CALIFORNIA LEGISLATURE

Senate

STATE CAPITOL
SACRAMENTO, CALIFORNIA
95814

Background Paper

for the

Hearing of the

Senate Special Committee

on

Local Government Investments

Monday, December 19, 1994

1:00 P.M.

ROOM 4203, STATE CAPITOL BUILDING

Senate Special Committee on Local Government Investments

Membership

Senator William A. Craven, co-chair

Senator Lucy Killea, co-chair

Senator Daniel Boatwright

Senator Tom Hayden

Senator Teresa Hughes

Senator Rob Hurtt

Senator Quentin L. Kopp

Senator John R. Lewis

Senator Cathie Wright

Public and Private Sector Members

Eli Broad
Chairman and CEO
Sun American, Inc.

James Burton
Chief Executive Officer, PERS

Douglas Charchenko
Senior Vice President
Kidder, Peabody

James Mosman
Chief Executive Officer, STRS

Peter Slusser
President
Slusser Associates, Inc.

Table of Contents

THE ORANGE COUNTY BANKRUPTCY

THE ORANGE COUNTY BANKRUPTCY

Overview

As widely reported, a fund managed by the Orange County Treasurer has suffered losses now estimated at $2.02 billion. The present estimated loss is 27% of the amount local agencies had invested in the fund. The total loss may prove to be somewhat larger than the current estimate. In particular, if interest rates increase further, fund losses will go up (the county estimates that fund value will decline about $300 million for a one percent increase in interest rates).

The fund consisted of about $7.5 billion in surplus cash and borrowed funds of Orange County and 186 other California public agencies. In addition, money borrowed by fund managers for reinvestment increased the total value of the fund to about $20 billion, until recently.

Facing an immediate cash crisis, the County has filed for bankruptcy under Chapter 9 of the Federal Bankruptcy Code. Some observations:

o The event was described by the Los Angeles Times as "the biggest municipal financial collapse in history...".

o A list of the over 180 public agencies with money in the Orange County fund is attached. The agencies are mostly in Orange County. Large investors include Orange County ($2.76 billion), Orange County Transportation Authority ($1.1 billion), 60 school districts ($1 billion), 37 cities ($1 billion), 11 water districts ($.5 billion). Agencies outside Orange County, including Atascadero, Mountain View, Milpitas, some Los Angeles County school districts, Montebello, Santa Barbara, Claremont, and other public agencies throughout California have money in the fund.

o The practical short term effect of the bankruptcy filing was to prevent mass, immediate withdrawals from the fund (which would have led to losses being disproportionately born by whomever was last out).

In the short run, the county and bankruptcy court are allowing local agency investors to withdraw money they need for "critical needs", as long as withdrawals do not exceed 30% of each agency's deposit. Interestingly, money needed to pay debt service on bonds is not defined as a "critical need."

o The County Treasurer-Tax Collector, Robert L. Citron, resigned December 5 after 24 years in office.

The Troubled Investments

Orange County's losses stemmed mostly from the county's aggressive use of "reverse repurchase agreements" (a.k.a. "reverse-repo's"). In short, the county used its funds to buy securities, used the securities as collateral to borrow more money, used that money to buy still more securities, etc. The fund had about $7.5 billion of public money invested in it, and reportedly borrowed an additional $12 billion through the reverse repurchase mechanism. When interest rates rose, the market value of the entire string of securities dropped. That's a big part of the problem.

The county also reportedly lost money on its investments in so-called "derivatives" or "structured notes." These terms include a wide variety of securities. Reportedly, Orange County invested heavily in "inverse floaters", which are securities where the interest paid goes down as market interest rates go up, and vice versa. The county apparently gambled that interest rates would go down, in which case this would have been an attractive investment. Unfortunately, they went up. The effect was to magnify the capital losses described in the preceding paragraph.

Local agency investment in reverse repurchase agreements is explicitly authorized in state law (although the practice must be authorized by the Board of Supervisors). State law does not appear to recognize the possibility of derivatives, but does not prohibit investment using them.

Orange County was assisted in its investment strategies by Merrill Lynch & Co., Morgan Stanley & Co., CS First Boston Corp., Nomura Securities, and perhaps other firms. There is speculation that these firms may be in some degree liable for part of the losses. Merrill reportedly earned $80 million from its dealings with the Orange County fund.

What Orange County Has Done Since

Since these losses became public, several major steps have occurred:

oThe county filed for bankruptcy under Chapter 9.

oSeveral securities firms which were holding Orange County securities under reverse repurchase agreements sold those securities, totaling about $11 billion. There is debate about whether they were entitled to sell the securities (the county felt the bankruptcy filing should have stopped the sales), and about whether they unnecessarily sold them at a large discount under fire sale conditions.

oThe county hired Thomas Hayes and Salomon Bros. to help straighten things out.

oThe county sold about $1 billion of its remaining securities on December 15 and 16, in part to raise cash to disburse to local agencies.

oAround 60% of the county's remaining securities are "structured notes" which are expected to be more difficult to sell and which expose the county to high risk of further loss if interest rates increase.

LEGISLATIVE HISTORY

Local Agency Investments

For over 60 years, state law has directed county treasurers where they can deposit and how they can invest temporarily idle cash or surplus funds not required for the immediate necessities of any local agency within the county. County treasurers can deposit funds in banks, savings and loans, credit unions, and industrial loan companies. In addition, county treasurers can put funds in 13 different types of investments (Government Code §53601 and §53635).

Orange County's investment problems reportedly came from combining two types of these investments:

Reverse repurchase agreements. AB 346 (Wray) Chapter 275, Statutes of 1979, authorized county treasurers to invest in reverse repurchase agreements. But a county treasurer must obtain approval from the county board of supervisors before investing in a reverse repurchase agreement (§53635 [i]).

Collateralized mortgages. AB 3576 (Umberg) Chapter 173, Statutes of 1992, authorized county treasurers to invest up to 20% of their portfolios in several forms of collateralized mortgage instruments, but the securities must be highly rated (§53635 [m]).

Since 1979, the Legislature has authorized a variety of instruments in which county treasurers may invest temporarily idle cash or surplus funds, as follows:

SB 285 (Beverly) Chapter 275, Statutes of 1979, required that negotiable certificates of deposit be issued by, rather than purchased from, a nationally or state-chartered bank or a state or federal savings and loan association. This bill also lowered the population threshold for local agencies eligible to invest in negotiable certificates of deposit from 250,000 to 100,000.

AB 346 (Wray) Chapter 275, Statutes of 1979, expressly authorized local agencies to purchase or sell securities under repurchase agreements or reverse repurchase agreements. This bill also authorized the State Treasurer to refuse to accept deposits into the Local Agency Investment Fund if it would adversely affect the state's portfolio. In addition, this bill made changes to conform with SB 285 (Beverly).

SB 1151 (Beverly) Chapter 185, Statutes of 1981, expanded the the types of investments that a local agency may make with surplus funds to include guaranteed portions of Small Business Administration loans. This bill also lowered the population threshold for local agencies eligible to invest in negotiable certificates of deposit from 100,000 to 50,000. In addition, this bill authorized the investment of state surplus funds in negotiable certificates of deposit issued by a state-licensed branch of a foreign bank.

AB 580 (Bane) Chapter 594, Statutes of 1981, authorized the Southern California Rapid Transit District and the San Diego Transit Corporation to purchase or sell futures contracts in heating oil on the New York Mercantile Exchange.

AB 3211 (Cortese) Chapter 508, Statutes of 1982, deleted the population threshold for local agencies eligible to invest in commercial paper and certificates of deposit. This bill also increased the proportion of a local agency's surplus funds that may be invested in certificates of deposit. In addition, this bill authorized a city retirement board, if there is one, or the city treasurer with the approval of the city council, to enter into certain security loan agreements with private broker-dealers and banks.

AB 695 (Cortese) Chapter 550, Statutes of 1983, increased the amount of a local agency's money that may be invested in commercial paper from 15% to 30% if the dollar-weighted average maturity of the entire amount so invested does not exceed 31 days. [Note: The dollar-weighted maturity is a method by which an assessment can be made relating to the risk of the investment.] This bill also authorized a local agency to invest in time certificates of deposit and permitted these certificates of deposits and negotiable certificates of deposit to be issued by a state-licensed branch of a foreign bank. In addition, this bill specified that these investments were subject to certain limitations. This bill also required that securities for the purpose of repurchase under a repurchase agreement be securities of the same issuer, description, issue date, and maturity. This bill was double-joined with AB 323 (Robinson).

AB 323 (Robinson) Chapter 567, Statutes of 1983, increased the amount of a local agency's surplus funds which could be invested in bankers acceptances from 30% to 40%. This bill was double-joined with AB 695 (Cortese).

AB 628 (McAlister) Chapter 659, Statutes of 1984, revised various provisions relating to the deposit or investment of local agencies' surplus funds in federal or state credit unions or in instruments issued by federal or state credit unions (e.g., negotiable certificates of deposit). These provisions became operative upon the enactment of a constitutional amendment authorizing the Legislature to provide for the deposit of public moneys in any federal or state credit union in California. This bill also contained provisions relating to share issuances by a credit union.

SB 2095 (Lockyer) Chapter 741, Statutes of 1984, authorized local agencies to invest in certain mortgage securities. The changes in this bill sunseted January 1, 1988.

AB 215 (Bane) Chapter 983, Statutes of 1985, in addition to revising provisions under the Savings Association Law, specified that the limitation on the amount of public which may be on deposit at any one time in savings accounts of associations and federal associations does not apply to negotiable certificates of deposit. This bill was double-joined with SB 115 (Marks).

SB 115 (Marks) Chapter 1526, Statutes of 1985, restricted the purposes for which local agency funds could be invested in a reverse repurchase agreement, and permitted funds to be invested in such an agreement only upon prior approval of the legislative body of the local agency and only for a term up to one year. This bill also required the inclusion of certain information in the monthly investment report prepared by the local agency treasurer or chief fiscal officer (i.e., information demonstrating that the local agency's expenditure requirements can be met in the following month).

AB 2595 (Robinson) Chapter 784, Statutes of 1986, expanded the types of securities and obligations in which a local agency could invest its surplus funds or funds in its custody to include medium-term corporate notes and shares of beneficial interest meeting certain conditions and issued by certain diversified management companies. This bill also provided that, notwithstanding any other provision of law, moneys held by a trustee or fiscal agent and pledged to the payment or security of bonds or other instruments may be invested in accordance with the laws and other conditions providing for their issuance. In addition, this bill required that money in the custody of a local agency be deposited in savings associations or federal associations or credit unions instead of state or federal associations, and permitted investment in negotiable certificates of deposit issued by a savings association or federal association or a state or federal credit union under certain conditions, instead of negotiable certificates of deposit issued by a state or federal association. This bill was double-joined with SB 2115 (Bergeson).

SB 2115 (Bergeson) Chapter 853, Statutes of 1986, revised the definition of repurchase agreement to provide that the transfer of underlying securities to the counterparty bank's customer book-entry account may be used for book-entry delivery and that a counterparty bank's trust department or safekeeping department may also be used for the physical delivery of the underlying security. This bill also deleted state associations from the list of entities for the deposit of local agency funds for safekeeping and added savings associations and credit unions to this list. This bill was double-joined with AB 2595 (Robinson).

SB 962 (Bergeson) Chapter 446, Statutes of 1987, added to the list of securities in which a local agency could invest its surplus funds notes, bonds, or other obligations which are at all times secured by a valid first priority interest in certain securities. This bill also specified that the securities serving as collateral must be placed by delivery or book entry into the custody of a trust company or the trust department of a bank which is not affiliated with the issuer of the secured interest, and the security interest must be perfected in accordance with requirements of the Uniform Commercial Code or applicable federal regulations. In addition, this bill revised the provisions relating to medium-term corporate notes to permit investment in these notes of a maximum of 5 years maturity issued by corporations organized and operating within the United States or by depository institutions operating within the United States which are rated "A" or better. Furthermore, this bill increased the amount of the local agency's surplus funds which may be used for purchases of medium-term corporate notes from 15% to 30%.

AB 1615 (Sher) Chapter 887, Statutes of 1987, revised the definition of local agency to include community college districts for the purpose of investing surplus funds. This bill also made corrective and clarifying changes in provisions which authorize investments of local agency funds in defined diversified management companies. This bill was double-joined with SB 962 (Bergeson).

SB 1883 (Beverly) Chapter 294, Statutes of 1988, revised the collateral requirements for local agency surplus cash deposits by deleting the prohibition against the use of mortgage loans with negative amortization features as collateral. This bill also provided that mortgages with negative amortization features may be used as collateral, provided any note secured by a mortgage allowing for negative amortization must be removed from the securities pool and and replaced with another eligible security whenever the loan-to-value ratio on the mortgage exceeds 85% of the original appraised value of the underlying property. In addition, this bill required the removal and replacement in the securities pool of any mortgages on which payment is more than 60 days, rather than 90 days, past due. [Note: This requirement would apply to all mortgages used as collateral for local agency deposits, not simply those with a negative amortization feature.] Furthermore, this bill repealed, as of January 1, 1994, the grandfather provisions for mortgages placed in a securities pool before December 31, 1986.

AB 4089 (Johnston) Chapter 491, Statutes of 1988, specified the limit on the term remaining to maturity of a security to 5 years unless otherwise specified.

AB 3752 (Johnston) Chapter 1004, Statutes of 1988, authorized the deposit of public moneys in federally insured industrial loan companies (i.e., a licensed industrial loan company, the investment certificates of which are insured by the

Federal Deposit Insurance Corporation), contingent on the adoption of ACA 63 which would permit the Legislature to provide for the deposit of public moneys in insured industrial companies.

AB 3576 (Umberg) Chapter 173, Statutes of 1992, expanded the list of eligible instruments in which a local agency may invest surplus funds to include any mortgage pass-through security, any collateralized mortgage obligation, any mortgage-backed or other pay-through bond, any equipment lease-backed certificate, any consumer receivable pass-through certificate, and any consumer receivable-backed bond of a maximum of five years maturity. This bill also specified that only securities that are rated "AA" or better or issued by an issuer having an "A" rating or higher for the issuer's debt are eligible for investment. Additionally, this bill limited the purchase of securities to 20% of the local agency's surplus money that may be invested.

Local Investment Reports

State law used to require regular reports by local treasurers about the funds they held on deposit. Those formerly state mandated reports are now optional.

SB 133 (Breed) Chapter 189, Statutes of 1933, required local treasurers to issue quarterly interest reports to local agencies that had money on deposit.

SB 765 (Cunningham) Chapter 81, Statutes of 1949, recodified the 1933 law as Government Code §53646.

SB 389 (Beverly) Chapter 105, Statutes of 1983, required the treasurer to issue quarterly reports only when the local agency asked for them.

AB 1073 (Cortese) Chapter 1226, Statutes of 1984, imposed a new state mandate after the City of San Jose lost substantial investments. The Legislature required treasurers to report more often to local officials about their investments. The bill mandated:

- An annual statement of the treasurer's investment policy.
- A monthly report on the type of investment, institution, maturity date, amount of deposit, and current market value, and other information the local agency asked for. The report must also state its relationship to the treasurer's statement of investment policy.
- A detailed monthly report if repurchase agreements or reverse repurchase agreements were involved.

The bill also contained a "sunset clause," automatically returning the law to its 1983 form on January 1, 1991, unless the Legislature extended the new state mandate.

SB 115 (Marks) Chapter 1526, Statutes of 1985, required the monthly reports to also include information demonstrating that the local agency's expenditure requirements can be met in the following month.

From 1985-86 to 1989-90, local agencies received $7,787,734 from the State General Fund to reimburse the costs of preparing state mandated investment reports.

The 1990-91 State Budget, Chapter 467, Statutes of 1990, suspended the 1984 state mandated investment reports during 1990-91 (Budget Item 8885-101-001, Provision 5 [q]).

On January 1, 1991, the law returned to its 1983 form (see SB 389, above) when the automatic "sunset clause" in the 1984 operated. Although an earlier version of AB 2771 (Cortese) Chapter 1112, Statutes of 1990, had proposed to delete the sunset clause and thereby making the mandated reports permanent, the author subsequently amended that provision out of his bill.

The 1991-92 State Budget, Chapter 118, Statutes of 1991, suspended the 1984 state mandated investment reports during 1991-92, even though the sunset clause had operated and the mandate ended on January 1, 1991 (Budget Item 8885-101-001, Provision 4 [n]).

The 1992-93 State Budget, Chapter 587, Statutes of 1992, suspended the 1984 state mandated investment reports during 1992-93, even though the sunset clause had operated and the mandate ended on January 1, 1991 (Budget Item 8885-101-001, Provision 4 [n]).

The 1993-94 State Budget, Chapter 55, Statutes of 1993, suspended the 1984 state mandated investment reports during 1993-94, even though the sunset clause had operated and the mandate ended on January 1, 1991 (Budget Item 8885-101-001, Provision 4 [n]).

SB 443 (Committee on Budget and Fiscal Review) Chapter 59, Statutes of 1993, proposed by the State Department of Finance, made the requirement for quarterly interest reports permissive, even if the local agency asked for them.

ORANGE COUNTY INVESTMENT POOL PARTICIPANTS

INVESTMENT POOLS
SUMMARY SCHEDULES
AS OF NOVEMBER 30, 1994

ID NUMBER	ENTITY NAME	COMMINGLED POOL	BOND POOL	COMMINGLED %	BOND %	TOTAL %
100	COUNTY OF ORANGE	2,555,620,144.87	204,659,991.48	41.56%	16.14%	37.21%
200	TRANSP. CORR. AGENCIES	45,469,591.93	296,294,198.03	0.74%	23.37%	4.61%
300	OCERS	133,368,133.21		2.17%	0.00%	1.80%
400	OCTA	533,214,927.34	559,733,372.30	8.67%	44.15%	14.73%
	SCHOOL DISTRICTS:					
	ANAHEIM ELEMENTARY	8,195,095.54		0.13%		0.11%
	BUENA PARK ELEMENTARY	4,372,802.89		0.07%		0.06%
	CENTRALIA ELEMENTARY	8,761,430.65		0.14%		0.12%
	CYPRESS ELEMENTARY	6,781,765.21		0.11%		0.09%
	FOUNTAIN VALLEY ELEMENTARY	5,652,274.37		0.09%		0.08%
	FULLERTON ELEMENTARY	5,135,976.87		0.08%		0.07%
	HUNTINGTON BEACH CITY/ELEM.	6,984,640.68		0.11%		0.09%
	LA HABRA ELEMENTARY	13,198,570.42		0.21%		0.18%
	LOWELL JOINT ELEMENTARY	224,115.13		0.00%		0.00%
	MAGNOLIA	5,709,823.30		0.09%		0.08%
	OCEAN VIEW ELEMENTARY	9,028,919.38		0.15%		0.12%
	SAVANNA	3,502,369.38		0.06%		0.05%
	WESTMINSTER	13,545,625.38		0.22%		0.18%
	ANAHEIM UNION HIGH	19,393,555.70		0.32%		0.26%
	FULLERTON HIGH	26,080,903.91		0.42%		0.35%
	HUNTINGTON BEACH HIGH	22,576,957.13		0.37%		0.30%
	BREA-OLINDA	7,490,680.57		0.12%		0.10%
	CAPISTRANO UNIFIED	74,977,478.92		1.22%		1.01%
	GARDEN GROVE USD	55,533,788.92		0.90%		0.75%
	IRVINE USD	105,816,239.05	1,981,245.96	1.72%	0.15%	1.45%
	LAGUNA BEACH UNIFIED	7,186,107.00		0.12%		0.10%
	LOS ALAMITOS UNIFIED	12,526,409.33		0.20%		0.17%
	NEWPORT-MESA UNIFIED	82,402,832.16		1.34%		1.11%
	ORANGE UNIFIED	18,067,197.12		0.29%		0.24%
	PLACENTIA UNIFIED	32,404,654.52		0.53%		0.44%
	SADDLEBACK VALLEY UNIFIED	62,628,980.07		1.02%		0.84%
	SANTA ANA UNIFIED	47,507,181.16		0.77%		0.64%
	TUSTIN UNIFIED	12,604,285.51		0.20%		0.17%
	COAST COMM. COLLEGE	21,706,393.84	2,555,730.02	0.35%	0.20%	0.33%
	NORTH O.C. COMM. COLL.	98,940,282.45		1.61%		1.33%
	RANCHO SANTIAGO	16,762,391.38		0.27%		0.23%
	SADDLEBACK COMM. COLLEGE	23,532,257.25		0.38%		0.32%
	ORANGE COUNTY DEPT. OF ED.	47,725,879.97		0.78%		0.64%
	SAN JOAQUIN ELEM.	1,548.82		0.00%		0.00%
	YORBA LINDA ELEM.	47,460.34		0.00%		0.00%

INVESTMENT POOLS
SUMMARY SCHEDULES
AS OF NOVEMBER 30, 1994

ID NUMBER	ENTITY NAME	COMMINGLED POOL	BOND POOL	COMMINGLED %	BOND %	TOTAL %
	SHANDON USD	178,411.17		0.00%		0.00%
	FOUNDATION TRUST FUND	1,321,071.41		0.02%		0.02%
	CFD #8	7,112,407.27		0.12%		0.10%
	COUNTY SCHOOL SERVICE	21,461,375.56		0.35%		0.29%
	CODESP JPA	262,157.50		0.00%		0.00%
	PROPERTY AND LIABILTY	-198,395.81		0.00%		0.00%
	DEBT SERVICE	2,040,681.15		0.03%		0.03%
	SPECIAL RESERVE	3,929,450.34		0.06%		0.05%
	PUBLIC EMPLOYEE'S RETIREMEN	3,189.06		0.00%		0.00%
	O. C. WORK COMP INS	6,900,645.08		0.11%		0.09%
	GREATER ANAHEIM SP ED GE	1,734,873.35		0.03%		0.02%
	SCHOOLS COMM. REVOLVE	1,911,586.09		0.03%		0.03%
	TEACHER'S RET ANNUITY	7,722,207.34		0.13%		0.10%
	UNAPPORTIONED SCH MONIES	1,366,588.68		0.02%		0.02%
	S.A. INS COMPRE. LIAB.	4,331,209.90		0.07%		0.06%
	CAPO LAGUNA REG OFF PROG	325,934.34		0.01%		0.00%
	PAYROLL REVOLVE-WARR	145,921.06		0.00%		0.00%
	PAYROLL REVOLVE-CHEC	29,764,468.93		0.48%		0.40%
	WEST O.C. SELF FUND WORK	8,949,311.84		0.15%		0.12%
	SO. O.C. PROP/LIA JT PWRS	2,998,753.41		0.05%		0.04%
	O. C. SCHOOL DIST	1,127,253.43		0.02%		0.02%
	O.C. FRINGE BENEFITS	4,959,561.58		0.08%		0.07%
	SCHOOLS EXCESS	47,718,984.82		0.78%		0.64%
	AREA WIDE SCHOOL TAX	67,192.25		0.00%		0.00%
	SCHOOL BLDG AID	30.62		0.00%		0.00%
500	TOTAL SCHOOLS:	1,043,512,338.57	4,516,975.98	16.97%	0.36%	14.13%
800	O.C. SANITATION DISTRICT	391,675,528.69	49,311,044.51	6.37%	3.89%	5.95%
	CITIES:					
	ANAHEIM	169,568,734.31		2.76%		2.29%
	ATASCADERO	5,082,641.04		0.08%		0.07%
	BREA	10,880,402.71		0.18%		0.15%
	BUENA PARK	28,953,542.12		0.47%		0.39%
	CAPISTRANO BEACH	1,759,441.70		0.03%		0.02%
	CLAREMONT	5,377,823.54		0.09%		0.07%
	COSTA MESA	7,149,035.00		0.12%		0.10%
	CYPRESS	5,847,611.30		0.10%		0.08%
	DANA POINT	15,859,985.01		0.26%		0.21%
	FOUNTAIN VALLEY	30,880,845.90		0.50%		0.42%
	FULLERTON	22,795,580.63		0.37%		0.31%

INVESTMENT POOLS
SUMMARY SCHEDULES
AS OF NOVEMBER 30, 1994

ID NUMBER	ENTITY NAME	COMMINGLED POOL	BOND POOL	COMMINGLED %	BOND %	TOTAL %
	GARDEN GROVE	5,451,587.24		0.09%		0.07%
	HUNTINGTON BEACH	48,805,050.26		0.79%		0.66%
	IRVINE	198,098,007.88		3.22%		2.67%
	LA HABRA	8,170,828.52		0.13%		0.11%
	LA PALMA	5,518,778.22		0.09%		0.07%
	LAGUNA BEACH	13,651,675.87		0.22%		0.18%
	LAGUNA NIGUEL	18,089,331.91		0.29%		0.24%
	LAGUNA HILLS	916,934.35		0.01%		0.01%
	LAKE FOREST	9,585,281.82		0.16%		0.13%
	LOS ALAMITOS	2,378,613.73		0.04%		0.03%
	MILPITAS	5,000,000.00		0.08%		0.07%
	MISSION VIEJO	21,657,039.12		0.35%		0.29%
	MONTEBELLO	47,108,000.00		0.77%		0.64%
	MOUNTAIN VIEW	39,783,094.99		0.65%		0.54%
	NEWPORT BEACH	6,095,463.02	13,631,537.16	0.10%	1.08%	0.27%
	ORANGE	28,194,017.90		0.46%		0.38%
	PLACENTIA	20,685,505.00		0.34%		0.28%
	SAN CLEMENTE	35,834,958.04		0.58%		0.48%
	SANTA ANA	56,547,256.87	94,211,999.52	0.92%	7.43%	2.03%
	SANTA BARBARA	27,733,246.39	11,780,015.49	0.45%	0.93%	0.53%
	SEAL BEACH	2,080,644.82		0.03%		0.03%
	STANTON	3,000,000.00		0.05%		0.04%
	TUSTIN	183,570.98		0.00%		0.00%
	VILLA PARK	1,282,297.02		0.02%		0.02%
	WESTMINSTER	99,858.90		0.00%		0.00%
	YORBA LINDA	7,017,099.68	8,487,112.83	0.11%	0.51%	0.18%
700	TOTAL CITIES.	916,903,871.77	128,110,665.00	14.91%	9.95%	14.06%
	WATER DISTRICTS:					
800	IRVINE RANCH WATER DISTRICT	300,905,317.40	0.00	4.89%	0.00%	4.06%
1100	OCWD	118,418,944.24		1.93%		1.60%
	MOULTON NIGUEL	22,158,563.26	25,017,352.35	0.36%	1.97%	0.64%
	SANTA MARGARITA	13,487,868.78	164,898.62	0.22%	0.01%	0.18%
	ALISO WATER MGMT AGENCY	13,150,774.78		0.21%		0.18%
	TRI CITIES	2,428,952.41		0.04%		0.03%
	CAPISTRANO BEACH WATER	2,307,828.65		0.04%		0.03%
	YORBA LINDA WATER	2,645,124.75		0.04%		0.04%
	SCWD	8,833,778.94		0.14%		0.12%
	MUNICIPAL	4,531,304.24		0.07%		0.06%

INVESTMENT POOLS
SUMMARY SCHEDULES
AS OF NOVEMBER 30, 1994

ID NUMBER	ENTITY NAME	COMMINGLED POOL	BOND POOL	COMMINGLED %	BOND %	TOTAL %
	SO. CA. CSTL. WTR. RESEARCH	941,874.01		0.02%		0.01%
	COASTAL MWD	1,232,734.85		0.02%		0.02%
	TOTAL WATER DISTRICTS	491,043,087.12	25,202,250.97	7.98%	1.99%	6.96%
	BANK OF CA - PARS	16,253,042.77		0.26%		0.22%
	ROSSMOOR CSD	711,381.40		0.01%		0.01%
	TREASURER CFD 90-1 INVEST	729,592.82		0.01%		0.01%
	OPTIMA OF ORANGE COUNTY	1,000,000.00		0.02%		0.01%
	CUYAMA CSD	1,186,153.65		0.02%		0.02%
	MADERA CO. SUPERINT. INVEST.	5,496,289.08		0.09%		0.07%
	S.E. REG. RECLAMATION AUTH.	7,312,198.52		0.12%		0.10%
	SOIA INVESTMENTS	1,132,412.88		0.02%		0.02%
	MIDWAY CITY SANITARY	3,977,189.61	2,057,712.34	0.06%	0.16%	0.08%
	SUNSET BEACH SANITARY	805,935.10		0.01%		0.01%
	SOUTH LAGUNA SANITARY	11,471.34		0.00%		0.00%
	DANA POINT SANITARY	31.17		0.00%		0.00%
	VOLUNTEER CTR. OF O.C. WEST	36,745.05		0.00%		0.00%
	CAPO BAY COMM. SVCS.	30,370.78		0.00%		0.00%
SSD	OTHER DISTRICT TOTALS:	38,682,794.15	2,057,712.34	0.63%	0.16%	0.55%
	SUBTOTAL	6,149,490,197.65	1,267,886,210.61	100.00%	100.00%	100.00%
	CHECK TOTALS	6,149,490,197.65	1,267,886,210.61			
	DIFFERENCE	0.00	0.00			

State Oversight Authority

Did the state fail to exercise existing statutory authority with respect to the investment policies of local officials in Orange County and thereby contribute to the financial crisis there?

A preliminary review of current law, supported by an informal opinion by the Legislative Counsels Office, indicates that state officials such as the Treasurer, the Controller, and others have no specific authority to determine the investment policies of county governments. Nor is there specific statutory authority for oversight of local investment policies.

oGovernment Code Sections 53600, et seq, specify that local officials have the power to establish their investment policies within certain guidelines (set forth in Section 53601 and 53635).

oGuidelines in Government Code Sections 53601 and 53635 specifically authorize local investment officers to engage in reverse repurchase agreements, which, based on information available at this time, is the primary source of the difficulties in Orange County.

oThe Treasurer and the Debt Advisory Commission within the Treasurers office (Gov. Code Section 8855) have some specific and general responsibility to work to improve the market for state and local <u>debt</u> issues, but the authority of the State Treasurer does not extend to the oversight of the policies of local investment officers with respect to their investment portfolios.

oGovernment Code Section 53892, et. seq., require county officials to submit to the State Controller specified information concerning liabilities and indebtedness, but statute grants no authority to the Controller to direct the investment policies of county officials. Legislative Counsel notes that the Controller is authorized to conduct certain audits of local government financial activities, but Government Code Section 12464 limits investigations to cases where information submitted is false, incomplete, or incorrect. Legislative Counsel is not certain at this time -- given the unavailability of the details concerning Orange County's difficulties -- how such audits might have been utilized to change Orange County's investment practices.

oThere is no specific statutory authority for the State Attorney General to oversee the investment policies of local treasurers or other investment officers. Action is justified under general constitution and statutory authority only if (1) there is evidence of unlawful activity, and (2) there is a compelling state interest not receiving remedy.

oA further review of existing law reveals no evidence of state authority in this regard other than very general responsibilities of state officials to promote the economic health of the state and to see that the laws of the state are executed.

Current Investigations

FEDERAL

Securities and Exchange Commission

o According to a December 7th Wall Street Journal article, 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 According to a December 16th Los Angeles Times article, the SEC has initiated an investigation into whether investment brokers connected with the county investment pool had paid kickbacks to Orange County elected officials. On December 14th, the SEC issued subpoenas to the five members of the Board of Supervisors demanding that, by December 29th, the supervisors turn over such items as: checking and savings account statements, all documents relating to communications with Merrill Lynch, campaign statements, etc.

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.

STATE

Bureau of State Audits

Governor Pete Wilson on December 12th requested that the state auditor review Orange County's financial situation. A team of auditors arrived in Orange County on Tuesday with orders to review all activities in the investment pool since June 30. According to staff at the Bureau of State Audits, their investigation will focus on the following:

- STATE EXPOSURE (including effects on bond ratings and the state's fiscal responsibility to K-12 schools)
- LOCAL IMPACT (including the condition of the portfolio, the immediate and short-term cash flow needs of the county and the 187 affected public agencies, ability to maintain general operations, and ability to pay debt service.)

LOCAL

Orange County District Attorney

Would not elaborate on the focus of their investigation.

The following government entities were contacted and claimed that no investigations were currently in progress:

Fair Political Practices Commission**
Department of Justice
Office of the State Controller
Office of the State Treasurer

** According FPPC policy, they "could neither confirm nor deny that an investigation had been initiated."

Possible State Implications

oSchool districts in Orange County and perhaps elsewhere have over $1 billion invested in the county fund. If they lose substantial portions of these funds, or if the funds are frozen for some time, the state may be responsible for bailing them out. Knowing that, the county may be tempted to distribute disproportionate losses to the schools.

oSchool districts in Orange County reportedly borrowed $250 million to invest in the county fund. Those loans must be repaid in June or July.

oLosses might interfere with payments on general obligation bonds, tax anticipation notes, redevelopment agency bonds, certificates of participation, and other borrowings of Orange County and other local agencies. Widespread default on California municipal debt, even if temporary, could raise borrowing costs throughout the state for a long time.

oMello-Roos bonds and special assessment bonds are also under tension because of the county's losses, although for a different reason. In this case, the special taxes and assessments to pay bond debt service should be protected. The danger is that the proceeds of bond sales, construction funds, and bond reserve funds may be invested in the county pool. So the bondholders should get paid, but the projects that taxpayers expect may not get built, in the worst case.

oIt is conceivable that other counties or cities in California will reveal similar investment practices and large losses (not as large as Orange Counties, one hopes). The Wall Street Journal identifies San Diego, San Bernardino, Monterey, and Placer Counties as having a high proportion of their funds in reverse repurchase agreements or derivatives.

oThe Orange County Transportation Agency was the largest fund participant, with $1 billion invested. Losses could endanger bus service and a number of construction projects on the state highway system that had been planned. In some cases, the money was to be the local match on a state funded project, and in some cases the money was to pay the full cost of the state highway system project.

The Transportation Corridor Agencies, which is a joint powers authority created to build several toll roads in Orange County, had $342 million in the fund. Its losses could delay the toll roads.

oIt is unknown if state apportionments to local agencies earmarked for health, welfare, or other projects might be in the fund, and partly lost.

oOther of the 180 or so local agencies with money in the fund could face large losses and file for bankruptcy, default on bond payments, or otherwise face financial rigor mortis.

oThe fund included money deposited in settlement of court cases. Some of these may prove to involve accident victims, widows, and others whose plight would arouse considerable public sympathy if they were short-changed.

Possible State Responses

A. Tighten local investment rules.

(i) Orange County's losses were exaggerated by their overuse of so-called reverse repurchase agreements, which allowed them to borrow their way into a highly leveraged losing position. Current state law allows this transaction. Some restrictions may be in order.

(ii) Orange County and at least some school districts also issued bonds, apparently just so they could speculate with the proceeds. Some restrictions on that kind of transaction may be in order.

(iii) The county's losses were apparently increased by their use of derivatives. Derivatives can have a legitimate role in government finance. Orange County apparently used them as a purely speculative device. Given the complexity and danger of these new age financing techniques, we may need rules on their use.

(iv) State law used to require that county treasurers report to the Board of Supervisors monthly on the condition of any investments involving repurchase agreements. That requirement was eliminated as of 1991, on grounds it was an unnecessary state mandate. Maybe it wasn't so unnecessary.

(v) State law requires that school districts keep their surplus cash invested with the county treasurer. We may need to reexamine that requirement.

This isn't as simple as just prohibiting local governments from ever investing in anything except 6 month T-bills. That would also cost the taxpayers a lot of money, because they would earn less interest on their tax revenue. The legislature might want to craft a set of rules that give local officials reasonable discretion but prevent recurrences of disaster.

B. Consider some state oversight of local investments.

Currently, no state official has any specific authority to oversee local investment practices. Perhaps the Treasurer, the Controller, the Governor, or some other official should be charged to do that.

C. Examine whether some state bail-out may be advisable.

It is not the state's responsibility to pay off local government gambling debts, and the state is pretty well broke anyway. So it isn't very likely that the state is going to step in and make Orange County's problems go away. Nevertheless, there may be some aspects of this disaster where the statewide interest is so strong that we will need to help out. Possibilities include:

(i) Schools. School districts are required to keep their money with the county treasurer. School districts had about $1 billion in the Orange County fund. It is possible that they may have short term problems meeting their payrolls, and longer term problems making up large dollar losses. Headlines in today's papers underscore this possibility. We need to keep the schools running.

(ii) Bonds. Orange county is already in default on at least one bond issue. It is possible that losses to the 180 plus local governments with money in the Orange County fund may cause others to have difficulty making bond payments on time (please note that we are not predicting that will happen or revealing any new information here, only recognizing a possibility that is apparent to anyone). It is in California's interest to try to protect the credit ratings of its local governments, to the degree that we can.

(iii) Transportation. Orange County's transportation agencies had over $1.3 billion in the fund. Some of that money was to be the local part of the cost of state highway and other projects. We will need to carefully assess how to protect the state projects, and yet not let those projects drain the rest of the state's transportation accounts.

D. Examine how the bankruptcy work-out will be structured.

A standard problem in bankruptcy is to establish the priority of various creditors' claims. In this case, creditors include the county, other cities, special districts, school districts, bondholders, public employees, and private vendors that do business with any government involved. These priorities have to do with who has first claim to immediate cash to meet their payrolls and debt payments, and who takes what part of the loss in the ultimate settlement. The state has an interest in seeing that these priorities are fair to all concerned, and in particular that agencies with state money (such as schools and transportation agencies) aren't at the short end of the queue. The state also has an interest in seeing that bondholders are protected, so that the borrowing ability of all California local governments isn't damaged.

E. Examine whether state law on municipal bankruptcy is adequate.

Questions have been raised about whether local governments in California have sufficient statutory authorization to use the federal municipal bankruptcy law (Chapter 9). There may also be interest in examining whether state law should set some restrictions on the circumstances when local governments can file for bankruptcy.

F. Consider creation of a state oversight authority for Orange County.

After New York City's default in the mid 1970's, the state created a special commission to oversee the City's financial rehabilitation (first a city/state Municipal Assistance Corporation, eventually a state dominated Emergency Financial Control Board). The financial markets found that a reassuring step, and it helped New York get back on its feet. While Orange County's problems are very different from those of New York, it is conceivable that the situation could evolve to the point where an analogous structure would be helpful. Perhaps it could lead to a quicker and more constructive resolution of this situation than a bankruptcy court. It might be difficult for the County to borrow money to help finance its rehabilitation without some external authority.

G. Consider new law restricting connections between securities firms and local investment officials.

There has been considerable innuendo suggesting impropriety in the relation between Mr. Citron and Merrill Lynch and perhaps other securities firms. While nothing has yet been clearly established, we may eventually need to consider whether new state law would help keep these relations above reproach.

H. Consider mandate relief and local revenue authority.

Under the most generous bail-out plausible, the communities of Orange County are still going to face an extremely large financial loss. They are going to have to cut their public services or raise additional revenue. There is no way around that. We may need to cut them some slack to allow either unusual service cuts or unusual tax increases, as they prefer. It is still too early to be at all specific about this, but either way we are talking about something seriously painful here.

DEFINITIONS OF INVESTMENTS THAT ARE PART OF Orange COUNTY'S PROBLEMS

Bond Counsel - the attorney or firm of attorneys that gives the legal opinion printed on the back of the bonds confirming that the bonds are legal, valid and binding obligations of the issue, and customarily, also that the interest on the bonds is exempt from state and federal income taxes.

Credit Rating Agency - The agencies provide, for a fee customarily paid by the issuer, an independent appraisal of the credit quality of a bond issue.

Derivatives - Financial instruments whose value is linked to, or derived from, the performance of some underlying asset or benchmark such as bonds, stocks or currencies.

Floaters - type of derivative with a yield that is periodically reset according to some formula or index.

Hedging - A strategy used to offset investment risk.

Index Cap - A type of derivative that has a floating rate with a built-in maximum high rate, or cap.

Inverse Floaters - A type of derivative with yields that move in the opposite direction of interest rates.

Leverage - A means of enhancing value or return without increasing the amount of the investment - essentially, borrowing to invest.

LIBOR - An acronym for London Interbank Offered Rate, the rate that the most creditworthy international banks dealing in Eurodollars charge each other for loans. The interest rate of other kinds of loans, such as home mortgages, may be tied to the LIBOR.

Municipal Bonds - A means for local or regional government to borrow money for general needs or special projects, such as building new streets or storm drains. Investors are guaranteed a fixed rate of return which is exempt from federal, state and local income taxes.

Municipal Bond Fund - A mutual fund that invests in municipal bonds.

Prime Rate - A key interest rate banks charge. The rate is determined by the market forces affecting the bank's cost of funds and the rates borrowers will accept.

Principal - Balance of debt, separate from interest.

Repurchase Agreements - When a seller agrees to buy back stocks or bonds at an agreed upon price, and usually, at a stated time.

Reverse Repurchase Agreements ("Repos") - When a dealer agrees to buy stock or bonds and the investor agrees to buy them back at a later date.

Structured Notes - Unlike conventional investments, such as fixed rate corporate debt, these securities carry significantly more risk. Typically, these investments gain value as interest rates go down and lose value as interest rates rise. See **Inverse Floaters**.

Swap - A means of converting a fixed-rate payment obligation into a variable-rate payment obligation. In a swap transaction, two parties agree to exchange their debt payment requirements. One issuer will agree to give another party his obligation to make payments based on a floating rate in return for an agreement to make payments based on a fixed rate instead.

Underwriter - The underwriter purchases bonds from an issuer with the intent to resell the bonds to investors.

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).

Credits

The following individuals wrote sections of this paper:

John Decker, consultant, Minority Fiscal Staff

Peter Detwiler, consultant, Senate Local Government Committee

Rodger Dillon, consultant, Senate Office of Research

Dean Misczynski, director, California Research Bureau

Karen Stapf Walters, consultant, Senate Subcommittee on Bonded Indebtedness and Methods of Finance

Collin Wong, consultant, Office of the President Pro Tempore

Betty Yee, consultant, Assembly Local Government Committee

This report was produced by Carol Thomas, committee secretary for the Senate Finance, Investment and International Trade Committee.