

TO: Senator Lockyer
Tricia
FROM: Collin
DATE: 12/13/94
RE: Orange County Overview

**A BASIC GUIDE TO UNDERSTANDING
ORANGE COUNTY'S INVESTMENT LOSSES**

OVERVIEW:

Orange County's Treasurer and Tax Collector, Robert Citron, with the approval of the Orange County Board of Supervisors, had leveraged the county's investment pool of \$7.5 billion, raising its value to more than \$20 billion. This was accomplished primarily by using short-term loans, backed by the pool's securities, to purchase additional long-term bonds that at the time were paying higher rates of interest. Citron's speculative investment strategy (which depended on interest rates remaining stagnant or decreasing) collapsed when the Federal Reserve began raising interest rates to control inflation. This collapse occurred because:

- 1) when interest rates increase; the value of bonds decrease. Consequently, concerned creditors required the investment fund to produce more collateral to back its loans;
 - 2) interest rates to renew the short-term loans were outpacing the interest earned on the long-term bonds.
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LEXICON (with practical applications):

bond rating - assessment of the likelihood of a bond issuer going into default. Ratings range from the top, AAA, where default is highly unlikely, to D, where default is very likely. Anything rated B or below is not considered investment grade, and some institutional investors are prohibited from purchasing these securities.

Chapter 9 - Section of the U.S. Bankruptcy Code that governs municipal bankruptcies (as opposed to Chapter 11, dealing with corporate bankruptcies).

The filing of Chapter 9 on December 6th, was intended to prevent the selling of securities, owned by the county's fund, but pledged to the firms as collateral against loans they had extended to the fund. The goal was to prevent paper losses from becoming realized losses (only occurring when the securities are actually sold).

derivatives - Investment contracts that derive their value from an underlying stock or index linked to such things as interest rates, commodities, or foreign currencies.

inverse floaters - Securities that lose value as interest rates

go up and gain value as rates go down.

reverse repurchase agreements (or "reverse-repos") - Funds are used to purchase securities; these securities are used as collateral on loans; funds from these loans are used to purchase more securities; etc. Reverse-repos are dependent on interest rates on the loan remaining lower than the yield on the security.
EXAMPLE:

(1) The mythical county of Deep Water purchases a \$100 million dollar security which yields 6%;

(2) This security is then pledged to an investment bank as collateral for a \$100 million loan;

(3) This loan is subsequently used to purchase another \$100 million security which yields 6%;

(4) Assuming the investor is being charged for the loan at a rate of 4%, then the yield on his \$100 million - - -originally only 6% - - - is now 8%: $6\% + 6\% - 4\%$.

Government Code Sections 53601(i) and 53635(i) authorize local entities to invest in reverse repos.

MAGNITUDE OF ORANGE COUNTY'S INVESTMENT LOSSES:

Value of Investment Portfolio:	\$7.5 billion*
Percent Loss	27%**
Paper Losses	\$2.02 billion**
Portion of Portfolio Leveraged:	2/3rds

Note: Approximately \$2.5 billion are due creditors.
County Treasurer and Tax Collector: Robert L. Citron (resigned on December 4th)

* This portfolio had been leveraged up to \$20 billion.

** With every 1% increase in interest rates, the fund will lose another \$300 million in value..

PUBLIC AGENCIES AFFECTED BY THE INVESTMENT LOSSES: (180 public agencies total)

<u>ORANGE COUNTY POOL INVESTORS (as of 11/30):</u>	AMOUNT (in millions)
County of Orange	\$2,760.5
Orange County Transportation Authority	1,092.9
Orange County Sanitation District	441.0
Transportation Corridor Agencies	341.8
Orange County Employee Retirement System	133.4
School Districts, 60 total, including:	1,048.0

Irvine Unified S.D.	107.8
N. Orange County Community College	98.7
Newport-Mesa Unified	82.4
Capistrano Unified	75.0
Saddleback Unified	62.6
Orange County Dept. Of Education	47.7
Cities, 37 total, including:	1,043.0
Irvine	198.1
Anaheim	169.6
Santa Ana	150.8
Huntington Beach	48.6
Montebello	47.1
Water districts, 11 total, including:	516.2
Irvine Ranch	300.9
Orange County	118.4
Moulton Niguel	47.2
Santa Margarita	13.7
Aliso Water Management	13.1
Other districts and agencies, total	40.7

CURRENT OVERSIGHT:

o According to Barbara Coates, President of State Association of County Treasurers, "With the exception of three appointed county treasurers who answer directly to their boards of supervisors (Los Angeles, Sacramento, and Santa Clara) all elected county treasurers in California operate independently."

o Government Code Sections 53601 and 53605 provide the only state guidelines/constraints for local government investing.

CURRENT INVESTIGATIONS:

o Securities and Exchange Commission

The SEC has initiated a two-prong investigation of the Orange County crisis, focusing on whether the county failed to meet its obligations as a public bond issuer and whether its treasurer violated securities laws.

- Issuers of municipal bonds are required by the SEC to disclose pertinent information to potential investors such as whether their activities would include derivatives. In June and July, 1994, Orange County issued one-year taxable notes to borrow about \$900 million to place in the county's investment fund. Investors were not notified that this money would be used to hold derivative positions.

- Robert Citron allegedly, via memorandum, told fund participants that he had a plan to protect the fund should interest rates rise. SEC officials are now investigating whether this statement constitutes fraud.

o United States Attorney General

Sources at the U.S. Attorney's office said they had begun an investigation into the Orange County investment fund that would focus on whether Citron has used the mails or wires to defraud investors.

- o Chicago Board of Trade
- o California State Attorney General
- o ???

MISCELLANEOUS:

o The Los Angeles-based law firm of Stutman, Treister & Glatt will represent Orange County in federal bankruptcy proceedings as special reorganization counsel.

o Orange County named Tom Daxon, former state auditor of Oklahoma, to step in as temporary treasurer-tax collector. He will serve until January.

o State and Local education officials made an agreement with the county to keep all school funds in an account separate from the ailing county treasury.

o Orange County is not alone in its investment losses:

SAN DIEGO COUNTY

Value of Investment Portfolio:	\$3.3 billion
Percent Loss	10.7%
Paper Losses	\$357.6 million
Portion of Portfolio Leveraged:	none

Note: Barring any further losses, San Diego's portfolio is estimated to earn 4.6% in 1994. This is down from 5.7% prior to the aforementioned losses.

County Treasurer and Tax Collector: Paul Boland