Agenda Report

TO: CITY COUNCIL **DATE:** March 24, 2008

FROM: CITY MANAGER

SUBJECT: ADOPTION OF A RESOLUTION OF THE CITY OF PASADENA APPROVING THE EXECUTION AND DELIVERY OF NOT TO EXCEED $138,000,000 AGGREGATE INITIAL PRINCIPAL AMOUNT OF VARIABLE RATE DEMAND REFUNDING CERTIFICATES OF PARTICIPATION, SERIES 2008A APPROVING THE FORM OF AND AUTHORIZING THE EXECUTION AND DELIVERY OF A THIRD SUPPLEMENTAL TRUST AGREEMENT, A SUPPLEMENT NO.3 TO LEASE, A SUPPLEMENT NO. 3 TO SUBLEASE, A PURCHASE AGREEMENT, A REIMBURSEMENT AGREEMENT, A REMARKETING AGREEMENT AND OTHER RELATED DOCUMENTS, AUTHORIZING THE DISTRIBUTION OF AN OFFICIAL STATEMENT AND APPROVING OTHER RRELATED ACTIONS IN CONNECTION THEREWITH.

RECOMMENDATION

It is recommended that the City Council adopt a Resolution approving the execution and delivery of not to exceed $138,000,000 aggregate initial principal amount of variable rate demand refunding certificates of participation, series 2008A, approving the form of and authorizing the execution and delivery of a third supplemental trust agreement, a supplement to No. 3 to lease, a supplement No. 3 to sublease, a purchase agreement, a reimbursement agreement, a remarketing agreement and other related documents, authorizing the distribution of an official statement and approving other related actions in connection therewith.

BACKGROUND

In 2006 the City sold $162.64 million in Certificates of Participation (COPs) to finance the expansion of the Pasadena Conference Center. The COPs were issued with a AAA municipal bond insurance policy with Ambac. The series 2006 COPs were structured in two tranches:

> Series A: $28 million Capital Appreciation Bonds (CABs). These are zero coupon bonds that effectively have a fixed interest rate; consequently, they have not been impacted by the recent market turmoil.
>
> Series B: $135.5 million Auction Rate Certificates which carry a variable interest rate reset every seven days.

The City simultaneously entered into a swap agreement with Depfa Bank when it issued the Series 2006B COPs. The swap requires the City to pay (Depfa) a fixed rate equal to 3.536% and in return the City receives a variable rate equal to 64% of London Interbank Offered Rate (LIBOR Index), which effectively creates a "synthetic fixed rate" of 3.536%. This synthetic rate structure has provided the City the least cost financing rate and saved an estimated $1.5 million in interest cost as compared to traditional fixed rate bonds over the last eighteen months.

The swap agreement is designed to pay and/or offset the City's underlying variable interest rate costs related to the Series B COPs. In other words, the 64% of LIBOR that the City receives under the swap is designed to nearly match the variable rate the City pays on its auction rate bonds. The difference between these two variable rates is called "basis risk". Basis risk has typically ranged plus or minus 5 basis points (0.05%) to 10 basis points (0.10%) Therefore, the City's actual rate is the synthetic fixed rate of 3.536% adjusted by the basis risk.

<u>Impact of Sub-prime Mortgage Crisis</u>

The sub-prime mortgage crisis has had a far reaching impact in the capital markets. The increasing rate of defaults on sub-prime mortgages, which serves as collateral for asset-backed securities and collateralized debt obligations (CDOs), has created a chain reaction in the capital markets. Investment banks have written off billions in losses for the unsold inventories of such securities that continue to decline in value, while bond insurers have experienced downgrades due to insufficient capital reserves to cover mounting defaults on the loans they have guaranteed. This has resulted in a liquidity crisis in the financial markets that is severely impacting the Auction Rate Securities (ARS) market.

In the past several weeks there has been wide-spread interest rate dislocation in the ARS market. Nearly 75% of the auctions have failed, causing the securities to reset at or near the maximum rate of 12-15%. The majority of ARS carried a municipal bond insurance policy. However, what had initially appeared to be a problem related to the bond insurers now appears to be a failure in the ARS product itself.

As a result of the failure in the auction rate market, the City's auction rate certificates are no longer generating the expected low financing cost. Over this same timeframe, the variable rate receipts the City receives from the swap provider have not been covering the variable rate interest payments the City paid on its auction rate certificates, leaving the City paying much higher interest rate costs (Basis Risk) than originally planned. Over the past several weeks the City has experienced up to 10% shift in interest rates, which has resulted in over $832,000 in additional borrowing cost. The following represents the interest rates paid on PCOC's auction rate securities over the last several weeks:

September 2006 – January 2008	3.41%
February 5, 2008	3.70%
February 11, 2008	3.70%
February 18, 2008	11.99%
February 25, 2008	8.45%
March 3, 2008	11.00%

On March 6, 2008, the City replaced UBS Securities with Banc of America Securities as the auction agent on the 2006 PCOC auction rate securities. Banc of America agreed to support the City's auction rate program and commit its capital to prevent auction failures. As a result the weekly auction rate on the bonds cleared at 5% on March 10 and March 17, 2008.

The City has invested the bond proceeds from the 2006 PCOC bonds in such a manner that the investment earnings on those proceeds exceed the bond yield or the allowable earnings rate; therefore an arbitrage rebate liability to the Internal Revenue Service (IRS) has accrued in an amount exceeding $2.0 million as of December 2007. This amount will be owed to the IRS in 2011 along with additional future arbitrage rebate liability. As a positive note, the increased rates that the City has been paying will offset a significant portion of the amount that will be due to the IRS.

<u>The Financing</u>

Staff proposes to refinance the outstanding 2006B Auction Rate Certificates with Variable Debt Demand Bonds (VRDB) backed by a 2-year Bank of America Letter of credit (LOC). The City will keep the synthetic fixed rate swap with Depfa in place. The City will issue a not to exceed amount of $138 million in refunding certificates (the estimated par amount of the refunding bonds is $136.5 million), which will include $1 million in new money to replenish the Capitalized Interest Account. The Capitalized Interest Account is used to pay interest during the construction period of the Conference Center, which has borne much higher than anticipated debt service costs over the past several weeks.

Variable Rate Demand Bonds or VRDBs are long-term bonds that carry a short-term interest rate that is reset every seven days. VRDBs, unlike auction rate bonds, have a seven day "put" feature and are backed by a liquidity facility and/or bank letter of credit. VRDBs are qualified investments for Rule 2a-7 money market funds and are typically sold to money market funds which are required by the Securities and Exchange Commission (SEC) regulation to purchase securities rated in the AA categories or higher.

Prior to concluding the recommended refunding, staff has evaluated numerous proposals from investment bankers and advisors as well as evaluated alternative financing solutions which include terminating the swap and issuing fixed rate bonds, utilizing the California Statewide Communities Development Authority (CSCDA), having the City buy its own auction rate bonds, and issuing short-term notes.

Fixed Rate Bonds – In order to issue fixed rate bonds, the City would be required to terminate the Depfa swap, which would require the City to pay Depfa Bank a termination fee well over $7 million in today's interest rate environment. Furthermore, given the 2034 final maturity on the bonds and current long term tax exempt interest rates around 5%, it would not be financially prudent to pursue this alternative.

CSCDA – The final terms of the CSCDA have not been set yet and are not likely to be implemented until sometime in May. Moreover, the CSCDA program is only intended to provide a temporary solution. Finally, the City would be locking in a 1-year fixed rate of probably 4.0% or higher, and thus assume an asset liability mismatch (pay fixed rate on bonds and receive a variable rate on the swap). Given the Federal Reserve indication that it intends to continue to cut interest rates, taking this type of asset liability mismatch is not recommended in a declining interest rate environment and will increase the overall cost of the existing synthetic fixed rate financing.

City Buys its own ARS – SB 344, as amended, changes current law so that the acquisition of bonds by or on behalf of a state or local government that issued the bonds does not cancel, extinguish, or otherwise affect the bonds. The SEC has also recently published guidelines that will enable municipalities to buy their own auction rate securities. However, without further tax guidance from the IRS, any purchase of its bonds or COPs by the City would result in an extinguishment of the debt. Thus, the City would be unable to issue refunding bonds. Even if the IRS provides tax relief from this consequence, a purchase by the City would still only be a temporary solution to the high interest rates on failed or flawed auctions. Moreover, the City has already obtained some relief from these higher rates by having Banc of America Securities provide liquidity until the financing is closed.

The following are the advantages and disadvantages of the proposed financing:

Advantages:

- Refunding the auction rate bonds with VRDBs permanently fixes the current problem;
- The proposed refunding brings the swap back to equilibrium and significantly reduces the basis risk;
- While municipalities are struggling to obtain letters of credit, City of Pasadena has already been approved by Banc of America Securities a credit facility amount of $145,000,000 at very competitive rates;
- The new bonds are expected to cost 2.25%-2.5% interest rate; including letter of credit fee and remarketing fee, the total cost is expected to range from 2.725% to 2.975%;
- The proposed refunding eliminates future uncertainty on credit availability in the market and eliminated future uncertainty on letter of credit fees.

Disadvantages:

- The City will lose the insurance from Ambac. The insurance premiums were paid in lump sum in 2006 in the amount of $1.15 million and are considered sunk cost;
- There is additional cost of issuing the bonds in the estimated amount of $260,000 and underwriter's discount in the amount of $295,578.

Potential Risks

While interest rates in the auction rate market could stabilize, there is no certainty of this occurring. In any case, it is expected that there will continue to be a penalty associated with auction rate securities as compared to variable rate demand bonds and especially auction rate securities backed by Ambac or another insurer without stable AAA ratings from all three rating agencies. Replacing the 2006B ARS with LOC-backed VRDBs provides the lowest expected cost solution. However, there is always the possibility that Bank of America is downgraded in the future. Moreover several banks could be subsequently downgraded, further tightening credit and raising LOC fees. In this case the City would be forced to find a replacement LOC bank, which would require additional bank and legal fees.

The Reimbursement Agreement to the LOC also stipulates that in addition to Bank of America's annual fees, the City may be required to pay any increased costs to the bank resulting from any change of law or regulation which increases the Bank's costs of providing the facility. The City's bond counsel advises that this provision is customary in this type of transaction. In addition, should the City default under the reimbursement agreement, the City's payment obligations would increase and the debt would turn into a bank term loan at prime rate plus 2%. However, the default provisions are customary for this type of financing, and a default is unlikely absent a marked deterioration in the City's financial conditions.

Official Statement

A description of the City's financial and operating data is omitted from the Official Statement for the 2008A COPs. Disclosure counsel has advised the City that finance and operating information about the City is not material to the purchase of the 2008A COPs because the short term funds that buy the COPs will rely exclusively on the ratings and credit of Bank of America. Any buyer of the COPs will have the absolute right to tender the COPs for purchase on seven day's notice, and Bank of America backstops this purchase under the letter of credit. Bank of America will make disclosure of its financial position in the Official Statement by incorporating its SEC filings. The City will have no liability for Bank of America's disclosure.

FISCAL IMPACT

The Series 2008A Variable Rate Demand Certificates will have a maximum term of 26 years with a final maturity in 2035 versus 2034 on the current outstanding bonds. The certificates will be issued as variable rate bonds and the interest rate will be reset every seven days. The City has obtained a 2-year letter of credit from Bank of America for 40 basis points (0.40%) per annum, and will also pay the bank 7.5 basis points (0.075%) per annum to serve as remarketing agent. The total annual fees will be 0.475% for the first two years as compared to 0.255% under the Auction Rate structure. Since the City will retain the existing swap, the net financing impact will be equal to the difference between the two fees, 22 basis points or 0.22% rate. This will increase the financing cost from its original 3.79% rate (swap rate plus auction fees) to 4.01% rate (swap rate plus L/C and remarketing fees). As a comparison, in the last five weeks, the City has paid an average of 6.28% more on the financing, pushing the annualized cost to 10.07% (3.79% plus 6.28%).

It is anticipated that upon the expiration of the letter of credit in two years, the pricing of letter of credits in the market will resume back to its normal rates. In this case, the only incremental cost to the City will be the 7.5 basis points (0.075%) remarketing fee. In addition, there will be approximately $260,000 in additional issuance cost and $296,000 in underwriter's discount that will be incorporated into the par amount of the 2008A refunding certificates.

The following is the estimated sources and uses of funds:

Sources:	
Bond proceeds	$135,705,000
Debt service reserve fund	12,363,039
Total sources	148,068,039
Uses:	
Refunding escrow deposit	135,500,000
1-week interest @12% rate	312,692
Debt service reserve fund	11,697,339
Cost of issuance	260,000
Underwriter's discount	295,578
Rounding	2,430
Total uses	$148,068,039

Respectfully submitted,

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