Exhibit VI-6

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How Plan to Help City Pay Pensions Backfired

By MARY WILLIAMS WALSH

Jeffrey A. Michael, a finance professor in Stockton, Calif., took a hard look at his city's bankruptcy this summer and thought he saw a smoking gun: a dubious bond deal that bankers had pushed on Stockton just as the local economy was starting to tank in the spring of 2007, he said.

Stockton sold the bonds, about $125 million worth, to obtain cash to close a shortfall in its pension plans for current and retired city workers. The strategy backfired, which is part of the reason the city is now in Chapter 9 bankruptcy. Stockton is trying to walk away from the so-called pension obligation bonds and to renegotiate other debts.

After reviewing an analysis of the bond deal, underwritten by the ill-fated investment bank, Lehman Brothers, and watching a recording of the Stockton City Council meeting where Lehman bankers pitched the deal, Mr. Michael concluded that "Stockton is entitled to some relief, due to deceptive and misleading sales practices that understated the risk."

"Lehman Brothers just didn't disclose all the risks of the transaction," he said. "Their product didn't work, in the same way as if they had built a marina for the city and then the marina collapsed."

Financial analysts and actuaries say essentially the same pitch that swayed Stockton has been made thousands of times to local governments all over the country — and that many of them were drawn into deals that have since cost them dearly.

Since virtually all pension obligation bonds turn on the same basic strategy that Stockton followed, Mr. Michael's research could be a road map for avoiding more such problems, or perhaps for seeking redress. His analysis was part of his August economic forecast for the region, which he prepares as director of the Business Forecasting Center at the University of the Pacific.

There are about $64 billion in pension obligation bonds outstanding, and even though issuance has slowed, more of the bonds are coming to market, even now.

Officials in Fort Lauderdale, Fla., are scheduled to vote on a $300 million pension obligation bond on Wednesday, for instance. Hamden, Conn., has amended its charter to allow for the bonds to rescue a city pension fund that is wasting away. Oakland, Calif., recently issued about $211 million of the bonds, following the lead of several other California cities and counties.

The basic premise of all pension obligation bonds is that a municipality can borrow at a lower rate of interest than the rate its pension fund assumes its assets will earn on average over the long term. Critics contend that municipalities that try this are in essence borrowing money and betting it on the stock market, through their pension funds. The interest on pension obligation bonds is not tax-exempt for this reason.

Alicia H. Munnell, director of the Center for Retirement Research at Boston College, looked at outcomes for nearly 3,000 pension obligation bonds issued from 1986 to 2009 and found that most were in the red. “Only those bonds issued a very long time ago and those issued during dramatic stock downturns have produced a positive return,” Ms. Munnell wrote with colleagues Thad Calabrese, Ashby Monk and Jean-Pierre Aubry. “All others are in the red.” Only one in five of the pension obligation bonds issued since 1992 has matured, so the results could change in the future.

Among the places where the strategy has failed miserably is New Orleans, which sold about $170 million of such debt in 2000 to produce cash to finance the pensions of 820 retired firefighters. Until then, New Orleans had never funded their benefits and simply paid them out of pocket, leaving the retirees fearful that in a budget squeeze, the city might renege.

City officials based the deal on the expectation that the bond proceeds would be invested in assets that would pay 10.7 percent a year — an unusually aggressive assumption, but one that made the numbers work. New Orleans’s credit was weak, and its borrowing rate was expected to be 8.2 percent. To get the rate on the bonds down as much as possible, New Orleans also issued variable-rate debt, combined with derivatives in an attempt to hedge against rate increases.

But instead of earning 10.7 percent a year, the bond proceeds the city set aside for the firefighters’ pensions lost value over the years, first in the dot-com crash and then in the financial crisis. And instead of hedging against interest rate increases, the derivatives failed, leaving New Orleans paying 11.2 percent interest. The city also has a $115 million balloon payment coming due on the debt in March.

“We might as well hand over the keys to the city,” New Orleans’s chief administrative officer, Andy Kopplin, told reporters in July, after meeting with the Louisiana State Bond Commission to seek permission to refinance the debt. He said the next batch of pension obligation bonds would have an investment-grade rating, because they would be backed by property taxes instead of investment returns from the firefighters’ pension fund. The commission approved the new bonds unanimously.

Stockton got a similar pitch in 2007 — that it could issue municipal bonds with a lower interest rate than the California state pension system, known as Calpers, expected its investments to return annually, on average.

The year that Lehman Brothers made the pitch to Stockton, for example, the city had a shortfall of $152 million with Calpers, which administers benefits for Stockton's retirees. The gap appeared because in 1999, Stockton increased the value of the pensions its workers were earning, without making a corresponding increase in the yearly prepayments it sent Calpers to cover the cost.

No one thought it had to; Calpers's actuary had projected that investment gains would pay for most of the increase. Then the dot-com bubble burst, blowing that expectation to bits. But Stockton's workers kept on building their retirement benefits at the richer rate, so by 2006, Stockton was $152 million short of what it should have had on hand at Calpers to pay for all of its current and future retirees' pensions.

Calpers, meanwhile, was assuming that its investments would earn 7.75 percent a year over the long term. And when a city, like Stockton, had a shortfall, Calpers treated it as if that city had borrowed from the pension fund — and it charged that city 7.75 percent interest on the loan.

Not only that, but the Lehman bankers also explained that Calpers had recently switched to a new way of billing its member cities for these "loans." It wanted to help them preserve their cash in the wake of the technology crash, so it had slowed the cities' payments to Calpers. The bad news was that it had slowed them so much that the bills were compounding before any city could pay them down. That meant Stockton's debt to Calpers was just going to get bigger and bigger over the years, the bankers said.

After laying out this daunting situation, the Lehman bankers said there was a way out: Stockton could raise the $152 million all at once in the municipal bond market, send the money to Calpers and get rid of the unpayable loan. The municipal bond market would charge Stockton just 5.81 percent interest. The city would come out way ahead.

What the bankers did not say was how seldom such pension bets ever pay off.

A recording of the Stockton City Council meeting where Lehman recommended the pension obligation bond shows that members sensed there was a catch, but they had trouble nailing down what it was.

"I don't understand the bond market," one said as he struggled with the projections showing that Stockton could never pay down its debt to Calpers. "Are these projections realistic?"

Another wondered whether Calpers might lower its assumed rate of return, eating into the spread Stockton hoped to achieve between the 5.81 percent and the Calpers assumed rate.

One of the Lehman bankers agreed there were risks.

“This is not a guaranteed deal,” he said. He explained that no one would know whether Stockton had come out ahead until all the bonds had matured, 30 years in the future. He said “the ultimate benchmark” for Calpers’s investments was Stockton’s own borrowing rate, 5.81 percent.

If Calpers’s investment earnings 30 years from then did not average out to at least 5.81 percent a year, he said, the bond would have been a bad idea. But then he dismissed this possibility, saying that if Calpers could not earn that much over time, “you have much bigger problems.”

Calpers’s investments lost about 25 percent of their value in the financial turmoil that began in 2008. That meant the city had a new debt to Calpers, compounding at 7.75 percent, on top of its debt to the bondholders. Stockton was worse off than ever, with 29 more years to go.

Mr. Michael, of the University of the Pacific, said Lehman Brothers had not let on that such an outcome was possible, and had, in essence, talked the City Council into making a huge gamble with public money.

Federal regulations require municipal bond underwriters to deal fairly with cities and not mislead or deceive them.

Mr. Michael said the fact that a troubled city like Stockton was able to borrow at a rate so much lower than Calpers’s assumed rate of return should have raised questions. Now that the bonds are in default, it is clear that the investors who bought them were not compensated enough for the risk they took on, he said.

The investors might thus have a case against Lehman, except that Lehman is now bankrupt.

The company that insures the bonds, Assured Guaranty, will make the bondholders whole, but the policy it issued allows it to file a claim in bankruptcy against Stockton for the money it pays the bondholders. Assured Guaranty will be an unsecured creditor for the claim. It said in a statement that Stockton was trying “to transfer the cost of lucrative, above-market employee wages and benefits, granted when tax revenues were flush, to capital market creditors by haircutting bond principal,” which it said was unprecedented.

In another statement, the insurer said Stockton might have avoided bankruptcy entirely if it had taken steps like restructuring its debts, selling assets and “pension reform.” But Calpers argues that the pensions it administers cannot be reduced for current workers or retirees — only for workers hired in the future, and Stockton is bankrupt today.

“If the city believes that third parties misrepresented the risks of the pension obligation bonds transaction, the city should seek recourse against the persons or firms responsible,” Assured Guaranty said in a statement.

This article has been revised to reflect the following correction:

Correction: September 3, 2012

An earlier version of this article gave the wrong time frame for a vote in Fort Lauderdale, Fla., on a $300 million pension obligation bond. The vote is set for Wednesday, not next week.