**FINANCE DEPARTMENT**

# AGENDA REPORT

**DATE:** November 17, 2015

**TO:** Mayor Butt and Members of the City Council

**FROM:** Bill Lindsay, City Manager
Belinda Warner, Finance Director

**SUBJECT:** TERMINATION OF THE INTEREST RATE SWAPS RELATING TO THE RICHMOND JOINT POWERS FINANCING AUTHORITY 2009 CIVIC CENTER LEASE REVENUE BONDS, ISSUANCE OF SERIES 2015 LEASE REVENUE BONDS, AND NOVATION OF THE 2007 PENSION BOND SWAPS FROM J.P. MORGAN CHASE BANK TO ROYAL BANK OF CANADA

**STATEMENT OF THE ISSUE:**

In order to accomplish the most cost effective resolution of the August 4, 2015 Additional Termination Event in connection with the 2007 Swaps (as defined below), the City wishes to:

(1) Fund a termination of the interest rate swaps (the "Civic Center Swaps") relating to the Richmond Joint Powers Financing Authority Series 2009 Civic Center Lease Revenue Bonds (the "2009 Bonds") by issuing Series 2015 Lease Revenue Bonds (the "Series 2015 LRBs"),

(2) Facilitate assignment of the 2007 Swaps from J.P. Morgan Chase Bank, N.A. ("JPM") to Royal Bank of Canada ("RBC"), and

(3) Amend certain provisions of the assigned 2007 Swaps.

As described below, this proposed financing plan is expected to be a more cost effective solution to the ATE than the issuance of Pension Obligation Refunding Bonds authorized by Council on October 6, 2015. Although the City and RBC have been in extensive negotiations regarding this transaction, RBC has not yet provided final approval for this transaction. The transaction will not go forward until final RBC credit,

business, and documentation approvals are obtained. Final approvals are not expected until December and will consider unaudited financials, the final 2015 audit (if available), the S&P rating on the bonds, and the S&P rating report.

**RECOMMENDED ACTION:**

ADOPT:

(1) A resolution of the Richmond Joint Powers Financing Authority authorizing the issuance, sale and deliver of not to exceed $40,000,000 of its Lease Revenue Bonds, Series 2015; approving the forms of and authorizing execution and delivery of a Trust Agreement, a Site Lease, a Facility Lease, a Bond Purchase Contract, and an Official Statement; authorizing forms of Termination Agreements and directing the termination of an Interest Rate Swap and Option on Interest Rate Swap associated with the Richmond Joint Powers Financing Authority Lease Revenue Refunding Bonds (Civic Center Project), Series 2009; and approving the taking of all necessary actions in connection therewith, and

(2) A resolution of the City Council approving the issuance by the Richmond Joint Powers Financing Authority of not to exceed $40,000,000 aggregate principal amount of Lease Revenue Bonds, Series 2015; authorizing the forms of and directing the execution and delivery of a Site Lease, a Facility Lease, a Bond Purchase Contract, and Official Statement and a Continuing Disclosure Agreement; authorizing forms of Termination Agreements and directing the termination of an Interest Rate Swap and Option on Interest Rate Swap associated with the Richmond Joint Powers Financing Authority Lease Revenue Refunding Bonds (Civic Center Project), Series 2009; authorizing a form of Novation Agreement and directing the Novation of two Interest Rate Swaps associated with the outstanding City of Richmond Taxable Pension Funding Bonds, Series 2005B-1 and Series 2005B-2, directing the execution of an amended and restated Schedule and two Confirmations related thereto; and approving the taking of all necessary actions in connection therewith.

**FINANCIAL IMPACT OF RECOMMENDATION:**

The issuance of the Series 2015 LRBs to refund the Authority's obligations under the Civic Center Swaps and assignment and amendment of the 2007 Swaps, is expected to add an annual average cost of approximately $350,000 to the City's combined (1) lease obligations to the Authority and (2) pension bond debt service through the 2037 final maturity of the Series 2015 LRBs. While the City considers this incremental cost estimate to be reasonable, the actual cost to the City will depend upon the interest rates on the Series 2015 LRBs, interest rates on future City bonds, if any, issued to refinance the 2007 Swaps and the Series 2015 LRBs, general future market conditions, and the exact cost of assigning the 2007 Swaps from JPM to RBC.

The following significant financial considerations may result in positive or negative impacts on the economics of these transactions, although the exact impacts on the plan of finance cannot be determined at this time:

1. The Series 2015 LRBs would be subject to early redemption no later than 2025, resulting in potential future refunding savings. The financing team will attempt to negotiate shorter call provisions depending on market conditions.
2. Termination of the Civic Center Swap (the "Swaption") entered into in July 2014 (a) eliminates the City's existing obligation to sell bonds in 2019 to fund a termination payment on that transaction in 2019 and (b) has the effect of the City regaining the benefit of any savings realized from a refunding of the 2009 Bonds which could occur in August of 2019.
3. The amended and restated 2007 Swaps, while retaining the current scheduled maturity date of August 1, 2034, will be subject to mandatory early termination on August 1, 2023. This new provision will likely require that the City issue bonds to finance any then-current settlement amount due.

The near-term budgetary impact of the recommended actions are increases in City costs of less than $200,000 in FY2015-16, and $950,000 to $1,000,000 in each of FY2016-17 and FY2017-18. These near-term increases represent the current interest that will be paid on the 2015 LRBs, compared to the City's obligations under the Swaption, whereby the City was accruing interest costs that would not be payable until August 2019.

**DISCUSSION:**

2005 Pension Funding Bonds

In November 2005, the City issued $114 million in Pension Funding Bonds, to fund the City's unfunded accrued actuarial liability with CalPERS. In August 2013, a portion of the bonds converted to Index Notes, where the interest rate resets on a weekly basis, and is tied to the London Interbank Offering Rate (LIBOR). The remaining portion of bonds is expected to convert to Index Notes in 2023. The current par value of the bonds is $66 million for the bonds that converted in 2013, and $127.9 million for the bonds that will convert in 2023. Because these bonds were issued as Capital Appreciation Bonds, the accrued interest from their issuance dates to their respective conversion (or maturity) dates is compounded, and essentially becomes payable as principal, resulting in a higher current maturity value than at issuance. Although the bonds themselves are variable rate upon conversion, the City entered into interest rate swaps in 2007 for each series of bonds, which essentially converted the interest rate to a synthetic fixed rate (the "2007 Swaps"). Bear Stearns Capital Markets, LLC, was the original swap counterparty on the 2007 Swaps, but subsequently assigned its rights to JPMorgan Chase Bank, NA, which is the current counterparty. The 2007 Swaps have a total current termination cost to the City of approximately $31.5 million.

Effect of Credit Rating Downgrades on 2007 Swaps

The August 4, 2015 action by Moody's Investor Services ("Moody's") to downgrade the City's Issuer Credit Rating to Ba1 (below the Baa2 rating threshold specified in the 2007 Swaps documentation), resulted in an Additional Termination Event ("ATE"), the primary effect of which is to provide the counterparty a right to terminate the 2007 Swaps and demand immediate payment of a settlement amount (the "Settlement Amount"). The Settlement Amount represents the present value of the City's expected future performance obligations under the 2007 Swaps and is intended to make the counterparty whole relative to the City actually satisfying its obligations over the scheduled life of the 2007 Swaps. Importantly, payment of the Settlement Amount would relieve the City of its obligation to make the expected future net 2007 Swaps payments, freeing up those funds for other City uses, including making principal and interest payments on any new debt obligations issued to fund the Settlement Amount.

Standard & Poor's Ratings Services ("S&P") has also recently downgraded the City. S&P's action included placing the City's credit rating on "CreditWatch," specifically advising that the rating could be further downgraded if the City were unable to address satisfactorily the possibility that JPM would exercise its right to terminate the 2007 Swaps and demand immediate payment of the Settlement Amount.

Issuance of Pension Obligation Refunding Bonds

On October 6, 2015, the City Council adopted a resolution (the "October 6th Resolution") authorizing the issuance of Taxable Pension Obligation Refunding Bonds, Series 2015A (the "Series 2015A POBs") to refund a portion of the outstanding 2005 Pension Funding Bonds and to fund the Settlement Amount. If issued, these bonds would be taxable bonds, with interest rates higher than tax-exempt bonds. As indicated in the Staff Report recommending adoption of the October 6th Resolution:

> *"The issuance of the Series 2015A POBs to refund a portion of the 2005 pension funding bonds and pay the costs related to the termination of the 2007 Swaps (as defined below), is expected to add approximately $500,000 to $1,000,000 per year in incremental pension bond debt service through the 2034 final maturity of the 2005 pension funding bonds."*

The transactions recommended herein are a more cost effective and otherwise more favorable resolution to the continuing existence of the JPM ATE than the actions authorized in the October 6th Resolution. However, as of the date hereof, RBC credit approvals required to proceed have not been finalized. Accordingly, while the City and RBC have been in extensive negotiations regarding this transaction and the City believes approvals will be obtained in the near future, until such time as RBC provides final approval and this transaction is consummated, the authorizations contained in the October 6th Resolution should remain in effect.

Novation of the 2007 Swaps from JPM to RBC

The financial advantage of the transactions recommended in this staff report over those authorized by the October 6th Resolution is primarily a function of the significantly lower expected borrowing cost of the (tax-exempt) Series 2015 LRBs than the (taxable) Series 2015A POBs. Tax-exempt bonds cannot be issued to fund the 2007 Swaps Settlement Amount. However, tax-exempt bonds can be issued to refinance the Civic Center Swaps. By terminating the Civic Center Swaps, the City reduces RBC's credit exposure to the City sufficiently to allow RBC to accept the additional credit exposure associated with stepping into JPM's position in the 2007 Swaps through a novation, subject to final RBC approval. Contemporaneous with the novation from JPM to RBC, assuming such approval, RBC and the City will amend and restate the 2007 Swaps, including eliminating the existence of the ATE by removing the reference to a Moody's rating in the ATE provisions. The S&P Issuer Credit Rating that will need to be maintained to avoid creating a second ATE will be BBB. Finally, by novating rather than terminating the 2007 Swaps, the City maintains its current protection against potentially higher interest costs on the variable rate Series 2005 POBs.

Termination of the Civic Center Swaps

The S&P ATE rating threshold in the existing Civic Center Swaps requires, effectively, the City to maintain its Issuer Credit Rating at the current level of BBB+. Terminating the Civic Center Swaps will eliminate the risk of an ATE with respect to the Civic Center Swaps. As reported above, the S&P ATE on the novated 2007 Swaps will still exist, but will be one notch lower – i.e., require the City to maintain an Issuer Credit Rating of BBB rather than BBB+.

The Swaption was designed to approximate the value (as of the date the Swaption was entered into) of the Authority's right to optionally redeem the Series 2009 Bonds on the August 1, 2019 call date. Under the terms of the Swaption, RBC purchased the right to require the Authority to cash-settle the value of the Swaption on August 1, 2019 in an exchange for an upfront payment by RBC to the City. Terminating the Swaption eliminates the potential for the Authority to be required to sell current refunding bonds in 2019, potentially before the City's credit ratings and market credit spreads have rebounded to their full potential. However, the City would still have the ability to issue refunding bonds in 2019, and would keep any associated savings as described above. In order to agree to accept assignment of the 2007 Swaps, RBC required that the City agree to terminate the transactions in 2023. While the existing 2007 Swaps do not contain such a requirement, the net effect of terminating the Swaption and adding a mandatory termination to the 2007 Swaps is that the date on which the City may be required to access the credit markets is pushed back four (4) years from August 1, 2019 to August 1, 2023.

Issuance of Series 2015 LRBs

The City can refund its obligations under the Civic Center Swaps by issuing the Series 2015 LRBs. The 2015 LRBs will be issued as fixed-rate tax-exempt bonds. Based on

the assumption that the City can resolve the CreditWatch negative from S&P and stabilize its rating, we are expecting a rating of BBB on the Series 2015 LRBs. Under current market conditions this rating level indicates a potential interest rate of approximately 5.00%. Assuming this rate, and a termination payment of approximately $26.65 million, this would add approximately $500,000 annually to the City's overall general fund obligations (exclusive of any future debt service savings derived from exercising the optional early redemption rights the Authority will own with respect to the Series 2015 LRBs).

Bond Team

The resolution also appoints a Bond Team for the 2015A POBs, comprised of RBC Capital Markets, LLC as underwriter, Orrick, Herrington & Sutcliffe LLP as bond counsel, Schiff Hardin LLP as disclosure counsel, The Majors Group as swap advisor, and Public Resources Advisory Group as financial advisor.

Next Steps

The proposed resolution will authorize the issuance of the 2015A Lease Revenue Bonds, as well as approve the form of the documents relating to the bonds. The City expects to have a decision from RBC on final approval by early December. If approved, the termination of the Civic Center Swaps and novation of the 2007 Swaps will be concurrent with the close of the 2015 LRBs, expected to occur by late December or early January 2016.

**DOCUMENTS ATTACHED:**

Attachment 1: JPFA Resolution
Attachment 2: City Council Resolution
Attachment 3: Preliminary Official Statement
Attachment 4: Trust Agreement
Attachment 5: Facility Lease
Attachment 6: Site Lease
Attachment 7: Termination Agreement – Civic Center Swap
Attachment 8: Termination Agreement – Swaption
Attachment 9: Novation Agreement