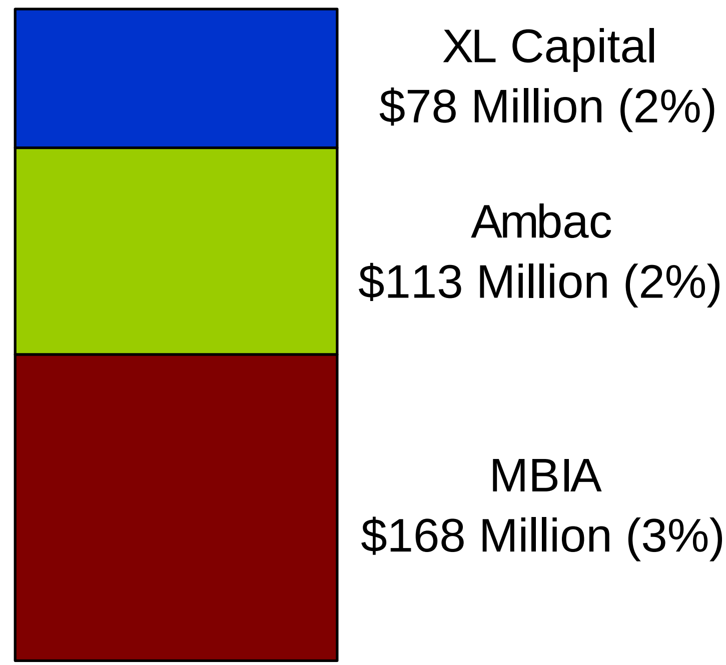
Current Debt Portfolio $4.9 Billion



Current Debt Portfolio $4.9 Billion

Bond Insurer	Issue (Project)	Par ($MM)	Variable Rate Mode
XL Capital	CSJFA 2005A (FMC)	$52.65	7-Day VRDBs
	CSJFA 2005B (FMC)	25.55	7-Day VRDBs
Ambac	CSJFA 2001B (Hayes Mansion)	23.90	7-Day VRDBs
	CSJFA 2001C (Hayes Mansion)	18.40	7-Day VRDBs
	CSJFA 2001D (Hayes Mansion)	10.80	7-Day VRDBs
	CSJFA 2002C (Civic Center)	60.00	7-Day VRDBs
MBIA	CSJFA 2000C (Ice Centre)	18.90	7-Day VRDBs
	CSJFA 2004A (Ice Centre)	9.23	28-Day Auction Rate
	CSJ Airport 2004A (Security Projects)	70.00	7-Day Auction Rate
	CSJ Airport 2004B (Security Projects)	70.00	35-Day Auction Rate
Total		$359.42	

Variable Rate Debt with Bond Insurance Exposure $359 Million (7%)



JPMorgan’s Role as Remarketing Agent

- Remarketing Agent for $25 million of the Authority’s Variable Rate Demand Bonds, insured by XL Capital Assurance.
- XL Capital downgrades
  - Fitch - 'AAA' to 'A'
  - Moody’s – 'Aaa' to 'A3'
- Investors (primarily money market funds) demand for the bonds has disappeared given rating requirements
- Corporate decision by JPMorgan to “tender” all of their XL Capital insured variable rate bonds to the respective liquidity banks
- City has only one bond issue in which JPMorgan is the remarketing agent insured by XL Capital

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JPMorgan – Proposal to Amend Agreement

- Concern over potential XL Capital insolvency, thereby causing immediate termination of the Standby Bond Purchase Agreement with liquidity provider (BofA)

- Potential impact of termination of SBPA on JPMorgan:
  - Holding illiquid securities/bonds
  - Concerned City would not honor "par value" (face value) of bonds

- JPMorgan requesting Amendment to the Remarketing Agreement, bonds to be held in inventory by JPMorgan, requesting that recognize bonds at their face value (par)

Impacts of Acceptance of Proposed Amendment

- JPMorgan has bonds in their inventory not marked at a “loss”

- City likely pays higher than market interest rate on the Bonds at a rate not to exceed 12%

- Provides time for the City to work through a refunding/restructuring of the Bonds and reduces immediate impact of Bank Bonds

Recommended Immediate Actions

- Allow tender to proceed and decline JPMorgan's Proposal

- Negotiate with Bank of America to modify terms of liquidity facility

- Approval of broader authority to the City Manager/Executive Director (or Designee) to take actions related to variable rate bond program

- Due to urgency to mitigate increases in City's interest rate exposure, compressed timeline for staff reports

Long-Term Solutions Under Consideration

- Extend broader authority to the City Manager/ Executive Director (or Designee)
- Refunding City's outstanding variable rate lease revenue bonds to remove bond insurance

Summary

- Current disruption in the municipal market is due to lack of investor confidence resulting from rating agency downgrades of several bond insurers, who insure mortgage backed securities in addition to municipal bonds

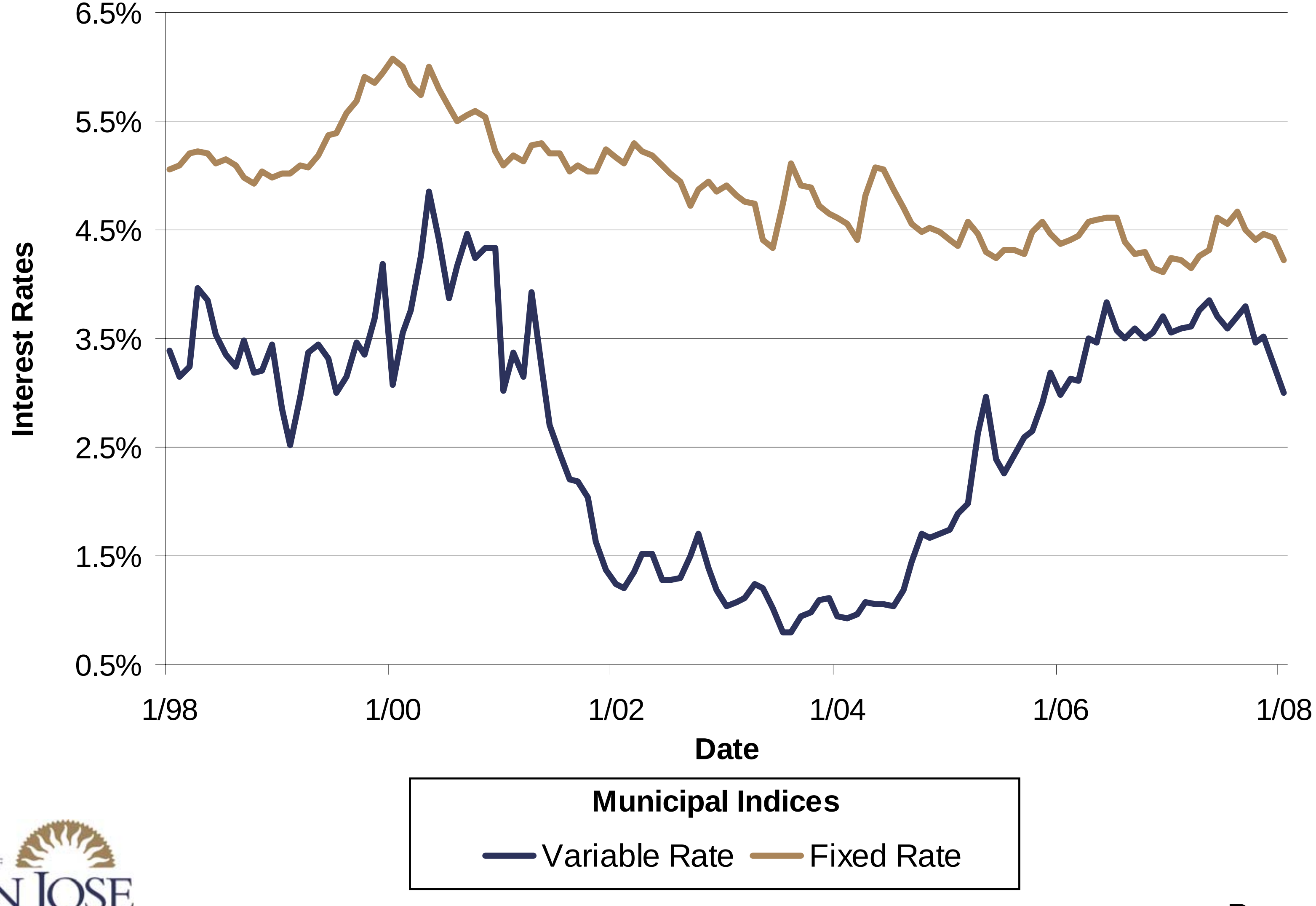
- Due to bond insurance downgrades, investors are less willing to purchase municipal bonds insured by these bond insurers

- No impact on City’s outstanding fixed rate debt; 93% of the City’s debt portfolio

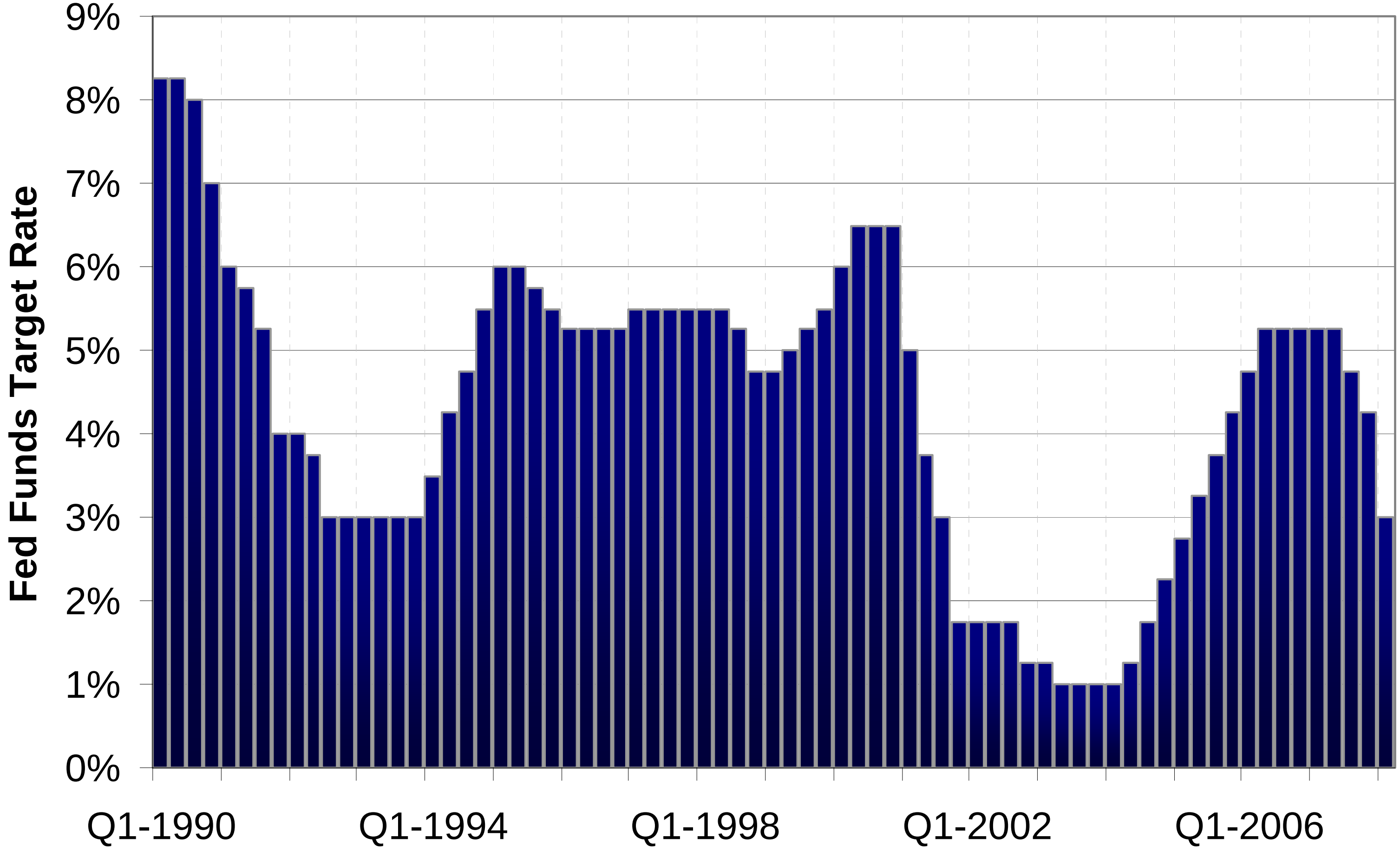
- Staff is working on long-term solutions to mitigate further interest rate cost increases to City

- City’s bond ratings continue to be very strong and have not been impacted by these recent market events in the global economy

Historical Fixed Rate vs. Variable Rate Interest Rate Comparison (10 Years)



Fed Funds Target Rate History



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US Treasury Yield Curve Shift (12/29/06 to 2/11/08)