


CITY OF LOS ANGELES
INTER-DEPARTMENTAL CORRESPONDENCE

0670-00037-0001

Date: June 27, 2014

To: The Mayor
The City CouncilFrom: Miguel A. Santana, City Administrative Officer Subject: **ADDITIONAL SWAP REPORT FROM FINANCIAL ADVISORS (C.F. 14-0566)**

On May 2, 2014, Council directed this Office to make efforts to renegotiate or terminate the swaps associated with the Wastewater System bonds (C.F. 14-0566). This memorandum provides the status as to our efforts in response to this motion, as well as additional information regarding the City's existing swaps.

Staff from this Office, including myself, met with the swap counterparties on June 19, 2014. Dexia Credit Local (DCL) is part of a European banking group that continues to receive systemic support from the governments of Belgium, France and Luxembourg after it was bailed out by the Belgium and French governments in 2008. DCL management indicated that they will consider renegotiating their swap but will be unlikely to offer a significant discount.

Bank of New York Mellon (BNY Mellon) is an American multi-national banking and financial services corporation. Its origins date back to the establishment of the Bank of New York by Alexander Hamilton in 1784. BNY Mellon is open to negotiate options related to the swap, however, they have indicated that will not terminate at no cost. Following the last discussion with BNY Mellon on June 25, 2014, this Office is developing options to present for further discussion with BNY Mellon.

This Office works with Public Resources Advisory Group (PRAG) in the management of the City's Wastewater System Debt Program. Attached is a memorandum prepared by PRAG that provides general information regarding swaps, background specifically related to the Wastewater System swaps and impacts on the swaps resulting from the Great Recession (Attachment A). This Office actively manages the Wastewater System Debt Program, including the swaps, and reviews all opportunities to achieve savings and improve the debt program. We will continue to report to the Mayor and Council in the future when such opportunities present themselves in the future.

RECOMMENDATION

Instruct the City Administrative Officer to continue negotiations with Dexia Credit Local and Bank of New York Mellon and report back.

Attachment A: PRAG memorandum dated June 26, 2014

MAS:NRB:SMB:09140256

ATTACHMENT A

PUBLIC RESOURCES ADVISORY GROUP MEMORANDUM

JUNE 26, 2014

PUBLIC RESOURCES ADVISORY GROUP

MEMORANDUM TO: Miguel Santana, City Administrative Officer (“CAO”), City of Los Angeles (the “City”)

FROM: Public Resources Advisory Group (“PRAG”)

SUBJECT: City of Los Angeles Wastewater System – Information Regarding Outstanding Interest Rate Swaps

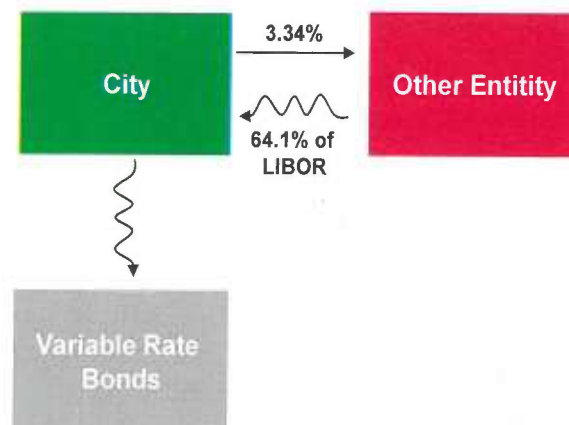
DATE: June 26, 2014

The City currently has outstanding \$151.1 million in floating-to-fixed rate interest rate swaps currently associated with a portion of its \$280.86 million Wastewater System Subordinate Revenue Bonds, Variable Rate Refunding Series 2012-D. The following is a summary description of how interest rate swaps are used, the reasons the City first entered into the interest rate swap transactions in March 2006, and information regarding the subsequent risk-reducing transactions that have occurred related to the underlying variable rate bonds which are associated with the swaps.

OVERVIEW OF INTEREST RATE SWAPS

What is a Swap? Interest rate swaps are financial products designed to hedge interest rate risk or change the risk profile of a particular debt instrument. They can be structured to covert floating rate bonds to fixed rate to hedge interest rate risk, and to convert fixed rate to floating rate to add interest rate risk. They are entered into between an entity such as the City, and a financial counterparty such as a bank, and are based on standardized swap documentation contracts used widely in the financial markets. The estimated size of the interest rate swap market is over \$500 trillion.

The City’s swaps convert floating rates to fixed rates to reduce interest rate risk. The swaps resulted in a fixed cost that was lower than the comparable level of fixed rates. The City issued floating rate bonds, and then entered into a swap in which the counterparties pay the City a floating rate equivalent to the floating rate on the bonds and the City pays a fixed rate on the swap. The City therefore pays the (a) fixed rate on the swaps, plus (b) the difference between the floating rate on the bonds and the floating rate on the swap, plus (c) support costs on the floating rate bonds. These swaps are used when the rates between the swap market and the bond market are favorable for the municipal issuer – i.e., when the swap can save the municipality in interest costs versus a conventional tax-exempt fixed rate bond transaction. The chart below illustrates the most common application of a floating-to-fixed swap.



The swap counterparty also attempts to manage its own risk from exposure to payments under the swap contract by entering into an offsetting swap with other counterparties or equivalent hedges, so that it can also lock-in the economics of the overall transaction at the time of closing. In general, most of the swap counterparty's profit on the transaction is realized when the transaction closes and not over time or at termination.

Why Do Municipal Issuers Use Swaps? While there are many types of swaps that a municipality might enter into, the vast majority of swaps are floating-to-fixed swaps which produce a fixed rate of interest. Swaps are used in lieu of fixed rate bonds because they can, under certain market conditions and for certain bond maturities, produce much lower fixed interest rates than the fixed rate municipal bond markets can provide. This was the case in 2006 when the City entered into its swaps. Because swaps introduce a number of risks that fixed rate bonds typically do not have (such as tax risk, basis risk, counterparty risk, and termination risk), most issuers, including the City, require swaps to provide significant cost savings over fixed rate bonds before they will enter into the swap transaction. These parameters are typically spelled out in the issuer's debt policy and/or a specific swap policy. The City's debt policy includes such parameters for the use of swaps.

How are Swap Valuations Determined? Swaps are financial instruments whose values change with changing market conditions, similar to a bond or a stock. The value of the swap varies from day to day and even moment to moment due to changes in interest rates. For the City's swaps in which it pays a fixed rate, in general, when fixed interest rates rise, the value of the swap goes down. When fixed interest rates fall, the value of the swap goes up. The valuation can result in a positive or negative number – i.e., the City would either receive a payment if it terminates with a positive number, or make a payment to terminate the swaps with a negative number. The City has the right to terminate the swap at any time by paying the market value of the swap. The counterparties have the right to terminate only if certain events occur, such as a default by the City or a credit rating downgrade of the City's Wastewater bonds below Baa2/BBB. The change in value of swaps is similar to the change in value of stocks – a stock may change in value from day to day or minute to minute, but the stockholder does not realize a gain or a loss until s/he sells the stock.

If the City elects to terminate a swap, the swap counterparty must also terminate its own hedge related to the transaction. If the City pays a termination payment, the swap counterparty also will have to make a termination payment to unwind its own hedge, and it uses the City's termination payment to do so. Similarly, if the City can terminate the swap and receive a payment, the swap counterparty uses the payment it receives when it terminates its swap to make the termination payment to the City.

How are Swaps Accounted for in the City's CAFR? In each of the City's Consolidated Annual Finance Reports ("CAFRs"), a calculation is made that is a snapshot in time of the future payments that would be made on its swaps, assuming market conditions as of the date of the calculation remain constant to the maturity of the swap transaction. The reported amounts of interest to be paid under the swap are not intended to reflect any expectation about the future performance of the swap. Rather, it is intended to be combined with the interest due on the related variable rate bonds to provide a holistic view of the City's future net payment obligation to maturity (similar to the CAFR's statement of debt service to maturity on fixed rate bonds). This is an accounting convention that is consistent with Generally Accepted Accounting Principles ("GAAP"). For example, the City's FY2012-13 CAFR used market conditions as of June 30, 2013 and showed \$2.6 million of interest on variable rate bonds and \$65.7 million of swap payments to maturity. These figures are not definitive statements of what will happen, only what would happen based on the assumption market conditions remain constant to the maturity of the bonds and swap.

THE SERIES 2006A-D BONDS AND ASSOCIATED SWAPS

In late 2005, the City had two series of outstanding Wastewater System Bonds that could be refunded for savings – the Refunding Series 1993D and Series 1998A Bonds. At that time, the interest rate swap market provided much lower fixed rates than the municipal fixed rate tax-exempt bond market. The City did not have the option to simply issue tax-exempt variable rate bonds, for two key reasons:

1. A fixed rate of interest, or fixed rate proxy such as the swap rate, is required for a refunding so that the bond yield can be calculated and the allowable yield on the refunding escrow is not exceeded so the refunding complies with federal tax law; and

2. A fixed rate of interest, or a fixed rate proxy, is needed to calculate expected savings to determine whether the refunding meets the City's savings requirements.

Analysis of a fixed rate issue versus swap transaction for the City's refunding demonstrated that the swap transaction produced much higher savings than a standard fixed rate issue, as summarized below:

| Type of Transaction | Expected Savings |
|---|------------------|
| Fixed Rate/Swap to Fixed Bond Structure | \$70.2 million |
| All Fixed Rate Refunding Bond Structure | 4.7 million |
| Expected Savings from Swap Structure | \$65.5 million |

The City went through a thorough review process to evaluate all of the known risks of a swap transaction, including termination risk, bank facility renewal risk, basis risk, tax risk, and counterparty risk, among others. However, these risks were considered acceptable and manageable in light of magnitude of the expected savings and the small proportion of the City's debt exposed to these risks.

Based on this analysis and review, the City issued \$316.8 million of variable rate bonds to refund the 1993D and 1998A Bonds. All of these Series 2006A-D Refunding Bonds were sold with municipal bond insurance from XL Capital Assurance ("XLCA"), which was then rated triple-A, to lower the cost of borrowing on the variable rate bonds and to provide for more favorable swap terms for the City. At the same time the Series 2006A-D Refunding Bonds were sold, the City also entered into two floating-to-fixed swaps totaling \$311.64 million to produce an all-in fixed rate. To diversify its risk, the City entered into two identically-structured swaps in the amount of \$155.82 million each with two swap counterparties: Dexia Credit Local ("Dexia") and The Bank of New York Mellon ("BONY"). The counterparties were selected by competitive bids. For each swap, the City receives 64.1% of 1-month LIBOR (a taxable floating rate index) in exchange for paying a fixed rate of 3.34%. The two floating rate legs – the City's variable rates and the 64.1% of LIBOR payments from the swap counterparties – were expected to cancel each other out, leaving the City with a net fixed rate of 3.34% plus support costs on the floating rate bonds which were initially 12 basis points (0.12%). If the City had issued the Series 2006A-D Bonds as fixed rate bonds issued in the tax-exempt municipal bond market, the comparable interest rate would have been 4.30%.

THE FINANCIAL CRISIS AND THE 2008 REFUNDING

The global financial crisis that began in late 2007 to early 2008 caused the financial markets to behave in many ways completely unanticipated by nearly every market participant – a "black swan event." Among other impacts globally, the financial crisis also resulted in the precipitous decline in the credit ratings of the municipal bond insurers due to their exposure to mortgage-backed securities. XLCA, the City's bond insurance provider for the Series 2006A-D Refunding Bonds, received several credit rating downgrades from the triple-A ratings that were in place at the time the refunding bonds were sold. Since its inception in 2000, XLCA had always maintained triple-A ratings. As a consequence of these downgrades, many of the buyers of the City's variable rate bonds sold their bonds back to the banks providing liquidity support for the variable rate bonds, and those that did not sell their bonds demanded higher and higher interest rates to continue holding them. Those bonds that could not be sold to new investors and were instead held by the banks then became subject to a "term-out" provision that would require an accelerated pay-down of the bonds beginning in six months. In addition, due to these abnormally high interest rates on insured tax-exempt variable rate bonds, the relationship between the variable rate interest the City was receiving from its swap counterparties (based on 1-month LIBOR) no longer correlated closely with its interest rates on the Series 2006A-D variable rate bonds, such that the variable rate interest from the swap counterparties was not sufficient to offset the City's actual variable rate interest cost.

The City had several alternatives to address this situation of the decline of XLCA's ratings: (1) do nothing and allow the variable rate bonds to stay at high rates and/or be subject to accelerated pay-down, (2) refund its variable rate bonds with fixed rate bonds and terminate the two swaps, or (3) refund the insured variable rate bonds with new variable rate bonds not backed by bond insurance. Option 1 – do nothing – was unacceptable as it would have exposed the City to the potential for accelerated payment of the variable rate bonds. Option 2 was also unacceptable as the cost to terminate the swaps and then replace the variable rate bonds with fixed rate bonds would have been too expensive. The best option at the time was to replace the bond insured variable rate

bonds with variable rate bonds backed by bank LOCs to allow the swaps to remain in place and the rates on the variable rate bonds to return to more normal levels.

Accordingly, the City refunded its insured Series 2006A-D with the Series 2008A-F1 variable rate bonds backed only by letters of credit ("LOCs") from two banks – ScotiaBank and Bank of America – which expired in 2010. These banks were replaced by J.P. Morgan and Bank of America in 2010.

THE SERIES 2012A REFUNDING

As a matter of practice and policy, the City regularly and proactively monitors its outstanding bonds for any opportunities to produce savings and reduce risks. In late 2011, due to favorable relationships between the fixed rate bond market and the swap market, the City identified and subsequently realized an opportunity to terminate a portion of its outstanding swaps and produce overall positive savings. The swaps were performing as expected and were not problematic; the 2012A refunding was entirely elective and was done to take advantage of a market opportunity. The City evaluated this opportunity as well as other options, including (1) doing nothing and letting the entire transaction stay in place, and (2) terminating the entire swap and refunding all the variable rate bonds with fixed rate bonds. Doing nothing (Option1) was an acceptable path because the swap and the variable rate bonds were performing as expected. Option 2 – terminating the entire swap and refunding the variable rate bonds with fixed rate bonds – would have increased the City's debt service costs materially, so was not considered a viable option.

Based on this analysis of alternatives, the City refunded the 2013 through 2024 maturities of the swapped variable rate bonds with fixed rate bonds at a 1.887% interest rate versus the 3.34% swap rate. The \$26.1 million termination payment was funded with additional bonds, and the savings generated by this large reduction in interest rates from 3.34% to 1.887% was more than enough to pay the additional bonds used to fund the termination payment, leaving approximately \$0.5 million in net savings to the City.

In addition to producing savings, this transaction also permitted the City to terminate \$164.7 million of the swaps in the 2013 through 2024 maturity ranges (i.e., matching the maturities of the refunded variable rate bonds). The swap amounts terminated were split equally between Dexia and BONY, as is the total remaining swap amount of \$151.1 million.

THE SERIES 2012D VARIABLE RATE REFUNDING

As noted above, the Series 2008A-F1 variable rate bonds issued to replace the Series 2006A-D insured variable rate bonds were supported by bank facilities that were subject to periodic renewal and replacement. In 2012, as part of a regular renewal and replacement process, the City solicited and received numerous proposals from banks interested in providing LOCs and other products. Among these, the lowest cost proposal was for a bank private placement of indexed floating rate notes, whereby the bank (Bank of America) would purchase the bonds and be paid a floating rate that was based on the same LIBOR index as the variable portion of the swap, plus a spread. This floating rate bank product allowed the City to avoid the costs of using an investment bank to sell the bonds and credit ratings, and did not require the preparation of an extensive disclosure document. Similar to bank LOCs, this bank private placement with Bank of America has a three-year life and will expire in December 2015, at which time the City will evaluate its options and select the most economic alternative.

SUMMARY OF SWAP COSTS AND SAVINGS VERSUS FIXED RATE

The global financial crisis and its long-term impact on financial markets have reduced the amount of savings that the City's swap-based refunding has provided versus a traditional fixed rate bond refunding. However, at this point in time, the majority of those savings remain intact, and we still expect the swap-based refunding to offer attractive savings. Below is a summary of the City's expected savings from the 2006 swap refunding transactions at the time of issuance of the Series 2006A-D Bonds versus the fixed rate alternative, the actual savings to May 1, 2014 versus fixed rate bonds, and what the projected savings would be to maturity if current market conditions continue to prevail:

| | Savings versus Series 1993D and Series 1998A Bonds | | | |
|---------------------------------|--|-----------------------|--------------------------------------|--------------------------|
| | Originally Expected to Maturity | Actual to May 1, 2014 | Additional Expected through Maturity | Total Currently Expected |
| 2006 Swap Transaction Structure | \$70.2 million | \$25.0 million | \$24.3 million | \$49.3 million |
| Fixed Rate Alternative | 4.7 million | 3.3 million | 1.4 million | 4.7 million |
| Difference | \$65.5 million | \$21.7 million | \$22.9 million | \$44.6 million |

As the table demonstrates, while the total expected savings of the 2006 swaps transactions versus the fixed rate alternative is lower than what was originally anticipated, due in large part to the refunding that was required in 2008 in response to the financial crisis and decline of municipal bond insurance, both the savings to date and the expected savings to maturity are still well in excess of what the City could have achieved on a fixed rate refunding: more than \$21.7 million in savings as of May 1, 2014, and approximately \$44.6 million (or an additional \$22.9 million) to maturity should current market relationships persist, versus the fixed rate alternative.

NEGOTIATIONS WITH SWAP COUNTERPARTIES

Recognizing that staff has been asked to pursue negotiations with Dexia and BONY regarding the swaps, and also recognizing that the City's swap contracts spell out the conditions under which termination can occur and the methodology for determining the termination amounts, the City has several, but limited, options. One, it could request that Dexia and BONY terminate the swaps at no cost to the City and refund all payments the City has made since the inception of the swaps. This type of request is beyond the specific terms of the existing swap contracts, however. If either of these banks would be willing to concede some or all of its past fees and/or termination amounts owed under the terms of the swap contracts, it would likely be to avoid protracted legal battles or to protect other business it has with the City, if any.

The most likely concession the City could receive is on the transaction costs embedded in the swap termination calculation, which is essentially the swap counterparties' profit on the trade – the bid/asked spread (similar to the transaction fee charged when an individual purchases a security.) As noted above, the vast majority of the termination amount goes to pay the costs of unwinding the swap counterparties' own hedges. If the City is willing to terminate the swaps, it could negotiate a favorable concession on that spread. For example, as of June 16, 2014, a fee spread of 2 basis points (0.02%) could reasonably be achieved and would result in termination payments totaling \$25.7 million to terminate both swaps. Alternatively, assuming the City negotiates a transaction fee that is in the middle of the bid/asked spread (known as a "mid-market" termination), the total termination payments would be \$25.4 million, for a savings of approximately \$325,000. However, as the City can see, this amount is a relatively small difference from the reasonably achievable termination amount at a 2 basis point spread. Further, if the City were to terminate the swaps, it would have to fund those termination payments from the proceeds of additional debt. Based on market conditions as of the same date of June 16, 2014, we estimate a fixed rate refunding and funding of the termination payments would cost the City \$23.5 million more to maturity than the current swap transactions.