THE CITY OF SAN DIEGO

REPORT TO THE CITY COUNCIL

DATE ISSUED: October 22, 2008 REPORT NO: 08-157

ATTENTION: Council President and City Council
Docket of October 27, 2008

SUBJECT: City of San Diego Debt Policy, 2008

REQUESTED ACTION:

Review and adopt the updated City of San Diego Debt Policy, 2008.

STAFF RECOMMENDATION:

Approve the requested action.

SUMMARY:

In November 2007, the City Council approved the City of San Diego Debt Policy ("Debt Policy"). Consistent with the Government Finance Officers Association ("GFOA") recommended practices and with examples of debt policies of other comparable municipalities and rating agency guidelines, this formal policy established guidelines for the City pertaining to debt instruments/securities issued by the City in public or private bond markets.

The Debt Policy addresses the following: purpose and need for financing; creditworthiness objectives; types of debt; affordability targets; structure and term of city indebtedness; method of issuance and sale; financing team role and selection process; refunding considerations; and post issuance administration.

Pursuant to Resolution R-303153, passed by City Council on November 6, 2007, Debt Management was directed to return to City Council on an annual basis for a review of the Debt Policy. Recommended substantive changes are notated in the attached copy of the Debt Policy on pages 11, 14, 17, 20, 21, 29 and 37. Minor changes, such as clarifying or grammatical changes, are not notated as they do not change the context or concepts set forth in the document.

In the motion approving the Debt Policy, City Council requested that a redevelopment debt policy, a CIP prioritization policy, and a variable rate and derivatives policy all be developed and presented to the Budget and Financing Committee ("Committee") by the end of Fiscal Year 2008. At this time, the Redevelopment Agency is developing the redevelopment debt policy, and anticipates it will present the policy to City Council by the end of Fiscal Year 2009. Revised

Council Policy 800-14, "Prioritizing CIP Projects" was approved by City Council on May 30, 2008 and is included in the updated Debt Policy. Based on the City Council discussion at the January 28, 2008 meeting and training regarding the use of variable rates and derivatives, Debt Management has removed any references to these types of instruments in the Debt Policy.

Pursuant to Resolution R-303153, it was also recommended that the existing San Diego Housing Commission ("Housing Commission") Multifamily Mortgage Revenue Bond Program be reviewed and updated, as appropriate, by the end of Fiscal Year 2008. The updated Housing Commission's Multifamily Mortgage Revenue Bond Program Policy was brought to the City Council by the Housing Commission where it was reviewed, noted and filed by the City Council on September 23, 2008, and is included in the updated Debt Policy.

Concurrent with the annual Debt Policy review, and pursuant to Resolution R-303153, Debt Management was asked to provide an informational report and include the following: a discussion of developments in the financial markets; the City's projected forward calendar for financings for the coming year; schedules showing all outstanding debt of the City and related entities that are subject to the Debt Policy, and all long term liabilities of the City, including pension and retiree healthcare costs that are not subject to the Debt Policy.

Municipal Debt Market Update

Financial markets changed significantly in 2008, and many of the changes had consequences for the municipal debt market. A primary factor contributing to the changes is the sub-prime mortgage crisis. The national and state residential housing market has been impacted by falling housing prices and an increase in mortgage delinquencies and defaults, particularly among property owners of sub-prime mortgages and other risky home loans. As a result, mortgage lenders were negatively impacted and lending standards were tightened. Many of the mortgages had been repackaged or structured into complex securities that were sold to other financial institutions which assumed the risk and began to experience losses. This led to a significant tightening of national and global credit markets.

The direct financial impact of the current market conditions to the City's outstanding debt issuances has been limited, but the practice of issuing municipal debt has been unsettled and will impact the City as it moves forward with planned debt issuances. Following is a discussion of specific developments in the municipal debt market:

Bond Insurers. Over the past year, rating agencies downgraded five of the seven major bond insurers that were rated AAA before the sub-prime mortgage crisis, including Ambac, MBIA and FGIC, which insure some of the City's outstanding debt issuances. Bond insurance guarantees the payment of principal and interest to investors in the event of an issuer default. In addition to guaranteeing municipal debt, these insurance companies were also ensuring mortgage related securities, and the downgrades were the result of this exposure.

The immediate effect to the City is limited. The purchase of bond insurance is an economic decision taken to reduce the overall cost of an issuance, and is not generally a requirement to issue new debt. Traditionally, bond insurance is purchased when the AAA insured rating results in lower interest rates to the issuer and the interest savings exceed the insurance premium. There is no economic advantage to purchasing bond insurance from companies with ratings less than or equal to the issuer, and the municipal market is currently looking through insured ratings to the underlying credit quality of issuers. Based on the current environment, the municipal market will be less reliant on insurance than in the recent past when approximately 50% of new issues were insured.

<u>Bank Consolidations.</u> Several large investment banks that provide underwriting services in the municipal market, including firms that have served as underwriters for City bonds and/or have routinely bid to provide underwriting services, have reorganized or went bankrupt. Merrill Lynch was purchased by Bank of America, and Bear Stearns was purchased by JP Morgan. Lehman Brothers declared bankruptcy and its investment banking business was purchased by Barclays. Other banks, such as UBS, have withdrawn from the municipal underwriting sector. Two other firms, Morgan Stanley and Goldman Sachs, have restructured from investment banks to bank holding companies and are expected to remain active in the municipal sector.

There have been immediate impacts to some issuers with transactions that were in the process of being priced or closed. When UBS announced it was exiting the municipal bond market, the pricing of the City's CFD No. 4 (Black Mountain Ranch Villages) transaction was delayed several weeks while the City conducted a competitive process to replace UBS with Stone & Youngberg LLC, at which point the bonds were successfully priced.

Going forward, the number of large banks with the expertise and capital to serve as underwriters for large bond issuances has declined; however, there is a pool of remaining institutions. In addition, several medium sized firms have remained relatively untouched by the sub-prime mortgage crisis and credit crunch and may take a greater share of the municipal market, offsetting the loss of the larger banks. There should be sufficient underwriters to maintain a competitive marketplace, however, it is too early to assess whether there will be any long-term impacts to pricing, fees, and terms offered by the decreased pool of underwriters.

<u>Variable Interest Rate Financings</u>. The auction-rate security (ARS) market has been significantly impacted by the current environment. An ARS security has a variable interest rate that is set periodically and the interest is payable at the end of each period. The securities are typically credit enhanced with bond insurance. As a result of the bond insurer downgrades, the ARS market has experienced failed auctions where there are not enough bids or the clearing rate is above the maximum rate established in the financing documents. In these cases, the issuer has had to pay interest at the maximum rate defined in the financing documents. In some cases, interest rates increased from 3-4% to as high as 8%-10%, or more. There have been no impacts to the City from this development because the City does not have any ARS debt, and the City's Debt Policy does not permit this type of debt to be issued.

<u>Municipal Bond Ratings.</u> The major rating agencies are moving forward with plans to use a single scale to rate municipal and corporate debt. This is expected to result in minor (one notch) across-the-board increases in municipal debt ratings. There will be little if any financial advantages from the modified rating system since the market already understands the relative credit risks of corporate and municipal debt. The implementation of a single scale could also decrease the use of bond insurance.

Nationwide, new municipal debt issuances declined in late 2008. Investors have adopted a "flight to quality" strategy, buying US Treasury securities and selling all other classes of bonds. This has led to both interest rate volatility and a widening of the spread between the yields of US Treasuries and highly rated municipal bonds. In addition, bond investors have focused their attention on the underlying credit qualities of each transaction instead of rating enhancements from credit derivatives.

Municipalities are moving forward more cautiously and may be opting to put pending deals on standby until there is some settlement in the market. Some transactions have been postponed or reduced in size and are being considered for day-to-day pricing depending on market conditions. Debt Management continues to move forward with debt issuances planed for calendar year 2009, working with rating agencies and structuring competitive bond offerings.

Financings to Date – FY 2009

Fund/Financing Type	Bond Issuance	Bond Issuance Date
Special Districts	Community Facilities District No. 4 – Black Mountain Ranch Villages, Series A of 2008	August 2008

Projected Forward Calendar – FY 2009

Fund/Financing Type	Bond Issuance	Target Date to Council
Water Enterprise	2009A and 2009B Water Revenue Bonds - Refund 2007A Water Revenue Notes, 2008A Water Revenue Notes, and 1998 Certificates (if economic); and new money CIP funding	October 2008 & April 2009
Wastewater Enterprise	2009 Wastewater Revenue Notes - Refunding Series and new money CIP funding	February 2009

Fund/Financing Type	Bond Issuance	Target Date to Council
Special Districts	Community Facilities District No. 2 – Santaluz, Improvement Area No. 1 Refunding (if economic)	May 2009
General Fund	FY 2010 Tax and Revenue Anticipation Note (TRAN)	June 2009

Outstanding City Debt, Long Term Liabilities of the City and Related Entities, and Pension and Retiree Healthcare Costs

1. Outstanding City Debt

Attachment 2 is a summary of debt obligations that includes General Obligation Bonds, General Fund Backed Lease-Revenue Obligations, and Wastewater and Water System Obligations.[1]

2. Long Term Liabilities of the City and Related Entities, including Pension and Retiree Healthcare Costs

Attachment 3 provides a comprehensive list of liabilities of the City and its Related Entities, including the City's Special Districts. This attachment is comprised of the below-listed Notes from the Comprehensive Annual Financial Report ("CAFR"), Fiscal Year 2006:

Note 5: Governmental Activities Long-Term Liabilities
Note 6: Business Type Activities Long-Term Liabilities
Note 7: Discretely Presented Component Units Long-Term Debt
Note 8: Short-Term Notes Payable
Note 12: Pension Plans
Note 13: Other Post Employment Benefits
Note 19: Third Party Debt (Conduit Debt)

Attachment 4 is the Redevelopment Agency ("RDA") Annual Financial Report, Fiscal Year 2005[2], and reflects the activities of the RDA as a separate legal entity from the City. Loans from the City are reflected as a long term liability in Governmental Activities Long-Term Debt, Note 5.

FISCAL CONSIDERATIONS:
None specific to this action.

[1] The source document for this data is the Fiscal Year 2009 Annual Budget.
[2] The Fiscal Year 2005 Redevelopment Agency Annual Financial Report is the most recent report issued. It is anticipated to be reviewed by the Audit Committee and received and filed by the City Council in Fall 2008.

PREVIOUS COUNCIL and/or COMMITTEE ACTION:
The initial Debt Policy was presented to the Budget and Finance Committee (the "Committee") on June 6, 2007, July 25, 2007 and September 26, 2007. On September 26, 2007, the Committee adopted and recommended the Debt Policy to the City Council with certain changes and additions. On November 6, 2007, the City Council approved the Debt Policy.

COMMUNITY PARTICIPATION AND PUBLIC OUTREACH EFFORTS:
There were no community participation or outreach efforts.

KEY STAKEHOLDERS AND PROJECTED IMPACTS:
None.

Lakshmi Kommi
Debt Management Director

Mary Lewis
Chief Financial Officer

Attachments:
1. City of San Diego Debt Policy, 2008
2. Annual Budget, Table 1 - Summary of Debt Obligations, Fiscal Year 2009
3. CAFR Notes 5, 6, 7, 8,12,13, and 19, Long Term Liabilities of the City and Related Entities, including Pension and Retiree Healthcare Costs, Fiscal Year 2006
4. RDA Annual Financial Report Note 5, Governmental Activities Long-Term Debt, Fiscal Year 2005