

**TO:** HONORABLE MAYOR,  
CITY COUNCIL, CITY  
EMPLOYEES AND RETIREES

**FROM:** Debra Figone

**SUBJECT:** FINANCIAL MARKET UPDATE #2  
AND IMPACT ON CITY OF  
SAN JOSE

**DATE:** October 9, 2008

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**INFORMATION**

**BACKGROUND**

The unprecedented turmoil experienced in the US financial markets has spread to markets in Europe, Asia and South America. The turmoil clearly illustrates how globally interconnected the world financial markets have become. This informational memo provides the Mayor, City Council, our employees and retirees additional information on how these financial market events may impact the City and our ability to provide the services to our community.

As discussed in the first informational memo dated September 29, 2008, the current market dislocation is the result of the unwinding of loose lending policies during the housing boom of the last decade. The crisis is unprecedented as to the extent of penetration of the crisis to world financial and economic markets; the economic sectors that have been affected; and the size and the complexity it has brought to the world economy. The crisis started to manifest itself beginning in early 2007 with home mortgages. Since then the tightening of lending criteria is spreading to the auto and credit card industries. In addition, non-financial companies who rely on short-term credit facilities to cover payroll and other operating expenses are finding access to funding difficult. All of this translates into less money available for student loans, home equity loans, auto financing and access to credit (consumer and business) for day-to-day business operations and consumer spending.

An abbreviated chronology of events was provided in the September 29<sup>th</sup> memo outlining the events that had occurred in the financial markets through the 29<sup>th</sup> of September. This report provides an update of key events since then. The week of September 29 to October 3 continued to demonstrate stresses in credit and equity markets in US and world markets:

- **Monday, September 29**

- ✓ Citibank announces that they will acquire Wachovia Bank in a deal that includes the Federal Government [through the Federal Deposit Insurance Corporation (FDIC)] assuming billions in loan losses

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- ✓ European Governments rescued four financial firms including the Belgium government taking a 49% stake in Fortis, the nation's largest bank
- ✓ The Dow Jones Industrial Average closed down 770 points, its largest single day point loss ever, after the US House of Representatives voted against passage of the Economic Stabilization Plan
  
- **Tuesday, September 30**
  - ✓ US House of Representatives announces that they will put the Economic Stabilization Plan before a vote again later in the week after making some changes
  
- **Wednesday, October 1**
  - ✓ US Senate approved the amended Economic Stabilization Plan which includes increasing FDIC insurance from \$100,000 to \$250,000 per account
  - ✓ Securities and Exchange Commission (SEC) and the Financial Accounting Standards Board (FASB) announce no changes to current mark-to-market accounting rules
  
- **Thursday, October 2**
  - ✓ SEC announces it will maintain a moratorium on short sales of 900 companies until after the US House of Representatives has voted on the Economic Stabilization Plan again
  
- **Friday, October 3**
  - ✓ House of Representatives approved and the President of the United States signed the "*Emergency Economic Stabilization Act*"
  - ✓ Wells Fargo Bank makes a counter offer for Wachovia Bank, which eliminates FDIC participation (see Monday Sept. 29<sup>th</sup> related item regarding Citibank)
  - ✓ Market Closing Statistics
    - 3 month US Treasury bills closed at 0.47%
    - The Dow Jones Industrial average experienced extreme fluctuations throughout the week and closed down 7.3 percent for the week at 10,325
    - Standard & Poor's 500 Index lost 9.4 percent for the week, its worst weekly performance since the 2001 terrorist attacks

The week of October 6 started with equal turmoil and unprecedented actions by governments around the world in an attempt to stabilize the financial markets. During the week of October 6 through Thursday, October 9 the significant market events include:

- **Monday, October 6**
  - ✓ Federal Reserve significantly increased the Fed's ability to purchase securities from financial institutions, by doubling the cap to \$900 billion in a continued effort to unfreeze short-term lending markets

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- ✓ Federal Reserve utilizes an element of the *Emergency Economic Stabilization Act* and begins paying banks interest on the banks cash reserves held at the central bank
- ✓ Multiple global governments increased efforts to shore up financial institutions by insuring and or guaranteeing deposits and seized control of troubled institutions
- ✓ Dow Jones Industrial Average closes below 10,000 for the first time since 2004
  
- **Tuesday, October 7**
  - ✓ Federal Reserve Board announced the creation of the Commercial Paper Funding Facility (CPFF). The Federal Reserve said it would start buying commercial paper, a key funding source for corporations
  
- **Wednesday, October 8**
  - ✓ In an unprecedented move, in a coordinated fashion to ease the financial markets, the Federal Reserve, in conjunction with the European Central Bank and four other central banks, cut the federal funds rate by half a percentage point to 1.50%
  - ✓ Due to the general “flight to quality” experienced in the financial markets (in which investors are choosing to purchase US Treasury Bonds, even at meager returns, as long as the investment is considered secure), the US Treasury announced it will increase sales of Treasury securities to address “severe dislocations” in the Treasury market due to high demand for Treasury securities, with expectations of stabilizing the Treasury yields
  - ✓ Federal Reserve authorizes the exchange of \$37.8 billion of securities from AIG in exchange for cash collateral to settle outstanding obligations. This is in addition to the previous \$85 billion the Federal Reserve has already extended to AIG
  
- **Thursday, October 9**
  - ✓ White House press secretary states the Treasury is “actively considering” direct cash infusions, thereby taking a yet to be defined equity stake in those US banks. The cash infusions are one option the Treasury is considering to use the newly formed Troubled Assets Relief Program
  - ✓ Dow Jones Industrial Average closes below 9,000 for the first time since 2003
  - ✓ Treasury Secretary and Federal Reserve Chairman scheduled to meet with Group of Seven financial counterparts tomorrow in Washington
  
- **Thursday, October 9** – Market Closing Statistics
  - ✓ 3 month US Treasury bills closed slightly below a yield of 0.52%
  - ✓ The Dow Jones Industrial average experienced extreme volatility throughout the week and is currently down 16.9% percent for the week at 8,579 and 35 percent year-to-date
  - ✓ Standard & Poor’s 500 Index has lost 38 percent year-to-date

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As discussed in the *Financial Market Update and Impact on City of San Jose* informational memo dated September 29, 2008, the ongoing stream of information and speculation on the state of the financial markets may have the effect of alarming members of the public; City staff continues to evaluate the impact on City operations and plan for the things the City can control, especially as it relates to taking appropriate budgetary actions (if necessary).

## **ANALYSIS**

Key departmental staff met to open a dialogue on the areas of City operations which may be impacted by these unprecedented financial market conditions. The areas identified for initial review and included in the September 29<sup>th</sup> informational memo were Interest Earnings on City Portfolio; Variable Rate Debt Service – City and Conduit (multi-family housing revenue bonds); Affordable Housing Program; Insurance Coverage and Claims Paying Ability; Near-term Market Access for upcoming Agency bond issue; and Retirement Plans.

This memorandum provides information in the following areas:

- “*Emergency Economic Stabilization Act of 2008*”
- Economic Data is Showing an Increased Chance of Recession
- Short-term Funding Concerns Grow
- Credit Market Tightness and its Implications for the State of California
- Market Access for Upcoming Agency bond issue and Affordable Housing Program
- Retirement Pension and Retiree Health Care Plans

A brief discussion is provided below on each of these areas. Staff continues to actively monitor the financial markets and will provide periodic updates as necessary.

### **“Emergency Economic Stabilization Act of 2008”**

The *Purposes* section of House Bill H.R.1424, otherwise known as the Emergency Economic Stabilization Act of 2008, simply states:

1. *to immediately provide authority and facilities that the Secretary of the Treasury can use to restore liquidity and stability to the financial system of the United States; and*
2. *to ensure that such authority and such facilities are used in a manner that—*
  - a) *protects home values, college funds, retirement accounts, and life savings;*
  - b) *preserves homeownership and promotes jobs and economic growth;*
  - c) *maximizes overall returns to the taxpayers of the United States; and*
  - d) *provides public accountability for the exercise of such authority.*

The remaining 450 pages of the document (initially 3 pages when first presented to Congress) describe the three primary areas to meet the intended purposes of the Bill. The three primary

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areas are: (1) Troubled Assets Relief Program (TARP), (2) Budget-Related Provisions, and (3) Tax Provisions. Attachment A provides a very brief synopsis of primary elements of the Act.

### **Economic Data is Showing an Increased Chance of Recession**

As noted above, The Federal Reserve Open Market Committee (Feds) (in conjunction with other global central banks) reduced the target for federal funds rate 50 basis points to 1.50% at an unscheduled policy meeting on October 8, 2008. The Federal Reserve, in their statement release, predicated their actions on evidence of continued economic weakening. Below is a quote from the release:

*“Incoming economic data suggest that the pace of economic activity has slowed markedly in recent months. Moreover, the intensification of financial market turmoil is likely to exert additional restraint on spending, partly by further reducing the ability of households and businesses to obtain credit. Inflation has been high, but the Committee believes that the decline in energy and other commodity prices and the weaker prospects for economic activity have reduced the upside risks to inflation.”*

Economic data releases for the week continued to be troubling with economists predicting that a US recession is likely inevitable. The Case-Shiller Home Price Index<sup>1</sup> reported a record 16.3% drop for July. The Labor Department reported that payrolls fell by 159,000 in September, its largest decrease in five years. The jobless rate remained at 6.1 percent for the nation, primarily due to a contraction in individuals seeking employment. The Institute of Supply Management's (ISM) manufacturing index<sup>2</sup> posted its biggest point and percentage drop since 1984 as it fell into recessionary territory at 43.5. Automakers reported a 27% percent decrease in overall car sales for September 2008 vs. September 2007, its lowest level in 15 years.

### **Short-term Funding Concerns Grow**

**LIBOR Index** -- LIBOR (London Inter Bank Offered Rate) is the rate that banks use to loan unsecured money to each other. LIBOR is set by a process of daily surveys of sixteen world banks, including three US banks (Citibank, Bank of America, and JP Morgan Chase). LIBOR is the basis for calculating rates on \$360 trillion of financial products worldwide, including home loans and corporate bonds. This week, 3 month LIBOR rates continued to rise to the highest point since January at 4.75% (as of October 9, 2008). The increased rates continue to reflect banks uncertainty of peers credit worthiness and their own inclination to protect capital rather than lend capital. This trend is troubling due to the magnitude of short term and variable debt

<sup>1</sup> The Case-Shiller Home Price Indices measure the nominal value of the residential real estate market in the United States.

<sup>2</sup> Institute of Supply Management's (ISM) manufacturing index – A national manufacturing index based on a survey of purchasing executives at roughly 300 industrial companies. Survey responses reflect the change, if any, in the current month compared to the previous month for: New Orders, Backlog of Orders, New Export Orders, Imports, Production, Supplier Deliveries, Inventories, Customers' Inventories, Employment and Prices.

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that is tied to the LIBOR. For example, many variable rate mortgages are set at the LIBOR index, plus additional basis points, in which the rates are "re-set" at the new LIBOR rate. Therefore, as these variable rate mortgages reset, there will be additional pressures on homeowners and potentially additional foreclosures.

*Commercial paper* – Commercial paper is short term, unsecured promissory notes, with maturities of fewer than 270 days. The commercial paper market has been under considerable strain in recent weeks as money market mutual funds and other investors have become increasingly reluctant to purchase commercial paper. As a result, interest rates on commercial paper have increased significantly, adding additional expense to already capital constrained firms. Commercial paper plays a critical role in the ability of many companies to pay salaries and other short-term expenses. In an effort to add liquidity to the commercial paper market, the Federal Reserve created the Commercial Paper Funding Facility to purchase commercial paper directly from corporate issuers.

### **Credit Market Tightness and its Implications for the State of California**

Recent market disruptions and the subsequent lack of demand in the municipal bond market has made new issuance and pricing of bond issues very difficult for many municipalities. Market media sources report that weekly sales of fixed-rate bonds, which averaged \$6 billion weekly this year, declined to \$800 million per week for the past two weeks. Municipal issuers have postponed more than \$12 billion in bond and note sales since the middle of September. The State of California has not been immune from these developments, and in a letter from Governor Schwarzenegger to the US Treasury Secretary, raised the possibility that the State may need a Federal loan if the State cannot access the credit markets in the coming weeks. California has often used revenue anticipation notes (RANs) to provide short term cash flow liquidity until anticipated revenues are received later in the fiscal year. If the State is unable to sell its planned \$7 billion RAN issue by the end of the month, the State will be unable to fund on-going operational needs, including entitlements and funding to service providers. Therefore, the Governor has indicated that the State may seek a Federal loan. Other states are experiencing similar constraints in the financial markets and are in need of cash flow liquidity; most notably, Arizona, Florida, Michigan, Rhode Island, Connecticut, New Jersey and New York.

### **Market Access for Upcoming Agency bond issue and City's Affordable Housing Program**

As noted above, municipal issuers have postponed more that \$12 billion in bond and note sales since the middle of September and the Redevelopment Agency of the City of San Jose is no exception. The Agency has delayed the competitive sale of their tax increment bonds to October 28, 2008, in anticipation of an improvement in long-term fixed rates and an easing up of access in the credit market. The Agency is also exploring alternatives and is preparing a separate informational memo to the Agency Board regarding the upcoming tax allocation bond sale.

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Based on current commitments in the City's Affordable Housing Program, the City anticipates the need to issue housing set-aside tax allocation bonds in early 2009. If the constraints in the market continue through the end of the calendar year, the ability for the City and affordable housing developers to access credit to fund projects would be a challenge, thereby impacting the City's affordable housing program.

### **Retirement Pension and Retiree Health Care Plans**

Recent media reports have highlighted declines in values of retirement funds across the state and country (both public and private). The current capital markets valuations are "snapshots in time". The City's retirement pension and retiree health care plans (the "Plans") are solvent. The Plans have sufficient liquidity to meet the monthly disbursements including payment of retirement benefits. It is important to note that the City's retirement plans are a defined benefit plan in which fixed benefits will be paid upon retirement of eligible employees.

As noted in the September 29, 2008 Financial Market Update memo, the federal government assumed control of American International Group Inc. (AIG), the largest insurance company in the U. S.; Lehman Brothers Holdings Inc., the 4<sup>th</sup> largest investment bank in the U.S. filed for bankruptcy; and Washington Mutual Inc. was seized by government regulators and its branches and assets sold to JPMorgan Chase & Co.

As of September 30, 2008, the fair value of the Plans' equity and fixed income investments related to AIG, Lehman Brothers Holdings Inc., and Washington Mutual Inc. are approximately \$19.7 million or 0.5% of the fair value of the Plans' total portfolio of approximately \$4.0 billion, excluding securities lending and transactions in transit. The fair value of the Plans' portfolio as of June 30, 2008, excluding securities lending and transactions in transit, decreased by 7.0 percent during the quarter ended September 30, 2008 (based on most recent available information on the Plans' portfolio). Although the Plans have experienced a decline in value due to the market volatility, it should be noted that these are NOT losses unless the Plans elect to sell investments. It should be noted that in any actively managed investment portfolio there may be times when assets are sold at a loss to reposition the portfolio or take advantage of other favorable investment opportunities.

As is the case with most retirement systems, the Plans are exposed to general market risk. In a pension plan context, the market risk is the risk that the rate of return earned on the pension plan assets could be below the long term rate of return assumed for each Plan, which is 8.0% for the Police & Fire Department Retirement Plan and 8.25% for the Federated Employees' Retirement System. This general market risk is reflected in asset valuations fluctuating with market volatility. Any impact from market volatility on the Plans depends in large measure on how deep the market downturn is, how long it lasts, and how it fits within fiscal year reporting periods.

Market risk could impact the financial condition of the Plans and the City's required contribution to the Plans. However, it should be noted that the Plans take a long term view and invest for the long term benefits. Market gains and losses are factored into the contribution rates through

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biennial actuarial calculations and "smoothed" or averaged over five years. This smoothing methodology has the effect of minimizing the possibility of large fluctuations in the contribution rates.

Employees and retirees should be assured by the City's ability to make retirement benefit payments today and in the future. The City has a legal obligation to make these payments, and the Plans have investment strategies in place which take into account long-term market perspectives and methods are in place to periodically evaluate the various assumptions and make adjustments in the contribution rates through the biennial actuarial evaluation process.

### SUMMARY

With all of the news regarding the US and global financial disruption, it is important to stay focused on the impact on the City of San Jose and our ability to provide services to the community. Key points to keep at the forefront of any discussion include:

- The City invests funds to meet day-to-day cash flow needs and we do not anticipate the need to issue bonds to meet our day to day operational costs.
- The City's conservative investment policy ensures investments are made with the principals of safety, liquidity and yield (in that order).
- The Budget monitoring efforts are ongoing and proactive to take any necessary actions to make adjustments in revenues and expenditures in order to maintain a balanced budget.
- The City's Retirement Plans are solvent and the benefits from the Plans are a defined benefit, in which fixed benefits will be paid upon retirement of eligible employees.

### COORDINATION

The interdepartmental team tracking and monitoring the potential impacts on the organization include representatives from the Finance, Human Resources, Housing, Public Works, Retirement Departments, Redevelopment Agency and the City Manager's Budget Office. The effort is being led by the Director of Finance.



Debra Figone  
City Manager

For questions please contact SCOTT P. JOHNSON, Director of Finance, at (408) 535-7000.

*Summary of Key Elements of  
"Emergency Economic Stabilization Act of 2008"*

- Authorizes the Treasury to establish a "Troubled Asset Relief Program" (TARP) to purchase troubled assets from financial institutions
- Requires the Treasury to establish an insurance program to guarantee troubled assets of financial institutions and establish premiums for such guarantees sufficient to cover anticipated claims
- Establishes the Financial Stability Oversight Board to review and make recommendations regarding the exercise of authority under this act
- Requires that profits of sale from troubled assets be used to pay down the national debt
- For mortgages and mortgage-backed securities acquired through TARP, the Treasury must implement a plan to mitigate foreclosures and encourage servicers of mortgages to modify loans
- Requires federal entities that hold mortgages and mortgage-backed securities to develop plans to minimize foreclosures
- Requires Treasury to establish executive compensation rules for institutions that sell their assets directly under the TARP program
- Requires the Treasury to receive warrants from participating financial institutions to allow taxpayers to share in any equity appreciation stemming from TARP use
- Authorizes the full \$700 billion implementation of TARP in increments of \$250 billion, \$100 billion, and \$350 billion
- Raises the debt ceiling from \$10 trillion to \$11.3 trillion
- Provides the Federal Reserve with the ability to pay interest on reserves
- Raises the Federal Deposit Insurance Corporation (FDIC) and National Credit Union Share Insurance Fund deposit insurance limits from \$100,000 per account to \$250,000 until December 31, 2009
- Extends current law tax forgiveness on the cancellation of mortgage debt