



**MATT FONG**  
*Treasurer of the State of California*

February 1, 1995

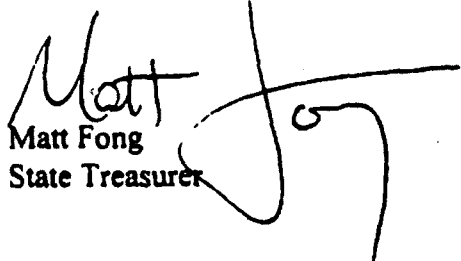
The Honorable Pete Wilson  
Governor  
State of California  
State Capitol  
Sacramento, California 95814

Dear Governor Wilson:

Pursuant to your request, I have assembled a Task Force of financial and investment experts from the public and private sectors to examine local and state government investment practices. You requested that I report the Task Force's preliminary recommendations and findings by February 1, 1995.

Enclosed please find the Task Force's preliminary recommendations and findings. I plan to circulate this report widely and seek comments for consideration by the Task Force for use in preparing the Task Force's final report.

Sincerely,

  
Matt Fong  
State Treasurer

MKF:sb

Enclosure

**TASK FORCE  
ON  
LOCAL AND STATE INVESTMENT PRACTICES**

**Preliminary Recommendations and Findings**

February 1, 1995

**Introduction:**

At the request of Governor Pete Wilson, California State Treasurer Matt Fong has assembled an eleven-member Task Force on Local and State Investment Practices. The Task Force is chaired by Treasurer Fong and includes an equal number of financial and investment experts from the public and private sectors. The members of the Task Force are identified in Appendix A.

The Task Force was requested by Governor Wilson to report recommendations and findings for possible investment guidelines to be considered by the California Legislature as a result of the losses incurred by the Orange County investment pool. The Task Force has not only examined the Orange County situation, but has also examined the investment practices of other California counties, the State's Pooled Money Investment Account, many California cities and other California local agencies. The Task Force held hearings at which expert testimony was received on state and local investment practices and has reviewed pertinent facts and applicable law and deliberated investment and disclosure issues.

California has 58 counties, 470 cities, 1,002 school districts, and more than 3,500 other local agencies. Each of these public entities has varying purposes and needs. These public entities invest surplus funds, bond proceeds, pension funds and other monies. Amounts that need to be invested can range from a few thousand dollars for a small single purpose local agency to billions of dollars for large entities. The Task Force's recommendations attempt to recognize these vast differences.

The Task Force's primary objective is to ensure that investment practices at all levels of government in California are consistently dedicated to the preservation of the security of the invested taxpayer funds and the maintenance of adequate liquidity. Only after these two priorities are met should consideration be given to the yields on investments.

The Task Force has reached a consensus on four preliminary recommendations to Governor Pete Wilson and the Legislature. These recommendations are preliminary and are based upon the Task Force's work to date.

Treasurer Fong intends to widely circulate this preliminary report and asks that written comments be directed to his office: 915 Capitol Mall, Room 110, Sacramento, California 95814, fax (916) 653-3125.

TASK FORCE  
ON  
LOCAL AND STATE INVESTMENT PRACTICES

Preliminary Recommendations

February 1, 1995

**Recommendation 1:** Amend state law to require each local treasurer or chief fiscal officer to provide annually a written statement of investment policy to the legislative body of the local agency for its consideration at a public meeting, and to submit a report no less frequently than quarterly to the legislative body and the chief executive officer containing a detailed description of the local agency's investment securities, including current market values. Require the State's cash management and investment pool to make such reports to the Pooled Money Investment Board. The quarterly reports would be required (i) to be submitted to the legislative body within 30 days of the quarter's end, (ii) to contain a statement with respect to compliance with the written annual statement of investment policy, and (iii) to be made available to taxpayers upon request for a nominal charge.

**Recommendation 2:** Amend state law to restrict the use of leverage in local and state investment portfolios by limiting reverse repurchase agreements used to buy securities to no more than 20% of a portfolio.

**Recommendation 3:** Refrain from making other changes in state law concerning permitted state and local investments until after a review of the forthcoming State Auditor's report on Orange County and reports from federal and state law enforcement agencies.

**Recommendation 4:** Ask statewide associations representing local agency financial managers and elected officials to work with the California Debt Advisory Commission to develop enhanced continuing education programs for state and local officials who have direct or supervisory responsibility for investments.

## Analysis

**Recommendation 1:** Amend state law to require each local treasurer or chief fiscal officer to provide annually a written statement of investment policy to the legislative body of the local agency for its consideration at a public meeting, and to submit a report no less frequently than quarterly to the legislative body and the chief executive officer containing a detailed description of the local agency's investment securities, including current market values. Require the State's cash management and investment pool to make such reports to the Pooled Money Investment Board. The quarterly reports would be required (i) to be submitted to the legislative body within 30 days of the quarter's end, (ii) to contain a statement with respect to compliance with the written annual statement of investment policy, and (iii) to be made available to taxpayers upon request for a nominal charge.

- Findings:**
- (a) Neither the State nor any local agency is required by state law to have a written statement of investment policy, let alone have it reviewed annually, or to file periodic reports more frequently than annually. For example, the Orange County Board of Supervisors received a report containing market values of the Orange County pool's investments only once a year.
  - (b) Annual reporting is too infrequent in today's fast-moving financial markets.
  - (c) Only regular reporting concerning market values of securities is likely to provide sufficiently timely information for adequate protection of invested taxpayer funds.
  - (d) Market value information should be required for all investment securities, not just those with a remaining maturity of more than 12 months. Many risky investments can have short maturities.
  - (e) At a minimum, quarterly reporting of market values should be required of all invested public funds, whether invested by the state, a local agency voluntary pool, or a local agency only investing its own funds.
  - (f) More frequent reporting of market values may be preferable to quarterly reporting, but the Task Force is concerned that mandating reports more frequently than quarterly may be burdensome and costly.
  - (g) Market valuation information for most securities should be able to be obtained inexpensively from custodial banks holding those securities.
  - (h) By requiring that each local agency must have a written annual statement of investment policy, the State is not mandating specific

investment objectives, practices and procedures; the State is simply requiring that each local agency address those issues itself by adopting a written annual statement of investment policy.

- (i) Requiring a written annual statement of investment policy and quarterly reports containing market value information is a reasonable approach to creating balance and oversight to limit a single person's power and control over investment strategy.

#### Discussion of Recommendation 1:

If Orange County had been required to disclose promptly the declines in the market values of its securities, the county supervisors, investors in the Orange County pool and taxpayers would have learned months earlier than they did that the county's investment strategy was flawed and that losses were building up. No corrective action was taken until losses were publicly disclosed in December, 1994. The former Orange County Treasurer filed reports with the county supervisors just once a year. Taxpayers, investors and perhaps even county supervisors cannot be expected to understand and evaluate complex investment strategies, but everyone understands losses. Thus, losses should be disclosed and disclosed promptly.

Legislation adopted ten years ago (after San Jose suffered big investment losses) required treasurers to report monthly to local officials about their investments. This law contained a "sunset clause" and expired in 1991. If this law had been in effect in 1994, the former Orange County Treasurer would have been required to publicly disclose the market losses that were building up as interest rates rose in 1994. Prompt public disclosure leads to corrective action in time to save taxpayers money.

In making Recommendation 1, the Task Force recognizes that the local agency costs of state-mandated programs can be recovered from the State. Costs for the prior legislation, which required monthly reports, were approximately \$5.5 million for the initial set-up year, and approximately \$2.5 million per year thereafter. By mandating quarterly (rather than monthly) reports, and taking into account the ready availability of market valuation information for most securities from custodial banks without significant additional charges, costs should not significantly exceed costs under the prior legislation and seem warranted to provide reasonable oversight over the investment of taxpayer funds.

The Task Force believes that the legislative body of each local agency needs to consider whether or not it needs a local agency oversight committee to evaluate the required written annual statement of investment policy and quarterly reports. In making that determination, the legislative body needs to determine whether or not it contains enough financial and investment expertise itself to be able to properly evaluate the written annual statement of investment policy and the quarterly reports. The Task Force recognizes that some legislative bodies do have the necessary expertise, while others do not. Further, the size of the local agency and the amount of funds invested by the local agency can vary widely from agency to agency. Thus, the Task Force believes that it is not appropriate to require a state-mandated oversight committee for each local agency.

The issue of whether to have an oversight committee appears best addressed by each local agency.

The Task Force considered whether market valuation should be reported for all investment securities or only those investment securities with remaining maturities of more than 12 months. While securities with remaining maturities of less than 12 months have historically been viewed to entail less risk, particularly if held to maturity, the Task Force believes that the marketplace has developed complex derivatives, structured securities and other instruments which can have significant risks and still have maturities of less than 12 months.

The Task Force requirement that the quarterly reports be submitted to the local agency legislative body within 30 days of the quarter's end is to ensure that the reporting occurs on a regular and timely basis. Requiring a statement of compliance with the agency's statement of investment policy forces each local agency to make a regular and ongoing determination that ongoing investment practices are or are not in conformity with the agency's written investment policy. A statement of nonconformity is obviously a wake-up call for the local agency. Making the reports available to taxpayers for a nominal charge will improve accountability of local agency officials to taxpayers, thereby providing additional oversight over investment practices of local agencies. This additional oversight should help prevent future occurrences similar to Orange County.

**Recommendation 2: Amend state law to restrict the use of leverage in local and state investment portfolios by limiting reverse repurchase agreements used to buy securities to no more than 20% of a portfolio.**

- Findings:**
- (a) Excessive leverage in the Orange County investment pool had been created by successive repeated use of reverse repurchase agreements.
  - (b) Recommendation 2 places reasonable limitations on the use of reverse repurchase agreements without unduly restricting the flexibility necessary for liquidity and legitimate investment purposes.
  - (c) Consideration should be given to amending state law to:
    - (i) Prohibit securities purchased with the proceeds of a reverse repurchase from being used as collateral for another reverse repurchase while the original reverse repurchase is outstanding;
    - (ii) Limit the maturity of each reverse repurchase agreement to the maturity of any securities purchased with the proceeds of the reverse repurchase (but in any event not more than one year permitted under current law); and
    - (iii) Limit reverse repurchase agreements to unencumbered securities already held in the portfolio.

**Discussion of Recommendation 2:**

Current state law allows investments in reverse repurchase agreements if approved by the legislative body of the local agency. There are legitimate and useful reasons for using reverse repurchase agreements. Nonetheless, the Task Force members seem to agree that one of the overriding limitations in state law should be reasonable limitations on the use of reverse repurchase agreements.

In a reverse repurchase agreement, the state or local agency sells an investment security to a dealer and agrees to buy it back at an agreed upon price; the transaction is similar to a loan. The cash proceeds of the reverse repurchase agreement are then used to purchase a second investment security. The Task Force's Recommendation 2 focuses on eliminating speculation resulting from excessive leverage. The 20% limitation permits the legitimate use of reverse repurchase agreements to seek a modest improvement in yield without subjecting the public to high-risk gambling.

**Recommendation 3:** Refrain from making other changes in state law concerning permitted state and local investments until after a review of the forthcoming State Auditor's report on Orange County and reports from federal and state law enforcement agencies.

- Findings:**
- (a) Federal, state and local investigations are underway in Orange County.
  - (b) It seems prudent to learn what the investigators have to say before the Task Force recommends changes in state law other than improved disclosure and restrictions on leverage.

**Discussion of Recommendation 3:**

In light of Orange County's bankruptcy and the magnitude of its losses, it is tempting to react prematurely with restrictive legislation without a full assessment of all of the circumstances surrounding Orange County's bankruptcy and losses. Existing laws governing state and local investment instruments have been developed over many years with input from public and private sector experts.

Federal, state and local officials have cautioned against confusing investment strategy with investment instruments and point out that Orange County's losses stemmed from a flawed investment strategy and lack of common sense. It would be inappropriate to penalize the State and all other local governments for Orange County's losses and that is exactly what we would do if we narrowed the list of permitted state and local investments. The marketplace is continually developing new financial and investment instruments, whether it be derivatives such as inverse floaters or other products. It should be up to local officials to develop prudent investment policies and make specific investments pursuant to those policies subject, of course, to the overriding limitations in state law.

This Task Force believes that limiting particular investment instruments beyond Recommendation 2 would be a premature reaction to the Orange County situation at this time. Common sense cannot be legislated.



**Recommendation 4: Ask statewide associations representing local agency financial managers and elected officials to work with the California Debt Advisory Commission to develop enhanced continuing education programs for state and local officials who have direct or supervisory responsibility for investments.**

- Findings:**
- (a) Enhanced continuing education programs are essential for keeping public officials responsible for investment decisions abreast with developments in the financial and investment markets.
  - (b) The California Debt Advisory Commission can provide support to statewide associations in developing enhancements to ongoing continuing education programs.

**Discussion of Recommendation 4:**

There should be renewed efforts to reach a wide range of public officials with affordable and accessible continuing education programs on investment practices. Organizations such as the California Association of County Treasurers and Tax Collectors, California Municipal Treasurers Association, California State Association of Counties, and League of California Cities can and should lead such efforts and the State can provide support through the California Debt Advisory Commission. Methods for encouraging attendance by public officials should be developed.

The Task Force recognizes a link between the fourth and first recommendations -- tying continuing education to the ability to produce an appropriate written annual statement of investment policy. Through various local agency associations, guidance can be made available to all California local agencies with respect to model statements of investment policy. Each policy can, of course, be modified to the objectives and needs of each particular local agency. By having model investment policies available for review by local agencies, the Task Force hopes that guidelines and benchmarks can develop over time concerning numerous investment matters, including (without limitation) oversight committees, coverage margins, minimum liquidity ratios or requirements, frequency and methods of reporting changes in market value (monthly, quarterly, fiscal year to date, etc.), ability to meet future expenditures (whether measured quarterly or annually), average weighted maturities, sensitivity to interest rates, fund accounting, procedures for purchases and sales of securities, percentage of transactions with any one broker/dealer, acknowledgement by broker/dealers of their understanding of the agency's investment policy, and other matters as may be developed over time as new financial investment vehicles are brought to the marketplace.

**TASK FORCE  
ON  
LOCAL AND STATE INVESTMENT PRACTICES**

**Appendix A**

**Chairman:**

**Matt Fong  
California State Treasurer  
Sacramento, California**

**Public Sector Members:**

**Alfred P. Balderrama  
Monterey Park City Councilmember  
and Former Mayor  
Monterey Park, California**

**Lambertus H. ("Bert") Becker  
Acting Chief Financial Officer  
Metropolitan Water District of  
Southern California  
Los Angeles, California**

**John L. de Russy  
Finance Director/City Treasurer  
City of San Mateo  
San Mateo, California**

**Russell S. Gould  
California Director of Finance  
Sacramento, California**

**George W. Jeffries  
Chief Investment Officer  
Los Angeles County Treasurer's Office  
Los Angeles, California**

**Private Sector Members:**

**Douglas L. Charchenko**  
Chairman  
California Public Securities Association  
San Francisco, California

**Thomas Kenny**  
Senior Vice President  
Franklin/Templeton Group of Funds  
San Mateo, California

**Francis X. Lilly**  
President  
Bear Stearns Fiduciary Services, Inc.  
Washington, D.C.

**Robert T. Slaymaker**  
President  
BA Securities, Inc.  
San Francisco, California

**Norwin Wong**  
Chief Financial Officer  
Portfolio Advisory Services, Inc.  
Los Angeles, California