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Metropolitan Transportation Authority

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**FINANCE AND BUDGET COMMITTEE
OCTOBER 15, 2008**

SUBJECT: AMERICAN INTERNATIONAL GROUP (AIG)

**ACTION: APPROVE UPDATED DEFEASED LEASE POLICY AND RELATED
ACTIONS**

RECOMMENDATION

- A. Approve the updated Defeased Lease Policy, Attachment A; and,
- B. Authorize the Chief Executive Officer to execute letters to elected and other governmental officials in support of legislative or regulatory actions that would protect our financial interests and those of the public transit industry.

ISSUE

The Board requested an update on financial matters related to our exposure to AIG under the current market conditions. Our primary exposure is in our defeased lease portfolio, lease/leaseback transactions. The proposed changes to the Defeased Lease Policy clarify that the Chief Executive Officer and designated officers have the authority to act to preserve our good standing in these circumstances of immediate concern. The policy has been reformatted so the updates as shown in Attachment B for comparison purposes appear to be extensive.

POLICY IMPLICATIONS

The purpose of the defeased leasing policy is to establish guidelines for the use and on-going management of defeased leases. Due the meltdown of the financial markets, changes in law, and current regulatory actions, it is necessary to update the policy to reflect changes that have occurred since the policy was last updated. The policy updates allow designated staff to act/react to changes under delegated authority because current highly volatile market when it is the best interest of the agency.

OPTIONS

Under current policy, transactions in excess of certain monetary thresholds require Board approval, a 60 day cycle. In the current highly volatile market place, it is not reasonable to expect financial terms to be held static for such a long time. Therefore, the Defeased Lease policy update authorizes designated staff to act/react to changing conditions when it is our best interest.

FINANCIAL IMPACT

Approval of the recommended actions has no financial impact.

BACKGROUND

On September 8, 2008, the federal government announced a “bailout” of AIG, a global diversified financial company, which is suffering from the “subprime meltdown.” On September 15, 2008, AIG’s credit ratings were further downgraded to A2 by Moody’s and A- by Standard & Poor’s, S&P. AIG’s ratings had been downgraded from AAA to A3 and AA- by Moody’s and S&P, respectively, earlier this year.

We deal with AIG and its subsidiary companies, in three areas, property and liability insurance, interest rate swaps and defeased leases.

Defeased leases - AIG is a participant in eight of our ten transactions. The combined value of these leases is nearly \$1 billion. In six of these transactions, they provide credit assurance to the equity investors in the form of guaranteed investment contracts (GICs) and/or letters of credit. Each of these contracts requires that we replace AIG when their credit ratings drop below “AA” within 60 days of the downgrade, by November 14, 2008. Two contracts have an earlier date of October 13, 2008 for providing firm quotes to the investors. Failure to successfully replace these credit facilities on a timely basis constitutes an “event of default” under the deal documents. The penalties for default are substantial and could be in excess of \$100 million.

We are reaching out to the equity investors in these transactions to determine whether alternative resolutions can be reached. Concurrently, efforts are underway to secure the necessary replacement credit items. We are also pursuing options for regulatory and legislative relief at the federal level.

Two major issues of concern to us are: 1) the current lack of acceptable credit providers in the financial market place as a result of the “subprime” problems that have resulted in bank failures/forced mergers and the continuing threat of further downgrades of the remaining institutions; and, 2) the recent announcement that the IRS removed the requirement for investors to use “best efforts” to terminate these transactions in exchange for “amnesty” that preserves a portion of the investors tax benefits in these deals. Elimination of that requirement shifts negotiating leverage to the private sector investors to our disadvantage.

It is estimated that the major transit agencies across the country executed over \$30 billion of these transactions up to 2003 when Congress specifically outlawed further transactions. AIG was a major player in this market and is involved in a substantial percentage of these transactions.

We executed a total of ten defeased lease transactions through 2003 and earned \$65 million for our participation. The remaining two deals have similar terms with exposures to other credit providers who appear to be stable for now.

Insurance – AIG participates in our liability insurance, covering the first \$50 million above our self-insured retention of \$4.5 million and covers \$25 million of our property. AIG's insurance ratings remain strong.

Interest rate swaps – AIG is the counterparty in two swap transactions with a nominal value of \$230 million. Under these two swaps, we would have to pay AIG approximately \$40 million based on current market conditions if they were terminated. Only an AIG bankruptcy can trigger the terminations. Based on the federal bailout, this situation appears to be stable.


NEXT STEPS

- Continue to seek replacement credit facilities
- Continue outreach to equity investors
- Pursue regulatory and legislative relief

ATTACHMENTS

- A. Updated Defeased Lease Policy
- B. Updated Defeased Lease Policy marked to show changes

Prepared by: Michael J. Smith
Assistant Treasurer



Terry Matsumoto
Chief Financial Services Officer and Treasurer



Roger Snoble
Chief Executive Officer

DEFEASED LEASE POLICY

OCTOBER 2008

I. Introduction

The purpose of the defeased leasing policy is to establish guidelines for the use and on-going management of defeased leases.

From January 1997 through July 2003, we entered into a number of leveraged lease agreements including “lease/leaseback” agreements for heavy rail vehicles, buses, light rail vehicles, and various real property operating facilities. Under these agreements, we entered into a head-lease as lessor with an investor and simultaneously into a sublease agreement as lessee to lease the heavy rail vehicles back. We received upfront rent prepayments that we invested in fixed income deposits in an amount that, including interest income, will be sufficient to fund all scheduled payments through exercise of the early buyout option. We have realized \$64.7 million in net benefit after funding of defeasance investments and payment of \$13.2 million of transaction expenses.

For the above transactions, we were obligated to insure and maintain the facilities, buses and rail cars. The Lease Agreements provided for our right to continue to use and control the facilities, buses, and rail cars during the term of the sublease. We agreed to indemnify the investors against increased costs, and any new or increased taxes or fees imposed on the leased assets, and cash flows or income of the lease, other than changes to the income tax rate. We also agreed to maintain certain investment vehicles and credit facilities and replace them or provide replacement credit enhancement upon their credit rating downgrade below specified levels.

II. Scope and Authority

This Defeased Lease Policy shall govern the execution and management of defeased leases entered into with institutional investors. The scope of this Policy is limited to defeased leases on our assets and excludes any funded leases that are otherwise covered under our Debt Policy. The assets include rolling stock, buses, maintenance facilities, train control systems, rail stations and rights of way.

While adherence to this Policy is required in applicable circumstances, we recognize that changes in tax laws, the capital markets, agency programs, and other unforeseen circumstances may from time to time produce situations that are not covered by the Defeased Lease Policy and will require modifications or exceptions to achieve policy goals. In these cases,

management flexibility is appropriate provided specific authorization from the Board is obtained or is authorized in this policy. The Chief Executive Officer, the Chief Financial Services Officer, the Treasurer and Assistant Treasurer, each, an “Authorized Signatory,” are each individually authorized to take all reasonable actions necessary to administer the defeased leases on an ongoing basis, including such actions as amending terms and pricing, as well as terminating and replacing credit facilities, agreements, leases and other related documents when in the reasonable judgment of an Authorized Signatory such action will be beneficial to us and consistent with the original Board approved objectives for entering into the initial defeased lease transaction, “Administrative Actions.”

The Chief Executive Officer, the Chief Financial Services Officer and Treasurer are the designated administrators of the Defeased Lease Policy. The Treasurer shall have the day-to-day responsibility and authority for managing existing defeased lease transactions.

The Board shall approve any transaction involving a defeased lease, other than transactions involving Administrative Actions. We shall be authorized to enter into defeased lease transactions provided that after analysis it has been determined that there is sufficient benefit to compensate for the risk of the transaction. The proposed benefit to us will be presented to the Board at the time of each transaction. Each Authorized Signatory is individually authorized to make appropriate modifications so long as the criteria set forth in the Defeased Lease Policy are met.

III. Managing Defeased Leases

1. Optional Termination

In consultation with our counsel, financial advisor and/or lease advisor, we may terminate a lease if it is determined that it is financially advantageous, or will further other policy objectives, such as management of exposure to related parties.

2. Mandatory Termination

In the event a lease or component of the lease transaction is terminated as a result of a termination event, such as a change in law, default or a decrease in credit rating of either a counterparty or us, we will evaluate whether it is financially advantageous to obtain a replacement lease or component, or, negotiate with other parties to the transaction to keep the lease in effect. If we are unable to replace or amend the lease or it is otherwise economically advantageous to terminate the lease, we will make required termination payments.

3. Credit Support and Related Matters

In the event a credit support provider or investment provider is no longer acceptable pursuant to the documents related to a defeased lease transaction, we shall attempt to obtain an acceptable replacement or obtain a waiver from relevant parties, in consultation with our counsel and advisors.

IV. On-Going Administration

We will comply with all covenants and reporting requirements, including monitoring the financial condition and ratings of counterparties and provide the certificates and information as required under the terms of the defeased leases.

GLOSSARY OF TERMS

1. Defeased Lease-A lease in which the Lessee's, in this case, our rental obligations and purchase option payment are fully provided for at closing. We effectively prepay all of our obligations, including the exercise of the purchase option under the Sublease (as defined below).
2. Types of Defeased Leases:
 - a) Sale-Leaseback-A lease in which the Lessee sells the asset to the Trust which in turn leases it back to the Lessee with a repurchase right.
 - b) Lease-Leaseback – A lease in which the Lessee leases the asset to the Trust which in turn leases it back to the Lessee.
 - c) Cross-border Lease-A defeased lease to a U.S. based Lessee from a foreign based equity investor.
3. QTE- An asset that is classified as “Qualified Technological Equipment” under Section 168(i)(2) of the Internal Revenue Code. QTE assets may be depreciated on a straight-line basis over a five-year recovery period, thus providing enhanced tax benefits in a U.S. lease financing.
4. Trust-a special purpose entity that is created to hold title to or a leasehold interest in property for the benefit of an equity investor who is also known as the beneficiary. In a defeased lease, a trust is established for the benefit of the Equity Investor to receive the monies used to fund the transaction and administer the various transfers of funds that occur over the term of the lease. The Trust functions as the Lessor in a defeased lease transaction.

5. Equity Investor-A financial institution or corporation who, as a taxable entity, receives a combination of tax benefits and cash in return for its investment in a defeased lease transaction.
6. Cash Benefit-The net cash flow received by us for our participation in a defeased lease transaction.
7. Broken Deal-A transaction that fails to proceed once a term sheet has been signed and the Lessee has paid out on transaction expenses.
8. Head Lease-The lease from us to the Trust. A Head Lease is used instead of a sale. The Head Lease qualifies as a sale for federal income tax purposes.
9. Sublease-The lease from the Trust back to us.

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II. Scope and Authority

This Defeased Lease Policy shall govern the execution and management of defeased leases entered into with institutional investors. The scope of this Policy is limited to defeased leases on our assets and excludes any funded leases that are otherwise covered under our Debt Policy. The assets include rolling stock, buses, maintenance facilities, train control systems, rail stations and rights of way.

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RESPONSIBILITIES ¶

¶ The MTA Defeased Leasing Program will be administered through the Office of the CEO, New Business Development Department, with coordination and participation from MTA Finance and other MTA departments as required.¶

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Implementation of a defeased lease transaction of any MTA asset shall not compromise existing or planned transportation uses or other functions of those MTA assets.

