Statement of Robert L. Citron
January 17, 1995 Hearing Before The
Senate Special Committee On Local Government Investments

Chairperson Craven, Chairperson Killea, distinguished Senators and ladies and gentlemen:

First, and foremost, let me express my deep sorrow to the people of Orange County for the financial crisis that has arisen. As Treasurer, I followed an investment course that I believed was prudent and suitable to meet the County's growing financial needs. In following that path, I relied on the expert advice of financial professionals. In retrospect, it is clear that I followed the wrong course. I will carry that burden the rest of my life. I am not here seeking to place blame or shirk responsibility-- I am here simply to tell the truth.

I am glad that the Committee has asked me to speak today regarding the financial crisis in Orange County. The avalanche of publicity, rumor and innuendo following Orange County's decision to file bankruptcy has bred many factual inaccuracies and misimpressions. Despite some reports to the contrary, I intend to answer every question raised in these hearings today. If you want to delve into personal financial information, please do not hesitate to do so. I have nothing to hide. I hope that my recollections assist you by shedding light on these unfortunate circumstances.

Please note that since leaving the Treasurer's Office I have not had access to my calendars for the years prior to 1994, my correspondence files or the vast majority of the County's investment records. I understand that many of these records are in the possession of the Orange County District Attorney's Office. Without these records it may be difficult or impossible for me to recall certain specific events. I invite the Committee to permit me to review any documents that you may have questions about.

Please let me begin with some general background information. I am 69 years old and a third generation native Californian. My wife Terry and I have been married almost 40 years. My parents raised me during the Great Depression. I was ineligible for military service due to an asthmatic condition and therefore entered the University of Southern California. During my first two years at U.S.C. I studied a "pre-med" curriculum as I wanted to follow in my father's footsteps. I switched in my third year to general business courses and left during my fourth year due to financial circumstances. I never received a college degree. I attended Loyola

University for a semester in the early 50's to learn about government finance.

Between 1948 and 1960, I was employed primarily in the area of consumer finance. In 1960, a friend encouraged me to seek employment with Orange County as a Deputy Tax Collector. I was hired in that year and held that position until 1970 when I was elected to the position of Tax Collector for Orange County. As a Deputy Tax Collector and Tax Collector, I was committed to public service. I supported programs to permit individuals and businesses to pay delinquent taxes on monthly payment plans, and to allow taxpayers to make their tax payments at their local banks rather than at the County offices.

In March 1973, I succeeded to the duties of County Treasurer in addition to my tax collection responsibilities. The duties of County Treasurer included the investment of County and District funds. At that point in time, I was an inexperienced investor. I had never, nor have I ever, owned a share of stock. My primary training was on-the-job. Due to my inexperience, I placed a great deal of reliance on the advice of market professionals. This reliance increased as the number and types of investment securities permitted by the Government Code were liberalized, and as financial instruments became more complex. This is not to say that by the time derivatives were first sold to the County , almost four years ago, that I didn't consider myself to be an experienced and successful treasurer. The County achieved many years of extremely high returns during my tenure. However, in retrospect, I wish I had more education and training in complex government securities.

I believe that in July 1991 the first government agency security derivative was sold to the County by Michael Stamenson of Merrill Lynch. At this point, I would like to provide the Committee a brief overview of the activities of Mike Stamenson and Merrill Lynch in the events leading to the Orange County crisis. There has been a great deal of attention paid to the role of derivatives and leverage in the portfolio's loss, and Merrill Lynch's activities are integral to a discussion of this subject.

I first met Mr. Stamenson in 1975 and I started doing business with him on behalf of the County in 1988 when he took over from Mr. Fred Walker as the County's Merrill Lynch representative. Merrill Lynch was the primary investment firm selling securities to the County in the late 80's and 90's. It was my regular practice to call Mr. Stamenson each morning to discuss his views on financial markets in general, and Merrill Lynch offerings in particular. I have heard the figure that Merrill Lynch sold the County about 70% of the approximately $20 billion of securities in the County's portfolio at the time of the bankruptcy. This figure is consistent with my recollection that Merrill Lynch was the predominant seller of securities to the County. Merrill Lynch was the only seller of securities that received reports of the County's entire portfolio on a routine basis. I recall occasions when Mike reminded me to send the County's monthly statements when Merrill Lynch had not received them.

There has been much stated in the press about whether Merrill Lynch was a "financial advisor" to the County. At least to this lay person, Merrill Lynch acted as a financial advisor to Orange County. In July 1991, Mike first sold the County a derivative. He was very high on derivative products. He repeatedly noted that derivatives were advantageous because they could be used by the County to leverage further derivative acquisitions. Mr. Stamenson also repeatedly encouraged the County to engage in greater leverage and to enhance yields by purchasing more derivatives.

In late 1992 and early 1993, Merrill Lynch recommended, after an analysis of Orange County's portfolio, that the County lower its risk profile in the area of derivatives. The County followed this advice by purchasing predominantly fixed callable instruments in mid 1993. Merrill Lynch also offered to buy back certain derivatives on March 31, 1993. Those derivatives represented some of the most profitable instruments in the portfolio as they were paying some of the greatest returns. The Treasurer's Office decided not to accept Merrill Lynch's proposal due in great part on its reliance on the economic analysis of Merrill Lynch Chief Investment Analyst Charles Clough. Clough stated that a period of low interest rates would last for three to five years, and perhaps for a decade. This would enhance the value of the County's derivatives. I understood Clough to be the preeminent expert in the field of investment strategy and, as Mike knew, I trusted Mr. Clough's judgment. The September 10, 1993 report of the County Treasurer to the Board of Supervisors, which also went to pool participants, is attached hereto(minus attachments) as Exhibit "A". This report references Clough's forecasts at pages 3 & 4, and generally references the interest rate risk associated with the portfolio. Incidentally, Merrill Lynch assisted in drafting portions of this report relating to possible changes in interest rates and their potential effects on the portfolio.

At the end of 1993 or early 1994, I received a copy of Merrill Lynch's Investment Strategy dated Winter 1993 (Copyright 1994). The first two pages are attached as Exhibit "B". Page 2 presents the "secular case for lower interest rates." During this time frame, Merrill Lynch guided the County toward purchasing more leveraged derivatives that fluctuated inversely to interest rates. Mr. Stamenson's recommendations seemed to be in the County's best interest. By the end of 1993, income generated by the County's portfolio was second only to property taxes as a source of revenue to the County. It was very important to maximize the return on the County's investments.

In early February 1994, the Federal Reserve Board raised the federal funds rate from 3% to 3.25%. This was the first of a series of an unprecedented rate hikes. On February 23, 1994, Assistant Treasurer Matt Raabe and I met with Merrill Lynch representatives, including Mike Stamenson, to discuss a lengthy "Presentation to Orange County" of the same date. This "Presentation" is attached in the most complete version available as Exhibit "C". In this document Merrill Lynch made a number of investment suggestions that the County strived to implement. There was no sense of doom or gloom at this meeting. In fact, six days later, on March 1, 1994, I had a breakfast meeting with Mike and Mr. Clough. Mr. Clough reiterated that interest rate increases were not sustainable. I continued to believe that the County's monies were being invested wisely and safely.

During the Spring and Summer of 1994, the County's portfolio was the subject of numerous reviews by Merrill Lynch and others. In April 1994, representatives of the Securities and Exchange Commission ("SEC") interviewed Matt Raabe and me about the County's investments. Also present was an attorney from LeBoeuf, Lamb, Greene, & MacRae, the County's bond counsel, and a County attorney. The attorneys did not raise any doubts concerning the safety of the County's investments, and the SEC took no action after ~~the int~~erview.

Also in April of 1994 representatives of Moody's, and Standard and Poor's, inquired about the County's investments. After the inquiries, both services continued to rate highly the County's debt offerings. Standard and Poor's indicated that their investigation had been extremely thorough . On April 22, 1994, Diane P. Brosen, a Director of Standard & Poor's, stated in *The Bond Buyer*: "We probably have put the Orange County pool under more scrutiny than any other investment pool.... The reverse repurchase agreements don't cause us any concern."

I viewed the Spring campaign statements of my opponent questioning the wisdom of the County's investment strategy as politically motivated. As far as I knew, neither the Supervisors, the County auditors and administrators, nor the professionals familiar with the County's portfolio believed there was any merit to the predictions of Mr. Moorlach.

In July 1994, the County issued $600 million in taxable notes, a portion of which would be invested in the County's pool. Merrill Lynch was the underwriter for this issuance, and Leboef, Lamb acted as bond counsel.

These experts were not suggesting at the time of the offering that there were problems with the County's portfolio.

Further steep interest rate hikes by the Federal Reserve Board in August and November 1994 depleted the cash holdings of the County. It was my investment philosophy to use the County's large cash reserves in periods of rising rates to cover the increased cost of borrowing. It was also my philosophy to hold the County's securities to maturity to avoid sustaining any loss in the principal value of the securities. Before the bankruptcy, I sincerely believed that these philosophies were sound. My adherence to these philosophies is a matter of public record. In retrospect, they were unable to weather the fastest interest rate hikes in history.

This concludes the written portion of my statement and I look forward to answering any questions you may have.