

Agenda Report

TO: City Council
Through Finance Committee

FROM: City Manager

DATE: July 24, 2000

RE: Restructuring the City's Collateralized Mortgage Obligation holdings
in the portfolio.

RECOMMENDATION:

It is recommended that the City Council authorize the City Treasurer to restructure a portion of the City's portfolio by replacing the Collateralized Mortgage Obligation (CMO) holdings within the portfolio with securities exceeding five years in stated maturity.

BACKGROUND:

The City currently holds in its portfolios Collateralized Mortgage Obligations (a form of Mortgage Backed Securities) issued by the Federal National Mortgage Association and Prudential Home Mortgage. The unpaid principal amount remaining on these securities was \$18,023,167.15 as of June 30, 2000. These securities were purchased prior to 1995 and were grandfathered into the City's portfolio with the authorization of the City Council in 1995. These securities were purchased when the Fed Funds rate was at 3% and the long bond (30 year Treasury) at 5% yield. The current average life of these CMOs are approximately 15 years at a yield of 6.5%. The CMOs were purchased at an average price of 98 and currently trade at an estimated price of 90 to 91, therefore approximately 7% or \$1,261,000 below cost.

DISCUSSION:

The market price of the CMOs is affected by the following factors in the market: 1) the spread they trade to the Treasury yield, 2) investors' demand for these type of securities or supply and demand in the market (CMOs are not very liquid and not traded daily in the market), 3) expected prepayment risk, 4) interest rate environment, and 5) the level of subordination of their respective tranches.

Staff recommends replacing the City's CMOs with US Treasury and/or Agency securities that will replicate and improve upon the CMO structure. Even though there is no need to liquidate these securities, it is staff's opinion that the market represents an opportune time to swap these securities for the potential improvement of the portfolio's performance in the long run.

The following represents the benefits of the simultaneous sale of the CMOs and purchase of US Treasury and Agency securities:

- Provides an investment structure that will have a certain final maturity in US or Agency securities versus the negative convex nature of the CMOs;
- Provides an investment that will guarantee the principal amount of the City's original investment at maturity;
- Shorten the duration (risk) from a variable mode that now exists in the CMOs to a determined duration which will drop each year as maturity approaches;
- Maintains a yield of 6.0% on original book investment and a current market yield at 50 to 75 basis points higher;
- Improves upon the manageability of investing in "known" US Treasury or Agency securities;
- Improves long term performance;
- Provides the opportunity to recoup realized losses with the incremental yield and potential capital gains if rates drop.

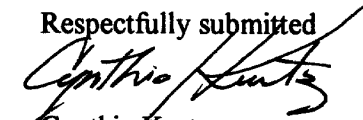
In addition to the above benefits, the City has the potential of realizing capital gains from the sale of the newly purchased Treasuries or Agency securities should interest rates decline in the future. This will allow the City to recapture its principal lost much sooner with the sale of the CMOs. Below are examples of estimated capital gains on the following securities based upon 0.50%, 1.00% and 1.50% decline in interest rates:

	<u>-50 bps</u>	<u>-100bps</u>	<u>-150bps</u>
US Treasury Strips (\$9.63 million)	474,000	948,000	1,421,000
Agency Bonds 10yr NC5 (\$6.77 million)	144,000	288,000	435,000
Estimated capital gain	\$ 618,000	\$1,236,000	\$1,856,000

FISCAL IMPACT


This type of investment restructuring has been used in the past upon the City Council approval. Specifically, staff has utilized this type of transaction twice to eliminate over \$35 million in mutual funds held in the portfolio. In each case, the City has successfully recovered all of its investments without losing any amount on the original principal cost.

Respectfully submitted




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