



Community Relations Division

MEMORANDUM

DATE: January 8, 2009
TO: Mayor and Council
THRU: Charles McNeely
FROM: Kevin Knutson, *Director of Community Relations*
Andrew Green, *Finance Director*
Andrew Artusa, *Managing Director, NSB Public Finance*
SUBJECT: **City of Reno Bond Situation Analysis**

In order to provide some context for the discussion about the necessary steps for refinancing the City's \$73 million in auction rate securities, at your request we have prepared some background notes on the causes of the auction failures, the history of the 2005 bonds and staff actions in response to market conditions.

The Impact of Subprime Mortgages

One of the key developments that directly led to the current situation was the growth of the subprime mortgage market. Over the course of several years, mortgage brokers, property appraisers, and lenders relaxed the standards that they used to make loans, making mortgages available to borrowers who either wouldn't have qualified in the past or who may have qualified for much smaller amounts.

Using adjustable rates, balloon payments, and other creatively structured payment schemes, borrowers got approved for loans that they ultimately could not afford.¹ This influx of new buyers helped increase the value of real property, faster than ever before, and to higher values than was supportable. These high values also created equity in existing stock that was then available through second mortgages or Home Equity Lines of Credit (HELOC). Many owners took advantage of the windfall and used the enhanced equity of their home to make improvements or other purchases they normally wouldn't have been able to afford.

The current high rate of default and foreclosures are a direct result of making loans that borrowers could not afford to pay back. There are also a large number of owners who are now "upside

¹ Weinstein, David A., *How the Subprime Mortgage Meltdown Morphed the Municipal Bond Market*, New Jersey Law Journal, Vol. CXCII, No. 16, April 21, 2008.

down”—they owe more on their property than it is worth. This situation is having an impact both on the housing market and on the overall credit market, making it difficult for anyone to get or use credit.

Before the collapse of the housing market, mortgage lenders packaged subprime loans into investment vehicles called Collateralized Debt Obligations (CDO). A CDO is corporate entity that holds fixed-income assets, like mortgages, and sells ownership in the CDO to investors. One way of looking at it is that they sell the future cash flows from the mortgages. The CDO continues to hold the original note, but has sold the future income to an investor in exchange for cash the owner of the CDO can use now.

This is a common way of leveraging assets, but the underlying quality of the asset determines the price, and in this case, many CDOs were overvalued, as the risk on the mortgages had not been properly assessed. While there is nothing inherently wrong with this kind of transaction, the lack of appropriate risk assessment did lead to inappropriate values, causing many CDOs to become overvalued, and therefore overleveraged.

The final layer of this house of cards was the issuance of insurance for the CDOs by bond insurance companies. The credit ratings on the CDOs were inexplicably good to begin with, but insurance made them even more attractive to investors. These insurance policies were written by the handful of bond insurers that also underwrite the municipal bond market.

When the credit rating agencies began to recognize the inherent risk in the CDOs that held subprime mortgages, they began lowering the credit ratings of the bond insurers who had insured them, making the insurance on the municipal bonds worthless. The collapse of bond insurance ratings was both unprecedented and completely unanticipated. (See “More about Bond Insurance” below.)

Another surprising impact of the subprime mortgage crisis is that the market for municipal bonds completely dried up. Beginning on Thursday, February 7th, 2008 investors and dealers declined to bid on auction rate securities, leading to the first auction failures in the history of that class of bonds. (See “Auction Rate Securities” below.)

In summary, the subprime mortgage market impacted the City of Reno:

- By lowering the creditworthiness of bond insurers, increasing the interest cost of City of Reno bonds;
- By driving away bond investors through lower returns and higher risk and causing bond auctions to fail;
- By wiping out the credit market, which impacted sales of consumer goods, thereby lowering sales tax revenues; and
- By sending property values into a slide that will ultimately impact property tax revenues.

Of course subprime mortgages had much more impact on the overall economy, and many other related economic problems have also contributed to the general economic weakness we are currently experiencing, but these were the most direct impacts on the City’s bonds.

More about Bond Insurance

The City of Reno has used bond insurance to guarantee principal and interest payments, giving our bonds the highest rating, AAA. The main value of this is to lower the interest cost—safer investments pay lower returns—as well as to improve the marketability of our bonds. In theory, it takes what is already considered one of the safest investments and makes it even safer.

Municipal bond insurance was first used in 1971 and has grown steadily over the years, to the point where about 45% of all municipal bonds in the country were insured as of December 2007.²

The other reason to use bond insurance is that the insurer does the research that a buyer would need to do before investing, creating a larger pool of potential investors for the bonds, facilitating liquidity in the market. The insurance is paid for over the life of the bonds, as the cost is built into the bond principal, and is usually remitted to the insurance company as a lump sum to the insurer from the proceeds of the bond sale.

The first rumblings of a problem in bond insurers exposure to the subprime market through CDOs was heard in November of 2007.³ Moody's, Standard & Poor, and Fitch Ratings all began investigating the issue, because by this time the defaults on subprime mortgages had been climbing for months.

The bond insurers at that time collectively insured \$2.5 trillion of bonds and structured financing, of which \$1.7 trillion was municipal bonds.⁴ None of the insurers had sufficient capital to cover the potential losses on defaults of the CDOs.

In January, the City's bond insurer on the Series 2005A bonds, Financial Guaranty Insurance Company (FGIC), had its credit rating cut, ultimately falling from AAA to Caa1/BB/CCC—all below investment grade—by June 2008.⁵ As a result, the City's insured bonds reverted to the City's underlying rating of Moody's Baa1 and Standard & Poor A.

As of January 2008, municipal bonds were trading at prices as if they were uninsured. By itself, this would have only meant modest increases in interest cost for the City, but another, more serious, problem had begun.

Auction Rate Securities

Auction Rate Securities (ARS) are a way of borrowing money over a long term while paying short term rates, which are typically significantly lower. The first auction rate security for municipal bonds was introduced in 1988 by Goldman, Sachs & Co., based on a product created by Lehman Brothers in 1984.

An ARS is a long-term, variable rate bond tied to a short-term interest rate. The bonds are sold through a Dutch auction at regular intervals, anywhere from every seven to 35 days. ARS require a broker to structure the issue and an auction agent to manage the auctions. The auctions are a competitive bidding process where buyers compete to purchase the bonds based on the interest

² WM Financial Strategies, *Bond Insurance*, at www.munibondadvisor.com.

³ WM Financial Strategies, *Bond Insurance—Recent Rating and Insurer Actions*, at www.munibondadvisor.com.

⁴ Saft, James, *The \$2.5 Trillion Bond Insurance Problem*, Reuters, November 6, 2007.

⁵ WM Financial Strategies, *Bond Insurance*, at www.munibondadvisor.com. [Moody's/S&P/Fitch]

rate they are willing to accept. Holders of ARS bonds have the option to hold or sell at each auction.

In the event of a failed auction, the existing holders will continue to hold the bonds, but at the maximum rate set in the official statement until sufficient bids are received to sell their stake.

One of the main benefits for the issuer is that ARS lowers overall bond costs or allows the issuer to borrow more money for the same payment. Experts agreed that it was a safe and effective way of leveraging assets, like tax revenues, with the goal of maximizing the utility of those assets.

In fact, in 2004, the California Debt and Investment Advisory Commission released an issue brief about ARS that concluded: “The use of ARS can provide significant benefits including reducing total interest costs, diversifying the debt portfolio, allowing the opportunity to take advantage of short term variable interest rate trends, and matching the structure of assets to liabilities.”

The report also noted that “public finance has become the fastest-growing sector to use auction rate securities, with total issuance projected to grow at double-digit rates in the future.”⁶

Up until recently, it was inconceivable that the market for municipal bonds would ever be less than completely liquid. In fact, no auction had failed in the more than 30 year history of the market and no municipal bond insurer had ever had its credit rating downgraded prior to 2007. Between 1984 and 2006, out of thousands of auctions there were 13 that did not attract bidders, but the dealers stepped in to buy the bonds rather than have the auction fail.⁷

For the City, when auctions fail, interest rates revert to the maximum rate, which, in the case of the 2005A Series, was 15%.

Today, traditional investors in municipal bonds, generally investment and commercial banks, are hoarding cash to hedge against the current market turmoil, and are therefore not investing in municipal bonds, further lowering demand.

The fact that an auction fails has no reflection on the creditworthiness of the City, but rather indicates wariness on the part of investors. For example, the Port Authority of New York and New Jersey, certainly a credible agency, was paying four percent on auction rate bonds until they failed in February and their rate went to 20%.⁸ Since February, most auction rate securities have not sold.

Bloomberg reported that local and state governments had a total of \$328 billion in the auction rate market in February, just shy of 20% of the \$1.7 trillion municipal bond market. There are more than 50,000 municipal issuers.

⁶ Skarr, Douglas, *Auction Rate Securities*, California Debt and Investment Advisory Committee Issue Brief, August 2004.

⁷ McDonald, Michael, *Auction Bond Failures Near 70%, No Sign of Abating*, Bloomberg.com, March 5, 2008.

⁸ Spitzer, Eliot, *Testimony Regarding Bond Insurance*, Subcommittee on Capital Markets, Insurance, and Government Sponsored Enterprises, Committee on Financial Services, US House of Representatives, February 14, 2008.

Some other government agencies recently in the news⁹ because of investments in the auction rate market included:

New York City	\$3.5 billion
City of Houston, Texas ¹⁰	\$1.9 billion
Chicago Board of Education	\$1 billion
Los Angeles County MTA	\$810 million
City of Denver, Colorado	\$700 million
State of California Department of Water Resources	\$690 million
San Diego County, California	\$485 million
City of Cleveland, Ohio	\$437 million
Sacramento Municipal Utility District	\$400 million
Clark County, Nevada (Airport)	\$318 million
Sacramento Regional County Sanitation District	\$250 million
Santa Clara Valley Transportation Authority	\$236 million
City of Minneapolis, Minnesota	\$221 million
Poudre Valley Health System, Colorado	\$215 million
City of Richmond, California	\$167 million
City of Roseville, California	\$150 million
El Dorado Irrigation District, California	\$100 million
South Placer Wastewater Management Authority	\$90 million
City of Redding, California	\$67 million
City of Buffalo, New York	\$62 million
Placer County Water Agency, California	\$35 million

In California alone, the Sacramento Bee estimated that local governments have issued a statewide total of \$27.8 billion in auction-rate bonds. Thompson Financial documents over 2,900 government ARS issues since 1990.

But by February 2008, the ARS market, formerly active and efficient, was no longer working.

In *The New Jersey Law Journal*, bond counsel David Weinstein said “the ARS market is no longer viable for the majority of issuers. As such, many issuers with ARS debt are seeking to refund the debt into VRDOs [Variable Rate Demand Obligations] or fixed-rate securities, which require a banks’ letter of credit.” Another side effect, he noted, was that “as a wave of issuers seek letters of credit in a tight market, banks with higher credit ratings are obtaining higher fees for the letters.”¹¹

The reason ARS do not require a letter of credit is that the investor does not have the ability to require the issuer to repurchase the bond, typically called a “put.” The issuer, therefore, is not required to have the resources on hand to repurchase the bonds. The buyers instead rely on the liquidity of the market to provide the opportunity to sell their bonds.

⁹ Various sources, including The New York Times, The Los Angeles Times, The Sacramento Bee, The Denver Business Journal, and The Chicago Tribune.

¹⁰ Preston, Darrell, *As Houston Auctions Fail, JPMorgan Exploits Taxpayers*, Bloomberg.com, March 6, 2008.

¹¹ Weinstein, David A., *How the Subprime Mortgage Meltdown Morphed the Municipal Bond Market*, New Jersey Law Journal, Vol. CXCII, No. 16, April 21, 2008.

Banks have slowed issuing letters of credit, particularly for any bonds that have been pledged on tax revenues that are in decline. According to Dakin Campbell in *The Bond Buyer*, "...some banks have already reached their entire yearly capacity for writing letter of credit policies, after just a month and a half; the use of letters of credit increased 244.4% in January over the same month last year."¹²

The Director of Research at Ziegler Research believes that the "auction rate market for municipals has been severely wounded by recent events and such wounds are fatal to the continued use of these securities."¹³

Since February, there has been a mass exodus from the auction bond market, making it much more difficult to convert auction rate securities into other types of bonds. In August, Bloomberg News reported that "states, cities, hospitals, and other municipal borrowers have now refinanced approximately \$96.2 billion of their \$166 billion in auction rate bonds, which amounts to about 58% of all auction-rate bonds."¹⁴ Bonds with the most stable revenues pledged were able to be converted quickly, those with more economically-sensitive revenues are proving harder to convert.

The best course of action under the current scenario is to convert auction rate bonds to variable rate under the existing swap rate, and then, when possible, convert or refund them into fixed rate bonds. In fact, that's what the City did earlier this year with the 2006A ReTRAC Bonds.

ReTRAC Bonds

The 2006A ReTRAC bonds, like the 2005A Series, were auction rate securities, but the conversion played out differently.

In 2006, a total of \$197,393,693 was refinanced into the 2006A and B Series Tax Exempt Sales Tax Bonds and the 2006 Room Tax Revenue Refunding Bonds to take advantage of significant interest savings. The 2006A Series, of \$137 million, were ARS, and had an effective interest rate of 3.778%, lower than was being paid on the original loan and bonds.

When the other ARS auctions began failing in February 2008, staff took immediate action to convert both the 2005A Series and the 2006A Series before they had a chance to fail. On March 4, 2008, the 2006A ReTRAC bonds were converted from ARS to VRDO, backed by a letter of credit from the Bank of New York. The 2008A and B ReTRAC Refund Bonds totaled \$190,626,227, and excluded the fixed-rate 2006 Room Tax Revenue Refunding Bonds, which had not been affected by the market difficulties.

Staff was not able, however, to get a letter of credit to back the 2005A Series bonds. A closer examination of the history of these bonds will explain why.

¹² Campbell, Dakin, *Interest Rate Swaps Under Scrutiny*, *The Bond Buyer*, February 20, 2008.

¹³ Merrigan, Edward, *Municipal Auction Rate Securities and the Recent Market Turmoil*, Ziegler Research, March 6, 2008.

¹⁴ Edwards Angell Palmer & Dodge LLP, *Decline in Municipal Auction-Rate Debt as Various States Continue to Refinance*, *InsureReinsure.com*, August 19, 2008.

The History of the Series 2005A Bonds

In **2002**, \$108.6 million in bonds, secured by room taxes, were issued to finance a renovation of the National Bowling Stadium and construction of the Special Events Center. Part of the original plan was to build a ballroom as part of the Events Center project, but it proved too costly, so the Reno Ballroom project was set aside until future financing could be secured.

With construction of the Events Center underway, a major piece in the puzzle for creating a viable downtown was starting to come to fruition, which made it even more desirable to complete other projects in the downtown. According to attendees, one of the topics discussed at the Council retreat in **February 2005** was the need to find ways to complete the ballroom and other downtown projects so that the City could realize the benefits associated with major redevelopment efforts and large, multi-purpose assembly facilities.

In **March 2005**, Goldman, Sachs & Co. made a presentation to the City of Reno entitled *Financing Opportunities for ReTRAC and Special Events Center* that proposed using synthetic fixed rate securities to lower the overall cost of the outstanding bonds and create additional proceeds from the pledged revenues. This was a good opportunity for the City to more efficiently leverage existing revenues, one that was commonly pursued by governments across the nation at that time.

What they proposed was a “synthetic fixed rate debt” that would generate between 80 and 100 basis points of savings on interest payments, or about \$10,000 on every million borrowed. The way it worked was that the City would issue variable rate bonds and then enter into a swap agreement with Goldman Sachs, who would guarantee a fixed rate of 3.49% plus a percentage of LIBOR¹⁵, making the net cost to the City about 3.95%. The swap was used to hedge against interest rate risk, another common practice.¹⁶

The scope of this initial proposal was to refund and extend the ReTRAC financing (TIFIA¹⁷ Loan and Series 2002 bonds), as well as restructure the financing for the Special Events Center (Series 1993 and 2002 bonds). The City would see no increase in annual debt service, extend debt service by only three years (through 2045), and generate approximately \$15 million in additional proceeds.

When the proposal was evaluated, it immediately became clear that there was an opportunity to fund the deferred Ballroom project—which staff knew was a Council priority—using the revenues initially identified for that project. This became the focus of the negotiations and Goldman Sachs returned with an updated proposal entitled *Proposed Convention Center Plan of Finance* in **April 2005**. Part of the plan was to enter into a management agreement for the completed Ballroom with the Downtown Management Company, LLC, so some of the bonds to

¹⁵ The London Interbank Offered Rate (LIBOR) is a daily reference rate based on the interest rates banks borrow unsecured funds from other banks on the London wholesale money market. It is comparable to the U.S. Federal funds rate. (Wikipedia)

¹⁶ Merrigan, Edward, *Municipal Auction Rate Securities and the Recent Market Turmoil*, Ziegler Research, March 6, 2008.

¹⁷ “The Transportation Infrastructure Finance and Innovation Act of 1998 (TIFIA) established a Federal credit program for eligible transportation projects of national or regional significance under which the U.S. Department of Transportation (DOT) may provide three forms of credit assistance – secured (direct) loans, loan guarantees, and standby lines of credit. The program’s fundamental goal is to leverage Federal funds by attracting substantial private and other non-Federal co-investment in critical improvements to the nation’s surface transportation system.” (tifa.fhwa.dot.gov)

be issued for construction of the ballroom had to be taxable, requiring additional types of bonds be issued.

Council members met individually with staff and Goldman Sachs representatives in **May 2005** to review and discuss the latest version of the proposal. Based on these discussions, Goldman Sachs returned with the final version of their proposal entitled *Special Events Center Series 2005 Bonds* and dated **June 17, 2005**.

The benefits of refinancing the ReTRAC and Events Center bonds were plentiful:

- Reduced borrowing costs;
- Capital improvements would generate additional sales tax and SAD income;
- Provided funding for the Reno Ballroom;
- Funded new lanes, carpet, roof, pinsetters, and other upgrades to the National Bowling Stadium to secure major conferences;
- Funded the Virginia Street narrowing;
- Provided Virginia Street beautification projects;
- Provided \$3.3 million for future post office plaza project;
- Provided funding for first installment payment for RTC site;
- Funded the ReTRAC Cover project;
- Provided \$2 million for the Community Assistance Center project;
- Received title for the National Bowling Stadium and land; and
- General Fund received \$3 million from RDA for repayment of outstanding loans.

Another benefit was that the City was able to build in a safety net for the future. At the suggestion of Council member Sferrazza, \$5 million was set aside as a stabilization fund, which would later turn out to be useful in bridging the gap between ARS and VRDO conversion.

On **September 14, 2005**, the Council approved resolutions amending the operating and inter-local agreements between the City and RSCVA, and held the first reading of the bond ordinance for the refinancing. On **September 28, 2005**, the Council adopted the bond ordinance to restructure debt.

Then, on **October 26, 2005**, the City issued \$73,450,000 of Tax-Exempt Capital Improvement Revenue Refunding Bonds, Series 2005A. The proceeds from the bonds were used for a partial advance refunding and defeasance of the City's Capital Improvement Revenue Bonds, Series 2002. As of June 30, 2008, the outstanding balance of the Series 2002 bonds is \$42,410,000, and the amount of \$65,355,000 is considered defeased and held in trust.¹⁸

In conjunction with the issuance of the 2005A Capital Improvement Revenue Refunding Bonds, the City entered into an interest rate exchange transaction with Goldman Sachs Capital Markets L.P. In general, the terms of the swap provide that the City will make semiannual payments to Goldman Sachs at a fixed interest rate (3.53%) based on an amount equal to the outstanding principal. In return, Goldman Sachs will make monthly payments to the City based on the same amount that reflect a variable rate of interest equal to the lower of (1) one-month LIBOR or (2) one-month LIBOR times 67% or times 56% plus 44 basis points, whichever is greater.

¹⁸ City of Reno, *Comprehensive Annual Financial Report for the Fiscal Year July 1, 2007 through June 30, 2008*, December 17, 2008.

Construction continued throughout 2005 and beyond, until the Reno Events Center opened in **January 2007** and the Reno Ballroom opened in **February 2008**.

When the bond insurers first started to face rating downgrades, Goldman Sachs contacted the City and provided a report, dated **February 8, 2008**, entitled *ARS Market Update*. Since December 2007 they had been working with staff to plan for a conversion of all ARS in the City's portfolio, anticipating the problems that might come if bond insurers were no longer creditworthy. The City's ARS and swap were functioning as planned, but it was clear that the City was facing potential increases in borrowing costs.

The exit strategy had always been to convert the bonds to VRDO until a fixed-rate bond could be issued to refund the ARS bonds, but in order to do that, the City needed a direct-pay letter of credit from a bank. No banks were issuing letters at that time, given the instability of the market and the defensive positions most banks were in. The City started to work with US Bank, who initially agreed to provide the letter.

On February 19th and 20th, staff, Andy Artusa from NSB Public Finance, and Jeff Holt from Goldman Sachs held individual conference calls with Council members to update them on the status of the ARS bonds and the City's strategy for dealing with the situation.

During these calls, a number of items were discussed including:

- The changes described above in the ARS market,
- FGIC's credit rating problems and the impact on Reno's ARS bonds,
- The City's potential exposure if the auctions were to fail,
- The possibility of needing to use reserve funds if room taxes continued to drop, and
- The City's exit strategy for the ARS issues.

It was also noted that where the Events Center issue had a reserve, the ReTRAC bonds did not.

After meeting with Council, the City Manager provided a memo faxed to Council which further explained the reason for restructuring the ARS debts, on **February 25, 2008**. Also starting in February, room tax revenues started to decrease significantly, making bonds backed by those revenues less attractive. In February, March, April, May and June room tax revenues decreased over the prior year 13.8%, 6.4%, 7.8%, 29.3% and 9.5% respectively.

On **February 27, 2008**, staff requested and received Council authorization to refund Revenue Bonds for ReTRAC, as described above. The staff report also noted "Staff is also working on a restructuring solution for the Events Center debt, which also has auction rate securities bonds. Staff will be presenting a proposed restructuring solution to Council before the end of the fiscal year."¹⁹

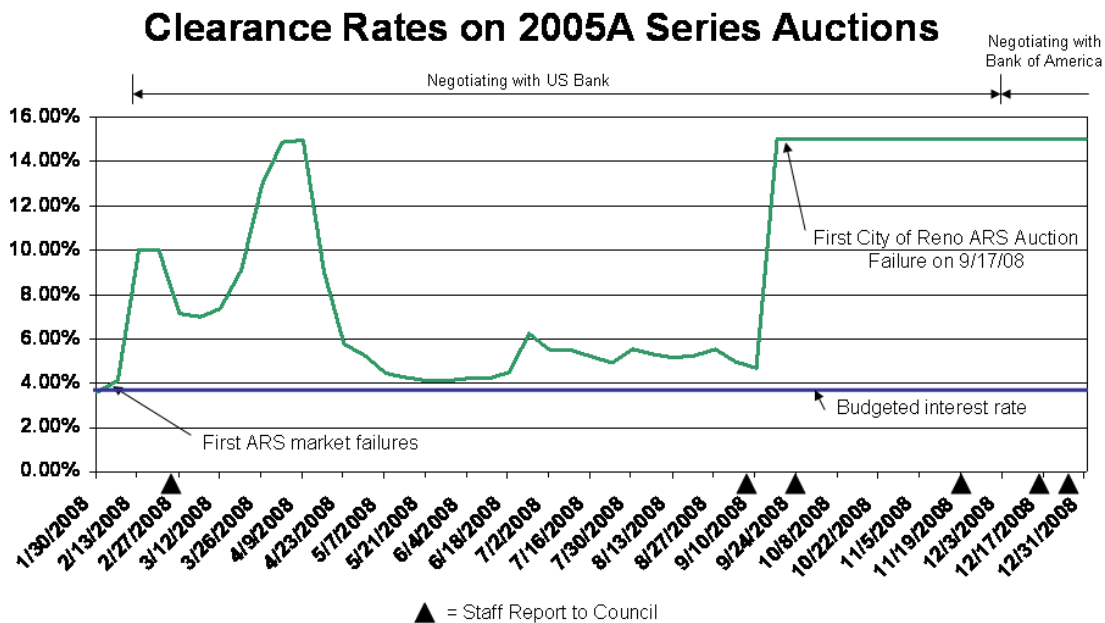
Staff was unable to bring back a proposal before the end of the fiscal year because no further action could be taken by Council until a letter of credit was in place to make the conversion from ARS to VRDO bonds. Between negotiations with the lender and the bond insurer, FGIC, there were several issues to be resolved. Staff remained focused on getting that letter of credit in place and continued to work with the only bank that had agreed to provide such a letter, US Bank.

¹⁹ Green, Andrew, *Staff Report: Ordinance designated as the "2008 Sales Tax Revenue Bond Ordinance"*, February 27, 2008.

Fortunately, during this time the City's auctions did not fail, so although there was still some urgency in making the conversion, the City was not being impacted as severely as it could have been. In fact, after a brief spike in February through April, clearance rates had "settled in the 5% to 7% range."²⁰ The stabilization reserve was only used a couple of times during this period, around June, as by that time the budgeted funds had been used up by the combination of the earlier interest rate spikes and the dropping room taxes.

The following table and chart are a week-by-week accounting of clearance rates.

Auction Date	Clearance Rate	Auction Date	Clearance Rate	Auction Date	Clearance Rate
1/30/08	3.600%	05/28/08	4.100%	09/24/08	15.000%
2/06/08	4.100%	06/04/08	4.200%	10/01/08	15.000%
02/13/08	10.000%	06/11/08	4.195%	10/08/08	15.000%
02/20/08	10.000%	06/18/08	4.479%	10/15/08	15.000%
02/27/08	7.110%	06/25/08	6.249%	10/22/08	15.000%
03/05/08	7.000%	07/02/08	5.480%	10/29/08	15.000%
03/12/08	7.370%	07/09/08	5.460%	11/05/08	15.000%
03/19/08	9.110%	07/16/08	5.190%	11/12/08	15.000%
03/26/08	13.000%	07/23/08	4.890%	11/19/08	15.000%
04/02/08	14.880%	07/30/08	5.500%	11/26/08	15.000%
04/09/08	14.950%	08/06/08	5.270%	12/03/08	15.000%
04/16/08	9.000%	08/13/08	5.140%	12/10/08	15.000%
04/23/08	5.750%	08/20/08	5.240%	12/17/08	15.000%
04/30/08	5.230%	08/27/08	5.500%	12/24/08	15.000%
05/07/08	4.440%	09/03/08	4.940%	12/31/08	15.000%
05/14/08	4.240%	09/10/08	4.690%		
05/21/08	4.090%	09/17/08	15.000%		



²⁰ Green, Andrew, *Staff Report: Resolution pertaining to the issuance of Bonds by the City of Reno*, September 24, 2008.

On **June 28, 2008** a letter of credit commitment was received from US Bank to convert the bonds to the more stable variable rate demand bond market. A condition of the letter of credit was to remove the existing bond insurance policy from FGIC. This was not an easy task since FGIC also insured the fixed rate 2005B and C bonds for Events Center, provided a surety policy on the reserve for the 2005ABC bonds, and also provided an insurance policy on the swap termination payment. This made converting or refunding the 2005A bonds out of auction rate very difficult. It required months of negotiating with FGIC to get them to agree to remove the policy on the 2005A bonds and keep the bond insurance policy on the fixed rate 2005B and C bonds. They also agreed to keeping the surety policy on the 2005ABC bonds combined reserve fund. They did require the swap termination policy to be cancelled. The confirmation from FGIC, which allowed the City to move forward, came in late **August 2008**.

Finally, in August, it looked like the City would be able to close the deal with US Bank. So on **September 9, 2008**, the Council authorized staff to move forward with the conversion of \$73,050,000 million of auction rate refunding bonds to variable rate demand bonds.

On **September 18, 2008** the financial markets crumbled with the Lehman bankruptcy. At the same time, there were continuing large decreases in room tax revenues in August (-24.3%), September (-18.5%), October (-12.1%), November (-20%) and December (-9.8%). The City's ARS auctions began to fail after that and have not recovered since.

Staff continued to move forward with US Bank, and on **September 24, 2008** staff requested Council authorization to sell or convert outstanding bonds for the Events Center. At that time, staff planned to return to Council in November with a revised bond ordinance, and estimated conversion would occur in early December.

As an update on the progress, on **November 19, 2008** staff reported to Council that "[t]hree weekly auctions have failed resulting in the City paying an interest rate of 15%. This equates to approximately \$125,000 per week in higher interest costs. As a result, more of the Stabilization Reserve is estimated to be used than originally anticipated. Staff is doing everything possible to expedite the conversion and retain as much of the Stabilization Reserve as possible."²¹

At the **December 3, 2008** Council meeting, the item was postponed because "Reno was notified that US Bank had declined to issue the [letter of credit] as promised due to a continuing decline in room tax and Consolidated Tax (CTAX) revenues."²² No action was possible given this turn of events.

Staff began negotiating with a new bank, Bank of America, the only other entity that expressed interest in providing a letter of credit. When staff returned with a resolution regarding conversion of interest rates on the 2005A Series pending issuance of a letter of credit from Bank of America on **December 17, 2008**, Council continued it to the week of December 23, 24, and 26 and requested a summary of the City's overall debt situation.

²¹ Green, Andrew, *Staff Report: Resolution pertaining to the conversion of the interest rate on the City of Reno, Nevada, Tax-Exempt Capital Improvement Revenue Refunding Bonds, Series 2005A*, November 19, 2008.

²² Green, Andrew, *Staff Report: Resolution pertaining to the Conversion of the Interest Rate on the City of Reno, Nevada, Tax-Exempt Capital Improvement Revenue Refunding Bonds, Series 2005A*, December 24, 2008.

In a staff report dated **December 24**, staff let Council know that “[e]very weekly auction has failed since the November Council action resulting in the City paying an interest rate of 15 percent. Given the continued volatility of the auction rate securities market, staff expects auctions to continue to fail. This means that another \$1 million of the Stabilization Reserve could be used before the conversion is completed.”

According to the report, the terms were much more in the bank’s favor, a trend that had intensified industry wide since the events of September. Although one condition that Bank of America was asking for wasn’t too onerous, “that they would assume the banking business of the City at the same rates charged by US Bank,” the rate for the letter of credit was also going to be at least 50 basis points higher. But, given the circumstances, “[s]taff believes that these changes are acceptable given the current 15 percent rate being paid.” The contract would be for one year, giving the City “time to renegotiate better terms and move forward with converting to a fixed interest rate.”

By this time the continued auction failures was beginning to have even more impact on the stabilization fund and staff estimated that it had used up “approximately \$4 million of this reserve.”²³

By **December 26, 2008**, staff had still not received confirmation that a letter of credit would be issued, but did report back to Council on the City’s overall bond portfolio.

²³ Green, Andrew, *Staff Report: Resolution pertaining to the Conversion of the Interest Rate on the City of Reno, Nevada, Tax-Exempt Capital Improvement Revenue Refunding Bonds, Series 2005A*, December 24, 2008.