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TOXICS AND PUBLIC SAFETY MANAGEMENT
TRANSPORTATION

December 10, 1994

The Honorable Bill Lockyer, President Pro Tempore
California Senate
State Capitol, Room 211
Sacramento, California 95814

Dear Bill,

Thank you for letting me serve on the Senate Committee looking into the Orange County financial catastrophe.

As we discussed, this scandal reflects the new importance of finance capital in our economy and politics as described by Kevin Phillips in his book Arrogant Capital.

I agree with the Governor that we should not bail out Orange County, but I disagree with the notion that we've had no hand in this. As the Saturday, December 10, 1994, issue of the Los Angeles Times makes clear, the state has allowed a situation of financial deregulation without oversight to develop over the past decade.

I propose the following outline for a legislative remedy:

1. Strong prohibitions against contributions by financial firms like Merrill, Lynch or their lawyer-lobbyists like Orrick, Herrington & Sutcliff to any local or state officials charged with making public investments.

2. Mandate local oversight committees to monitor the investment instruments used by local governments.

3. Create strict and uniform reporting requirements from the municipal money managers to members of the funds, and from bond houses to the municipal money managers. Specifically, require local governments to send public reports of the investment strategies used (and the types of investments and their relative risks) to all members of the funds (which the state fund already does).

(It should be noted that a Orange County grand jury audit a decade ago called for written policies and procedures, including information on the types of investments, the firms used, dates of maturity, current market value and rates of interest. All of these prudent proposals were ignored.)

4. Repeal or reform the state law which allows local governments to invest in A-rated instead of AAA-rated securities.

5. Prohibit government funds purchasing very-long term (six years or more) investments. A major problem in Orange County was that long-term investments (bonds) were used as collateral for short-term loans, and the high interest rates devalued the long-term investments.

6. Ban the leveraging of investments to purchase other investments, the practice which was the death-knell of the Orange County fund.

The type of leveraging Orange County Treasurer Robert Citron used is called "reverse repurchase agreements" or "reverse repos". What Citron essentially did was buy bonds and use the value of those bonds as collateral to secure loans from investment banks to buy more bonds (or derivatives). When the interest rates increased, the value of the bonds used as collateral fell and the investment banks demanded that Orange County pay money to offset the decreased value of the collateral. Citron had leveraged so much of the fund's assets that only $350 million remained in the investment pool as liquid assets. Citron basically leveraged the $7.5 billion investment pool up to more than $20 billion.

7. Create sharp limits on the percentage of state and local government investment in derivatives. Local money managers should not be allowed to tempt fate by investing a significant portion of their holdings in these high-risk instruments. However, allowing the use of derivatives on an extremely limited basis when interest rates are low might be advantageous.

8. Finally, we may want to include a provision that prohibits state government from loaning money to, or guaranteeing the bonds of, Orange County or other local governments which have pursued such practices. This will effectively discourage other county treasurers from gambling with public money in the belief that the state will bail them out.

This is an initial legislative framework. It can be modified as new information develops. But its principles are clear:

--NO SPECIAL INTEREST INFLUENCE. Public funds should be invested in the public interest, free from the corrupting influence of special interest bond firms and their lobbyist-lawyers.

--GREATER ACCOUNTABILITY. Investment decisions should be subject to the checks and balances of public review, not made by shrouded czars shielded from accountability.

--DISCLOSURE. The stakeholders have a right to receive complete information about all such investments instead of trusting their resources to the whims of self-styled experts.

--FISCAL PRUDENCE. There is no justification for the gambling of public funds as if the economy is a giant casino.

Thank you for your prompt leadership in addressing the Orange County issue. I think it is essential to hold several investigatory hearings into the root causes of his crisis and have assigned an attorney from my staff, Stephanie Rubin, to work full-time on this critical matter.

Sincerely,

Tom Hayden

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