COUNCIL AGENDA: 05-05-09
ITEM: 3.5

CITY OF
SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO: HONORABLE MAYOR AND CITY COUNCIL

FROM: Scott P. Johnson

SUBJECT: SEE BELOW

DATE: April 13, 2009

Approved Christine J. Shippey Date 4/20/09

COUNCIL DISTRICT: City-Wide

SUBJECT: APPROVAL OF THE SIXTH SUPPLEMENTAL TRUST AGREEMENT FOR CITY OF SAN JOSE AIRPORT REVENUE BONDS

RECOMMENDATION

Adopt a resolution of the City Council authorizing the negotiation and execution of the Sixth Supplemental Trust Agreement to the Master Trust Agreement by and between the City and The Bank of New York Mellon related to City of San José Airport Revenue Bonds to permit the continuance of two collateralized investment agreements by and between The Bank of New York Mellon and Citigroup Global Markets Inc. related to the City of San José Airport Revenue Bonds, Series 2004A, Series 2004B, Series 2004C, Series 2004D, Series 2007A, and Series 2007B.

OUTCOME

Approval of this memorandum's recommendation will allow the City to retain two collateralized investment agreements related to capital improvement projects at the Norman Y. Mineta San José International Airport with interest earnings rates significantly above current market rates.

EXECUTIVE SUMMARY

Consistent with the bond indenture for the City's Airport Revenue Bonds, in September 2007 the City invested the bond proceeds from the Airport Revenue Bonds, Series 2007A and Series 2007B, in two collateralized investment agreements with guaranteed earnings rates of approximately 4.5%. The investment agreement provider's ratings have recently been downgraded to a level not permitted under the bond indenture. If the City takes no further action, it will be necessary to terminate the investment agreements and reinvest the bond proceeds at substantially lower earnings rates. The recommended actions will modify the bond indenture to allow the investment agreements to continue for a net benefit to the Airport ranging from approximately $2.0 million to $9.3 million.

The two collateralized investment agreements (the "Agreements") by and between The Bank of New York Mellon (the "Trustee") and Citigroup Global Markets Inc. ("CGMI") were executed in conjunction with the issuance of City of San José Airport Revenue Bonds, Series 2007A and Series 2007B. At the time that the City directed the Trustee to enter into the Agreements, the Agreements conformed to the permitted investments provisions of the Master Trust Agreement (including, specifically, the definition of "Investment Agreement" in the Master Trust Agreement) and the City's Investment Policy (the "Investment Policy"); however, subsequent downgrades of CGMI's ratings have caused the Agreements to no longer meet the requirements of the Master Trust Agreement. The Agreements remain in compliance with the Investment Policy as described below.

As a result of the rating downgrades, CGMI has posted collateral as required under the Agreements and the collateral levels are currently in excess of the levels required by the Investment Policy. However, although the City has not seen any indications that CGMI will file for bankruptcy, in the event that CGMI files for bankruptcy protection, is forced into bankruptcy by its creditors, or is forced into bankruptcy by the Securities Investor Protection Corporation ("SIPC"), there is a risk that collateral posted under the Agreements may become temporarily inaccessible. If this were to occur, staff has a mitigation plan as described in the Risk Mitigation Strategies section below.

If the City takes no further action, it will be necessary to terminate the Agreements to remain in compliance with the Master Trust Agreement. The balance of the Agreements, approximately $380 million, would be reinvested at market earnings rates that are substantially lower than the earnings rates guaranteed under the Agreements.

If the City amends the Master Trust Agreement to include the Agreements as permitted investments, then the City may retain the Agreements. Continuance of the Agreements is projected to create a net benefit to the Airport ranging from approximately $2.0 million to $9.3 million over the remaining term of the Agreements depending on staff's implementation of risk mitigation strategies. This range is based on the current cash flow/expenditure projections and it may be substantially increased or reduced to the extent that the timing of actual project expenditures varies significantly from the current projection.

BACKGROUND

Issuance of Bonds for Airport Capital Projects

On June 24, 2004, the City issued its City of San José Airport Revenue Bonds, Series 2004A, Series 2004B, Series 2004C, and Series 2004D (collectively, the "2004 Bonds"), for the purpose of financing a portion of the improvement projects at the Norman Y. Mineta San José International Airport (the "Airport"). These projects included the North Concourse Project, which is currently under construction. Subsequent to the issuance of the 2004 Bonds, the City issued its City of San José Airport Revenue Bonds, Series 2007A and Series 2007B (collectively, the "2007 Bonds"), to provide funding for Phase 1 of the Airport Development Program (the "Phase 1 Projects"), including funding for the completion of the North Concourse Project.

The 2004 Bonds and the 2007 Bonds were issued pursuant to a Master Trust Agreement between the City and The Bank of New York Mellon Trust Company, N.A., as successor trustee (the "Trustee"), dated as of July 1, 2001, as amended and supplemented to date (the "Master Trust Agreement"). The Master Trust Agreement contains provisions allowing the City to invest in Permitted Investments, which includes investment agreements that meet the requirements of an "Investment Agreement" as defined in the Master Trust Agreement. Per the Master Trust Agreement, an Investment Agreement is defined to include "a collateralized investment agreement that is provided by ... a registered broker/dealer subject to SPIC jurisdiction rated 'A1' or better by Moody's and 'A+' or better by Standard & Poor's".

Airport Bond Proceeds Invested in Investment Agreements

In conjunction with the issuance of the 2007 Bonds and after an analysis of investment alternatives, the City issued an RFQ for competitive proposals for collateralized investment agreements. Based on the results of this process, the City directed the Trustee to enter into two collateralized investment agreements (the "Agreements") with Citigroup Global Markets Inc. ("CGMI")[1]: one agreement related to the 2004 Bonds with an initial balance of approximately $46 million and earnings rates ranging from 4.521% to 4.732% per annum and a second agreement related to the 2007 Bonds with an initial balance of approximately $614 million and earnings rates ranging from 4.533% to 4.539% per annum, for an aggregate total of approximately $660 million.

The funds and accounts invested pursuant to the Agreements included the capitalized interest accounts, capitalized fee funds and construction funds with respect to the 2004 Bonds and the capitalized interest accounts and construction funds with respect to the 2007 Bonds. The provisions of the Agreements related to the 2004 Bonds construction funds expired by the Agreement's terms on February 28, 2009. Those funds are now held by the Trustee and invested in alternative investments pursuant to the Investment Policy and the Master Trust Agreement.

Investment Agreements – Ratings and Collateral Requirements

On the date that the Trustee entered into the Agreements with CGMI as directed by the City, the Agreements met the rating requirements specified in the Master Trust Agreement and the Investment Policy and the collateralization level required under the Agreements complied with the terms of the Investment Policy. CGMI was rated "Aa1" by Moody's Investors Service ("Moody's") and "AA" by Standard & Poor's ("S&P") and the Agreements were collateralized at 104% for U.S. Treasury Securities and 105% for U.S. Agency Securities. Consistent with the

[1] CGMI is a broker-dealer, which through its predecessors, has been registered with the Securities and Exchange Commission pursuant to Section 15 of the Exchange Act since 1960. It is also a member of the National Association of Securities Dealers. CGMI is a subsidiary of Citigroup Inc., which is a publicly held Delaware corporation headquartered in New York, New York.

Investment Policy, the Agreements are marked to market on a daily basis. When marking to market, the Trustee determines the market value of the collateral and requests additional collateral from CGMI to the extent that the value of the collateral falls below the required collateral levels.

On December 18, 2008, CGMI's rating was downgraded by Moody's to "A2". On December 19, 2008, CGMI's rating was downgraded by S&P to "A". Due to these downgrades the Agreements no longer meet the criteria set forth in the definition of Investment Agreement and therefore no longer qualify under the definition of Permitted Investments as defined in the Master Trust Agreement. However, the City may amend the Master Trust Agreement to include the Agreements as permitted investments. The Agreements continue to comply with the Investment Policy because, consistent with the Investment Policy, the Agreements specify that in the event of downgrade of the provider, the Agreements may be terminated without penalty or the provider is required to provide additional collateral.

As of April 13, 2009, CGMI is rated "A3" from Moody's and "A" from S&P. The aggregate balance of the Agreements is approximately $380 million and the Agreements, per their terms, are over-collateralized at 107% for U.S. Treasury Securities and 108% for U.S. Agency Securities. This is the maximum collateral level specified in the Agreements; therefore CGMI is not required to provide collateral above the 107% for U.S. Treasury Securities and 108% for U.S. Agency Securities. The collateral is held by the Trustee for the benefit of the City under the terms of the Agreements.

ANALYSIS

Construction of the Phase 1 Projects is currently in progress. A majority of the projects funded from the bond proceeds currently invested in the Agreements are anticipated to be completed within the next sixteen months. Staff anticipates that the combination of bond proceeds and interest earnings as of March 31, 2009 will be sufficient to complete all of the projects contemplated at the time of issuance of the 2007 Bonds. To the extent that the amount of interest earned exceeds the amount required to complete the Phase 1 Projects, the Master Trust Agreement allows those amounts to be used to fund additional capital projects at the Airport, to pay down debt, or to be used for another purpose that receives a favorable opinion of bond counsel.

City May Amend the Master Trust Agreement

If the City takes no further action, it will be necessary to terminate the Agreements to remain in compliance with the Master Trust Agreement. The balance of the Agreements, approximately $380 million, would be reinvested in a portfolio of securities as permitted under the Master Trust Agreement and the Investment Policy. If the City amends the Master Trust Agreement to include the Agreements as permitted investments, then the City may retain the Agreements.

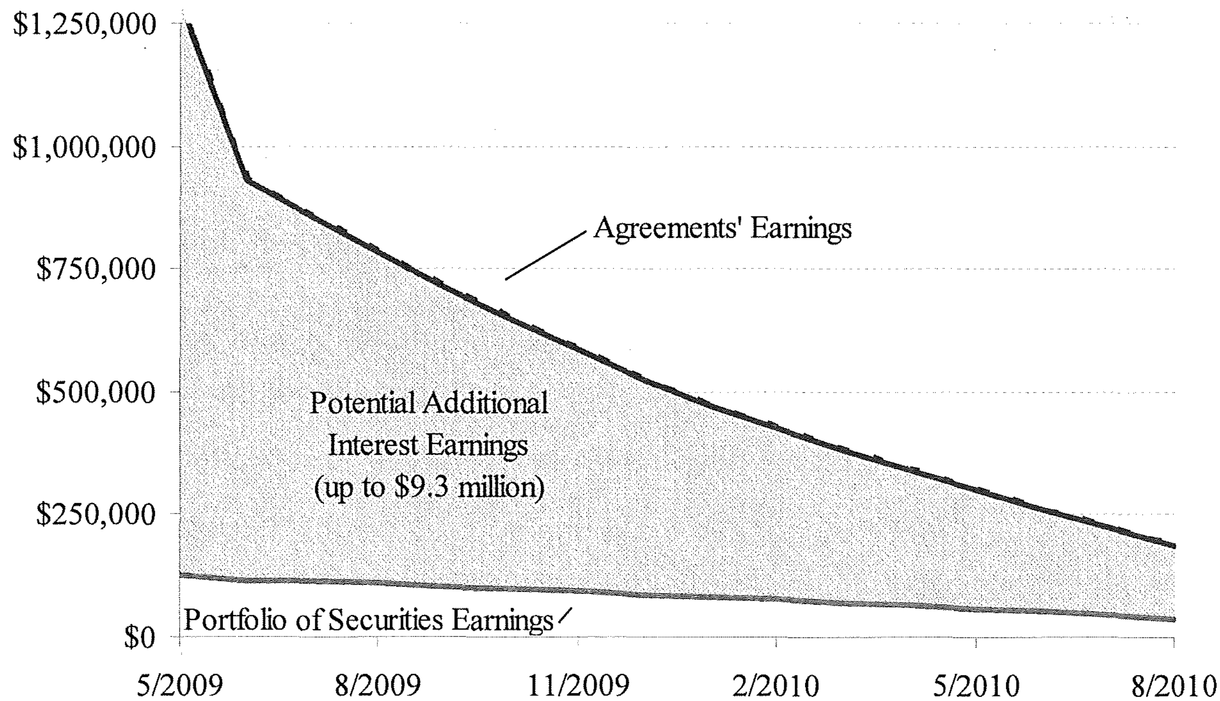
Benefit to City to Continue Investment Agreements

Continuance of the Agreements is projected to create a net benefit to the Airport ranging from approximately $2.0 million to $9.3 million over the remaining term of the Agreements, depending on staff's implementation of risk mitigation strategies. This range is based on the current cash flow/expenditure projections and it may be substantially increased or reduced to the extent that the timing of actual project expenditures varies significantly from the current projection.

For comparative purposes, it is useful to observe the yield curve for Federal Agency Securities, another permitted investment vehicle. Indicative earnings rates as of April 10, 2009 were 0.15% for an investment maturing in one month and 0.93% for an investment maturing in sixteen months. As noted earlier, the guaranteed earnings rate on the Agreements are approximately 4.50%.

The chart below illustrates the estimated monthly gross earnings for the Agreements and a portfolio of Federal Agency Securities based on current cash flow/expenditure projections. The range of net benefits between the projected earnings on the existing Investment Agreements and what would be earned on a portfolio of Federal Agency Securities at a much lower rate is depicted as the shaded region between the two interest earnings lines.

Estimated Monthly Gross Earnings



The analysis below provides further information on the risk factors associated with retaining the Agreements, strategies that may be used to mitigate those risks, and the process to retain the Agreements.

Investment Agreements' Risk Factors

If CGMI files for bankruptcy protection, is forced into bankruptcy by its creditors, or is forced into bankruptcy by the Securities Investor Protection Corporation ("SIPC"), then the City may be exposed to the following two risks:

1) An automatic stay would apply to the collateral backing the Agreements and the City would not have access to the collateral even if CGMI was not performing under the Agreements. The City would then need to apply to the bankruptcy court for relief before accessing invested amounts.

2) To the extent that new collateral was provided to the Trustee during the 90-day period preceding the bankruptcy, then the bankruptcy court could take control of this collateral as part of the bankruptcy estate.

The Phase 1 Projects' construction costs are paid from the City's Investment Pool (the "Investment Pool") pending the processing of reimbursement requests submitted by the City to the Trustee. In processing the reimbursement requests from the City, the Trustee draws down from the Agreements and reimburses the City for eligible project costs. If the Agreements were impacted by either of the two risks noted above, there may be a temporary delay in accessing the posted collateral, representing amounts invested in the Agreements, for reimbursement of project costs. Although there is very little precedent and it is difficult to predict the delay with certainty, the delay could be reasonably expected to be between 2 and 6 months; however, it could be longer or shorter depending on the nature and extent of the bankruptcy proceeding and the particulars of the City's situation at the time. The City most likely would not be at risk for losing the principal invested.

A delay in reimbursing the Investment Pool for prior expenditures would have a negative impact on the Investment Pool's earnings. In the event that alternative funding sources were not available and the expenditures paid from the Investment Pool remained unreimbursed, the Investment Pool's earnings would be reduced by approximately $2,700 per month for each $1 million of unreimbursed expenditures.

Based on these potential risks, staff developed the following risk mitigation strategies.

Risk Mitigation Strategies

Staff regularly monitors the Agreements, including review of daily collateral valuation statements and review of changes to Citigroup's short-term and long-term ratings, which are automatically provided to staff through Bloomberg Data Service. Staff also regularly reviews the Federal government's activities related to Citigroup and the U.S. financial system.

To the extent that there are signs of increased risk associated with Citigroup, staff is able to take a variety of actions to ensure that project expenditures are reimbursed in a timely manner. Among these strategies, staff may:

1) If there are additional concerns about CGMI's financial condition prior to a formal CGMI bankruptcy event, preemptively withdraw funds from the Agreements in amounts sufficient to reimburse multiple months of projected expenditures.

2) In the event of a CGMI bankruptcy, recommend that the City Council approve interfund loans from the Investment Pool to the Airport capital funds until the collateral backing the Agreements becomes available.

3) In the event of a CGMI bankruptcy, issue Airport commercial paper notes to reimburse expenditures until the collateral backing the Agreements becomes available.

At this time, staff does not intend to withdraw funds from the Agreements for risk mitigation purposes; however, the above strategies may be implemented at any time in a manner appropriate and commensurate with the Agreements' risks. As noted above, the net benefit to the Airport of retaining the Agreements would be decreased by staff's implementation of these risk mitigation strategies.

Process to Retain Investment Agreements

In consultation with bond counsel, staff has determined that the Agreements may be retained if the bond insurers of all outstanding series of the City's Airport Revenue Bonds consent to an amendment to the Master Trust Agreement as provided for therein. The proposed amendment would amend the definition of "Investment Agreement" to explicitly allow the Agreements to remain in effect for the term of the Agreements. In other words, the proposed amendment would only apply to the Agreements and would not apply to any future investment agreement related to the City's Airport Revenue Bonds.

The bond insurers for the City's outstanding Airport Revenue Bonds are Ambac Assurance Corporation ("Ambac"), Financial Guaranty Insurance Company ("FGIC")[2], Financial Security Assurance Inc. ("FSA"), and MBIA Insurance Corporation ("MBIA"). Staff has discussed the consent request with Ambac, MBIA, and FSA and all three bond insurers have indicated that they are willing to consent to the amendment. Staff sent final consent letters to the bond insurers and anticipates that the executed consent letters will be returned to the City prior to the date of the City Council meeting on May 5, 2009.

[2] FGIC and MBIA have entered into an Administrative Services Agreement under which MBIA has agreed to provide certain administrative services including the approval of consent and waiver requests. As a result, staff will seek consent to the amendment from MBIA on behalf of FGIC.

If the City Council takes the actions in the Recommendation section of this memorandum, then staff will follow the procedures to amend the Master Trust Agreement as outlined therein and the amendment will take effect once the City and Trustee execute the amendment. This process is anticipated to be completed within two weeks following the City Council's approval.

EVALUATION AND FOLLOW-UP

This memorandum presents the recommendation related to the City Council's approval of the Sixth Supplemental Trust Agreement and requires no follow-up to the City Council.

PUBLIC OUTREACH/INTEREST

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

☐ **Criteria 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)**

☐ **Criteria 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 report was prepared by the Finance Department in coordination with the Airport Department, the City Attorney's Office, and the City Manager's Budget Office.

COST SUMMARY/IMPLICATIONS

As noted in the Analysis section, staff anticipates that the combination of bond proceeds and interest earnings as of March 31, 2009 will be sufficient to complete all of the projects contemplated at the time of issuance of the 2007 Bonds. To the extent that the amount of interest earned exceeds the amount required to complete the Phase 1 Projects, the Master Trust Agreement allows those amounts to be used to fund additional capital projects at the Airport, to pay down debt, or to be used for another purpose that receives a favorable opinion of bond counsel.

Compensation for the City's consultants is billed on a "time and materials" basis and will be paid from the Airport Operating Fund or commercial paper note proceeds.

CEQA

Resolutions No. 67380 and 71451, PP 09-057

Scott P. Johnson
SCOTT P. JOHNSON
Director, Finance

For questions, please contact Scott P. Johnson, Director of Finance, at 535-7000.