CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

# Memorandum

**TO:** HONORABLE MAYOR AND CITY COUNCIL AND CITY OF SAN JOSE FINANCING AUTHORITY

**FROM:** Scott P. Johnson

**SUBJECT:** **POSSIBLE ACTIONS RELATED TO VARIABLE RATE BONDS**

**DATE:** February 14, 2008

Approved [signature] Date 2/14/08

**COUNCIL DISTRICT:** City-Wide

## RECOMMENDATION

(a) Consideration of and possible action on a proposed amendment to the Remarketing Agreement by and among the City of San José, the City of San José Financing Authority and J.P. Morgan Securities, Inc. ("Remarketing Agent") related to the City of San José Financing Authority Lease Revenue Bonds, Series 2005B to restrict the ability of the City and the Authority to remove the Remarketing Agent under certain circumstances

(b) Adoption of a resolution of the City of San José Financing Authority Board ("Board") to authorize the Executive Director or the Executive Director's authorized designee, through March 10, 2008, to take various actions with respect to the Authority's outstanding variable rate debt without further action of the Board when the Executive Director determines it would be prudent to do so

(c) Adoption of a resolution of the City Council to authorize the City Manager or the City Manager's authorized designee, through March 10, 2008, to take various actions with respect to the outstanding variable rate debt of the City or the Authority without further action of the City Council when the City Manager determines it would be prudent to do so

## OUTCOME

Approval of these recommendations will facilitate the City's ability to respond to financial proposals related to its variable rate bond portfolio during the current period of disruption in the financial markets.

## BACKGROUND

On February 17, 2005, the City of San José Financing Authority (the "Authority") issued its Lease Revenue Bonds, Series 2005A ("2005A Bonds") in the amount of $54,480,000 and its Lease Revenue Bonds, Series 2005B ("2005B Bonds") in the amount of $25,545,000 pursuant to a Trust Agreement (collectively, the "2005 Bonds") for the purpose of financing the land acquisition of the FMC Property. The 2005 Bonds are insured by XL Capital Assurance ("XL Capital") with liquidity provided by Bank of America, N.A. ("Bank of America"). The 2005A Bonds are remarketed by Lehman Brothers Inc. ("Lehman") and the 2005B Bonds are remarketed by J.P. Morgan Securities Inc. ("JPMorgan").

The recent disruption in the financial markets related to the default potential of subprime mortgages has disrupted the variable rate municipal bond market. This disruption is evidenced by the recent downgrades of bond insurers, who insure mortgage backed securities in addition to municipal bonds.

In January 2008, XL Capital's long-term rating was downgraded by Fitch Ratings ("Fitch") from AAA to A and by Moody's Investor Services ("Moody's") from Aaa to A3. Consequently, the long-term ratings on the 2005 Bonds changed from AAA to AA reflecting the City's underlying long-term ratings based on the City's credit rather than the bond insurer's ratings. In addition, Moody's has recently downgraded the short-term rating on the 2005 Bonds from VMIG 1, the highest short-term rating, to SG, a non-investment grade, on the basis of certain bond insurer related provisions in the Standby Bond Purchase Agreement among the City, the Authority and Bank of America (the "SBPA"), which provides liquidity support for the 2005 Bonds. This action has resulted in a market situation in which there is little or no demand for the 2005 Bonds in the open market.

On or about February 7, 2008, the City was notified that JPMorgan had made a corporate decision to tender all of their holdings of XL Capital insured variable rate demand bonds. In the case of the 2005B Bonds, the bonds will be tendered to the liquidity provider, Bank of America, on Friday, February 15, 2008 (the "Tender Date"). JPMorgan's corporate decision was based on its concern that XL Capital will become insolvent and that Bank of America, per the terms of the SBPA, would immediately stop providing liquidity for the 2005 Bonds.

**These actions are not in response to a change in the City's high credit quality, but to a change in the market's confidence in the bond insurers. The actions are a function of the disruption in the municipal bond market and only affect specific financing structures. The City continues to maintain its high credit ratings and continues to pay debt service on all of its outstanding obligations.**

## ANALYSIS

In light of the recent actions noted above, the City is currently working expeditiously to implement the long-term solution identified in the table below on an extremely compressed financing schedule. Staff's current goal is to complete the implementation process within 90 days; however, that timeline is predicated on an accelerated staff report process and various parties to the current financing waiving notice requirements.

The City received verbal notification late last week that JPMorgan was tendering all of the 2005B Bonds effective Friday, February 15, 2008. On Wednesday, February 13, 2008, the City received a proposed amendment to the remarketing agent agreement from JPMorgan. A comparison between allowing the tender to proceed versus accepting JPMorgan's proposal is described below.

### Allowing Tender to Proceed and Decline JPMorgan's Proposal

If the 2005B Bonds are tendered, the financing documents provide language that governs the mechanics of the City's obligation with respect to the tendered bonds. The tendered bonds will become Bank Bonds that will pay a fixed rate of 6.5% over the first 60 days. Beginning with the 61st day, the "Term-Out" provisions of the SBPA are scheduled to take effect and the rate on the Bank Bonds increases to 7.0%; however, staff made an inquiry to Bank of America requesting that the terms under the first 60 days be extended for an additional 60 days while staff pursues the long-term mitigation strategy. While the 2005B Bonds are Bank Bonds, the Authority avoids the possibility of an event of default on the 2005B Bonds if XL Capital becomes insolvent.

### Accepting JPMorgan's Proposal

JPMorgan has given the City a verbal commitment to hold the 2005B Bonds if JPMorgan is unsuccessful in remarketing the 2005B Bonds in the open market. Under this scenario, the 2005B Bonds are expected to pay a rate of approximately 7%, but the rate would be reset weekly at a rate determined by JPMorgan, not to exceed 12%.

Additionally, JPMorgan's proposed amendment to the Remarketing Agreement restricts the City and the Authority from terminating JPMorgan as remarketing agent while JPMorgan is holding the Series 2005B Bonds and is unable to remarket them to holders in the open market, either because of the recent ratings downgrades or because Bank of America has stopped providing liquidity. However, in this scenario, if XL Capital becomes insolvent or otherwise repudiates its policy of bond insurance, and if JPMorgan decides to tender the 2005B Bonds to the Authority, then, absent the City's ability to provide funds to pay the full purchase price for the 2005B Bonds, the Authority would be immediately in default under the terms of the Trust Agreement.

If the City chooses to accept JPMorgan's proposal it must approve the proposal by the Tender Date. However, JPMorgan is aware that staff is bringing JPMorgan's proposal to the City Council/Authority Board on the morning of February 15, 2008. Staff will provide a verbal update on Friday morning regarding the status of JPMorgan's proposal.

The following table further summarizing the options and the mitigating strategies is presented in the table on the following pages.

| **Variable Rate Bonds Option Analysis** | | |
|---|---|---|
| **Time Frame** | **Tendered Bonds** | **JPMorgan Proposal** |
| 0-60 Days | JPMorgan tenders bonds to Bank of America and the bonds become "Bank Bonds".<br><br>Total interest cost estimated to be approximately $273,000 for the first 60 days; fixed at 6.5%. | So long as the SBPA remains effective (i.e., so long as no insolvency or policy repudiation by XL Capital), JPMorgan holds the bonds for a temporary period until debt is refunded paying at a rate set by JPMorgan not to exceed the maximum rate defined in the Trust Agreement, 12%.<br><br>Interest cost will not exceed $504,000 for the first 60 days assuming that JPMorgan continues to hold the bonds for that period. JPMorgan will have no legal obligation to do so. |
| 60+ Days | "Term-Out" provisions of the SBPA begin. City begins paying "Term-Out Rent" to enable the Authority to repay the Bank Bonds. On a monthly basis, the amount is approximately $1.2 million.<br><br>Triggers obligation to begin redeeming Bank Bonds in January 2009. | Same as above. |
| Short-term Mitigation | Amend the Standby Bond Purchase Agreement to extend the terms under the 0-60 day provisions. This may result in a renegotiation of the ongoing liquidity fees payable to Bank of America.<br><br>Issue lease revenue commercial paper notes to redeem the bonds. | No mitigation necessary. Will continue pay rate determined by JPMorgan not to exceed the maximum rate defined in the Trust Agreement, 12%. |
| Long-term Mitigation | Refund the 2005B Bonds as part of a larger strategy related to the City's variable rate lease revenue bonds | Refund the 2005B Bonds as part of a larger strategy related to the City's variable rate lease revenue bonds |

| | | |
|---|---|---|
| Risks | XL Capital bankruptcy triggers immediate termination of the Standby Bond Purchase Agreement<br><br>OR<br><br>S&P downgrades XL Capital to below AA- triggering 90-day notice period before termination of the SBPA.<br><br>If Bank Bonds cannot be refunded within the first 60 days and no additional grace period can be negotiated with Bank of America, under the terms of the SBPA, the City would be required to continue to pay the "Term-Out Rent" to the Authority and the Authority would be obligated to pay a penalty interest rate on, and make an accelerated repayment of the principal of, the Bank Bonds. | XL Capital bankruptcy triggers immediate termination of SBPA; 2005B Bonds cannot be remarketed. See JPMorgan Proposal – Short-term Mitigation<br><br>S&P downgrades XL Capital to below AA- triggering 90-day notice period before termination of the SBPA; JPMorgan probably would tender the 2005B Bonds, which would become Bank Bonds. See Tendered Bonds – Risks.<br><br>If XL Capital insolvency triggers immediate termination of the SBPA and JPMorgan tenders the 2005B Bonds to the Authority, the Authority would be obligated to pay the full Purchase Price of the 2005B Bonds, equal to principal plus accrued interest. If the City did not provide funds for the Authority to do so, the 2005B Bonds would be returned to JPMorgan and an Event of Default of the Authority would be triggered under the Trust Agreement. JPMorgan could continue to set the interest rate on the defaulted bonds at a rate up to 12%. The City and Authority would be obligated to pay this default rate of interest, but there would be no acceleration of the payment of principal on the 2005B Bonds. |

## Staff's Recommended Actions

### Allow Tender to Proceed and Decline JPMorgan's Proposal

Based on staff's evaluation of quantifiable outcomes and the real possibility of XL Capital's insolvency triggering an immediate termination of the SBPA and potential Event of Default under the Trust Agreement, staff recommends allowing the tender to move forward.

### Bank of America – Modify SBPA Terms

Additionally, staff will attempt to mitigate short-term risks by approaching Bank of America with a request to extend the terms under the 0-60 day period by an additional 60 days while expeditiously commencing work toward long-term mitigation strategies, which include: refunding all outstanding variable rate lease revenue bonds within the next 90 days.

**Delegation of Authority**

Staff is also requesting Authority Board and City Council's approval to delegate authority to the Executive Director/City Manager or authorized designee, through March 10, 2008, to take various actions on the City's variable rate bond program. This will allow staff to respond and react to additional proposals related to the City's outstanding variable rate bonds, which may be presented to the City, and to pursue short-term mitigation measures such as pursuing an amendment to the SBPA.

In this regard, the Executive Director/City Manager or authorized designees will be authorized to take actions related to the various documents governing the City's and the Authority's outstanding variable rate debt when the authorized officials determine it is prudent to take action without obtaining the approval of the Authority Board or City Council, as applicable. These proposals will be evaluated in the context of minimizing the financial and budgetary risks. The report back to Council on March 11, 2008 will include a report on any actions taken by staff under this delegation and a discussion of strategies being pursued by other comparable local agencies.

**Compressed Timeline for Staff Reports**

In an effort to expedite the City Council's approval and execution of long-term mitigation strategies it will be necessary to agendize items outside of the normal Council process. Items may be added to the Council agenda as late as one week prior to the City Council meeting including delayed distribution of staff reports.

## EVALUATION AND FOLLOW-UP

Staff will report back to the City Council on March 11, 2008 with a summary of any actions taken under this delegation of authority and a discussion of strategies being pursued by other comparable local agencies. In addition, staff will provide an update on the long-term mitigation strategy identified above.

## PUBLIC OUTREACH/INTEREST

Not applicable.

☐ **Criterion 1**: Requires Council action on the use of public funds equal to $1 million or greater.
**(Required: Website Posting)**

- ☐ **Criterion 2:** Adoption of a new or revised policy that may have implications for public health, safety, quality of life, or financial/economic vitality of the City. **(Required: E-mail and Website Posting)**
- ☐ **Criterion 3:** Consideration of proposed changes to service delivery, programs, staffing that may have impacts to community services and have been identified by staff, Council or a Community group that requires special outreach. **(Required: E-mail, Website Posting, Community Meetings, Notice in appropriate newspapers)**

## COORDINATION

This staff report has been prepared by the Finance Department in coordination with the City Attorney's Office.

## COST SUMMARY/IMPLICATIONS

No budget action is required at this time. The Finance Department is evaluating the budgetary impact from this date through the end of the fiscal year and will return to Council with a recommendation for additional budget appropriations if necessary.

## CEQA

Not a project.

Scott P. Johnson
SCOTT P. JOHNSON
Director, Finance

For questions please contact Scott P. Johnson, Director of Finance, at (408) 535-7001.

# Glossary

**Acceleration** – A remedy provided in many security agreements (including many indenture and bond resolutions) by which the trustee may declare all future payments of principal immediately due and payable after the occurrence of certain specified events – usually called events of default.

**Bank Bond** – Each bond (whether or not such bond is at the time of determination owned by the bank) purchased with funds provided by the bank, until such bond is remarketed.

**Default or Event of Default** – Failure to make prompt debt service payment or to comply with other covenants and requirements specified in the financing agreements for the bonds.

**Liquidity** – The ease with which an investment may be converted to cash, either by selling it in the secondary market or by demanding its repurchase pursuant to a put or other prearranged agreement with the issuer or another party.

**Liquidity Facility** – See "Letter of Credit."

**Letter of Credit** – An arrangement between an issuer and a bank which provides additional security that money will be available to pay debt service on a bond issue.

Customarily, a letter of credit is issued by a commercial bank directly to the trustee allowing the trustee, if certain conditions are met, to draw upon the letter of credit by submitting to the bank a written request for payment. Letters of Credit are also referred to as liquidity facilities in connection with obligations such as commercial paper and variable rate bonds.

**Remarket** – A bond purchased from the original or subsequent holders of the bonds by the issuer or another party upon the occurrence of certain events specified in the legal documents. With respect to variable rate bonds, remarketings commonly occur in connection with a tender of the bonds at the option of the holder.

In a remarketing, bonds tendered by their holders (perhaps mandatorily) for purchase are sold to new purchasers. A remarketing is usually conducted on behalf of the issuer by an investment bank or commercial bank acting as remarketing agent pursuant to a remarketing agreement entered into at the time of the original issuance of the bonds. Frequently, the remarketing agent is the same firm that acted as the managing underwriter for the original issue.

**Remarketing Agent** – The investment bank or commercial bank retained to remarket bonds that have been tendered for purchase by the issuer or another party pursuant to an option to sell (a put) that accompanies the bond.

**Standby Bond Purchase Agreement** - An agreement between an issuer and a financial institution, usually a bank, whereby the bank agrees to purchase bonds in the event the bondholders tender them to the issuer and they are not remarketed to new purchasers.

**Tender** - An unconditional offer by a party to a contract to perform their part of the agreement. In a Trust Agreement, a tender would be an act of the issuer producing the amount owing and offering it to the bondholder.

**Trust Agreement** – An agreement executed by an issuer and a fiscal agent/trustee which pledges certain revenues and other property as security for the repayment of the bonds, sets forth the terms of the bonds and contains the responsibilities and duties of the trustee and the rights of the bondholders. The rights of the bondholders are set forth in the indenture provisions relating to the timing of the interest and principal payments, interest rate setting mechanisms (in the case of variable rate bonds), redemption provisions, events of default, remedies and the mailing of notices of various events.

## Table 1-1
## Short-Term Tax-Exempt Debt Credit Rating Definitions

<table>
<tr><th>Rating</th><th>Moody's</th><th>Rating</th><th>S&P</th><th>Rating</th><th>Fitch Ratings</th></tr>
<tr><td rowspan="2">MIG-1/ VMIG-1</td><td rowspan="2">MIG-1 - Superior credit quality. Excellent protection afforded by established cash flows, highly reliable liquidity support, or demonstrated broad-based access to the market for refinancing.<br><br>VMIG-1 – Superior credit quality. Excellent protection afforded by the superior short-term credit strength of the liquidity provider and structural and legal protections that assure the timely payment of purchase price on demand.</td><td>SP-1</td><td>Strong capacity to pay principal and interest. An issue determined to possess a very strong capacity to pay debt service is given a plus (+) designation.</td><td rowspan="2">F1</td><td rowspan="2">Highest credit quality. Indicates the strongest capacity for timely payment of financial commitments.</td></tr>
<tr><td>A-1</td><td>Degree of safety regarding timely payment is strong. Those issues determined to possess extremely strong safety characteristics are denoted by a plus (+) sign.</td></tr>
<tr><td rowspan="2">MIG-2/ VMIG-2</td><td rowspan="2">MIG-2 -Strong credit quality. Margins of protection are ample although not as large as in the preceding group.<br><br>VMIG-2 – Strong credit quality. Good protection afforded by the strong short-term credit strength of the liquidity provider and structural and legal protections that ensure the timely payment of purchase price on demand.</td><td>SP-2</td><td>Satisfactory capacity to pay principal and interest, with some vulnerability to adverse financial and economic changes over the term of the notes.</td><td rowspan="2">F2</td><td rowspan="2">Good credit quality. A satisfactory capacity for timely payment of financial commitments, but the margin of safety is not as great as in the case of the higher ratings.</td></tr>
<tr><td>A-2</td><td>Capacity for timely payment on issues with this designation is satisfactory. However, the relative degree of safety is not as high as for issues designated 'A-1.'</td></tr>
<tr><td rowspan="2">MIG-3/ VMIG-3</td><td rowspan="2">MIG-3 - Acceptable credit quality. Liquidity and cash flow protection may be narrow, and market access for refinancing is likely to be less well-established.<br><br>VMIG-3 – Acceptable credit quality. Adequate protection is afforded by the satisfactory short-term credit strength of the liquidity provider and structural and legal protections that ensure the timely payment of purchase price on demand.</td><td>SP-3</td><td>Speculative capacity to pay principal and interest.</td><td rowspan="2">F3</td><td rowspan="2">Fair credit quality. The capacity for timely payment of financial commitments is adequate; however, near-term adverse changes could result in a reduction to noninvestment grade.</td></tr>
<tr><td>A-3</td><td>Issues carrying this designation have an adequate capacity for timely payment. However, they are more vulnerable to the adverse effects of changes in circumstances than obligations carrying the higher designations.</td></tr>
</table>

(Table 1-1 continued on next page)

**Table 1-1**
**Short-Term Tax-Exempt Debt Credit Rating Definitions (continued)**

| | | | | | |
|---|---|---|---|---|---|
| Speculative Grade (SG) | **MIG–SG** Speculative grade credit quality. May lack sufficient margins of protection.<br><br>**VMIG–SG** Speculative grade credit quality. Demand features rated in this category may be supported by a liquidity provider that does not have an investment grade short-term rating or may lack the structural and/or legal protections necessary to ensure the timely payment of purchase price upon demand. | B | Only speculative capacity for timely payment. | B | Speculative. Minimal capacity for timely payment of financial commitments, plus vulnerability to near-term adverse changes in financial and economic conditions. |
| | | C | Doubtful capacity for payment. | C | High default risk. Default is a real possibility. Capacity for meeting financial commitments is solely reliant upon a sustained, favorable business and economic environment. |
| | | D | Default. | D | Default. Denotes actual or imminent payment default. |

**Table 1-2**
**Long-Term Tax-Exempt Debt Credit Rating Definitions**[2]

| Rating | Moody's | Rating | S&P | Rating | Fitch Ratings |
|---|---|---|---|---|---|
| Aaa | Demonstrates the strongest creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | AAA | Highest rating. The obligor's capacity to meet its financial commitment on the obligation is extremely strong. | AAA | Highest credit quality. Assigned only in case of exceptionally strong capacity for timely payment of financial commitments. This capacity is highly unlikely to be adversely affected by foreseeable events. |
| Aa | Demonstrates very strong creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | AA | Differs from the highest rated obligation only in small degree. The obligor's capacity to meet its financial commitment on the obligation is very strong. | AA | Very high credit quality. Very strong capacity for timely payment of financial commitments. This capacity is not significantly vulnerable to foreseeable events. |
| A | Present above-average creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | A | Somewhat more susceptible to the adverse effects of change in circumstances and economic conditions than obligations in higher-rated categories. However, the obligor's capacity to meet its financial commitment on the obligation is still strong. | A | High credit quality. The capacity for timely payment of financial commitments is considered strong. This capacity may, nevertheless, be more vulnerable to changes in circumstances or in economic conditions than is the case for higher ratings. |
| Baa | Demonstrates average creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | BBB | Adequate protection parameters. However, adverse economic conditions or changing circumstances are more likely to lead to a weakened capacity of the obligor to meet its financial commitment on the obligation. | BBB | Good credit quality. The capacity for timely payment of financial commitments is considered adequate, but adverse changes in circumstances and in economic conditions are more likely to impair this capacity. This is the lowest investment-grade category. |

(Table 1-2 continued on next page)

[2] Moody's appends the numerical modifiers 1,2, and 3 to each generic rating category from Aa through Caa. Modifier 1 indicates that the issuer or obligation ranks in the higher end of its generic rating category; modifier 2 indicates a mid-range ranking; and modifier 3 indicates a ranking in the lower end of that generic rating category. Standard & Poor's and Fitch use a +/- or no modifier much in the same way.

**Table 1-2**
**Long-Term Tax-Exempt Debt Credit Rating Definitions (continued)**

| Rating | Moody's | Rating | S&P | Rating | Fitch Ratings |
|---|---|---|---|---|---|
| B | Demonstrates weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | B | More vulnerable to nonpayment than obligations rated 'BB,' but the obligor currently has the capacity to meet its financial commitment on the obligation. Adverse business, financial, or economic conditions will likely impair the obligor's capacity or willingness to meet its financial commitment on the obligation. | B | Highly speculative. Indicates significant credit risk is present, but a limited margin of safety remains. Financial commitments are currently being met; however, capacity for continued payment is contingent upon a sustained, favorable business and economic environment. |
| Caa | Demonstrates very weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | CCC | Currently vulnerable to nonpayment and is dependent upon favorable business, financial, and economic conditions for the obligor to meet its financial commitment on the obligation. In the event of adverse business, financial, or economic conditions, the obligor is not likely to have the capacity to meet its financial commitment on the obligation. | CCC | High default risk. Capacity for meeting financial commitments is solely reliant upon sustained, favorable business or economic developments. |
| Ca | Demonstrates extremely weak creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | CC | Currently highly vulnerable to nonpayment. | CC | Default is probable. |
| C | Demonstrates the weakest creditworthiness relative to other U.S. municipal or tax-exempt issuers or issues. | C | Subordinated debt that is highly vulnerable to nonpayment. Bankruptcy petition may have been filed, but payments are being continued. | C | Imminent default. |
| | | D | Default. | DDD<br>DD<br>D | Default. The ratings of obligations in this category are based on their prospects for achieving partial or full recovery in a reorganization or liquidation of the obligor. |