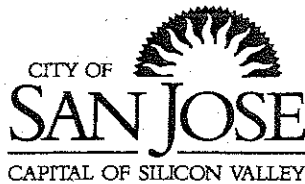


Distributed on:

Sent to Council: ~~SEP 29~~ 2008



by City Manager's Office
Memorandum

TO: HONORABLE MAYOR
AND CITY COUNCIL

FROM: Debra Figone

SUBJECT: FINANCIAL MARKET UPDATE
AND IMPACT ON THE CITY OF
SAN JOSE

DATE: September 29, 2008

INFORMATION

BACKGROUND

The turmoil in the financial markets over the past few weeks has been unprecedented. The market has seen the Federal Government essentially bail out Fannie Mae and Freddie Mac (these two agencies are publicly traded companies that back almost half of the US mortgage debt of approximately \$5 Trillion.) In addition, the federal government recently seized control of American International Group Inc. (AIG), the largest insurance company in the United States; Lehman Brothers, the 4th largest investment bank in the US filed for bankruptcy, the largest bankruptcy in US history; Washington Mutual Inc. was seized by government regulators and its branches and assets sold to JPMorgan Chase & Co. in the biggest U.S. bank failure in history.

Over this past weekend, Wachovia Corp. was acquired by Citigroup Inc. who agreed to buy the banking operations and absorb as much as \$42 billion in losses, in addition, four European banks required government-orchestrated rescues over the past two days. This morning's announcements included the intention of the Federal Reserve to pump an additional \$630 billion into the global financial system, flooding banks with cash to alleviate the worst banking crisis since the Great Depression. This liquidity infusion included participating authorities of the European Central Bank, the Bank of England and the Bank of Japan. The Fed's expansion of liquidity, the biggest since credit markets seized up last year, comes as Congress prepares to vote on a \$700 billion bailout for the financial industry. This crisis is not "just a US Wall Street problem", it is reverberating through the global economy, causing stocks to plunge and forcing European governments to rescue banks.

The current market dislocation is the result of the unwinding of loose lending policies during the housing boom over the past decade. The global financial market crisis we are experiencing started to manifest itself beginning in early 2008. The City experienced the impact as early as this past February when the City restructured its variable rate bond program. Over the past year prior to the most recent events, the finance industry was significantly disrupted by the collapse of the market for sub-prime mortgages. This disruption included the failure of several investment banks and rating downgrades of the leading bond insurers, and resulted in substantial increases in interest rates paid by the City on its variable-rate bonds. During this difficult period, the City's Finance Team worked diligently to reduce the City's borrowing costs by redeeming the existing

variable-rate bonds, all of which had been insured and affected by the bond insurer downgrades, and refinancing them with bonds and notes secured by bank letters of credit, rather than bond insurance. Through eight months of continuous exertion, under market conditions which have frustrated the similar efforts of many other public agencies, the City succeeded in restructuring ten series of variable-rate bonds, totaling over \$359 million. The savings the City achieved are likely to exceed \$5 million over the next fiscal year, absent further erosion of the variable rate bond program as a result of the current market turbulence.

Unfortunately, the market turbulence has continued with the solutions still unresolved. Its impact on the global market has baffled many market experts, bankers, rating agencies, economists, the Federal Reserve, the US Treasurer, Congress, and the President of the United States. Up to this point, the Federal Open Market Committee (Federal Reserve) has attempted to respond to and mitigate the impact to these market conditions through monetary policy by reducing the Federal Funds Rate and infusing cash into the market to provide much needed credit liquidity. As the market disruptions continue, most recently the President of the United States has proposed a financial bailout plan of up to \$700 billion to solve the market unrest, intended to restore confidence in the nation's banking and financial systems. If approved, the bail out plan would be the largest government intervention in the markets since the Great Depression. However, as of this morning, the U.S. House of representatives rejected the \$700 billion financial-rescue plan by a vote of 228 to 205. Upon this news, the financial markets responded very unfavorably; by the close of the US Stock Markets today, the Dow Jones Industrial Average fell by 778 points, a decline of almost 7 percent; oil prices plunged and US Treasury bonds rallied the most in two weeks; the Standard & Poor's 500 Index fell as much as 9.14 percent, the most since Oct. 26, 1987, as 492 companies declined; the Nasdaq index composite fell by 8.81%; the World Index of 23 developed markets sank 5.9 percent, the steepest decline in the measure's 38-year history; trading on Brazil's market was halted after their main stock index plummeted 10 percent; the euro and the pound sank and bonds rose; crude oil futures tumbled more than \$11 a barrel. In addition, with Wall Street in turmoil, the yield on the 3-month Treasury bill fell to 0.32 percent this morning from 0.87 percent on Friday, showing that investors were prepared to get meager returns on an investment as long as it was secure.

The vote for the bail out plan dealt a blow to government efforts to contain a lending and financial market crisis and the leaders are in process of meeting to determine what the next steps are.

Chronology of Market Events

Below is an abbreviated chronology of events that has occurred in the financial markets leading up to the most recent bailout proposal:

- April 2007 – New Century Financial (one of the nations largest subprime lenders) seeks bankruptcy protection
- August 2007 – Countrywide Credit draws down \$11.5 billion from its credit lines
- September 2007 – Federal Reserve starts to cut the Fed Funds target rate. Over the next 8 months Fed Funds go from 5.25% to 2.0%

- **March 2008** - Federal Reserve assumes \$30 billion of MBS and debt as part of engineered takeover of Bear Stearns by JP Morgan Chase
- **July 2008** – Federal regulators seize IndyMac. First major bank failure of the crisis
- **July 2008** – President signs Housing Bill enabling Treasury to provide capital to Fannie Mae & Freddie Mac
- **September 7, 2008** – The Treasury Department seizes control of FNMA and FHLMC by putting them into conservatorship and increasing credit lines to \$100 billion each

The past two weeks have experienced historical stresses in the financial market place. Below is a summary of events for the weeks of September 14th and September 21st:

Week of September 14th – significant market events:

- **Sunday, September 14** – Ten global banks establish \$70 billion credit facility to provide emergency liquidity in financial markets to participating banks.
- **Monday, September 15**
 - ✓ Lehman files for bankruptcy; 4th largest investment bank in US and largest bankruptcy in US history
 - ✓ Bank of America announces buy-out of Merrill Lynch
- **Tuesday, September 16** –
 - ✓ US Government seizes control of AIG with \$85 billion bailout. AIG, crippled by losses tied to the worst U.S. housing slump since the Great Depression, agreed Sept. 16 to turn over a 79.9 percent stake to the U.S. Government in exchange for a federal loan of as much as \$85 billion.
- **Wednesday, September 17**
 - ✓ Reserve Primary Fund, the nation's oldest money-market fund, could not maintain a \$1.00 share price
 - ✓ Investors pulled a record \$89.9 billion from money market funds
 - ✓ 3-month Treasury bill rates dropped to a yield of 0.03%
 - ✓ Tax-Exempt Weekly Variable Rate index (SIFMA) reset at 5.15% up from 1.79%
 - ✓ The Dow Jones Industrial average experienced significant downward pressure, declining by 450 points (over 4% decline) from 11,059 the previous day close to 10,609 close of market on September 17th.
- **Thursday, September 18**
 - ✓ Federal Reserve injected \$60 billion into US financial system
 - ✓ Treasury and Federal Reserve explore plan to take over bad debts
- **Friday, September 19**
 - ✓ Federal Government announced its plans to create a \$700 Billion bailout fund to purchase distressed assets and re-inject liquidity into the market place
- **Friday, September 19** – Market Closing Statistics
 - ✓ Total money market outflow for the week = \$132 billion
 - ✓ 3 month US Treasury bills closed slightly below a yield of 1%, at 0.99%

- ✓ The Dow Jones Industrial average experienced extreme fluctuations as evidenced by September 17th's decline by over 4% at 10,609, to a close of 11,388 by September 19, representing a two day swing of almost 780 points (+7.3%).

Week of September 21st – significant market events:

- Monday, September 22 –
 - ✓ Goldman Sachs and Morgan Stanley emerged from the weekend announcing they would become bank holding companies, subjecting themselves to greater regulation and effectively agreeing to take on fewer risks.
- Tuesday, September 23 and Wednesday, September 24 –
 - ✓ Treasury Secretary Paulson and Fed Chairman Bernanke address US Senate Committee and US House Committee, respectively.
- Thursday, September 25 –
 - ✓ Washington Mutual was seized by the government [the Federal Depository Insurance Corporation (FDIC)] and its branches and assets sold to JP Morgan Chase, representing the biggest bank failure in the nation's history.
- Friday, September 26 –
 - ✓ Negotiations continue on federal bailout of distressed assets

Investor and Consumer Confidence is waning

Investors continue to remain more concerned about return of principal (maintaining the value of their investments) rather than their return on principal (rate of return or yield on their investments). American consumers lost confidence in September as they saw the credit crisis deepen, a sign they will curtail spending. The U.S. has lost jobs every month this year, and the unemployment rate in August jumped to a five-year high of 6.1 percent, according to Labor Department data. In addition, the Commerce Department has reported that retail sales fell in August for a second consecutive month. In addition, holiday sales during November and December may be the weakest in six years as high food prices pare spending on non-essential items.

Other market indicators, including commodity prices on oil and gold, were volatile as well. Oil dropped from a high this summer of \$145 a barrel to almost \$90 a barrel, but by Monday, September 22, it experienced the largest one day increase jumping \$16 per barrel closing at \$121 per barrel. Gold prices skyrocketed as well, rising nearly a \$100 per ounce during the course of the week of September 15 to September 19.

Market Conditions - Impact on the City of San Jose

While the ongoing stream of information and speculation on the state of the financial markets may have the effect of alarming members of the public, it is important to provide a level of reassurance with respect to things the City can control, and how we are undertaking a responsible approach in evaluating our risks, making recommendations to mitigate those risks, and taking

appropriate actions (including budgetary actions, if necessary) to ensure City services continue to be provided to our residents and businesses.

Many areas of our local economy remain healthy and strong. The City's continued commitment to work with local business in efforts to maintain that strength will assist in mitigating any negative impacts the current financial market disruption has on the City's fiscal situation.

With respect to potential loss of principal on any of our investments, the City Council should feel assured that our conservative investment policy limits the composition of the holdings within the City's investment portfolio. Nearly 80% of the portfolio is invested in US Government Securities and the remaining is allocated between the California Local Agency Investment Fund (LAIF) (8%) and highly rated corporate commercial paper (14%). Review of the holdings in the City's Investment portfolio confirms no investments with Lehman Brothers, Merrill Lynch or AIG. The Finance Department's investment staff continues to focus investment decisions in accordance with the Council's Investment Policy's primary investment priorities of safety, liquidity and yield; in that order.

ANALYSIS

Earlier this week, a multi departmental dialogue with key departmental staff was undertaken to focus on areas of City operations which may be impacted by the unprecedented financial market conditions. The areas identified for initial review included:

- Composition of and interest earnings on the City's investment 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 Redevelopment Agency bond issue
- Retirement Plans
- Deferred Compensation and Employee Communication Efforts

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.

Interest Earnings on City Portfolio

The Investment Program currently anticipates that the recent economic conditions will likely reduce the budgeted interest earnings on the City's Investment Portfolio. Since the development of the FY 2008-09 interest earnings assumption, the Federal Reserve has reduced the Federal Funds rate an additional 100 basis points to 2.00%. In addition, market conditions have also reduced potential investment yields in the type of securities predominately included within the portfolio (US Government Agencies) as other market participants strategize to seek a flight to

quality, thereby investing in the safety of US Government issues in their efforts to minimize their financial exposures. As the flight to quality continues with demand of US securities on the rise, yields on these conservative investments decline (due to market pressures of supply and demand, as demand rises, bond prices increase resulting in lower yields to the investor). Staff is currently preparing an updated analysis on interest earnings rate projections for the current fiscal year and will make recommendations to the City Manager's Office as necessary with respect to any need to modify current year's earnings.

Variable Rate Debt Service – City and Conduit (multi-family housing revenue bonds)

The instability in the financial markets has multiple potential and immediate impacts to the City's variable rate bond program. As noted above, the market disruption has resulted in a significant shift of short-term investment to Treasury bills and US Government Agencies, which are perceived as the safest investment vehicle. As a consequence, the demand in the market for variable-rate bonds has plummeted, and the interest rates on those bonds have significantly increased. Similar to the impact the City experienced on interest rates through our variable rate bond program during the sub-prime market disruption that began this past February, over the past two weeks the variable interest rates paid by the City, the Redevelopment Agency (both redevelopment and housing set-aside program), the San Jose-Santa Clara Clean Water Financing Authority, and a number of the City's affordable housing borrowers have more than doubled, and in some cases even tripled.

If the Federal Government is successful in implementing its bailout plan, it is quite possible that the market's confidence will be restored and variable rates return to the relatively low levels of early September. In that case, the interest cost associated with the current spike in variable rates could be largely offset by low rates for the remainder of the fiscal year. This seems particularly possible with the Federal Reserve indicating that it will likely not increase its Fed Funds target rate in the near future.

To the extent that the demand for variable rate bonds does not appear to be returning to normal levels and interest rates remain high, the City and its related entities would need to consider taking actions to control debt service costs which could include temporary or permanent conversion of variable-rate bonds to pay fixed interest rates. Although many of the City's affordable housing borrowers are protected from much of the interest rate volatility by caps and swaps, affordable housing borrowers who are not protected may have more difficulty than the City in implementing conversion strategies and may need assistance to meet their cash flow needs.

Affordable Housing Program

The instability in the financial markets has multiple potential and immediate impacts to the Housing Department. The first area of concern is the multi-family affordable housing projects already financed and those in the pipeline seeking financing in the next six months to a year.

Financed and completed projects that utilized variable debt to finance the rehabilitation and construction are generally protected from instability within the market through the use of interest rate caps and swaps executed at the time of the project financing. These caps and swaps generally limit the interest rate paid on the debt to a maximum of 6.0%. Concerns exist in the market place that these cap/swap rates may not be honored if the bonds are "put" or returned to the bank at which point, the rates may be set on the bonds at the bank default rates – which may be as high as 20%. These higher rates may impact the financial stability of the project, if cash flow is insufficient to support higher rates on the bonds.

Future affordable housing projects may also be impacted in their ability to secure financing from other sources as well as the possibility of more expensive debt than anticipated previously. Additional area of concern is the Housing Department's debt program secured by 20% tax increment. The Department has approximately \$60 million in outstanding variable debt with the rate paid on this debt historically averaging 3.0%. In early September the two series of outstanding variable rate bonds had rates reset at 1.76% and 1.75%; last week on September 17, the rates increased to 5.59% and 4.50%, and by this week (September 24), interest rates climbed to 7.89% and 7.50%. As noted above, we expect the market to return to "normal" after the Federal Government completes its bail out package.

Additionally, the City was recently notified by Bank of New York Mellon they will no longer be providing lines of credit to municipalities and therefore will not be extending their existing Line of Credit, scheduled to expire on April 1, 2009. This \$50 million line of credit provided the Housing Department with access to readily available cash to provide interim financing. To meet projected cash-flow needs to finance affordable housing projects, the Housing Department anticipates issuing bonds within the next six months to provide the cash necessary to fund projects currently in the pipeline. The rates on this new debt may be more costly than in the past. As time moves on, it is likely that additional impacts to the Housing Department may be identified. As noted earlier, the City Council will be kept apprised as necessary, through informational memos.

Insurance Coverage and Claims Paying Ability

The City's insurance exposure to the current financial crisis is minimal at this time. AIG Commercial Insurance is among several insurance carriers that currently provide the Owner Controlled Insurance Program (OCIP) for the Airport. AIG was also the OCIP provider for the New City Hall project. AIG Commercial Insurance exposure is limited since it is an independent subsidiary from the AIG parent company. The parent company cannot use funds from its independent subsidiary to meet its current liquidity obligations.

Last week as the financial issues with the AIG parent company began to publically emerge, various proposals were under consideration to mitigate the exposure to AIG's financial crisis. However, as noted above in the chronology of market events, on September 16th the Federal Government interjected by seizing control of AIG (the parent company) by providing an \$85 billion loan to stabilize their financial position. The City's insurance exposure is further reduced

by the oversight provided by the California State Insurance Regulatory Agency. Insurance companies are required to meet certain reserves and funding for payment of claims. Furthermore, the financial strength of AIG Commercial Insurance is excellent. It has approximately \$30 billion in policy holder surplus and has been operating at peak profit in the last three years.

On October 1, 2008, the City will renew its insurance policies for property, casualty, and some professional liability. All of the insurance carriers recommended to provide these policies for the City are not affiliated with AIG and are financially sound based on their AM Best financial ratings.

Near-term Market Access for upcoming Agency bond issue

As noted earlier, interest rates on municipal bonds have been affected by the recent financial market disruptions. As an example, municipal bond issuers across the country postponed over \$7 billion in new money bond offerings during the week of September 15. The average rates are at the highest level in nearly six years. Delays of municipal new money issuance have continued into this week (September 22). The Redevelopment Agency Board approved the issuance of tax increment bonds at their meeting on September 23 and Agency staff reported that they have currently postponed the bond sale one week to the second week in October. It is their expectation to close the bond issue by the end of October, but they will continue to monitor market conditions.

The City does not have any new issuance contemplated in the near term, and anticipates the next sale of bonds in the first quarter of calendar year 2009 at the earliest. It is our expectation that market equilibrium will have returned; but staff does acknowledge that rates may be higher and the costs of completing a transaction (issuance costs) may also be higher as well. Staff will continue to monitor and evaluate the situation.

Retirement Plans

The funds of both of the City's retirement plans are diversified by counterparty exposure. Consequently, the retirement plans' exposure to the collapse of individual companies is not significant. However, the retirement plans' continue to be exposed to general market risk; in a pension plan context, this is the risk that the rate of return earned on the pension plan assets could be below the actuarially assumed rate of return, which is 8.0% for Police & Fire Plan and 8.25% for Federated Plan. Market risk could impact the financial condition of the Plans and the City's required contribution towards the Plans. Retirement Services Department is working to reduce the plans' exposure to general market risk by improving the plans diversification. The latter could be achieved through an increase in the long-term asset allocation to alternative investments.

Deferred Compensation and Employee Communication Efforts

The recent turmoil in the financial markets has prompted some deferred compensation account holders to question the impact on their ING accounts (the current provider of the City's deferred compensation plan). The San Jose Deferred Compensation Plan (SJDCP) is funded by investments in separate account insurance products issued by ING Life Insurance and Annuity Company (ILIAC), a Connecticut life insurance company. All of the SJDCP investments are held in trust by ING National Trust, a federally chartered trust company regulated by the Office of the Comptroller of the Currency (OCC).

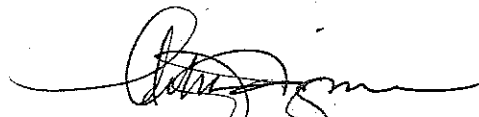
Trust assets, by their very nature, do not constitute property of the trust institution that would ever be subject to claims of trust institution creditors. Under the insurance laws, assets held in a separate account are not chargeable with liabilities arising out of any other business of the insurer. Hence, the plan's assets associated with the separate account are "insulated" from general creditor's claims.

All of the assets of the SJDCP are required to be held in an additional trust for the exclusive benefit of plan participants and beneficiaries in accordance with Internal Revenue Code section 457(g). By virtue of that entrusted exclusive benefit arrangement, deferred compensation plan assets are not available for any non-plan purpose. Furthermore, ING remains a very financially sound company as affirmed by Moody Investor Services on September 16, 2008, with rating of Aa2, stating that the rating reflects "the global franchise and the combined credit strengths of the group's various operating entities, from both banking and insurance."

In any market environment, investors should focus on a diversified portfolio across a variety of asset classes. Investors can help ensure that their portfolio is properly diversified and that their financial plan supports their long-term goals, time horizon, and tolerance for risk.

COORDINATION

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



DEBRA FIGONE

City Manager