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 $30,000,000 AGGREGATE INITIAL PRINCIPAL AMOUNT OF REFUNDING CERTIFICATES OF PARTICIPATION, SERIES 2008B, APPROVING THE FORM OF AND AUTHORIZING THE EXECUTION AND DELIVERY OF A FOURTH SUPPLEMENTALTRUST AGREEMENT, A SUPPLEMENT NO.4 TO LEASE, A SUPPLEMENT NO. 4 TO SUBLEASE, A PURCHASE AGREEMENT, A CONTINUING DISCLOSURE AGREEMENT AND OTHER RELATED DOCUMENTS, AUTHORIZING THE DISTRIBUTION OF AN OFFICIAL STATEMENT AND APPROVING OTHER RELATED ACTIONS IN CONNECTION THEREWITH.

RECOMMENDATION

It is recommended that the City Council adopt a Resolution approving the execution and delivery of not to exceed $30,000,000 aggregate initial principal amount of refunding certificates of participation, series 2008B, approving the form of and authorizing the execution and delivery of a fourth supplemental trust agreement, a supplement to No. 4 to lease, a supplement No. 4 to sublease, a purchase agreement, a continuing disclosure agreement, and other related documents, authorizing the distribution of an official statement and approving other related actions in connection therewith.

BACKGROUND

In 2004 the City issued $40.325 million in Certificates of Participation (COPs) in two series. Series 2004A COPs were issued in the amount of $10.25 million for the purpose of refunding a portion of the City of Pasadena 1996 Certificates of Participation (Multipurpose projects), and Series 2004B certificates were executed and delivered for the purpose of refunding a portion of the 1993 COPs (Refunding and Capital projects). The 2004 COPs were auction rate certificates issued with a AAA municipal bond insurance policy with Ambac. The 2004 auction rate certificates have no swap associated with them and are completely exposed to the fluctuation of market rates.

Impact of Sub-prime Mortgage Crisis

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 the past several weeks the City has experienced failed auctions and the rate on the 2004 auction rate certificates were set based on a formula specified in the bond documents. The following represents the interest rates paid on the City's auction rate securities (2004 ARS) over the last several weeks:

February 19, 2008	5.27%%
February 26, 2008	5.25%
March 4, 2008	4.84%%
March 11, 2008	4.50%
March 18, 2008	4.27%
Average	4.82%

The Financing

Staff proposes to refinance the outstanding 2004 Auction Rate Certificates with fixed rate bonds. Given the level of current interest rates and the short maturities of the bonds (final maturity in 2019), it is anticipated that the true interest cost on a fixed rate bond will be 3.65% to 3.75%. This will eliminate the City's exposure to interest rate fluctuation and reduce the financing cost by as much as 1.2% compared to current rates the City has been paying.

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 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.

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 incur a cost higher than fixed rate bonds.

City Buys its own ARS-(SEC ruling and SB 344) – 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 recently published guidelines that will enable municipalities to buy their own auction rate securities. Again this is a temporary solution to prevent cities pay high interest rates on failed auctions until they exit the market. This process will require significant disclosure and allows municipalities to provide liquidity only. The legislation and regulation does not allow municipalities to manipulate or artificially lower the rate of the securities.

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

Advantages:

- Refunding the auction rate bonds with fixed rate bonds permanently fixes the current problem;
- The proposed refunding eliminates the City's exposure to abnormal market rates;
- The refunding reduces the cost of the financing compared to the current rates paid on the bonds;
- The true interest rate on the new bonds is expected to be 3.65%-3.75%.

Disadvantages:

- The City will lose the insurance from Ambac. The insurance premiums were paid in lump sum in 2004 in the amount of $268,377 and are considered sunk cost;

- There is an estimated $375,000 additional cost to cover the issuance cost and the underwriter's fee.

FISCAL IMPACT

The refunding COPs will have a maximum term of 11 years with a final maturity in 2019. The certificates will be issued as fixed rate bonds with level debt service as opposed to the current uneven principal maturities. The level debt service structure will generate the lowest true interest cost on the financing at an estimated rate of 3.65%. The following represents the estimated sources and uses of funds:

Sources:	
Bond proceeds	$29,375,000
Uses:	
Refunding escrow deposit	29,000,000
Cost of issuance	200,000
Underwriter's discount	171,474
Rounding	3,526
Total uses	$29,375,000

Respectfully submitted,

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