CITY OF SAN JOSE
CAPITAL OF SILICON VALLEY

Memorandum

TO:	HONORABLE MAYOR AND CITY COUNCIL	**FROM:**	Julia H. Cooper Jim Shannon
SUBJECT:	**CITY OF SAN JOSE 2020 TAX AND REVENUE ANTICIPATION NOTES**	**DATE:**	June 12, 2020

Approved D. DSyL   Date 6/12/2020

RECOMMENDATION

(a) Adopt a resolution:

(1) Authorizing the issuance and sale of the City of San José 2020 Tax and Revenue Anticipation Notes (the "2020 Notes") in an aggregate principal amount not to exceed $130,000,000 to be sold through private placements; and

(2) Approving, in substantially final form, the Note Purchase Agreements and authorizing the Director of Finance or other authorized officers to execute the Note Purchase Agreements with Bank of America, N.A. and U.S. Bank National Association and other related documents, as necessary, in connection with the issuance of the 2020 Notes and authorizing other related actions in connection therewith.

(b) Adopt the following Appropriation Ordinance and Funding Sources Resolution amendments in the General Fund for Fiscal Year 2020-2021:

(1) Increase the estimate for Other Revenue in the amount of $130,000,000; and

(2) Increase the Citywide TRAN Debt Service appropriation to the Finance Department in the amount of $130,000,000.

OUTCOME

Approval of the recommendations will result in the issuance and sale of the City of San José 2020 Tax and Revenue Anticipation Notes ("2020 Notes"). Based on historical cash balances, specifically those balances in the General Fund, and information contained within the *2020-2021 Proposed Operating Budget* (the "Proposed Budget"), the proceeds of the 2020 Notes will provide necessary funds for cash flow purposes. This cash flow borrowing, along with approximately $231.7 million in cash, will provide for a single lump-sum contribution (i.e., prefunding) towards the employer retirement contributions for Tier 1 members, across all funds, for Fiscal Year 2020-2021. The City does not intend to prefund any portion of the Tier 2 or retiree healthcare contribution for Fiscal Year 2020-21.

EXECUTIVE SUMMARY

The City began prefunding the employer retirement contributions for the Federated City Employees' Retirement System and the Police and Fire Department Retirement Plan (collectively the "Retirement Plans") in 2008 for budgetary savings. Beginning in 2010-2011 and in each fiscal year thereafter through 2018-2019, the City entered into short-term borrowings to avoid a negative cash balance in the General Fund portion of the City Investment Pool. Annually, staff evaluates the budgetary benefit of both the issuance of tax and revenue anticipation notes ("TRAN") and prefunding of the City's retirement contributions. While in 2019-2020, a TRAN issuance did not provide budgetary savings, the strategy of prefunding will provide budgetary savings to the City in 2020-2021. For 2020-2021, the budgetary savings are estimated at $13.9 million in all funds and $7.4 million in the General Fund, as included in the 2020-2021 Proposed Operating Budget.

For 2020-2021, the City intends to issue the 2020 Notes in the aggregate principal amount of $130 million on July 1, 2020 to be purchased by Bank of America, N.A. ("Bank of America") and by U.S. Bank National Association ("U.S. Bank" and together with Bank of America, the "Banks"), in the amount of $65 million each. The City will sell the 2020 Notes directly to the Banks in separate private placements. The estimated interest expense is $1,490,000 and costs associated with the financing are estimated at $75,000, resulting in a total projected cost of borrowing at approximately $1,565,000.

BACKGROUND

During the development of the *General Fund Structural Deficit Elimination Plan* in 2008, a set of strategies was developed. One of the strategies approved by the City Council on May 16, 2008 was to "utilize financial strategies that have positive net present value," which included annual prefunding of the City's portion of retirement contributions. Historically, the Retirement Plans required the City to make biweekly contributions in conjunction with each payroll distribution. Those biweekly contributions were calculated based on actual payroll amounts and the contribution rate approved by the Retirement Plans Boards was based on biennial actuarial studies.

The *2008-2009 Proposed Operating Budget* included a proposal to recognize ongoing budgetary savings that would result from the prepayment of employer retirement contributions for the Retirement Plans. On June 17, 2008, the City Council approved changes to the San José Municipal Code, and on August 1, 2008, the City made its first prefunding of employer retirement contributions, which included only pension contributions. In 2009-2010, the City again prefunded employer retirement contributions, but included contributions for both pension as well as retiree health benefits.

Annually, staff evaluates the budgetary benefit of both the issuance of a TRAN and the prefunding of the City's retirement contributions. From 2008-2009 through 2018-2019, that analysis demonstrated that prefunding provided significant budgetary savings to the City. Beginning in 2010-2011, short-term borrowings were undertaken to prefund the pension and retiree employer contributions, given insufficient funds on a cash flow basis to make the payments without causing a negative cash balance in the General Fund's portion of the City's Investment Pool. For eight years, the City issued TRANs in amounts ranging from $75 million to $150 million to prefund the retirement contributions. For 2019-2020, the City did not prefund retirement contributions because the market conditions were not favorable – the savings from prepayment were not sufficient to offset the combination of lost interest earnings and associated TRAN debt service costs. With market conditions changing once again, the City and Retirement Plans Boards are both receptive to pre-payment strategies for fiscal year 2020-2021.

Based on the figures included in the 2020-2021 Proposed Operating Budget, the pre-funding of City Retirement Contributions provides net savings of $7.4 million to the General Fund and $13.9 million across all funds. The TRAN will facilitate prepayment of the City's retirement costs in the amount of $361.7 million for both the Tier 1 pension costs including the Tier 1 Unfunded Actuarial Liability in the Retirement Plans. The prepayment includes cash ($231.7 million) and the 2020 Notes proceeds ($130 million). The City making annual prepayments of its employer contributions to the Retirement Plans in lieu of biweekly contributions will generate approximately $13.9 million in savings in all funds, $11.4 million in the General Fund. In the General Fund, these savings will be offset by an estimated $2.6 million loss in interest earnings and $1.4 million in short-term borrowing costs (TRAN debt service), resulting in a total net savings of $7.4 million. As described below, the most recent estimate of short-term borrowing costs is approximately $1.6 million, which would reduce the overall General Fund savings by approximately $200,000.

<u>ANALYSIS</u>

Several large General Fund tax revenues are received in an uneven manner based on predetermined schedules, seasonality, and other economic factors. For example, Property Tax Receipts, the largest General Fund revenue source, are received primarily in January and June based on a schedule set forth by the Santa Clara County Controller-Treasurer's Office. Sales Tax Receipts are received on a monthly basis and vary based on seasonal factors such as holiday sales.

In contrast, expenditures in the General Fund are relatively level throughout the fiscal year. This is largely the result of personnel expenditures accounting for approximately two-thirds of General Fund expenditures. These expenditures occur biweekly through payroll disbursements. Months with somewhat higher expenditures occur when there are three payroll disbursements or large periodic expenditures such as debt service, but these months are infrequent, and the expenditures are generally predictable based on historical patterns.

The result of this timing mismatch between General Fund revenues and expenditures is large net cash outflows (expenditures exceed revenue received) in the first six months of the fiscal year and large net cash inflows (revenues received exceed the amount of expenditures) in January, April, and June. To analyze the impact on the General Fund's cash position of the annual prefunding of employer retirement contributions, Finance staff prepared a projection of General Fund cash flows for 2020-2021. Based on this projection, after the payment for the prefunding is made in July 2020, the General Fund cash balance will decrease significantly during the first half of fiscal year 2020-2021. To smooth out the cash balance and maintain the City's liquidity level, staff recommends the issuance of the 2020 Notes.

Plan of Finance

Based on the need to expedite the development of a short-term borrowing, the City will offer the 2020 Notes through a private placement. A private placement does not require a public offering document and has a shorter timeframe to execute. Bank of America has purchased the City's TRAN in the past, but the COVID-19 pandemic has placed increased demand for bank credit support across all sectors of the municipal credit market and Bank of America indicated that it would not be able to lend the City the full amount sought by the City. In response, the City conducted an informal solicitation to three banks in late April - Bank of America, U.S. Bank and J.P. Morgan - to get indications of their capacity and anticipated pricing levels to purchase the City's TRAN in 2020. In particular, the City was interested in hearing from each bank about their capacity and pricing to provide all or a portion of the requested TRAN funding of $150 million. To facilitate rapid implementation of the TRAN transaction, the City desired to use the document structure from the 2018-2019 TRAN transaction in substantially the same form, including documents ("Note Purchase Agreement") and pricing structure (i.e., LIBOR-based, indexed variable rate) with pre-payment flexibility and no required pay down schedule. Historically, the City repaid the TRAN in full by May of the respective fiscal year, with about 70% of the principal having been paid by February.

A summary of the preliminary indications is as follows:

Bank	Amount	Upfront Fee (bps)	1-Month LIBOR + Spread (bps)	LIBOR Floor (bps)
Bank of America	Less than $150 million	n/a	150-200	75-100
J.P. Morgan	Min - $75 million; Max - $150 million	10bps	175	100
U.S. Bank	$75 million	n/a	125-150	75

After evaluation and further discussion with each of the banks, the City decided to proceed with Bank of America and U.S. Bank, both of which agreed to: purchase separate 2020 Notes in the amount of $65,000,000 each ($130,000,000 total); use in substantially similar form, the Note Purchase Agreement from the 2018-2019 TRAN; agree to common pricing of 1-Month LIBOR (subject to a minimum LIBOR rate of 0.75%) plus an Applicable Margin of 140 bps (or 1.40%); agree to a common minimum pay-down schedule for the 2020 Notes.

In this transaction, the City agrees to sell the 2020 Notes directly to the Banks in a private placement. Similar to previous year's Notes, a public offering document is not required or prepared, the Banks cannot publicly trade the 2020 Notes, and ratings are not required.

Description of the 2020 Notes

The Banks will purchase the 2020 Notes in an aggregate principal amount not to exceed $130 million, with a stated maturity date of June 30, 2021 (the "Maturity Date"). The full amount of $130 million is currently anticipated to be purchased by the Banks in the form of two notes: (1) the City of San José 2020 Tax and Revenue Anticipation, Note R-1 (or "Bank of America Note"), anticipated to be purchased by Bank of America in the amount of $65,000,000; and (2) the City of San José 2020 Tax and Revenue Anticipation, Note R-2 (or "US Bank Note"), anticipated to be purchased by US Bank in the amount of $65,000,000, (together the "2020 Notes"). Closing for the 2020 Notes is scheduled for July 1, 2020.

The Note Purchase Agreements, more fully described below, require a prepayment schedule on the 2020 Notes, split equally between the two Banks, as follows:

Retirement Date	Payment/Retirement Schedule		Principal Balance
	Percentage of Original Principal	Amount	$130,000,000
February 1, 2021	30%	$39,000,000	$91,000,000
April 1, 2021	60%	$78,000,000	$52,000,000
June 1, 2021	80%	$104,000,000	$26,000,000
June 30, 2021	100%	$130,000,000	$0

Prepayment of the 2020 Notes in whole or in part may be made at the City's option, with written notice to the Banks at least three (3) business days prior to such prepayment date (for prepayment on a date other than the end of the monthly interest period, a breakage fee may be due to the Banks). Partial prepayments must be made equally between the two 2020 Notes.

The outstanding amounts on the 2020 Notes will bear interest at a variable rate based on a LIBOR[1] rate effective for any given interest period ("Interest Rate"), plus a margin or spread of 1.40% for Bank fees (the "Applicable Margin"), with a minimum LIBOR rate or floor of 0.75%. In summary, the total interest rate will not be lower than 2.15% while the 2020 Notes are outstanding (*the sum of the minimum 1-month LIBOR interest rate floor of 0.75% plus the 1.40% Applicable Margin*). The Applicable Margin will increase in the event the ratings on the City's general obligation bonds are downgraded as summarized in the table below. The City's current general obligation bond ratings are Aa1/AA+/AA+ by Moody's, Standard & Poor's and Fitch, respectively.

[1] LIBOR stands for London Inter-Bank Offered Rate. The LIBOR rate is a benchmark interest based on the interest rate charged for interbank loans in London.

	City General Obligation Bond Rating			**Incremental Increase in Applicable Margin**
	Moody's	**S&P**	**Fitch**	
Level I	Aa2 or above	AA or above	AA or above	0 bps
Level II	Aa3	AA-	AA-	+20 bps
Level III	A1	A+	A+	+35 bps
Level IV	A2	A	A	+45 bps
Level V	A3	A-	A-	+55 bps

The Applicable Margin of 1.40% is higher than the 2018 TRAN of 0.32% because of the strained municipal credit caused by the COVID-19 pandemic, which has led to increased demand for bank credit, scarcer supply of credit, higher borrowing costs, and more stringent terms, as evidenced by the split purchase of the 2020 Notes between the two Banks, the required minimum principal prepayment schedule, and the generally higher pricing (including a LIBOR floor). The aforementioned pricing elements are still in line with market rates for similar bank private placement products as surveyed by the City's Municipal Advisor.

After the Bank's purchase of the 2020 Notes on July 1, 2020, the Interest Rate is initially based on the daily LIBOR rate plus the Applicable Margin. Effective on the third London Banking Day from and including the Effective Date (expected to be July 1, 2020), the Note will be automatically converted to a Fixed Rate LIBOR Loan, based on the 30-day LIBOR rate plus the Applicable Margin, until the earlier of the maturity date (June 30, 2021) or the date the 2020 Notes are paid in full. During the fixed rate LIBOR period, the interest rate on the 2020 Notes will be reset monthly based on the monthly LIBOR rate (subject to the 0.75% LIBOR floor). Interest on the 2020 Notes is payable on the first business day of each month. The City will also have the option to convert the interest rate from the 30-day LIBOR fixed rate to a daily LIBOR rate.

Conservative interest cost estimates for the 2020 Notes of $1,490,000 and financing costs of approximately $75,000, results in a total projected cost of borrowing of approximately $1,565,000, which is higher than the $1,420,000 included in the 2020-2021 Proposed Operating Budget for the 2020 Notes expense. The Administration will monitor actual interest expenses and recommend adjustments as necessary as part of a future budget process.

Security for repayment of the 2020 Notes is a pledge of the City's 2020-2021 secured property tax revenues (excluding property taxes levied for general obligation bonds) and all other legally available General Fund revenues of the City, if required. The 2020 Notes will have a stated maturity of June 30, 2021 for payment in full, but as noted above, can be prepaid at the City's option without prepayment penalty on the last day of any monthly interest period.

Note Purchase Agreements

To proceed with the issuance of the 2020 Notes, the City Council must adopt the resolution described above. As referenced in the proposed resolution, staff recommends that the Director of Finance or authorized designees be authorized to execute and deliver the 2020 Notes and that the Director of Finance, or authorized designees be authorized to enter into and deliver two separate Note Purchase Agreements (the "Purchase Agreements") also described below. These documents, in substantially final form, will be available for review on the City Clerk's website on or about June 18, 2020.

The Purchase Agreements will consist of: (1) a Note Purchase Agreement between the City and Bank of America, N.A., with its 2020 Note designated as R-1, in the amount of $65,000,000; and (2) a Note Purchase Agreement between the City and U.S. Bank National Association, with its 2020 Note designated as R-2, in the amount of $65,000,000. The Purchase Agreements set forth requirements under which the Banks will purchase the 2020 Notes, establishes the interest rate mechanism, outlines repayment terms, contains representations and warranties of the City and the Banks, and specifies conditions precedent to the Banks entering into the Purchase Agreements.

Consistent with other agreements that the City has entered into with various banks, the Purchase Agreements provide that both Banks waive their respective right to a jury trial in the event of a dispute. Additionally, the City waives any right to consequential damages in the event of the Banks' breach and the City agrees, to the extent permitted by law, to indemnify and defend the Banks against all liabilities arising out of the Purchase Agreements, except for liability arising from the Banks gross negligence or willful misconduct. As is the case with several City agreements with banks, the law governing interpretation of the Purchase Agreements is New York law, the law governing the City's duties and obligations under the Purchase Agreement and the 2020 Notes is California law, and any lawsuits concerning the Purchase Agreements and the 2020 Notes are to be filed in New York.

Finance Team Participants

The financing team participants consist of:

• City's Municipal Advisor:	Public Resources Advisory Group
• Note Counsel:	Hawkins Delafield & Wood LLP
• 2020 Note Purchasers:	Bank of America, N.A. US Bank National Association
• Purchaser Counsel:	Nixon Peabody

Public Resources Advisory Group was selected as the Municipal Advisor from the Municipal Advisory Pool.[2] Hawkins Delafield & Wood LLP (as Note Counsel) was selected as the Note Counsel from the City's bond counsel pool that was established through a competitive process. Bank of America, N.A. and US Bank National Association were selected to be the 2020 Note Purchasers as described above.

Financing Schedule

The current proposed schedule is as follows:

- Council approval of 2020 Notes Financing Documents June 23, 2020
- 2020 Notes Closing July 1, 2020

CONCLUSION

Approval of the recommendations will result in the issuance and sale of the 2020 Notes. The issuance of the 2020 Notes cash flow borrowing ($130 million), along with approximately $231.7 million in cash, will provide for a single lump-sum contribution (i.e., prefunding) towards the employer retirement contributions for Tier 1 members, across all funds, for Fiscal Year 2020-2021.

EVALUATION AND FOLLOW-UP

This memorandum presents the set of recommendations related to the City Council's approval of the issuance of the 2020 Notes and requires no follow-up to the City Council.

CLIMATE SMART SAN JOSE

The recommendation in this memo has no effect on Climate Smart San José energy, water, or mobility goals.

POLICY ALTERNATIVES

Staff explored the Federal Reserve Bank of New York Municipal Liquidity Facility authorized under Section 13(3) of the Federal Reserve Act as an alternative to a TRAN issuance.

To address financial impacts on state and local governments from the COVID-19 pandemic, Congress passed the Coronavirus Aid, Relief, and Economic Security Act, or CARES Act, on March 28, 2020, creating a Municipal Liquidity Facility ("MLF"). Under the MLF, the Federal

[2] General Municipal Advisors were selected, and Municipal Advisory Pools were established in August 2017 through a Request for Proposals process.

Reserve Bank of New York ("Reserve Bank") will commit to lend to a special purpose vehicle ("SPV") on a recourse basis, with the SPV having the ability to purchase up to $500 billion in Eligible Notes directly from Eligible Issuers at the time of issuance. Eligible Issuers include states, certain counties and cities, and multi-state entities.

Per the most recent Reserve Bank term sheet dated June 3, 2020, for cities to qualify as an Eligible Issuer, participating cities must have a minimum population exceeding 250,000 residents, have a credit rating higher than BBB-/Baa3, and have an eligible security (note) for purchase (i.e. TRAN). The SPV Eligible Notes may be purchased with the MLF until December 31, 2020. The proceeds of the MLF may be used to manage reductions of revenue and increases in expenses resulting from the COVID-19 pandemic; payment of principal and interest on Eligible Issuer's obligations; and the MLF must be repaid within three years. The City qualifies as an Eligible Issuer. While the MLF program allows for repayment period of up to three years, the California Constitution prohibits the City from borrowing funds for longer than a fiscal year issuing debt for longer than one-year without voter approval.

Alternative: Apply for one-year loan of $130 million from MLF

Pros: Provides for an alternative mechanism for providing additional funding to prepay the City's retirement contribution.
Cons: Two-level approval process and expensive pricing.
Reason for not recommending: MLF requires two levels of approval (i) approval as an Eligible Issuer (including repayment sources and repayment mechanisms) by the Federal Reserve, and (ii) approval of the Eligible Note, which prior to issuance requires legal opinions and disclosures. This approval process would not meet the City's funding timeline of July 1, 2020. Additionally, the pricing structure of the MLF includes a 0.10% origination fee and the interest rate is a spread over the comparable maturity overnight index swap rate, and in the case of taxable notes, divided by a factor of 0.65. In the current market this results in a rate well in excess of the estimated borrowing cost of the 2020 Notes.

PUBLIC OUTREACH

This memorandum will be posted on the City's website for the June 23, 2020, City Council meeting.

COORDINATION

This report was coordinated with the City Attorney's Office and the financing team participants.

COMMISSION RECOMMENDATION/INPUT

This recommendation has not been heard by any commission.

FISCAL/POLICY ALIGNMENT

The proposed financing plan is consistent with the City Debt Management Policy, which establishes the following equally important objectives in order to obtain cost-effective access to the capital markets:

- Minimize debt service and issuance costs;
- Maintain access to cost-effective borrowing;
- Achieve the highest practical credit rating;
- Full and timely repayment of debt;
- Maintain full and complete financial disclosure and reporting; and
- Ensure compliance with applicable State and Federal laws.

COST SUMMARY/IMPLICATIONS

Based on a final analysis of anticipated retirement contributions and General Fund cash flow, the aggregate principal amount of the 2020 Notes to be issued is $130 million to pre-pay the City's contribution to the Retirement Plans. The $130 million will be repaid in 2020-2021. Estimated interest expense and costs of issuance for the 2020 Notes are conservatively estimated at $1,565,000 reflecting costs for interest expense, note counsel, purchaser counsel, and municipal advisor. The 2020-2021 Proposed Operating Budget includes funding of $1,420,000 for debt service and costs of issuance. The Administration will monitor actual interest expenses and recommend adjustments as necessary as part of a future budget process.

BUDGET REFERENCE

The table below identifies the fund and appropriations to fund the repayment of the 2020 Notes. As the issuance of the 2020 Notes ensures sufficient cash balances to prefund the City's retirement contributions across all funds, costs associated with this issuance will be apportioned at a later date, typically as part of the overhead allocation plan.

Fund #	Appn #	Appn. Name	Proposed Appn.	Proposed Budget Action	2020-2021 Proposed Operating Budget Page[1]	Last Budget Action (Date, Ord. No.)
001	R130	Other Revenue	$48,198,439	$130,000,000	V-36	N/A
001	3904	TRAN Debt Service[2]	$1,420,000	$130,000,000	VIII-14	N/A

[1] The 2020-2021 Proposed Operating Budget is scheduled for approval by the City Council on June 16, 2020 and adoption of the annual appropriation ordinance for 2020-2021 on June 23, 2020.

[2] Once final costs are determined, an increase in the debt service due and cost of issuance amount may be brought forward as part of a future budget process.

CEQA

Not a Project, File No. PPl7-004, Government Funding Mechanism, or Fiscal activity with no commitment to a specific project which may result in a potentially significant physical impact on the environment

/s/
JULIA H. COOPER
Director of Finance

JIM SHANNON
Budget Director

I hereby certify that there will be available for appropriation in the General Fund in 2020-2021, monies in excess of those heretofore appropriated there from, said excess being at least $130,000,000.

JIM SHANNON
Budget Director

For questions please contact Julia H. Cooper, Director of Finance, at (408) 535-7011.