ATTACHMENT B

Swap Financial Group

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MEMORANDUM

To:	Andrew Green, Director of Finance Vic Erganian, Deputy Director of Finance / City Treasurer The City of Pasadena, California
From:	George Majors (Direct Phone 215.859.6791)
Concerning:	DEPFA BANK plc Interest Rate Swap Termination
Date:	March 4, 2011

INTRODUCTION / BACKGROUND INFORMATION

On July 31, 2006, the Pasadena City Council authorized the City to enter into an interest rate exchange agreement (the "DEPFA Swap") with DEPFA BANK plc related to the Series 2006B Conference Center Auction Rate Certificates of Participation (the "2006B Certificates"). The DEPFA Swap provides for the City to make monthly payments at a 3.536% fixed rate and to receive monthly payments on a variable rate basis equal to 64% of the then-current 1-month LIBOR rate. The variable rate ***receipts*** on the DEPFA Swap were expected to be approximately equal to the variable rate 2006B Certificate ***payment obligations.*** With those two payment streams effectively off-setting each other, the City's net result was a substantially fixed-rate financing structure at a cost significantly lower than was available to the City by issuing traditional, long-term, fixed-rate Certificates. This approach of combining a variable rate debt structure with a pay-fixed / receive-variable interest rate swap is generally referred to as "synthetic" fixed-rate debt.

In April 2008, the City deemed it advantageous to replace the 2006B Certificates, the periodic variable rate on which was determined pursuant to an auction-type process, with its Variable Rate Demand Refunding Certificates of Participation, Series 2008A, (the "2008A Certificates"). The periodic variable rate payable by the City with respect to the 2008A Certificates is determined pursuant to the more traditional remarketing agent process and benefits from payment obligations to certificate holders being secured by a Bank of America Letter of Credit. Replacement of the 2006B Certificates with the 2008A Certificates had no effect on the DEPFA Swap and the overall synthetic fixed-rate structure has functioned substantially as anticipated.

Interest rate exchange agreements are contracts that require ongoing performance by both parties. One risk of non-performance by DEPFA BANK plc is financial deterioration, including, ultimately, the possibility of insolvency and a related bankruptcy proceeding. In order to protect the City against this risk, the DEPFA Swap provides that if DEPFA BANK plc fails to maintain credit ratings in the "A" category by at least two nationally recognized credit rating agencies (e.g., Moody's and Standard & Poor's), then the City may terminate the DEPFA Swap. DEPFA BANK plc's credit ratings are now below the required levels and, despite the intervention of the German government, DEPFA BANK plc's future as an ongoing concern is uncertain.

This type of credit protection provision, which is generally referred to as a "ratings-based termination event," is intended to allow the City to make alternative arrangements while DEPFA BANK plc is still a viable, solvent entity able to meet its financial obligations, including being able to make any payment(s) due to the City upon an early termination. Given that the value of an interest rate swap fluctuates with general market interest rate conditions (much like the market price of a bond varies), terminating a swap early typically involves a "termination payment" from one party to the other. Termination payments can be substantial, so it is important that the party owing the payment is still financially capable of making the payment. Additionally, as entities that were parties to financial contracts with Lehman Brothers discovered, dealing with an entity that has filed for bankruptcy protection, regardless of whether you are a creditor or a debtor, can be complex and otherwise time-consuming.

For these and other reasons, it is generally prudent to include ratings-based termination events in interest rate swaps as the City did in the DEPFA Swap, and to exercise the right to termination when a ratings-based termination event occurs.

ALTERNATIVES AVAILABLE TO THE CITY

The City's available alternatives can be summarized as follows:

1. **Terminate The DEPFA Swap Without Replacement.** As described above, the DEPFA Swap, in combination with the variable rate 2008A Certificates, provides a substantially fixed-rate debt structure. Terminating the DEPFA Swap without replacement and without a fixed-rate refunding of the 2008A Certificates would result in a net variable rate structure.
    a. While in some circumstances variable rate debt structures are appropriate, I am not aware of any change in the City's original rationale for utilizing a fixed-rate structure;
    b. As described below, if terminated under current market conditions, the City would owe a substantial (i.e., > $12,000,000) Termination Payment to DEPFA. Absent using a Replacement Transaction or new bond/certificate issue as a source for such payment obligation, the payment would presumably need to be made from available City cash;
    c. This alternative is ***NOT RECOMMENDED***.
2. **Terminate The DEPFA Swap And Issue Fixed-Rate Refunding Certificates.** Issuing fixed-rate refunding certificates would preserve the fixed-rate debt structure and provide a source of payment for the Termination Payment. Traditional fixed-rate debt structures also have other advantages over synthetic fixed-rate structures, including the absence of risks and costs associated with maintaining the variable rate debt program and the interest rate swap. However, the interest cost of a fixed-rate issuance would be substantially (at least 1.00%) higher than continuing with the synthetic fixed rate structure described above, with a present value cost to the City of at least $18,000,000. The expected cost advantage to the City of the synthetic fixed-rate structure is almost certainly far greater under current market conditions than when originally chosen over a traditional fixed-rate structure.
    a. With the Synthetic fixed-rate structure continuing to provide a significant cost advantage over the traditional fixed-rate alternative, this alternative is ***NOT RECOMMENDED***.
3. ***RECOMMENDED ALTERNATIVE* - Terminate The DEPFA Swap And Enter Into A Replacement Transaction**. As described in detail below, the DEPFA Swap provides for the City to terminate the DEPFA Swap and enter into a Replacement Transaction with all costs of such termination and replacement borne by DEPFA. This alternative has the following relative advantages:
    a. The City's new (i.e., "Replacement") swap counterparty being:
        i. of stronger credit quality than DEPFA, including being rated at least Aa3/AA- by Moody's and S&P, respectively;
        ii. a potential provider to the City, at attractive cost levels, of future credit and other banking services, including, for example, letters-of-credit and direct bond purchases;
        iii. a domestic bank with local branches;
    b. While, as described below, the City has no immediate risk of loss due to DEPFA non-performance, if DEPFA enters into bankruptcy-type proceedings the City would find it more difficult and, potentially more expensive to exercise its rights under the DEPFA Swap. Swap

counterparties of Lehman Brothers, including both those that owed payments to Lehman upon termination and those that were owed payments, have experienced extraordinary administrative and economic burdens as a result of the favorable treatment afforded to the Lehman estate by the Bankruptcy Court. Distancing itself from DEPFA, an entity at relatively heightened risk of deterioration into bankruptcy or other insolvency-type proceedings, well before such an event occurs, should be considered among the City's material objectives; and

c. The new (i.e., "Replacement") swap containing any modifications, relative to the DEPFA Swap, that the City, in its sole discretion, deems advantageous in reflecting changes in (i) City circumstances; (ii) the structure of the related variable rate obligations, and (iii) the financial markets and financial industry practices since the DEPFA Swap was entered into in 2006;

d. As described in greater detail below, the specific mechanics of terminating the DEPFA Swap and determining the Termination Amount due create the potential for the amount of the Termination Payment due to DEPFA, including the City's expenses, being less than the amount received by the City in connection with a Replacement Transaction;

e. Also as described in greater detail, below, the exact pricing and terms of both the DEPFA Swap termination and any replacement transaction, can be determined, at the City's discretion, pursuant to either a negotiated or competitive process.

4. **Take no action**. The City is not at any ***immediate***[1] risk of loss due to DEPFA non-performance and, therefore, arguably could take a "wait-and-see" approach to further developments in DEPFA's credit situation:

   a. The sole advantage of this alternative relative to others available to the City is a slightly lower required *current* effort level on the part of City Staff;

   b. Other available alternatives contain one or more material benefits relative to taking no action, making this alternative unequivocally inferior to one or more others and, therefore, ***NOT RECOMMENDED;***

   c. The reasons that the City is at no ***immediate*** risk from DEPFA failing to meet its potential (x) monthly "Scheduled" or (y) "Termination" payment obligations to the City are described in some detail in the Endnotes hereto.

5. **Negotiate Additional Credit Protections With DEPFA**. DEPFA has offered to provide a third-party guarantee of its obligations under the DEPFA Swap. The guarantee, which would be provided by an entity currently rated AAA/Aaa, if the City and its counsel deemed its form acceptable, would adequately address the City's concerns regarding DEPFA's ability to meet its payment obligations over the life of the DEPFA Swap. However, the guarantee would not necessarily address the bankruptcy issue described in Section 3(b) above, or compare favorably to the recommended alternative given the potential relative benefits described in Sections 3(a), 3(c), and 3(d), above.

   a. While certainly a reasonable remedy for the specific DEPFA downgrade event, when viewed in the context of the City's larger, overall circumstances and objectives, this alternative does not serve the City's interests as well as the recommended alternative and, therefore, is ***NOT RECOMMENDED;***

THE EARLY TERMINATION PROCESS AS PROVIDED FOR IN THE "MASTER AGREEMENT"

The Master Agreement governing the DEPFA Swap provides, conceptually, that a party that causes a Termination Event (the "Affected Party" – or, in this case, DEPFA) bears the cost of making the other party (the "Non-Affected Party" – or, in this case the City) economically indifferent to the early termination. For example, one resolution to the occurrence of the Early Termination Event would be for the DEPFA Swap to be replaced by a substantially similar swap (a "Replacement Transaction") with another financial institution (that is a Qualified Swap Provider under the 2008A Certificates Trust Agreement and otherwise acceptable to the City) with any costs the City incurred to effect that replacement (e.g., legal and financial advisory fees) paid by DEPFA.

However, the Master Agreement does not require that the City enter into another swap at all, much less one with terms substantially identical to those of the DEPFA Swap. For example, if the City were to issue fixed-rate Certificates rather than continue with the variable rate 2008A Certificates in their current form, the City would no longer have a need for any swap. Accordingly, the Master Agreement provides for payment of a single dollar amount Termination Payment that serves, in-lieu-of requiring a Replacement Transaction, to making the City economically indifferent to the early termination. The provisions of the Master Agreement that govern the mechanical process of determining the Termination Amount are set out in some detail in APPENDIX I, hereto, **SUMMARY OF PROCEDURAL PROVISIONS OF INTEREST RATE SWAP DOCUMENTATION UPON OCCURRENCE OF A TERMINATION EVENT.**

Generally, the Master Agreement provides for the City to conduct, without any right of approval or participation of any kind on the part of DEPFA, a solicitation (or, "bid") process pursuant to which each of four selected financial institutions (referred to as "Reference Market-makers") would be asked to indicate the amount of money it would pay, or require to be paid, to enter into a Replacement Transaction with the City. These "indicated amounts" are referred to as "Market Quotations." The Termination Amount is determined, in part, by discarding the high and low Market Quotations and averaging the remaining numbers. (There are alternate provisions if fewer than three Quotations are received, but that is unlikely to occur in the immediate circumstances.)

If the City wishes to enter into a Replacement Transaction, one way of accomplishing that objective is to require that the Market Quotations be submitted as actual, actionable competitive bids to enter into a Replacement Transaction. The City would be free to enter into a Replacement Transaction with the high bidder even though the amount contractually due to DEPFA would be the lower amount described above. Under this approach, the City would contemporaneously terminate the DEPFA Swap and enter into the Replacement Swap with the payment made to the City by the Replacement Swap Counterparty being the source of the payment due to DEPFA.

As described in APPENDIX I, the final Termination Amount includes some additional, usually small, adjustments, including for any reasonable fees and other costs incurred by the City in connection with enforcing its termination rights, including entering into a Replacement Transaction, if any, to be paid by DEPFA. In the current circumstance, because the Termination Payment will be payable by the City to DEPFA, the City can simply subtract its eligible expenses from the final payment it makes to DEPFA.

NEGOTIATED RESOLUTION IN-LIEU-OF INVOKING MARKET QUOTATION PROCESS

The results of a Market Quotation process are unpredictable as prospective Reference Market-makers may have materially different views of the value of the DEPFA Swap because several of the provisions favor the City rather than being "industry standard." DEPFA is aware of the potential for an unfavorable result and is expected to make an offer to the City for an amount it would accept on a negotiated basis. If the City wishes to enter into a Replacement Transaction and can identify a desirable Replacement Counterparty willing to pay an amount at least as large as DEPFA's offer plus all of the City's costs, the City would have the option of effecting the contemporaneous DEPFA Swap termination and Replacement Transaction initiation on a negotiated basis.

The potential advantages of such a resolution would be:

1. Receiving a full release from DEPFA with respect to any future claims or actions;
    a. while the Market Quotation and other provisions of the Master Agreement, if followed in good faith, do not expose the City to material risk of future claims, former swap counterparties of Lehman Brothers and, to a lesser extent, other firms such as AMBAC, have been burdened by ongoing informational requests and other activities.
2. If desired, flexibility to negotiate modifications to the existing DEPFA Swap terms that take into account changes in both (i) City circumstances and (ii) the financial markets since the DEPFA Swap was entered into in 2006;
3. Greater discretion to choose a Replacement Counterparty, including taking into account differentiating factors such as credit rating, customer service, and the potential to establish or enhance a longer-term relationship that could benefit the City in other ways, including, for example, such firm providing a letter of credit on favorable terms; and
4. Negotiating a larger payment to the City than will be due to DEPFA (net of the City's fees and costs). While, as described above, the Market Quotation process creates the potential for some net economic benefit to the City, the results of that process are, again, inherently unpredictable.

Exploring a negotiated resolution would not preclude the City from ultimately choosing to unilaterally terminate the DEPFA Swap, including determining the Termination Amount pursuant to the Market Quotation process.

CITY POLICY & CREDIT RISK CONSIDERATIONS

The City's Debt Management Policy includes guidelines for interest rate swap terms and provisions, including, Section 14.9 "Minimum Counterparty Requirements." DEPFA's current credit ratings are below those specified as the minimum acceptable in the City's Debt Management Policy. Additionally, the Trust Agreement related to the 2008A Certificates defines a Qualified Swap Provider as, among other things, an entity rated in the "double A" (i.e., "AA") category. While that requirement applies only to the time at which the swap is entered into, the substantive reasons for the higher standard still apply, particularly when the higher standard can be realized at no cost to the City.

FISCAL IMPACT

As described above, contemporaneous termination of the DEPFA Swap and initiation of a Replacement Transaction can be accomplished with no net cost to the City and, potentially, with the result of a net positive economic impact. All costs and fees are payable from, and fully contingent upon, adjustments to amounts otherwise payable to DEPFA.

ENDNOTE

[1] The reasons that the City is at no ***immediate*** risk from DEPFA failing to meet its payment obligations to the City are:

1. The City's monthly 3.536% fixed-rate payments are currently significantly higher than the variable rate payments DEPFA is obligated to make to the City. The DEPFA Swap provides for the party making the larger payment each month to subtract or "net-out" from its payment obligation the amount due to it from the other party. Accordingly, so long as the City is a monthly "net payer," it is not at risk of DEPFA failing to make a monthly payment. This situation is very unlikely to change in the next year or more;

2. In addition to DEPFA having potential monthly payment obligations to the City, DEPFA, potentially, could have a Termination Payment obligation to the City. Under current market conditions, if the DEPFA Swap were terminated the City would have a payment

    a. Termination Payments are, essentially, "make-whole" payments from one party to the other equal to the present value of the difference between payments due on the DEPFA Swap and payments that would be due on a hypothetical, identical swap entered into at the current market rate for that transaction.

    b. The City's obligation to pay 3.536% is greater than the current market rate of approximately 2.66%, with the effect that any termination payment (of at least $12 million) would be due ***from*** the City ***to*** DEPFA. The City therefore would not have any risk of DEPFA failing to make a termination payment unless the current market rate rose above 3.536%.

    c. While long-term interest rates rising to that level is certainly very possible, such an increase would most likely take place incrementally over at least several months, giving the City an opportunity to take remedial action before it incurs net exposure to DEPFA.