COUNCIL/AUTHORITY AGENDA: 03-11-08
ITEM: #2

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: **CITY AND AUTHORITY'S OUTSTANDING VARIABLE RATE BONDS IMPACTED BY RECENT DOWNGRADE OF BOND INSURERS**

DATE: March 3, 2008

Approved Christine J. Shippey

Date 3-6-08

COUNCIL DISTRICT: City-Wide

RECOMMENDATION

(a) 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 June 23, 2008, to take various actions with respect to the outstanding variable rate debt of the Authority without further action of the Board when the Executive Director determines it would be prudent to do so.

(b) Adoption of a resolution of the City Council to authorize the City Manager or the City Manager's authorized designee, through June 23, 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.

(c) Acceptance of staff's report related to proposed actions to be taken on the City's and Authority's outstanding variable rate debt, which is currently impacted by the recent downgrades of municipal bond insurers.

OUTCOME

Approval of these recommendations will continue to 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

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. A summary of the most current ratings for the bond insurers is provided as Appendix A to this memorandum. The ramifications of these events are being felt throughout the municipal bond market and many issuers across the country are working to address these issues as they impact their various debt portfolios.

On February 15, 2008 the City Council and City of San José Financing Authority Board (the "Authority") held a special meeting to address a proposed amendment to a remarketing agent agreement with J.P. Morgan Securities Inc. ("JP Morgan") related to the City of San José Financing Authority Lease Revenue Bonds, Series 2005B ("2005B Bonds") issued in conjunction with the City of San José Financing Authority Lease Revenue Bonds, Series 2005A ("2005A Bonds") for the purpose of financing the land acquisition of the FMC property. The liquidity facility for the 2005A and the 2005B Bonds is a Standby Bond Purchase Agreement (the "SBPA") with Bank of America, N.A ("Bank of America"). A detailed analysis of that proposal was provided to the City Council/Authority Board along with a recommendation to decline the proposed offer.

The City Council/Authority Board approved staff's recommendation and directed a dialogue with Bank of America to occur in order to negotiate revisions to the terms of the SBPA. These revisions were intended to reduce the City's financial exposure by extending the terms under the 60 day grace period by an additional 60 days while staff works to expeditiously implement long-term mitigation strategies, which include refunding all outstanding variable rate lease revenue bonds within the next 90 days and redeeming the Airport's auction rate securities with Airport commercial paper.

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

Summary of Status of February 15th Council Direction

- ***Allow Tender to Proceed on City of San José Financing Authority Lease Revenue Bonds, Series 2005B (FMC Land Acquisition)***
  As contemplated during the discussion at the special council/board meeting on February 15, 2008, JPMorgan, as remarketing agent, tendered $24 million of the $25.545 million of the outstanding 2005B Bonds to the liquidity provider, Bank of America.

- ***Bank of America – Modify SBPA Terms***
  As a follow-up to JP Morgan's decision to tender the bonds, staff requested that Bank of America amend the terms of the SBPA by extending the grace period provisions from 60 to 120 days. This extension of the grace period allows the City to avoid increased payments that would otherwise be required starting on the 61st day as outlined in staff's memorandum presented at the special council/board meeting on February 15, 2008. On February 25th staff received notice of approval from Bank of America to these revised terms. This renegotiated 120 day period will allow staff to work on refunding the bonds, along with the Authority's other variable rate lease revenue bonds noted on page five of this memorandum. The amendment to the SBPA is being prepared by Bank of America's counsel as is customary in the banking industry for standby bond purchase agreements and letters of credit. Staff anticipates that the draft amendment will be sent to the City for review during mid-March.

- ***Delegation of Authority***
  On February 15, 2008, the City Council and the Board delegated authority to the Executive Director and/or City Manager or their authorized designees to take various actions with respect to the variable rate debt of the City and the Authority through March 10, 2008. No additional proposals have been presented to the City since February 15, 2008. Staff is requesting an extension of this delegation to June 23, 2008 to allow staff to react to additional proposals related to the City and Authority's outstanding debt as prudent and to enter into agreements to reduce the financial exposure of the City and the Authority, such as the amendment to the SBPA with Bank of America.

  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 City Council or Authority Board, as applicable. These proposals will be evaluated in the context of minimizing the financial and budgetary risks.

- ***Compressed Timeline for Staff Reports***
  The need to agendize items outside of the normal Council process was discussed at the special council/board meeting on February 15, 2008, and it is anticipated that this need will continue through the requested extension period of the delegation of authority.

Update on City of San José Financing Authority Lease Revenue Bonds, Series 2005B (FMC Land Acquisition)

On February 25th, Standard & Poor's ("S&P") downgraded XL Capital Assurance Co. from AAA to A- following rating actions by Fitch and Moody's. As a result of this downgrade by S&P, and absent any upgrade of XL Capital by any of the rating agencies to the AA category in the next 90 days, Bank of America may declare an Event of Default under the SBPA. If after 90 days, if all three rating agencies still rate the bond insurer below AA-, Bank of America can provide the City with notice to terminate the SBPA, effective no less than 30 days from the date of the notice to the City. Under these circumstances, holders of the 2005A and 2005B Bonds that have not previously been tendered would tender them to Bank of America prior to the termination date.

However, based on staff's current financing schedule for refunding the City's variable rate lease revenue debt, contemplated to close on or about April 16, 2008, the termination provisions contained in the SBPA are not anticipated to trigger since the refunding is well within the time frame staff negotiated with Bank of America in extending the Term-Out provision. It is important to note that this Event of Default is **NOT** as the result of any credit issue of the City.

Implementation of Long-Term Solutions

In light of the recent disruption in the financial markets, staff is currently working expeditiously to implement the long-term solutions for the City's and Authority's impacted variable rate debt. These activities include a "take-out" of $140 million in Airport Revenue Bond Auction Rate Securities with Airport Commercial Paper and refunding approximately $219.42 million of general fund variable rate lease revenue bonds.

- ***Redemption of Airport Auction Rate Securities with Airport Commercial Paper***
  The plan to redeem $140 million of Airport Revenue Bond Auction Rate Securities by issuing Airport Commercial Paper was preliminarily discussed at the February 12, 2008, City Council meeting. The key dates in the financing schedule are highlighted below:

  - Receipt of Credit Approval from Lloyds TSB Bank plc — March 5, 2008
  - Distribution of Council Report — March 10, 2008
  - Council Approval of Expansion of Airport CP Program — March 25, 2008
  - Redemption of Auction Rate Securities — April 3, 2008

- ***Refunding of City of San José Financing Authority Variable Rate Lease Revenue Bonds***
  Staff is working on the refunding of up to eight series of City of San José Financing Authority variable rate lease revenue bonds, totaling $219.42 million, which are identified in the table on the next page along with the current bond insurer rating and outlook from each of the three rating agencies. A preliminary financing schedule is highlighted below.

  - Receipt of bank proposals to convert liquidity — March 7, 2008
  - Preparation of Offering Documents — March 28, 2008
  - Council/Authority Approval of Refunding — April 8, 2008
  - Refunding of Variable Rate Bonds — April 16, 2008

  As discussed in the February 14, 2008 staff report, the current goal is to complete the refundings by the end of April. However, these timelines are predicated on an accelerated staff report process and various parties to the current financing waiving notice requirements.

Summary of Credit Enhancement and Ratings of City of San José Financing Authority Variable Rate Lease Revenue Bonds

	Bond Insurer	Moody's Investors Service	Standard & Poor's	Fitch Ratings
CSJFA 2000C (Ice Centre) $18,900,000	MBIA Insurance Corp.	Aaa on review for possible downgrade	AAA negative outlook	AAA negative watch
CSJFA 2001BCD (Hayes Mansion) $53,100,000	Ambac Assurance Corp.	Aaa on review for possible downgrade	AAA negative watch	AA negative watch
CSJFA 2002C (Civic Center) $60,000,000	Ambac Assurance Corp.	Aaa on review for possible downgrade	AAA negative watch	AA negative watch
CSJFA 2004A (Ice Centre) $9,225,000	MBIA Insurance Corp.	Aaa on review for possible downgrade	AAA negative outlook	AAA negative watch
CSJFA 2005AB (FMC Land Acquisition) $78,195,000	XL Capital Assurance Inc.	A3 stable outlook	A-minus negative watch	A negative watch

EVALUATION AND FOLLOW-UP

Staff will report back to the City Council on June 24, 2008 with a summary of any actions taken under this delegation of authority and a discussion of current market conditions and the impact on the City and Authority's short and long-term debt.

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 David Persselin, Debt Administrator, at (408) 535-7012.

APPENDIX A

CURRENT RATINGS OF BOND INSURERS

	Moody's Investors Service	Standard & Poor's	Fitch Ratings
Ambac Assurance Corp.	Aaa on review for possible downgrade	AAA negative watch	AA negative watch
Assured Guaranty Corp.	Aaa stable outlook	AAA stable outlook	AAA stable outlook
CIFG Assurance North America Inc.	Aaa on review for possible downgrade	AAA negative outlook	AAA negative watch
Financial Guaranty Insurance Co.	A3 on review for possible downgrade	A "developing" watch	AA negative watch
Financial Security Assurance Inc.	Aaa stable outlook	AAA stable outlook	AAA stable outlook
MBIA Insurance Corp.	Aaa on review for possible downgrade	AAA negative outlook	AAA negative watch
Radian Asset Assurance Inc.	Aa3 stable outlook	AA stable outlook	A-plus on "evolving" watch
XL Capital Assurance Inc.	A3 stable outlook	A-minus negative watch	A negative watch
ACA Financial Guaranty Corp.	Not Rated	CCC "developing" watch	Not Rated

Source: The Bond Buyer, February 26, 2008.