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**DEBT ISSUANCE AND INVESTMENT PRACTICES
OF STATE AND LOCAL GOVERNMENTS**

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Debt Issuance and Investment Practi...

HEARINGS

BEFORE THE

SUBCOMMITTEE ON

CAPITAL MARKETS, SECURITIES, AND GOVERNMENT
SPONSORED ENTERPRISES

OF THE

COMMITTEE ON BANKING AND
FINANCIAL SERVICES

HOUSE OF REPRESENTATIVES

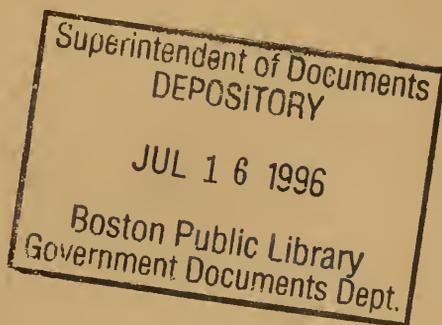
ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

—————
JULY 26, 27, 1995
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Printed for the use of the Committee on Banking and Financial Services

Serial No. 104-28



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DEBT ISSUANCE AND INVESTMENT PRACTICES OF STATE AND LOCAL GOVERNMENTS

WEDNESDAY, JULY 26, 1995

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:02 a.m., in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Members present: Chairman Baker, Representatives Cremeans, LoBiondo, Kelly, Roukema, Hayworth, Bono, Cox, Kanjorski, and Bentsen.

Chairman BAKER. If I can ask everyone to please take seats, we will convene this hearing of the Subcommittee on Capital Markets. I'd like to make a brief opening statement as to the elements of this hearing and intended purposes, and then recognize Mr. Kanjorski for any statement he may choose to make.

We have a lengthy series of panels today which will cover a broad range of interests, and I will try to move the hearing along as expeditiously as possible.

I should make clear to everyone that at 11:00 a.m. this morning, by order of the House, the Committee will recess for an address to a session of the House of Representatives, and we will stand in recess from 11:00 until noon. It is my intention to reconvene at noon and then proceed with subcommittee business until we conclude.

The capital markets provide important financial resources to local and State governments. The complexity of the marketplace, and the difficulty for managing investments needs to be understood.

It is important we understand potential long-term effects for State and local governments, of events like the decision of Orange County to declare bankruptcy.

I believe it important to understand the appropriateness of regulatory constraints, and to determine who is responsible for making the investment decisions of public funds.

It's further important to understand whether current disclosure requirements are sufficient, are the rating systems adequate enough, would a reasonable investor be able to make appropriate decisions as to the nature of a risk they might assume, whether the

instrument is a derivative or any other type of investment transaction.

I think it's important to assess whether the current Federal law or remedies available under the various states' laws is either sufficient or an inappropriate barrier to debt resolution when market difficulties do occur.

It's perhaps important to say what the hearing is not about. It's not an attempt to identify any guilty party in any particular community or state as to recent events, or to assign responsibilities for apparent actions, but really an attempt to gather adequate information about current market structure, the Federal legislative role, and to take any action that may be warranted after careful review of all current facts.

Those who work in the marketplace to provide capital for these needed public purpose projects must have confidence that the system is stable in order for that delivery of needed capital to continue to be available. But frankly, I think it's of much greater importance that we know that there are clear guidelines for those who invest public funds to ensure that unreasonable risk is averted and that taxpayers are not made to suffer the consequences from imprudent business judgments.

I think this overview is important because there are many who have opinions as to the subcommittee's interests and actions, and this will be a very slow, measured review of current market practices. And we will take action only if found to be warranted as a result of our better understandings.

With that, I'd like to recognize the ranking minority Member, Mr. Kanjorski, for any opening statement.

[The prepared statement of Hon. Richard Baker can be found on page 113 in the appendix.]

Mr. KANJORSKI. Mr. Chairman, thank you very much. I want to compliment you for organizing holding these hearings. With the amount of investment at the local, county and State level and the need for oversight and reexamination of particularly debt investment in this country and the new products that are within the market, it is essential that this subcommittee exercise its jurisdiction to make a review of this.

I compliment you that this is not a fault-finding investigation but merely an inquiry as to whether there is need for additional legislation.

I know we have a very thorough number of witnesses with great expertise, and I don't want to take a great deal of time from the subcommittee, so I have remarks I will revise and extend. And ask the indulgence of the Chair because I'll have to excuse myself because I must testify before another subcommittee on the reform of the administrative law judge procedure, of which I'm an original co-sponsor.

But I congratulate you again, Mr. Chairman, and look forward to the fruits of this hearing.

Chairman BAKER. I thank the gentleman and certainly understand the press of legislative business.

Since there are no other Members present, Congressman Cox, I want to offer you full opportunity to be heard. I don't think we

have a call of the House at the moment. I'll recognize you with a brief introduction.

As a senior Member of the Congress, recognized by elective office to a leadership position, it certainly is a pleasure to have you come before the subcommittee this morning and express your views with regard to this important subject. And assuming we have no intervening call of the House for any recorded vote of any sort, the floor is yours, Congressman.

**STATEMENT OF HON. CHRISTOPHER COX, A REPRESENTATIVE
IN CONGRESS FROM THE STATE OF CALIFORNIA**

Mr. COX. Well, I'm accustomed to working with the bells, as are you, so I'll proceed duly warned.

I want to thank you for convening this important hearing on current problems in municipal finance, and I want to join with you and other members of the subcommittee in welcoming members of our next panel sitting behind me—Matt Fong, California's treasurer; Gaddi Vasquez is chairman of the Board of Supervisors; Mark Petracca from the University of California at Irvine.

An important part of your focus is on Orange County; it should be. We should study what happened in Orange County because the problems can and will be repeated elsewhere.

Orange County is far more typical than you might think. It's one of America's largest municipalities, with over 2.6 million people. Today one in every 100 Americans lives in Orange County.

It's not a particularly affluent county. In fact, the average income is about equal to the State median. Its per capita household income is nowhere near that of wealthy counties like San Francisco and Marin County.

The truth is that except for a few small beach enclaves that drive up the statistics, the millions of people who live in Orange County are just everyday folks. Nearly 8 percent of them live below the poverty line.

This is not to say that Orange County's municipal finances are like those of New York City or Los Angeles or Washington, DC. To the contrary, neither the county nor its many political subdivisions were guilty of Marion Barry-style deficit spending. They lived within their means. They even had surplus money, which they put in the county investment pool so that it could earn a safe return.

Orange County's investment pool was advertised as a safe bet. Its strategy, however, was inherently risky. The county treasurer, Bob Citron, was the manager of the pool. He borrowed money at the county's low municipal rate and then invested it to try to earn higher rates.

To get the highest possible return on the borrowed money, he tried to outsmart the market. He bet that interest rates would fall but instead, they rose.

The financial markets, and even more so the general public, simply didn't appreciate just how bad a bet Citron had made. But it's important to realize that the reason that we're here today discussing Orange County's bankruptcy is not that Bob Citron guessed wrong. It's not that part of the portfolio was invested in derivatives.

Citron drove Orange County into bankruptcy because he leveraged his portfolio nearly three to one and made a very simple and very wrong guess about the direction of interest rates.

And even though he went back to the market time and again to borrow more money to keep the risky scheme going, the market didn't discipline him. It didn't even exact a premium for the risk.

The most important question for this subcommittee to ask about the Orange County bankruptcy is why almost no one in the market knew just what Bob Citron was up to and how dangerous his investment practices really were.

Our task is to understand why everyone, including the Securities and Exchange Commission, Standard & Poor's, Moody's, institutional investors and the financial press, all of them failed to see the obvious.

Even a political campaign focused entirely on Citron's risky investment strategy failed to gain the serious attention of many people. Bob Citron was the only Democrat elected to office in Orange County government. He had to stand for election last year in a Republican county. One would think that would be controversy enough to attract press attention.

His Republican opponent, John Moorlach, gave the *Los Angeles Times* and the *Orange County Register* documents showing that a financial disaster was imminent. But in the words of the *American Journalism Review*, the newspapers "blew it." I know because I was John Moorlach's campaign manager.

But the truth is, markets shouldn't have to rely simply on information available in the press. That will almost always be inadequate. As the *Register* publicly admitted, "Moorlach handed everybody the story on a silver platter. Maybe if he had said Citron hired an illegal immigrant for a babysitter, somebody would have paid attention."

But almost no one in the press did pay attention. The only reason John Moorlach knew what was going on in the Orange County portfolio is that he obtained documents only after threatening to request information under California's Freedom of Information Act. Citron tried to keep him from getting them.

But by May of last year, by May of 1994, John Moorlach had gotten enough information to write a one-page summary of the county fund showing that of Citron's total \$21 billion, \$14 billion was borrowed.

In May 1994, John Moorlach predicted, in writing shared with reporters, that the county was headed for a billion-dollar crash as soon as interest rates rose. The newspapers did not write the story. The editor of the *Orange County Register*, Tonnie Katz, said it was too complicated. She said, "Give us a good fire, a good earthquake, a nice hurricane—that's pretty easy to cover. This is just the reverse. We're talking about financial transactions and numbers."

So instead of analyzing Moorlach's data themselves, the *Los Angeles Times* and the *Orange County Register* checked with the experts. The *Register* relied, in part, on Standard & Poor's and Moody's. But the rating agencies missed what was going on even worse than the newspapers.

Just last year, Orange County went to the financial markets to borrow \$600 million in order to invest still more borrowed money

in the pool. Standard & Poor's rated this debt A-1 Plus. This was July of last year. Not until a few days before the county actually filed bankruptcy in December did S&P put Orange County's debt on CreditWatch, which means that they were signalling a possible downgrade.

When the rating agencies failed to see anything wrong in Orange County's investments, the markets didn't either, and the press simply followed suit.

But that's not all. The Securities and Exchange Commission also investigated the investment pool last year, and, according to Citron, the SEC gave him a clean bill of health. The SEC requested documents that filled more than 20 boxes, and SEC attorneys questioned Citron and his cohorts for 3½ hours in Los Angeles.

Yet just like the press and the rating agencies and the market itself, they failed to see anything wrong. The SEC investigation didn't even rise to the level that merited disclosure to potential bond buyers, according to the county's bond counsel.

And therein lies the rub. Municipal disclosure rules are virtually freeform. Unlike the very specific rules for corporate disclosure, cities and counties can disclose just about whatever they want. Practice varies widely.

Quite obviously, the manner in which Citron disclosed his strategy and his portfolio was wholly inadequate, since only by months of research and a threatened Freedom of Information Act request could Moorlach obtain enough information to figure it out. And yet it's quite likely that Citron's disclosure was all perfectly legal.

If the market had known and understood what John Moorlach knew, Citron would have been stopped dead in his tracks. He certainly would not have been able to borrow that last \$600 million in July 1994. He probably would have been forced to accept Merrill Lynch's offer in 1993 to buy back all the derivatives he'd bought from them. Had he accepted that offer, the county would have made a profit and the bankruptcy would never have happened.

Today, municipal government, through its borrowing, competes unfairly with private securities. Not only is it tax-exempt, which is proper, but also it doesn't have to comply with the same disclosure rules. No mutual fund that sells to investors would get away with the skimpy disclosure that municipalities make. In the future, no municipality should be able to get away with it, either.

The consequence for our national savings is very dangerous. For the first time, total outstanding municipal debt is larger than all outstanding corporate debt in America. Simply put, the unfair advantage that municipal finance enjoys is diverting ever more of our private savings into government and away from private enterprise.

Since the inception of our Federal securities laws, municipal securities have been exempt from the disclosure rules that apply to virtually everyone else. We are now reaping the whirlwind from that unjustified distinction.

While Federal registration is neither practical nor desirable, detailed Federal disclosure rules, enforced by the market and private rights of action, are essential. The recent changes to rule 15(c)(212) are only a start. The fact is no rules change can be adequate without new legislation.

Municipal accounting varies widely from jurisdiction to jurisdiction. Not only the quantity but the quality of disclosure is everywhere lacking. Rating agencies cannot evaluate risks without adequate information, and neither can the market.

All of the investors in Orange County's \$600 million issue last year were sophisticated institutions, but none of them appreciated the problems with the county portfolio. As we've seen, even the SEC and the press failed us in the current system.

All too often, the assumption is that government bonds are virtually risk-free, but that is obviously not so. If Orange County's misfortune can contribute anything positive to the Nation, let it be this lesson. It is now up to us in Congress to give the marketplace the disclosure tools to better evaluate these risks before the next Orange County happens.

Thank you very much, Mr. Chairman.

[The prepared statement of Hon. Christopher Cox can be found on page 156 in the appendix.]

Chairman BAKER. Thank you, Mr. Cox, for an excellent statement, and I think it clear that your overview of the circumstance and events do lead one to recognize disclosure was, at best, sadly lacking, and that perhaps there is some need for standardization in the market.

And I know Energy and Commerce will carefully review this, and I'm certain that Chairman Leach will find your remarks to be of extreme importance and help to us in working with your committee in attempting to resolve these issues.

But there are really two parts to this difficulty. One is how we got there, which apparently you feel strongly was built around a lack of adequate disclosure, and second, what one does when you arrive at this circumstance. That may be a bit more difficult to resolve.

I do thank you for your comments. Would any Member have comments? Mr. Bentsen.

Mr. BENTSEN. Yes. Congressman Cox, I have a couple of questions. I had the occasion to read about your interest in disclosure in the *Bond Buyer* before I came to this body and you were already a Member. You were a securities lawyer prior to becoming a Member of the House?

Mr. COX. Yes, that's right.

Mr. BENTSEN. In the corporate sector?

Mr. COX. Right.

Mr. BENTSEN. Did you do any work in the municipal sector?

Mr. COX. No, I did not.

Mr. BENTSEN. OK. You've mentioned 15(c)(212), which does provide for subsequent disclosure for secondary market. You don't believe that's adequate at this time?

Mr. COX. That's a very positive step. I think current real-time update for the market is important. But what I'm concerned with is that whereas there are longstanding, well understood market-tested disclosure rules for corporate securities, there are not such rules for municipal securities. Rather, we have only the anti-fraud provision, and the rest of the official statement is rather freeform.

Mr. BENTSEN. This may not be a fair question, but do you think had Orange County been required to register prior to offering, for

instance, the \$600 million, the 1994–1995 \$600 million taxable notes, which were effectively arbitrage notes, from what I can tell—

Mr. COX. That's exactly what they were.

Mr. BENTSEN. And whether or not registration and subsequent filings of some form of 10-Qs and 10-Ks would have made a difference?

Mr. COX. Well, I oppose registration of municipal securities, but I do believe that if the quality of the disclosure—I'm not now speaking about the quantity; we know that the SEC looked through boxes and boxes of documents—if the quality of the disclosure had been on parity with the quality of disclosure required in private finance, I think this would have been communicated to the market. The risks would have been understood. It was there for someone to see, if only they knew.

Mr. BENTSEN. I would also point, just for the record, and we'll hear from James Spiotto of Chapman and Cutler later that in his testimony he does point out the disparity in the number of defaults and volume of defaults between the corporate and municipal markets. And it is true that the level of defaults in the municipal markets are much lower than that in the corporate markets.

Now, I will add a caveat to that, that the credit is different, although with Orange County maybe we're seeing some difference in that.

Let me ask, Mr. Cox, one final question. I appreciate your comments about the press, and all of us in public office know how difficult it is to get press. In fact, in Houston we used to joke that you had to have a motorcycle accident to get any press coverage whatsoever, and I still think that may be true.

But you talked about Citron being the only Democrat, and I don't want to sound partisan, but I do think it's important, for the record, again, if you look at this official statement, and there are other official statements that I've reviewed, and they're all pretty standard, that the Board of Supervisors are listed, as well.

And while the statement is signed by the assistant treasurer, Matthew Raabe, which is standard practice—either the treasurer or chief financial officer of an issuing authority will sign it—is it your understanding, under California law, that the Board of Supervisors has to approve either an indenture or the offering documents at some point? Or is this done—was Citron able to just conduct these financings without the Board of Supervisors having any idea whatsoever as to what was going on?

Mr. COX. Well, as you know, there is a great deal of litigation surrounding the nearly \$2 billion loss that was occasioned by Mr. Citron's management of that portfolio. So while I have a pretty fair idea of what the law is, I don't want to opine because I think there are others who you will hear from today who can testify with expertise on that issue.

I will say that the reason I mentioned that Bob Citron was the only Democrat elected to countywide office in Orange County and that he had to run for election last year is to say that normally that would be something of a man-bites-dog story. And if there were controversy in that election, one would think it would receive adequate coverage.

It was despite that inherent, it seems to me, journalistic appeal that the story didn't get covered. And I find it a tragedy that that was the result.

Mr. BENTSEN. Mr. Chairman, I have a great deal of respect for Mr. Cox's ability in this area. I sometimes disagree with him, although I have to say, for the record, I have yet to meet a securities lawyer who would give me an unqualified opinion.

Chairman BAKER. Mrs. Kelly.

Mrs. KELLY. Thank you, Mr. Chairman. I reserve my right to add some comments for the record.

Chairman BAKER. Certainly. Mrs. Roukema.

Mrs. ROUKEMA. Mr. Chairman, I'm not going to belabor this point, but I do appreciate our colleague's testimony today.

And I would simply observe, and I don't have a specific pointed question for you, Congressman Cox, but I would simply observe, and you may want to respond, that I do think that we have to go for more than disclosure. And I recognize the recommendations or the call for action that SEC Chairman Arthur Levitt called for. To my knowledge, nothing was done on that score. Is that correct? Nothing more has been done on that score?

Mr. COX. On which score?

Mrs. ROUKEMA. With respect to repealing the municipal securities exemptions. Repeal would subject the States and municipalities to the same disclosures that apply to corporations that sell securities. This is evidently what you're recommending here.

Mr. COX. Yes. Now, I know that you have occasion to hear from Chairman Levitt.

Mrs. ROUKEMA. Yes.

Mr. COX. We have had him testify before our Commerce Committee, and I will leave it to the Commission to represent faithfully what is the Commission and the Chairman's view. But my understanding is that Chairman Levitt does not believe that we should change the current regime that wholly exempts municipalities and municipal securities from registration.

For my own part, I think I may have a rather more aggressive approach, which is to maintain the current situation in which municipalities need not register but to impose, at the Federal level, much more detailed, explicit and thorough-going rules on the kinds and quality of disclosure that must be made to the market.

Mrs. ROUKEMA. Well, maybe we're getting, then, to the same point. I hope it's not just a semantic one, but the definition of disclosure, as opposed to further regulations. And that's where we might have to explore what we truly mean by this kind of vocabulary. And I'm not quite sure, either, but that's why I'm here today and anxious and thankful for the chairman having these hearings. We need to know more about this before there are further terrible disasters, whether of the bearing type or the municipal type.

Thank you.

Chairman BAKER. Thank you, Mrs. Roukema.

Congressman, we thank you very much for your courtesy and your testimony. I look forward to working with you.

Mr. COX. Thank you very much, Mr. Chairman.

Chairman BAKER. I'll call the second panel and while that panel is coming forward, announce that we don't believe there will be any legislative activity until 11:00, and we will recess at 11:00.

For Members arriving after my opening comments, the House will require our attendance for an address on the House floor from 11:00 until 12:00. It would be our intention to recess at 11:00 and then promptly reconvene at noon to continue the hearing. We have a lengthy set of panelists to follow and to avoid concluding these hearings late in the afternoon, it'll be necessary to reconvene promptly at noon.

Let me say at the outset today we have an extraordinary number of distinguished individuals with lengthy records of public achievement at State and local level, as well as those from Federal Government. All witnesses' resumes are made part of our record.

In order to expedite time, I will be very brief in my introductions. I'm sure others may choose to make comment as to their constituents of particular note, but I will be very brief and recognize those here by virtue of their current position, and would first recognize the Treasurer of the State of California, who's with us this morning, Mr. Fong, and certainly welcome you here, sir, and I'm looking forward to your testimony.

Let me further add, for everyone's benefit, to the extent your remarks can be constrained to 5 minutes, your official remarks will be made part of our record and I assure you every word carefully reviewed.

So if you can help the subcommittee with that, we have four panels today and they're all rather lengthy. Thank you for your understanding. Mr. Fong.

STATEMENT OF MATT FONG, TREASURER, STATE OF CALIFORNIA

Mr. FONG. Thank you, Mr. Chairman, Members. Thank you for the opportunity to address your subcommittee on the worst municipal disaster in California's history.

Since taking office in January, I have witnessed firsthand how the risky and irresponsible investment strategy of the previous Orange County treasurer can throw uncertainty into the municipal market and cost local government, most of which already face financial difficulties, millions of dollars in penalties.

Bob Citron, the former Orange County treasurer, leveraged his way into notoriety while the local governing body turned a blind eye to his irresponsible investment practices, which promised returns that were twice that of most investment pool managers.

Although municipal finance and the trading of municipal securities have changed forever, I believe many of the changes are for the better.

The Orange County investment pool losses, I believe, represent an isolated incident that occurred because of an arrogant treasurer and an inattentive Board of Supervisors. Recurrence should be prevented in the future with simple oversight and limited restrictions on certain types of investments and investment strategies.

One of the first duties I took after taking my oath of office was to chair a Task Force on Local Investment Practices at the request of Governor Wilson. The task force recommended restrictions on

leveraging investment pool securities and limitations on reverse repurchase agreements. The task force also recommended better education for local officials about investment practices and the adoption of investment policies and reporting requirements to local governing bodies.

These recommendations have been incorporated into several bills now that are making their way through our legislature.

Additionally, investors appear to be demanding better disclosure information and issuers are responding to those needs. The market mechanisms are indeed addressing this issue without additional government intervention. This is the healthy by-product of the Orange County situation.

Also, the recently amended disclosure requirements of the SEC should further strengthen market confidence that local government investment practices and other financial information are adequately disclosed.

There has been a significant change in the relationship between municipal issuers and investors. Investors are much more wary of the municipal market, the market that was once regarded as a safe place to invest.

In California, especially in light of Orange County's bankruptcy, the present relationships are more cautious than in the past.

But unlike the corporate bankruptcy model, municipalities under Chapter 9 retain democratic control over operations while receiving protection from creditors. It appears, however, that at least in the Orange County situation, bankruptcy strategies have hindered an expeditious resolution of the problem.

With the litigious and adversarial culture that surrounds a bankruptcy, the emphasis is placed on winning in a litigation context, rather than on problem-solving.

This "I've got to win" mentality is the right strategy in a corporate bankruptcy where you can completely shut down the bankrupt business and start in a fresh location. But county governments cannot simply close up shop. They cannot clean the slate and go out of business, leaving behind as many creditors as possible. Orange County will always remain Orange County.

And while the county continues to provide services to its citizens, a workable solution must be sought out through negotiation and with ongoing creative financial strategies. A strategy that maximizes litigation hurts any county's ability to provide needed services.

Unfortunately, in Orange County millions of taxpayer dollars are being diverted from paying bills into the hands of lawyers, accountants, underwriters and financial advisors.

One of the recommendations of the Task Force on Local Investment Practices was that the Congress and the California State Legislature not overreact to the Orange County situation. What I fear happening is what I call the "Florida doctor syndrome." When the doctor in Florida amputated the wrong leg recently, the solution was not to pass a bill outlawing scalpels because the problem wasn't the scalpel; it wasn't the instrument; it was the doctor. And in this case, the problem wasn't the instrument; it was the treasurer.

The way to prevent another Orange County is oversight, with a good dose of common sense.

I don't believe that regulators and regulations have any potential for minimizing risk of this kind of catastrophic event in the future. It will be nearly impossible for them to anticipate every type of situation that arises.

In short, you cannot legislate common sense nor good judgment. We need to educate the public and its officials about investment functions, the risk of aggressive and irresponsible investment policies, and the benefits of vigilance, oversight and accountability.

So in conclusion, yes, there was a financial train wreck in Orange County, and the bill for the damage must be paid and there is no way around it. But municipal markets are more alert and are demanding more information from issuers, which is, as I said, the healthy by-product.

And finally, and most importantly, if Congress and State legislatures overreact by outlawing specific types of investment products, I think two things will happen.

First, you won't be able to keep up with all of the new investments products that will be invented down the road. Wall Street is just too creative.

But more importantly, you will take away valuable investment tools that treasurers all over the country use wisely to earn hundreds of millions of dollars for their government operation.

There's only one way, then, to replace those revenues, and that's through additional fees and higher taxes.

Oversight, education, vigilance, and accountability—these are the watchwords to live by and, I believe, to prevent another disaster. Thank you.

[The prepared statement of Mr. Matt Fong can be found on page 161 in the appendix.]

Chairman BAKER. Thank you, Mr. Fong. We certainly appreciate your time in being here today and your insights.

Our next witness is the auditor from the State of California, Mr. Kurt Sjoberg. It's a pleasure to have you here this morning, sir.

STATEMENT OF KURT SJOBERG, AUDITOR, STATE OF CALIFORNIA

Mr. SJOBERG. Good morning, Mr. Chairman and Members. I'm Kurt Sjoberg, California State Auditor.

Since the Orange County bankruptcy in December 1994, my office has been involved in a series of audits relating to local government investment practices. Initially, at the request of Governor Wilson, I sent a team to Orange County just after the announcement of the bankruptcy, and then subsequently, the California State Legislature asked that we look at the other 57 counties in our State to determine the extent perhaps that these high-risk investment strategies may be employed by other locales.

As a result of these audits, we've issued a series of recommendations, which I will outline in just a few moments.

First of all, what we found when we arrived in Orange County was that the former treasurer, Bob Citron, had employed an investment strategy that basically violated the tenets of prudent investing; that is, he did not ensure that his portfolio was safe and liquid

before he went about maximizing its yield. And, in fact, by his own admission, the pursuit of yield became his primary motivator.

I've also been asked many times what caused the \$1.69 billion loss, and it's my view that it was not any single one investment strategy that was used. It was not simply overleveraging through the use of reverse repurchase agreements, nor the purchase of volatile derivative securities, although each of those techniques was used to an extreme.

In fact, in July 1994, the portfolio was leveraged about three to one, and almost half of the investments were in either inverse floating rate notes or some other structured security that actually went down in value as interest rates rose.

So it's my view that it was when these two strategies reacted, if you will, with the 300 basis point increase in interest, which we saw in 1994, that this portfolio reached a critical flashpoint.

Now unfortunately, at that moment there were about \$13 billion in reverse repurchase agreements soon coming due. And of course, the derivative securities that had been purchased with these borrowed dollars had lost significant value.

So what occurred, of course, were collateral calls by those persons who held the pledged securities or collateral. And, as a result, on December 6 the county filed for bankruptcy protection under Chapter 9.

Now, what we've found in the other 57 counties was somewhat concerning to my office, in that the investment strategies did vary widely, and we do have many small counties, as well as many large ones.

However, we found six that employed one or more of the investment strategies that we deemed to be too risky for a short-term local government investment pool. We found some counties with more than 30 percent of their portfolio in volatile derivative securities; that is, those that were either inverse floating rate notes or some other type of structured note where principal potentially could be at risk.

We also, in fact, found two counties that had more than two-thirds of their portfolio in inverse floaters. We also found others holding more than 40 percent of their portfolios in reverse repurchase agreements. One county had an 80 percent leverage factor.

And none of these counties had matched maturities. That is to say they were investing short-term borrowed funds in long-term securities, which is, of course, the formula for potential problems.

And then finally, we found that they were holding securities that averaged over 2½ years, average weighted maturity. In fact, one county had an astounding 27.9-year average weighted maturity in their short-term portfolio.

Luckily, no other counties in California are on the verge of municipal bankruptcy as a result of their high-risk investing. Each of the counties that we contacted believe they had sufficient liquidity to weather out the storm they were in and that they would not have to realize the losses that they had experienced.

Now, we've made a series of recommendations to the California Legislature and, in fact, currently more than 30 bills are pending in Sacramento. We've grouped our recommendations into two areas.

One has been discussed some this morning, and that is the area of disclosure. We believe that there needs to be much more disclosure as to the investment practices of local governments, primarily through the use of investment committees, local committees, and also committees wherein stakeholders, these participants in the pool, can also come forward.

But in these meetings, we think that the type of disclosure that the treasurer provides is very important. Clearly, there needs to be an investment marked to market, on a quarterly basis, at least, so that all of the investing participants know exactly what their current value is.

We also think that there needs to be some type of interest rate sensitivity analysis on the portfolio so one can assess the relative risk that's being assumed.

We also think that the prudent person rule needs to be defined and, in particular, minimum qualifications for those people who are making investment decisions.

And then finally, the fiduciary relationship between the treasurer and the investor needs to be established more clearly.

Now, that relates to disclosure and as it relates to limiting investment strategies, we, a lot like the task force of Treasurer Fong, believe that reverse repurchase agreements should be limited to no more than 20 percent of the portfolio and then only for specified purposes; that derivatives and other securities—and I want to emphasize—that introduce additional risk to the portfolio, as measured by an interest rate sensitivity analysis, like a duration analysis, need to be limited to no more than 5 percent of the portfolio; and then, finally, that these average weighted maturities need to be shortened, perhaps as low as 2 to 2½ years or less.

It's my view that, in conclusion, as it relates to our problem in California, that if these recommendations are taken and become law, that future municipal bankruptcies, as it relates to investment practices, will be avoided.

[The prepared statement of Mr. Kurt Sjoberg can be found on page 165 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Sjoberg. I'm sure my companions will have significant questions at the appropriate time. Thank you for your testimony.

Our next witness is the CEO of Orange County, Mr. William Popejoy. Pleasure to have you here, sir. Thank you.

STATEMENT OF WILLIAM J. POPEJOY, CHIEF EXECUTIVE OFFICER, ORANGE COUNTY

Mr. POPEJOY. Thank you, Mr. Chairman.

Last December, I was incredulous to read that Orange County had declared bankruptcy. It lost \$1.7 billion due to a financial strategy which included extreme leverage and the use of derivatives.

As a 15-year resident of Orange County and someone who has background in finance, including derivatives, I was astounded and angry that my county had been allowed to bet the bank. I wondered how a county government could get itself in such a mess.

And while financial leverage and the use of derivatives might be acceptable for high-risk portfolio managers and management, I fail

to see how such strategy has any place where public tax money is involved.

In a county of more than 2.5 million and a form of government more than 100 years old, how could this disaster occur? Our county treasurer had been on the job over 30 years and had been lauded throughout the State for his performance. How could he pursue such a reckless and ill-fated investment program, and how could that program go undetected?

Where are the other safeguards—our elected representatives, our auditors, our advisors—the list goes on—rating agencies, indeed, the investment banking community? Well, there still are, as there were then, many unanswered questions.

After liquidating its risky portfolio and investing in lower risk securities without leverage, the County Board of Supervisors, the senior body of the county, sought the services of an interim chief executive officer, a CEO.

On February 21, 1995 I was designated as the county's first CEO and given broad powers to manage the county and develop a bankruptcy plan of recovery. Working with county employees, outside experts, a large number—I think you should bear this in mind—a large number of volunteers, like myself, who were also experts in their fields, we quickly put in place many changes.

Among those, we found it necessary to accept or prompt resignations from six members of senior management of the county, conduct an asset sale, primarily through an auction, of real estate assets owned by the county, merged two very large agencies of the county, conducted a lay-off of 1,000 employees, did so with little or no complaints from the employees in terms of legal complaints. We used extensively job fairs, out-placement counseling to try to help these employees, who were basically the innocent bystanders. They didn't cause the problem. They carried the major part of the burden, however, of sacrifice as a result of the cut-back in the county.

Cut our budget, our discretionary budget, that budget where we have any control, by 41 percent. Not annualized, not over time, but in a matter of 3 months, cut it by 41 percent, from \$463 million to \$275 million, a reduction of \$188 million.

Pushed through a difficult to achieve self-help legislative package through the State government; negotiated with our experts—primarily, our experts did the negotiating—a complex settlement agreement with over 190 entities, basically investors who invested in the Citron pool. These are schools and cities, water districts, and so forth. That amounted to some \$5.1 billion after the loss that was experienced by the pool.

Issued recovery notes to help pay the schools up to 90 percent of the amount of money that they had invested with Mr. Citron; commenced negotiations with a major litigation defendant for possible settlement.

I think, most importantly, we proposed a bankruptcy plan of recovery to the Board of Supervisors, which was approved unanimously by the board. The centerpiece of the plan was a one-half cent sales tax proposed for the citizens of the county. Well, that tax was overwhelmingly, overwhelmingly defeated by the voters on June 27, 1995.

On June 29 the Board of Supervisors decided to reinvolve themselves in county's management and rein in my responsibilities. They basically changed the job for which I was hired.

Now, let me underscore that while I was disappointed because I felt such change could possibly represent a return to the management approach which helped create some of our problems, I respected then and I respect now the board's right to make the change. They were elected by the people of Orange County; I was not. I was hired by the board.

On July 6 we completed negotiations with our short-term bondholders—this was terribly important for us to avoid default on the bonds we had outstanding—and received a 1-year extension of the maturities on those bonds.

Once the breathing room of the 1-year extension had been achieved, I resigned from the county, effective August 1 of this year. I indicated then and I indicate now a willingness to serve in the future as an unpaid consultant, but I did not feel I could be effective leading the county's recovery in the new reduced and restructured role.

What are some of the things that I've learned during my brief tenure as a government employee, particularly someone who spent almost all of their time in the private sector?

I found that a chief executive officer with private sector experience can help make a great deal happen in government. We did. Government workers can and will accomplish much if treated with respect and given an opportunity to do their jobs.

I also found out that you shouldn't ask the citizens to approve a tax increase until their sense of betrayal subsides and they're convinced that fundamental changes have occurred to avoid what they believe caused the problem.

I also came away from my experience with a very strong feeling that our current organization of county government just doesn't work well. It doesn't have—I'm not talking about the individuals; I'm talking about the organization—it does not work well.

You have, in effect, five individuals running the county; all five are chief executive officers. You have an elected treasurer who basically doesn't report directly to them. The only qualification to be the treasurer of Orange County is you get one more vote than your competitor. You don't have to know how to count.

The next problem we have is you have an auditor-controller that is elected, does not report to the Board of Supervisors. Now, I suggest respectfully the only reason God made an auditor was to watch the controller, and in this instance we've combined the two and they don't report to the Board of Supervisors.

So I hope in the future we can see an organizational change, not only for Orange County, but one that can be looked at to see if it applies elsewhere in the State.

I've also learned—maybe I knew this already, but it certainly was reemphasized by my experience—that we should—we here in Washington, we in Sacramento, we in Orange County—should require high standards of ethics and responsibility of those who do business with government entities, for the ultimate burden of buyer beware, the buyer beware business approach, falls on the taxpayers.

I also feel, even though I wasn't here when the decision was made—I say “wasn't here,” I wasn't part of county government when the decision was made—that bankruptcy for county government seems like a poor substitute when compared to the parties involved voluntarily getting together and working out a 100 percent plan of recovery.

But let me repeat, I wasn't there and this was a very complex matter and one that the advice given to the board was to seek bankruptcy. But I have had a chance to see some of the acrimony and divisiveness caused by bankruptcy, and I'm not sure how well it works in a government situation.

I really do believe the people of Orange County will develop a program where their debts are honored. This will not only be done because it's in our economic best interest to do so, but it's the right thing to do.

Most importantly, as citizens, we must watch, participate and vote on the manner of our government's conduct. The recent election in Orange County, probably the most important matter ever facing that county in its 100-year plus history, it was on the front page of the newspapers, the two major newspapers virtually every day for several months, and still nearly 70 percent of the registered voters did not vote on the matter that faced their county on June 28 and it just is something that makes you wonder about what's going to be in the future, with that sort of apathy.

I also believe that what we have experienced in Orange County may be, and I hope I'm wrong, a sneak preview of what other counties in California may be facing. Thank you very much.

[The prepared statement of Mr. William J. Popejoy can be found on page 172 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Popejoy. I certainly appreciate your comments.

Mr. Vasquez, it appears that you might have an actual 5-minute rule imposed on you. If you would care to proceed, I'd be happy to recognize you at this time. Or if you want to wait until after the recess, it's your discretion, sir.

Mr. VASQUEZ. Mr. Chairman, I believe I can meet the requirement of time.

Chairman BAKER. Please proceed, sir.

STATEMENT OF GADDI H. VASQUEZ, CHAIRMAN, BOARD OF SUPERVISORS, ORANGE COUNTY

Mr. VASQUEZ. I apologize in advance. I will repeat some of the statements of fact that have been provided to you. My name is Gaddi Vasquez and I'm the current chairman of the Board of Supervisors in Orange County.

As you already know, on December 6, 1994, Orange County, California filed for protection under Chapter 9 of the Bankruptcy Code in an effort to stabilize a fiscal crisis that threatened the economic stability of our county. We are now experiencing one of the most difficult times in our county's history by virtue of the financial collapse of the Orange County investment pool and the loss of \$1.7 billion to the pool.

All of the county's funds were deposited in the Orange County investment pool and suffered a loss of \$650 million. The school districts, special districts, and cities who invested lost \$1.05 billion.

The consequences have included a dramatic reduction, as has been mentioned, in the county budget, as well as a reduction and/or elimination of services. I would like to give your subcommittee, however, a brief overview of the Orange County investment pool's history and again, some of it, unfortunately, will be redundant. I'll move as quickly as I can.

The pool was established and managed by the Orange County treasurer-tax collector, who was an independently elected official and had served in the same elected office for over 20 years. During his tenure, he had established a long track record of performance and had been recognized by many professional organizations for his accomplishment as treasurer-tax collector of Orange County.

His records of high yields made the Orange County investment pool an attractive opportunity for public agencies. His record of performance prompted jurisdictions outside of Orange County to participate, and some public agencies even borrowed amounts above their available resources for the expressed purpose of investing in the pool.

Eventually, 190 agencies became pool participants. Most of them had elected governing boards and professional experts who reviewed the portfolio's performance. In addition, the portfolio was audited by an independent outside auditing firm on an annual basis, and rating agencies had historically, as you've already heard, given Orange County bonds high ratings, thus creating a basis for confidence and trust in the performance and management of the pool.

In late 1994, the treasurer-tax collector announced that the pool had suffered a "\$1 billion paper loss." That "paper loss," however, represented a genuine loss in value and evolved into the financial crisis of 1994.

On December 6, 1994, the Orange County Board of Supervisors met and evaluated all of the options that were available and determined that a Chapter 9 filing was the only real option available to the county. To do otherwise would have compounded the crisis and made our situation worse.

Since December, as has been mentioned, we have made many advances toward resolution while recognizing that many formidable and difficult challenges remain. The first major step was the liquidation of the remaining assets of the investment pool. Our second major step was achieving a pool settlement on the distribution of the remaining funds, which totaled \$5.9 billion.

The plan was submitted to and approved by the Federal Bankruptcy Court on May 2, 1995.

Most recently, as has also been mentioned, on July 7, 1995 we were able to achieve a debt rollover of all of the county's short-term debt to June 30, 1996 in order to give the county time to develop options and alternatives for repayment of the bond debt.

But now the County of Orange faces the task of reducing its budget in order to meet obligations and to provide services to the residents of our county. We have partially achieved that through budget reductions, as has been mentioned, totaling \$188 million.

Our workforce has been reduced by 1,488 employees, and we have reduced our county general fund budget of \$460 million per year to a proposed budget of \$275 million for fiscal year 1995-1996.

We have engaged in the sale of county assets, such as land and buildings. We are negotiating agreements for importation of solid waste, which would create a new revenue stream, and the board has placed, as mentioned, a half-cent sales tax which was rejected by the voters at the ballot box.

The county is working with the legislature and other counties who are also facing financial difficulties to obtain relief from unfunded mandates. The State legislature has already been helpful in passing legislation that has given us some relief, but much work remains to be done.

Until late 1994, there were no significant indications that the Orange County investment pool was in jeopardy. No public agencies had raised concern that management or stability of the pool was in jeopardy, and those who we relied on to give us on-going appraisals did not raise any form of notice that the pool was going down a destructive path. That all changed in early December.

Once faced with the facts and realities of the crisis, the board viewed the filing of Chapter 9 as the absolute last option to avoid an outright financial meltdown of the investment pool and the county budget.

We have now established an investment oversight committee which is refining the investment policies of the county and redefining the disclosure requirements of the investment practices, as well as proposed changes that are occurring in the treasurer-tax collector's office.

We have separated the audit function from the auditor-controller's office which had responsibility for auditing the activities of the treasurer-tax collector.

And finally, Mr. Chairman and Members, as a county, we look forward to moving forward by developing options to address the longer term issues of debt repayment, which remains a goal of the county. We have recently issued recovery notes that are secured by an intercept program of vehicle registration fees that will be used to repay the debt, and we continue to work with the legislature and the governor's office to develop a workable strategy.

Mr. Chairman, I thank you for this opportunity to address your subcommittee. Obviously, my remarks are much more extended, and I've submitted those to your subcommittee, but I thank you for this opportunity.

[The prepared statement of Mr. Gaddi Vasquez can be found on page 177 in the appendix.]

Chairman BAKER. Thank you, Mr. Vasquez.

Let me indicate to Members before we recess for the address to the joint session that we will reconvene as closely to noon as is practicable. I have several questions of this panel and I'm sure there are others for the panelists, so there is considerable interest in not only returning to hear Mr. Petracca's testimony, but also in addressing some of the issues raised by your comments here this morning. So we will have a busy and active session starting right at noon.

So we now stand in recess for 1 hour.

[Recess.]

Chairman BAKER. I'd like to reconvene our hearing of the Capital Markets Subcommittee. I know that Members will be joining us here momentarily. The session on the floor was just recessed a moment ago and the House will reconvene at 12:15 for business.

So given the window of opportunity we have to proceed without interruption, I wanted to call on Professor Petracca. Am I pronouncing that name correctly?

Mr. PETRACCA. You got it.

Chairman BAKER. Terrific. Professor, University of California, Irvine, to give his remarks at this time. Professor.

**STATEMENT OF MARK P. PETRACCA, PROFESSOR,
UNIVERSITY OF CALIFORNIA, IRVINE**

Mr. PETRACCA. Thank you very much, Mr. Chairman, for the opportunity to address the subcommittee on the subject of Orange County's bankruptcy and its aftermath.

Let me begin by emphatically noting for the subcommittee and members of the audience that Orange County is not bankrupt. Though still struggling to emerge from a 5-year recession, the County of Orange is reasonably healthy, with future prospects for growth cautiously optimistic.

The government of Orange County is bankrupt, however, and in more ways than one. Not only is county government bankrupt to the tune of \$1.7 billion, but county government is politically bankrupt, as well. Indeed, Mr. Chairman, a crisis of political legitimacy plagues and disables Orange County every bit as much as the current fiscal crisis.

Orange County's financial troubles, in my view, cannot be understood without an appreciation of the rather feudal political structure which characterizes the county's political regime. The concentration of political power in my county in the hands of wealthy developers, landowners, financiers and self-appointed political kingmakers, coupled with the absence of any countervailing source of political power, made Orange County's bankruptcy not only more likely, but makes its recovery far more difficult.

Let me turn my attention to the proposed sales tax, which voters defeated 61 percent to 39 percent on June 27, hardly a quiet suggestion by the voters regarding their aversion to that tax.

There is a strong aversion to taxation in Orange County, which was immediately evident in polls conducted for the *Los Angeles Times* starting in December, 1994. However, it is important to note for all those people around the country who have been laughing at Orange County since December 6, 1994, and who have wondered about the irresponsibility of Orange County voters since June 27, it is important to note that on two occasions in just the past 5 years, Orange County voters did support sales tax increases when, unlike the most recent instance, they were presented with very specific ironclad expenditure targets and guarantees.

That voters were not prepared to support Measure R, the proposed one-half cent increase in the county's sales tax, in my view is neither surprising nor is it lamentable. Like most Americans, if polls are believed, Orange Countians are reasonably suspicious of government, perhaps a little bit more so in Orange County, given

the local political culture, and given some of the people who govern us.

Specifically, they're concerned about the size of government relative to the private sector, the functions provided by government in relationship to those which could be provided by the private sector, and the representativeness, honesty and integrity of government officials.

As soon as the Board of Supervisors unanimously called for a June 27 special election to consider Measure R, Orange County voters began asking why other alternatives to a sales tax increase weren't being pursued first. They had been told all along, after December 6, that a sales tax would be attempted only as a last resort. And yet, in fact, it was being offered, put before the voters, as the first step in bankruptcy recovery.

The answers they received to these questions from tax proponents were obviously not very persuasive. None of the money to be raised by Measure R was earmarked for any specific purpose—not for public education, nor for health care, the elderly, public safety or, for that matter, even specifically for repayment of bondholders or creditors.

Consequently, a yes vote on Measure R required voters to trust, to trust the current Board of Supervisors and the political structure of power within which the board functions, to trust them and that structure to spend \$140 million a year annually for the next 10 years and to spend that money wisely.

Unfortunately, Mr. Chairman, as I argue in my testimony in greater detail, the Orange County electorate is plum out of trust in the Board of Supervisors and in that structure of power. Four months after the bankruptcy, a poll conducted by the *Los Angeles Times* showed that fully 87 percent of Orange County voters thought the Board of Supervisors was doing only a poor or a fair job responding to the financial crisis. Just in this Monday's edition of the *Orange County Register* (July 24), three out of four elected officials polled in the county have no confidence in the ability of the Board of Supervisors to solve the bankruptcy.

Orange County voters, Mr. Chairman, are not deadbeats. They're not arrogant and they're not irresponsible, as the national and local press have been so quick to allege, for voting against Measure R. No, the defeat of Measure R was a completely rational response by the electorate to a proposed new revenue stream which the Board of Supervisors could not be trusted to spend.

After all, Mr. Chairman, by their own admission, members of the Board of Supervisors in Orange County did not know that they had the statutory responsibility and authority to supervise the county treasurer's office until they were told so after December 6 by reporters from the *Orange County Register*. It was incredible. It's been an incredible 8 months.

In its infinite wisdom, Measure R was the only measure placed on the June 27 ballot by the board, an election that cost the taxpayers an additional \$800,000. Voters were denied any other electoral opportunity to express rejection of county government and the people running it.

Knowledgeable voters, in my view, with ample time and opportunity to weigh the merits of the case for and against the sales tax,

came to a rational deduction, not an emotive, knee-jerk response. The case was not sufficiently made or validated that despite what the developers wanted, a sales tax was the only viable recovery option.

Moreover, voters, Republicans and conservatives, libertarians and Democrats, large D Democrats—yes, there are Democrats living behind the orange curtain, and I'm one of them, which is why I'm seated to the left of everybody else on this panel, to my right—they were all convinced overwhelmingly that various disadvantages associated with the increase in the sales tax did not outweigh the reputed benefits.

Measure R was and is a referendum on county government as much as it was a proposal for recovery. The electorate sent a loud message to the board and, in my view, the board has yet to hear or fully comprehend that message.

One of the very first things that the board did after the June 27 vote was to diminish the authority given to Mr. Bill Popejoy as county CEO. In response, Mr. Popejoy has honorably, in my view, tendered his resignation.

Ironically, Mr. Popejoy, even though he was the main visible proponent of Measure R, is the only person in the county right now with the stature and respect to bring all sides of the Measure R debate together for the purposes of crafting the new recovery plan. With Mr. Popejoy's provoked departure, the crisis of political legitimacy will continue. So long as it does, the county will have a very difficult time recovering from its financial plight.

I go on in my testimony, Mr. Chairman. As a social scientist, I indicate that I'm reluctant to reason to broad conclusions from a single case. I urge the Congress's hesitancy in doing so from the Orange County fiscal debacle. But, in closing, let me make four quick observations about what I think Congress might learn from what happened here in Orange County.

First, Congress might consider moving slowly in transforming all Federal service programs to block grant funding. If Orange County had been able to tap into the \$3 billion it currently gets with State and Federal strings attached to it, people in Orange County would be suffering even more than they currently are.

Second, I would argue that the Congress should hesitate to gift the El Toro Marine Base to Orange County in response to the county's current financial plight. Here I'm referring to legislation pending, offered by Congressman Ed Royce. Revenue generated from the sale of El Toro Marine Base rightfully belongs to the American taxpayer, not to the taxpayers of Orange County alone.

Third, I would strongly counsel against any effort to outlaw or regulate the use of derivatives as an investment instrument. I would associate myself with Mr. Cox's remarks here. However, there's certainly a need for legislation, probably at the State level, to severely constrain the ability of public authorities to play roulette with the public's money.

And fourth, there is one greater area of Federal activity that seems to be necessitated by the Orange County debacle, namely, an enhancement of capacity and propensity for regulation and oversight by the Securities and Exchange Commission.

In closing, Mr. Chairman, let me thank you and your staff of the subcommittee for providing a forum to discuss the Orange County bankruptcy which, in my view, has been far more open and inclusive than any one likely to be found back behind the orange curtain. Thank you very much.

[The prepared statement of Mr. Mark P. Petracca can be found on page 185 in the appendix.]

Chairman BAKER. Thank you, Professor. I will proceed, Mr. Bentzen. We'll swap back and forth here, maybe in light of the fact that our participation is rather limited at the moment.

Let me start first, Mr. Sjoberg, responding or reflecting on the direction of your testimony, which was centered around concerns about poor maintenance of liquidity and overleveraging of the investment portfolio and, given the study of other counties in the State, it would indicate that some of these investment strategies are indeed duplicated by others, maybe to a lesser degree, slightly different mix, but the elements of concern are still prevalent in other counties within the State.

If I'm understanding that certain permitted investment practices which may not be bad but which when used with other practices could cause too much risk. Do we need to ensure that arbitrary standards are established so that municipal or State investors don't exceed the limits.

I'm concerned about applying limitation on investment practices. It seems to me that market conditions can vary so greatly that no artificial limit can possibly foresee all market circumstance, that, as Mr. Fong indicated earlier, the best limit may well be common sense regulations, audited by outside parties, pursuant to appropriate disclosure.

So others might second-guess your investment strategy but, in this case, it seems that the fault or problem, more appropriately, relates to the level of disclosure and perhaps a push by some in government to achieve a higher rate of return on investments. Additional risk was assumed by Orange County that perhaps wasn't fully understood by those seeking the high rates of return on investment.

To put this in a capsule, based on your audit of Orange County and others in California, what specific investment instruments should be prohibited from public investment? Do you believe, B, that arbitrary caps are the most appropriate, or C, should we attach ourselves more closely to a full disclosure requirement, leaving those other two elements alone?

Mr. SJOBERG. Mr. Chairman, it's my view that I think we need to begin with full disclosure and, if I might use this analogy, and then from that, disclosure and an involvement by the investment stakeholders, the participants, as well as outside investment committees.

I think that each county is somewhat different or each municipality is sufficiently different that certainly the mix of their investments would likely be different, as well.

But if we were the 190 investors in Orange County and we were to get together and discuss the relative risk that we could all assume in our portfolio, we may then begin to sort through that, and I think that there would be the ability to establish a certain level

of risk which we, the investment stakeholders, would agree is prudent.

It's our view that one could actually determine that risk by a number of analyses and we could, if you will, create a number which represented a certain level of risk—a duration analysis, for example. Let's say it would be we can accept a risk of 1.8 in a duration analysis, or some other interest rate sensitivity.

Within that 1.8, we think then the active investor ought to be able to decide what to acquire, how to hedge and how to balance, to fulfill that 1.8 duration.

And so our recommendation says that if Orange County chooses 1.8 but Modoc County or some other rural county chooses 1.0, that they should manage within those constraints and not to acquire a particular investment that would exceed or contribute to excessive risk above that threshold that we've all agreed so.

So when we say 5 percent limit, we're saying 5 percent limit on the purchase of securities which exacerbate or go beyond that threshold that we have all agreed to. And that would vary by county.

Chairman BAKER. But not the necessity for a Federal one-size-fits-all investment portfolio strategy? Rather, a Federal standard that looks to disclosure on some consistent form that all investors can read and properly understand, but leave the blend to local administration or State administration as to what's appropriate for that environment.

Mr. SJOBERG. That's absolutely our view.

Chairman BAKER. Mr. Fong, I want to follow up on the two-part aspect of this problem. One is leading up to the event and then resolution after the event.

As to leading up to it, you indicated that you felt the disclosure issue was the principal cause for a very complex set of circumstances, to wake up and read, "We have a bankruptcy."

Do you think we should stop short of registration of all municipal issues or do we move aggressively to a full disclosure in some standardized form? How far do you think, based on your view of circumstances in this instance, should we go in a national standardization of this information?

Mr. FONG. Mr. Chairman, I think the two things that led up to the Orange County situation, one was the lack of disclosure, and I think disclosure is the prime remedy in that California had legislation. We had a similar problem 11 years ago in San Jose, not to the magnitude but similar, and it resulted in legislation which required disclosure.

That disclosure legislation sunset, and almost to the day of that sunset, you could see the former treasurer, Bob Citron, then embark on his very high-risk strategy. So I do think disclosure would solve and remedy the problem.

He also had another element to this, and that was oversight by the Board of Supervisors. One of the other elements that we're looking for, then, is whether it's the supervisors or someone who they designate to oversee their portfolio, to be a watchdog, so to speak, and advisor.

We have over 2,000 treasurers in California, from county to city and other types of government entities, and only one got in trouble.

Now, our auditor general mentioned that there's maybe a handful that are in the yellow cautionary zone, but the point I'm trying to make is that by and large, the system worked. The marketplace today is reacting, and whether you pass disclosure laws or not, the marketplace is going to demand greater disclosure before they give their stamp of approval. So I think the marketplace is also adjusting to this new reality.

Chairman BAKER. Thank you, Mr. Treasurer. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I have questions for a few of you all. Mr. Fong, and I would ask this also of the auditor, did Mr. Citron violate California investment law? I know he's pleaded guilty on several counts but did he violate specific California investment laws that relate to securities or to duration that we talked about? Or is there any California law other than permitted investments for public funds?

Mr. SJOBERG. We found that county treasurers have great discretion in what they can purchase. There are some limits in California statutes, but those primarily focus on the creditworthiness of what is being purchased, a AAA bond or something of that sort, government-backed securities. And, as we all know, many of them become the basis for some of these structured notes later.

So in the sense of an absolute prohibition, what we found that ultimately led to the criminal complaints related not to what he purchased, but rather the misappropriation of funds, interest, and so forth.

Chairman BAKER. Will the gentleman yield on that point?

Mr. BENTSEN. Yes.

Chairman BAKER. Let me add a point of clarification on that issue. I am advised that in an earlier appearance before a Senate committee questions were asked of Mr. Citron if he violated California laws on investments. He answered affirmatively.

Has that been acknowledged, and is that a correct and accurate summary?

Mr. SJOBERG. I believe he testified that on two occasions he had purchased, on one occasion, a bond that was perhaps backed by the German mark or the underlying index was a German mark, and then that there had been another bond that was a corporate bond that might have been rated below a certain level, but he had immediately divested himself of that as soon as he learned of it.

And I believe certainly none of them were a factor at all in the bankruptcy.

Chairman BAKER. I thank you. I thank the gentleman.

Mr. BENTSEN. There is no California law that restricts duration or that sets a percentage as it relates to repos or reverse repos as a percentage of the funds?

Mr. SJOBERG. Not currently, although both the Treasurer's Task Force and my office and others have recommended that there be some limits placed on reverse repurchase agreements, for example, not to exceed 20 percent of the portfolio. Those do not exist currently.

Mr. BENTSEN. I'd had the opportunity to check with my State treasurer of Texas before I came back and I'll note for the record that they had set a rule of 25 percent for reverse repos in the Tex Pool.

Let me point out to the auditor, you've commented that in your research, as of July 1994, the Orange County Investment Pool had over half its investments in derivative securities or derivative instruments; is that correct?

Mr. SJOBERG. What I believe I said was over half actually were structured such that their value decreased as interest rates rose. He had other structured notes—

Mr. BENTSEN. Inverse floaters, things like that?

Mr. SJOBERG. Yes, that did not decrease.

Mr. BENTSEN. I would, for the record, point out, and I would imagine the lawyers are already looking at this, but the official statement dated August 18—actually, dated June 30—I'm sorry, August 12, 1994 for the Teeter Plan tax exempt notes on page 15 talks about, in the disclosure of the Orange County Investment Pool, the market value and liquidity of the county investment pool, it states that as of June 30, 1994, approximately 20 percent of the county investment pool was invested in derivative products, of which substantially all were floating rate and inverse floating rate government securities.

This is, again, the disclosure document that is widely used in the market.

Mr. Chairman, my time is about up. If possible, after the other Members finish, I have some other questions I'd like to ask this panel.

Chairman BAKER. Certainly. Mr. Bono.

Mr. BONO. Thank you, Mr. Chairman. First of all, I'd like to state that two of the panelists are very close friends of mine and have been for a long time, Mr. Fong and Mr. Vasquez, and I have great confidence in both of them.

And second, I got here late, so I don't have the entire gist of the situation here, but I'll ask Matt, is the question we're looking at now whether the Federal Government should get involved with a solution to this problem?

Mr. FONG. I think the issue before the subcommittee is to what extent should the Federal Government provide some type of uniform standard without being overburdensome and still maintaining flexibility at the local level.

Mr. BONO. OK, thank you. My feeling has always been the same about the Federal Government getting involved with local government, especially when we have the kind of competency that we have here. As far as I'm concerned, the horse is out of the barn and that's the end of that story, and probably the analysis of what occurred has been gone over with a fine tooth comb, and I'm sure that by now you have an assessment.

I guess my next question would be do you feel at this point that you need any assistance from the Federal Government as far as preventing this kind of a situation again? Or can you now handle this and can we stay out of it?

Mr. FONG. Well, Congressman, I know in our State, in California, the legislature is drafting legislation that will deal with this in our own State and if the Congress wants to adopt something similar and make it uniform, my only concern is the extent that it becomes overburdensome.

We have so many different municipalities, their funds are so different and unique in character, that to try to make a one-size-fits-all may very well have a chilling effect and have a net result increase of fees and taxes to make up for income not earned on an incremental basis for some of these programs that are being challenged now by proposed legislation.

I still think, very simply, that if the Congress wants to move in the disclosure section, and not just disclosure of what's in the fund, but to also require that a strategy be stated, a strategy be stated of what kind of return and how that return is going to be achieved, and on a quarterly basis require the measurement of what's done in that past quarter against the strategy and present that to whether it's the Board of Supervisors or to the governing board of the pool, that then gives the kind of disclosure necessary, I think, that would have prevented something like what happened in Orange County.

Mr. BONO. Thank you.

I understand you're not a coalition, I'd like to ask Gaddi, Mr. Vasquez, do you concur with what Mr. Fong has just articulated?

Mr. VASQUEZ. Mr. Congressman, I do and I believe that we have been working, over the last several months, both in the State Capitol of California as well as internally in the county, as I've described in my earlier statement, to work with the legislature to define some of the issues that relate to the function of treasurers in California. I think Mr. Sjoberg has also referenced that particular issue.

We are also revamping and redoing our process so that there is investment overnight by an independent committee. We've separated the auditing function from the auditor-controller function so that there is that independence, separate and apart from the typical auditor-controller function.

So we are working diligently and, I think, making some progress.

Mr. BONO. Thank you. I see my yellow light is up. I would just like to say that again, I have a tremendous amount of confidence in my two friends, and probably the rest of the testifiers here that as much as we can keep the Federal Government out of this, I think would be the way to go. If they have a recommendation, I would certainly concur with that. But I think that they have dealt with this problem day and night and certainly, at this point, have a handle that is more of a local handle than a Big Brother handle.

My view, Mr. Chairman, is that we limit our participation and let them take this problem and solve it. The more we get off their backs, the sooner they can solve it. Thank you.

Chairman BAKER. I thank you, Mr. Bono.

If I might follow up with you, Mr. Popejoy, and your comments, given your unique posture in the current circumstance. You indicated some expression of frustration about the bankruptcy decision, somewhat surprised by the decision to declare bankruptcy.

Given the fact that there were significant pool withdrawal restrictions at the outset, that I'm counseled that the major investors had indicated a willingness to leave their funds in the pool. In light of that, what alternative steps, in your view, could have been taken, other than Chapter 9 protection, that might have led to a more appropriate remedy?

It appears that in the intervening 8 months, there has been some discussion as to appointment of a State trustee to intervene and make unilateral decisions about the most appropriate action for resolution. Is that an alternative that perhaps should be made available, rather than Chapter 9, for other municipalities or counties facing a similar circumstance?

Mr. POPEJOY. Mr. Chairman, my thoughts regarding the county's bankruptcy are not ones that fall in the category of black or white. I would have liked to have seen, with the benefit of hindsight—remember, I wasn't there; I wasn't subject to the pressures, the need for cash, the need to protect the county's ability to pay its bills. I feel a little awkward, but I do think that bankruptcy doesn't serve a government well.

When people buy the bonds of a government entity, they don't expect that entity to go into bankruptcy, at least not a United States government.

So I think going forward, there's going to be more and more concern in the bond market about whether or not this county or this entity might go into bankruptcy, to Chapter 9, and not pay our bonds, as they should, or try to.

I guess, once again, with a giant dose of hindsight, Monday morning quarterbacking, and I'm guilty of that here, Mr. Chairman, that I would have liked to have seen the county try the New York approach that was adopted in the late 1970's, where they had a similar problem, for different reasons, and they basically brought together the parties and worked out a program.

Now, they also got a guarantee from the State, which we have not sought and do not have, so it made their job a little easier.

We will have, if nothing else, a huge amount of litigation going forward. I don't know what it'll be but it probably is already approaching \$40 million. That probably could have been avoided without a bankruptcy.

But there's a flip side to this, and the question of whether or not we could have protected ourselves from withdrawals, if we could have paid our bills at all, if we could have done a better job protecting the collateral that was held behind the reverse repos—it's not clear, but I do wonder whether or not bankruptcy, Chapter 9 bankruptcy, is appropriate for any government entity because of the level of confidence that that probably will take away, going forward, for the bond buyers.

Chairman BAKER. My question is in relation to the effect on others and the ability to generate capital for future needs, and it appears that the current circumstance is one filled more with uncertainty than it is clarity, that when these untoward events develop, we don't know what the next step will be.

It would seem advisable that with not acting just in a singular fashion on the Chapter 9 issue, but with adequate standardized disclosure, where markets can rate, we can avert this potential; and then second, perhaps a slightly different procedural process through which one would engage in order to extricate yourself and perhaps make it inappropriate for bankruptcy protection at all, would make great strides toward satisfying investor pools that this activity is warranted in the future for all local and State governments who use this resource.

And finally, I think it's important from a taxpayer perspective. You then mitigate, I think, dramatically potential losses and unwarranted litigation costs.

Mr. Vasquez, I'm going to try to be brief because I knows Mr. Bentsen has further questions, as well. Could you express your view as to the appropriateness of the bankruptcy remedy? Although I understand the difficulty the county faced in resolution of this matter, it seems as though there was a very short fuse between the announcement of potential difficulty and the finality of the bankruptcy announcement.

Can you enlighten us as to the elements that went into that determination and what, in your view, made that appropriate?

Mr. VASQUEZ. Well, Mr. Chairman, just generally, the Board of Supervisors met in session to discuss the options that were available to us. We sought and received counsel from both our county counsel and private bankruptcy counsel. And I might add that Mr. Bruce Bennett, who was the legal counsel that advised the board on the issue of the Chapter 9, is here in this room and is available to the subcommittee if you so desire.

Essentially, it was a process whereby all of the fiscal issues, the legal options, the financial options, and the fact that the county was literally in a financial meltdown, if you will, at the time, that the board, after evaluating all of the options that were available and had been placed before us by a number of legal counsel, that we found no option but to go forward, as painful as it was.

And I can assure you that there are many disincentives, particularly in the aftermath of the filing, that we're certainly cognizant of for a Chapter 9 filing, but at that particular point in time, the board believed that it was the only viable option available to us, in view of the circumstances that were coming at us from a variety of directions, both the financial markets as well as the general stability of the county's financial ability to continue to deliver the services to the people of Orange County on a daily basis.

Chairman BAKER. This may be difficult for you to forecast, but assume for the moment the problems have been resolved, it's 2 years hence. Some new sophisticated investment opportunity is presented. The person charged with that responsibility decides to invest, and the county's again faced with a similar circumstance.

Would you advocate, with your knowledge today, based on your experience involved with the resolution of this matter, that the county would again consider that avenue as an appropriate remedy, or would other mechanisms be more advantageous?

Mr. VASQUEZ. Well, sir, if I understand the question, I would certainly hope that the lessons learned from this experience will result in the development and implementation of safeguards and provisions that will never again put us or any other county, I hope, in California and this country, in that position. So that would be my response to that.

Chairman BAKER. Thank you. I appreciate it.

Mr. BENTSEN, I'll yield to you.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Vasquez, in your testimony you said that the pool, the investment pool was established and managed by the Orange County treasurer-tax collector. Under California law, Citron was able to es-

establish that pool, or did it have to go through the Orange County Board of Supervisors? Was there some resolution that had to be adopted, or how did that work?

Mr. VASQUEZ. There were resolutions that predated my coming to the Board of Supervisors that had to do with a number of policy issues. But as I understand it, sir, and I'm not a lawyer and I don't specialize in the structure in particular, but what I understand it to be is that the pool was established and had statutes that required certain funds to be deposited—that is, the school funds—deposited in the investment pool, as per State law and State requirements.

So there were provisions of State law that required that pool to exist, as I understand it.

Mr. BENTSEN. You said that the portfolio was audited by an independent outside auditing firm. Who hired the outside auditing firm?

Mr. VASQUEZ. I don't recall specifically, sir, at this time whether it was the board or the treasurer-tax collector, but it was—

Mr. BENTSEN. If you could get that for the record, that would be great.

Mr. VASQUEZ. Yes, sir, absolutely.

Mr. BENTSEN. Are you familiar with the \$600 million 1994–1995 taxable note issue?

Mr. VASQUEZ. Generally, yes, sir.

Mr. BENTSEN. OK. Are you familiar with the reason for the issuing of the notes or what the purpose was for, the use of the proceeds?

Mr. VASQUEZ. [Nods].

Mr. BENTSEN. From my reading, it would appear that the notes were issued for the purpose of investing to earn at least 150 basis points over the cost of the notes over time, in effect, to earn arbitrage. Is that your understanding?

Mr. VASQUEZ. Yes, sir.

Mr. BENTSEN. OK. And the issuer of the notes is the County of Orange, California. I read through this and under the authority for the sale and issuance, the notes are issued in accordance with the constitution and laws of the State, which includes a resolution duly adopted by the Board of Supervisors of the county.

In the process of doing this, and the various—I've got four or five official statements up here; I assume that's just California code for issuance purposes—the treasurer comes and presents what the issue is, the lawyers, the bankers, whoever is working on it, and explains what the deal is, and then it's adopted in a public forum by the county, correct, by the Board of Supervisors?

Mr. VASQUEZ. Yes, sir.

Mr. BENTSEN. Did you read the official statement or do you know if other members of the supervisors read the official statement before the issuance?

Mr. VASQUEZ. The official statement, sir, reviewed by County Council and reviewed by the staff that we have and reviewed by my internal staff.

Mr. BENTSEN. I would reference, and I lost my section, but if you look under risk factors that's in this official statement, it does reference that there's the possibility of insufficient returns on the re-

venues and that that would allow for other revenues of the county to be legally allowable to pay the debt. And I would refer Members to that. I appreciate your comments on that.

Let me state very quickly for my colleague, I think it's very difficult to come up with some Federal solution to this because I don't know if anybody knows what the solution is. I think part of our problem is finding out what the problem was to begin with and then trying to address it, and I think we have to be very careful of that. So I agree with my colleague from California on that.

I have a couple of questions for both Mr. Fong and Mr. Popejoy. In fact, Mr. Popejoy, let me ask you first. You came to this job from the private sector. Presumably you were involved with the capital markets at some time or another during your private sector experience, in the issuing of debt or equity offerings. You've been involved with disclosure, I would assume.

You were just involved with this most recent transaction, I would assume, that Orange County did as part of paying some of the beneficiaries of the pool, the MBIA transaction. So I'm sure you went through extensive meetings in disclosure of that.

Do you believe, given your experience in both the corporate and municipal markets, that there is sufficient disclosure procedure in the municipal markets?

Mr. POPEJOY. No. No. The municipal markets have been based upon trust, and it's almost been a gentleman's club. They have not had to follow the scrutiny of the corporate markets by any stretch of the imagination. And fully disclosure isn't even attempted. Partial disclosure probably is a better description. And in a corporate world, you wouldn't be allowed to issue the so-called casino bonds of 1994 without much more disclosure regarding the underlying financial strategy of the portfolio.

Mr. BENTSEN. If I might, Mr. Chairman, I realize that you were at the end of a job that you weren't fairly compensated for probably and you're now giving voluntary assistance, but if you could, for the record, I think it would be good for the Members if you could list out 10 or 15 points for the record where you think there is a difference between corporate and municipal disclosure and where you would recommend changes in municipal disclosure.

You don't have to do it now, but at some subsequent date for the record, I think that would be helpful to us.

If I might very quickly ask Mr. Fong a question, you talked about Measure R failing. You said that the governor is looking into this; the auditor general has been in Orange County; the legislature is dealing with this.

What plans does California, the State of California have to deal with the Orange County situation now? Is there a California MAC coming? Is there some intervention plan?

Mr. FONG. Well, Congressman, I believe that with the success of the rollover strategy, which now gives the county a year's time to work on solutions which Chairman Gaddi Vasquez was laying out to you, that I do not see and I don't think the State has any type of a plan to do any kind of a bail-out or type of a MAC.

I think that the conditions for having a MAC or trusteeship would arise maybe one, if the county asked for it voluntarily, saying, "Gee, we'd like some help from the State; please bring in a

trustee," but I don't see them doing that right now; two, if the county is dysfunctional and services aren't being provided, but if you drove through Orange County today you'd see everything's working, the police are showing up, firemen are going to work, services are being provided, so I don't see the critical mass there for a takeover; or three, if the county totally repudiated its obligations, which it has not. It has technically taken a note which was due and payable within 1 year and negotiated—some might say cram down the negotiation, but albeit it did negotiate a rollover and they're paying interests on it.

So without any of those three conditions and a philosophical belief that the State should allow the county to solve its problems and should not reward, in effect, the county with a kind of a bailout, to the extent that other county treasurers in other counties have been tightening the screws up and, in effect, to have those counties now send their money down to help out Orange County, I think philosophically is what we'd be against.

There are a lot of taxpayers in Orange County that obviously voted against Measure R, which is why it was defeated. But the bottom line is that they're not claiming responsibility in that effect. But the county treasurer was elected, the supervisors were elected.

I see this no different than if your son or daughter, and God forbid, my son's now starting to learn how to drive—he's in high school—but if he were to put the family car into a tree, it's not my fault as a parent—I didn't put the car in the tree—but I'm still responsible for paying the bill, and it will come home to roost back in Orange County. And that's, I think, the fundamental position of the state.

Mr. BENTSEN. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Cremeans, do you have any questions?

Mr. CREMEANS. Mr. Fong, as a former small businessman, I proceed either from the advantage or disadvantage of litigation-related expenses or, for that matter, county expenses. And one of the purported reasons that Orange County declared bankruptcy was to control those expenses.

Now, it is my understanding that that was measured somewhere in the neighborhood of \$40 million. Now, after having gone through this, I guess my question is did that particular approach, Chapter 9, meet your expectations and could you give me any advice or perhaps this Committee any advice as to the future?

Mr. FONG. Yes, Congressman. I think I share Mr. Popejoy's views that there must be another way to do this because we're spending an awful lot of money on lawyers and others that should be going to solve the problem.

The other concern I have about a bankruptcy track, and bear in mind that we're in new territory. I don't think a county's ever gone this far with this size, and so the bankruptcy model is essentially a corporate model, and so the paradigm would one come forward to solving this problem is one of a corporate restructuring and the fact that, as a corporate bankruptcy lawyer, your client can change its name, your client can move out of the State if it wants to, start afresh and get a new life.

But a county can't do that. Wall Street will always remember and always penalize, as we've seen in Washington and other places that have had problems, as well as in California.

What we're trying to do in California now is to make it more difficult to file for bankruptcy, to give assurance to the marketplace, and some states have a requirement that before a county can file for bankruptcy, it must get a second opinion, and usually it's from the state.

Mr. CREMEANS. You're talking about just municipalities.

Mr. FONG. Yes. So that one piece of legislation that we're trying to now present through our legislature is to eliminate a county from being able to just pull a trigger.

Now, I'm not going to second-guess Chairman Vasquez now because I also was not sitting there, but as you look with hindsight, a bankruptcy track does not put the players in a win-win solution. It's very much like trying to rack up the score—I mean, I'm a lawyer, and if you're in litigation, your attempt is to win for your client. That means getting major damages.

Well, major damages and your incentives for a corporate bankruptcy are far different than a municipal bankruptcy, and that's the problem that we're in.

Chairman BAKER. I want to express my appreciation to all the panelists for your time and willingness to participate. In light of the fact that the subcommittee still has much work to do, I would encourage any who have further comment to submit them to the subcommittee in writing.

Likewise, there are Members who have indicated to me an interest in further questions, but given our time constraints, we'll forward those to you at a later time, hopefully for a response as you see fit. But thank you very much for your participation.

At this time I'd like to call the members up for our third panel to give testimony, please. By way of introducing our third panel, thank you first for coming, and second, indicate, as I have to others, that to the extent you're able to limit your remarks to 5 minutes, your formal presentation will be made a part of the record and carefully reviewed by all Members and staff.

And I first call on Mr. Richard Sigal, senior partner, Hawkins, Delafield & Wood, who I believe to be correct in stating at one point was a consultant or adviser to the Orange County in relation to the current matter that's under discussion. Mr. Sigal.

**STATEMENT OF RICHARD L. SIGAL, ESQ., SENIOR PARTNER,
HAWKINS, DELAFIELD & WOOD**

Mr. SIGAL. Good morning, Mr. Chairman. Thank you very much for inviting me to testify at this hearing. As you know, we submitted to you a very detailed response to your many important questions, and I am not going to dwell on the specific answers, as such.

For the record, I should note that our firm was retained after the County of Orange filed for bankruptcy for a brief period until December 1994, and I am confining my remarks to those not affecting my attorney-client relationship.

We also, for the record, represent several counties and cities in California, as we speak, on many of the questions that are being raised today.

As a senior partner at Hawkins, Delafield & Wood, I do bring to these hearings over 31 years of experience in municipal fiscal crises and over 100 years of accumulated experience of our firm. Our experience does range from serving as bond counsel to the Municipal Assistance Corporation for the city of New York, including the creation of the corporation, working on the structure of those financings and working out the situation without resort to bankruptcy.

We also served as bond counsel to the city of Yonkers, which we brought right to the brink of bankruptcy without going into bankruptcy on the theory that that wasn't the proper solution there, either.

As we sit today, we are representing the Municipal Assistance Corporation for the city of Troy, New York, which was recently established by the State of New York in order to avert bankruptcy by the city of Troy.

In the State of Connecticut, we also serve as special counsel to the state with respect to the city of Bridgeport, which had a brief experience with bankruptcy for a period, and for the town of West Haven, which has successfully come out of a controlled situation, and for others.

We are thoroughly familiar with many, many, many municipal fiscal crises of the magnitude and of the problems associated with Orange County, all of which have been resolved without resort to the bankruptcy code.

We believe very strongly that this subcommittee can be of great assistance to the municipal finance community. We have many issues to talk about with you and because we're limited to 5 minutes, I can't speak to all of them, but I do want to speak to one in particular. That is the opportunity for amending the legislation to make it more difficult for municipalities to enter into bankruptcy.

We believe, as a condition precedent to even the filing of a petition for bankruptcy, there should be consideration of whether or not the wealth of the community has been made available to work out the situation prior to the resort of bankruptcy, that some State type of approval should be also required prior to filing, and finally, that a bona fide good faith effort has been made to try and resolve the fiscal problem short of the bankruptcy.

I recommend this primarily based on my experience that there are very solid and very good solutions to municipal crises short of bankruptcy and, if nothing else, what has at least been discussed so far, it appears that those who have now experienced the situation of being in bankruptcy, it is not a very good system in which to work out your problems.

The very existence of the Tenth Amendment of the Constitution makes that an obvious problem. The Federal Government, through the Bankruptcy Court, cannot change State law. So by definition, the limitations of the Bankruptcy Court are grounded in the Constitution, and there's very little statutory work we can do in terms of working out situations, like has been done in corporate bankruptcies.

We note unequivocally that the counties, cities, villages and towns will continue to have to provide essential services and, whether we like it or not, one of those ways of providing the essen-

tial services is through bonding. And that is the ingredient that has not been brought to bear in terms of the bankruptcy code.

And when we are talking about good faith efforts, every single solution, whether it's the city of Cleveland, whether it was the city of Philadelphia, whether it was the city of Chelsea in Massachusetts, were worked out through stretching out the problem over a period of time so that both the essential services, the capital requirements, and the budgetary problems could be worked out over time.

Where I'm going and what I'm working on in terms of this testimony is to try and figure out exactly how that balance can be put in place for the bankruptcy code. I've come down to the concept, at least, of trying to make it so that bankruptcy is not a business choice of a municipality and that it is only a harbor of last resort. It's only a refuge. It's not an inviting harbor as a business choice.

The municipal market has extended extraordinary efforts every single time to try and work out the situation short of bankruptcy. The geniuses in New York, from the governor, from Felix Rohatyn, and from all those people, including some of the people that are on your staff today, worked day and night short of bankruptcy to solve the problem.

There was a consensus that finally emerged from the employees, from the taxpayers and all of the disparate groups that were, at first, not together, came together to resolve the problem. And that was a \$9 billion problem, or more.

So the issues of disclosure and some of the others that have been brought up today, I don't believe, as a basic matter, that the corporate model for municipal disclosure is necessarily the right model because it's grounded on the fact that a corporation can go out of business, and it's grounded on the fact that the stockholders', if you will, risk is the value of the stock, if it goes down to zero.

The real wealth of a community, whether it be a county or a village, ultimately is the taxpayers. And the risk there is unlimited.

So for a starter, the corporate model versus the municipal model, I don't know is the right route to go. And I do believe the record of municipal financing in this country is extraordinary. It is a safe investment. It has been for many, many years in that defaults and the bankruptcies are very few.

And I would suggest that there is, in the disclosure, and particularly Paul will be talking on the SEC—the SEC is doing an excellent job. The secondary market requirements that they have brought to bear on the market are working. Everyone is cooperating. There are, to my knowledge, and we have a national practice—we do not have one client who is balking at the requirements that the SEC has put out, and everybody is working to make sure that not only the primary market but the secondary market complies with those rules. And those rules are basically modeled on municipal rules which have worked for many, many years.

So notwithstanding some of the testimony you've heard today, I don't think it's a disclosure problem. But I do think what the municipal market needs from, I guess, this Congress is some recognition that bankruptcy is not a business choice.

And I think the real problem is that bankruptcy no longer is an embarrassment, and therefore it seems to be available as a busi-

ness choice. Certainly in the corporate world it seems to be that way quite often, whereas in the municipal market it is not that way.

And in general, and without being specific, we'd like to think of Orange County as an anomaly, but, at the same time, if there is not a change in the bankruptcy code and if it is a business choice, then municipal officials faced with such things as reduction of Federal aid, such things as base closings, fiscal catastrophes, meeting them, they must, as their public duty, look at the bankruptcy option.

And if they see a bankruptcy option that appears to simply say are we unable or are we unwilling to pay our debts, then maybe they are unwilling. But if they see a bankruptcy provision that says work it out, work with the State, make a bona fide effort to do the job before you file, I think we would all be better served.

And frankly, the interest rates that would be saved by eliminating the risk of business choice of going into bankruptcy would be a savings that's a win-win all the way.

So what I'm suggesting basically, in closing, is that this would be an amendment without cost to the Congress, to the Federal Government and to the states, and we would eliminate any risk penalty that might be associated with a business choice of a municipality to go into bankruptcy. Thank you.

[The prepared statement of Mr. Richard L. Sigal can be found on page 198 in the appendix.]

Chairman BAKER. Thank you, Mr. Sigal. Appreciate your remarks.

The next witness is director of the Office of Municipal Finance from the Securities and Exchange Commission, Mr. Paul Maco. Mr. Maco.

STATEMENT OF PAUL S. MACO, DIRECTOR, OFFICE OF MUNICIPAL FINANCE, SECURITIES AND EXCHANGE COMMISSION

Mr. MACO. Chairman Baker, good afternoon. My name is Paul Maco, and I'm director of the Securities and Exchange Commission's Office of Municipal Securities.

I appreciate the opportunity to appear on behalf of the Commission to discuss the events surrounding the bankruptcy of Orange County and to provide an overview of our activities in the municipal securities markets.

I ask that, with respect to Orange County, you remember that the Commission is in the midst of an active investigation and I cannot address nonpublic matters that may become the subject of action by the Commission.

I have been asked by Chairman Arthur Levitt to make the following statement, which is also supported by Commissioner Wallman.

The Orange County bankruptcy and default followed the loss of an estimated \$1.7 billion in public funds in a risky investment strategy. There have been reports of other losses, fortunately less severe than Orange County's. A control board has been established with control over the spending of our Nation's capital, and Los Angeles County is struggling to close a \$1.2 billion deficit.

This time of difficulty in municipal finance will doubtless produce lessons for all of us. One lesson we should not draw, however, is the wrongheaded notion that Chapter 9 may be an alternative to responsible but unpopular decisions to fulfill the obligations incurred by local governments. Chapter 9 should be a last resort, not an easy way to avoid debts or a safe haven for faint-hearted officials.

The real lesson of this crisis is the need for prudent management of public funds. Our markets have developed complex instruments that are capable of producing breathtaking returns or breathtaking losses.

The three basics of public fund management, however, have not changed: safety, liquidity, and yield, in that order. Exotic instruments should only be considered by entities that have the required expertise and resources. To make an analogy, electricity is a wonderful thing, but if you don't understand it, you probably shouldn't try wiring a house by yourself.

The Commission does not generally have, nor does it seek, the authority to regulate investment decisions by municipalities or other end users of securities. However, where the anti-fraud provisions apply to the issuers of securities, as they do to the issuers of municipal debt, or in the case of entities we regulate, such as money market funds and broker-dealers, the SEC stands ready to take action.

The Commission continues to believe that efforts should be made to help promote the use of sound investment strategies and modern risk management techniques by State and local governments. We feel that we can play a constructive role in this process. We've already begun to address these questions at forums with local officials.

We've made progress on a number of other issues in the municipal markets. In March, 1994, the Commission noted that municipal issuers need to be concerned that they do not mislead investors, both when offering their securities and on an on-going basis.

The most effective way to avoid misleading investors is to adopt a program for providing updated financial information on a continuing basis, and for timely disclosure of material events.

In November, with the help of the industry, we adopted extensive revisions to existing broker-dealer rules to facilitate annual disclosure of financial information and timely disclosure of events that affect the value of municipal securities. These measures took effect this past July 3.

We took these steps in the belief that we should act before the next crisis and because the market had changed in a fundamental way that required the SEC to act for the protection of investors.

A decade ago, individual investors held about 45 percent of outstanding municipal securities. Today that figure is more than 75 percent. The increasing public nature of this market demands that issuers and dealers meet standards of disclosure, transparency, and fairness taken for granted in other markets.

Mr. Chairman, the SEC is deeply committed to reforming the municipal bond business. To us, this thriving market represents the schools that teach our children, the water we drink, and ultimately the faith of our taxpayers in the future of our communities.

It deserves the very highest ethical standards and the very lowest regulatory burden.

We are confident that, with your support, the Commission can achieve these goals. Thank you.

[The prepared statement of Mr. Paul S. Maco can be found on page 243 in the appendix.]

Chairman BAKER. Thank you, Mr. Maco.

The next witness is the executive director of the Municipal Securities Rulemaking Board, Mr. Christopher Taylor. Welcome, Mr. Taylor.

STATEMENT OF CHRISTOPHER A. TAYLOR, EXECUTIVE DIRECTOR, MUNICIPAL SECURITIES RULEMAKING BOARD

Mr. TAYLOR. Thank you, Chairman Baker. As executive director of the Municipal Securities Rulemaking Board I appreciate the opportunity to testify before this subcommittee concerning the municipal securities market and the events in Orange County.

Before I address the Orange County situation, I would like to provide a brief background about the MSRB. The MSRB's rule-making authority extends only to securities dealers and only to their municipal securities activities.

The main focus of the MSRB and its rules is the protection of municipal securities investors and the municipal securities marketplace. The MSRB does not have the authority to write rules governing the activities of municipalities, either in their capacity as issuers of municipal securities or as investors in securities in general. So too, the MSRB has no role in municipal bankruptcies.

The MSRB, however, is very concerned about the Orange County situation and its impact on the municipal securities market.

Since 1987, the MSRB has made significant progress on systems, through our municipal securities information library, for providing market participants with more information regarding the description and value of municipal securities and more information about the issuers of securities.

The MSRB created the MSIL System to improve the flow of information in the market so that dealers could carry out their responsibilities under our rules.

Regarding the situation in Orange County, the MSRB has been viewing with concern the steps taken thus far to resolve the difficulties. It is too early to tell if this situation is an isolated incident or the beginning of a fundamental change in how municipalities view their commitment to general obligation bondholders.

A number of other issuers in difficult financial situations may determine their own course of conduct based on the outcome of the actions of Orange County. If Orange County does not completely fulfill its commitments to bondholders, other issuers may follow suit. Investors may then lose confidence in this important market and the market for new issue and outstanding general obligation bonds will suffer.

General obligation bonds, bonds secured by the full faith and credit of an issuer with taxing power, have been considered to be the most secure of all municipal issues because governments have the power to levy taxes to meet payments of interest and principal.

Full faith and credit has been interpreted to mean that the issuer will use all available taxes and other revenue sources to the extent necessary to raise the funds needed to repay the principal and interest on bonds when they become due.

Historically, the default rate for general obligation bonds has been exceptionally low. Not only are these bonds desired by investors who seek to minimize risk, but they provide investors with a lower cost of capital.

When municipalities with a large amount of outstanding general obligation debt are faced with financial difficulty, most have taken steps, with the assistance of the state, to stave off default in order to avoid the stigma of default and bankruptcy and to allow access to the capital markets at a reasonable cost in the future.

For example, in 1975, New York City was unable to meet its short-term obligations and was unable to market its debt. New York State created a financing authority, the Municipal Assistance Corporation, which was designed to raise money for the city and created the Emergency Financial Control Board to ensure fiscal responsibility on the part of the city.

In addition, the city of Philadelphia faced severe financial problems in 1991. Pennsylvania stepped in to create an authority to raise money and impose fiscal restraints.

The current uncertainty regarding the intentions of Orange County has had a negative effect on the market. A rapid resolution, through a credible plan of action, will not only resolve the bankruptcy issues and restore credibility to Orange County, but will instill confidence in this large and important market.

The MSRB will monitor the events and actions of Orange County. If we determine that the principles behind general obligation bonds or an investor perception of the safety and liquidity of such securities has changed, we will take steps to protect investors through additional dealer disclosure requirements. Thank you.

[The prepared statement of Mr. Christopher A. Taylor can be found on page 307 in the appendix.]

Chairman BAKER. Thank you, Mr. Taylor.

Mr. Sigal, I understand your concern with regard to the ease with which bankruptcy was embraced by Orange County. But short of barring that as an avenue, which would be difficult to do, it seems that the uncertainty of what will be done is more detrimental than almost any other factor. It has been 8 months since the bankruptcy filing.

Would it be a responsible public policy to outline a procedural step that a local government must take, as you suggested, State government approval before taking bankruptcy. If action is not then taken by a local supervisory board, should the State appoint a trustee? This would possibly allow a friendly resolution earlier in the process, because ultimately there would be one person to make judgments about the best interests for all parties.

Is this something that, from your experience in this matter, would make sense?

Mr. SIGAL. Let me try and be a little bit circuitous on answering that because the answer is yes and no. The Tenth Amendment, as I mentioned—

Chairman BAKER. You're at home in Washington; I can tell you.

Mr. SIGAL. The Tenth Amendment is a serious matter for State and local government, and we all know it reserves the power to the States. So any time the Federal Government starts to intrude on prerogative of governance, it becomes a problem.

What I'm trying to suggest is a compromise between that. I don't think the Federal Government should say it must be the governor of the State that authorizes it. On the other hand, the State of Connecticut, after having gone through this experience with Bridgeport, which they provided with a control board and then the city itself went into bankruptcy and the attorney general went into court and fought that, they did pass a statute which basically now says they have a whole stage of tier one, tier two, tier three. And, in the final analysis, it is with the approval of the governor.

So I'm not saying that that isn't the right solution. It's a question of how to phrase it at the Federal level so the Federal people are not seen, as Mr. Bono said, it's not seen that they're intruding on the prerogatives of State government.

I don't know whether it should be the governor. It happened to be in Connecticut that way. It might be the legislature. It may not even be necessary to go to that level, if there is an overall strategy in effect at the State level.

What I am suggesting, though, is that the Federal Government, because it has the only power to allow municipalities to go into bankruptcy, it can make the condition for bankruptcy more difficult, so that there is at least something like the corporate world, where there is fair valuation. The corporations, as I understand it, just can't walk in. They have to show that their debts far exceed their fair valuation.

So there can be some preliminary requirements, either of the bankruptcy court, particularly is the wealth of the community fully leveraged to solve the problem, or is it necessary to be in bankruptcy? By doing that, you can create, as I've suggested in my actual written testimony, the effort required before you use the bankruptcy court. And in that way, you would get to the point that that might include using State oversight, State supervision, but without the Federal Government actually saying to any particular State, or as a nationwide standard, that it should be the governor.

I think you can let the States work that through on their own, as long as you don't make the entry level the way it is today.

The earlier bankruptcy code actually had a better standard and made it more difficult. When the amendments came in, this unwillingness or inability became just sort of like a business choice. There wasn't a fair valuation.

So something that sort of taps in, as has been stated here, like Philadelphia or even Cleveland. But Yonkers, for instance, we did it without any State supervision. We just got a new budget act, similar to what had been done in New Jersey. So there's no one solution, but there is an entry level to the bankruptcy court.

And just if I may take 1 second more, I do believe that in the final analysis, there will be some municipalities that frankly are so poor and frankly have been abandoned by their State and their local that they do not have any choice. That hasn't really happened in a general purpose municipality yet, but it could happen. So I

don't think you want to eliminate the option, just make it more difficult.

Chairman BAKER. Thank you.

Mr. Maco, I understand that the SEC, in some capacity, reviewed the investment pool of Orange County prior to any bankruptcy determination early in the spring of 1994. Can you make comment, without prejudicing any interest currently pending, as to what determinations were reached by the SEC pursuant to that inquiry? And can you tell me on what basis did you review the investment pool in the spring of 1994, since I understand generally you act in response to a complaint.

Mr. MACO. Mr. Chairman, our action was not in response to a complaint; but rather, in late April 1994, the staff read news articles about Robert Citron and the possible risky investment strategy being pursued by Citron with county funds. The allegations were made by Mr. Citron's campaign opponent.

On May 2 1994, the staff met with Mr. Citron, assistant treasurer Matthew Raabe, Terry Andrus, deputy county counsel, and their outside legal counsel in our offices in Los Angeles. At the time, the county also produced documents to the staff.

The county represented that the pools were invested primarily in fixed rate securities. The portfolio listing provided to the staff did not indicate any derivative instruments. The staff verified that the investments engaged in by Citron were within his authority under State law. The staff also verified that all of the securities purchased by the pools were held in a custodial account at Bank of America.

The staff verified that the county auditor performed quarterly audits of the funds in the pools. Additionally, the staff determined that the pools and any of the individuals associated with the pools were exempt from registration with the Commission.

Finally, the staff was advised that the investment strategy had been discussed with all the pool's participants and with the Board of Supervisors. In fact, the annual report had been presented to the Board of Supervisors after the appearance of newspaper articles describing Citron's strategy.

As a result, the staff concluded that, while the investment strategy involved a high degree of risk, it was permitted by State law. The participants did not seem to object to the risk. There was a liquidity reserve in the pool, and the custodial arrangement appeared secure.

Absent an indication of fraud, we do not have authority to act, let alone question, the investment strategy of municipal governments, which we do not see as a proper Federal role.

Simply put, we did our job.

Chairman BAKER. Is it your opinion, then, given the review that was engaged in at that moment and the disclosures made to you at that time, that either, one, the disclosures were not adequate for you to make a full and proper analysis or two, that the disclosures were somehow inappropriate and did not reflect the real risk associated with that investment practice?

Mr. MACO. Mr. Chairman, unfortunately an answer to that question would begin to stray into the territory that, because of our pending enforcement investigation—

Chairman BAKER. Let me ask it a different way. In the event we were not talking about Orange County and we're talking about future actions of this Congress, and we were to engage in a public policy debate as to the necessity for more complete or standardized disclosure with regard to municipal investment activities, do you now believe there is a need for such standardization for reporting, or do you think current disclosure requirements are adequate?

Mr. MACO. Well, Mr. Chairman, I can point out that the Commission has, in an interpretive release, alerted the municipal market to perceived deficiencies in primary market disclosure.

One of the needs that we highlighted was the need for municipal issuers to discuss their activities as end users of volatile instruments, such as derivative securities, to fully explain to their investors the potential risks associated with those investments, not only credit risk but market risk, as well.

We've made that comment and raised that concern under the anti-fraud provisions, which do apply to offering documents distributed by issuers of municipal securities to investors.

Chairman BAKER. Some have suggested that it might be an advisable policy in the construction of investment practices that caps be established on certain types of investment instruments, whether they be inverse floaters, whether it be some other sophisticated leveraging instrument, or that there be a higher liquidity standard.

Do you believe that any of those possible policy determinations should be advisable from a national policy perspective?

Mr. MACO. Mr. Chairman, the Commission believes that matters of investment strategy and permissible investments, in short, the means by which State and local public funds are protected, are primarily the responsibility of State and local governments, that this is not an appropriate Federal role.

Chairman BAKER. So that, in summary, based on your knowledge in this general field, that perhaps enhanced disclosure requirements, with perhaps more frequent auditing of compliance with those disclosure requirements, to make sure investors are understanding what they're buying and that the fund manager understands the risk that he's assuming, may be an adequate remedy for any potential problem we may face in the future.

Mr. MACO. Yes, Mr. Chairman, that's correct. As a general matter, I might also add that we have been encouraging State and local fund managers to consider three measures—a written investment policy, frequent marking to market of portfolio securities, and an independent oversight board, as manners of providing greater assurance in these areas.

Chairman BAKER. Thank you, Mr. Maco. We appreciate it very much.

Mr. Taylor, you made a comment that you had some concern with the actions taken to date by Orange County in resolution of the current difficulty, and perhaps you can explain for my benefit what action you think might be appropriate, in light of the current circumstance, for a timely resolution. Comment if you choose as to the advisability of a Chapter 9 proceeding, and to the appointment of a trustee. What do you think makes sense?

Mr. TAYLOR. I would state that trying to sit at this distance from Orange County and crafting a specific solution within the context

of California law and Orange County's specific situation would probably be inappropriate for me to do.

However, the one thing that markets abhor, and you clearly pointed this out in your question to Mr. Sigal, is uncertainty, and we have had 6 months of uncertainty as to how this situation is going to be resolved.

And although the rollover of the \$600 million worth of notes that came due in early July has provided some breathing room, we would look forward to a very fast and rapid resolution of this crisis so that investors have some certainty as to how general obligation bonds would be treated in this market, as well as how municipalities who face financial difficulty will resolve those situations.

We, frankly, have 50 States in this union, each of them with wholly separate sets of laws governing taxing, spending, debt issuance authority, and the like. And trying to craft a solution or suggest a solution as being sort of transportable from one State to the other or imposed at the Federal level is somewhat difficult to see.

Chairman BAKER. Do you think it warranted, however, that some parameters be established? For instance, if barriers to bankruptcy filing were adopted, it would be more difficult for an entity to get to court. Second, there might be some time limit during which the local political jurisdiction is given time to resolve its difficulty.

I'm trying to deal with the issue of the uncertainty in this, and I don't know that we've got a good answer. But if we expect the markets to continue to respond to public financing needs, the markets have to be assured that there's a debt resolution mechanism with some definitive course of action. Is that appropriate?

Mr. TAYLOR. I think that's absolutely the case, that you do need some certainty on the part of market participants. Investors want some certainty as to what's going to happen when an issuer gets into trouble.

As Mr. Sigal points out, and I think as most of us who are following the question, there was quite a bit of surprise when Orange County chose that particular route.

That was not what the market anticipated, and so I think everyone in the market would appreciate knowing exactly what circumstances or when a particular entity who's in financial difficulty, what route they are likely to take. And if that means changing the Federal bankruptcy laws or changing the way in which things are resolved to give investors certainty, we would certainly be very supportive of that.

Chairman BAKER. Thank you very much. I again express my appreciation to each of the witnesses for being here. We still have another panel so I'll say thanks to you.

If there are further written comments you wish to make, I certainly would be pleased to receive them, and I also have some follow-up questions that I'll get to your attention. Thank you.

Good afternoon. Welcome. I appreciate your patience. We've had a rather long day and certainly appreciate your willingness to participate.

Let me indicate an interest in encouraging comments to be limited, as far as possible, to 5 minutes. Your entire statement will be made part of the official record and carefully reviewed, and I'll simply begin by calling on our first witness, Mr. Daniel Heimowitz,

from Moody's Investor Service, to make any comments you deem appropriate, sir.

STATEMENT OF DANIEL HEIMOWITZ, MOODY'S INVESTOR SERVICE

Mr. HEIMOWITZ. Chairman Baker, good afternoon. I'm Daniel Heimowitz, Director of the Public Finance Department of Moody's Investor Service.

I'd like to thank the subcommittee for inviting me to speak today on a topic of great significance to me professionally and to the industry in which I work.

Since 1909, Moody's has been a publisher of rating opinions. We maintain 56,000 ratings on the debt obligations of 22,000 municipal issuers, including ratings on a range of Orange County securities. We have followed the situation closely since the December bankruptcy filing and have issued credit comments updating the market on the status of events.

After the Federal Government's own securities, municipal bonds are the most default-free of publicly offered bonds. Municipal issuers' practices are generally sound, with adherence to good management practices and attention to maintaining creditworthiness, even under conditions of fiscal pressure.

Defaults on debts issued by established municipalities and paid out of general municipal resources are extremely rare. Consequently, prior events offer limited precedent, making it difficult to predict the ultimate market impact of the Orange County events.

The three areas that I would like to discuss today are: investment practices, the decision to file for bankruptcy, and the threat of debt invalidation. I will speak to the likelihood that other municipalities may follow Orange County's lead and whether the events surrounding the county's collapse will alter beliefs or practices fundamental to the municipal market.

Orange County's general obligation debt was not directly linked to its investment practices. Rather, its debt was secured by the county's general resources. In rating general obligation bonds, Moody's weighs and relies on current and historical information regarding a municipality's economy, debt burden, fiscal management, and administrative skill. This information is provided by issuers in a number of forms, including official statements and audited financial reports.

The county was perceived as financially strong, sophisticated, responsible, and well managed. Nothing led Moody's to believe that the county's investment practices were a threat to repayment of its own debt or the debt issued by local governments investing in the county pool.

Other municipalities that incurred investment losses have always stepped up and made payments on their own debt obligations. This is the behavior the market has grown to expect and by which Orange County was and is being measured.

Orange County incurred losses through commonly used investment practices: duration, leverage, derivatives. But our nationwide survey of municipal investment practices confirmed that Orange County's behavior was beyond the norm.

Although Orange County is a unique situation, Moody's has responded by requiring changes in the information that all issuers must provide and by giving investment practices greater weight and closer, more continuous scrutiny.

As with past financial crises, the Orange County experience has brought to the public greater understanding and appreciation of risk, which, in turn, has focussed individual issuers, States and industry associations on better investment practices and improved investment disclosure. We encourage these efforts.

Municipal bankruptcy has been unthinkable, an option of last resort. Given the stigma and complexities of operating under bankruptcy, there is no reason at this time to believe that it will be viewed as a viable alternative to addressing the fiscal challenges faced by municipal governments.

A broader, related concern is how difficult it has been for Orange County to deal with its fiscal crisis. The magnitude of the Orange County experience has heightened the municipal market's awareness of the very real fiscal constraints under which the States and their localities now operate.

Of far greater concern is whether Orange County's actions or inactions may undermine or erode the fundamental trust between municipal issuers and investors. The market expects Orange County to state unequivocally its intention to pay its debts in full and to act responsibly to those ends.

The resounding rejection of the sales tax proposal, after receiving only lukewarm support from most county officials, has begun to fray the edges of public trust. This fraying of trust could become a breach if Orange County follows through on its threats to invalidate certain debt obligations.

Any county justification for not paying its debts would be an attempt to put a moral gloss on what really amounts to a way to stiff its creditors. It would be naive to think that Orange County could surgically extract itself from obligations which, in retrospect, it wished it had not undertaken, without damaging the entire system by which State and local governments issue debt.

Any such attempt will give the market substantial pause and could be extremely disruptive. Simply the threat of debt invalidation shifts our analytical perspective by creating an environment of mistrust. The fact that governments do not disappear and that the vast majority of governments strive to maintain their creditworthiness and therefore, their access to a continuing source of capital, are accepted truths that foster market confidence.

The trust of the marketplace has been appropriately earned. As a result, the market is rigorous yet accommodating. The market has and will continue to adjust to events in Orange County. If the county takes any actions which undermines the trust, it would likely call for a rethinking of the fundamental underpinnings of the public finance market. Thank you.

[The prepared statement of Mr. Daniel Heimowitz can be found on page 317 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Heimowitz.

Our next witness is from Standard and Poor's Rating Group, Mr. Richard Larkin. Mr. Larkin.

STATEMENT OF RICHARD LARKIN, STANDARD & POOR'S RATING GROUP

Mr. LARKIN. Thank you, Mr. Chairman, members of the subcommittee.

I'm Richard Larkin. I'm managing director at Standard & Poor's Public Finance Rating Services. Along with my testimony, which you have, I have included analytical commentaries previously published in Standard & Poor's *Credit Week Municipal*, which describe in greater detail our views on Orange County's bankruptcy filing, the lessons to be derived from it, and a comment describing our established guidelines for government investment pools seeking to preserve principal.

Orange County's filing for Chapter 9 represents a unique event in the history of public finance. As stated earlier, unlike previous municipal fiscal crises, Orange County's collapse did not result from a difficult economy or overbudgeting and unrealized projections of operating revenue and expenses. Nor was it attributable or caused by the issuance of short-term debt in order to mask operating deficits.

Finally, the county's difficulties did not result from cuts in State and Federal aid, although the limits imposed by Proposition 13 have placed increased pressure on all California counties.

Rather, the Orange County filing for Chapter 9 stemmed from an investment policy which generated \$1.7 billion in losses to the county, as well as for 180 governmental units.

While a few other municipal market entities have incurred losses during the 1994 bond market downturn, notably Cuyahoga County, Ohio and Odessa Junior College District in Texas, to name two, they did not approach the magnitude of the losses as those realized by the Orange County pool, either in dollar amount or as a percentage of total spending.

Standard & Poor's considers most of the county's debt apparently in default, even though the majority of the noteholders agreed to a 1-year maturity extension. We have also expressed doubts as to whether the county will be able to repay these notes when they do become due again in 1996.

In this case, investors were unilaterally confronted with the option of being paid back 1 year later, at a .95 premium, or 95 basis points, or not to be paid at all.

Now, despite Orange County's actions and the bankruptcy filings, Standard & Poor's believes the municipal issuers we rate are fiscally sound. So far, market concerns have been largely confined to investors in California municipal debt.

Market investors may, in time, return to Orange County if officials there adopt a realistic, workable plan. If, on the other hand, the county were to ultimately repudiate debt, the repercussions would reverberate well beyond the county and State line, and I would be happy to expand on that comment during questions and answers.

To date, investor wariness has been primarily confined to Orange County and the pool's passive investors, who have remained current in honoring their obligations, and have not followed the county into bankruptcy, despite these losses.

Signs of this wariness have been evident during the on-going short-term note season, which is an annual occurrence in California municipal finance. These issues typically receive Standard & Poor's highest short-term ratings, based on the strength of expected tax receipts, as has been the case this year.

A few issuers have had to withdraw the issue and remarket them at higher yields with credit supports, such as bank letters of credit. From that perspective, the Orange County bankruptcy has already cost these counties millions of dollars in increased borrowing costs for short-term debt, even though their credit fundamentals remain as strong as they ever were.

Apart from Orange County's Chapter 9 filing, the \$1.3 trillion municipal market remains strong and liquid. The average unenhanced municipal rating from Standard & Poor's is around A, and some 40 percent of the total municipal debt market is insured by private companies and rated AAA by Standard & Poor's.

Orange County's filing for Chapter 9 protection, Standard & Poor's believes, is noteworthy precisely because it is a unique and isolated event. In this instance, bankruptcy reversed the established principal of municipal finance that governments had a moral, as well as legal, obligation to repay their debts. The overwhelming majority of State and local finance officials in the governments and agencies we rate understand and honor their obligations to bondholders.

We believe the Orange County precedent is an isolated event, a crack in an otherwise strong foundation. In order to maintain the security of the municipal finance market, to repair the crack before it spreads, it is important to ensure bondholders are made whole in this instance.

The Orange County experience could lead to more municipal bankruptcies or it could very well be the test case and convince governments that bankruptcy is not a viable option to be pursued. Only time will tell, and that will depend upon the negative consequences of bankruptcy, on the county's on-going need for credit, and they will continue to need credit.

Standard & Poor's places great importance on its integrity and on communicating with the public markets. Our rating criteria, the standards by which we rate bonds, is an open book. Standard & Poor's publishes its complete rating criteria and provides updates as we introduce new rating innovations or if market dynamics justify a change.

In the course of rating various offerings issued by the county, Standard & Poor's reviewed documents and met with county officials. As described in extensive detail in one of your attached *Credit Week* reports, "Orange County, a Unique Disaster," the information regarding the investment pool strategy provided to Standard & Pooers, upon which we based our rating of county debt, proved to be unreliable.

Standard & Poor's has a keen interest in supporting expanded market information. To that end, when an issuer requests a Standard & Poor's rating, they must also agree to provide current, timely information, including audited financial statements, to adhere to our surveillance requirements for maintaining ratings.

This information must be supplied at least annually, more frequently if material events warrant. But, as Orange County demonstrated, disclosure, by itself, cannot guard against fraud.

On the matter of governmental investments and policies and trends, from our experience, the majority of government investment pools are conservatively managed. From our perspective, derivatives can be a double-edged sword. Used appropriately, fund managers can reduce interest costs, interest rate risk, and refund bonds in advance synthetically.

However, if used excessively or to speculate on interest rate directions, derivatives can produce losses.

Standard & Poor's is currently surveying 7,000 issuers rated by Standard & Poor's in order to evaluate investment pool practices around the country. We are currently gathering the data and expect to have the information available in the near future.

In conjunction with its survey, Standard & Poor's issued published guidelines for evaluating investment pool safety. In brief, a pool is considered to meet Standard & Poor's safety guidelines if, number one, the portfolio's weighted average maturity is less than 1 year; two, the pool has adequate liquidity to meet its participants' projected cash flow needs; third, the pool's exposure to reverse repurchase agreements, securities lending programs and other forms of leverage is less than 20 percent; four, the pool has little or no exposure to risky structured notes or risky mortgage derivatives; five, the pool is limited to high quality securities, and this is probably the area of least worry, since there is much current State law requiring minimum credit requirements for investments in most municipalities; and six, the city's elected and appointed management is fully aware of the investment policies of the issue, portfolio risks undertaken, and that the pool's investments are marked to market more than once a year, preferably monthly.

Again, these are guidelines. They're not forced requirements for rating by Standard & Poor's.

In moving past Orange County, what lessons have been learned? First, timely and accurate disclosure is an imperative, but no mandate for disclosure will prevent fraud or the dissemination of inaccurate information.

Short-term debt can lead to credit problems. When financial problems arise, as they have in Philadelphia, New York City and now Orange County, the difficulty of making large bullet payments increases exponentially, especially when compared to just meeting normal day-to-day operating and debt service expense.

Investors cannot count on outside intervention if a city or county defaults. While State intervention remains a possibility for Orange County, the scale of such action is uncertain, given the State's own fiscal problems.

California and a number of other States have implemented tax and revenue limits, which may or may not be good public policy, but they have been partially responsible for rating downgrades in California in the last 3 years.

Finally, while bond ratings are meant to be long-term indicators of fiscal strength or weakness, Orange County's rapid deterioration will likely put more weight on short-term factors at Standard & Poor's, such as current year budget problems if they exist.

What am I saying here? Just that in the event of temporary budget shortfalls or perspective deficits, anything less than quick, timely, corrective action clearly leads to serious consideration of downgrades from Standard & Poor's, now more than ever.

Again, in closing, I'd like to say S&P continues to believe that the events we have witnessed are a rarity. That is not to say there will not be variations on the Orange County experience in other locations and at other times in the future. Indeed, there have been events similar to Orange County in the past 15 years, of similar percentage magnitude but not of the same dollar amount.

If there is a final lesson to be learned, it's that Orange County should not be allowed to become a model to be cloned in other jurisdictions. Rather, it should be seen as a fiscal experiment which went awry.

That concludes my testimony. I'll be happy to answer any questions at the end of this panel. Thank you.

[The prepared statement of Mr. Richard Larkin can be found on page 445 in the appendix.]

Chairman BAKER. Thank you, Mr. Larkin.

Our next witness is an attorney with the firm of Hunton & Williams with expertise in the area of bond issuance, Mr. Dean Pope. Welcome, sir.

STATEMENT OF DEAN POPE, ESQ., HUNTON & WILLIAMS

Mr. POPE. Thank you. Mr. Chairman, Mr. Bentsen, my name is Dean Pope. I am a partner with Hunton & Williams. I have practiced municipal finance law for more than 20 years.

The written testimony that I have submitted to this subcommittee today reflects a belief that (1), Orange County should not create a crisis in the municipal bond market and (2), with few exceptions, the issues raised by Orange County's problems are not Federal issues and must be solve by Orange County and the State of California.

Any discussion of the broader problems of the municipal bond world should not distract us from the fact that Orange County's problems, if not unique in every respect, have little to do with the problems that most localities face.

Orange County got into trouble because of a dangerously flawed investment strategy and a related dependence on investment income to balance its budget. I know of no local government in my region facing a situation remotely comparable to Orange County.

By and large, local governments are, quite properly, solely in the business of being local governments, borrowing not to make money but to provide public services, and investing not to make up revenue shortfalls but to protect and enhance capital. Most municipalities in most States cannot, as a matter of law, seek relief in bankruptcy, as Orange County has.

Orange County has, however, pointed out a basic problem with State laws governing the investment of public funds. Most of these statutes were drafted to ensure that public monies are invested in securities with a low credit risk, where the party promising to pay can keep that promise. These statutes generally do not look to protect against the special risks that Orange County took in its deriva-

tive investments, the risk, not of creditworthiness, but of interest rate volatility.

In simplest terms, these statutes usually address credit risk but not market risk.

It may be appropriate now for States to consider amendments to these statutes. But no statute can ever eliminate the need for local government officials to exercise good judgment in investing the public's money. Any law that permits desirable flexibility inevitably permits the imprudent to act unwisely.

Orange County has also raised the specter of collapsed confidence in that bluest of blue chip obligations in the municipal market, the general obligation or "full faith and credit" bond. Commissioner Richard Roberts of the Securities and Exchange Commission recently warned publicly that Orange County could have a devastating effect on the municipal market by causing investors to question the sanctity of general obligation bonds.

This, of course, raises the question of what a general obligation bond is and what is its alleged sanctity. Here we face the fact that there are 50 states, each with different laws. But while there are differences from State to state, you should be able to identify a general obligation bond by its two common distinguishing features: first, a pledge of the full faith and credit of the municipality; that is, of all its available funds, and as opposed to a limited revenue stream; and second, an obligation to levy and collect taxes sufficient to pay the debt.

Bond lawyers and academics have long known that there are practical limits to enforcing the promise of any government to pay. There has always been right much "faith" in "full faith and credit."

Court cases going back to an era where defaults were, in fact, common indicate that there have always been devices for avoiding mandamus and other proceedings to compel payment. But investors in general obligation bonds traditionally have assumed that these technical problems and unanswered questions about remedies created no material risk. And in most cases, that assumption was correct.

What could happen that might result in a differing perception as to the value of general obligation credits throughout the country? This is a very important question because even a minor shift in the creditworthiness of general obligation bonds relative to other forms of debt could cost local governments billions of dollars.

What could lead to this result? One answer is a series of court decisions, including bankruptcy court decisions, that go further than courts have heretofore gone in undermining the integrity of the "full faith and credit" pledge. Fortunately, I have no reason to believe that courts will make such decisions.

Orange County in fact suggests that the pressing problems with general obligation credits is not legal, or even economic, but political. A recent editorial in the *Financial Times* concluded that decisions to invest in municipal bonds "must now focus as much on the willingness to pay as on the ability to pay. In a nation with a strong and growing anti-tax, anti-government sentiment, willingness to pay may no longer be axiomatic."

If Orange County remains an isolated case, the damage, while real to the municipal market, is likely to be limited in time and in location.

If, instead, municipalities regularly test the limits of the law in avoiding or delaying their obligation to pay, all of us will pay higher local taxes to reflect higher borrowing costs.

Here the role of the States will be critical. In the Federal system, local governments are the creation of the State. It is the State that can impose severe restrictions and discipline on localities that do not keep their financial promises. It is the State that decides if municipalities have access to bankruptcy.

So Orange County is a serious problem for the State of California, but it ought not to be a serious problem for the State of Virginia or the State of Louisiana or the State of Alaska. Orange County is not a symbol for the deficiencies of the law, either Federal or State. It is, instead, Mr. Chairman, a sobering reminder that ultimately, there is no substitute for sound decisionmaking by public officials. Thank you.

[The prepared statement of Mr. Dean Pope can be found on page 462 in the appendix.]

Chairman BAKER. Thank you, Mr. Pope.

Our next witness is Mr. James Spiotto from the Chapman and Cutler firm with expertise in municipal bankruptcy. Mr. Spiotto, welcome.

STATEMENT OF JAMES SPIOTTO, ESQ., CHAPMAN AND CUTLER

Mr. SPIOTTO. Thank you. Mr. Chairman, members of the subcommittee, staff, it's my pleasure to be here. We have submitted written testimony that outlines in further detail the points that I wish to make in the statement.

Obviously, we all recognize that municipal finance has been an important part of the life and breadth of the American experience. All our roads, in each city, county, and village, by and large, have been financed by municipal finance. Most of the infrastructure that we use each day in our towns and villages has been financed through municipal finance.

It has been done by a unique experience which our Founding Fathers gave to us that no other country has had, where local governments can go out and finance their improvements without asking the Federal Government for help, aid or involvement.

Now comes a time when people are questioning the effect on the market when one, purportedly large and financially well-off municipal body goes into a bankruptcy proceeding and makes statements that certain bondholders and other creditors may not be paid in full.

The history has been quite the opposite. Municipalities have a long, proud tradition of paying their debts as they mature. In fact, with respect to credit and credit ratings, by and large, most municipalities, even the very weakest credits, still are paying and will pay their debts as they mature. They dip down into their pockets, they do what they can, and they make sure those debts get paid.

The willingness question has not, in the past, been a real issue. In the future, it may be called into question.

By and large, bankruptcy has been the last resort. Since 1937, when legislation was enacted to prevent municipalities from annihilating litigation, there have only been 492 municipal bankruptcies under Chapter 9 and the predecessor statute. By and large, Chapter 9 has been utilized by special tax districts, small municipalities who just could not pay their debts who needed an adjustment, and a fresh start.

Larger municipalities, including the largest, such as New York, Cleveland, Philadelphia, have solved their problems out of court, out of bankruptcy, without stigma and to the great pride of the whole municipal market.

The changes that have been made in the past to the Chapter 9, which Congress adapted in 1984 and 1988 and again in 1994, were an attempt to strengthen the credibility of debt obligations in the municipal market by providing the concept of special revenues to ensure that if a municipality is in trouble, that if they go into a Chapter 9, there are certain types of revenue streams that will not be set aside, that those bondholders will be paid.

There was enacted, in 1994, the requirement that States have to specifically address, by specific statute, whether or not they want their types of municipalities to go into Chapter 9. Thirty-one States have not addressed that specifically by statute. Six have provided for commissions or authorities that have to review the situation and then will give authority or not to the municipality to file.

Twelve have specific authorization—one is California—that permits their municipalities to file. One—Georgia—specifically prohibits its municipalities from filing.

The problems of Orange County and its bankruptcy is not a real problem of Chapter 9. Chapter 9 basically works. We have to work to understand the effects of Chapter 9. The real problem is what do we do to prevent municipalities from turning to Chapter 9 quickly, instead of using Chapter 9 as a last resort, and sometimes going into a freefall bankruptcy that impacts the market and others like an earthquake of more than Californian proportion.

The problem is created not just by Orange County or Chapter 9. Tax cap legislation, which appears not only in California but in many States and is very popular, is helpful to give assurances to citizens that government dollars will not be wasted. The problem is, if the cap is unrealistic, if it is arbitrary, and the cash-starved municipality does not have the revenues to pay for necessary services, such municipalities may go off and do other things. In the case of Orange County, their third largest revenue source was investment income, which is not a traditional municipal revenue source.

It probably is too early to tell what all the messages from Orange County and its experience should teach us. However, I think that it is important to note that Chapter 9, to date, has worked, that Orange County is an aberration, and that yes, we can do things to help prevent municipalities from prematurely or unfortunately going into Chapter 9. Nevertheless, by and large, it isn't necessary to make drastic changes to the Bankruptcy Code.

In the 1980's, the National League of Cities, the National Association of Bond Lawyers, the Government Finance Officers Association all worked together, with Congress, to come up with what they

thought was a workable Chapter 9. Obviously, people will study Orange County and see if further amendment is necessary.

I think there are some things we can do, though, both on the State level and possibly at the Federal Government level, to look at this problem.

First of all, I think that the States have to consider whether municipalities within their borders can utilize Chapter 9 because you have given them the specific directive in the 1994 amendments, consistent with the Tenth Amendment, to pass legislation as to whether municipalities are authorized to utilize Chapter 9.

With that, States should consider whether or not they should follow the example of Philadelphia and the Commonwealth of Pennsylvania, where they have a State statute that authorizes an authority to provide oversight, and to work with the municipality in trouble. Only after exhausting the State remedies would a Chapter 9 be considered, and the municipality needs State authority to so proceed.

Ohio has a similar law. New Jersey has a similar law. There is a trend in the States in moving in that direction. A State municipal finance assistance or oversight authority, similar to the Municipal Assistance Corporation that New York City had in times of need, may very well be the trend of the future.

The question then is how do we solve the concerns that people are raising in the market? I think first we have to make sure that we correct the market perception to correspond with the actual reality. There are structures, there are investments which we need to better understand and to make sure that the market better understands them, especially in the case of default and bankruptcy.

We need to provide breathing room for municipalities in trouble. Perhaps we go back to the legislative history of the 1930's and we look for an interim step, a Federal statute that provides a stay of litigation against a municipality prior to filing a bankruptcy. The stay would be approved, say, by a State officer, such as the Governor. That stay could be for a 6-month period, which could be renewed. It doesn't resolve the litigation; it provides a stay, so people aren't spending money on lawyers or time in courtroom or distracted by such activity, but they meet with their creditors and try to resolve their problems. That could be very helpful.

There should be a discouragement of artificial or unrealistic tax caps which do not provide, on the local level, the type of tax revenues necessary for municipal services which are required. Likewise, unnecessary and wasteful expenditures should be cut out.

There should be a strengthening of local investment guidelines. Reference to nationally recognized and respected models such as the GFOA guidelines and others should be encouraged.

There should be a promotion of disclosure, both at the primary and secondary market levels, to avoid surprises and to educate and inform the market of the true condition of municipal issuers. A more extensive review by municipal analysts should also be promoted.

The amount spent on research in both the corporate and municipal sectors has probably been cut in the last 10 to 15 years. There were more writings on municipal credits 10 to 15 years ago than there are really today. And if a credit is highly rated, many ana-

lysts, because there are few analysts and more credits, will write about the lesser known and more troubling credits. And that is why some of the issues with regard to Orange County were not as detailed and as written about and as analyzed, because the Orange County issues were viewed as far better credit.

I think there is a way of encouraging, both at the Federal level and the State level, State finance assistance commissions. As, Mr. Chairman, you mentioned, perhaps we ought to have a very clear direction that, prior to bankruptcy, there is a State commission. The States ought to consider passing legislation for that, and they should work with the municipalities.

There can be a stay of litigation, through Federal litigation, that allows them breathing room, and then the State can authorize them to go through a Chapter 9. And if that doesn't work, or if they're not successful, the use of a trustee or other more drastic remedies would then be employed.

But keeping Chapter 9, or even the appointment of a trustee as a last resort, is very important. Municipalities and States have to explore the ability to refinance and restructure outside of court, which is very important.

And I think lastly, there ought to be a consideration of Federal legislation to prevent municipalities from going to the marketplace and saying, "This is a valid and binding obligation," and then, a few years later, when they've misused the funds or they have defaulted, claiming that "it's no longer a valid obligation; it is no longer legal."

That is what upsets the bond market. And legislation on the Federal level that says you can't use interstate commerce and the markets and then repudiate your debt later would provide assurance in the market that you can't go out with a bond issue and later contend, as Orange County is asserting, that those debts are no longer valid and binding.

And there should be a reaffirmation of the stigma of bankruptcy, the stigma of default, and a discouragement of the ease to resort to Chapter 9.

And I think with that, you will have an educated market, you'll have aided it by providing breathing room from annihilating litigation, which was one of the fears of Orange County and why it went into Chapter 9, and you will provide the ability to assess the situation at a State level first, and only as a last resort use Chapter 9, only in those cases of an extreme nature that require that type of relief. Thank you.

[The prepared statement of Mr. James E. Spiotto can be found on page 495 in the appendix.]

Chairman BAKER. Thank you, Mr. Spiotto.

Our next witness is Mr. Marlin Mosby, who's with Public Financial Management, Inc., a debt management consultant. Welcome, Mr. Mosby.

STATEMENT OF MARLIN MOSBY, PUBLIC FINANCIAL MANAGEMENT, INC.

Mr. MOSBY. Thank you, Mr. Chairman and members of the subcommittee, members of the staff. I thank you very much for the op-

portunity to be here today. I'm going to make my comments very brief and we can go to the questions.

There are a couple of just major points that I would like to make. First, I am a managing director of Public Financial Management. FPM is the largest financial adviser in the country to State and local governments.

And my particular practice, though, is basically in the Midwest and the eastern part of the United States. So I have not had direct involvement in Orange County, and my comments should not be taken as being involved there, but more from the perspective of the impact that will have on the rest of the country.

The first point I'd like to make is that the U.S. financial markets are extremely efficient. That efficiency is based upon, however, the flow of information and the regulation of the flow of that information.

If you look at how the Federal Government has controlled that regulation, there are really two things. They have prohibited certain regulation or certain information from being used, or basically insider-type information, misleading information. And the second thing that they have done very successfully is to require information to be provided.

The most recent example of the SEC going through with secondary market disclosure requirements in the municipal market is a great example of how that can be done well. The process of involving local government, involving the different members of the financial community and determining what should be involved in the regulation has been very successful and, I think, will improve that market.

The assumption is that if you provide good information and accurate information, that individuals in the market can then make sound business decisions. The government's role, therefore—the Federal Government's role—is not to prevent losses but to ensure market participants have access to important information.

Finally, for those markets to remain efficient, there is a level of trust that's required. And the municipal markets have been particularly based upon trust. You heard an earlier witness basically say today, when you asked the question about whether or not the corporate disclosure was the same as in the municipal market, and he basically said to you no, it was not, and that the municipal markets have always been based upon a handshake. "This is my word; this is what I will do."

I do not claim to be a bankruptcy expert, but I firmly believe that the worst result of this situation or any situation similar to that is a loss of that trust in the marketplace. If that were to happen, all communities will pay a higher cost for their infrastructure, and many marginal communities will not even have access to the market.

As a financial adviser to communities, water districts, small communities throughout the state, I am always amazed at how communities that are very small, very weak type communities do have access to this public market today. They are able to put together issues and raise capital and build infrastructure.

That is based upon the assumptions in the market that public entities repay, regardless of how difficult the situation will be. If

that changes, those are the communities that are going to take the hardest hit.

I've said before, I've been in public finance for 20 years. In this time, I have worked for several government agencies that have had severe economic or financial problems. Throughout all of those engagements, one assumption was always made. If the community had entered into a prior contractual agreement with bondholders, they would honor that agreement.

PFM is the financial adviser to the city of Philadelphia. We have worked for the city for over 4 years. When we came and entered that engagement, the city was on the verge of—they seriously didn't know if they were going to be able to make the payroll payments week to week.

In all of the discussions on restructuring the city of Philadelphia, there was never once the question raised, "Do we default on this debt?" The question always was: "How do we restructure? How do we get it to the point that we can bring the city back to an investment grade?"

It is one thing for a water district, who has lost or has never gotten its customers, to default on a revenue bond that clearly pledged revenue from water customer revenues. It's quite another thing for a general community—a county, a municipality—who has pledged the full faith and credit, to decide not to pay their debt simply because the citizens do not want to raise taxes high enough to pay that debt.

The second point is that market participants are very different. Therefore, it is very difficult to legislate what are proper investments. A security that is very conservative to one investor might be highly speculative to another investor.

An example, we have a client, a college, a large college, that has a very large endowment fund. That endowment fund is invested with an average return or an average duration or average maturity of 2 to 2½ years.

They have, on the other hand, fixed rate debt, a lot of fixed rate debt. It would appear to be very conservative fixed rate debt. But when you look at the mismatch between their assets, their endowment fund which, every time interest rates go up, they get a wind-fall; every time interest rates go down, they take a hit. Their budget goes up and down, up and down because of a mismatch between their assets and their liabilities.

For that particular community, variable rate debt would be a much more conservative recommendation. They could enter into variable rate debt, more that particular entity, a college, they could enter into variable rate debt and match that debt up with their assets, and now they know they've got a fixed spread. Interest rates go to 14 percent; that's OK. Their debt's going to go up and their assets are going to go up. Their income is going to go up. But they've got a fixed spread. If interest rates go to 2 percent, they have the same spread.

You take that same variable rate debt and move it into the city like East St. Louis or Newark or any other city who has trouble meeting their obligations day to day, and you say let's borrow—go in with 1-month or 7-day variable rate kind of debt, it is a disas-

trous decision. It's a horribly inappropriate type of debt for that community.

When we start to talk about derivatives, it's really kind of interesting. We want to put derivatives in kind of this box that derivatives are all bad. However, if you look at the very simplest derivative, U.S. Government strip, it's been around for a number of years; strip security is one where we have taken the U.S. Treasury, the most high quality investment security there is, and we've taken off of that security the coupons, and we have converted it basically into a zero coupon bond.

If we were to say a 5-year strip—I have a 14-year-old daughter and I have a 70—I won't say how old—mother-in-law who could afford to buy that strip and put it in an account for my daughter, to help her college. And for her, she doesn't need that money for the next 5 years. Whether interest rates go up or down is irrelevant to her. That is the perfect investment vehicle for her.

On the other hand, if you take that same strip security and put it in a city, which you would think would be much stronger or a much more viable entity than my mother-in-law, that becomes again, an inappropriate security.

So my point is it's very, very difficult for the Federal Government, in particular, and even State governments, to legislate exactly what people will invest in.

Another point I would like to make is that public managers and private managers are very similar. It is somewhat different. You look at the public sector, and the public managers are managing public dollars, and there is some accountability that we would want them to have.

But if you look at it, at just the level of operation, they're really very similar people. Their goal is to maximize yield within a given risk profile. They are inundated, and if any of you have ever been in a local government finance office, the calls that they will get—it's daily from someone trying to sell them something.

The information, as we are creating new securities or creating new investment vehicles, there's someone out there who's going to be beating on your door, trying to tell you this is the best thing since sliced bread.

Regardless of how smart you are or how financially sophisticated you are or how financially sophisticated or large your staff is, you cannot stay on top of all of the new investment products being created and marketed. Very few of the local governments or even the corporations have the resources to do the research in new products that are presented to them.

Given that, those different points, it seems to me that if there is a role for the Federal Government, that that role is in the area of disclosure and in the area of basic research, where you could provide value-added to the market.

This is very much, if you've, and I'm sure you have, been following Arthur Levitt's comments at the SEC and what they have been doing, it's very much in line with what they have been saying for the last few months. Mr. Maco this morning reiterated that again, that the role is to provide better disclosure, better information.

To the extent that the SEC can set minimum disclosure guidelines for the investment side, as well as the debt side, it seems to me that that would be useful.

Second, I think the role of providing independent research, where someone can help fund and distribute the information and the results of that research, would be extremely helpful to local government and local government officials.

The other final point I would like to make is we look at Orange County, and Orange County really is unique. People have said that here time and time again. I think that is true. It is a result of communities—the whole growth of investment pools in the country is really a result of local governments not having enough information to make good decisions and because the pressures at the local government level are really not to invest efficiently.

I would venture to say today, if you were to look at really where the large costs are—\$1.7 billion is a big number, I have to admit, and that will make up for a lot of small governments. However, if you were to look at where the losses are, you still have governments throughout this entire country that are investing large sums of money in checking accounts, in savings accounts, and in CDs at significantly below market rates.

So if the interest is taxpayer, saving money for the taxpayers, both of these are, in fact, losses that taxpayers are incurring. We don't want to do something that will stop a trend that is moving government into making better and better investments.

I thank you for the opportunity to be here and I'll be glad to answer any questions that you have.

Chairman BAKER. Thank you, Mr. Mosby.

Mr. Heimowitz, I'm very interested in comments you made relative to the analysis of Orange County's condition, particularly since, as I understood it, your focus in determining investment grade quality centers on duration, leveraging, and liquidity issues.

Earlier in today's testimony, there were other witnesses who indicated that on all three points, the county seemed to be somewhat lacking. How is it that you felt that prior to the bankruptcy determination, that the information Moody's based its determinations on was unable to reach those conclusions about the Orange County real investment status?

Mr. HEIMOWITZ. I'll start by saying that in my comments I said that Orange County's losses stemmed from common practices—duration, leverage and derivatives—used in a very unusual way. I did not say that that was part of our analysis, in fact, and it was not.

As I said, the county's debt was not directly linked to the investment practices of the pool. The county's debt was secured by its general resources, and that's primarily where we looked.

With regard to the investment pool, the county was acting as fiduciary. It invested on behalf of local governments and therefore was required to follow the prudent person rules. The investment pool was audited every year by the county's auditors, and their review of the pool's investment practices was part of the footnotes to the county's financial statements.

Between the time that, in fact, there was some particular public attention drawn in the spring of 1994 and the bankruptcy filing, the county brought to us for ratings eight municipal issues to rate.

We relied on the county's disclosure. We relied on the official statements that were prepared and the other information which the county brought forward. None of that information in any way said that things were different or abnormal, or required a change from prior disclosure that they had.

So we had followed the information. We rely on their disclosure. We are not auditors. In our practice, we rely on the information that's disclosed to us. And so when we talk about efforts in the industry to improve disclosure, we certainly are supportive of those, but we still will rely on the official representations of the issuers that come forward for ratings with us.

Chairman BAKER. Certainly, and I'm not attempting to place responsibility or make any comment as to fault or anything. I'm really trying to understand it because your organization is very sophisticated organization which, if you have an inability to capture the problem at an early point, certainly an unsophisticated municipal fund manager or a local government official might certainly be understandably confused by the circumstance as well.

Is this more a case of we accepted the historic principles and practices as the methodology for determination of value when, in fact, the county—provided what they were asked, but they weren't necessarily the right questions in light of the new adventuresome investment practices the county apparently was engaged in.

Mr. HEIMOWITZ. In that regard, I think the key question is how closely linked was the county's decision to try to earn above market rate using the techniques they were using.

Chairman BAKER. And that's my point, I guess, that given the earnings, which was significantly above normal expectations in the market for the period of time for which it was earned—anybody can get lucky for 90 days, 30 days; in my case, rarely.

But from my review, it appears that they had extraordinarily high rates of return for a fairly long period of time. No one associated that with an elevated degree of risk?

Mr. HEIMOWITZ. In rating their debt, the first place that was looked to was, in fact, the general resources that were securing the debt, and not—

Chairman BAKER. The underlying—

Mr. HEIMOWITZ. Not any direct pledge. So the economy, the wealth, as fifth wealthiest county in the country, their good management record, their low debt levels—all those things spoke to good management.

The earnings were discussed and questioned, and the county had plans to deal with the potential for those earnings to come down over time. They had built a large reserve. They had dedicated earnings in excess of what they had budgeted each year to an excess earnings fund, to offset future years in which those earnings might come down. And they spoke about ways in which they would cut their budget or otherwise seek fees.

So the fact that they chose this route to add revenues to their overall operations was somewhat out of the ordinary, but they had an explanation, and they certainly continued to put forward a position in which they had liquidity in their pool and knew what they were doing.

Chairman BAKER. Thank you. Mr. Larkin, and again, please correct me because I made very brief notes as you proceeded, I believe you reflected on the Orange County information as the data being "unreliable," meaning that there was one of three possibles: a misrepresentation of some sort, maybe not intentional but incorrectly categorizing the status of accounts; either an error by omission, either the question wasn't asked or the information was withheld; or worse and perhaps most remote, outright fraudulent conduct.

Do you believe that to be the elements that were principally involved in not viewing the Orange County investment circumstance in a proper light, or what elements do you believe were at the heart of this difficulty?

Mr. LARKIN. I don't think I'm able to say which of those three elements, but I think it could be some or all of them. And again, in the hand-outs I've given you, we went into a fairly detailed discussion of what we did look at when we were rating the county's debt. We—

Chairman BAKER. But you're not willing to exclude any of the three is the point?

Mr. LARKIN. No, I'm not willing to exclude any of the three. It could be any of them; it could be all of them. It's very difficult to know.

The point I'm trying to make is we had a lot of information about what the county was doing with their investments. What we relied on, probably the key thing that we relied on where representations and information supplied to us by the county that there would be no need for liquidating the investments, that they had fairly captive investments and that, with longer duration, they could ride out that longer duration because of the cash flow expectations, the outflow of investments—to put it another way, the participation in the county's need to withdraw monies from the fund were felt to be very low, so they could maintain longer duration.

The credit quality of the investments were never felt to be risky, and the representations by the county were there was not going to be need to liquidate those investments, that they could ride them out to maturity and wait until they get their money. There was never any doubt about that in our mind and apparently in the county's.

Obviously what happened was a meltdown and massive withdrawals of those funds. The county indicated to us that that was not going to happen, and gave us documentation to show that.

Chairman BAKER. Thank you very much.

Mr. Pope, you indicated you find little necessity for Federal intervention in these matters since investment strategies are best left to States, reporting and debt resolution mechanisms are best left to States.

The only concern I have is that although not directly affecting a community in which I have a direct interest, certainly if this turns out not to be the unique case which many hope that it is, that it does affect the cost of funds for everybody else, and that as another witness pointed out, affects those who are now marginal, at best, in entering this field of finance, whether it's a volunteer fire department trying to get money for a new truck.

That's what troubles me, is that the activities of another party will, in effect, have some direct consequence on currently innocent parties and that to avert that in the future, at least standardized disclosure of risk, requiring certain elements to be made known; and second, steps precedent to a filing of bankruptcy might be advisable so that the markets and the holders of the obligations know what's going to happen and that we don't get surprises.

Do you feel that inappropriate, in light of my concerns?

Mr. POPE. You have touched on the two issues that I agree, and my written testimony points out, are legitimate Federal issues, and that's disclosure under the Federal securities market and bankruptcy law.

I believe there can be three things wrong with disclosure. One, the law can be inadequate. Two, the law can be adequate but the disclosure is inadequate under the law. And three, the disclosure can be adequate but people don't read it and pay any attention to it. And I think right now, the problem is right much of three and a declining amount of two.

There are, I think, 50,000 or so different municipal issuers. I'm very suspicious, Mr. Chairman, and I think all of the professional and organizations like the GFOA that have looked at it and produced attempts at standardized disclosure are suspicious of any format that tries to push Orange County and a rural school district in Alabama into the same disclosure mold.

The continuing disclosure requirements and the other activities that the SEC has undertaken in recent years will take full advantage of the remarkable flexibility, I think, of the securities law and of the concept of "full disclosure" and the concept of "material omission."

Therefore, I believe that the question really is going to be: Is the enforcement going to be adequate, and if the experience in the next few years show that enforcement alone won't do it, what changes are to be made? But I continue to believe that the state of the Federal securities law right now is not the problem.

On the issue of municipal bankruptcy, I hesitate, particularly in Mr. Spiotto's presence, to make any simple statements about bankruptcy, but I believe, in simple terms, there are four possible effects from Orange County's bankruptcy, and one of them may trigger a Federal response.

One is that the bankruptcy proceeding of Orange County shows that Chapter 9 works and that it does not encourage the promiscuous filing of bankruptcies. That would be the best result of all.

Another result is that it does not show that, and that the fears that have been expressed here today about the ease with which bankruptcy can be undertaken are realized. If that happens, then I think it would be appropriate for the Congress to consider if it needs to change Chapter 9 to make it less easy for local governments to avail themselves of bankruptcy.

If it chooses not to do that, then the question is back to where it is right now—with the States. The State of California can decide that the bankruptcy of Orange County has threatened, as it would if it were perceived to be something too easy to do, the borrowing costs of all the borrowing local government entities in California.

As I've said earlier, in my State, localities can't file bankruptcy. So I don't think the Orange County bankruptcy constitutes a threat to them. If California views it as a threat and the Federal Government hasn't acted, then California has a decision to make. If California fails to make that decision, and that's a mistake, then local governments throughout California will pay, in my view, a permanent premium. But I don't think local governments in Louisiana or Virginia will.

Chairman BAKER. Thank you, Mr. Pope.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. Larkin, Mr. Heimowitz, I want to talk a little more about the taxable note deal, the 1994-1995 taxable note deal, the \$600 million deal which was the taxable arbitrage deal. Let me ask a couple of questions.

One, Standard & Poor's gave a rating of an A-1 plus, it looks like, and Moody's a P-1. If I understand this transaction correctly, this was a deal where the proceeds were going to be deposited in the fund and invested to yield 150 basis points over the yield on the notes.

In your review, in providing these ratings, did you review the investment side of this transaction? And did that have an implication on the rating that your respective firms subsequently awarded to the issue?

Mr. LARKIN. I can answer that first for Standard & Poor's. Yes, we did look at the investment side. In fact, we had been giving greater scrutiny to the investment side since that spring, especially with some of the disclosures coming out in the press that came out in the campaign about the treasurer's investment strategy.

So I believe it was March, right through to that sale in September, we had several meetings and telephonic conversations, conference calls conversations, with the county officials over their investment strategy, including our rating on that September issue.

Mr. BENTSEN. So previously, one of you all had stated that you didn't look at the pool, you rate their deals, which I understand. You rate the bond issues that they bring to the market. And you rely on the data which is provided by the issuer or that you request from the issuer, and I understand that, as well.

But in this case, this was an issue where it wasn't a question of saying we're going to issue these bonds and they're going to be repaid by some certain revenue stream. If I understand it correctly, the initial pledge to the bonds or to the notes was from the investments.

So would you have not, then, looked at the investments and would you have not, at that point, seen that perhaps they were overleveraged or that there was some risk associated that maybe wouldn't—that subsequently, and I don't want to have you second-guess, but maybe you wouldn't give it an A-1 plus; maybe you wouldn't give it—

Mr. LARKIN. I may be wrong, but I don't think the primary security for the debt was specifically the investments made from the proceeds. I think there was disclosure that they were taking the proceeds, and those proceeds or those investments, along with other county investments, would be used as a source of repayment.

But I don't think it was specifically a structured transaction where that issue's payment was dependent upon the successful investment of those individual proceeds. I don't believe that was the case.

Mr. HEIMOWITZ. I might answer for Moody's, as well.

Mr. BENTSEN. Yes, sir.

Mr. HEIMOWITZ. The \$600 million of taxable notes were issued under the note statutes in California, just as their tax-exempt notes were issued. The debt was not directly linked to the pool. The pool was not the issuer of those notes. The county was the issuer of those notes. And they were ultimately secured by the county's general obligation.

The pool and the bankruptcy filing subsequently were as much a factor on those notes as they have been for all of the county's other obligations. In fact, while the county's tax-exempt notes for operating purposes were not specifically for deposit only into the fund, the proceeds were initially deposited into the pool and, the repayment monies, as they came in in December, when the taxes came in, were to go into the pool.

And so the pool was the county's cash management and was an integral part of its normal operations, but it was not specifically pledged. We continued to look to the general strengths of the county and to officials' basic disclosures about its financial position, about the relative liquidity that the pool offered them to help them support their general operations.

Mr. BENTSEN. Well, if you look at the official statement, it talks about the proceeds being deposited into a special fund, the repayment fund. It talks about the security, for principal and interest, being the repayment fund. It talks about that it's going to earn 150 basis points over the cost of the notes.

It says, under "Risk," that the county intends to invest the monies in the repayment fund in the county investment pool. If the investment pool suffers an overall investment loss on the portfolio, pledge monies may be insufficient to pay the principal off and interest on the notes. In the event of a deficiency, resolution provides that such deficiency shall be satisfied and made up by the county from any lawfully available money received in or attributable to fiscal year 1994-1995.

So this deal, rather than other deals, seems a little more structured, to me. And my experience with both S&P and Moody's is quite good. You all tend to ask for a lot of data. You run a lot of scenarios.

Did you ask—did you have outside counsel review this deal?

Mr. HEIMOWITZ. If I can start and say in Moody's case, no, we didn't. We relied on the bond counsel opinions by the county and the county's experts. Certainly we appreciate your confidence in our process. Our process was diligent. We always ask tough questions. We did in these cases, but the answers that we got were not ones which seemed to imply any undue alarm on the county's part that they didn't have ample liquidity to fully manage their situation and their financial needs.

Mr. BENTSEN. Did you require the issuer to prepare any cash flow analysis regarding liquidity, regarding investment return?

Mr. HEIMOWITZ. We did not require any special cash flows—we accepted the disclosures and the basic normal documentation that

we would have expected from the county. This was not the first time they'd done an undertaking like this. They'd done similar financing the year before, as had other counties in California.

Mr. BENTSEN. Let me ask you this. Assume that the city of Houston decided to come to the market next week with a half a billion dollar taxable note deal that they were going to invest in a fund, similar to this deal. Would you use the same review procedures, or have you changed your procedures now as it relates to deals like this?

Mr. HEIMOWITZ. Our same basic review procedures would be used. As I said in my written testimony, we continuously adjust based on experience and what we learn. By no means do we have our heads in the sand, in any sense, as we learn from experience. We are asking different questions. We certainly are looking for better disclosure in these areas and are very supportive of all the efforts by GFOA, by National Association of Counties, by the PSA, by individual states, to improve disclosure, to update investment laws and guidelines for states.

That's all to the positive, but at the end, we would, in our process, look to the representations, look to the specific security of the particular issue, and rate on that basis.

Mr. LARKIN. If I could just make some comments, obviously I can't speak for Moody's or Mr. Heimowitz and he can't speak, as well, for me.

I didn't want to leave a misimpression that we did not look at the investments. We did look at the investments that the county was making in September, and earlier. What I was saying before is we never took this particular issue as a structured issue payable only from those investments.

Of course, the management of those investments, as well as other investments made by the county for itself and the pool was important because it was not just only this deal alone that the county had to pay debt service on. There were other deals. And, as Mr. Heimowitz pointed out, the county investment pool was the primary source of cash, not only to meet day-to-day operations, but also its debt service.

So I wouldn't want to leave the impression that we didn't look at the investments at all. We were scrutinizing the investments fairly carefully since April, even before, 6 months before that deal was done, and through, although I don't recall offhand what information we did ask, we did ask for information on cash flows in the investments in the manner of an update from our earlier discussions, which stretched from April through August.

So in September, we did ask for an update, which probably went beyond what was just disclosed in the official statement. I just don't recall exactly what it was.

Mr. BENTSEN. But at that time, nothing appeared out of the ordinary that would cause any concern to affect the rating?

Mr. LARKIN. At the time, one of the other things we relied on at the time, the county was still maintaining—at least represented to us—a fairly substantial liquidity position of about \$1 billion in short-term—again, presented to us, represented to us—short-term marketable securities, which could be used in the event of collateral calls and things like that.

Again, I don't remember the exact number in September, but I think it was at least \$1 billion, and that was the last information we got prior to the meltdown in early December.

Mr. BENTSEN. If I could, Mr. Chairman, on the recovery, refunding recovery bonds, the 1995 Series A, which was an MBIA deal, a couple of questions on that.

Did either of you all provide a shadow rating for MBIA on this?

Mr. HEIMOWITZ. With regard to the recovery bond, we looked at the issue in terms of the obligation of MBIA and assigned a AAA rating based on MBIA's ironclad and unconditional guarantee of the obligation.

We had expressed at the time our concerns that we saw no certainty in repayment. We expressed that publicly in public comment. We questioned the security pledged to that issue. The issue was an interest-only issue, I believe, for 6 or 7 years. When principal is due, there's sort of a presumption that things will have cleared up by then, or the bond will otherwise have been refinanced, and we have expressed some concerns that, in fact, this is not the strongest risk, from MBIA's perspective.

Mr. BENTSEN. I would note that in the June 12 *S&P Credit Week*, Mr. Larkin, that you made the comment if the referendum failed, the tax referendum failed or the report made the comment that it appeared unlikely that Orange County would be able to meet its note obligations.

Is that still the view of Standard & Poor's?

Mr. LARKIN. That's correct, and it's been confirmed by defaults which occurred on July 10 and July 19. The defaults we're talking about are the notes that were sold last year and were due to be payable on July 10, 19.

They have been extended because the noteholders have—I don't know if you could call it voluntarily—extended payment. I don't think they had much choice. It was either accept it or not get paid at all.

So frankly, yes, I think we still stand by the statement.

Mr. BENTSEN. Does your statement carry forward to the next year, to the roll-over period?

Mr. LARKIN. Yes, and I think I mentioned that in my testimony earlier.

Mr. BENTSEN. Mr. Chairman, I have some other questions but I'd be glad to yield.

Chairman BAKER. I hate to curtail it, but it appears that we may have more than just one vote, and I would suggest that—I have a series of questions myself. Perhaps we'd both agree to follow up in writing to the witnesses and not hold them unduly, because I'm not certain how long we'll be detained on the floor.

Let me say to each of you, we appreciate your comments. We will correspond with you. We hope you'll be able to respond to questions we forward, and do appreciate your appearance here today.

Thank you very much, and our meeting is adjourned.

[Whereupon, at 2:42 p.m., the hearing was adjourned, to reconvene at the call of the Chair.]

DEBT ISSUANCE AND INVESTMENT PRACTICES OF STATE AND LOCAL GOVERNMENTS

THURSDAY, JULY 27, 1995

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
Washington, DC.

The subcommittee met, pursuant to notice, at 10:05 a.m. in room 2128, Rayburn House Office Building, Hon. Richard H. Baker [chairman of the subcommittee] presiding.

Present: Chairman Baker, Representatives Cremeans, Fox, LoBiondo, Kelly, and Bentsen.

Chairman BAKER. I would like to call this meeting to order. As you are painfully aware, members have busy schedules. I am certain there will be others joining our hearing as we proceed, but I would like to keep us as much as is practicable on some reasonable schedule for your time as well as ours.

Let me briefly outline the interest and scope of today's hearing. This is the second in a 2-day series relating to the condition of our municipal finance markets, the implications of the failure to make repayment obligations by local government entities, and the ability to provide needed financial resources for improvements for public purposes by governmental agencies.

The municipal finance market is indeed an important one to the finance markets. It is certainly and obviously an important element to local government, but it also is problematic for the taxpayer if assurances for repayment are not met and taxpayers are faced with unexpected bills for obligations they were not fully informed of.

For these reasons, these hearings are inquiring into the state of Federal regulatory and statutory provisions to determine their adequacy. No determination has been made as to whether any legislative action is needed, but certainly legislative initiatives will follow if it is warranted.

Mr. Bentsen has joined us. I will ask if he has any opening remarks.

Mr. BENTSEN. Not at this time. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

With that brief introductory statement, I would introduce the first witness. For those not here yesterday, I would ask that when possible please try to keep the verbal testimony to 5 minutes in order to allow us adequate time for questions. Your full and com-

plete statement will be made part of the record and carefully reviewed by members and staff.

Our first witness is the president of the Government Finance Officers Association and finance director from the city of Dayton, Ohio, Mr. Timothy Riordan. It's nice to have you with us this morning, sir.

STATEMENT OF TIMOTHY RIORDAN, FINANCE DIRECTOR, CITY OF DAYTON, OHIO AND PRESIDENT, GOVERNMENT FINANCE OFFICERS ASSOCIATION

Mr. RIORDAN. Thank you, Mr. Chairman. Good morning, Mr. Chairman and members of the subcommittee. My name is Timothy Riordan. I am finance director of the city of Dayton, Ohio. Today I am really speaking in my role as President of the Government Finance Officers Association.

GFOA is a professional association that represents over 10,000 State and local government officials, both elected and appointed. Their responsibilities encompass all the public finance disciplines, including cash management and debt administration.

Today I want to highlight several points that respond to the questions that you raised in your letter of invitation.

First, you asked if the regulatory structure governing cash management and debt administration for State and local governments is adequate.

GFOA believes that the current regulatory framework, which includes local policies, State laws and Federal oversight, has successfully governed these areas and has provided adequate investor and taxpayer protection.

You asked whether Orange County is an isolated case.

GFOA believes that the problems in Orange County don't reflect a national trend. GFOA believes that the problems experienced in Orange County have many causes but are primarily rooted in an investment strategy that was seriously flawed.

What can be done to prevent another Orange County?

First, GFOA strongly suggests sly investing. Safety and liquidity must be given priority over yield when investing public funds.

Second, our association calls upon governments in their debt policies to reaffirm their commitment to full and timely repayment of all debt.

What is being done by associations such as ours that will help to avoid another Orange County?

GFOA is actively working to facilitate self-regulation of local financial practices. We help governments improve their practices through numerous cookbook type publications and practical training programs. We developed model investment legislation for adoption by State and local governments. We just published and endorsed a sample investment policy which State and local governments can use as a base for their policies. We developed the disclosure guidelines for offerings of municipal bonds. We sponsor a certificate program for excellence in financial reporting, a program that is highly regarding by market participants.

Lastly, we adopt and advocate recommended practices for use by our members. For example, a year ago GFOA in a best practices statement urged its members to use extreme caution if they consid-

ered investing in derivatives and provided specific guidelines for dealing with these volatile securities and thereby avoid some more problems in this area.

In addition, GFOA's local and State government professionals will continue to work with Congress, Federal agencies and the private sector to further our objectives.

Lastly, you asked whether the Federal Government should do more.

There are two important items that the regulators can do. The first one is to provide strong enforcement of sales practice rules. Finance officers across the country report that derivatives have been aggressively marketed and these finance directors have been inappropriately assured in many cases by the sales forces that the products are safe, government guaranteed and will protect principal.

As a point of special emphasis, GFOA believes that brokers and dealers should have an affirmative duty to know their customers' policies, to know their customers' constraints and affinity for risk, and to determine the suitability of a particular instrument for their customer. We don't believe, however, that brokers and dealers have a responsibility to guarantee investment results.

The second thing we would ask of the regulators is to encourage the use of volatility ratings to aid investors in gauging the risks of particular securities.

Lastly, in terms of Congress, there are two suggestions we have for actions that they can take. The first is to enact investment advisor legislation providing for more oversight of investment advisors.

Second, to exercise committee oversight of sales practice rules.

In my full testimony I have provided other suggestions for improving cash management and debt administration that can be followed by local, State and national governments as well as the private sector. GFOA is committed to working with others to strengthen financial practices and to build on the lessons learned in Orange County.

Thank you.

Chairman BAKER. Thank you very much, Mr. Riordan.

[The prepared statement of Mr. Timothy Riordan can be found on page 696 in the appendix.]

Chairman BAKER. Our next witness is the President of the National Association of State Treasurers and also the treasurer for the State of Nevada. I certainly welcome you here.

STATEMENT OF ROBERT SEALE, TREASURER, STATE OF NEVADA AND PRESIDENT, NATIONAL ASSOCIATION OF STATE TREASURERS

Mr. SEALE. Thank you, Mr. Chairman and members of the subcommittee. I am Bob Seale, treasurer of the State of Nevada and president of the National Association of State Treasurers.

State treasurers are the chief financial officers of their States, responsible for cash management, debt management, public pension fund investment, and a variety of other functions.

I am joined today by my colleague State Treasurer Ken Blackwell of Ohio, representing the National Association of State Auditors, Comptrollers and Treasurers.

We are all well aware of the disclosure of unwise practices in which a few local fiscal officers were engaged over the past year. California State Treasurer Matt Fong yesterday addressed the issues in California. I am pleased that both Treasurer Fong as well as Treasurer Blackwell are members of the National Association of State Treasurers Task Force on Local Government Investment Pools which I created earlier this year to review and update our 1989 guidelines for State-managed LGIPs.

My two-part goal today is to offer NAST's perspective on the questions you have raised for the subject of this hearing and to share with you NAST's work to put together the recommended best practices for prudent investment management by public entities.

Mr. Chairman, no duty is more important in public finance than the prudent day-to-day management of public monies. This responsibility is more important today than ever in this era of tight budgets and growing demand for services.

NAST has been working on best practices for prudent investment management for some time. Indeed, all of our programs include education directed toward improving the ability of State treasurers and our staff in handling the most important area of cash management both for our State funds as well as the local funds entrusted into our care. In fact NAST has undertaken an ambitious continuing education initiative known as the National Institute for Public Finance, which is taking place right now at the University of Delaware.

When I appeared before the Senate Banking Committee in January I indicated at that time that NAST had begun to review investment guidelines for local government investment pools and to take other steps which would serve to improve investment management. Now I want to report that we have completed our review of our 1989 LGIP guidelines, and I am pleased to inform you that your subcommittee is the first to see these new revised guidelines as well as the results of our LGIP survey.

We specifically call your attention to the revised guidelines for LGIP managers and participants calling for an even greater emphasis on improved and continuing disclosure of pool investment policy and operation to participants, including, for example, disclosure of any off-balance sheet obligations. The revised guidelines also recommend independent third-party oversight and input into the policies and procedures of the LGIP through establishment of an advisory board.

Next, the document recommends that the broker/dealer community adhere to the same standards of conduct applying to treasurers and that the private sector is equally responsible for carrying out disclosure and suitability practices in service to participants.

Further, the revised guidelines call for ongoing education of public officials to maintain their expertise amid changing market conditions in an ever-increasing array of investment options. The guidelines, however, continue to stress that the overriding goal of any LGIP investment strategy is and should remain that of assuring safety of principal first, then liquidity, and then yield.

The three most important points made by the NAST guidelines are disclosure, disclosure, and then yet more disclosure. Under the disclosure practices recommended by the guidelines, each partici-

pating local entity will know the risks and benefits of pool participation. Items for disclosure to participants include the following: The legal authority for and investment objectives of the pool, including any potential limits on the ability to access funds.

The accrual, frequency and method of distribution for earnings, yield calculation methodology, safekeeping practices, and policy on allocation and amortization of gains and losses.

Administrative costs and procedures for proposed changes to those costs, minimum and maximum account size policies, monthly statements, distribution of quarterly portfolio holdings and market values with monthly availability, and a copy of the independent accountant's opinion and report.

This communication to participants and disclosure of information will also go to an oversight board, contributing to an effective system of checks and balances, something which was lacking in Orange County and other instances. The residents of Orange County may find little solace right now with this increased emphasis on oversight, but other citizens across the country will be well served by systems which prevent crises before they reach the taxpayer.

In keeping with the guidelines' recommendation of ongoing education for public officials, NAST, as I have mentioned, is now holding its first National Institute for Public Finance. It is a week-long, college level education program which will be held annually. Indeed, I have just come from the campus of the University of Delaware where it is being held, and I will return there later today.

Our participants include not only nine State treasurers and investment staff from 21 States, but other State and local finance officials, including John Moorlach, the new Orange County treasurer-tax collector.

The Public Finance Institute faculty features experts in the field of public finance. Some of our faculty are among those witnesses that you have asked to testify here today.

The vigorous curriculum is tailored to the responsibilities carried out by State and local government investment officials. It includes such topics as how we might better finance public investments, the intricacies of municipal bond pricing and negotiation, and the correct usage of credit enhancements. Many of these responsibilities were addressed by the NAST LGIP Task Force.

In January I testified that I believe Orange County represented an exception and not the norm. I don't have a crystal ball allowing me to make any guarantees, but I still think the States are the appropriate level of governance in this area and that there is already enough regulatory authority in place. However, in individual instances where unanticipated losses have occurred, States have advanced remedies that are appropriate to address the situation and are taking steps to make the possibility of losses more remote. I believe that our survey results and the revised NAST guidelines will be a useful tool for Federal, State and local policymakers, State and local cash managers, and the public.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Seale. I appreciate your testimony, sir.

[The prepared statement of Mr. Robert Seale can be found on page 734 in the appendix.]

Chairman BAKER. Our next witness is the State treasurer from the State of Ohio, also representing here today the National Association of State Auditors, Comptrollers and Treasurers, Mr. Ken Blackwell. Welcome, sir.

STATEMENT OF KEN BLACKWELL, TREASURER, STATE OF OHIO AND MEMBER, EXECUTIVE COMMITTEE OF THE NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS AND TREASURERS

Mr. BLACKWELL. Thank you, Mr. Chairman. Mr. Chairman and members of the subcommittee, in light of the recent losses of public funds, officials who have the responsibility for the investment of public funds must now lead in the efforts to restore the confidence and trust of our constituents in the investments of their tax dollars.

The leadership and the restoration of public confidence made necessary as a result of these recent losses can best be accomplished by public fund managers returning to certain simple and basic investment principles that were once, and again must be, the proper role in investment objectives for government.

Investors come to capital markets with diverse needs, risk tolerances and objectives. Individuals who manage the private funds of others are free to make investment decisions using that money so long as risk is disclosed. In contrast, public fund investors are managing funds held in trust on behalf of our citizens. The purpose of this trust is not to maximize investment income but rather to fund essential governmental services.

Recognizing that even in the investment of public funds there are differing measures of governmental needs, objectives and strategies, the investment needs and objectives of a cash management account are quite different from the objectives and needs of, for example, a public pension fund portfolio.

What I am speaking of today is the investment of tax dollars pending their disbursement to pay for State and local obligations. In my opinion, the investment objective and the investment strategy of a public funds cash manager must be singularly directed to the preservation of capital.

Mr. Chairman, because the current political environment makes it difficult for public officials to make decisions to raise taxes or cut spending, local treasurers and public fund managers are facing increasing pressures to provide more income for their respective budgets. This leads to riskier investments that might not have otherwise been made under the conservative hierarchy of principles so adequately articulated by our first two speakers of safety first, liquidity second, and lastly, yield.

In this respect, the proper investment objectives of the cash management portfolio has been lost. A case in point is the standard rationale for the inherent value of derivatives.

Derivative instruments are sold by market professionals as a means to reduce or eliminate an investor's exposure to market risk. However, I question the value of these strategies if in fact we hold the traditional role of the public fund manager. In my view, an analogy can be made between derivatives and explosives. Each has a beneficial purpose but derivatives, like explosives, if they are put

in the wrong hands or used in ways not contemplated by the manufacturer, they can and do blow people up.

Risk, confusion and abuse are ripe to occur where market professionals sell to public fund managers based upon an investment strategy that is not grounded in a proper investment objective. When that happens everyone loses.

In Ohio my office has helped draft a bill that would reform permitted investments of cash management portfolios of local governments. Ohio Senate Bill 81 is aggressively conservative and prohibits most derivatives from use in public cash management portfolios.

Protection of taxpayer funds from the creativity of the financial engineers in the marketplace requires a broad prohibition, but prohibition doesn't mean that all derivatives are bad and that they are not at some point and in some instances a very valuable tool. However, in the case of public funds cash management portfolios a conservative investment objective requires reining in permissive investment authority.

In summary, I believe, as does the consensus view of NASACT, that the existing regulatory structure and current initiatives at the State and Federal levels are adequate to deal with the recent incidents of financial distress and potential defaults on the servicing and repayments of local government debt.

I encourage the subcommittee to monitor and evaluate the enforcement of existing Federal regulations and self-regulatory organization rules cited in my written testimony. I believe that in doing so the subcommittee will find that the great majority of State and local government financial administrators are highly qualified and perform their duties well. I also believe that the subcommittee will find that State and local government securities are some of the safest investments available to investors anywhere in the world.

NASACT and I appreciate the opportunity to provide a statement to Congress on this issue of national importance.

Chairman BAKER. Thank you very much, Mr. Blackwell.

[The prepared statement of Mr. Ken Blackwell can be found on page 750 in the appendix.]

Chairman BAKER. Our next witness is the director of the Advisory Commission on Intergovernmental Relations, Mr. Philip Dearborn. Welcome, Mr. Dearborn.

STATEMENT OF PHILIP M. DEARBORN, DIRECTOR, ADVISORY COMMISSION ON INTERGOVERNMENTAL RELATIONS

Mr. DEARBORN. Thank you, Mr. Chairman. My statement today is based on the ACIR reports City Financial Emergencies, done in 1971, and Bankruptcies, Defaults, and Other Local Government Financial Emergencies, done in 1985, and a report that we did on Understanding State and Local Cash Management in 1977. I was also an expert witness in both the South Tucson and Bridgeport municipal bankruptcy cases and bring that to my statement.

In 1971, ACIR, which is an independent commission chartered by Congress, undertook an investigation of the financial condition of major cities to determine what might cause financial emergencies and to recommend what the respective roles of State and national

government should be in the prevention and treatment of these emergencies.

We reviewed all past defaults, bankruptcies and other financial emergencies, and the general conclusion of the report that we issued was that unsound financial management is the most important potential cause and that prevention and treatment should be primarily a State responsibility.

The commission did recommend, however, retention of Chapter 9 of the U.S. bankruptcy law as a standby remedy, but I think the conclusions in that regard are important to today's discussion, and I quote. "The Federal courts are not well equipped to render financial advisory service to a troubled municipal unit. If guidance or supervision is needed to put a municipality on a sound economic basis, the courts should recognize that a State agency or court appointed commission is likely to be better qualified to render financial management assistance."

The 1985 ACIR report updated the occurrences and causes and, based on that review, found that there was no evidence that local governments at that time were experiencing increased financial emergencies or that they were likely to do so in the future.

I believe that finding is still valid despite the Bridgeport and Orange County declarations of bankruptcy. In both instances there were unusual circumstances, and we find no widespread evidence of financial emergencies about to happen.

The ACIR investigation of emergencies, as I said, found that typically it was bad budgeting practices that caused them in the past, but in the 1985 report we found two additional causes. One was unwise investment policies and ironically, that was based primarily on the San Jose, California loss of \$60 million from bad investments. The second was large court judgments against small local governments.

The Orange County financial emergency was obviously a clear result of unwise investment policies. ACIR had made a recommendation in its 1985 report regarding such emergencies. It said strict State laws covering local government investments of inactive cash, and careful adherence to those laws, should be followed. A local government must time its investments so that funds will be available when needed. It should invest only in U.S. Treasury securities, certificates of deposit with full collateral or insurance protection, and other similar conservative investments.

It is now obvious that the State of California did not have those strict laws that were recommended and that as a result Orange County did not invest conservatively. Preventing such problems in the future, we believe, should remain the responsibility of State governments and they should follow our recommendations if they have not done so.

In addition to recommending ways to prevent local financial emergencies, we have also reviewed and made recommendations about what should be done to relieve them if they do occur. The principal recommendation is that because they result from bad management and management is really within the purview of States, it should be a State responsibility to look after the problems if they occur. There is a record in Michigan as well as in other in-

stances where State supervision has been perfectly adequate to do that.

There have been no instances investigated by ACIR or by me in which the Federal Government or Federal courts played an important role in resolving a local government financial emergency with the exception of New York City, which was unusual because of its size. The few local governments that have used the Federal municipal bankruptcy provisions have done so mainly to delay or avoid actions that they otherwise would have been required to take by State orders or by State court actions.

One clear possibility that could change the outlook, however, is if Orange County succeeds in avoiding its financial obligations by use of the municipal bankruptcy law. There are many local governments today that have been forced by budget problems to make very hard choices involving increased taxes or reductions in vital services. That is not easy at the local level. Any evidence that such hard choices can be avoided by use of the bankruptcy law could trigger similar efforts by other local governments, and I think it's important that that not occur.

The bankruptcy law should be retained. However, its use should come only after all available State remedies have been exhausted and specific State permission for the filing has been granted to the local government and there is clear evidence of insolvency. If a pattern of abuse of the municipal bankruptcy law should develop as a result of Orange County, then the law should be amended to ensure that it is used only in the very limited instances in which it is appropriate.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Dearborn.

[The prepared statement of Mr. Philip M. Dearborn can be found on page 757 in the appendix.]

Chairman BAKER. Our next witness is a partner in the firm of Fish & Lederer, Mr. Charles Fish. We certainly welcome you here this morning, Mr. Fish.

STATEMENT OF CHARLES W. FISH, PARTNER, FISH AND LEDERER, MONEY MANAGER, ORANGE COUNTY

Mr. FISH. Thank you. Thank you for having me.

The Orange County bankruptcy has brought to light a number of the problems, but not all of the problems, that we have in California in the arena of public finance. I am identifying it as a Californian problem because I am a strong advocate that the States ought to take care of public finance issues within their own borders.

As to the question of whether the Orange County bankruptcy is an isolated situation, I think it is absolutely not an isolated situation. I think maybe in terms of magnitude. The events that took place there, I think, might not happen next week or next year, but they will happen in any State where they fail to exercise the type of leadership and oversight that has been so lacking in California.

I think it is well that before we start changing codes and rewriting regulations and adjusting responsibilities and everything else that you hear from the investors. I don't think you heard from one yesterday. I think I'm the only one here today. The investor's per-

spective is a lot different, and I am telling you from the trenches it is a little appalling, and I think that you all need to be aware of that.

In my mind, oversight of a public treasurer conducted solely by elected officials that have no expertise is no oversight at all. The States have the resources and the authority to provide the type of oversight to prevent Orange counties, and they need to do it.

Furthermore, the State's presence is needed to discourage local politicians from pursuing personal agendas at the expense of investors. I know that sounds a bit harsh, but I'm telling you on the record here today that I have sold bonds—that's what I do for a living, manage people's portfolios—I have sold bonds that were highly rated because I discovered through my own efforts that the issuer had failed to live up to the covenants of the issue. The rate increases that were supposed to go into effect automatically weren't imposed because they had been blocked by politicians, because the local politicians evidently didn't want to incur the wrath of some of their constituents who were going to have to pay a modestly higher fee.

Here is the problem. The problem is that no alarm went off. The trustee didn't have a clue, or if he did, he certainly didn't say anything. Rating agencies were clueless. Probably still are. We were left entirely dependent on the integrity of the issuer. In this case obviously that was misplaced.

So among my other recommendations, I certainly feel that a State should impose the requirements for monitoring and disclosing all of the covenants involved. In my way of looking at this situation, I think that probably should be placed with a trustee. It fits there better than anywhere else.

I am also well aware that the vast majority of banks that act as trustees, fiscal agents, paying agents and the like conduct their affairs admirably. But there are certain situations, and I've recounted them over the years, where that trustee, who, by the way, is usually designated as the attorney in fact for the bondholders, is responsive to the issuer who is paying their fees and is capable of providing them with ongoing business.

I will give you an example. Right after Orange County declared bankruptcy I discovered, much to my chagrin, that a bank acting as fiscal agent for one of the local district's bonds had invested the entire reserves in Mr. Citron's pool. I reviewed those documents and I confronted the trustee with the language in them and pointed out the fact that Mr. Citron's pool wasn't an eligible investment, pointed out the fact that he had responsibility to ensure the sufficiency of those reserves, and that meant that he had to keep track of the market value of them, which was an impossibility in the case of Mr. Citron's pool. His response to me was, "Well, we did that because we were instructed to do so by the issuer, and I have a letter to prove that."

Well, he was concerned about the issuer and obviously concerned about protecting himself, but he didn't give any thought to the investors at all.

I don't want to digress on this, because I know our time is very limited here. I think I gave pretty good coverage in my written testimony.

The point is there is even a worse problem in California when an issuer tries to act as a fiscal agent or trustee for himself. It just doesn't work, and the minute there is a little bit of a problem, there is gigantic conflict of interest. Simply stated, the issuer cannot honor the obligations that a trustee should have to a bondholder and look after their interest simultaneously. It's common sense.

I have already stated the problem with the oversight that occurred there. Probably the most glaring example is that on June 14, 1994, when Orange County supervisors approved, by the way, as a consent agenda item, Mr. Citron's issue of \$600 million in taxable notes, they abdicated their responsibility. This is even more appalling, for those of you who are not aware of it, if you stop for a second to think about it. A municipality whose largest single line item of revenue was interest income and their fiscal 1994-1995 budget was in excess of \$160 million, way over property taxes, way over sales taxes, and still they abdicated responsibility.

Just as blatant but overlooked by everybody, including the press, I think, was about 2½ months later, when there was another issue, half of which, the Series B portion, was \$110 million in Orange County pension bonds. They had a put option on them where the investors could tender their bonds at par with 7 days advance notice. The credit arrangement had been recommended through a syndicate headed by CS First Boston, the re-marketing agent for the bonds.

Part of the plan, however, was abandoned when Mr. Citron, apparently without consulting with any other member of the pool, claiming or thinking that he could save the county a little money, insisted on using the county treasurer's investment pool to be used as a facility for the standby withdrawal agreements, and he entered into that contract just 96 days before the county declared bankruptcy, well beyond the period when Mr. Citron surely knew how precarious the pool's liquidity was.

Any State that has not already done so must provide clear regulations for effectively monitoring the investment practices of any political subdivision within its borders. Any practice that is inconsistent with State policy guidelines should require approval in advance.

Further, if a treasurer wants to accept deposits from outside his district in a common pool, he should be required to provide such depositors with prospectuses that clearly state the strategic objectives of the pool and specific investments that will be employed in reaching those objectives. The use of any tactic or investment vehicle that is not clearly provided for in that prospectus should be against the law. For obvious reasons, they should use a third-party custodian and that custodian should report to each depositor monthly on what the market value is. As has been suggested by one of my colleagues earlier, stress testing is a darn good idea, particularly if they are going to be using derivatives.

The subcommittee has asked if there has been a fundamental shift between the issuers and the investors. My answer to that is yes, absolutely yes. I think two of the main reasons for that fundamental shift being a negative one is the fact that the market overall from my perspective has less liquidity now, with less true

market makers in it, and the other most important thing, I suppose, is that the standing precepts regarding a community's obligations and ability and willingness to pay have been severely damaged by the Orange County situation.

Thank you very much.

[The prepared statement of Mr. Charles W. Fish can be found on page 760 in the appendix.]

Chairman BAKER. Thank you, Mr. Fish. I would like to start the questions with you. I think your comments with regard to the Orange County perspective are particularly enlightening. It seems to me, however, that despite the belief by many that the rest of the market is significantly different in scope and operation from Orange County, I had difficulty in reaching that conclusion given the circumstance in Orange County. Rating services of national recognition, the Securities and Exchange Commission, people of sophistication and ability to analyze within literally days of the bankruptcy proceeding found no basis on which to doubt the solvency or financial condition of the county's financial structure.

What also troubles me, though, from a market perspective, given the covenants, given the circumstance of the issues, there was no hesitancy by the market to acquire debt issues of the county.

Then the county, acting in response to the troubling financial circumstance, moved very quickly to declare bankruptcy, not, as some have suggested, only as a matter of last resort. In taking bankruptcy, the State was not counseled. It was almost overnight the bankruptcy determination was made as a matter of some surprise to even county officials.

This is a very simplistic observation, I am certain, but it would appear that our current regulatory methodologies are not keeping track of the development of new market product. An inverse floater is a relatively new investment instrument. Matching durations, liquidity analysis, leverage ratios—rating agencies apparently didn't even look at these issues.

How can we not say that significant alteration, if not at the Federal level, at least at the State-by-State level, is not an absolute necessity to prohibit this type of activity from occurring again, because I'm confident clever marketing people are selling municipal fund managers a lot of things this morning and the customers don't fully understand the associated risk in spite of the Orange County circumstance. Am I wrong?

Mr. FISH. You make some valid points. A thought that comes to my mind is "Lady, not only are these bonds AAA rated, but they are also insured." People grin, because you can say this particular investment is a direct obligation of the U.S. Treasury. It sounds wonderful, but that's because they are only looking at the credit aspect and they don't know any of the other dimensions of risk that are involved in managing a portfolio.

I think part of the fundamental problem that we have here, and it certainly was the case in Orange County, is the people, you may not expect them to have the expertise, but when they are hiring people to issue debt, for example, in that part of the CAO's office, they go looking for county employees that have, like—well, I don't need to mention names. But the point is they had absolutely no knowledge whatsoever of the securities market or investments in

general. They were administrators. They didn't hire anybody with that expertise. Nor am I aware of any programs they sent them to to get them up to speed. So they were relying 100 percent on what the Street was telling them in given situations, and that is just not going to work over the long haul.

Chairman BAKER. With a requirement for some standardized fuller disclosure would not reasonable persons with sufficient skills to manage a fund be able to identify the risk they are assuming? I'm of the opinion now that people with reasonable skills who are responsible money managers don't get the basic information they really need.

Mr. FISH. There is no question about that. At the time a transaction takes place everything that is material is supposed to be disclosed. There was no adequate disclosure here. If you talk to an investment manager about derivatives and repos, and so forth, and so forth, he's not going to get upset, because those are common tools. If you say that the repos that are used are going to be in excess of 200 percent of the corpus of the portfolio, he'd have a heart attack. That type of thing wasn't disclosed. So we have a serious problem with disclosure, and I really think what the SEC is trying to do now with CDI may not be the best way to do it, but it needs to be done.

Chairman BAKER. Mr. Blackwell mentioned that there might be some necessity to absolutely prohibit the utilization of certain investment practices and investment tools. Do you think that is necessarily the course of action we should pursue, to prohibit a municipality from investing in a structured note or inverse floater, or is the higher standard one to allow money managers to use their best judgment but to ensure the money manager has the information at hand he needs to fully understand the risk he is assuming?

Mr. FISH. Each State needs to set the standards. All the activities that are taking place in the political subdivisions under that State have to meet those standards, and if they want to deviate from it, they should get permission to do so beforehand.

As to whether or not you should say you can't do this and you can't do that, put an absolute prohibition on certain type of investments, I would hate to see it that cold and black and white, because I really think ultimately that's at the expense of the taxpayer.

Chairman BAKER. Thank you, sir.

Mr. Blackwell, I didn't know if you would care to comment on that particular point.

Mr. BLACKWELL. I think ultimately what happens and what has happened in Orange County is that the taxpayers are now being asked to tax themselves a second time for something that they have already taxed themselves for. So it's a double dip on the part of a government and taxpayers are paying the cost for misjudgment.

Let me underscore a couple of points. One, NASACT is fully confident that each State should sort of govern and provide oversight for local and State investment processes.

My call for a prohibition on the use of derivatives in cash management portfolios, these are portfolios that are designed for the express purpose of safeguarding investments until they can in fact

fund services or meet the obligations of local government. What we believe is that by definition a derivative is inherently too risky to invest in at that local level for that character of portfolio.

We do not advocate a broad prohibition of derivatives by others that have other needs and risk tolerances, but we are saying given the character of cash manager portfolios, derivatives really do fly in the face of the hierarchy of conservative objectives of safety, liquidity and yield.

Chairman BAKER. I would like to follow up. Mr. Bentsen, I am taking a little extra time. I'm sure you will be given broad latitude.

Mr. Blackwell, I would be interested in your view. If an investment fund at a municipal level developed problems, would you advocate the municipality taking bankruptcy?

Mr. BLACKWELL. No, and in Ohio that wouldn't be the treasurer's unilateral call.

Chairman BAKER. Should it be?

Mr. BLACKWELL. No. I think for Ohio the structure that we have allows for five officers of the State to make that call. The answer to your question is no.

Chairman BAKER. Thank you.

Mr. Seale, given the circumstances that have developed, given the potential that Orange County might not be able to repay its financial obligations, given my belief that I think that such a failure will raise the cost of funding for other municipal issues and perhaps limit access by some marginal communities to borrowed funds, do you think that the uncertainty about resolution of the financial difficulty is a problem that warrants some structured plan being put into effect? Not that the Federal Government manages nor gets involved, but that there is a national standard that one must follow: a certain period of time must lapse; either the State treasurer or the Governor or someone at the State level must approve the bankruptcy filing; the appointment of a trustee to manage for some period of time to negotiate a settlement.

I find it troublesome to allow a bankruptcy filing and then to have the Federal judge appoint a trustee to go back and do what could have been worked out prior to getting into court. You spend a lot of money and time with attorneys to get what seems to be the appointment of a trustee. Is there a better alternative, and wouldn't the elimination of the uncertainty in the market be of some consequence and benefit everybody?

Mr. SEALE. I would agree with that. Clearly the Orange County situation is one that is of grave concern to the treasurers and to the National Association of State Treasurers, which is part of the reason that we wrote and rewrote our guidelines so that there is some standard at a national level that not just the States can use, but also the municipalities as well.

I believe that States have some responsibility, not to necessarily step in and bail out and become the big brother for all of the municipalities. In fact in Nevada a small locality ran into some trouble and we took an effort between the governor and myself and others to devise a mechanism that would preclude this locality from being in the position to have to file bankruptcy. We were fortunate to have been able to see the situation before it got to the level that Orange County did.

But you are absolutely right. The Orange County bankruptcy is going to have an impact, certainly on Orange County, certainly on California, and is more of a concern to the rest of us in the country. Certainly as a neighbor to Orange County and California, we in Nevada are concerned. Some mechanism—I do not have the answer, sir, as to just exactly what should happen. The debt was incurred. The participants in that locality need to stand up to that obligation no matter how painful it is, in our opinion.

Chairman BAKER. Thank you, sir.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman. In Washington subcommittee and committee chairmen are allowed to determine time like no place else. I respect that right.

I have a number of questions. First of all, Mr. Fish, I want to thank you because you have underscored some arguments that I made yesterday. We heard some testimony yesterday regarding Robert Citron as sort of a rogue agent who was out conducting these investments, and I don't deny his culpability. However, I think there were others who were just as culpable, and I think you raised that question.

Again, I would show for the record as I keep going through the various official statements, this is the pension bond issue which had the put on Series B bonds, and this statement was signed by Thomas Riley, who was the chairman of the board of supervisors. So I think as we go through a look at the issue of municipal finance we have to understand that there are a lot of parties involved in this.

You also raised a question regarding the problems with trustees. I would just say not necessarily as a question but perhaps, Mr. Chairman, maybe we want to look at the trust indenture issue, the Federal laws that apply to the Trust Indenture Act. I don't think that's the actual term, but I think that that might be something.

Mr. Riordan, you raised a number of points in your testimony. In GFOA's opinion, what is your opinion as it relates to registration, the Tower amendment? Do you believe that 15(c)(212) will be adequate, or do you think that we should be looking at registration, the repeal of the Tower amendment, and if so, what do you believe the cost would be to municipalities, and would that outweigh the risk?

Mr. RIORDAN. Mr. Bentsen, we have worked hard with the SEC to try to put 15(c)(212) and make that work. We think our members will make it work. We are in fact putting together some video conferences to help make that work at the national level. So we are very supportive of that and we oppose repeal of the Tower amendment.

In terms of what it will cost municipalities, there will be a cost to municipalities to comply with the SEC rule, but I think it's well worth the cost.

Mr. BENTSEN. Do you think the cost would be greater if you repealed the Tower amendment?

Mr. RIORDAN. I don't think there is really going to be any particular benefit from repealing the Tower amendment. Already in the municipal area the default rate is significantly less than in the

private area where there is the prior disclosure requirement. So I think the 15(c)(212) is going to handle those questions.

Mr. BENTSEN. In your testimony you expressed opposition to the issuance of tax exempt securities for the sole purpose of investing proceeds in higher yielding taxable or tax exempt bonds, which, of course, the Service looks down upon. What is your opinion on issues like the \$600 million 1994-1995 taxable notes which, as best as I can tell, were taxable arbitrage bonds?

Mr. RIORDAN. I'm not real familiar with that case, Mr. Bentsen, but my understanding is the same as yours, and our position has been that we don't favor the issuance of bonds for arbitrage purposes.

Mr. BENTSEN. Yesterday we heard testimony from two of the three or four major rating agencies. In their testimony, particularly talking about this issue, they told us that they relied primarily on looking at the financial statistics of Orange County; they really didn't consider this a structured note deal; but in fact, when you read the official statement, it appears that the funds were being invested in the Orange County investment pool to earn excess arbitrage in order to secure the principal and interest.

I realize that your relationship with them is different, but do you think the rating agencies should be paying more attention to this? The pension bonds, which included a put facility, a liquidity facility, which was also backed by the pool, apparently the rating agencies didn't take a hard look at that because they gave it a double-A rating as well.

Mr. RIORDAN. First of all, the rating agencies are in fact asking a lot more questions. When we issue bonds now, they ask a lot more questions. I happened to issue a \$15.5 million worth of notes on Tuesday of this week. Several of the investors called me directly. They asked me a number of questions about Dayton, Ohio, and they also asked me questions about what is our portfolio. After I explained that, their question was, do you have any derivatives in your portfolio? So the questions and the awareness on the part of the investors and the rating agencies is out there, I think.

Mr. BENTSEN. Mr. Chairman, I have some other questions. I know we have some other members here. Hopefully we will get to come back.

I agree that we need to be careful in some of the things that we do. I appreciate on page 3 where you talk about looking at Bankers Trust and the Fed. I think that we ought to take a close look at the Gibson Greeting and Procter and Gamble cases as well as we develop any Federal legislative effort. Thank you.

Chairman BAKER. Thank you, Mr. Bentsen.

Mr. Fox.

Mr. FOX. Thank you, Mr. Chairman. My questions are for any panel member that would like to answer.

Do you feel that Orange County should have declared bankruptcy or taken another route instead of doing that?

Mr. Dearborn.

Mr. DEARBORN. Mr. Chairman, Mr. Fox, it is our feeling that they should not have declared bankruptcy until State court and State agency actions had been exhausted.

Mr. Chairman, I wanted to respond to your question about when and if the bankruptcy law should be used. The way it is now written it does contain requirements that the government be insolvent, that there be State approval, and these other things, but the situation is that a municipality can file in Bankruptcy Court not having met any of the requirements, and immediately it puts a stay on the State actions and the State court actions until there is a hearing. Bankruptcy judges, it appears, don't move with alacrity in moving these to hearings. So the very purpose of delay, which is generally what is desired, can be accomplished indirectly while the case will subsequently be thrown out.

This is what happened in the case of Bridgeport, for instance, and several of these other municipal bankruptcy cases. They didn't have merit under the law, but the mere act of filing permitted things to happen. I think that is what happened in Orange County, that there never was an opportunity for this to be properly addressed by the State and by the State courts before it was removed from their jurisdiction.

It is my feeling that this would not be in the posture it is in today had this not been permitted to be a late night filing as it was but had been left with the State agencies and the State courts.

Mr. FOX. A significant portion of the Orange County investment pool was invested in government-sponsored enterprise structured notes. Such notes carry low credit risk but high market risk. Such notes therefore carry a AAA rating, which can be misleading to investors. Should such notes also carry some sort of market risk rating?

Mr. RIORDAN. Mr. Fox, in the GFOA testimony we did recommend that the rating agencies do have such kind of ratings and markings on them. We think it would be helpful to investors if more people used these kind of ratings to indicate what risk is out there.

Mr. FOX. I have been told that it is not the derivatives that are the problem but the leveraged use of them that caused the problems. Would you care to comment on that?

Mr. SEALE. Clearly the tremendous amount of leverage that was used in Orange County led to the problems and less so the instruments. The guidelines that we have developed at the National Association of State Treasurers require that this kind of leveraging or any leveraging be disclosed so that the world can know what it is that we are doing in our pool. We also discourage the use of leveraging, particularly to that extent.

I can't imagine anybody going to the extent that happened in Orange County with that kind of leveraging. To the extent that it is used, we are requiring that it be disclosed so that the world knows.

Mr. FOX. As a follow up, do you think it is important that we have a minimum standard of financial expertise for treasurers of municipalities and counties, and so forth, or is the problem one where we need to have some kind of Federal law passed to provide the protection to the investors?

Mr. SEALE. Education is a huge and important part of what we are doing, certainly at the State level, and we continue with our National Institute of Public Finance to try to educate our members.

We believe that continuing education is absolutely essential to those of us who are dealing with public monies.

Mr. FOX. Mr. Blackwell.

Mr. BLACKWELL. I want to go back to your first question. I think that there is leverage inherent in the design of most derivatives that subject these instruments to large price volatility and potential losses. This is my opinion and my advocacy reflects this in Ohio. I think that they are inappropriate for cash management portfolios, which is the dominant character of portfolios managed at the local level.

I want to underscore that there hasn't been a State treasurer in this country any more vocal than I on the need for education and standards, particularly on the danger of leverage.

However, I believe that the issue is more than education. It is a matter of philosophy and principles. You have heard many of us give credence to the hierarchy of the conservative principles of safety, liquidity and yield. If that is to be more than an empty slogan, safety means something, and the preservation of the capital and the measurement of risk to return have to be institutionalized in our day-to-day execution of our responsibilities.

I think that if you look at the resistance among the public fund managers at the local level, at least in the State of Ohio, to any mandated set of requirements or any measure of financial expertise, you only have two routes.

One is you at least mandate continuing education where folks get exposed to new instruments and new conditions in the marketplace.

Second, you establish by law, based on the character of the portfolios that they manage, the limits to which they can go. I don't think that it is any accident that after Proposition 13 in California, when there was obvious political pressure to roll back taxes and contradictory pressure not to cut pet projects, that local politicians would turn to public fund managers, to create the new cash cow for their respective budgets, new unrestricted revenue, which meant that what they engaged in was riskier and riskier investments.

We saw the maturity limitations in most States go from 2 years to 5 years to 10 years and in Ohio to 30 years. Essentially what we are trying to do now is to roll back these limitations to a more conservative set that is consistent with the objective of principal preservation, which is inherent in, I think, the management of cash portfolios.

Mr. FOX. Mr. Chairman, can I ask one final question?

Chairman BAKER. Sure.

Mr. FOX. I would ask the panel, Mr. Blackwell included, if they would like to answer this.

Is there as a possible solution to not having an Orange County situation again something like we have in Pennsylvania where we restrict municipal authorities from certain kinds of investments as a restriction on the possibility of having a county go under or a municipality go under?

If someone is looking for a silver bullet theory, what answer is there that we can package up for Congress to look to that you think with your years of experience and expertise in the field would

give Chairman Baker and his subcommittee something we should be chewing on?

Mr. BLACKWELL. Let me just say that I don't think there is a Congressional silver bullet, and I don't think Ohio's solution to its problems necessarily fits Nevada's. From my standpoint, working on these at the individual State level is what is inherently prudent.

The second point that I wanted to make is that from NASACT's standpoint, from positions that reflect broad consensus in the organization of over 170 treasurers, auditors and comptrollers, finding some way of getting into secondary market disclosure and just putting a lot of things in the sunlight is what is desperately needed at the local level.

Mr. FISH. Mr. Fox, I want to give you something to chew on. It occurs to me that I have in recent history established credit lines through repo arrangements with major brokerage firms on behalf of clients of mine that are commercial banks. In my most recent effort, I think that we finally wound up with a \$10 million line. We were originally offered a \$5 million line. But this is with a bank that had unimpaired capital to the tune of \$13 million and probably unimpaired securities, all of which were direct, non-callable treasuries due in 5 years and less of approximately \$40 million.

That brokerage firm was willing, after persuading them to allow a line—by the way, these are very short term repos, 2 weeks or less—to go along with a securitized line of repurchase agreements of \$10 million. That's against \$13 million in capital and \$40 million unencumbered securities.

How could that same securities firm, if they are operating under those rules—and I'm telling you, from national reputation they are supposed to be the toughest in the business; they don't make exceptions for anybody, but I'm here to tell you when the business was on the table the exception was made for Orange County to allow them to do repurchase agreements amounting to two and three times the size of the corpus of the portfolio, which is unconscionable. Let alone the fact that the account they were doing it with was one that had a fiduciary responsibility. Whereas my banks have responsibility to the depositors and all the regulators and so on and so forth, you can't really compare it to what that municipality's responsibility was. So where was the ethics?

I guess what I am trying to say here is that even if a public treasurer wants to shoot himself in the head, the Street shouldn't be allowed to help him.

Mr. FOX. Thank you.

Chairman BAKER. Thank you, Mr. Fox.

Mrs. Kelly.

Mrs. KELLY. I am sitting here a little stunned by that last remark. There are people out here like me and my mother, people who really trust that the people are good people who are investing our tax dollars and taking care of our counties in the way that the people did in Orange County and are doing it in all good faith, and we have to trust them.

I think what disturbs me most about this whole hearing and the one we had before was that according to Congressman Cox's testimony, John Moorlach had issued warnings that the Orange County fund had taken some really excessive hits. What disturbs me is

that people like us who are not financially sophisticated, like me and my mom and people who just pay their taxes and trust the big guys to do the right thing, how do we know? How do we set it up so that the disclosures you make are comprehensible and complete enough that we can know what our risk is all about when you are handling our tax money?

I'm going to throw this out to the whole board, because I think it is really what is frightening to people about Orange County, that this could happen and no one seemed to know.

Who wants to tackle that one?

Mr. SEALE. Mrs. Kelly, it is disturbing that John Moorlach, who, I might add, is at the National Institute of Public Finance up in Delaware that I am attending this week, has made the effort to come and find out more about what he is doing. But it is disturbing that he knew and that he told a lot of people and it didn't go anywhere. Someone was asleep at the switch.

One of the problems with this kind of information is that it is not sexy, it is not really exciting. Where was the press until it blew up? And then they are all over the situation.

We can create new guidelines; we can adhere to those guidelines. There has got to be a responsibility of others to investigate these things. Certainly the oversight boards that we are recommending, people need to be attending those and hearing what it is that we have to say and what we are doing. The press should be involved in that as well. But there are no assurances that every entity is going to be following our guidelines.

Mrs. KELLY. That is one of the problems, Mr. Seale. I have here a copy of the 1995 "Survey of Government Investment Practices" that was included in Mr. Riordan's testimony and I have circled something here: "Most governments have not modified their investment practices since the Orange County bankruptcy." There is a bullet right under that: "25 percent have reviewed their investment policy since Orange County." Other places I have heard figures higher than that. One implied that most counties have reviewed.

It is hard for the average person who isn't motivated to come out to the meetings and isn't motivated to read. I realize it is incumbent upon all of us to do this. But it is hard for us to understand it let alone get ourselves out there to do it. We need to have a certain amount of trust in those people who are handling the money, and if this figure is true, 25 percent have reviewed their investment policy since Orange County—only 25 percent? I think this is what I am talking about in terms of disclosure.

Mr. RIORDAN. Mrs. Kelly, one of the things in my testimony we talked about in order to protect you and your mom was to encourage the broker/dealers to understand what your objectives are and what your ability to handle risk is so that when they sell you something they are not selling you something that is above the kind of risk that you and your mom are willing to take. We think that is an important part. It is part of the 1993 Government Securities Act, and we think these kinds of regulations should be enforced on the broker/dealers so that this doesn't happen.

Mrs. KELLY. You think also questions should be asked about how far out those deals are leveraged; is that correct?

Mr. RIORDAN. Yes, Mrs. Kelly. People ought to be disclosing that to you; they ought to be asking you what is your affinity for risk, how much of this can you take on, so that then you do it.

I guess in one way it is almost as American as apple pie, and that is greed. Eventually if you want to go out and try to achieve a whole lot more in the fixed income market, you can probably do it, but you are always going to accept a whole lot more risk. I think that is really what we saw in Orange County. They were getting yields that were significantly above the market. Well, you don't do that in this marketplace unless you are willing to accept significant risk, and eventually you pay the price for that.

Congressman Fox asked the question about the derivative products. Frankly, in these times for governments, where people were pushing hard for investors to find more money, there was pressure because the investment yields were going down. I will go back to your question about the investment policies. I think, however, most jurisdictions have very good, conservative investment practices that protect us against most of these situations.

Mrs. KELLY. Thank you very much. My time is up.

Chairman BAKER. Thank you, Mrs. Kelly.

Mr. CREMEANS.

Mr. CREMEANS. First of all, I would like to welcome my good friend and fellow Buckeye Mr. Blackwell and ask him a question that I think relates to the great State of Ohio.

Yesterday I asked the question about the legal fees and accounting fees that have accompanied the bankruptcy in Orange County, I think to the tune of approximately \$40 million. Currently Mr. Blackwell is the treasurer of the State, but before that I think we had some problems in one of our municipalities in northern Ohio.

I guess my question to Mr. Blackwell would be, if an Orange County situation occurred in Ohio in a municipality, given at least the one example that I have illustrated with the legal fees and the accounting fees, and there are many more, would you have recommended bankruptcy?

Mr. BLACKWELL. Mr. Cremeans, it is good to be here and I know that Washington is a safer place with you here.

Let me just say that Ohio was the first State to enact a comprehensive municipal financial emergency law, and from its enactment in 1979 to 1992 and under the terms of the law 22 municipalities were declared under financial distress. Sixteen of these municipalities had the declaration lifted upon successful recovery from financial distress. In Ohio we have a sinking fund made up of other constitutional officers that were in place to make sure that obligations are met but were not there to mandate that municipalities file bankruptcy.

Mr. DEARBORN. Mr. Chairman, Mr. Blackwell is being modest. In our review we looked at the Ohio law and found that it was, in our opinion, a model that could very well be followed by other States in this regard.

Mr. CREMEANS. Now you see why we have him as treasurer.

At present the bankruptcy code leaves the States and its municipality entities the power to avail themselves of the bankruptcy process. I guess I could address this question to anyone, and I think it is worthy of highlighting.

Should the law require a municipality to confer with State government before commencing bankruptcy? Anyone care to respond to that inquiry?

Mr. DEARBORN. Absolutely. That was one of our principal recommendations in both the 1971 and 1985 reports. As I indicated to the chairman, however, the bankruptcy law has been used in several instances to do exactly the opposite. In the case of Bridgeport it was because the State agency was about to order it to take corrective actions and they filed to avoid the State actions. In two or three other instances it was State courts they were trying to avoid having rule on them.

Something has to be done to put teeth into this so that you can't just go in whenever you don't like what is about to come down from the State court or a State agency and say, we don't want to do that, so let's just go file for bankruptcy and that will stop the State from doing this. It should be just the opposite. It should be a requirement that you can't even file until you have discussed this and dealt with the State agency.

Mr. CREMEANS. Finally, Mr. Fish, do you see the Orange County bankruptcy as an economic or a political failure?

Mr. FISH. Very definitely a political failure. Probably the best example of that was an independent survey that was taken on the Measure R vote. For those of you who don't know, the sales tax initiative failed rather miserably, by about a two to one margin. The poll one of the local papers ran said, if the measure said that if you vote for the tax, it also means that simultaneously all of the incumbents would be put out of office, how would you vote? And the thing passed in the 90th percentile.

The problem with the people who were in favor of Measure R was the fact that they failed to disassociate the increased tax with an endorsement of the incumbency which was being blamed for the problem in the first place.

Mr. CREMEANS. Curiously, what has happened to the property values in Orange County since December?

Mr. FISH. May I give you a personal example?

Mr. CREMEANS. Yes.

Mr. FISH. I've lost 40 percent of the value of my home in the last year and a half.

Mr. CREMEANS. Thank you. Thank you, Mr. Chairman.

Chairman BAKER. Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

I would just note that I think both the chairman and I, coming from the Southwest, are familiar with what happens when you lose 40 percent of the value of your house.

Mr. Blackwell, with respect to the local investment practices proposal that NAST has put out, is there unanimous support with respect to that?

Mr. BLACKWELL. It represents a broad consensus, if not unanimous.

Mr. SEALE. We are not complete with our voting, but we certainly have a clear majority and we continue to get full support from our members. I anticipate that by the end of the week I will have all of the States back in support.

Mr. BENTSEN. Thank you.

I would ask Mr. Dearborn and the State and local finance officials here, is there a need for uniform public investment law?

We have heard testimony in the last day of one State having a certain public investment law, another not, one county having one, another county not. I can tell you from my experience on the other side of the transaction that you look at each entity's public investment law. I am not particularly advocating one, but I am just curious what your feeling is on that.

Mr. RIORDAN. Mr. Bentsen, I would say definitely not. It would be similar to saying we should have one investment policy for all residents of the United States. There are just different circumstances and different situations and I think each State and locality is going to have to build their own policies.

Mr. DEARBORN. I agree, but I do think that the contents of each State's law should be very similar and it should be very limiting and very conservative.

Mr. BENTSEN. It is ironic, I think, that we are talking about Chapter 9 and bankruptcy and on the one hand we are talking about taking away the power from the municipalities or counties to have the flexibility to utilize Chapter 9 perhaps and have some prior approval of the states at the same time that this Congress has been talking about decentralizing everything, to let the counties be the counties and the states be the states and everything else. But I guess it's just a matter of the issue that you are looking at.

Mr. Riordan, you talked about looking at sales practice issues related to the sales of securities, primarily, I guess, derivative securities, and that that is something that the Federal regulators ought to look at and that perhaps Congress ought to look at. You also talked about bank exemption for sales of securities, which the chairman and I have talked about from time to time with relation to the Financial Services Act. I would be interested in your comments. In sales practices, exactly what would GFOA be looking at?

Mr. RIORDAN. Looking for the broker/dealers to have a more proactive and affirmative responsibility when they are selling things. As a finance director over the years, I deal with a certain number of people at the local or even at the State level that we buy securities from, but there is a constant barrage of telephone calls from people who are trying to aggressively sell us. They have no idea what our objectives are, what our policies are. We try to tell them that this is what we want and whether this fits or not within our policy.

What we are suggesting as GFOA is that there ought to be a responsibility on the part of the broker/dealers to know and understand what our investment policies and our affinity for risk is. We think there is language in the 1993 Government Securities Act. There are rules that are still being developed for that, and we think those rules ought to come out and be clearly implemented so that there is a responsibility on the broker/dealers' part to know to whom it is he or she is selling.

We don't think they should guarantee the investment. They are not going to be guaranteeing investments, but they ought to know the policies of the people to whom they are selling.

Mr. BENTSEN. We've heard a lot of stories. I think the *Wall Street Journal* has written some articles on what is called toxic waste and the sale of securities that "had the full faith and credit of the U.S. Government behind them." Do we need to prescribe some form of disclosure as it relates to various structured notes involving U.S. Government securities, CMOs, things like that that discuss duration, discuss variations in weighted average maturity?

Mr. RIORDAN. I guess I wouldn't be in a position to say exactly what kinds of things we ought to do. What we have talked about from GFOA's perspective is saying let's let the market and the rating agencies make some comment as to the risk involved in those particular instruments. So put some kind of a notification out that indicates what level of risk investment this is, and then you also tie that with the broker/dealers' affirmative responsibility to know what the customer's affinity for risk is.

Mr. BENTSEN. I believe the Congress, before I was here, enacted legislation relating to the savings and loans, and I believe banks as well, that set various parameters and tests that financial institutions had to use in order to purchase mortgage backed securities. There were certain types of analyses which had to be prepared bearing on changes in interest rates, prepayment speeds. Is that unreasonable to look at for State and local governments?

Mr. RIORDAN. We don't have a definitive position on that. That certainly is one of the things that could be looked at. I think it probably is more in the purview of the States in their State laws.

We, for instance, have put together model State legislation that we have encouraged the States to adopt or adopt some form of and have been pushing that for about 8 or 9 years. I am not sure if we get into the concepts of duration in terms of what is in that model State investment ordinance, but I would think that is more of an item that you could do at that level.

However, I still think what you would end up with is talking about the portfolio, and you still get to whether or not somebody is going to buy this particular instrument and you still get back to having to make that decision. You've got a seller and a buyer and they have each got responsibilities.

Mr. BENTSEN. If I might, one more question.

Mrs. Kelly brought up the issue of Moorchach and why wasn't anybody paying attention. Unfortunately, we don't have a copy of it and my recollection is only from the *New York Times* a year ago, I think. Apparently there was a letter from senior executives at Merrill Lynch, who was acting as one of the primary broker/dealers to Orange County, stating that they believed that Orange County was taking excessive risk in the building of reverse repos and in the investments that they were making.

If I recall correctly, and correct me if I am wrong, not only were they concerned about it, but I think they maybe even offered to purchase back some of those investments at par value.

As the article goes on, if I recall, Citron rejected the letter and in fact wrote back—and it would be nice if we could get these for the record—that if Merrill Lynch wanted to continue doing business with Orange County that they should in effect keep their mouth shut and go forward.

What is your reaction to that?

Mr. SEALE. I think your characterization is fairly accurate. It goes along with my recollection, and my reaction is that it is appalling. I am stunned that he would have done that under the circumstances. This man was clearly very aggressive, far more aggressive than any treasurer I have seen out there. I'm from a State where we understand risk. There is a certain amount of luck involved. You can calculate it. He would have done well to have brought his entire portfolio to Nevada and put it on the pass line, based on the ultimate outcome.

There are and will continue to be people like this who will find whatever mechanism they can to advance their own agendas. That was his agenda, I believe, not Orange County's agenda.

You can outlaw derivatives and you can outlaw whatever instrument, CMOs that you may find offensive at this point in time. That is not going to do any good for tomorrow, for tomorrow the market will have come up with yet another instrument that we have not even thought about and somebody like Mr. Citron is going to find a way to use that for their purposes. But for him to do what he did I think has given us all a great deal of heartburn.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

I know you have been here for a while. Mr. Riordan, I want to wrap up with one more question to make sure I am understanding. You suggested that the GFO Association has a suggested model for disclosure that you have attempted for some 8 or 9 years to see universally adoption. That's a very important point, I think.

Given the environment which we face, the recent failures, and the fact that it has taken some 8 or 9 years of professional effort on your organization's part to get everyone to consider adopting a common approach, I think that is what is troubling the subcommittee this morning, that and the comments of Mr. Seale that no matter what you pass there is somebody in the market who will find a way to take advantage of an unsuspecting municipal fund manager and put public funds at risk.

The only hope I think we have in this process is a uniform disclosure requirement, require outside audit, and hope the market is smart enough to identify the risk so they won't buy them in the first place.

It seems to me there was enough culpability to go around all over the place with the Orange County matter, from professional regulators to the market to the issuer. We simply cannot allow, however, these conditions to repeat themselves because of the impact it has on important public projects that cannot be constructed without access to capital.

If it has taken the organization 8 or 9 years to suggest this to their members and we still have those who have not yet adopted the model, isn't it time we discuss some national standard?

Mr. RIORDAN. Mr. Chairman, our organization made the recommendation and began working with the various States. I would have to get back to you later to give you an exact number. I think a number of the States have adopted or have worked off of our model to make some changes in the State laws that require that.

Chairman BAKER. If we took your recommendation and molded it into a piece of legislation to require what you are suggesting, is

there some element of that that is offensive? Is it simply that the Feds ought not to tell the States what to do, or is there some other reason that we ought not be involved in that?

Mr. RIORDAN. It's part of that in a sense and it is also part that we come up with a model and we work that with members from all over the country to put together a model. A model doesn't make it perfect. You try to include the basic features that you would need. It is going to have to be massaged by each State to meet the requirements and the needs of the various States and what their people say.

We think that it's a good starting point for the States to begin talking about that and it can point out areas where maybe the States don't have a few features that our professionals thought they ought to have. So it becomes more of a starting point. We don't view it as a standard that ought to be adopted *carte blanche*, but it becomes a straw man in effect that they can see these are the major components you ought to have and you ought to take a look at it. I don't think we ever developed that model with the sense that we wanted to insist that every State do it and everybody do the same thing.

In the last year we also adopted a sample investment policy that localities can adopt. So we are going to do the same thing with that. We are going to start promoting that. It doesn't mandate anything to them, but it says these are the kinds of things that you ought to make sure you have in your policy. So we are going to be doing a lot of promotion of that.

Chairman BAKER. Thank you, sir.

Mr. Blackwell, did you want to respond as well?

Mr. BLACKWELL. I was just going to say that disclosure of financial information for risk of investments, derivatives, and so forth, for State and local governments is under the purview of the Governmental Accounting Standards Board. If the Federal Government needs additional disclosure, then perhaps they could be subjected to the same as GASB.

Chairman BAKER. Thank you very much. I want to thank each of the witnesses for being here this morning and for your patience in staying for such a long time. It was most informative and helpful. Thank you very much.

I am told some members have follow-up questions they will submit in writing at a later time.

I would like to ask the members of our second panel to please come forward. I would like to welcome the witnesses who are appearing on our second panel this morning. I will extend to you our appreciation for your patience through what was a longer session this morning than expected. I will renew my request for your statement of less than 5 minutes if possible. Your full, complete statement will be made part of the record and reviewed by staff and members.

I would at this time introduce as our first witness the chairman of the Public Securities Association and executive vice president of the Bank of America, Mr. Robert McKnew. Welcome Mr. McKnew.

STATEMENT OF ROBERT McKNEW, EXECUTIVE VICE PRESIDENT, BANK OF AMERICA AND CHAIRMAN, PUBLIC SECURITIES ASSOCIATION

Mr. MCKNEW. Thank you, Chairman Baker, very much, and good morning. We appreciate the opportunity to appear here to present the views of the Public Securities Association, the PSA. In the interest of brevity, I would like to focus my remarks on three key policy issues related to the unfortunate events in Orange County: State and local investment policies; the responsibilities of securities dealers and institutional investors; and municipal bankruptcy.

As you suggest, I would like to request that my written statement be entered into the record.

It is important and appropriate for public officials at all levels of government to examine the events in Orange County in order to determine how such an affluent and seemingly well managed jurisdiction could be subjected to the largest municipal bankruptcy in history.

When you do, I think you will find that the enormous investment losses suffered by the county were not the result of the use of any particular financial instruments. The losses occurred because the county's investment managers, apparently with full knowledge and understanding, engaged in a highly leveraged investment strategy which exposed their portfolio to extraordinarily high levels of interest rate risk.

With that in mind, I am troubled by some of the policy responses that have been suggested to prevent occurrences similar to Orange County's elsewhere. Some legislators, for example, have advocated restricting the investment of public funds to a short list of financial instruments deemed to be of "low risk." I believe this approach is shortsighted because it ignores the responsibility of public officials to truly understand their investment decisions and because it is impossible to devise a list of investments that are always appropriate for all public investors.

Sensible measures to regulate State and local investment practices and to ensure accountability are needed. However, these measures should not unduly restrict the investment options for State and local governments.

First, all public investors should develop and adhere to well defined investment guidelines.

Second, public investors should be required to mark their portfolios to market periodically.

Third, investment managers should be required to report regularly their activities and be subject to stringent oversight.

Finally, it is appropriate for States and localities to establish minimum standards of qualification for the officials charged with managing public funds. Such standards would be in the interest of both communities whose funds are at stake and market participants ourselves who trade securities with State and local governments.

I would note that, like Bob Seale, I am on my way immediately after this hearing to the University of Delaware to participate in NAST's Public Finance Institute. We applaud NAST for establishing this set of qualifications and school to better educate the State

treasurers of the country to the intricacies of the markets in which they participate.

The Nation's securities markets can operate efficiently only if institutional investors, including State and local governments, are prepared to bear responsibility for their investment decisions.

In free and open markets losses, although unfortunate, inevitably occur. Efforts by institutional investors to shift investment losses to securities dealers carry ominous implications for our markets, including lost liquidity, higher cost, and less efficient pricing. A market where investors are permitted to reap the benefits of rising prices but are able to transfer losses incurred through falling prices back to the dealer who sold the securities cannot work.

In order to clarify this point, the Public Securities Association is committed to developing a sample agreement for securities dealers and public sector investors. At the very least, a sample agreement should recognize the nature of the relationship between securities dealers in distinct contrast to investment advisers and institutional investors.

In addition, a sample agreement should embody the principle that investors, especially institutional investors, must bear responsibility for their decisions.

Finally, the issue of municipal bankruptcy. I would like first to emphasize that one of the reasons that Orange County's bankruptcy filing is so noteworthy is because actions of that sort are so rare. Very few municipal governments have sought bankruptcy protection because, first, the vast majority are well managed and fiscally sound. Second, the economic disincentives to bankruptcy imposed by the market in the form of prohibitively high financing costs or complete loss of normal access are very great.

The Orange County bankruptcy and subsequent default have roiled the municipal securities markets and have caused some investors to rethink the value of the financial pledge of a general unit of government. However, the market effects, fortunately, have not been as severe as many had predicted they would be. I believe that the Orange County situation is unique. I do not believe that the county's bankruptcy and default represent a trend among local government borrowers.

The unfortunate events in Orange County have focused new attention on the unique nature of the trust associated with the investment of public funds. We should seize the opportunity to rethink some of the principles associated with sound State and local financial management and the nature of investor responsibility.

It is appropriate, for example, to reassess the soundness of municipal investment strategies, the soundness of municipal investment practices, and the adequacy of State and local information disclosure and the extent to which institutional investors are willing and able to bear responsibility for their decisions.

While recognizing that future investment losses can and will occur, responsible actions to help minimize and elucidate the risk to public funds are called for.

The subcommittee's attention to these and similar issues is commendable. We appreciate the opportunity to participate and look

forward to working with Members and your staffs in the future. Thank you very much, Mr. Chairman.

Chairman BAKER. Thank you very much.

[The prepared statement of Mr. Robert McKnew can be found on page 767 in the appendix.]

Chairman BAKER. Mr. Craver, I believe we have sufficient time before I must step out for a vote. If you would like to proceed, I would be happy to introduce you in your capacity representing American Bankers Association and as Executive Vice President and Corporate Treasurer of First Interstate Bancorp. Mr. Theodore Craver.

STATEMENT OF THEODORE CRAVER, EXECUTIVE VICE PRESIDENT AND CORPORATE TREASURER, FIRST INTERSTATE BANCORP, LOS ANGELES, ON BEHALF OF THE AMERICAN BANKERS ASSOCIATION

Mr. CRAVER. Thank you, Mr. Chairman. Mr. Chairman and members of the subcommittee, I am Theodore Craver, Executive Vice President and corporate treasurer of First Interstate Bancorp, headquartered in Los Angeles, California. I am responsible for, among other things, managing the corporation's investment portfolio, managing the corporation's interest rate risk, and for the corporation's broker dealer and bank dealer operations, which includes municipal underwriting activity.

I appear here today on behalf of the American Bankers Association and the ABA's Securities Association, the latter of which I serve on its board of directors.

Mr. Chairman, the recent filing for bankruptcy by Orange County and the magnitude of the investment losses suffered by the county has raised many issues with which this subcommittee through these hearings is appropriately examining. These issues are very important to the investing public, the State and local government issuers, and to State and local taxpayers.

I believe we can say that the occurrence of investment portfolio losses certainly was not unique to Orange County. However, in my opinion the negative effects of the bankruptcy that resulted from those losses have largely been localized to Orange County.

Interestingly enough, there have been a number of positive effects which have spread far beyond Orange County. By this I mean virtually everyone connected with municipal finance has asked the questions, could there be another Orange County problem and what should we be doing differently as a result of Orange County?

This is very healthy, particularly for the municipalities, and is leading to self-imposed reviews and changes to investment policies, to governance, controls, and very importantly, to investment strategies.

Understanding the causes of the investment portfolio losses in Orange County will lead me to the first important point we at the ABA and ABASA would like to make to this subcommittee regarding derivatives.

In my opinion the causes of the losses were the result of an overly aggressive investment strategy. Specifically, it was the use of leverage and the intentional mismatching of the portfolio to exercise a view on the direction and volatility of interest rates that led to

the losses. The investment instruments, including the derivative instruments, per se were not bad, but rather the investment strategy itself was flawed.

We believe the Orange County events do not warrant enactment of Federal legislation aimed at curbing the use of derivative instruments. Any effort to restrict this market would increase costs and burdens and actually increase risk. Specifically, restrictive legislation could result in market participants, including banks, losing the ability to control market risk through the use of derivatives, or alternatively, making less credit available to local communities.

In addition, many investing institutions, including banks, could be denied the ability to acquire investment securities appropriate to that institution's particular investment philosophy.

This Congress does, however, have an historic opportunity to improve municipal market liquidity through two different pieces of legislation currently under review, and the restoration of liquidity or expansion of liquidity is very important given the events of Orange County.

The first involves raising the small issuer exception limit. As a direct result of tax legislation enacted in the 1980's, bank holdings of municipal securities has declined dramatically, from 41 percent of all tax exempt securities in 1980 to 9.6 percent in 1994. The tax legislation enacted in the 1980's eliminated the ability of banks to deduct interest expense on municipal securities except for municipalities that issue less than \$10 million debt a year, the so-called small issuer exception.

The proposals currently under review by the House Ways and Means Committee will, if enacted, raise that limit somewhat and thereby encourage additional bank investment in municipal securities of small communities.

Second, the full House Banking Committee has put forth legislation that would allow banks to underwrite municipal revenue bonds in addition to general obligation bonds which are currently permissible. If enacted into law, State and local governments will have better access to the capital markets and their securities will achieve increased liquidity which in turn results in lower borrowing costs inuring to the benefit of State and local governments and their taxpayer constituents.

This is made all the more important since a number of high profile Wall Street firms have withdrawn from the municipal securities underwriting business in the last few years.

In summary, Mr. Chairman, although the events in Orange County have been unfortunate, they have spawned a great deal of self-examination by all involved in the municipal securities markets. In general, we believe the natural market mechanisms have responded well and thus we need to take care not to overreact with a legislative response. There are, however, some opportunities before Congress to improve the availability of financing for municipalities that we hope will be enacted.

We at the ABA commend you, Mr. Chairman, for your leadership and concern on this issue. We look forward to working with you and the members of the subcommittee on these issues in any way that we can. Thank you.

[The prepared statement of Mr. Theodore Craver can be found on page 786 in the appendix.]

Chairman BAKER. Thank you very much, Mr. Craver.

We will stand in recess momentarily pending action on the House floor. We will return as quickly as possible. Thank you.

[Recess.]

Chairman BAKER. We will reconvene our hearing.

Mr. Genader, I'm sure other Members are on their way back momentarily, but I would like to introduce you to make your remarks as the chairman of the Association of Financial Guaranty Insurers and senior Vice President of AMBAC. I would like to welcome you this morning and we look forward to hearing your remarks. Mr. Genader.

STATEMENT OF ROBERT J. GENADER, SENIOR VICE PRESIDENT, AMBAC AND CHAIRMAN, ASSOCIATION OF FINANCIAL GUARANTY INSURERS

Mr. GENADER. Chairman Baker and members of the subcommittee, I am Robert Genader, Chair of the Association of Financial Guaranty Insurers, also known as AFGI, and executive vice president of AMBAC Indemnity Corp. It is in my capacity as the Chair of AFGI that I appear before you today.

AFGI is comprised of nine triple-A rated U.S.-based companies that are active solely in the writing of financial guarantees. Seven of our member companies serve as primary insurers of municipal bonds. The members of AFGI appreciate the opportunity to share their views with you and stand ready and willing to assist the subcommittee as it addresses critical issues affecting the municipal securities industry as a result of the Orange County bankruptcy.

Our industry insures approximately 38 percent of all municipal bonds. As of July 19, 1995, the nine AFGI companies have an aggregate par exposure to Orange County municipal obligations of approximately \$542 million and an aggregate par exposure of municipal obligations to cities, school districts and special districts which invested in and lost money in the Orange County investment pool of approximately \$3.3 billion.

Our written testimony concentrates on certain concepts and suggestions, some of which I would like to briefly summarize for you.

First, the municipal bond market functions on trust, honor and the character of its issuers. Unfortunately, certain legal postures taken by Orange County in its bankruptcy bring that county's willingness to pay its debts and thus its character into question.

For example, Orange County has reserved its right to challenge the crucial lease/debt distinction, which is the foundation of the certificates of participation financing structure, better known as COPs. A certificate of participation represents an undivided interest in a stream of lease installment payments for the use of a public building, for example, a jail, a courthouse or a parking lot, for which the county previously received a lump sum payment from investors.

Investors hold these COP certificates and receive their proportional interest on a regularly scheduled basis. COPs have accounted for over \$37 billion worth of structured financings in California in the last 10 years.

In addition, the recharacterization of leases as debt is a common tactic employed in Chapter 11 reorganizations by corporate debtors to avoid creditors' efforts to force a debtor to assume its leases. However, such a recharacterization would have an extremely negative impact on the use of this important financing instrument by all municipalities in the future.

Similarly, Orange County has reserved the right to challenge bondholders' security interests in accounts established specifically for the repayment of bondholders. Orange County has also challenged a fundamental premise of California municipal finance when it declined to set aside tax revenues pursuant to a lien created for the benefit of holders of tax and revenue anticipation notes or TRANs. This issue is now on appeal before the Ninth Circuit Court.

Orange County's most shocking act to date may have been its reservation of rights to void its obligation to pay \$600 million of taxable TRANs that were issued as recently as 1994. If exercised, this reservation, more than any other, will strain the county's character and potentially damage the entire California market.

Second, in our written comments we also suggest some specific changes to Chapter 9. These include requiring a State to specifically authorize a municipality's filing for Chapter 9, which we believe will make the State more accountable for the fiscal condition of its subdivisions.

We further suggest prohibiting recharacterization of municipal finance transactions.

In addition, Chapter 9 should be revised to permit the appointment of a third-party trustee to protect the interest of creditors in a municipal bond bankruptcy.

In addition, the exit requirements for Chapter 9 should be revised to require a debtor to make a showing of best efforts to repay all of its debt in full before the court may confirm a plan which impairs the creditors.

Chapter 9 should also be revised to establish that funds and accounts, especially debt service reserve funds related to bonds and certificates of participation transactions, are held in trust for the benefit of the bondholders and do not constitute the property of the debtor.

AFGI further suggests that States should enact or review the existing parameters on investment policies and practices and municipalities should be required to adhere to these parameters. Moreover, a municipal investment manager should be required to report regularly to the local legislative body on the status of the municipality's investment portfolio, and local legislation should require that these managers should mark to market the securities held by the municipality on a regular and periodic basis.

Mr. Chairman, municipal bond insurers are an integral part of the municipal finance industry. We have insured \$387 billion of bonds. We also invest in bonds ourselves. Of the nine companies, we have approximately \$8 billion invested in municipal bonds.

AFGI feels that the Orange County bankruptcy has raised issues which require serious but measured response on many levels and in many forms.

We look forward to assisting the subcommittee in that pursuit.

Chairman BAKER. Thank you, Mr. Genader. I appreciate your comments.

[The prepared statement of Mr. Robert J. Genader can be found on page 805 in the appendix.]

Chairman BAKER. The next witness is the president of the Investment Company Institute, Mr. Matthew Fink. Welcome, Mr. Fink.

STATEMENT OF MATTHEW P. FINK, PRESIDENT, INVESTMENT COMPANY INSTITUTE

Mr. FINK. Thank you, Mr. Chairman. We are the representatives of the mutual fund industry. Mutual funds provide millions of Americans with the ability to invest in a broad array of municipal bonds and thus to obtain the tax advantages from those bonds. Indeed, in recent years mutual funds have become by far the largest purchasers of municipal securities.

As the other witnesses have said, the participants in the municipal market were taken with great surprise when Orange County filed for bankruptcy because the filing involved one of the largest and wealthiest counties in the Nation which previously had issued high rated debt. The bankruptcy and its overall impact on the municipal market are, of course, still unfolding and events seem to occur on an almost daily basis. Therefore, at this time we can only offer our preliminary views on the impact of the filing and on our suggestions for reform.

First, as to market impact. We believe the bankruptcy has the serious potential of affecting overall investor confidence in the municipal market. As SEC Chairman Levitt pointed out, municipal bonds represent a contract between the issuer and the investor, a contract that is bound by trust and confidence. Investors trust municipal bonds because they are based on an implicit agreement by the issuer that investors will be repaid before anyone else.

An erosion of confidence, even if subtle, will result in higher costs of borrowing by State and local governments. For example, in recent weeks California issuers report that it has been necessary for them to obtain credit enhancements or pay higher yields when issuing securities.

In terms of our recommendations for reform, we believe that it may be premature to offer suggestions at the Federal level because developments are still unfolding. We do believe, however, that this is a most appropriate time to make specific recommendations for reform at the State and local level, because, after all, that's where the core of the problem is, and indeed the States have already begun considering changes.

We have two recommendations in the State area.

First, State and local governments should impose substantive requirements on the operations of their government pools, and in doing so they should look at the precedent of the Investment Company Act, which for 55 years has imposed substantive requirements on pools such as mutual funds.

Indeed, as other witnesses have testified, in effect the Orange County pool and similar pools are in fact unregulated mutual funds. Had the California Orange County investment pool been subject to the types of very basic requirements imposed by the In-

vestment Company Act, it is most unlikely that this unfortunate bankruptcy ever would have occurred in the first place.

Just to give you four kinds of protections in the Investment Company Act that State and local governments should impose on their investment pools, first, the Investment Company Act requires mutual funds to mark all of their assets to market every day. Not once a year. Not semiannually. Not once a month. Not whenever they feel like it, but every day.

Second, the Investment Company Act severely limits the kind of leveraging that mutual funds can engage in. The kind of three to one leveraging that apparently went on in Orange County would be a felony under the Investment Company Act.

Third, the Act requires periodic reporting to investors with audited financial statements.

Fourth, it requires that all fund officers and employees be bonded against larceny and embezzlement.

We are not alone in recommending that the States and local governments look to the Investment Company Act as a model. A number of other witnesses during these hearings have done the same.

That is our first recommendation, that the State and local governments shape up their requirements and look in drafting those requirements at the Investment Company Act.

Second, there is an irony in what some States and local governments have been doing, because as they have been going through their laws a number of them have been trying to put limitations on investment by municipal pools and State pools in mutual funds which, as I said, are regulated under the Investment Company Act.

Instead, I think State and local government should recognize, in light of the Orange County problem, that mutual funds are an ideal investment for municipal investment pools because they are fully regulated by the Investment Company Act and thus offer diversification, professional management and liquidity under a very strict regulatory regime.

In short, our second recommendation is that instead of States discouraging investment in regulated pools like mutual funds, they should encourage it.

Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Fink.

[The prepared statement of Mr. Matthew P. Fink can be found on page 888 in the appendix.]

Chairman BAKER. Our next witness is the president of the Securities Industry Association, Mr. Marc Lackritz. Welcome, Mr. Lackritz.

STATEMENT OF MARC E. LACKRITZ, PRESIDENT, SECURITIES INDUSTRY ASSOCIATION

Mr. LACKRITZ. Thank you, Mr. Chairman and members of the subcommittee. I appreciate the opportunity to bat cleanup here at this hearing. I will limit my testimony to the areas of reform that we would advocate at this time.

The Securities Industry Association is the trade association of the securities industry. We have approximately 750 members that represent around 90 to 95 percent of all securities industry revenue. Our members are engaged in every aspect of the securities

business, ranging from brokerage to investment advice to dealing to underwriting and the whole gamut of securities activities.

With respect to the current state of municipal finance, we would like to make the following three points.

First, efforts to improve public disclosure concerning municipal securities and municipal investment pools should continue.

Second, State responses to losses suffered by municipalities should be mindful of the need for flexibility in managing an investment portfolio to get the best return for taxpayers and should reflect the reality of the institutional markets.

Third, State and municipal investment managers should be better trained and qualified to invest funds in a prudent and professional manner.

With respect to enhanced disclosure, Mr. Chairman, we believe that investors in municipal securities and local government investment pools should receive more comprehensive disclosure of the risks associated with those investments. For example, as Mr. Fink has already articulated, periodic disclosure of information regarding the value and performance history of an investment pool would enable investors and taxpayers to evaluate the performance of the pool's management. In addition, the use of mark to market accounting would also improve disclosure by bringing unrealized losses to light much earlier.

We do not believe that legislation is necessary at this time to accomplish these objectives, and we fully support all private sector efforts to improve transparency in the municipal markets.

Second, with respect to State initiatives in municipal finance, we generally endorse efforts by the States to require municipalities to establish clear but flexible written investment policies and to require State and local investment officers to receive some minimum training in finance.

We are concerned, however, with provisions in State investment guideline bills that would impose stringent restrictions on the use of "derivatives" or attempt to legislate the relationship between municipalities and securities firms in a manner which does not reflect the realities of the institutional marketplace.

We believe that municipalities should not be prohibited from using derivatives or any other investment product. Losses in Orange County and other jurisdictions were not caused by a particular product but by the use of investment strategies whose risks were not fully understood. Such strategies would have caused losses even if they had been implemented solely with cash instruments.

For the most part municipalities have used derivatives to manage risks in ways that have saved taxpayers significant amounts of money. Limiting municipalities' ability to use derivatives for hedging purposes would only impede their ability to manage management risk to the detriment of both taxpayers and investors.

We are also troubled by provisions in some State investment guideline bills that would create a presumption that any securities firm executing a transaction with a municipality is implicitly representing that transaction to be appropriate for that municipality and in accord with its investment guidelines.

Compliance with such a provision would be virtually impossible, because most State or municipal entities manage their own investments and use a number of securities firms to execute portfolio transactions. Because municipal investors typically do not disclose any information regarding their portfolio that is not directly related to a particular transaction, most broker/dealers do not have nearly enough information to make such sweeping appropriateness determinations.

We fear that enactment of such provisions would cause some of the most responsible and careful securities firms to refrain from conducting business with entities covered by such provisions, which ultimately will hurt State and local taxpayers and bondholders who ultimately pay for investment mistakes.

There are a number of initiatives under way to articulate guidelines for market participants operating in the institutional markets that we outline in more detail in our written testimony. We hope these efforts will ultimately strike the appropriate balance between the respective duties of dealers and their customers.

With respect to financial management, Mr. Chairman, we believe all participants in financial markets should be responsible for ensuring that they understand how a particular instrument or investment strategy will affect their overall financial position. Investment officers who commit a municipality to a financial obligation that they do not understand merit neither sympathy nor a remedy when losses result.

Municipalities can retain professional financial advisers to assist investment officers in evaluating transactions and strategies they do not fully understand. Securities firms who have not been engaged as financial advisers and who do not have the type of financial information necessary to evaluate the appropriateness of a transaction should not be held responsible for the investment choices of those municipal customers.

In conclusion, Mr. Chairman, the issues identified by the subcommittee in connection with this hearing are terribly important. Although improvements can be made in State and local government investment practices, we would caution against legislative or regulatory actions that could lead to higher costs, increased risks and harm to taxpayers. We believe, though, that enhanced municipal disclosure, appropriately flexible written investment guidelines, and better training and qualification criteria for investment managers should alleviate many of the concerns expressed in these hearings.

We appreciate the opportunity to present our views on municipal finance practices and we stand ready to work with you and the subcommittee on these important issues, Mr. Chairman. Thank you.

[The prepared statement of Mr. Marc E. Lackritz can be found on page 898 in the appendix.]

Chairman BAKER. Thank you, Mr. Lackritz.

I would like to start the questioning with you, Mr. Fink, concerning one element of the Orange County circumstance that is particularly troubling.

In earlier testimony we have heard how rating agencies, the SEC and others examining the records made available did not find sub-

stance to understand fully Orange County's financial weakness. We certainly can lay some blame for the circumstance at the fund manager's method of risk taking.

But given the fact that the \$600 million issue was to a large extent acquired by mutual funds which serve individual investors, the fact that there were unaudited financials at least a year old that were the substance basis on which you would look at the \$600 million issue in some cases to back up the claims of that issue, how is it that the market absorbed the \$600 million so readily and did not at least extract some premium for the apparent risk that was being assumed?

I am told that the marketing of that \$600 million issue proceeded just as if it was another Orange County issue with no recognition of the underlying elements, especially in light of the public accusations made, albeit in a political environment, as to the inappropriate conduct in the management of that fund. I have always been told about the markets it's buy the rumor and sell the fact.

In light of that, what was going on with the marketplace at the time of the \$600 million issue?

Mr. FINK. I think, Mr. Chairman, our answer is probably pretty much what I gather you heard from the two rating agency issuers yesterday. They looked at the offering circular and other documents, which is their normal practice. Money market funds are required to make their own independent analysis. There are probably fifty involved, so we'd have to inquire of each of them. But I gather generally they made their normal due diligence inquiry.

A lot of them purchased TRANs notes, which are these tax anticipation notes. There they particularly look at the cash flow estimates in the offering circular, and I gather by inference that they thought those were satisfactory. So their own inquiry, they missed it.

Second, they also are required by the SEC to look at the rating agencies' ratings, and as you heard yesterday, the rating agencies, I guess, gave the issues a high rating.

So these things happen. I think it was probably inadequate disclosure. As you heard from the rating agencies yesterday, their duty is to look at the financial statements and not to go under and do an audit of what underlies those statements.

I certainly think improvements can be made, as the SEC is trying to do through its rules, but I think the key is the breakdown at the State and local level. In this case, failure to supervise, from what I've seen in the record.

Chairman BAKER. I read with interest as to the growth in the municipal bond market, that in 1994 it constitutes \$1.2 trillion in outstanding bonds as compared with \$1.3 trillion in corporate bonds, an extraordinary growth in the number of individual investors holding those bonds, from some 44 percent in 1983 to 76 percent of the market in 1993.

My experience is you are looking at a mutual fund. Someone says, here's the spread; we've got X percent in tax free munis triple-A rated by Standard & Poor. Today I have a distinctly different comfort level about that statement than I had 40 hours ago.

People are relying on the mutual fund managers to do the due diligence to ensure that the risk they are taking is fully com-

prehended. Are we just simply asking the wrong questions? We have new investment strategies, new investment tools, and we are using questions built around financial policy of a decade ago.

Everyone tells me, "We ask the questions we've always asked." Maybe they weren't the right questions. Is that possible?

Mr. FINK. It's possible. We would have to go look at each instance to see what they looked at. I read last evening the rating agencies' testimony. They did their normal look, and I think one of them said that if you get fraudulent financial statements it is very hard to go underneath and find that. A lot depends on who prepares those statements and who reviews them. Professional investors hit problems just like you and I do directly.

Chairman BAKER. Thank you.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Let me follow up a little bit. I think in yesterday's testimony with the rating agencies, and certainly they are private companies and their relationship is with the market and their publications in the market, the whole trust is determined by the market, but the rating agencies, when we are talking about the \$600 million 1994-1995 taxable note deal, I think they missed the boat on how that deal was structured.

I've only reviewed parts of the official statement, but they said they were relying on the financial data of the county and not looking at the structure of the deal. You all may correct me or I may further review it, but that looked to me like a structured finance deal. That didn't look like a revenue bond based upon the revenues of the county.

Mr. Fink, do you think that there should be some requirement for additional analysis done? I know in structured finance deals that I've been involved with we run all sorts of cash flow analyses on duration of maturity, loss, loss recovery. Do you think that is something that should be considered here?

Mr. FINK. The SEC has a special rule, 2(a)(7), that tells managers of money market funds, taxable or tax exempt, that they have to do independent credit analysis. I think it would be pretty hard for the law or regulations to dictate the details because these deals differ. We would end up with a set of rules for structure and we would end up with another one for something else. I think it's hard to dictate that. I think people are looking more closely.

I guess the other thing, Mr. Bentsen, that probably happened here—again, I haven't talked to every one of the fifty groups—is not only did they look at the deal. They are used to, as different witnesses said, looking at municipal obligations that are full faith and credit obligations. When a municipality does get in trouble, in the past examples they have always done their level best to pay the notes first.

So I think there were two surprises here. First was the economic surprise of what happened to the Orange County pool, and second was Orange County filing for bankruptcy.

To answer your question precisely, I think it would be pretty hard to dictate to money managers precisely what they should do in each instance because the instances differ.

Mr. BENTSEN. I respect that none of you all are disclosure counsel. Do you think that the Merrill Lynch letters were material items for disclosure? I think there were bonds issued subsequent to those letters being sent to Citron.

Mr. GENADER. Sir, I can't answer the specific question about the Merrill Lynch letters, but I think the industry needs much more disclosure. You are very right. The municipal market is about the same size as the corporate market. Yet there is a fundamental trust in the municipal market based in part upon very low historical default rates, unlike the corporate market where statistics may indicate that a triple-B bond over a 5-year duration will on average file for bankruptcy 36 percent. That type of data has not been accumulated on the municipal side because of trust. This was a county that did not provide enough disclosure in its initial documents.

Also disclosure is a two-sided obligation. There also needs to be disclosure locally to the citizens and the investment pool so that they know exactly what is the value of the local investment portfolio at any given point in time.

Mr. BENTSEN. Mr. Genader, I may be wrong, but I think that none of the Orange County transactions in default were insured. Certainly none of the ones I have looked at. Can you compare for us the difference in the situation in Orange County with the situation in, I think, Broward County, Florida, where there was a bond issue that a subsequent board said was not a legal issuance and now that issue has been raised a little bit with Orange County.

Mr. GENADER. It's a matter of how municipal financings are structured. Both Brevard County in Florida and Orange County in California issued certificates of participation. However, there are basically two different types. One is secured by an abatement bond. That is the type that Orange County had, under which as long as the County has the use of the facility, they are obligated to make lease payments.

In the earthquake in northern California, I believe the city of Oakland had a situation where actually there was damage to a particular building. Rather than allowing a default in the certificates of participation which financed that building, they chose to find another use for that building, which still added value to the city and permitted them to make good on their obligations. Orange County, on the other hand, is reserving the right to recharacterize those leases, thus enabling it to renegotiate their terms.

Mr. BENTSEN. Does that lead to the need that I think Mr. Pope from Hunton and Williams raised at yesterday's hearing for some sort of national standard for general obligation?

Mr. GENADER. I think that is best left to not only the individual States but the 50,000 issuers that are defining the particular structure that they are issuing and selling to the investor, and the investor should be able to discern the difference.

Mr. BENTSEN. I have more questions, Mr. Chairman, if we get a chance to ask them.

Chairman BAKER. Certainly.

Mr. LoBiondo.

Mr. LOBIONDO. No questions.

Chairman BAKER. Thank you.

I would like to come back to the bankruptcy question again. Mr. Craver, in your testimony you seem to indicate that the bankruptcy proceeding was entered into in a responsible manner and that it perhaps provided time for appropriate steps to be taken to manage the problem. Many have suggested that bankruptcy be entered into only as an extraordinary last resort and that perhaps requiring some State official, the Governor, the State treasurer, someone to give approval to a municipality's bankruptcy filing might be an appropriate step; that there should be a demonstration perhaps that all reasonable effort had been made to resolve the crisis; that there was in fact an insolvency that existed, that there wasn't net worth available to resolve the problem, as politically distasteful as it might be; that there might be some intervening steps before the expensive filing takes place. Some have even gone further and said in fact some have entered into bankruptcy to avoid directives to take appropriate corrective action.

Is it your view that the bankruptcy and the Chapter 9 process is something that should not be modified in any way, and do you believe that the Orange County officials acted in the best interest of all parties?

Mr. CRAVER. Mr. Chairman, it is a difficult question for me to answer. I'm not a bankruptcy lawyer. I believe, though, there are a couple of underlying principles that are important.

The first is that as a banker you are typically going to look for some means of working out your problems with a creditor. You are always inclined to want to try to find solutions short of entering into bankruptcy. This is a normal banking response to the types of things that we deal with every day.

In that regard, I think bankers would look to bankruptcy as a last resort or step and actually a generally less than productive one.

In terms of the Orange County situation, I think the speed with which bankruptcy was entered into and the surprise feature somewhat suggests that other remedies were not fully explored. Bankers would prefer that all other remedies be explored before moving to bankruptcy.

However, I don't feel I'm really properly educated in bankruptcy law to answer your question more specifically.

Chairman BAKER. Unfortunately, it doesn't stop members of Congress either.

Mr. McKnew, let me address again the question with regard to the market's response on the issues of Orange County with what now appears to be the evident indicators that were available. If not the traditional analytical models, at least common sense: rates of return above market expectations for an extended period; unaudited financials accompanying the issue; public allegations as to inappropriate investment practices.

Were underwriters looking beyond the obvious and only to the historic data that is required to be provided, or was there something else that led the market to follow the footsteps of virtually everyone else in this matter who appeared to make a misjudgment about what was happening there?

Mr. MCKNEW. Let me say a couple of things. First of all, we are dealing in a retrospective here. As I believe someone has testified

before, the sheer number of municipal obligations that are issued every year necessitates some level of generalization when dealing with this.

I personally do not believe that prior to all of this gaining any nationwide attention that there was a general lack of recognition of the situation in Orange County. I personally remember a number of press accounts of the investment prowess of the Orange County treasurer in managing not only his own funds but the funds of the investment pool. I believe there was at least within the professional community a general understanding of what was going on.

Let me also say that a number of financial institutions, broker/dealers, banks, and so forth, were directly involved in dealing with the county in one way or another. I believe that all of them in doing their own analysis of their own transactions with the county were performing as they should.

I don't think it's possible to answer the question as to whether the market therefore had reacted in any way prior to all of this coming out. I suspect that it did. Bankers asking for more covenants, for perhaps a slightly higher interest rate applied to borrowings. I believe there were things like that going on.

In retrospect, was that adequate? The answer is probably no. I do know that there were a number of institutions, broker/dealers that stopped on their own particular knowledge dealing in one way or another with Orange County. I know that simply from reports in the press.

I think there was some smoke that was out there. Enough to indicate the fire that was really going? Perhaps not.

Chairman BAKER. The \$600 million Orange County issue was unusual because of the size, the amount of leverage and the aggressive investment practices used. There are 50,000 different units that can issue debt. Many are troubled financially and looking for new sources of revenue. Are smaller, less sophisticated, issuers likely to follow the lead of Orange County?

Are you fairly confident or somewhat troubled at this point after Orange County with all the discussion being given it that the market has significantly altered its view or that the fund managers themselves are now more cognizant of the risk? Has the world changed dramatically, or isn't it operating pretty much as it was before the bankruptcy?

Mr. MCKNEW. I think there are at least two questions there.

First of all, I do not believe that there are any circumstances out there that remotely approach the reported aggressive style that Treasurer Citron used in Orange County. We are dealing with a scale here. I am suggesting that from my experience and knowledge there is no one so far out on the scale so as to even remotely compare with the investment strategy used by Treasurer Citron.

If you are asking me are there circumstances where broker/dealers are not fully comporting with regulation in terms of determining the suitability or the appropriateness of securities transactions with institutional investors, all I can say is that I believe it is every couple of weeks in the *Wall Street Journal* I read in very, very small print lots and lots and lots of registered representatives who

are being disciplined one way or the other by the NASD. So I can only assume that that does go on.

Let me say, though, that I don't believe that that in any way represents the general mode of doing business in our industry. The suitability requirements for institutional investors that the NASD has promulgated and is now in the process of being vetted by the SEC that was called for by the GSA will go a long way toward codifying the responsibilities that I think we all have felt in our dealings with our institutional customers in the sense that it will put down on paper as best as can be written those responsibilities that we have to deal with the individual situations arising institutional investor by institutional investor.

Chairman BAKER. Thank you, Mr. McKnew.

Mr. Bentsen.

Mr. BENTSEN. Thank you, Mr. Chairman.

Mr. McKnew—I also would ask Mr. Fink this on the other side of the transaction—do you believe there is adequate disclosure in the municipal market or do you think that we need more disclosure?

Yesterday we had Representative Cox from Orange County testify. He criticized fairly broadly the municipal market disclosure. You are right. There are less bankruptcies in the municipal market. Do you think we need more disclosure? Do you think that there would have been a difference if there had been registration, quarterly reports?

Mr. MCKNEW. To me, frankly disclosure is kind of an unmitigated religious virtue. Speaking for myself, I think there can never be enough disclosure. Having said that, disclosure is expensive. Particularly for smaller issuers, a very high level of formal, independently verified disclosure can be economically just not worth the benefit that is brought to the marketplace.

The SEC in its new regulations for the first time requires broker/dealers who are bringing in a primary issuance to be sure in the form of a contract that the issuer of the security will provide ongoing disclosure primarily of material adverse events such that we, broker/dealers, in carrying out our suitability responsibilities to adequately inform our customers as to the nature of the security that they are buying will know with certainty what is going on with regard to the financial realities of the issuer of that security. That is only now starting to come into effect.

I can tell you that there have been a number of issues that were contemplated to be brought to market where an underwriter has said, "I don't think what you are telling me you are going to disclose in the future is adequate for me to be able to certify my duties under the SEC regulation and therefore I will not underwrite your issue."

That's a very powerful thing for a broker/dealer to say to a municipal treasurer and more times than not will bring the municipal treasurer to the point of contractually obligating himself to provide what we believe is adequate.

Your basic question is, do I think there is enough? I don't think there is ever enough, but I think that this SEC regulation will go a very long way toward improving the situation out there.

Mr. BENTSEN. Mr. Fink.

Mr. FINK. I guess I would echo that, maybe in slightly different words. I think more disclosure is needed, probably always needed. I think it would be premature to go to the extreme and repeal the Tower amendment and have municipalities file and register with the SEC, as I guess has been proposed somewhere in these hearings.

Mr. McKnew said the SEC's new requirements just went into effect quite recently. I think I would wait and see how those requirements plus the impact of Orange County are affecting disclosure, and a year from now I might do some type of survey and see what kind of disclosure is happening.

My guess is the combination of the SEC's requirements and this Orange County problem will produce much better disclosure because the dealers and the buyers, the banks and mutual funds will demand better disclosure.

Mr. BENTSEN. Is there a risk in buying a Treasury security?

Mr. FINK. Yes.

Mr. BENTSEN. Is there a similar risk in buying a Treasury security to buying a strip or buying a structured note or buying an inverse floater?

Mr. FINK. Yes. Maybe different degrees of risk, but they all have interest rate risk. They may not have credit risk, but as some of your witnesses have testified, I think one of the problems the way these municipalities have run their pools they have only looked at credit risk and not interest rate risk.

Second, and I think Mr. Lackritz made the point, and other witnesses did, I think when one looks at a pool, be it a mutual fund or a bank trust fund or a municipal pool, the risk that should be looked at is the risk of the pool as a whole and not individual securities. I think every security has risk even if there is no credit risk.

Mr. BENTSEN. My time is up. I have one quick question and then hopefully I have a few more if we can come back to it.

Let's talk about the other side of the transaction for a little bit. Let's talk about Orange County as a purchaser. Orange County was an institutional investor. They were a big boy in the market. Do they inherit risk as such?

Obviously there was a political meltdown in Orange County, I think. Should we be looking at it from that perspective and saying, sure, there are all sorts of products out there, there are Treasury bonds that you could buy and you could buy the wrong maturity? Is this a case of a big boy investor who got in over his head? Should we be looking at it only from that perspective or should we still be looking at it from the perspective we talked about in terms of looking at Chapter 9, looking at investment guidelines, sales practices guidelines?

Mr. CRAVER. I think it is an excellent question. It's one that I don't think we have focused on enough here so far today. You have to have a balance in all of these markets. I think even in society you have to have a balance. Not everything is going to work because you've got legislation or you've got particular rules in place or you've got an auditor or a cop at every corner.

The market really behaves and operates the way it does because there is good information and because all of the parties bear a responsibility for their part of the transaction. I think certainly the

issuers have a responsibility; the investors have a responsibility; the broker/dealers have a responsibility vis-a-vis determining suitability and appropriateness. Everybody has a piece of that pie.

The market will never work properly without each of those participants taking the proper due diligence on their own to determine whether they are getting properly rewarded for the risks that they are taking.

I think in this particular circumstance, and I believe the chairman made this comment before, there is probably enough blame to pass around. There are a number of people who participated in this thing from a lot of different angles that did not end up perhaps doing all their homework, their due diligence, as they should, including the investments that Mr. Citron was making.

Mr. MCKNEW. If I could, just a little extension of that. I think one of the things that is very important that has come out of all of this after the fact is talk about the roles of each of the parties involved here. I think that to the degree that the roles and responsibilities in this case of the supervisors of Orange County, the treasurer as an institutional investor, any adviser that he might have had, a broker/dealer, and our regulators, if each of those roles can be clarified and publicized, the markets will work better.

To the degree, however, that the roles and responsibilities get merged and confused and made unclear, I think the markets are hurt and inevitably the participants in the markets, all of them are hurt.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. I just have one follow-up, Mr. Lackritz. If this subcommittee were to take any action at all based on the testimony we have heard over the last 2 days, it would have to be centered on some sort of improved disclosure requirement implemented by the States. The disclosure would cover investment activities. The disclosure would be simply understood by the individual investor.

Is that something that makes market sense, regulatory sense, investor sense?

Mr. LACKRITZ. Mr. Chairman, it's a very good question because you have really hit on conceptually the issue that in fact involves risk management. Conceptually you want to have disclosure of the portfolio risk, which may involve its duration, its volatility, and a number of other characteristics of the portfolio. Trying to reach some form of quantitative measurement is hard to do in reality because of all the different risk characteristics of all the different instruments.

There are modeling theorists in each of our firms, and the firms represented down the table, individuals with Ph.D.'s in mathematics that spend an enormous amount of time constructing models of how portfolios behave under different circumstances. It is very hard to reduce all of the complexities to either a number or one concept or one measurement that would in fact be adequate in terms of fully explaining what all those characteristics are. You would almost have to have some disclosure of the models and, in fact, in another context, we have been urging regulators to rely more heavily on the models used by the firms themselves in terms of analyzing capital adequacy and that kind of thing in a different

context, in the context of derivatives. Here I think you have touched on exactly the same issue.

In concept it's a very good idea. In terms of practice and putting it together, you get into the complexity of how to measure this and how to disclose fully.

Chairman BAKER. But we seem to be in a very difficult circle. On the one hand you should not invest unless you understand the portfolio structure, but the answer to that question is too difficult for us to prescribe on a national basis for each of the 50,000 issuers of these instruments, but at the same time one would be well advised not to participate unless you understand the risk you are undertaking. There perhaps should be a different statement at the top. Maybe a Surgeon General's warning on the face of each of these.

Mr. LACKRITZ. Proceed at your own risk.

Chairman BAKER. Perhaps that's the bottom line here, that you should know and trust the people that you rely upon for investment advice. Does that lead you to conclude that the current regulatory, statutory provisions we currently have in effect are sufficient in light of the potential risk in the municipal bond market?

Mr. LACKRITZ. That's why we said that there are a number of developments that are proceeding toward improving disclosure and that in fact some of the efforts that have been undertaken at the State and local level to improve this disclosure should be given some time to work.

Chairman BAKER. Wouldn't it be a disservice if somehow we have improved disclosure that doesn't really lead one to understand the risk and you have the assumption that you are being told all you need to know?

Mr. LACKRITZ. You have raised a good question. The fact is increased disclosure over time is going to improve understanding of risk, and in fact, as more instruments are developed, as portfolio theory develops, and as more models are being developed, more information and disclosure is leading to increased understanding of the risks involved, and I think over time the market will continue adjusting to that.

Chairman BAKER. Thank you. I don't want to delay the hearing unduly. Mr. Bentsen.

Mr. BENTSEN. I just had a couple of questions and then I should be finished.

Mr. Craver, you talked in your testimony about bank eligible bonds and changes that the Ways and Means Committee may be looking at, and this may be a better question for the Ways and Means Committee.

Do you think we are reaping part of the results of the 1986 Tax Reform Act as it relates to restrictions on arbitrage earnings and construction funds and other things for municipal issuers, that now we have these municipal issuers out looking for other ways to make up those funds and cover negative arbitrage that they have on other issues?

Mr. CRAVER. It's difficult to say those are directly connected. I think we certainly can say that the Tax Act of 1986 reduced bank investment in tax exempt securities because the interest expense deduction was eliminated. I mentioned the statistics. Banks held

41 percent of all tax exempt securities in 1980 and they now hold less than 10 percent. That's a direct result of that Tax Act change, in my mind. There are other circumstances, but that's certainly a very large piece.

We have talked a lot here today about the large municipalities and triple-A rated and double-A rated type debt. There are a ton of communities out there that issue unrated debt and the disclosure requirements associated with these issuing communities are less than what the rating agencies will want.

The primary investors in that debt are banks and have been for a long time. The banks really understand the small community situation because in many cases they are taking deposits or providing operating accounts, and so on. So I think banks play a real role not only in the large municipality financing, but more importantly, in the small community financing.

The Tax Act has made that more difficult because it makes the holding of those securities frankly uneconomical vis-a-vis taxable securities. That is the issue that we at ABA and ABASA have been trying to raise the visibility on.

I think particularly trying to deal with that small issuer exemption would be very helpful. Also the proposal that we talked about regarding allowing banks to underwrite revenue bonds. We need to do some things that restore some liquidity to this market, particularly when some of the high profile Wall Street firms have had to back away from the market, or have seen fit to back away from the market.

Mr. BENTSEN. You raise an issue that the chairman and I have discussed before on the ability of banks to underwrite revenue bonds. It is one of the issues we happen to disagree upon, but nonetheless it's an issue that maybe we will address later.

I would argue that I think there is some risk associated with revenue bonds and that is something we should address, but I think it's a little unrelated to this hearing, although we may use it as a later argument.

Mr. Chairman, I would like to ask unanimous consent to be able to include additional material in the record subsequent to the closing of this hearing.

Chairman BAKER. Without objection.

Mr. BENTSEN. Thank you, Mr. Chairman.

Chairman BAKER. Thank you, Mr. Bentsen.

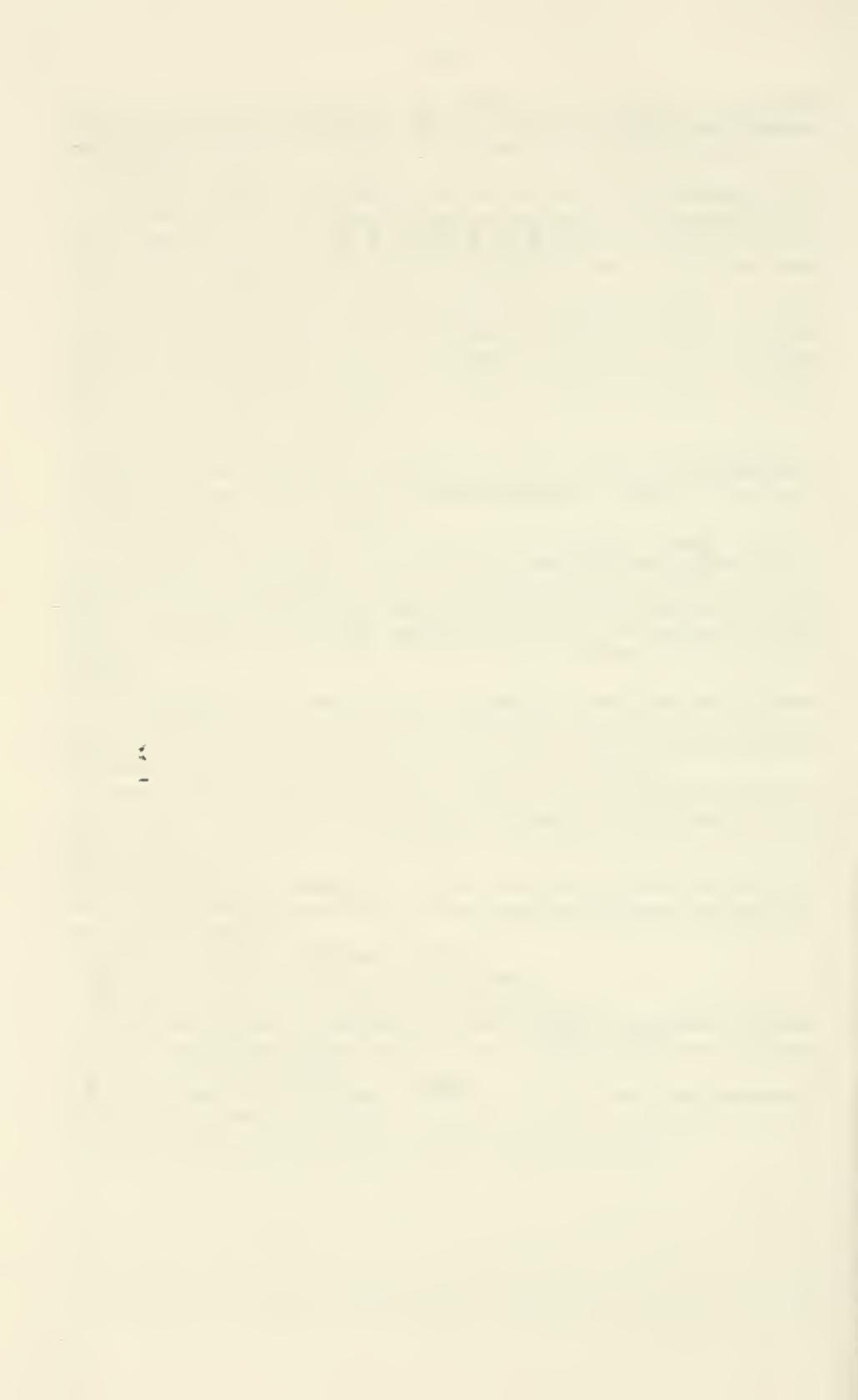
I am advised that members will have written questions, believe it or not, to follow up our lengthy hearing. We will forward those to you as soon as possible.

I thank you, first, for your testimony, second, for your patience. This meeting is adjourned.

[Whereupon at 1:05 p.m. the hearing was adjourned.]

APPENDIX

July 26, 1995



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CHAIRMAN RICHARD H. BAKER
SUBCOMMITTEE ON CAPITAL MARKETS,
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PREPARED STATEMENT
JULY 26TH and 27TH HEARING ON MUNICIPAL FINANCE

The subcommittee begins two days of hearings on the municipal finance markets, a vital component on the country's financial system. Investors from across the country invest in our cities, counties, and states by purchasing the bonds of these governments. These investors range from sophisticated institutional investors to senior citizens investing a portion of their life savings. The revenue realized from these investments are important sources of income for the investor.

Similarly, the money raised by the municipality is critical to the well being of its citizens. The size of the municipal finance market is evidence enough of why this is such an important topic - the Bond Buyer reported that during 1994 local and state governments raised over \$204.4 billion in long- and short-term debt (7/6/95). Paving roads, building schools, and maintaining our ports are just a few examples of capital projects financed by municipalities in the bond market.

Because of the important role that the municipal finance markets play for the investor and the local government, it is vital that we make sure the municipal finance markets run as efficiently as possible. An inefficient markets jeopardizes both the borrower and the lender and also affects the borrower's citizens. An efficient market benefits all parties and best serves our constituents.

Municipalities are not only borrowers, they also enter the capital markets as investors. As any investor knows, there is no sure thing. Investors can and do lose money on their investments, and governments are no different. Because of their unique status, when governments lose money on their investments, the consequences can be far reaching and deep. These consequences affect our constituents, the taxpayers.

During recent months some municipalities have experienced difficulties with their investments. Orange County is the most notable, but clearly it is not the only municipality to incur problems. Large cities, such as New York, Cleveland, and Philadelphia have had severe financial problems. The reason I called these hearings is to examine the municipal finance markets and see if recent events are isolated occurrences or are trends beginning to develop. I believe the witnesses testifying over the next two days will provide the subcommittee a wealth of information so we may better understand the current shape of the municipal finance markets. I want to thank them in advance for their willingness to travel great distances to help us in our efforts.

Before turning to the Ranking Minority Member, Mr. Kanjorski, for his opening statement, I want to comment on how some people perceive these hearings. During the next two days, the subcommittee will focus on the state of the municipal finance markets. These hearings are not "derivatives" hearings. Many people know that I am very interested in derivatives and their use, and that I intend to have the subcommittee further examine derivatives in the future. This is not the time for an in depth examination on derivatives. That being said, I realize any discussion on municipal finance must include some discussion on derivatives.

As I mentioned above, these are not "Orange County" hearings. While Orange County has experienced well publicized investment losses leading the county to declare bankruptcy, they are not the only municipality to have such problems. In addition, the county is involved in complex litigation, and it is impossible to have comprehensive congressional hearings into the matter when the litigants would not be able to properly assist the subcommittee. We are looking at the broader issues of municipal finance. I believe the Orange County incident provides some good lessons and I look forward to the testimony of the witnesses.

SUBMITTED BY HON. RICHARD H. BAKER

M E M O R A N D U M

DATE: July 19, 1995
 TO: Ted Beason, Subcommittee on Capital Markets, Securities
 and GSEs
 FROM: O'Melveny & Myers
 SUBJECT: History of Statutes Authorizing Local Agency
 Investments

This memorandum discusses the development of California law authorizing local agency investments. The primary statutes regulating local agency investments are California Government Code Sections 53600 et seq. In particular, Sections 53601,¹ 53635 and 53651 address the types of securities local agencies may purchase. Section 53601 lists the types of securities that a local agency's legislative body may purchase, while Section 53635 lists what securities a local agency's treasurer may purchase. Sections 53601 and 53635 are virtually identical. Section 53651 defines "Eligible Securities." The category of "Eligible Securities" is broader than the types of securities listed in Sections 53601 and 53635. Section 53652 requires that certain bank deposits be secured by Eligible Securities.

Before 1967 local agencies could only invest in government securities, defined as obligations of the United

¹ All sections referred to in this memorandum are from the California Government Code. The full texts of California Government Code Sections 53601, 53635 and 53651 are attached. Also attached is a chronological chart of the development of Section 53601.

States Treasury, the State of California and local agencies in California. Starting in 1967 the California legislature has adopted a series of amendments which have broadened the investment authority of local agencies.

Government Sponsored Enterprises

In 1967 the legislature authorized local agencies to invest in obligations of certain quasi-governmental organizations such as Federal Land Banks, Federal Home Loan Banks, the Tennessee Valley Authority and the Federal National Mortgage Association.²

Bankers Acceptances

In 1974 the California legislature authorized local agencies with large cash balances³ to invest in bankers' acceptances issued by commercial banks.⁴ The statute required that the bankers' acceptances have less than 90 days maturity and not exceed 15% of the agency's investment portfolio. The 15% limit was raised to 30% in 1977⁵ and to 40% in 1984.⁶

Commercial Paper and Negotiable Certificates of Deposit

² 1967 Cal. Stat. 1316, sec. 2.

³ Cities and special districts having treasury balances greater than \$8 million and counties having treasury balances greater than \$30 million at the end of the prior fiscal year.

⁴ 1974 Cal. Stat. 1354, sec. 1.

⁵ 1977 Cal. Stat. 1138, sec. 1.5.

⁶ 1984 Cal. Stat. 659, sec. 2.

In 1978 the state legislature authorized large local agencies⁷ to invest in commercial paper and certificates of deposit.⁸ The commercial paper must have the highest ranking given by Moody's or Standard and Poor's and its issuer has to have assets greater than \$500 million. Originally the local agency could not have more than 15% of its investment portfolio in commercial paper and 15% of its investment portfolio in certificates of deposit. The 15% limit was raised to 30% in 1982 for certificates of deposit⁹ and raised to 30% in 1983 for commercial paper.¹⁰

Repurchase Agreements

In 1979 the California State Legislature authorized local agencies to invest in repurchase agreements and reverse repurchase agreements.¹¹ The repurchase or reverse repurchase agreement's underlying security must be one of the types of securities that the local agency is authorized to purchase.

Mortgage Repurchase Agreements

In 1984 the state legislature authorized local agencies to invest money in mortgage repurchase agreements.¹² The

⁷ Local agencies with a population greater than 250,000.

⁸ 1978 Cal. Stat. 65, sec. 1.

⁹ 1982 Cal. Stat. 508, sec. 2.

¹⁰ 1983 Cal. Stat. 550, sec. 1.

¹¹ 1979 Cal. Stat. 275, sec. 2(i).

¹² 1984 Cal. Stat. 741, sec. 1(j).

legislation required that the investments in mortgage securities not exceed 25% of the agency's investment portfolio. The legislature deleted this specific authorization in 1987, but simultaneously authorized investments in secured notes, a broader category of securities which probably includes mortgage repurchase agreements.¹³

Corporate Medium-Term Notes

In 1986 the legislature authorized local agencies to invest in medium term corporate notes. Originally the notes had to be rated in the top three note rating categories by two of the three largest nationally recognized rating services and could not exceed 15% of the agency's portfolio.

In 1987 this provision was liberalized to allow the local agencies to invest in notes of depository institutions as well as corporate notes. In addition the legislature liberalized the rating qualification, lowering the standard to an "A" equivalent or better by one nationally recognized rating service. The legislature also increased the limit on the amount that a local agency could invest in medium term notes to 30% of the portfolio.¹⁴

Mutual Funds

In 1986 the legislature authorized local agencies to invest in mutual funds that invest in securities that are

¹³ 1987 Cal. Stat. 446, sec. 1.

¹⁴ 1987 Cal. Stat. 446, sec. 1.

authorized for purchase by local agencies.¹⁵ The mutual fund must attain the highest ranking of two of the nationally recognized rating services or retain an experienced investment advisor registered with the Securities and Exchange Commission. The local agency may not invest more than 15% of its portfolio in mutual funds.

Secured Notes

In 1987 the legislature authorized investments in notes secured by Eligible Securities as defined in Section 53651.¹⁶

Mortgage Backed Securities

In 1992 the legislature authorized local agencies to invest in Collateralized Mortgage Obligations and other pass-through securities. The securities must be rated "A" or higher and have a maximum of 5 years maturity.¹⁷ The agency cannot put more than 20% of its portfolio in pass-through securities.

Term Restriction

In 1988 the legislature added a term restriction to the investments of local agencies.¹⁸ The law requires that the local agencies invest only in instruments with a maturity of 5 years or less. However, a local agency may escape this requirement if the

¹⁵ 1986 Cal. Stat. 853, sec. 2.5.

¹⁶ 1987 Cal. Stat. 446, sec. 1.

¹⁷ 1992 Cal. Stat. 173, sec. 1.

¹⁸ 1988 Cal. Stat. 491, sec. 1.

agency's legislative body grants express approval to the investment.

§53601. Authorized investments; circumstances

The legislative body of a local agency having money in a sinking fund of, or surplus money in, its treasury not required for the immediate necessities of the local agency may invest any portion of the money that it deems wise or expedient in those investments set forth below. However, where this section does not specify a limitation on the term or remaining maturity at the time of the investment, no investment shall be made in any security, other than a security underlying a repurchase or reverse repurchase agreement authorized by this section, that at the time of the investment has a term remaining to maturity in excess of five years, unless the legislative body has granted express authority to make that investment either specifically or as a part of an investment program approved by the legislative body no less than three months prior to the investment:

(a) Bonds issued by the local agency, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency or by a department, board, agency, or authority of the local agency.

(b) United States Treasury notes, bonds, bills, or certificates of indebtedness, or those for which the faith and credit of the United States are pledged for the payment of principal and interest.

(c) Registered state warrants or treasury notes or bonds of this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or authority of the state.

(d) Bonds, notes, warrants, or other evidences of indebtedness of any local agency within this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency, or by a department, board, agency, or authority of the local agency.

(e) Obligations issued by banks for cooperatives, federal land banks, federal intermediate credit banks, federal home loan banks, the Federal Home Loan Bank Board, the Tennessee Valley Authority, or in obligations, participations, or other instruments of, or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association; or in guaranteed portions of Small Business Administration notes; or in obligations, participations, or other instruments of, or issued by, a federal agency or a United States government-sponsored enterprise.

(f) Bills of exchange or time drafts drawn on and accepted by a commercial bank, otherwise known as bankers acceptances. Purchases of bankers acceptances may not exceed 270 days maturity

or 40 percent of the agency's surplus money that may be invested pursuant to this section. However, no more than 30 percent of the agency's surplus funds may be invested in the bankers acceptances of any one commercial bank pursuant to this section.

This subdivision does not preclude a municipal utility district from investing any surplus money in its treasury in any manner authorized by the Municipal Utility District Act, Division 6 (commencing with Section 11501) of the Public Utilities Code.

(g) Commercial paper of "prime" quality of the highest ranking or of the highest letter and numerical rating as provided for by Moody's Investors Service, Inc., or Standard and Poor's Corporation. Eligible paper is further limited to issuing corporations that are organized and operating within the United States and having total assets in excess of five hundred million dollars (\$500,000,000) and having an "A" or higher rating for the issuer's debt, other than commercial paper, if any, as provided for by Moody's Investors Service, Inc., or Standard and Poor's Corporation. Purchases of eligible commercial paper may not exceed 180 days maturity nor represent more than 10 percent of the outstanding paper of an issuing corporation. Purchases of commercial paper may not exceed 15 percent of the agency's surplus money that may be invested pursuant to this section. An additional 15 percent, or a total of 30 percent of the agency's surplus money may be invested pursuant to this subdivision. The additional 15 percent may be so invested only if the dollar-weighted average maturity of the entire amount does not exceed 31 days. "Dollar-weighted average maturity" means the sum of the amount of each outstanding commercial paper investment multiplied by the number of days to maturity, divided by the total amount of outstanding commercial paper.

(h) Negotiable certificates of deposits issued by a nationally or state-chartered bank or a state or federal association (as defined by Section 5102 of the Financial Code) or by a state-licensed branch of a foreign bank. Purchases of negotiable certificates of deposit may not exceed 30 percent of the agency's surplus money which may not be invested pursuant to this section. For purposes of this section, negotiable certificates of deposits do not come within Article 2 (commencing with Section 53630), except that the amount so invested shall be subject to the limitations of Section 53636.

(i) Investments in repurchase agreements or reverse repurchase agreements of any securities authorized by this section, as long as the proceeds of the reverse repurchase agreement are invested solely to supplement the income normally received from these securities. Investment in a reverse repurchase agreement shall be made only upon prior approval of the legislative body of the local agency. For purposes of this section, the term "repurchase agreement" means a purchase of securities by the local agency pursuant to an agreement by which

the seller will repurchase the securities on or before a specified date and for a specified amount and will deliver the underlying securities to the local agency by book entry, physical delivery, or by third-party custodial agreement. The transfer of underlying securities to the counterparty bank's customer book-entry account may be used for book-entry delivery. The term "counterparty" for the purposes of this subdivision, means the other party to the transaction. A counterparty bank's trust department or safekeeping department may be used for physical delivery of the underlying security. The term of repurchase agreements shall be for one year or less. The term "securities," for purpose of repurchase under this subdivision, means securities of the same issuer, description, issue date, and maturity.

The term "reverse repurchase agreement" means a sale of securities by the local agency pursuant to an agreement by which the local agency will repurchase those securities on or before a specified date and for a specified amount.

(j) Medium-term notes of a maximum of five years maturity issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States. Notes eligible for investment under this subdivision shall be rated in a rating category of "A" or its equivalent or better by a nationally recognized rating service. Purchases of medium-term notes may not exceed 30 percent of the agency's surplus money which may be invested pursuant to this section.

(k) Shares of beneficial interest issued by diversified management companies, as defined in Section 23701m of the Revenue and Taxation Code, investing in the securities and obligations as authorized by subdivisions (a) to (l), inclusive, of this section and which comply with the investment restrictions of this article and Article 2 (commencing with Section 53630). To be eligible for investment pursuant to this subdivision, these companies shall either:

(1) Attain the highest ranking or the highest letter and numerical rating provided by not less than two of the three largest nationally recognized rating services.

(2) Retain an investment adviser registered with the Securities and Exchange Commission with not less than five years' experience investing in the securities and obligations as authorized by subdivision (a) to (m), inclusive, and with assets under management in excess of five hundred million dollars (\$500,000,000).

The purchase price of shares of beneficial interest purchased pursuant to this subdivision shall not include any commission that these companies may charge and shall not exceed

15 percent of the agency's surplus money that may be invested pursuant to this section.

(l) Notwithstanding anything to the contrary contained in this section, Section 53635, or any other provision of law, moneys held by a trustee or fiscal agency and pledged to the payment or security of bonds or other indebtedness, or obligations under a lease, installment sale, or other agreement of a local agency, or certificates of participation in those bonds, indebtedness, or lease installment sale, or other agreements, may be invested in accordance with the statutory provisions governing the issuance of those bonds, indebtedness, or lease installment sale, or other agreement, or to the extent not inconsistent therewith or if there are no specific statutory provisions, in accordance with the ordinance, resolution, indenture, or agreement of the local agency providing for the issuance.

(m) Notes, bonds, or other obligations that are at all times secured by a valid first priority security interest in securities of the types listed by Section 53651 as eligible securities for the purpose of securing local agency deposits having a market value at least equal to that required by Section 53652 for the purpose of securing local agency deposits. The securities serving as collateral shall 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 obligation, and the security interest shall be perfected in accordance with the requirements of the Uniform Commercial Code or federal regulations applicable to the types of securities in which the security interest is granted.

(n) Any mortgage pass-through security, collateralized mortgage obligation, mortgage-backed or other pay-through bond, equipment lease-backed certificate, consumer receivable pass-through certificate, or consumer receivable-backed bond of a maximum of five years maturity. Securities eligible for investment under this subdivision shall be issued by an issuer having an "A" or higher rating for the issuer's debt as provided by a nationally recognized rating service and rated in a rating category of "AA" or its equivalent or better by a nationally recognized rating service. Purchase of securities authorized by this subdivision may not exceed 20 percent of the agency's surplus money that may be invested pursuant to this section.

§53635. Funds of local agency; deposit or investment

As far as possible, all money belonging to, or in the custody of, a local agency, including money paid to the treasurer or other official to pay the principal, interest, or penalties of bonds, shall be deposited for safekeeping in state or national banks, savings associations or federal associations, credit unions, or federally insured industrial loan companies in this

state selected by the treasurer or other official having the legal custody of the money; or, unless otherwise directed by the legislative body pursuant to Section 53601, may be invested in the following:

(a) Bonds issued by the local agency, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency or by a department, board, agency, or authority of the local agency.

(b) United States Treasury notes, bonds, bills, or certificates of indebtedness, or those for which the faith and credit of the United States are pledged for the payment of principal and interest.

(c) Registered state warrants or treasury notes or bonds of this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the state or by a department, board, agency, or authority of the state.

(d) Bonds, notes, warrants, or other evidences of indebtedness of any local agency within this state, including bonds payable solely out of the revenues from a revenue-producing property owned, controlled, or operated by the local agency, or by a department, board, agency, or authority of the local agency.

(e) Obligations issued by banks for cooperatives, federal land banks, federal intermediate credit banks, federal home loan banks, the Federal Home Loan Bank, the Tennessee Valley Authority, or in obligations, participations, or other instruments of, or issued by, or fully guaranteed as to principal and interest by, the Federal National Mortgage Association; or in guaranteed portions of Small Business Administration notes; or in obligations, participations, or other instruments of, or issued by, federal agency or a United States government-sponsored enterprise.

(f) Bills of exchange or time drafts drawn on and accepted by a commercial bank, otherwise known as bankers acceptances, which are eligible for purchase by the Federal Reserve System. Purchases of bankers acceptances may not exceed 270 days maturity or 40 percent of the agency's surplus funds which may be invested pursuant to this section. However, no more than 30 percent of the agency's surplus funds may be invested in the bankers acceptances of any one commercial bank pursuant to this section.

This subdivision does not preclude a municipal utility district from investing any surplus money in its treasury in any manner authorized by the Municipal Utility District Act, Division 6 (commencing with Section 11501) of the Public Utilities Code.

(g) Commercial paper of "prime" quality of the highest ranking or of the highest letter and numerical rating as provided for by Moody's Investors Service, Inc., or Standard and Poor's Corporation. Eligible paper is further limited to issuing corporations that are organized and operating within the United States and having total assets in excess of five hundred million dollars (\$500,000,000) and having an "A" or higher rating for the issuer's debt, other than commercial paper, if any, as provided for by Moody's Investors Service, Inc., or Standard and Poor's Corporation. Purchases of eligible commercial paper may not exceed 180 days maturity nor represent more than 10 percent of the outstanding paper of an issuing corporation. Purchases of commercial paper may not exceed 15 percent of the agency's surplus money which may be invested pursuant to this section. An additional 15 percent, or a total of 30 percent of the agency's money or money in its custody, may be invested pursuant to this subdivision. The additional 15 percent may be so invested only if the dollar-weighted average maturity of the entire amount does not exceed 31 days. "Dollar-weighted average maturity" means the sum of the amount of each outstanding commercial paper investment multiplied by the number of days to maturity, divided by the total amount of outstanding commercial paper.

(h) Negotiable certificates of deposit issued by a nationally or state-chartered bank or a savings association or federal association or a state or federal credit union or by a state-licensed branch of a foreign bank. Purchases of negotiable certificates of deposit may not exceed 30 percent of the agency's surplus money which may be invested pursuant to this section. For purposes of this section, negotiable certificates of deposit do not come within Article 2 (commencing with Section 53630) of Chapter 4 of Part 1 of Division 2 of Title 5, except that the amount so invested shall be subject to the limitations of Section 53638. For purposes of this section, the legislative body of a local agency and the treasurer or other official of the local agency having legal custody of the money are prohibited from depositing or investing local agency funds, or funds in the custody of the local agency, in negotiable certificates of deposit issued by a state or federal credit union if a member of the legislative body of the local agency, or an employee of the administrative officer, manager's office, budget office, auditor-controller's office, or treasurer's office of the local agency also serves on the board of directors, or any committee appointed by the board of directors, or the credit committee or supervisory committee of the state or federal credit union issuing the negotiable certificates of deposit.

(i) Investments in repurchase agreements or reverse repurchase agreements of any securities authorized by this section, so long as the proceeds of the reverse repurchase agreement are invested solely to supplement the income normally received from these securities. Investment in a reverse repurchase agreement shall be made only upon prior approval of

the legislative body of the local agency. For purposes of this section, the term "repurchase agreement" means a purchase of securities by the local agency pursuant to an agreement by which the seller will repurchase the securities on or before a specified date and for a specified amount and will deliver the underlying securities to the local agency by book entry, physical delivery, or by third-party custodial agreement. The transfer of underlying securities to the counterparty bank's customer book entry account may be used for book entry delivery. The term "counterparty" for the purposes of this subdivision, means the other party to the transaction. A counterparty bank's trust department or safekeeping department may be used for physical delivery of the underlying security. The term of repurchase agreements shall be for one year or less. The term "securities," for purpose of repurchase under this subdivision, shall mean securities of the same issuer, description, issue date, and maturity.

The term "reverse repurchase agreement" means a sale of securities by the local agency pursuant to an agreement by which the local agency will repurchase such securities on or before a specified date and for a specified amount.

(j) Medium-term notes of a maximum of five years' maturity issued by corporations organized and operating within the United States or by depository institutions licensed by the United States or any state and operating within the United States. Notes eligible for investment under this subdivision shall be rated in a rating category of "A" or its equivalent or better by a nationally recognized rating service. Purchases of medium-term notes may not exceed 30 percent of the agency's surplus money which may be invested pursuant to this section.

(k) Shares of beneficial interest issued by diversified management companies, as defined in Section 23701m of the Revenue and Taxation Code, investing in the securities and obligations as authorized by subdivisions (a) to (k), inclusive, of this section and which comply with the investment restrictions of this article and Article 1 (commencing with Section 53600). To be eligible for investment pursuant to this subdivision, these companies shall either: (1) attain the highest ranking or the highest letter and numerical rating provided by not less than two of the three largest nationally recognized rating services, or (2) have an investment adviser registered with the Securities and Exchange Commission with not less than five years' experience investing in the securities and obligations as authorized by subdivisions (a) to (m), inclusive, of this section and with assets, under management in excess of five hundred million dollars (\$500,000,000). The purchase price of shares of beneficial interest purchased pursuant to this subdivision shall not include any commission that these companies may charge and shall not exceed 15 percent of the agency's surplus money which may be invested pursuant to this section.

(l) Notes, bonds, or other obligations which are at all times secured by a valid first priority security interest in securities of the types listed by Section 53651 as eligible securities for the purpose of securing local agency deposits having a market value at least equal to that required by Section 53652 for the purpose of securing local agency deposits. The securities serving as collateral shall 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 obligation, and the security interest shall be perfected in accordance with the requirements of the Uniform Commercial Code or federal regulations applicable to the types of securities in which the security interest is granted.

(m) Any mortgage pass-through security, collateralized mortgage obligation, mortgage-backed or other pay-through bond, equipment lease-backed certificate, consumer receivable pass-through certificate, or consumer receivable-backed bond of a maximum of five years maturity. Securities eligible for investment under this subdivision shall be issued by an issuer having an "A" or higher rating for the issuer's debt as provided by a nationally recognized rating service and rated in a rating category of "AA" or its equivalent or better by a nationally recognized rating service. Purchase of securities authorized by this subdivision may not exceed 20 percent of the agency's surplus money that may be invested pursuant to this section.

§53651. Eligible securities

Eligible securities are any of the following:

(a) United States Treasury notes, bonds, bills or certificates of indebtedness, or obligations for which the faith and credit of the United States are pledged for the payment of principal and interest, including the guaranteed portions of small business administration loans, so long as the loans are obligations for which the faith and credit of the United States are pledged for the payment of principal and interest.

(b) Notes or bonds or any obligations of a local public agency (as defined in the United States Housing Act of 1949)¹ or any obligations of a public housing agency (as defined in the United States Housing Act of 1937)² for which the faith and credit of the United States are pledged for the payment of principal and interest.

(c) Bonds of this state or of any local agency or district of the State of California having the power, without limit as to

¹42 U.S.C.A. § 1460

²42 U.S.C.A. § 1437a

rate or amount, to levy taxes or assessments to pay the principal and interest of the bonds upon all property within its boundaries subject to taxation or assessment by the local agency or district, and in addition, limited obligation bonds pursuant to Article 4 (commencing with Section 50665) of Chapter 3 of Division 1, senior obligation bonds pursuant to Article 5 (commencing with Section 53387) of Chapter 2.7, and revenue bonds and other obligations payable solely out of the revenues from a revenue-producing property owned, controlled or operated by the state, local agency or district or by a department, board, agency or authority thereof.

(d) Bonds of any public housing agency (as defined in the United States Housing Act of 1937, as amended)³ as are secured by a pledge of annual contributions under an annual contribution contract between the public housing agency and the Public Housing Administration if such contract shall contain the covenant by the Public Housing Administration which is authorized by subsection (b) of Section 22 of the United States Housing Act of 1937, as amended, and if the maximum sum and the maximum period specified in the contract pursuant to that subsection 22(b) shall not be less than the annual amount and the period for payment which are requisite to provide for the payment when due of all installments of principal and interest on the obligations.

(e) Registered warrants of this state.

(f) Bonds, consolidated bonds, collateral trust debentures, consolidated debentures, or other obligations issued by the United States Postal Service, federal land banks⁴ or federal intermediate credit banks⁵ established under the Federal Farm Loan Act, as amended,⁶ debentures and consolidated debentures issued by the Central Bank for Cooperatives⁷ and banks for cooperatives established under the Farm Credit Act of 1933,⁸ as amended, consolidated obligations of the federal home loan banks established under the Federal Home Loan Bank Act,⁹ bonds, debentures and other obligations of the Federal National Mortgage

³42 U.S.C.A. § 1437c

⁴12 U.S.C.A. § 2011 et seq.

⁵12 U.S.C.A. § 2071 et seq.

⁶12 U.S.C.A. § 2001 et seq.

⁷12 U.S.C.A. § 2121 et seq.

⁸12 U.S.C.A. § 2121 et seq.

⁹12 U.S.C.A. § 1421 et seq.

Association¹⁰ or of the Government National Mortgage Association¹¹ established under the National Housing Act, as amended,¹² bonds of any federal home loan bank established under that act, bonds, debentures and other obligations of the Federal Home Loan Mortgage Corporation established under the Emergency Home Finance Act of 1970,¹³ and obligations of the Tennessee Valley Authority.¹⁴

(g) Notes, tax anticipation warrants or other evidence of indebtedness issued pursuant to Article 7 (commencing with Section 53820), Article 7.5 (commencing with Section 53840) or Article 7.6 (commencing with Section 53850) of this Chapter 4.

(h) State of California notes.

(i) Bonds, notes, certificates of indebtedness, warrants or other obligations issued by: (1) any state of the United States (except this state), or the Commonwealth of Puerto Rico, or any local agency thereof having the power to levy taxes, without limit as to rate or amount, to pay the principal and interest of such obligations, or (2) any state of the United States (except this state), or the Commonwealth of Puerto Rico, or a department, board, agency or authority thereof except bonds which provide for or are issued pursuant to a law which may contemplate a subsequent legislative appropriation as an assurance of the continued operation and solvency of the department, board, agency or authority but which does not constitute a valid and binding obligation for which the full faith and credit of such state or the Commonwealth of Puerto Rico are pledged, which are payable solely out of the revenues from a revenue-producing source owned, controlled or operated thereby; provided the obligations issued by an entity described in (1), above, are rated in one of the three highest grades, and such obligations issued by an entity described in (2), above, are rated in one of the two highest grades by a nationally recognized investment service organization that has been engaged regularly in rating state and municipal issues for a period of not less than five years.

(j) Obligations issued, assumed or guaranteed by the International Bank for Reconstruction and Development, Inter-American Development Bank, the Government Development Bank of

¹⁰12 U.S.C.A. § 1716 et seq.

¹¹12 U.S.C.A. § 1716 et seq.

¹²12 U.S.C.A. § 1701 et seq.

¹³12 U.S.C.A. § 1451 et seq.

¹⁴16 U.S.C.A. § 831 et seq.

Puerto Rico, the Asian Development Bank, the International Finance Corporation, or the African Development Bank.

(k) Participation certificates of the Export-Import Bank of the United States.

(l) Bonds and notes of the California Housing Finance Agency issued pursuant to Chapter 7 (commencing with Section 51350) of Part 3 of Division 31 of the Health and Safety Code.

(m) Promissory notes secured by first mortgages and first trust deeds which comply with Section 53651.2.

(n) Any bonds, notes, warrants, or other evidences of indebtedness of a nonprofit corporation issued to finance the construction of a school building or school buildings pursuant to a lease or agreement with a school district entered into in compliance with the provisions of Section 39315 or 81345 of the Education Code, and also any bonds, notes, warrants or other evidences of indebtedness issued to refinance those bonds, notes, warrants, or other evidences of indebtedness as specified in Section 39317 of the Education Code.

(o) Any municipal securities, as defined in Section 3(a)(29) of the Securities Exchange Act of June 6, 1934, (15 U.S.C. Sec. 78, as amended), which are issued by this state or any local agency thereof.

(p) With the consent of the treasurer, letters of credit issued by the Federal Home Loan Bank of San Francisco which comply with Section 53651.6.

California Government Code Section 53601

Year	A. Bonds issued by the local agency	B. U.S. Treasury obligations	C. State of California obligations	D. Obligations of other local agencies within	E. Obligations of federal land banks, Farmac	F. Banker's Acceptances	G. Commercial Paper	H. Bank Certificates of Deposit	I. Repurchase Agreements and Reverse Rep	J. Mortgage Repurchase Agreements	K. Corporate Medium-term notes	L. Mutual funds investing in above	M. Statutory exception for certain bond prov	N. Notes secured by "Eligible Securities"	N. Mortgage Backed Securities
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Proposition 13 adopted

Bond Investors Association

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July 17, 1995

Ms. Terri Miller
House Committee on Banking
2129 Rayburn House Office Building
Washington D.C. 20515-6050

Dear Ms. Miller

Regarding our conversation on Friday about Orange County and our study of municipal default rates, I have the following comments:

- On February 6, the Bond Investors Association sponsored a bondholders meeting in Anaheim at which various experts on municipal defaults and bankruptcy spoke (see enclosed agenda). SEC Commissioner Richard Roberts also addressed the group and outlined what role his organization may play. At that meeting, a bondholders committee was formed and I believe its Chairman, Arthur Hoffer, would be an excellent candidate for your committee to call as a witness of what bondholders currently feel and are expecting.

- We held this meeting in February because we saw the situation in Orange County showed signs that it would turn into another disaster such as the \$1.25 billion Washington Public Power Supply System debacle of the 1980's. Both Mr. Hoffer and I were active in that default. We ran the WPPSS bondholders committee for eight years with the co-operation of Chemical Bank, the trustee. We learned many lessons from the WPPSS default and are determined to see that the same mistakes are not repeated.

- Regarding your inquiry about our study of municipal default rates, this report was prepared from our database of municipal defaults which we have maintained over the last 12 years. The report is a product we sell and therefore not something I want to put free of charge into the public record. I can cite for you a number of the key statistics which would be of interest to your current inquiry:

- During the decade of the 1980's investment grade rated municipal bonds experienced a default rate of 2.7% of the bonds issued or 1.7% of the dollar amount issued. In number terms, this is 464 issues totalling \$10.1 billion. Note that insured bonds were excluded from this analysis.

- Unrated bonds experienced a default rate of 4.1% of the issues or 2.7% of the dollar amount issued. In number terms, this is 815 issues totalling \$5.7 billion.

- The relative strength of a rating gave no clue as to its likelihood of default. In fact, the better quality bonds had a higher default rate than the lower qualities. This surprising result is explained by the fact that most of the weak, lower quality bonds are insured and therefore disappear from this analysis. The true default rate on such issues is not known since insurers don't report when they intervene in a default situation.

Enclosed are editorials I have written on Orange County and its likely long term consequences. The major lasting effect I anticipate from Orange County's actions is a change in attitude by investors as to the strength of a general obligation pledge. Orange County has demonstrated that the ability of a county to meet its debt (and it is this ability which rating agencies evaluate as 'AA') is meaningless if there is not a recognition by the local electorate to honor their debts in a crunch. The importance of this perception has meant an average interest rate saving of between 15 and 25 basis points between "AAA" and "AA" rated municipals and "AAA" insured issues. An adverse result for bondholders from Orange County could cause "AAA" insured issues to become a preferred alternative. In this case, the gap between the yields will close, undoubtedly through uninsured issues having to pay a higher interest rate.

The ultimate danger here is that this in turn will put unprecedented power into the hands of the bond insurers since they will dominate market access. Since the bond insurance industry is an oligopoly, it is likely that municipalities will find obtaining bond insurance a constraint on their ability to control their future finances. This is because bond insurers will demand special language in the guarantee contract. Protective language that mandate tax increases or budget cuts.

I would be glad to elaborate on any of the above comments if they are of interest to your committee. Enclosed are various things I have published on related subjects including a chapter on risk in municipal bonds published in 1994 in "The Handbook of Municipal Bonds" published by Probus.

Very truly yours,



Richard Lehmann
President

CHAPTER 33**Municipal Bond Defaults**

*C. Richard Lehmann
President
Bond Investors Association*

A SHORT HISTORY OF DEFAULTS

Municipal defaults have a default history as long as that of bonds themselves. Government financing in the 1800s, combined with the rapid growth of the Republic, led to numerous misadventures as well as outright corruption. A wave of defaults occurred in the 1870s and again in the 1890s, paralleling downturns in the general economy at the time.

The Great Depression proved to be disastrous for all types of investment activity, so it is no surprise that municipal bond defaults were extensive as well. The only effort to quantify the default history of this era was a study done by George Hempel¹ which, for lack of any others, became the authoritative source for developing a worst-case scenario for the municipal market. It also became the foundation for developing statutory reserving requirements for bond insurance companies.

Unfortunately, the data used in the Hempel study was lost. It is known, however, that no records of defaults in dollar terms were being kept by anyone in those days. Hence the Hempel data depended on a count of issues versus an estimate of the number of issues actually outstanding.

This limitation in data is unfortunate because it has undoubtedly given an exaggerated impression of default expectation in a worst-case situation. We say this because the more recent record keeping of default histories clearly illustrates that small issues have a much higher default rate than large ones. Hence, a study such as Hempel's would have a built-in bias toward overstatement of default risk when one uses the data to derive dollar-based reserving requirements or default risk premiums.

¹ Hempel's data is put in context by Robert Godfrey in his book *Risk Based Capital Charges for Municipal Bonds* (JAI Press, 1990).

Default concern today must be put in a different context from decades past because the nature of the risk has changed significantly. A general and prolonged depression is unlikely to recur if one believes we have learned something from the Great Depression and now know how to moderate and shorten such economic calamities. The default risk in municipals today is due more to a shift in the type of bonds and their backing than to drastic changes in economic conditions.

Revenue bonds, which put a narrowly defined revenue stream behind a bond issue, have become the majority of the market. In addition, many such issues are backed by private enterprises rather than government. Hence, the default risk in municipals today must be examined by market segment in order to get a meaningful idea of the risk. The history of municipal defaults over the last ten years, broken down by bond purpose, demonstrates just how significant sector analysis is.

Table 1 shows the issuance and default volumes for the years 1983 through 1992. (Note: The defaults and issuance numbers do not totally correlate. All percentages are understated, since year-to-year issuance volumes increased dramatically during this time period. The intention here is only to illustrate comparative risk.)

Table 1. Ten-Year History of Municipal Defaults by Bond Purpose (1983-1992)

	<i>Issuance¹</i> <i>(\$ Billions)</i>	<i>Defaults²</i> <i>(\$ Millions)</i>	<i>%</i>
General Obligation	558.2	1,103 ³	0.2
Revenue by Type:			
Housing	167.6	4,572	2.7
Health care	156.9	2,745	1.7
Electric power	118.6	3,536 ⁴	3.0
Utilities	112.0	29	0.3
Transportation	107.6	689	0.6
Education	101.0	112	0.1
Environmental	71.6	1,543	2.2
Industrial development	54.0	1,631	3.0
Public facilities	16.1	164	1.0
Taxable Issues	26.6	1,850 ⁵	7.0
Other—not identified	61.3		
	1,551.5	17,974	1.2

1 Per the *Bond Buyer Yearbook*

2 Per the Bond Investors Association database

3 Includes Special Assessment Districts

4 Includes WPPSS Projects 4 & 5

5 Includes the Executive Life GIC-backed issues

A failure by individuals to perceive the diversity in the municipal market allows the sale of many issues that could never be marketed under their sponsor's name. This use of a municipality's name to provide a patina of respectability beyond its merits is one of the greatest abuses still occurring in the municipal market and a major source of the defaults that occur.

Looking at default rates year by year as a function of all the bonds issued that year provides the best measure of default risk. Table 2 demonstrates such rates on an aggregate basis since 1979. Default rates for the years after 1986 are not as high because the bonds for those years have not had enough time to reflect all defaults.

Table 2. Municipal Bond Defaults by Year of Issuance

	<i>Issuance</i> ¹ (\$ Billions)	<i>Defaulted</i> ² (\$ Millions)	%
1979	42.3	1,052	2.49
1980	47.1	1,126	2.39
1981	46.1	901	1.95
1982	77.2	1,320	1.71
1983	83.3	1,834	2.20
1984	108.9	1,371	1.26
1985	204.2	3,062	1.50
1986	151.3	2,711	1.79
1987	105.4	642	0.61
1988	117.8	773	0.66
1989	125.0	795	0.64
1990	127.9	588	0.46

1 Per the *Bond Buyer Yearbook*

2 Per the Bond Investors Association database

DEFAULT PATTERNS

Deregulation of the airline industry led to extensive debt default and industry restructuring. As happens in these corporate bond issues, many municipal defaults can also be tied to the economic or political events that triggered them. The defaults that result from mismanagement, miscalculation, ineptitude, or just bad luck are random events. Such defaults are hard to avoid, and one must therefore focus on early detection as the primary remedy to minimizing loss.

Fortunately, predicting most defaults involves identifying a common causal event that will trigger them. Numerous land development issues defaulted in Nebraska when the agricultural boom ended there in the mid-1980s. The same thing occurred in the late 1980s in Colorado when the oil boom ended. We now see such a wave in California, where a contraction of the defense industry has deflated the real estate

boom. How bad will it get? No one knows; however, it is not an area one would shop for bonds.

Similar patterns can be seen developing in areas such as health care. Health care issues have been squeezed because many facilities were built to accommodate a local need during a time when "cost containment" was not in anyone's vocabulary. Federal government attempts to rein in health care costs have pressed many facilities into mergers and other drastic measures in an often-hopeless effort to survive. Present plans for a national health plan may result in more casualties.

A final example of common cause default events can be seen in the current budgetary squeeze being felt at all levels of government. The sharing of the burden has not, however, been uniform. As the federal deficit widened, the federal government cut revenue sharing with state and local governments. As the states were squeezed, they cut revenue sharing with local government. As the local governments are squeezed, they are asking, who do I cut? For now, the expectation is you cut the firemen, policemen, and any other local services. But for how long? At some point, local politicians may decide it is in their personal interest to appease their electorate at the expense of bondholders. So far, this has been only a threat, which frankly comes as a surprise given that default and bankruptcy has achieved enhanced respectability over the last decade.

Sometimes defaults are due to changes in economic and social patterns that no one predicted. A fall in the real estate market, an economic recession, industries that go bust, power plants that don't produce, severe weather or other conditions in nature, all contribute indirectly to municipal bond defaults. Even the termination of the Cold War has been blamed for some special assessment district defaults when defense plants and military bases were closed and housing developments for those workers went begging. Good intentions gone bad—such as alternative energy projects, drug rehabilitation facilities, nursing homes and hospitals—are not exempt from failure. Sometimes an idea that looks good on paper just doesn't work in practice. Other times an area becomes so economically depressed that stores, restaurants, hotels and offices that were bond-financed close or suffer from such low occupancy that the facilities are unable to generate enough revenue to pay the bond debt. Defaults such as these happen in all areas of the country from New York City to Wichita, Kansas, to Los Angeles, California.

While occasionally an issue will default for reasons outside human control, defaults can most often be traced to errors in judgment. These can occur while the bond deal is being put together or after the bonds are sold. Such "misjudgments" can manifest themselves as flawed feasibility studies, sloppy record keeping, inadequate research, cost overruns, gross oversights, omissions, and sometimes just plain bad luck.

Adding to the default problem is the fact that many projects financed with municipal bonds have no ownership cash investment, i.e., all the development capital is contributed by bondholders. When things go bad, the people in charge often have no shares or money of their own on the line. In such a circumstance, perseverance and imagination is often lacking.

One the biggest areas of default currently is multifamily-housing revenue bonds, which are issued to finance apartment buildings. Many such projects defaulted despite near full occupancy simply because rental fees remained lower than projected. This is

an example of human miscalculation combined with economic events over which those involved in the bond deal had no control.

BOND RATINGS AS A DEFAULT INDICATOR

The lack of reliable public information on many municipal issuers has made the Moody's and Standard & Poor's ratings a principal measure of bond safety. In order to calculate their ratings, these agencies are given access to information not generally available to the public and they receive periodic updates. In fact, a rating will be suspended if a municipality fails to provide them with timely updates. While these facts would tend to provide comfort and a sense of reliability to investors, things are not all so satisfactory.

A problem with rating reliability stems from the fact that the fee for rating a municipality is paid by the municipality and not by the underwriter or bond buyer. Furthermore, once an issue is sold (and provided the issuer has no plans for further debt issues) continuing to pay the rating agencies to maintain a rating is, in a sense, gratuitous.

Rating agencies, when facing a marginal credit situation, are in the unenviable position of having to tell "government" that it does not measure up. The reaction by "government" is often political. A recent example was when a credit agency downgraded the city of Detroit and the politicians invoked racism as the cause rather than their dismal financial prospects. In contrast, during the Presidential campaign in 1988, the governor of Massachusetts, Michael Dukakis, was running on his record for good financial administration. The fact was, however, that the state's economy was unraveling at that very time. The rating agencies held off downgrading the state's rating until after the election, leading to the not illogical conclusion that politics influenced the credit process (a charge that would inevitably have been made by the other side had they downgraded before the election). Even more blatant, however, was the way the credit agencies were browbeaten by the City of New York in the late 1970s to delay a downgrading. Their failure to give earlier warning of the city's inevitable financial collapse only made the ensuing crisis worse.

On an ongoing basis, one of the things credit agencies are reluctant to do is downgrade an issuer to below-investment-grade, or junk, status. Such a downgrading draws immediate media interest at the local level and can threaten the reelection chances of those in power. Hence, ratings of Baa3 or BBB-, the lowest investment grade rating, have become surrogates for a junk rating. As a result, towns such as Bridgeport, Connecticut, are rated BBB- right up to the moment they file for bankruptcy despite having threatened to do so months before.

One cannot totally fault the rating agencies for displaying this flexibility. They are, after all, not government; they are in business to make money. The contracts to rate a municipality run for decades and represents a highly predictable income source for them. Also, there are at least four recognized agencies providing ratings. It is no mere coincidence that most issuers retain two or more agencies to rate them. This arrangement provides a constant reminder to the agencies that individually they are expendable. By way of analogy, suppose a corporation retained two CPA firms to certify its financial statements. Imagine how much more flexible these accountants

would be knowing that their relationship could be terminated without serious disruption for the client.

In the municipal market, practically the only below-investment-grade issues are those that got there due to a fall from the ranks of investment grade. The practice is for issuers to sell bonds unrated unless they can obtain an investment-grade rating. This is made possible by the fact that the municipal market has such a high reputation that a third-party credit opinion is not considered critical. The mere fact that a municipality stands behind an issue is sufficient inducement to many individual investors, most of whom, alas, are unsophisticated. Not that this is the only explanation. Many communities are such solid credit risks and have such low financing needs that they have no difficulty finding buyers for their debt. Also, many buyers of municipal debt are large institutions who do their own credit evaluation and often end up buying entire issues or are able to write special protective covenants into the bond indenture. While ratings have their vulnerabilities, they are far and away the best single indicator of default risk.

POLITICAL RISK

The biggest risk to holders of municipal bonds is one that cannot be quantified by a credit agency or expressed in a letter grade. It is political risk. For our purposes here, we define political risk as the defaulting on a municipal debt obligation for nonfinancial reasons. Such defaults can result from a groundswell of public opinion that finally expresses itself in default. It also can happen very suddenly following an election result or political stalemate. When such defaults occur, they are frequently on a huge scale in terms of the dollar amounts of bonds affected. This is not surprising given that it takes a sizable amount of money to get public support for renegeing on a debt obligation. A review of two recent defaults and one near default will demonstrate just why this risk is so unpredictable.

THE WASHINGTON PUBLIC POWER PROJECTS 4 & 5 (WPPSS) DEFAULT

The WPPSS default on \$2.25 billion of debt is a classic example of how politics can precipitate a default and also obstruct a just settlement. Volumes have been written on the factors surrounding the default and the subsequent litigation. To focus on just the points relative to this analysis, the chronology of events can briefly be summarized as follows:

The Northwest, and most specifically Washington State, had attracted power-hungry industries and developed very high power consumption habits due to the historically low cost of power in the region. This low cost was due in large part to federally subsidized hydroelectric power. In the early 1970s, when a perceived energy crisis hit the country, the federal agency for this region, the Bonneville Power Authority (BPA) urged the construction of nuclear power plants to meet the projected energy needs. Five plants were eventually authorized and put under construction.

The Three Mile Island nuclear accident in Pennsylvania in 1979 led to a call for more rigorous safety standards and a dramatic shift in public sentiment against nuclear

power in general. This quickly accelerated into an outcry when plant design changes resulting from this accident multiplied construction costs and necessitated rate hikes. To fatally complicate matters, the rate hikes demonstrated that electric demand was highly elastic and, furthermore, growth projections had been seriously overestimated. Hence, rate increases resulted in consumption decreases so great that they decreased total revenues. The end result was a decision in 1982 to terminate construction on at least two of the five projects (eventually, four of the five plants were terminated).

Since the plants were not going to be needed, a legal challenge arose over the supply contracts signed by the municipal utility companies, contracts that constituted the only collateral for the bonds. The contracts, termed "take or pay contracts," called for the utilities to pay for the plants whether or not they received any power. The issue eventually came before the Washington State Supreme Court, a publicly elected body, which ruled that the municipalities did not have the authority to obligate themselves under these contracts and that they were therefore null and void.

The trustee for the bondholders then sued the utilities under the state securities fraud statutes, which were quite liberal in holding issuers responsible. To thwart what was a clear violation of these laws, the state legislature retroactively amended the statutes, exempting municipal utility officials. This action effectively cut off the principal remedy for bondholders. Subsequent litigation and recovery had to be carried on under federal fraud statutes, which are much more difficult for bondholders since they require demonstration of intent to defraud.

Because of the strong politics surrounding this default, litigation dragged out for seven years. Bondholders were characterized as fat cat speculators who took a chance and lost. The municipal utilities, in contrast, were characterized as the victims. The villains in this piece, need we add, were the underwriters and stockbrokers. There was never any serious debate that only bondholders should suffer the financial consequences from voters electing muffler shop owners and sheep farmers (the WPPSS board of directors as described on a "60 Minutes" TV segment) to oversee the simultaneous construction of five state-of-the-art nuclear plants. This was an undertaking described by some as being as complex as the placing of the first man on the moon.

The weight of accumulated legal fees appears to have been more of a factor in eventually obtaining a settlement than the merits of the case. Had the trustee not had over \$90 million in escrow to fund this effort, bondholders would probably have lost all rather than getting about 40 percent of their principal back.

THE RICHMOND SCHOOL DISTRICT DEFAULT

This school district came under severe economic stress and in 1991 filed for Chapter 9 bankruptcy. The default shook the municipal market, since bonds issued for such essential purposes as schools were thought to be immune from default. The fact was, however, that when it came to a choice between paying teachers and keeping voters happy or paying bondholders, the latter lost out. The state, after two years, intervened and provided backing for a new bond issue to pay off the old bonds. This, however, was not until they tried in court to have the bonds declared to have been illegally issued (à la WPPSS) and thereby abrogate the obligation entirely!

THE BREVARD COUNTY GOVERNMENT CENTER COPS

In 1989, the Brevard County Commission authorized \$23.9 million in Certificates of Participation (COPs) to construct a new government center for the county. The COPs were backed by lease payments, which had to be appropriated annually. This financing arrangement was used to avoid having to put the issue before the voters for approval. The bond issue became controversial because the new center was built in a remote area and many employees did not want to relocate there. The matter became a campaign issue locally and resulted in a majority of the new county commission being elected on the promise to cancel the lease. Pressure from MBIA, who had insured the bonds, resulted in the question being put to the voters. In effect, voters were being asked whether or not the county should honor its debts!

While one can agree with letting voters approve a debt issue before it is incurred, it is quite another matter to put honoring a debt to a vote. As with WPPSS, the issue was misrepresented. It was framed not as a debt default but rather whether or not a lease should be canceled as a cost-cutting measure. By a slim margin, voters approved the continuation of the lease.

Political risk is the major uncertainty in evaluating bond default risk and it provides a major rationale for why bond insurance is worthwhile for individual investors. In the Brevard County example, the bond insurer would have been the loser. However, had the voters elected to cancel the lease, a dangerous precedent would have been set, with far-reaching implications.

In the WPPSS default we saw government use its power to default for political considerations and then to cut off the bondholders' legal recourses. A default occurred not because the issuer could not afford the debt, but rather because they did not want to pay. Note that nuclear plants 1 and 3 also were never completed, but since a federal agency was guaranteeing these bonds, it (the federal government) did not give the utilities (local government) the option to default.

The Richmond School District represents the most dangerous type of political risk because it deals with a default brought about by the all-too-common problem of budgetary pressure. Local government in America provides the most visible essential services that voters and taxpayers get. Things like police, fire protection, and schools. Cutting back on these services in a community with heavy bond debt service is a formula for trouble. Faced with losing an upcoming election, politicians will search for ways to pacify their electorate. So far when these crises have occurred, the state governments have intervened and eventually resolved the crisis. Politics being what they are, however, such a solution will not always be there.

BOND FRAUD

On occasion, bonds will default due to deliberate and conscious fraud on the part of the developer, the underwriter, or someone directly or indirectly involved in the bond deal. The firm retained to conduct a feasibility study, for example, can come up with contrived projections that indicate the bond deal is a viable investment. Many municipally-financed projects are conceptualized without benefit of a third-party feasibility study. Such studies are often done as an afterthought to facilitate the sale of the bonds. Hence,

one must be extremely skeptical of such reports, especially when they are dated close to the date of the bond offering.

There is an extensive history of underwriting firms and developers who have committed fraudulent acts in putting together bond deals that resulted in default with severe monetary loss to the investors.

In the 1980s the underwriting firm of Buchanan & Co. sold over 66 bond issues, totaling over \$400 million, which defaulted. One of the favorite ploys of Buchanan during their heyday was to offer free lunches to senior citizens to sell them nursing and retirement home issues. Knowing that the elderly are vulnerable and that they would be more apt to invest in a nursing and retirement home, Buchanan targeted these people and bilked many of them out of their life savings. He would offer "free advice" to potential investors and advise them to reduce their risk by investing their money in several bond issues rather than a single issue. What he failed to mention was that he was involved in all of the issues offered and one was as bad as the next. In fact, over half the underwritings done by this firm ended up in default.

The First Humanics scandal is another example of bond fraud involving 21 issues totaling \$82 million. The bond issuers used a not-for-profit structure to lend credibility to their intent; however, this structure only provided a means for taking profit at the front end of a project without investing any equity capital that could be lost in the ensuing default.

While several underwriters have been brought to trial and received jail sentences for fraudulent practices, bondholders rarely recover even half of their invested capital despite the fact such issues had first-mortgage liens on real estate.

INTENTIONAL DEFAULTS

Another type of deception that many issuers and developers are guilty of is a staged default. A staged, or intentional, default, while not as serious as fraud, can still result in a monetary loss to a bondholder because his or her premium bond is devalued to par and because there is no opportunity to reinvest the capital at comparable rates of return.

Staged defaults usually occur when the stated interest rate is higher than the market average and there are no early call provisions on the bond. The debtor will then force a default in order to implement a refunding or a refinancing of the bond debt. Some will even threaten to file for bankruptcy if the interest payments on the bond are not lowered. Unfortunately, staged defaults are rarely if ever proved, hence, one should be extremely wary of paying a premium price for a bond with an above average interest rate and no early call provisions.

BOND DEFAULTS BY TYPE

As demonstrated in Table 1, general obligation municipal bonds, backed by the full faith and credit of the issuing authority, rarely default. This is because such issues are supported by property and income taxes, which are stable and predictable. Aside from this, such debt issues are generally approved by a public vote and therefore are less vulnerable to political risk.

Unrated bonds are the most likely to default. Industrial development revenue bonds, issued to build a structure that supports the bond debt—such as an office building, hotel, or retirement home—are frequently unrated because of weak sponsorship and a speculative outlook. There are many factors that can cause insufficient revenue and cash-flow problems for these types of facilities. Recent default experience was frequently the result of unrealistic projections of inflation and growth. Another factor is an economic downturn in the area surrounding the facility. Anyone buying unrated municipal bonds should remember that interest payments come only from the revenue generated from the operation of the facility after all operating costs are paid. Given that debt financing often constituted 110 percent of the required funding, there is usually little room for miscalculation.

SPECIAL ASSESSMENT DISTRICT BONDS

California Mello Roos bonds are special assessment district bonds named after the sponsors of the 1982 legislation that allows any landowner to set up a special taxing district and issue tax-free bonds. Similar legislation existed in Colorado in the 1980s and resulted in defaults on 34 issues totaling over \$450 million. Several Texas Municipal Utility Districts (MUDs) have also defaulted, although the losses are not expected to be as extensive as those in Colorado and California.

Special assessment district bonds provide local governments with a flexible way to finance infrastructure such as roads, water and sewer lines, and recreational facilities for development projects. Interest on the bonds, sometimes called “dirt” bonds, is paid through property taxes levied against the district’s individual property owners. Because debt service is paid out of property taxes, such bonds are deceptive in their appearance of safety. Often they are characterized as general obligation issues by underwriters and even some institutional investors. If there is an economic slowdown in the area and construction is stalled, the unlimited tax pledges behind the bonds may be raised to levels that inhibit new construction and sales. Developers, who are initially the sole property owners, sometimes subsidize the debt service in order to keep the tax levies at a reasonable level. But since such developers generally have little of their own money at stake, their willingness to fund a shortfall is usually quite limited. Most vulnerable to default are issues backed by districts with mostly undeveloped land located in a remote area.

In a default, a special assessment district issue can prove to be one of the worst type of issues to own. With a revenue bond issue, one can force a Chapter 11 bankruptcy and eventually foreclose and sell the assets. A special assessment district, however, is technically a government entity, which cannot be forced into bankruptcy against its will. If it does file for bankruptcy, it comes under Chapter 9 bankruptcy rules. Since government cannot go out of business, such Chapter 9 bankruptcies are generally settled by a restructuring of the bonds by the court without so much as a by-your-leave from the bondholders. Interest rates and principal amounts can be reset by the court based on a new feasibility study, which will have little resemblance to the one used to launch the bond issue. It rarely provides any relief for bondholders should a turnaround prove more successful than forecast in the study, hence there is every motivation to be conservative in the projections.

HOUSING ISSUES

In the past three years single-family and multifamily housing issues have topped all other issues in volume of defaults. Since 1980, over \$4.5 billion of housing bonds have defaulted. This is principally the result of the 1986 Tax Reform Act and the general deflation that has taken place in the U.S. economy in the last decade.

OTHER FREQUENT DEFAULTS

Nursing and retirement home defaults have totaled \$2 billion since 1980. As a percentage of total issuance, they have one of the highest default rates of any bond type. There are several reasons for this. Such bonds were the subject of extensive underwriting fraud by Buchanan & Co. and others because they were easy to sell despite having no ratings. Investors felt they understood this business and often felt they were doing a public service by investing in such facilities. The facts, however, were quite different.

Nursing and retirement homes are a difficult business that is made more difficult by bureaucratic red tape and governmental price controls. The fact is that running a nursing home takes considerable talent—more talent than most nursing home operators have. They are mostly mom-and-pop operators who understand nursing care but know little about finance, reporting, or operating a business. Even large operators like Beverly Enterprises have found little profit despite all the advantages of centralized control and a depth of management. Nonprofit religious organizations have also been active in the operation of such facilities, but they too have not escaped unscathed.

Due to such facilities being vulnerable to governmental price and quality controls, high staff turnover, and poor management as a norm, they will probably always be a high-risk investment area. Investing in such bonds should be left to the specialists who are prepared to monitor their investment on an active basis. This is not easily done, given the lack of continuous reporting and disclosure standards for the municipal bond market.

TYPES OF DEFAULT

Escrow default. An escrow, or debt reserve, default will usually precede a “full,” or monetary, default. In an escrow default, debt reserve funds are tapped in order to pay the interest or principal payment due bondholders. While some experts do not consider an escrow default to be a “true” default, it is certainly a good indicator of problems ahead. The Bond Investors Association, the principal organization reporting on municipal defaults, defines a bond default as any situation where timely interest or reserve fund payments are not being made or are being made by someone other than the obligor. In an escrow default, bondholders may be receiving interest and principal payments on schedule; however, an arrearage situation exists regarding the monthly payments that the issuer is supposed to make to the trustee.

Monetary default. A monetary default occurs once a scheduled interest or principal payment to bondholders is missed. Many times this is the first indication the bondholder has that there is a problem with the bond issue. Bearer bondholders are

usually notified not to turn in their coupon for payment as there are no funds available to make the payment. The trustee will then advise what action is being taken to cure or correct the default.

THE DEFAULT PROCESS

The trustee is the first to know when a bond issue defaults. What he or she does with that information will vary from one institution to another. In municipal defaults, unlike corporate defaults, the trustee is the main source of information for the bondholders and is the lifeline between the creditors and the debtor. This responsibility sometimes falls on inexperienced shoulders, with many bondholders finding out their bonds are in trouble only when an interest payment is missed. Many trustees have been sued in class action litigation due to mishandling of bond indenture procedures.

Once a bond defaults, the trustee generally follows one of two courses of action. She may state that she will take no action unless instructed to do so by 25 percent of the bondholders. Alternatively, she may request that bondholders meet and form a bondholders' committee. The committee is there to endorse any actions taken by the trustee during the default process and may even propose a plan to cure the default. Such committees rarely have representative talent that will contribute positively to a solution. The exceptions are when large institutional holders or professional speculators who know how the process should work are represented.

Trustees can rack up disproportionate legal and trustee fees, eating up whatever recovery they might have gained for the bondholders. This comes about due to the fact that much of what the trustee does in administering a default is done principally to protect his institution. Faced with a choice of actions, he will generally pursue the course of least resistance, which is invariably the course of least recovery. A frequent recourse for trustees is to hand administration of the default over to an outside attorney. This introduces an added element of cost and delay to a default, since such attorneys have a client (the bondholders) who have little say over their legal bill.

It is up to the bondholders to see that the trustee is doing everything possible to correct the default in a way that will result in the most recovery for them as investors. Any correspondence or notices to bondholders from the trustee regarding the default should be read thoroughly. It is also a good idea to get on the bondholders committee if one is formed. Trustees are mixed in their reaction to bondholder committees. Since such committees are contentious and hard to deal with, many trustees resist them. Others, however, recognize that a committee provides an important protection for them in doing what is right and, at the same time, safe. The endorsement of any trustee action by a bondholder committee provides the best defense against disgruntled bondholders later on, especially if such bondholders chose not to be on the bondholder committee.

DECLARING A DEFAULT

The indenture trustee notifies bondholders when a bond defaults. This is usually done via a "Notice to Bondholders," which is sent to all registered holders. If the bonds are bearer bonds, a notice of default will usually appear in a trade paper such as *The Bond Buyer* or *The Wall Street Journal*. An "Event Of Default" notice gives the trustee

certain rights and remedies under the terms of most indenture agreements, but a default must be declared in order to trigger these rights. Once the trustee declares a default, his or her burden of responsibility increases substantially; hence, it is often put off as long as possible.

Significant improvement in default administration by trustees requires modification in the powers of trustees to act on behalf of bondholders. Currently, trustees can hide behind the language of the bond indenture to justify their actions or inactions. It has been proposed that bond trustees be guided by a standard set of guidelines, enacted by Congress, which supersede any language in the bond indentures. This would give bondholders greater assurance that trustees will pursue default remedies on their behalf as vigorously as if the default was on the books of the bank. It also provides a stricter performance measure by which bondholders can hold the trustee legally responsible if he or she is negligent. So long as the bond issuer, through the bond indenture, is allowed to define the remedies available to the trustee when he or she defaults, there will be little improvement in default administration.

WHAT HAPPENS AFTER A BOND DEFAULTS

The trustee may choose to exercise several remedies once a bond default is declared. The first and most common action is to accelerate the issue, which means that the entire debt is now due and payable. This is usually a moot action, since there are rarely funds available to call in the issue. However, acceleration is required before the trustee can pursue foreclosure actions or activate certain third-party guarantees.

Often the trustee will first attempt to negotiate a new payment schedule to cure the default. This can be done via a refinancing or restructuring of the bond debt. If a bankruptcy petition has been filed, the trustee's actions will be dictated by the priority of the bondholders' claim. If the bonds represent a first-mortgage lien on the principal asset of the debtor, the bondholders become the key creditor. In such a situation the trustee must decide whether it is better to leave the debtor in place to administer the asset on behalf of the bondholders. The alternative is to ask the court to allow the trustee to foreclose on the property, remove it from the bankruptcy estate, and seek an outside buyer. Bankruptcies are frequent in real-estate-backed issues because they often involve personal guarantees by the project backers. The bankruptcy route is used by the debtors to get out from under these personal guarantees either through a court decision or because of the threat of additional loss due to the delay.

If an agreement cannot be negotiated between the investors and the debtor, the priority becomes protecting the bondholders' collateral, which is the project financed by the bonds. This can be an apartment building, hotel, nursing home, manufacturing plant, etc. Foreclosure proceedings enable the trustee to gain title to the property on behalf of the bondholders. He or she then inherits the responsibility for managing the property, marketing it, and negotiating a sale. These are not activities in which most trustees have great talent, hence there is a strong reluctance by trustees to undertake foreclosure.

The property is eventually sold or liquidated and the proceeds are distributed to the bondholders. Rarely will a trustee undertake to restructure the bonds and solicit the consent of bondholders to accept a lower interest rate and continue with the bonds

under contract management. This is, however, precisely what most buyers of such properties do.

It is not uncommon for a buyer of a defaulted issue to use the bonding authorization of the defaulted bonds to issue new tax-free bonds at a lower interest rate and a lesser principal amount to finance the takeover of the project. In effect, they are doing precisely what the trustee could and probably would do if the bank itself were the lender on the property. Since such deals are generally done at from 40 percent to 60 percent of the value of the original bond issue, the loss to bondholders is substantial. Here again, an effective bondholder committee would promote consideration of such a solution.

Foreclosures and liquidations are usually a last resort by trustees for several reasons. First, there is almost always a loss to bondholders in a foreclosure. Trustee and legal expenses eat up a large part of the liquidation proceeds. Many times real estate brokers must be brought in to market the property (which sometimes takes years) and property taxes and insurance and other expenses must be paid, always by the bondholders. Sometimes the property is simply unmarketable. Many times the facility is abandoned by the debtor because of a severe economic downturn in the area or because of environmental problems. Contamination problems must sometimes be corrected before the facility can be sold. In some cases bondholders may be liable for the clean-up costs. If the facility has been abandoned, it is almost always in poor physical condition. Sometimes thousands of dollars must be invested in renovation to make the property marketable, and even then there is no guarantee it will sell quickly or sell at all.

While foreclosure and liquidation may be the only avenue left for the trustee to take, it is usually the least favorable in terms of recovery for bondholders.

BANKRUPTCY

One of the most common actions taken in a bond default is a bankruptcy filing by the debtor. Debtors will file either a Chapter 11 bankruptcy, which reorganizes or restructures the bond debt, or a Chapter 7 bankruptcy, which liquidates all remaining assets and distributes those assets to the creditors. Commonly, the debtor will present a reorganization plan that will either restructure the bond debt or allow the facility to be sold and the proceeds distributed to bondholders. The bankruptcy court will often allow the indenture trustee to propose a foreclosure action, but it can also decide to invoke a cram-down procedure, whereby a settlement is forced on the bondholders. There are many factors involved in a bankruptcy filing, most of which have a negative effect on the bondholders' recovery prospects.

Bankruptcy is used by bond issuers to delay a foreclosure proceeding against the bondholders' collateral by the trustee. It often allows the issuer to continue to enjoy paid employment while the bondholders go unpaid. When a bond issuer has personally guaranteed a bond issue (secondary collateral in a bond issue), he or she will often use the threat of a bankruptcy filing and the attendant delay and costs as a ploy to obtain release from the guarantee.

There are no standards for how quickly a default will settle. A good rule of thumb, however, is the longer the default, the less the recovery for bondholders. Anything involving the courts and the judicial system will extend the settlement day

and rack up more legal and trustee expenses. However, it is usually difficult to settle a default without some type of legal intervention.

THIRD-PARTY GUARANTOR DEFAULT SETTLEMENTS

When an issue is secured by a letter of credit, surety bond, bond insurance, or any other type of credit enhancement, the issue is said to be guaranteed. This is generally understood to mean that if a default occurs, the credit enhancer will pay the interest payments or provide the funds to accelerate the issue and pay off the bond debt. While this is comforting to the bondholders, a default situation still exists. If an insurance company or letter-of-credit bank needs to be called in to pay the interest payments, they will experience the loss. This loss constitutes a default on the bonds even though the bondholders will be made whole.

An interesting question arising in third-party guaranteed defaults is what happens when the guarantor collapses? When the letter-of-credit bank or insurance company goes under, or the corporate guarantor goes bankrupt, there is no more credit enhancement or guarantee on the bond issue. In these instances bondholders usually lose. Such was the case with the \$1.6 billion of munis backed by Executive Life and the \$600 million of housing issues backed by Mutual Benefit Life Insurance Company. It can also happen with the various guaranteed issues inherited by the RTC in its takeover of defaulted savings and loans. The RTC has taken the position that it will make good on such guarantees on a selective basis. The scope of this selectivity is still fluid to at this time.

When you hear of a large corporation such as LTV or Lone Star or Days Inns of America filing for bankruptcy, all of the muni bonds they backed or guaranteed default as well. Such issues become claims against the company with no special priority over the corporate bond creditors. In such defaults, the muni indenture trustee is generally an observer on the sidelines rather than a proactive agent for the bondholders.

One of the subtleties of third-party guarantees is how they differ in a true default situation. With bond insurance by a monoline bond insurance company, the company promises to step into the shoes of the issuer and continue debt service per the original schedule. Bank letter-of-credit guarantees generally pay off the issue in total when default occurs. Government-backed issues such as those of the FHA and RTC may continue debt service for an indefinite period and call the issue only when required to facilitate the sale of the project. This is of no small consequence to investors, since guaranteed bonds with high coupon rates represent an irreplaceable investment opportunity in a low interest rate environment.

It has happened that the credit enhancer cannot provide funds to make good on his guarantee. Most recently we saw Mutual Benefit Life Insurance Co. go into conservatorship with the New Jersey Insurance Commissioner. The company provided a standby guarantee on some 43 municipal bond issues, which financed money-losing real estate projects in which it had an equity interest. Not only did all guarantees by the insurer terminate, the bondholders' claims were subordinated to such an extent that they will likely never be a source for recovery. Even the collateral value of the bondholders' first-mortgage lien was compromised through an appraisal procedure

that wrote such claims down to current market values and gives MBL first claim to any future appreciation.

If an issue is backed by HUD or FHA insurance funds, a claim is made to the agency by trustee. Disbursements are made in two installments, with the initial disbursement being the highest. These bonds rarely if ever result in a loss to the bondholders.

CLASS ACTION SUITS

If fraud or mismanagement can be proved, a class action suit may be filed against the offending parties. A class action suit is a legal proceeding in which named plaintiffs sue on behalf of themselves and all other persons similarly situated. Such a suit is usually grounded on the premise that the original offering prospectus was false or fraudulent. The plaintiffs may contend that the feasibility study was flawed, that the prospectus contained false and misleading information, that the developer and underwriter knew at the time of the sale that the issue would default, or that relevant information was not presented at the time of the sale that would show that the bonds were a risky investment.

Anyone involved in the sale of the bond issue can be named in a class action suit. Almost always named are the guarantors and their officers, the underwriters, the marketing consultants, and the bond attorneys. In some cases the accountants, the trustees, and the issuing authorities are also named. The results of the lawsuit, generally reached through an out-of-court settlement, are binding on all bondholders who do not exclude themselves from the class. Bond trustees are often named defendants in such suits simply because they are easy targets. This vulnerability accounts for many of the nonsensical and costly procedural actions by trustees.

CONCLUSION

Municipal bond defaults run in excess of \$1 billion every year. While sizable, this is small in comparison to the size of the market and to default rates for corporate bonds.

Present debates in Congress, the SEC, and the MSRB are focusing on improving and even mandating routine periodic disclosure by all municipal bond issuers. Defaults have been a compelling force behind this perceived need. More compelling, however, are the defaults that may happen in the future if the chronic illiquidity of the municipal secondary market leads to a severe curtailment of the new issue market. This occurred in 1990 in the high-yield corporate market with the result that the new issue market collapsed and a wave of defaults ensued. Such an occurrence in the municipal market is predictable, possible, and at this point, still avoidable.

STATEMENT FOR CONGRESSMAN FLOYD H. FLAKE
BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
GOVERNMENT SPONSORED ENTERPRISES
JULY 26, 1995

GOOD MORNING CHAIRMAN BAKER AND MEMBERS OF THE
SUBCOMMITTEE. MR. CHAIRMAN, I AM PLEASED TO DISCUSS THE ISSUES
SURROUNDING STATE AND LOCAL GOVERNMENT DEBT ISSUANCE AND
INVESTMENT PRACTICES, AS WELL AS, THOSE SURROUNDING THE BANKRUPTCY
FILING OF ORANGE COUNTY. RECENTLY, THERE HAVE BEEN SEVERAL
INSTANCES OF POOR MONEY MANAGEMENT AT THE LOCAL LEVEL, WHICH HAS
RESULTED IN TAX INCREASES OR A REDUCTION IN LOCAL GOVERNMENT
SERVICES TO CITIZENS. THESE ISSUES ARE OF CRITICAL IMPORTANCE TO
INVESTORS IN THE MUNICIPAL SECURITIES MARKET, STATE AND LOCAL
GOVERNMENT INVESTORS, AND TAXPAYERS WHO STAND BEHIND LOCAL DEBT
OBLIGATIONS.

HENCE, I WILL PAY CLOSE ATTENTION TO WHETHER THERE IS A FEDERAL
ROLE IN THE AREA OF MUNICIPAL FINANCE. I BELIEVE THAT THE FEDERAL
GOVERNMENT SHOULD ENSURE THAT PROPER SAFEGUARDS ARE IN PLACE TO
ENCOURAGE MUNICIPAL MONEY MANAGERS TO PRUDENTLY INVEST
TAXPAYERS DOLLARS. WE MUST DEVELOP REGULATORY AND OVERSIGHT
POLICIES WHEREBY LOCAL GOVERNMENTS CAN CONFRONT FINANCIAL
DIFFICULTIES WITHOUT EXPOSING TAXPAYERS TO UNDUE RISK.

I WANT TO BE ON RECORD AS EMBRACING THE TRADITION OF MUNICIPAL FINANCE AND THE OPPORTUNITY FOR LOCAL GOVERNMENTS TO ISSUE THEIR OWN DEBT. HOWEVER, ALONG WITH THIS ECONOMIC OPPORTUNITY, THERE IS A CORRESPONDING RESPONSIBILITY ON STATES AND MUNICIPALITIES TO REPAY THEIR DEBTS.

ORANGE COUNTY IS NOT THE FIRST MUNICIPALITY TO FACE A FINANCIAL CRISIS, AND UNFORTUNATELY WILL NOT BE THE LAST. NOTWITHSTANDING, IT IS THE RESPONSIBILITY OF ALL OF US HERE TO PREVENT ANOTHER FINANCIAL DISASTER OF THIS MAGNITUDE FROM OCCURRING AGAIN IN ORDER TO PROTECT THE FINANCIAL MARKETS AND TAXPAYERS. I DO NOT WANT TO MICRO-MANAGE MUNICIPAL FINANCE. HOWEVER, IT MAY NOT BE UNREASONABLE TO SUBJECT STATE AND LOCAL GOVERNMENTS TO THE SAME DISCLOSURE REQUIREMENTS THAT APPLY TO CORPORATIONS SELLING SECURITIES TO THE PUBLIC. OUR GOAL HERE SHOULD BE TO ENSURE FISCAL RESPONSIBILITY AND PROTECT SCARCE GOVERNMENT RESOURCES.

AGAIN CHAIRMAN BAKER, I WOULD LIKE TO THANK YOU FOR HOLDING THIS IMPORTANT HEARING, AND I PLEDGE MY SUPPORT AND COOPERATION TO YOU AND THE DISTINGUISHED WITNESSES BEFORE THE SUBCOMMITTEE IN GRAPPLING WITH THESE COMPLEX ISSUES.

OPENING STATEMENT OF MAXINE WATERS**Hearing on Derivatives and
State and Local Governments**

July 26, 1995

Mr. Chairman, I commend you for holding this most important hearing. There have been a series of unfortunate incidents involving derivative investments and local government losses -- this includes a highly publicized incident very close to my Congressional District in Orange County, California. This development is extremely troubling, to say the least.

What is more disturbing is that the number of highly publicized losses associated with local governments could be exceeded by pension fund losses. While pensions are not the explicit subject of this set of hearings, there are few issues which are potentially more destabilizing to more families than pension funds investments which turn sour. The fact remains that many money managers, representing millions of American citizens, have chosen risky financial instruments to invest their clients money.

The federal government has a tremendous responsibility to do all it can to protect pensioners and local governments from any abuses which might lead to overly risky and -- as was the case in Orange County -- extremely costly public investments.

It seems that many of the stories we will hear about today could have been prevented. There is evidence that financial consultants, many of whom seek out

their customers, do not fully disclose the potential risks involved with derivative products. If there is abuse in the selling of these highly complicated investment instruments, we should explore penalties for improper conduct.

Moreover, it may also make sense to develop policies which forewarn any user, but especially financial officers representing governments or pension funds, of the risks that are often involved with derivatives. Clearly, the preventative measures currently in place have are not working all the time.

Mr. Chairman, I know it was a top priority of Chairman Gonzalez last Congress to regulate the use of derivatives. I hope we continue with those priorities and, as part of that process, we look extra hard at ways to protect localities, who may be victims of either bad advise or bad administration. If the federal government cannot use its power to prevent millions of dollars in unintended losses for its citizens, we are falling down on our job. This issue is analogous to federal deposit insurance for taxpayer contributions to their local governments. It deserves our attention.

Testimony of U.S. Representative
Christopher Cox
Before the House Banking Committee
July 26, 1995

Thank you for convening this important hearing on current problems in municipal finance.

An important part of your focus is on Orange County. We should study what happened in Orange County, because the problems can and will be repeated elsewhere.

Orange County is far more typical than you might think. It is one of America's largest municipalities, with over 2.6 million people. Today, one in every 100 Americans lives in Orange County.

It is not a particularly affluent county; in fact, the average income is about equal to the state median. Its per capita household income is nowhere near that of wealthy counties like San Francisco, or Marin County. The truth is, except for a few small beach enclaves that drive up the statistics, the millions of people who live in Orange County are just everyday folks. Nearly 8% of them live below the poverty line.

This is not to say that Orange County's municipal finances were like those of New York City, Los Angeles, or Washington D.C. To the contrary, neither the county nor its many political subdivisions were guilty of Marion Barry-style deficit spending. They lived within their means. They even had surplus money, which they put in the county investment pool, so it would earn a safe return.

Orange County's investment pool was advertised as a safe bet. Its strategy, however, was inherently risky. The county Treasurer, Bob Citron, was the manager of the pool. He borrowed money at the county's low municipal rate, and then invested it to try to earn higher rates. To get the highest possible return on the borrowed money, he tried to outsmart the market. He bet that interest rates would fall, but instead they went up.

The financial markets, and even moreso the general public, simply didn't appreciate just how bad a bet Citron had made. But it's important to realize that the reason we are here today discussing Orange County's bankruptcy is not that Bob Citron guessed wrong. It is not that part of the portfolio was invested in derivatives. Citron drove Orange County into bankruptcy because he leveraged his portfolio nearly 3 to 1 and made a very simple and very wrong guess about the direction of interest rates.

And even though he went back to the market time and again to borrow more money to keep the risky scheme going, the market didn't discipline him. It didn't even exact a premium for the risk.

The most important question for this Committee to ask about the Orange County bankruptcy is why almost no one in the market knew just what Bob Citron was up to and how dangerous his investment strategy really was.

Our task is to understand why everyone--the SEC, Standard & Poors, Moody's, institutional investors, the financial press--all of them--failed to see the obvious.

Even a political campaign that focussed entirely on Citron's risky investment strategy failed to gain the serious attention of many people. Bob Citron was the only Democrat elected to office in Orange County government. He had to stand for election last year. His Republican opponent, John Moorlach, gave the Los Angeles Times and the Orange County Register documents showing that a financial disaster was imminent. But, in the words of the American Journalism Review, the newspapers "blew it." I know, because I was John Moorlach's campaign chairman.

But the truth is, markets shouldn't have to rely simply on the information available in the press. That will almost always be inadequate. As the Register publicly admitted, "Moorlach handed everybody the story on a silver platter. . . . Maybe if he had said Citron hired an illegal immigrant for a babysitter, somebody would have paid attention."

But almost no one in the press did pay attention. The only reason John Moorlach knew what was going on in the Orange County portfolio is that he obtained documents under CA's Freedom of Information Act. Citron tried to keep him from getting them. But by May of last year, John Moorlach had gotten enough information to write a one-page summary of the county fund showing that of Citron's total \$21 billion, \$14 billion was borrowed.

In May 1994, he predicted in writing to reporters that the county was headed for a billion-dollar crash as soon as interest rates rose.

The newspapers didn't write the story. The editor of the Orange County Register, Tonnie Katz, said it was too complicated. She said, "Give us a good fire, a good earthquake, a nice hurricane --that's pretty easy to cover. . . . This is just the reverse. . . . We're talking about financial transactions and numbers"

So instead of analyzing Moorlach's data themselves, the LA Times and the OC Register checked with the experts. The Register relied in part on Standard & Poors and Moody's. But the rating agencies missed what was going on even worse than the newspapers.

Just last year, Orange County went to the financial markets to borrow \$600 million in order to invest still more borrowed money in the pool. Standard & Poors rated the debt A-1 Plus. This was in July of last year. Not until a few days before the county actually filed bankruptcy in December did S & P put OC's debt on credit watch, which signals a possible downgrade.

When the rating agencies failed to see anything wrong in Orange County's investments, the markets didn't either. And the press simply followed suit.

But that's not all. The Securities and Exchange Commission also investigated the investment pool last year, and according to Citron, the SEC gave him a clean bill of health. The SEC requested documents that filled more than 20 boxes. And SEC attorneys questioned Citron and his cohorts for 3 1-2 hours in Los Angeles. Yet just like the press

and the rating agencies and the market itself, they failed to see anything wrong. The SEC investigation didn't even rise to the level that merited disclosure to potential bond buyers, according to the county's bond counsel.

And therein lies the rub. Municipal disclosure rules are virtually freeform. Unlike the very specific rules for corporate disclosure, cities and counties can disclose just about whatever they want. Practice varies widely.

Quite obviously, the manner in which Citron disclosed his strategy and his portfolio was wholly inadequate, since only a man armed with the product of several Freedom of Information Act requests could figure it out. And yet it is quite likely that Citron's disclosure was all perfectly legal.

If the market had known and understood what John Moorlach knew, Citron would have been stopped dead in his tracks. He certainly wouldn't have been able to borrow that last \$600 million in July last year. He probably would have been forced to accept Merrill Lynch's offer in 1993 to buy back all of the derivatives he'd bought from them. Had he accepted that offer, the county would have made a profit and the bankruptcy would never have happened.

Today, municipal government borrowing competes unfairly with private securities. Not only is it tax exempt, which is proper, but also it doesn't have to comply with the same disclosure rules. No mutual fund that sells to investors would get away with the skimpy disclosure that municipalities make. In the future, no municipality should be able to get away with it, either.

The consequence for our national savings is very dangerous. For the first time, total outstanding municipal debt is greater than all outstanding corporate debt in America. Simply put, the unfair advantage that municipal finance enjoys is diverting ever more of our investment into government and away from private enterprise.

Since the inception of our federal securities laws, municipal securities have been exempt from the disclosure rules that apply to virtually

everyone else. We are now reaping the whirlwind from that unjustified distinction. While federal registration is neither practical nor desirable, detailed federal disclosure rules enforced by the market and private rights of action are essential. The recent changes to rule 15c2-12 are only a start. The fact is, no rules change can be adequate without new legislation.

Municipal accounting varies widely from jurisdiction to jurisdiction. Not only the quantity but the quality of disclosure is everywhere lacking. Rating agencies cannot evaluate risks without adequate information, and neither can the market. All of the investors in Orange County's \$600 million issue last year were sophisticated institutions, but none of them appreciated the problems with the county portfolio. As we've seen, even the SEC and the press failed us in the current system.

All too often, the assumption is that government bonds are virtually risk free. But that is obviously not so. If Orange County's misfortune can contribute anything positive to the nation, let it be this lesson. It is now up to us in Congress to give the marketplace the disclosure tools to better evaluate these risks in advance, before the next Orange County occurs.

**Matthew K. Fong
California State Treasurer**

**Testimony Before
The
Subcommittee on Capital Markets, Securities and
Government Sponsored Enterprises
of the
House Banking Committee**

**Hearing on Local Government Investment Practices
July 26, 1995**

Mr. Chairman and Members:

Thank you for the opportunity to address your committee on the worst municipal disaster in California's history.

Since taking office in January I have witnessed firsthand how the risky and irresponsible investment strategy of the previous Orange County Treasurer can throw uncertainty into the municipal market and cost local government, most of which already face financial difficulties, millions of dollars in penalties.

Robert Citron, the former Orange County Treasurer, leveraged his way into notoriety while the local governing body turned a blind eye to his irresponsible investment practices which promised returns that were twice that of most other investment pool managers (Or. Co. investment pool was leveraged by approximately 300%).

Although municipal finance and the trading of municipal securities have changed forever, I believe many of those changes are for the good.

LOCAL GOVERNMENT INVESTMENT PRACTICES

- The Orange county investment pool losses, I believe represent an isolated incident that occurred because of an arrogant treasurer and an inattentive Board of Supervisors. Recurrence should be prevented in the future with simple oversight and limited restrictions on certain types of investments and investment strategies.
- One of the first duties I under took in office was to chair a Task Force on Local Investment Practices at the request of Governor Wilson. The task force recommended restrictions on leveraging investment pool securities and limitations on investments reverse repurchase agreements. The Task Force also recommended better education for local officials about investment practices and the adoption of investment policies and reporting requirements to the local governing body.
 - These recommendations have been incorporated into several bills that are making their way through California's state legislature.
- Additionally, investors appear to be demanding better disclosure information and issuers are responding to those needs. The market mechanisms are indeed addressing this issue without additional governmental intervention. This is a healthy bi-product of the Orange County situation.
- Also, the recently amended disclosure requirements of the SEC should further strengthen market confidence that local government investment practices and other financial information are adequately disclosed.

ISSUER & INVESTOR RELATIONSHIPS

- There has been a significant change in the relationship between municipal issuers and investors. Investors are much more wary of the municipal market; the market that was once regarded as the safe place to invest. In California, especially in light of Orange County's bankruptcy, the present relationships are more cautious than in the past.

MUNICIPAL BANKRUPTCY

- Unlike the corporate bankruptcy model, municipalities under Chapter 9 retain democratic control over operations while receiving protection from creditors.
- It appears, however, that, at least in Orange County's situation, bankruptcy strategies have hindered expeditious resolution of the problems. With the litigious and adversarial culture that has evolved, emphasis is placed on winning rather than on problem solving.
- This "I've-Got-To-Win" mentality is the right strategy in a corporate bankruptcy where you can completely shut down the bankrupt business and start fresh in a new location.
- County governments simply cannot close up shop, clean the slate and go out of business -- leaving behind as many creditors as possible.
- While a county continues to provide services to its citizens, a workable solution must be sought out through negotiation and with ongoing creative financial management strategies. A strategy that maximizes litigation hurts any county's ability to provide needed services.
- Unfortunately, in Orange County millions of taxpayer dollars are being diverted from paying bills into the hands of lawyers, accountants, underwriters, and financial advisors.

GOVERNMENT REGULATION

- One of the recommendations of the Task Force on Local Investment Practices was that the Congress and the California state legislature not overreact to the Orange County situation.
- What I fear is what I call the "Florida Doctor Syndrome." When that doctor in Florida amputated the wrong leg recently, the solution wasn't to pass a bill outlawing scalpels! The way to prevent another Orange County is oversight -- with a goodly dose of common sense.
- I don't believe that regulators and regulations have any potential for minimizing risk of this kind of catastrophic event in the future. It will be

nearly impossible for them to anticipate every type of situation that arises.

- In short, you can legislate neither common sense nor good judgment.
- We need to educate the public and its officials about investment functions, the risks of aggressive and irresponsible investment policies, and the benefits of vigilance, oversight, and accountability.

CONCLUSIONS

- There was a financial train wreck in Orange County and the bill for the damage must be paid. There's no way around it.
- Municipal markets are more alert and are demanding more information from issuers. This is a healthy bi-product.
- The bankruptcy laws of Chapter 9 don't work properly if a county employs a corporate bankruptcy strategy.
- Finally, and most importantly, if Congress and state legislatures overreact by outlawing specific types of investment products, two things will happen.
 - First, you won't be able to keep up with all the new investment products that will be invented down the road.
 - But more importantly, you will take away valuable investment tools that treasurers all over the country use wisely to earn hundreds of millions of dollars for their government operations. There's only one way to replace those revenues -- through additional fees and taxes.
- Oversight, education, vigilance, and accountability -- These are the watchwords to live by and to prevent another disaster.

Thank you again for this opportunity to testify before the Committee. I will be happy to answer any questions.

Statement by Kurt R. Sjoberg
California State Auditor
Before the Committee on Banking and Financial Services
July 26, 1995

Good Morning. I am Kurt Sjoberg, California State Auditor. My comments today will focus on the results of various audits that the Bureau of State Audits recently performed on investments made by county treasurers in California, as well as the recommendations we have made to improve local government investment practices.

Our Review of Orange County

Upon receiving the alarming news in December 1994 from Orange County that it had incurred significant losses causing it to declare bankruptcy, Governor Wilson requested that my office immediately start an audit of the county treasurer's office. A team of auditors from my office commenced work in Orange County on December 13, 1994.

The county had one elected treasurer, Robert Citron, from 1973 to December 1994, when he resigned. In addition to managing county funds, the treasurer managed investments for various public agencies, including cities, special districts, and school districts. State law generally requires that county entities and school districts deposit their money with the treasurer. Others, such as cities and special districts, voluntarily deposit their funds into the county treasury.

The pool proved to be very popular and the number of investors and amount invested grew over the years. The reason that the pool was so attractive was that it was achieving investment returns significantly higher than comparable funds. By December 1994, nearly 190 public agencies with contributions totaling \$7.6 billion were participating in the county's investment pool. Additionally, some entities found the pool's returns to be so attractive that they sold taxable notes for the sole purpose of increasing their investment in the pool. However, this all came to an abrupt end in early December 1994, with the announcement that the pool had sustained significant losses and that the county was unable to resolve its financial problems without filing for protection under Chapter 9 of federal bankruptcy laws. The losses were later calculated to be \$1.69 billion, or 22 percent, of the \$7.6 billion invested by participants.

How did the county lose such a vast amount of money?

We found that the former treasurer pursued an investment strategy that violated the basic principles of prudent investing; namely, safety, liquidity, and yield, in that order. In fact, his investment strategies directly contradicted these principles. His investments were unsafe, highly risky, extremely volatile, and lacked the liquidity needed to meet the portfolio's objectives.

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In our opinion, not one single factor caused the county's losses. The losses were the result of a dangerous amalgam of several risky strategies. Specifically, the treasurer assumed a high degree of risk using various strategies to increase investment yield: Investments were highly leveraged through the use of reverse repurchase agreements and the proceeds from this borrowing were invested in derivative securities where value declined as interest rates rose. Further, the treasurer invested funds generated from short term borrowing to purchase long term securities; thus, funds were not available when these loans came due.

Orange County's Use of Leveraging

The first way in which the former treasurer incurred risk on the county's portfolio was through the use of reverse repurchase agreements (reverse repos). In a reverse repo, the owner of a security "borrows" by selling the security to an investment broker with an agreement to repurchase it a short time later. In effect, the security held by the broker is collateral for a loan transaction. The security owner agrees to pay a stipulated rate of interest to the broker as the cost of borrowing the money. The security owner can then invest the cash received, leveraging the original principal by, in effect, investing the same money twice.

Using reverse repos was a primary strategy that the former treasurer used to increase the yield on his portfolio. As long as the cost of borrowing was less than the earnings that he received from investments made with the borrowed cash, he would profit from the transaction. However, the way in which the county was able to achieve such a favorable return was by investing its borrowed funds in long-range investments that paid interest rates higher than the short-term borrowing rates.

In pursuing his reverse repo strategy, the former treasurer did not limit himself to borrowing only once on a security, but instead incurred multiple levels of borrowing on a single security. For example, the county would purchase a security that it then used as collateral to borrow money under a reverse repo. The borrowed cash was used to purchase a second security which was again used as collateral to borrow more cash. This sequence would then be repeated several more times.

The treasurer's strategy regarding reverse repos resulted in dramatically increasing the size of the portfolio. By November 30, 1994, the treasurer had increased the size of the base portfolio representing the participants' original investment value of \$7.6 billion to a portfolio valued at \$20.6 billion through the use of leverage. The \$13 billion increase

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represented investments purchased with borrowed money obtained by using reverse repos. As a result of this strategy, the portfolio was leveraged more than 270 percent, or 2.7 to 1. Furthermore, a portion of the portfolio representing the county's general fund was leveraged even more significantly. For example, in January 1994, the county's general fund segment of the investment pool amounted to \$100 million, but through the use of leverage was increased to \$2.9 billion, a leverage factor of 29 to 1!

Additionally, because the former treasurer was "borrowing short to buy long," he had to continually borrow at the current rates to provide collateral for the long-term securities. As interest rates rose, reverse repo borrowing costs rose, thus reducing, or eliminating the spread between the borrowing costs and his investment returns. Additionally, the risk of collateral calls increased. To protect their interests, the brokers require collateral in excess of the amount lent. If the market value of the collateral declines, brokers can send out collateral calls to restore the collateral to its original value. Collateral calls can place untimely and significant demands on a portfolio by draining its cash or equivalent securities or by requiring the premature liquidation of other assets.

Orange County's Use of Derivatives

We found that Orange County's portfolio was also risky because the former treasurer bought billions of dollars worth of highly volatile derivative securities.

In the broadest sense, the term derivatives is used to define any financial instrument where the value depends upon, or is "derived" from, the performance of a secondary source such as an underlying asset, reference rate, or index. There are many different kinds of derivatives and not all are bad investments for a local government investment portfolio. However, the vast majority of Orange County's derivatives were a type of structured note known as inverse floating rate notes (inverse floaters). Inverse floaters are structured notes in which the interest rate moves in the opposite direction from the underlying index, such as the London Interbank Offer Rate (LIBOR). Thus, if interest rates rise, these securities lose value and their coupon earnings fall.

By November 1994, the former treasurer's portfolio contained at least \$6.6 billion, or 32 percent, in inverse floaters. By investing substantially in inverse floaters, the former treasurer was betting heavily that interest rates would remain low or fall. However, during 1994, interest rates rose 300 basis points, causing a steep decline in the portfolio's value.

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Reckless Investment Strategies Caused \$1.69 Billion in Losses

The former treasurer's tactic of heavily leveraging the portfolio, coupled with the purchase of higher risk, interest-sensitive investments, amplified the pool's vulnerability to interest rate increases. Our investment experts employed an analytical technique called a "duration analysis" to provide a quantitative measure of the portfolio's sensitivity to a 1 percent interest rate change. Based on that analysis, our investment experts found that Orange County's portfolio was four times more risky than funds with comparable objectives. The former treasurer's high-risk strategies ultimately caused a \$1.69 billion loss to the portfolio and led the county to bankruptcy.

The Former Treasurer Also Violated His Public Trust

In addition to the former treasurer's imprudent investment strategies which resulted in losses to all pool participants, the treasurer also took certain actions that resulted in the county benefiting to the detriment of other participants. Specifically, the treasurer's office altered accounting records, which allowed the county's general fund to receive \$93 million more in interest earnings than it was entitled to receive. Further, the treasurer's office transferred securities that had lost \$271 million in market value from the county's general fund to the investment pool where all participants would share in the loss. Although these actions did not cause the bankruptcy, they are indicative of the lack of control that existed over Orange County's investment operations.

Our Review of Other County Investment Practices

In early 1995, the California Legislature requested that my office determine the prevalence of risky investment strategies for California's remaining 57 counties. To perform this audit, we surveyed the 57 county treasurers to identify various investment practices and to obtain other pertinent information. After assessing various risk characteristics contained in the initial county responses, we selected 8 counties for further review.

As of June 30, 1994, the 57 county treasurers managed a total of approximately \$29.4 billion in investment funds. In general, we found that county treasurers exercised significant discretion in their investment activities. As elected officials, each believed that they were responsible to their constituents and not their county board of supervisors or other governing body. The investment skills of the treasurers also varied, for there is no minimum set of standards or expertise required.

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Most of the treasurers had established written investment policies that emphasized safety, liquidity and yield, but none are required to report periodically to local governing boards or to investment participants on their actual investment activities, and several did not appear to be complying with their own policies. Further, none of the counties we visited utilized an investment advisory committee, although a few were considering establishing them after the audit was completed.

The results of our audit found that several county treasurers employ risky investment strategies in their management of these public funds. Specifically, seven of the eight counties we visited employ one or more investment strategies that we believe can put public funds at risk. These high-risk strategies include holding excessive concentrations of often volatile structured notes, excessively leveraging or borrowing against portfolios through reverse repurchase agreements, and investing significant proportions of their portfolios in securities with long-term maturities. Using these strategies, either alone or in concert, is inappropriate for short-term investment pools like those used by the counties because, like Orange County, they do not emphasize safety and liquidity over yield and expose the portfolios and their participants to increased risks. We found that:

- Six of the eight counties we visited held concentrations of volatile structured notes in excess of 30 percent of their respective portfolios as of March 31, 1995. Many of these structured notes were not actively traded and, therefore, are harder to accurately price and sell, typically considered less easy to convert to cash, and more sensitive to changes in interest rates that can decrease their market value;
- Four of eight counties leveraged their portfolios by more than 40 percent at some point in 1994, with one county leveraging its portfolio as much as 80 percent. Significant use of leverage dramatically magnifies the portfolio's exposure to risk; and
- Six of eight counties managed portfolios of investments with maturities averaging 2.5 years or more during 1994. The average maturity for one county's investments was an astounding 27.9 years. Throughout all of California, 27 counties had average maturities of less than one year; however, four averaged more than three years. When most of a portfolio is made up of securities with long maturities, the portfolio is much more sensitive to interest rate changes, and the treasurer's ability to meet unforeseen cash needs is diminished.

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Although we found some of the same risky investment strategies as those used in Orange County, fortunately, none of these practices were taken to the extremes that we found there. Nevertheless, the high incidence of county treasurers using one or more of these high-risk strategies is disturbing and points to the need for amending California's current laws governing local investment practices.

Security Lending by Agents

In addition, our audit of local county investment practices revealed that some counties are using agents, who in many cases also act as the securities custodians for the same counties, to execute securities lending and/or reverse repurchase transactions on behalf of the counties. Agents acting on behalf of three counties we reviewed performed hundreds of millions of dollars worth of securities lending and reverse repurchase transactions that current regulations and guidelines fail to address. Therefore, these transactions are not reported to oversight agencies and pool participants, were not reflected in the counties' financial statements or clearly disclosed in footnotes, and were not considered by the counties when determining compliance with pertinent investment laws and county policies. Moreover, we found that the investment pools of the three counties that delegate their investment authority to agents bear all the risk if investment losses occur, while the agents share between 30 and 50 percent of the profits. Finally, two of the three agent agreements we reviewed allowed the agents to buy and sell securities with their affiliates. This allowance raises questions regarding the prudence and ethics surrounding these investments.

Lessons Learned for Legislative Action

Based on our experience relating to both the audit of Orange County and our audit of the investment practices of the remaining counties, we made numerous recommendations for improving the investment practices of local governments, including recommendations requiring the amendment of current state law. We have recommended that the Legislature:

- Require written investment policies for all local entities investing public funds that are approved and adopted by their local governing body. These policies should ensure that the goals of safety and liquidity take precedence over yield;
- Establish and define a prudent person rule for the local investment officer. The prudent person rule should detail the fiduciary responsibilities vested in the investment officer and establish an expected level of expertise;

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- Limit the use of reverse repurchase agreements to no more than 20 percent of the portfolio, primarily to meet immediate or unexpected cash flow requirements, and not for reinvestment. In no case should the use of reverse repurchase agreements or other types of borrowing for yield enhancement or risk arbitrage exceed more than 5 percent of the portfolio. Further, multiple levels of borrowing should be prohibited;
- Limit the use of derivatives or other structured investment instruments and prohibit those that put principal at risk. None of these instruments are to be purchased with borrowed or leveraged funds. Further, the derivatives or structured investments purchased should be openly traded in the secondary market on a recognized exchange. Any investments in derivatives or other structured notes that increase risk to the portfolio (as measured by a duration analysis) should be limited to no more than 5 percent of the portfolio;
- Limit the average maturities of securities held in county portfolios for short-term, operating, and surplus cash investments to 2.4 years or less;
- Mandate investment reports at least quarterly to the governing body and investment pool participants that include detail of the portfolio and investment transactions during the period, weighted average maturity, current market value, duration or other similar interest rate sensitivity analyses, and yield calculation for the portfolio; and
- Include investments made by agents in statutory limitations regarding specific investments and considered when performing compliance reviews. Also, securities lending and reverse repurchase transactions executed by agents should be reported in the counties' annual financial statements and in reports to governing bodies and pool participants and that dealings with agent affiliates be prohibited.

Conclusion

I believe that if the recommendations we made as a result of our audits of county investment practices in California are implemented, we can avoid future municipal bankruptcies like the one declared in Orange County.

WRITTEN TESTIMONY OF WILLIAM J. POPEJOY

*Prepared for the Committee on Banking and Financial Services
Capital Markets Subcommittee Hearing on
State and Local Government Debt Issuance and Investment Practices*

U.S. HOUSE OF REPRESENTATIVES

July 26, 1995

Last December, I was incredulous to read that Orange County had declared bankruptcy. It lost \$1.7 billion due to a financial strategy which included extreme leverage and the use of derivatives. As a 15-year resident of Orange County and someone who has a background in finance, including derivatives, I was astounded and angry that my County had been allowed to "bet the bank." I wondered how a County government could get itself into such a mess. And while financial leverage and the use of derivatives might be acceptable for high-risk portfolio managers, such strategy had no place where the public tax money was involved.

In a County of more than 2.5 million people and a form of government more than 100 years old, how could this disaster occur? Our County Treasurer had been on the job over thirty years and was lauded throughout the state for his performance. How could he pursue such a reckless and ill-fated investment program? And how could the senior governing body -- the five elected Supervisors of Orange County -- allow this foolishness to take place? Where were the other supposed safeguards, i.e. auditors, advisors, attorneys, rating agencies, and the investment banking community? Well, there were -- and still are -- many unanswered questions.

After liquidating its risky portfolio and reinvesting in low-risk securities with no leverage, the County Board of Supervisors sought the services of an interim Chief Executive Officer (CEO).

On February 21, 1995, I was designated as the County's first CEO and given broad powers to manage the County and develop a bankruptcy plan of recovery.

Working with County employees, outside experts, and a large number of volunteers (who were also experts in their fields), we quickly put in place:

1. An employee (including bargaining units) communication program;
2. Community communication program;
3. Administrative office restructuring (from 92 to 31 employees);
4. Accepted and/or prompted resignations of six members of senior management;
5. Eliminated a "flex-time" four-day work week;
6. Eliminated reserved parking (parking was established on a first come-first park basis);
7. Conducted an assets sales program (primarily real estate);
8. Merged two large agencies;
9. Conducted a layoff of about 1,000 employees;

10. Established major outplacement program (including counseling and job placement);
11. Cut the County Discretionary Budget by 41 percent (from \$463 to \$275 million);
12. Pushed through a difficult to achieve self-help state legislative package;
13. Negotiated a complex investor (schools, cities, etc.) settlement agreement with over 190 entities, for an amount of approximately \$5.1 billion;
14. Issued crucial Recovery Bonds to help insure up to 90 percent repayment to our schools;
15. Established a task force to determine the feasibility of selling the County-controlled airport;
16. Commenced negotiations with a major litigation defendant for possible settlement;
17. Implemented changes intended to move three major waste disposal facilities controlled by the County from operating at losses to generating a profit;
18. Proposed a Bankruptcy Recovery Plan to the Board of Supervisors which was approved unanimously by them. The centerpiece of the plan was a 1/2-cent sales tax increase proposed for the County.

This tax increase was overwhelmingly defeated by the voters on June 27, 1995.

On June 29th, the Board of Supervisors decided to reinvolve themselves in the County's management and to "rein in" my responsibilities. They basically changed the job for

which I was hired. While disappointed, because I felt such change would be a return to the management approach which helped create our problems, I respected the Board of Supervisors' right to change my job.

On July 6th, we completed negotiations with our short-term bondholders (principal amount outstanding of approximately \$812 million) for a one-year extension to pay our debt.

Once the breathing room of the one-year extension had been achieved, I resigned from the County, effective August 1, 1995. I indicated a willingness to serve the County in the future as an unpaid consultant, but did not feel I could be effective leading the County's recovery in my now reduced and restructured role.

Here are some of the things I've learned during my time with the County:

- A CEO with private sector experience can help make a great deal happen in government.
- Government workers can and will accomplish much if treated with respect and given an opportunity to do their jobs.
- Don't ask citizens to approve a tax increase until their sense of betrayal subsides and they are convinced that fundamental changes have occurred to avoid what they believe caused the problem.

- Change the organization of Orange County government from its current form of five Supervisors (each, in effect, a CEO) with an elected Treasurer, Assessor, and Auditor-Controller none of whom are directly supervised by the Board of Supervisors -- to a functional organization that is more conducive to accountability and that is based on ability.
- Require high standards of ethics and responsibility of those who do business with government entities for the ultimate burden of a "buyer beware" business approach falls on the taxpayers.
- Bankruptcy for a county government seems like a poor substitute when compared to the parties involved voluntarily getting together and working out a 100 percent plan of recovery.
- I am confident that the people of Orange County will develop a program in which their debts are honored. This will be done not only because it is in our economic best interest, but it is the right thing to do.
- Most importantly, as citizens, we must watch, participate and vote on the manner of our government's conduct. I fear what we have experienced in Orange County may be a "sneak preview" of what other counties in California may be facing in the future.

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STATEMENT
OF
SUPERVISOR GADDI H. VASQUEZ
TO THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
GOVERNMENT SPONSORED ENTERPRISES.

JULY 26, 1995

Mr. Chairman and Members of the Committee:

My name is Gaddi Vasquez and I am the current Chairman of the Orange County Board of Supervisors and I thank you for the invitation to participate in today's hearing.

As you know, on December 6, 1994, Orange County, California, filed for protection under chapter 9 of the bankruptcy code in an effort to stabilize a fiscal crisis that threatened the economic stability of our county. We are now experiencing one of the most difficult times in our county's history by virtue of the financial collapse of the Orange County Investment Pool and the loss of \$1.7 billion to the pool. All of the county's funds were deposited in the Orange County Investment Pool and suffered a loss of \$650 million. The school districts, special districts, and cities who invested lost \$1.05 billion. The consequences have included a dramatic reduction in the county budget as well as the reduction and/or elimination of services.

In order to put some of my comments into perspective, I would like to give your committee a brief overview of the Orange County Investment Pool's history. The pool was established and managed by the Orange County Treasurer-Tax Collector who was an independently elected official and had served in the same elected office for over twenty years. During his tenure, he had established a long track record of performance and had been recognized by many professional organizations for his accomplishments as Treasurer-Tax Collector of Orange County. His record of high yields made the Orange County Investment Pool an attractive opportunity for public agencies. His record of performance prompted jurisdictions outside of Orange County to participate and some public agencies even borrowed amounts above their available resources for the expressed purpose of investing in the pool.

Eventually 190+ agencies became pool participants. Most of them had elected governing boards and professional experts who reviewed the portfolio's performance. In addition, the portfolio was audited by an independent outside auditing firm on an annual basis and rating agencies had historically given Orange County bonds high ratings thus creating a basis for confidence and trust in the performance and management of the pool.

In late 1994, the Treasurer-Tax Collector announced that the pool had suffered a "\$1 billion paper loss." That "paper loss," however, represented a genuine loss in value and evolved into the financial crisis of 1994.

On December 6, 1994, the Orange County Board of Supervisors met and evaluated all of the options that were available and determined that a chapter 9 filing was the only real option available to the county. To do otherwise would have compounded the crisis and made our situation worse.

Since December, we have made many advances toward resolution while recognizing that many formidable and difficult challenges remain. The first major step was the liquidation of the remaining assets of the investment pool.

Our second major step was achieving a pool settlement on the distribution of the remaining funds which totaled \$5.9 billion. The plan was submitted to and approved by the federal bankruptcy court on May 2, 1995.

The settlement essentially provided for school pool participants to receive .90 of each invested dollar in cash, a subordinated claim in the Orange County case for the .10 remainder plus interest earned since the pool resolution and non-school participants to receive .80 of each invested dollar in cash. In addition, non-school participants received a senior claim of .09 cents on the dollar and subordinated claim of .11 cents on the dollar plus interest earned since the pool restructuring.

Most recently, on July 7, 1995, we were able to achieve a debt roll-over of all the county short term debt to June 30, 1996 in order to give the county time to develop options and alternatives for repayment of the bond debt.

But now the County of Orange faces the task of reducing its budget in order to meet obligations and to provide services to the residents of Orange County. We have partially achieved that through budget reductions totaling \$185 million. Our workforce has been reduced by 1,488 employees. This has been achieved by layoffs, deletion of budgeted positions, retirees and voluntary terminations. We have reduced our county general fund budget of \$460 million per year to a proposed budget of \$275 million for fiscal year 1995-96.

We have engaged in the sale of county assets such as lands and buildings. We are negotiating agreements for importation of solid waste which would create a new revenue stream and the Board of Supervisors placed a 1/2 cent sales tax on the ballot which was overwhelmingly rejected by the voters on June 27, 1995.

The county is working with the legislature and other counties who are also facing financial difficulties to obtain relief from unfunded mandates. The state legislature has already been helpful in passing legislation that has given us some relief but much work remains to be done.

In California, counties have been subjected to enormous reductions in revenue and we have struggled to make ends meet while trying to maintain the levels of service that constituents have come to expect. Thus, bond financing, borrowing, and investing has been a necessity that had been managed with skill and accomplishment.

Until late 1994, there were no significant indications that the Orange County Investment Pool was in jeopardy. No public agencies had raised concerns that management or stability of the pool was in

jeopardy and those who we relied on to give us ongoing appraisals did not raise any form of notice that the pool was going down a destructive path. That all changed in early December.

Once faced with the facts and realities of the crisis, the Board of Supervisors viewed the filing of chapter 9 as the absolute last option in order to avoid an outright financial meltdown of the investment pool and the county budget. I can assure you there are no incentives to file for chapter 9 and in fact the negative standing that a jurisdiction faces is a great disincentive. However, in our case, we had exhausted all other options.

As I stated earlier, the legislature has held extensive hearings on the issue of the Orange County bankruptcy and proposals are being advanced to reform the functions and latitude of county treasurers. I believe that when it is all said and done, there will be dramatic reforms in California that will protect against the type of crisis we now face and prevent a recurrence.

At the county level, we have now established an investment oversight committee which is refining the investment policies of the county and redefining the disclosure requirements of the investment

practices. While still in the final draft stages, the policies proposed will dramatically change the practices of the Treasurer-Tax Collector's Office.

The county is also evaluating the merits of asking the voters of Orange County to convert our county from a general law county to a charter county form of government. The latter would give the Board of Supervisors and more importantly, the people, a greater say in the governance of the county and could change the status of elected officials such as the Treasurer-Tax Collector from an elected to an appointed position.

We have separated the audit function from the Auditor-Controller's office which had responsibility for auditing the activities of the Treasurer-Tax Collector. This is now a separate function of county government independent and led by a different person.

But one major factor that must be pointed out is the role of the Treasurer-Tax Collector. He was an elected official who was charged with the responsibility of overseeing, managing, and administering the pool. It has since been determined that he violated his own

investment policies and that he willfully and intentionally misrepresented reports and facts to the Board of Supervisors and to pool participants. On April 27, 1995 he pled guilty to six felony counts in a California court and additional legal proceedings are still pending. So while there is need for change and reform, it is important and relevant to point out that part of the problem was created by the misconduct of an elected official who had been entrusted by the voters to adhere to the laws of the state and as well as the county investment policy. He violated both.

As a county, we will move forward by developing options to address the longer term issues of debt repayment which remains a goal of the county. We have recently issued recovery notes that are secured by an intercept program of vehicle registration fees that will be used to repay the debt and we continue to work with the legislature and the Governor's Office to develop a workable strategy.

Mr. Chairman, I thank you for this opportunity to address your committee and would be pleased to answer any of your questions to the best of my ability.

TESTIMONY OF

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BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
GOVERNMENT SPONSORED ENTERPRISES

COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON:

THE ORANGE COUNTY BANKRUPTCY AND ITS AFTERMATH

JULY 26, 1995

1. Mr. Chairman, thank you for the opportunity to address the Subcommittee on the subject of Orange County's bankruptcy and its aftermath. With your permission I have attached a bibliography of my selected publications on the bankruptcy, the proposed sales tax hike, and what should come next for Orange County.

2. I am an Associate Professor of Political Science at the University of California, Irvine where I have taught and studied politics since 1984. I have also been a faculty member at the University of Chicago, Amherst College, and Beijing University in the People's Republic of China. I hold an A.B. in government from Cornell University (1977) and an A.M. (1979) and a Ph.D. (1986) in political science from the University of Chicago.

3. Mr. Chairman I have responded to the questions posed in your letter of invitation to testify before this Subcommittee, dated July 13, 1995, within my area of expertise. I will focus most of my remarks on the recently defeated sales tax proposal in Orange County per your suggestion.

SUMMARY STATEMENT

4. Let me begin by emphatically noting that Orange County is not bankrupt. Though still struggling to emerge from a five-year recession, the economy of Orange County is reasonably healthy with future prospects for growth cautiously optimistic. The government of Orange County however is bankrupt and in more ways than one. Not only is county government bankrupt in the amount of \$1.7 billion, but county government is politically bankrupt as well. Indeed, Mr. Chairman, a crisis of political legitimacy plagues and disables Orange County every bit as much as the current fiscal crisis.

5. Orange County's financial troubles cannot be understood without an appreciation of the feudal political structure which characterizes the county's political regime. The concentration of political power in the hands of wealthy developers, landowners, financiers, and self-appointed king-makers coupled with the absence of any countervailing source of political power made Orange County's bankruptcy much more likely and makes it's recovery far more difficult.

6. Let me turn my attention to the proposed sales tax which voters defeated 61% to 39% on June 27th. Back in January of 1995, if not earlier, members of the elite Business Council in Orange County, led by Gary Hunt, Vice President of the Irvine Company and George Argyros, President of Arnel Development--started talking about raising the sales tax as a response to the bankruptcy. This, well before Mr. Popejoy volunteered to join the county in the newly created position of Chief Executive Officer.

7. There is a strong aversion to taxation in Orange County which was immediately evident in polls conducted for the Los Angeles Times starting in late December of 1994. However, it's important to note that on two occasions in just the past five years county voters have supported increases in the sales tax when they were presented with very specific, iron-clad expenditure targets and guarantees. That they were not prepared to support Measure R--the proposed half-cent increase in the county sales tax--is neither surprisingly nor lamentable.

8. Like most Americans, if the polls are believed, Orange Countians are reasonably suspicious of government. Perhaps even more so than most Americans given the local political culture. Specifically they are concerned about the size of government relative to the private sector, the functions provided by government in relation to those which could be provided by the private sector, and the representativeness, honesty, and integrity of government officials.

9. As soon as the Board of Supervisors unanimously called for a June 27th special election to consider Measure R, Orange County voters began asking why alternatives to a sales tax increase weren't being pursued first. They kept asking this question throughout the three month campaign. The answers they received from the proponents of the tax hike were obviously not very persuasive.

10. None of the money to be raised by Measure R was earmarked for any specific purpose--not for public education, nor for health care, the elderly, public safety, or even repayment of bondholders and creditors. Consequently, a yes vote on Measure R required voters to have trust and faith in the current Board of Supervisors and the structure of political power within which the Board functions to spend the \$140 million raised annually by Measure R wisely.

11. Unfortunately, Mr. Chairman, as I argue below in greater detail, the Orange County electorate is plumb out of trust and faith in the Board of Supervisors. Four months after the bankruptcy a poll conducted for the Los Angeles Times showed that fully 87% of Orange County voters thought the Board of Supervisors was doing only a fair or poor job responding to the financial crisis.

12. Orange County voters are not deadbeats, arrogant, or irresponsible--as the national and local press have been so quick to allege--for voting against Measure R. No. The defeat of Measure R was a completely rational response by the electorate to a proposed new revenue stream which the Board of Supervisors could not be trusted to spend. After-all, Mr. Chairman, by their own admission the Orange County Board of Supervisors did not know that they had the statutory authority and responsibility to supervise

the County Treasurer until reporters from the Orange County Register told them so.

13. In its infinite wisdom, Measure R was the only measure placed on the June 27th ballot by the Board--an election which cost the taxpayers approximately \$800,000. Voters were denied any other electoral opportunity to express their rejection of county government and the people running it. Knowledgeable voters, with ample time and opportunity to weigh the merits of the case for and against the proposed sales tax hike came to a rational deduction. The case was not sufficiently made or validated that despite what the developers wanted a sales tax was the only viable recovery option. Moreover, voters--Republicans and conservatives, Libertarians and Democrats (yes, there are Democrats, like myself who live in Orange County)--were convinced that various disadvantages associated with an increase in the sales tax did not outweigh the reputed benefits.

14. Measure R was as much a referendum on county government as it was a proposal for recovery from bankruptcy. The electorate sent a very loud message to the Board of Supervisors who have, in my estimation, yet to hear and/or fully comprehend it. One of the first actions taken by the Board after June 27th was to diminish the authority given to Bill Popejoy as county CEO. In response, Mr. Popejoy has honorably tended his resignation and will be leaving the county on July 31st.

15. Ironically, even though Mr. Popejoy was the most visible proponent of Measure R--only one member of the Board, Supervisor Marian Bergeson actively campaigned on behalf of the measure--he is probably the only person in the county right now with the stature and respect to bring all sides of the Measure R debate together for the purposes of crafting a new recovery plan. With Mr. Popejoy's precipitous and provoked departure the crisis of political legitimacy will continue. So long as it does, the county will have a very difficult time recovering from its financial plight. This is one of the reasons, even conservative groups in the county have started to look favorably upon a proposed state-trusteeship.

WHY DID COUNTY GOVERNMENT GO BANKRUPT?

16. By now just about everyone in the country is familiar with the investment strategy which precipitated Orange County's financial catastrophe. The county was put in this precarious financial situation through leveraged investments in interest-sensitive derivatives. When the Federal Reserve Board started to raise interest rates the county was caught short. It had to pay more on what it borrowed than it was earning and the general value of its bond portfolio started to fall. On December 6th, the county defaulted on a \$1.2 billion loan and the Board of Supervisors claims it had little choice but to file a Chapter 9 bankruptcy to

protect the county's \$20 billion investment portfolio from a \$12 billion debt. The county has lost \$1.7 billion, not including enormous expenditures on consultant, accounting, and attorneys fees associated with what's taken place after December 6, 1994.

17. Two aspects of the Board's filing for Chapter 9 bankruptcy protection are worth noting. First, the day after more than 200 investors in the Orange County Investment Pool (OCIP) received their first payment from a behind-closed-doors "negotiated" (some have said coerced, see "Ricky Young and Kim Christensen, "Deal Behind Closed Doors," Orange County Register, April 9, 1995, pp. 1 & 24) settlement agreement, U.S. Bankruptcy Judge John E. Ryan ruled that the \$5.7 billion pool was ineligible for bankruptcy (see Ronald Campbell, "Judge: Pool's bankruptcy inappropriate," Orange County Register, May 25, 1995, pp. 1 & 24). Second, the consulting firm that initially discovered the county's investment losses had presented a "platter of alternatives" to bankruptcy on December 6th, but its advice was ignored. As usual, the Board of Supervisors responded to this revelation in February of 1995 by saying that they were never told of these options (see Jim Mulvaney, "Did O.C. have to go bankrupt?" Orange County Register, February 18, 1995, pp. 1 & 18).

18. However, we're less comfortable explaining why the county and many local governmental bodies were willing to make and take such risky investments in the first place.

19. The conventional explanation is plain, old-fashioned greed. Indeed, the portrait of Orange County painted by the press is of a place brimming with yachts, palm trees, well-manicured lawns, BMWs, and Spanish-tiled homes with spectacular ocean vistas. Clearly, a distorted image of the county as a whole. But, ironically, not inconsistent with the image the county has worked so hard to fashion and market. Daily life in Orange County is supposed to be "another day in paradise." That so many people around the country might now take some Faustian delight in the loss of paradise here is understandable.

20. To some extent "greed" works as an explanation. But it's not a very complete or penetrating account. It ignores some of the palpable conditions which both necessitated and encouraged this high-risk gamble--not as justification, but as explanation.

21. To begin with, there have been serious pressures on the county and local governing entities in California to raise funds for general operating purposes. At the same time, their ability to do so has been seriously constrained. Pressure came from residents, the state, and developers. Orange County residents expect a high level and wide range of services from their government. Expectations are as high as home prices and apartmental rentals in many quarters of the county.

22. However, during the last five years, government coffers have been hit hard by the recession. Tax revenues declined, but the public demand for the promised "quality of life" in paradise did not waver. To make matters worse, the state has been siphoning off an escalating share of local tax dollars to pay its own bills; due to the state-wide recession, federal spending mandates, state mandated expenditure categories, and budgetary bumbling. [This, in addition to the fact that Orange County is a net tax exporter to the state government, receiving far less in revenue from the state for municipal government and school districts than it contributes.] Consequently, governing bodies--from school boards and municipalities to water districts and transportation agencies--had less money to make financial ends meet.

23. Meanwhile, Orange County's developers were lobbying the county for funds to build the infrastructure necessary to make possible the new construction of homes, retail centers, and commercial office space. Developers in Orange County along with their organized special interests, who help fill the campaign coffers of most elected officials, can be very persuasive. In fact, the expenditure of county funds to build the roads, sewers, utilities, etc., as a stimulant for development was also viewed as essential to the county's economic recovery. Keynesian economics is alive and well in Orange County--for the right price.

24. Where were the needed funds to come from? Two constraints made it very difficult to raise funds the "old-fashioned way" through tax increases, assessments, or user fees. First, Proposition 13 makes raising property taxes very difficult, since approval requires support from two-thirds of the voters. A few jurisdictions tried to raise parcel taxes; some came close to the two-thirds mark, but none made it. Second, leaving Prop. 13 aside, few elected officials in the county have the political courage to advocate any sort of tax hike. Orange County voters are tax averse. Elected officials advocating a tax increase could face a recall attempt and would certainly face trouble in the next election. Indeed, three members of the Fullerton City Council were recalled in 1994 for raising the utility tax.

25. Consequently and not surprisingly, most officials throughout the county were very satisfied with the returns their jurisdiction received from the county's investments. It meant they could continue to meet their financial obligations without having to go before the voters and ask for tax increases. Officials were so satisfied with the returns from Citron's magical investment portfolio that many borrowed even more money to invest. In the "master-planned" community of Irvine, for example, the school board borrowed \$54.5 million in June of 1994 and the city council borrowed \$60 million in July of 1994 to add to what they had already invested with the county.

26. In truth, almost no one in the county, save Bob Citron's

opponent in the June election and a few leaders of the County's GOP, had an incentive to challenge this risky investment strategy, least of all the Board of Supervisors. As long as the investments were paying handsome dividends all was well, until the roof caved in at the Hall of Administration.

27. The county's risky investment strategy could be viewed as both an economic and political necessity. But it was also induced or permitted by the local culture of risk-taking. Risky economic ventures are common place in Orange County. The people who take them are highly regarded and well rewarded for their success. The county is filled with individual entrepreneurs willing to gamble their own money (and often the investments of others) on a new idea, product, or strategy. Though it's not the only place in America where the entrepreneurial spirit is still alive and well, it's one of the few places where the culture of risk-taking defines private economic life for so many people.

28. It should come as no surprise that this same attitude would permeate the public sphere, as in fact it did. The former county treasurer, Bob Citron, wasn't the only risk-taker around, he was joined by countless elected and appointed officials throughout the county who gambled the public purse and rode the revenue stream of county investments. Throughout the ride, Orange County's famous fiscal conservatives were content to put ideology aside in favor of big cash returns on the derivative market.

29. For years to come we'll all be paying for the county's past financial success, a lack of careful oversight, the absence of political courage, and the consequences of what happens when the entrepreneurial spirit gets the better of public officials.

WHY WAS MEASURE "R" DEFEATED?

30. The voters of Orange County have been unfairly maligned by the national and in some cases the local press for overwhelmingly rejecting a proposal--Measure "R"--to tax the county out of bankruptcy. Orange County voters have been called "irresponsible," and "arrogant," the outcome of the vote on Measure R has been referred to as "embarrassing," and the county has been characterized as "deadbeat" and "cultist."

31. With all due respect, these commentators and editorial writers--most of whom have spent little time living behind the "Orange Curtain"--don't understand why the defeat of Measure R was a rational and prudent reaction by the voters of Orange County. I've attempted to offer such an explanation above.

32. Measure R went down to defeat for one over-riding reason: Voters have lost nearly all trust and faith in the Board of Supervisors and the structure of county government. That membe

of the Board of Supervisors have yet to realize this problem only exacerbates the loss of legitimate governing authority. Orange County government maybe financially bankrupt, but it is politically bankrupt as well. Unfortunately, the latter makes any publicly approved solution to the former tenuous at best. The evidence for this conclusion is abundant.

33. Support for county government in Orange County has been collapsing for some time, as evidenced by data presented in the Orange County Annual Survey prepared by Mark Baldassare, PhD of UCI. Additionally, recent surveys conducted by Baldassare for the Los Angeles Times evidence the collapse in public support for the Board of Supervisors.

34. Prior to the bankruptcy in May of 1994 a survey was conducted which asked Orange County voters to rate the Board's handling of various areas of government in the past few years. Fostering the county as a place to do business? 40% responded excellent or good. Providing overall leadership? 31% responded excellent or good. Maintaining integrity and high ethical standards? 29% responded excellent or good. Representing the views of local residents? 27% responded excellent or good. All of these responses were down considerably from the same survey questions posed to voters back in 1988 (see Kevin Johnson, "Few Voters Have Confidence in County Leaders," Los Angeles Times, May 31, 1994, pp. A1 & A16).

35. Immediately following the bankruptcy in December of 1994 survey respondents were asked to rate the job performance of Orange County's Board of Supervisors in handling the county's financial crisis. Only 21% responded excellent or good. Four months later voters were polled again and the percentage responding excellent or good had dropped to 13%--with fully 48% of the respondents saying the Board was doing a poor job (see Mark Platte, "Most Opposed to Hiking Sales Tax," Los Angeles Times, April 11, 1995, pp. A1 & A18).

36. Just a few weeks before the defeat of Measure R another poll was taken. Supervisor Marian Bergeson received the highest job performance rating for a Board member, with a score of 19% saying she was doing an excellent or good job. Next, Supervisors William Steiner, Jim Silva, and Gaddi Vasquez received an 11% rating of excellent or good, and Supervisor Roger Stanton received a 9% rating for doing an excellent or good job (see Jodi Wilgorn, "O.C. Sheriff Trains Sights on Bankruptcy," Los Angeles Times, July 10, 1995, pp. A1 & A12).

37. There were many reasons advanced for the adoption of this sales tax hike, some of them potentially persuasive. But nothing could overcome the prevalent public sentiment that given the current composition of the Board and construction of county government, a new sales tax would amount to throwing more money

after bad. No amount of money spent by the proponents of Measure R could overcome this fundamental problem.

38. The campaign for Measure R was led by Mr. Popejoy along with O.C. Sheriff Brad Gates, and Supervisor Bergeson along with the League of Woman Voters, the California Teachers Association (CTA), the editorial board of the Los Angeles Times, the O.C. Employees Assn. (OCEA), the Democratic Party of Orange County, and various developers, landowners, and corporate executives. The campaign for Measure R was lavishly funded by the Irvine Company, Charles Schwab Corp., the CTA, OCEA, Walt Disney Co., Rockwell International Corp., Boston Co., Pacificare Health Systems, Chevron USA, Rancho Santa Margarita Joint Venture, and the Orange County Building Industry Assn. among others (see Debra Vrana, "The Tax Team," Los Angeles Times, June 11, 1995, pp. D1 & D6).

39. The case for Measure R boiled down to four major arguments: (A) There is no other viable alternative; (B) There is no time to try any other option; (C) The proposed hike in the sales tax won't cost consumers very much money; and (D) We have a moral obligation and responsibility to pay the county's debts.

40. The campaign against Measure R brought together a very diverse group of participants. Led by the Committees of Correspondence and Bruce Whitaker, the campaign against the tax was joined by the Lincoln Club, the O.C. Republican Party, the O.C. Libertarian Party, the Chairman of the O.C. Democratic Party (Jim Tolendano), United We Stand Orange County, leaders of Asian and Latino community organizations, small businessmen, automobile dealers, and prominent opinion leaders from the far right (e.g., GOP activist Buck Johns and former State Assemblyman Gil Ferguson), center-right (e.g., local attorney and talk show host Hugh Hewitt) and left (e.g., former Irvine Mayor Larry Agran and myself) along with the editorial board of the Orange County Register.

41. Most municipal officials in the county opposed Measure R, while a slim majority of school board members supported the tax proposal. Every member of the county's state legislative delegation opposed Measure R. Three members of the Board of Supervisors (Bergeson, Vasquez, and Steiner) supported the tax hike, but only Bergeson actively campaigned for it. The two other members of the Board (Silva and Stanton) eventually came out against the tax proposal. Not surprisingly, Governor Pete Wilson took no position on this controversial issue.

42. During the three month campaign over Measure R there were an astounding number of public debates and community forums (close to 200 by my estimate) held on the tax measure throughout the county. Polls conducted during this three month period showed that voters were very aware of the issues involved.

43. The case against Measure R varied depending upon the

speaker and the event. The case against Measure R made by Republicans, conservatives, and libertarians tended to focus on the need to reduce the size, scope and expense of county government first, the economic impact of a tax hike, the availability and viability of other non-tax options, the lack of accountability for the expenditure of funds raised by Measure R, and the inequity of a single-rate tax hike along with other arguments designed to capitalize on the anti-government fervor of the electorate.

43. There were also sound, non-emotive reasons for liberals, progressives and Democrats throughout the county to oppose Measure R. Some of these were as follows:

44. (1) Measure R contained no expenditure guarantees. Not a dime of the funds raised by Measure R was targeted for expenditure on schools, children, health care, or public safety. All claims made to the contrary by the proponents of Measure R amounted to wishful thinking and political rhetoric. Voters who read the measure understood this and refused to be hoodwinked once again.

45. (2) Measure R did nothing to realign the county's penchant for privileging pavement over people in the expenditure of public funds.

46. (3) The case for a tax hike was never substantiated. Measure R certainly constituted a way to approach recovery from bankruptcy. However, it was never shown--beyond rhetorical claims, that all other revenue-generating or revenue-savings options could not be pursued first. The hesitancy of the Board to take any decisive action along these lines fueled the widespread public perception that a vote for Measure R was a vote to keep county government that way its been. Given the widespread distrust of county government this was hardly a compelling reason to support a new tax.

47. (4) Like all sales taxes, Measure R was regressive. It would have placed a larger burden on the shoulders on the poor and middle classes for recovery, as a function of the higher percentage of income expended by these groups on taxable goods. Not surprisingly, there is a clear correlation between income and the vote on Measure R. The higher the income the more likely a vote for Measure R and vice versa.

48. (5) Measure R was also inequitable. Everyone would have to pay the new tax to help bail out the county. However, the losses suffered by the Orange County Investment Pool were not distributed equally.

49. (6) Measure R was fundamentally unjust since it asked those citizens in Orange County who benefited least from Bob Citron's risky investments to pay a larger percentage share of the

recovery costs.

50. (7) Measure R contained insufficient expenditure safeguards. The Oversight Committee proposed in Measure R was an empty shell. It lacked the legal authority to audit county expenditures and was not given the legal power of subpoena. In short, the Oversight Committee--which was included in the Measure R no doubt to allay fears about the Board of Supervisors--contained insufficient enforcement capacity to calm anyone's nerves about giving the Board another \$140 million annually for the ten years to spend as they pleased.

51. (8) Measure R could be counter-productive for a healthy economy. First, it might slow or stifle economic growth. Small businessmen throughout the county certainly thought so. Second, by encouraging individuals to shop outside of Orange County in lower or comparable sales tax jurisdictions, the county could actually end up losing more total sales tax revenue than it would gain from increasing the tax.

52. (9) Measure R is not a particularly reliable revenue stream. If the fate of Orange County's recovery hinges on a new revenue stream, then it probably shouldn't be a sales tax. Sales tax revenue rises when economic times are good, but when times are bad, sales tax revenue plummets. There's been a great deal of experience with the latter phenomenon throughout the county during the last five years. Consequently, if a new revenue stream is what the county needs, it shouldn't pin its hopes on one which is so elastic and subject to economic uncertainty.

53. (10) Finally, nothing contained in Measure R would fundamentally alter the structure of decision-making at the County Hall of Administration or the distribution of political power in Orange County. Voters understood that a vote for Measure R was a vote to preserve the status quo. Absent any substantial evidence that the current structure of decision-making or the distribution of political power in the county was undergoing significant change, voters rationally, in my view, rejected the tax as the only opportunity given to them by the Board of Supervisors for an expression of public sentiment.

54. In the final analysis, a majority of Republicans, Independents, and Democrats in the county voted against Measure R. Out of 31 cities in the county, in only two--Newport Beach and Laguna Beach--did a majority of voters support the proposed tax hike. A cursory inspection of the election results show that income, education, and partisanship were linked to the vote on Measure R. While Measure R was trounced almost everywhere in the county it came close to winning or actually won only in highly affluent, highly educated, more Republican neighborhoods (see Ronald Campbell and Ernie Stone, "Tax foes far, wide," Orange County Register, June 29, 1995, p. News-22.

WHAT ARE THE IMPLICATIONS OF ORANGE COUNTY'S BANKRUPTCY FOR FEDERAL POLICY?

55. Mr. Chairman, as a social scientist I am reluctant to reason from a single case to broad conclusions. Indeed, there is significant danger in designing legislation or changing public policy in reaction to Orange County's financial debacle and I would caution restraint in doing so.

56. In general terms, I am not sure there is any need for an affirmative federal response to the Orange County bankruptcy. What went wrong in Orange County has much more to do with California's current political and economic morass, the distribution of political and economic power in Orange County, and the local political culture than with the absence of federal legislation. Orange County's legislative needs are being and have been appropriately addressed to the state legislature.

57. Nevertheless, Mr. Chairman, I do have a few preliminary recommendations and words of advice to offer which are related to the federal government.

58. First, Congress should move slowly in transforming all or most important federal service programs into bloc grants for state and local governments. Had the Board of Supervisors had the authority to tap into the \$3 billion of the county's budget which comes to it with federal and state strings attached I have every reason to believe they would have done so after December 6th--to the authentic detriment of a great many Orange County residents. Should similar financial crises occur at the state or local level around the country, governing bodies should not be able to raid programs funded by federal tax payers and designated for very specific purposes.

59. Second, Congress should not gift the El Toro Marine Base to Orange County in response to the county's current financial plight. Here I am referring to legislation that's been proposed in the House by O.C. Congressman Ed Royce and supported by O.C. Congressman Dana Rohrabacher. As you know, the El Toro Marine Base has been scheduled for closure in 1999. However, it belongs to the federal government and revenue generated from its sale to the highest bidder, as Congressman Christopher Cox has proposed, should go into the federal treasury. Goodness knows, the federal deficit is at least a tad more compelling than Orange County's.

60. Third, I would strongly counsel against any effort to outlaw or regulate the use of derivatives as an investment instrument. Derivatives didn't cause Orange County to go bankrupt; an over-reliance upon them as a revenue-generating mechanisms (for reasons detailed above), along with bad advice by those paid to serve the county and the utter lack of appropriate oversight by the Board of Supervisors is what precipitated Orange County's financial

debacle. However, there is certainly a need for legislation, probably at the state level, which severely constrains the ability of public authorities to gamble with the public's money. We have ample opportunity for gambling to throughout California and in nearby Nevada. There is no good reason public officials should be gambling with public tax dollars. Legislation which enables such should be promptly revoked and policies at the state level establish to prevent its reoccurrence. Remember however, gambling loses are not the only cause of impending governmental bankruptcies as the case of Los Angeles County certainly suggests.

61. Fourth, the one area where greater federal activity seems appropriate relates to the Securities and Exchange Commission. The capacity and propensity for investigation of bonds relating to the provision of municipal services, school districts, new residential and commercial development, and the privatization of formerly public services (such as tollroads) must be encouraged and enhanced. With shrinking dollars for the direct funding of public projects, governments will increasingly turn to the private sector for bond funding. The issuing of these bonds and their linkage to the public purse must be carefully scrutinized. There are innumerable special districts in Orange County that have one to the bond market as a way of funding various projects which are largely beyond public scrutiny, even though the good faith of the public purse is often invoked to guarantee future payment.

62. In closing, Mr. Chairman, let me thank you and your staff of the Subcommittee for providing a forum to discuss the Orange County bankruptcy which is far more open and inclusive than one likely to be found back in Orange County.

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Testimony of
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Governmental Sponsored Enterprises
of the Committee on Banking
and Financial Services
U.S. House of Representatives

July 26, 1995

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Introductory Remarks

Thank you for the invitation to testify at this hearing on state and local government debt issuance and investment practices.

For the record, I should note that several weeks after Orange County, California filed for bankruptcy, it retained my firm as its bond counsel until December, 1994 and accordingly, I have confined my remarks to those not affecting my attorney/client relationships.

As a senior partner in the national public finance law firm of Hawkins, Delafield & Wood, I bring to this hearing 31 years of professional practice advising state and local issuers and the accumulated experience of my firm over the past 100 years. Hawkins, Delafield & Wood is one of the very few law firms in the United States whose practice is devoted almost exclusively to municipal financial services. We currently have more attorneys engaged in the full-time practice of public finance and municipal transactions law than any other firm in the country. The firm has served as Bond Counsel, Special Tax Counsel and Counsel to Underwriters in connection with tax-exempt and taxable municipal financings in most states in the United States from Maine to Hawaii (both before and after statehood) and from Alaska to Florida and including the District of Columbia, Puerto Rico and the Virgin Islands.

My specific credentials for this hearing include serving as Bond Counsel in the conception, enactment and execution of successful solutions to municipal fiscal distress in New York, Connecticut, Ohio and Michigan and familiarity with solutions to other municipal distress circumstances such as in Philadelphia,

Pennsylvania and Chelsea, Massachusetts. My experience includes the creation and financings of the Municipal Assistance Corporation for New York City and the Special Finance and Budget Act for the City of Yonkers, and most recently assisting with the Municipal Assistance Corporation in Troy, New York and special legislation involving Bridgeport, West Haven and Jewett City in Connecticut, as well as the development and drafting of P.A. 93-421 respecting Assisting Connecticut Communities Seeking Economic Stability legislation. (See Exhibit A)

Mr. Chairman, the many questions set forth in your letter to me of July 14th are all very important questions for the municipal financial community and I sincerely hope that during your two days of hearings and from the work that will follow, consensus direction can be developed. For the record and based on my expertise and experience, I have provided my specific short answers to the questions after these introductory remarks.

As we all know, there is in fact a fundamental distinction between bankruptcy by a corporate and municipal entity, especially a municipality with general taxing power and general public service responsibilities such as police, fire, judicial, road, sewer and water services. Municipal corporations, such as counties, cities, towns and villages are different from private for-profit corporations because their business is providing public services and their "stockholders" are their respective taxpayers. It should be clear to all that the only asset of such a municipal corporation

of significant importance to its creditors and bondholders is its tax base.¹

Some public services may be provided by "enterprise funds", such as airports, solid waste disposal, electric power facilities, and, occasionally, water and sewer facilities. The source of revenues for "enterprise funds" is generally derived from rates and charges imposed on users of such facilities based on revenues derived from use rather than from general taxing powers. While the character of such entities is perhaps more similar to the character of private corporations, the significant difference is that the functions and uses of such facilities are intended to achieve fundamental public uses and purposes. Accordingly, such undertakings should be accorded under the Federal bankruptcy code the respect currently afforded private for-profit corporations which provide essential services (such as railroads) to protect the public interest.

Finally, there are those private activity municipal financings, commonly known as industrial development bonds whereby the political subdivision serves as a conduit for financings by for-profit and not-for-profit entities.

I believe the distinctions between the various types of municipal entities and financings should be better recognized by the Federal bankruptcy code thereby eliminating the perception that

¹ The fundamental credit of a general obligation full faith and credit municipal bond is as follows:

All the real property within which is subject to the levy of *ad valorem* taxes without limitation as to the rate or amount.

all municipal bankruptcies are the same; the Federal bankruptcy code could be further amended to more accurately reflect these distinctions (e.g. the definition of municipality could be subdivided into distinctive categories with separate sections to follow thereafter similar to the 1994 amendments for small business.) In this way, the investors in municipal bonds, particularly individuals, will begin to appreciate the significant differences in credit analysis of various municipal credit instruments. The SEC in its new disclosure rules has made a very decent effort to make these distinctions and those rules could serve as a model for the revising of the Code in this regard.

Returning to the primary purpose of this hearing, I find that the fundamental difference between a general purpose municipal entity such as a county and a private corporation is not well understood or respected and, in fact, the Federal bankruptcy code itself may be partly at fault for providing access to such statutory protection for fiscal distress situations for which such relief is inappropriate. In a corporate bankruptcy there is always the potential of the business disappearing entirely, including the value of the stock being reduced to zero; at least that is the limit of the loss. In a general purpose municipal bankruptcy the "business" of the municipality will and must continue to provide the essential public services and the exposure is unlimited. In such circumstances, the real property of the taxpayers within a municipality is fully exposed. Similar concepts of unlimited exposure can also be applied to the level of a sales tax or a corporate and personal income tax and other taxes, fees and

charges, although to a lesser extent, since those taxes do not represent the bedrock of municipal credit. Consumers can trade elsewhere and thereby avoid an excessive sales tax and businesses and persons can remove themselves from the municipality and thereby avoid an excessive income tax.

In many states, municipalities have shifted their dependence from the real property tax base to sales taxes, personal and corporate taxes and other taxes, fees and charges either by choice or constitutional mandate, such as Proposition 13 in California. However, I posit that a Federal bankruptcy code applicable to all States should be crafted in such a manner which considers a measure of wealth of an entity attempting to invoke that Code, which is consistent with continuing to pay for public service expenditures and debt service on outstanding debt. Such a standard would thereby offer the protection of the Federal bankruptcy code only to those municipalities who are "poor" by nationwide measures of municipal wealth and not those who are "poor" by design.² As

² I refer you to an article of a Hawkins, Delafield & Wood partner in 22 Virginia Law Review at page 39 entitled "Legal Problems of Financially Embarrassed Municipalities" written in 1935 wherein reference is made to the 1880's when municipalities would adopt all sorts of expedients, often with the aid of state legislatures, to avoid payment to creditors.

For example, most of you would agree that a private corporation that owns a goldmine would not be eligible to petition for the protection of the Federal bankruptcy code without including the valuation of the gold even if its corporate board and stockholders have refused to vote to extract the gold. Similarly, a municipality with practically full employment and the site of many substantial and successful persons and businesses should not be able to avail itself of the protection of the Federal bankruptcy code simply by refusing to approve an increase in a tax, such as a sales tax. Yet that appears to be the situation under the Federal Bankruptcy Code.

municipalities move away from dependence solely on the real property tax, and the cost of goods and services and the demand for more services increase, they have also recognized that their ability to borrow is an essential ingredient of their ability to provide sufficient municipal services. For example, the County of Westchester, New York now borrows to pay for its ongoing capital programs whereas in the 1930s, for the most part, it paid for its capital needs from current tax receipts and revenues. I should also recognize that successful resolution of every major general service municipal fiscal crisis other than Orange County since the early 1970s has been accomplished, in part, by the funding of the accumulated debt and deficit liability through the exercise of the borrowing power and without seeking the priority protection of the provisions of the code. The Federal bankruptcy code should be revised in a manner which measures "wealth" by criteria other than simply the real property tax base. Specifically, the Federal bankruptcy code should clarify that a municipality is eligible to invoke its provisions only when that municipality has established that it does not have access to the public credit markets for purpose of paying its creditors, bondholders and employees.

Thus, while the wealth of any municipality is measured in large part by the value of its real property and the ratio of debt and expenditure associated with taxing that base, the very process through which a municipal corporation reacts to fiscal distress should be a critical element in determining whether such municipality should be eligible for protection under the Federal bankruptcy code. In other words, why not codify in the Federal

bankruptcy code what appears to be the prevailing practice and precedent for state and local government responses to fiscal distress and condition petitions for code protection on a response to the following question: has the municipality (and perhaps with assistance from the State through supervision or other means) tried to make ends meet by exercise of its borrowing as well as its budgetary powers?

Specifically, I recommend that the definition of "insolvent" be amended to read as follows: "... with reference to a municipality, financial condition such that the municipality

(i) is generally not paying its debts as they become due unless such debts are subject of a bona fide dispute; or

(ii) is unable to pay its debts as they become due; and

(iii) in either case has made a bona fide effort to access the credit markets without success." (underscored material is new)

The concept of "bona fide effort" would need to be defined to reflect that the debt offered when attempting to access credit markets pledged both a promise to pay and to use in good faith the municipality's general revenue powers to produce sufficient funds to pay the principal of and interest on the obligation as it becomes due. (See Flushing National Bank v. MAC (40 NY2nd 731 at page 735).

In the alternative to the requirement of a bona fide offering for certain circumstances where the municipality is by all objective standards obviously "insolvent" and cannot access direct or indirect State support, the Federal bankruptcy code should

probably provide for the waiver of a bona fide offering by requiring the written consent of the Governor of the State (or approval of the State legislature). The concepts of "wealth" of the municipality and "financial condition" could be drafted to include a measure, for bonding and current budgetary analysis, of the taxing resources at fair valuation, analogous to the Code's current provisions for private corporations other than a partnership whereby the sum of such private entity's debts is required to be greater than all of such entity's property, at a fair valuation.

Such a change to the Federal bankruptcy code would provide a better understanding by taxpayers of the definition of insolvency for a municipality and, in terms of the real world of municipal finance, introduce to the Federal bankruptcy code a method of measuring municipal wealth and willingness to pay prior to a municipality seeking the protection of the Federal bankruptcy court.

I believe such changes would be welcomed by municipal buyers and municipal bond issuers since the rules for seeking protection of the Code would be clarified, would be consistent with current practice and precedent, would make the bankruptcy option less likely and accordingly, should calm the waters, thereby avoiding some interest rate penalty that may be currently occurring. As evidence for this belief, I bring to your attention that the common thread in every successful resolution of municipal fiscal crises since the 1970s is that major municipal entities providing essential services to the public and confronted with the realities

of fiscal stress, elected to avoid the embarrassment and complexities of the Federal bankruptcy court and, through a combination of self-help and state support or supervision, have successfully met the challenge of governance by borrowing to provide the necessary cash to pay its debts and to fund deficits in its capital and general funds and without seeking judicial adjustment of debt. The basic underlying philosophy of these communities is that their continuing "business" of providing essential public services necessarily included the on-going need to borrow for certain of its capital and cash flow requirements and that honoring its debt obligation timely and fully was essential to its ability to continue to provide those public services. Except for an interim period in Bridgeport (and for reasons other than a desire to repudiate its debt obligations) at no time did these communities signal to the holders of its debt an unwillingness to pay or seek a "cram down" discount. Instead, each went through extraordinary efforts to amend and rearrange its statutory authorization and structure so as to enable it to continue to borrow, directly or indirectly, in order to meet its creditor and debt obligations when due and to continue to provide its essential services. Creative municipal solutions and proven financial mechanisms are available to provide credit access to municipalities in fiscal distress without resorting to the protection of the Federal bankruptcy court, assuming a municipality's wealth and willingness to pay.

If there is a consensus in the financial, legal and political community that there are proven products of municipal finance short

of the bankruptcy, to solve fiscal crisis situations ranging from multi-billion dollar problems in New York City and Philadelphia to the 15 million dollar problem in Cleveland, Ohio, a question can be raised as to whether there is any real reason to afford municipalities the protection of the Federal bankruptcy court in the first place.

I believe the answer to this question is yes because, in the final analysis, there will be situations of fiscal stress that are simply too substantial and a general service municipality simply too "poor" (despite its willingness to try to borrow) to sustain a successful fiscal solution based on these models. In my view, that situation has not yet occurred. In addition, with respect to certain contractual arrangements (other than debt obligations) the threat of resorting to the benefits of the Federal bankruptcy code can assist in negotiations.

Let us review some real world problems.

In the corporate world, bad things happen to cause private for-profit corporations to seek bankruptcy protection 1) over expansion and excessive borrowings so debts far exceed ability to pay from anticipated sales of the company product; 2) extraordinary environmental liability from pollution caused by the production of the product; 3) almost unlimited liability from the sale of products later proven harmful; 4) liability from industrial accidents resulting from negligent operations; 5) liability from fraudulent practices of officers; and 6) other examples which each of you can add.

Thus, private for-profit corporations may legitimately seek the protection of the bankruptcy court because their asset base and their sale of product potential seemingly is not sufficient to meet their liabilities which in certain of the above cases may be almost unlimited and the business may need to be completely dissolved or the creditors must reach accommodation in order to recoup any of their investments.

Bad things can happen also to municipalities such as: 1) significant corporate relocations; 2) defense closings; 3) too many employees under escalating cost contracts; 4) excessive borrowings; 5) environmental liability from improper discharges; 6) recessionary and other situations resulting in unemployment and reduced property values; 7) significant investment losses; and 8) other situations which each of you can add. However, the basic question, unlike private for-profit corporations, is whether or not the "tax base" of the municipality can be leveraged to meet that the resulting liability or loss and still provide essential services. In almost all cases, it is not an option of general service municipalities to be dissolved.

The single question is whether the loss or liability can be covered through a debt offering or series of debt offerings with a maturity long enough to accommodate debt service payments and payment for the essential services. We know that a municipality must maintain its municipal services if people are to continue to live in the municipality. Thus, the taxing power to be of any value must be utilized to pay for those essential services. Before "bankruptcy" can be selected as an option, there should be a

concrete test of the capacity of the municipality to access its taxing power for paying for those services and paying its debts. Thus, the fundamental flaw in the current provisions of the Federal bankruptcy code is that the criteria for access to the Federal bankruptcy court does not explicitly reflect the essential element of borrowing capability or, to put it another way, is the basic "wealth" of the community so eroded as to preclude its ability to meet its liabilities and service requirements. I do not believe for municipalities that the Federal bankruptcy court should be the place to settle or stay disputes over previous practices, whether they may be political, fraudulent, fiscal or contractual, but only should be the place of last resort when a municipality is simply too poor to meet its obligations, has exercised significant efforts to reach a reasonable municipal finance solution without success and therefore cannot access the municipal bond marketplace in order to meet its current obligations. The fundamental fairness of this concept, I believe, should be obvious to all. If the Federal bankruptcy court becomes simply a "business choice" for municipalities to settle its contractual differences or otherwise adjust its liability to its bondholders and creditors and others with whom it does its day-to-day business such as investing its public funds, then the investors and creditors will necessarily reflect that risk in its lending or pricing decisions with the result that the taxpayers throughout the nation will pay the penalty since there will not be any fundamental way of assessing the creditworthiness of a municipality because elected officials

can and do change and therefore business choices may change, as happened, for an interim period, in Bridgeport. "Wealth" of the municipality and a good faith effort to mine that wealth should be a condition precedent to filing a petition for Federal bankruptcy protection.

In a very general sense, according to various public reports and comments this is the difficulty of the Orange County circumstances. It is perceived by many commentators that the "wealth" of Orange County by various criteria traditionally used to reflect "creditworthiness" can accommodate a solution to its fiscal problems without the protection of the Federal bankruptcy court and without compromising any of its claims against those who participated in the investment practices that brought on the fiscal crises. The fact that the option under these circumstances of the Federal bankruptcy court based on the words of the Federal bankruptcy code has been available, in my view, should be soon remedied by Congress because I have been informed that other municipalities and states throughout the nation are already paying some interest penalty in their borrowings as a result of the perception that municipalities now have simply a business choice to seek protection of the Federal bankruptcy court. In addition, many municipalities are under tremendous fiscal pressure to reduce taxes and balance budgets while continuing to provide essential public services during this period of recessions and federal and state reductions in assistance. If the Federal bankruptcy code is a federally approved option for reducing its debt and creditor liability through "cram down" plans, then public officials, as part

of their public duty, must explore and even choose such option. However, if the Federal bankruptcy code is clarified so that there is a well drafted "means" test based on objective criteria associated with the wealth of the community, which also includes the municipalities' willingness to borrow and to pay over time its creditors and bondholders, as well as pay for its essential services, then the municipal market forces and municipal officials will be in balance.

Based on my experience and expertise as Bond Counsel, I believe such amendments can be drafted and put into place and are prepared to assist in that effort. It is clear that remedial steps should be taken quickly so that a trend does not develop.

Banks have vast holdings of municipal bonds as investments and in trust accounts with marked to market requirements and if the entire municipal bond market is assessed a penalty for the added risk of the bankruptcy option, then that could result in a more severe fiscal problem for the municipal market than any other market element adversely affecting the municipal market since it has been generally considered a "safe" investment market and it appears to be one of the few financial markets that has come out of the 1980's without a significant number of defaults and bankruptcies, notwithstanding its share of fiscal distress situations. In addition, the taxpayers of this Country who are paying for the essential services and infrastructure of municipal government deserve better than to pay a penalty of higher interest because it is perceived that the Federal bankruptcy court has become a "business" option rather than a last resort for municipal

fiscal distress. The fact that in our culture it appears that bankruptcy is no longer an embarrassment to be avoided at all costs we probably cannot change; therefore, it seems critical to revise the Federal bankruptcy code to reflect a "means" test that must be documented in an objective manner so that only the truly "bankrupt" municipalities, in the old fashioned sense, can be protected.

In my answers, as follows, to your specific questions, I have made more further suggestions with respect to these matters and are ready to answer any additional questions that you may have.

Subcommittee Written Questions and My Answers for Hearing at
U.S. House of Representatives
Subcommittee on Capital Markets, Securities,
and Government Sponsored Enterprises of the
Committee on Banking and Financial Services

QUESTION 1: Has there been a fundamental shift in the credit relationship between the issuers of state and local debt and investors in the debt?

ANSWER: I believe there has been a slight shift, which could become a "sea change" if certain provisions of the Federal bankruptcy code, as applicable to municipal corporations and as currently construed, are not changed by Congress or judicial decisions arising out of the many Orange County cases. (See Exhibit B.) In particular, I understand that on certain credits, in California and even on the East coast, the security for which is subject to appropriation or otherwise dependent on "good faith" willingness to pay, that certain bond investment funds are exacting an increased interest rate penalty for "risk" and/or requiring municipal bond insurance. However, there is, right now, an undersupply of municipal bonds compared to investment cash available so it is hard to quantify a real interest rate penalty. (See Exhibit C from The Bond Buyer, July 20, 1995.)

Although this is less a question of law rather than a matter of marketplace dynamics, notice should be taken as to certain conditions which now prevail in the municipal market; for example: (i) municipalities with taxing power and market access which are under fiscal pressure may seek protection of the federal Bankruptcy Code against their general obligation bond and note holders; (ii) a substantial period may elapse before determination of insolvency or other prerequisites to filing during which general obligation holders are faced with uncertainty thereby adversely affecting market value; (iii) super priority obligations may be issued pursuant to Code Section 928, putting outstanding bond and note holders in a subordinate and less secure position; and (iv) the fact that recovery of post-petition interest is not assured appears to be leading to a reevaluation of the relative security of both general obligation and "special revenue" obligations (the latter thought to have been largely excluded from bankruptcy risk pursuant to Code Section 928).

Erosion of market acceptance of general obligations based on the taxing power, which is a uniquely elastic municipal asset, would be both costly and limiting for municipalities: costly, as not all municipal finance needs are readily associated with adequate revenue streams; and limiting, as the imposition of special revenue liens will progressively limit the flexibility with which municipalities may finance non-revenue producing and extraordinary needs. This may be more dramatically the case in light of increasing participation of rating and valuation sensitive purchasers such as bond funds.

QUESTION 2: Should Chapter 9 of the federal Bankruptcy Code governing municipal bankruptcy be changed?

ANSWER: Yes.

The municipal market has evolved effective methods allowing a distressed municipality to provide payment to its general obligation bond and note creditors and to continue to provide essential services through creative municipal financing mechanisms with state support and supervision legislation and without endangering access of other State entities to the capital markets. It should be recognized that the States have a strong interest in the continued availability of those methods as fundamental to assuring the capacity of the distressed municipality and of its other constituent units to finance the provision of basic services without penalty. I believe the Federal bankruptcy code ought to be changed as an incentive to municipalities and certain states to utilize those methods, prior to seeking relief under the code and thereby make the bankruptcy option more remote.

See my "Introductory Remarks" for specific suggestions in this regard.

The weaknesses of Chapter 9 from a state standpoint include: (i) the absence of any direct mechanism of state control once a petition has been filed, creating the possibility of a runaway municipality; (ii) the substantial damage which may accrue through delay in a determination of the eligibility of a municipality to file as a debtor; and (iii) the all-or-nothing nature of a petition, requiring a municipality to threaten its bond and note obligation payment ability in order to gain the benefits of the Code while negotiating with its other creditors.

Applicability of Chapter 9 is dependent upon the provisions of Code Sections 101 and 109(c) which condition the capacity of municipalities to file Chapter 9 petitions. It should be noted that many States have not yet adopted legislation in response to the 1994 amendment to Code Section 109(c)(2) requiring specific categoric or individual State law authorization for a municipality to be a debtor. Certain states, however, have adopted or are considering legislation conditioning such authorization upon specific instance approval after consultation with State officials or similar processes creating an opportunity for State intervention. It would be beneficial for Congress, rather than the courts, to clarify that State authorization for purposes of Section 109(c)(2) may be so conditioned.

The definition of "insolvency" as a condition to municipal bankruptcy under the Code is inherently imprecise with respect to a municipality's ability to leverage a pledge of tax revenues. While this imprecision, and the delay experienced prior to determination in a particular case, may be advantageous in facilitating access by municipalities to address the broad range of potential economic, political and service pressures, both the uncertain standard and the uncertainty of particular case determination are extremely negative for the municipal market. Again, this is especially true with respect to the managers of regulated institutional bond funds.

Code Section 921(c) should be amended to address these concerns as follows: The court should be required to conduct a hearing and determine the eligibility of the municipality as a debtor immediately upon the filing of a petition. The court should be further required to dismiss the case in its entirety, or with respect to the bond and note obligations of the municipality, upon motion of the State. In the absence of such a motion, the court should nonetheless be required to dismiss the case with respect to the bond and note obligations of the municipality, absent a showing by the municipality that such a dismissal would prevent filing of a feasible plan. A conforming change to Section 922 should prevent application of the stay with respect to timely payment of bond and note obligations prior to such determination. Consideration should be given to allowing municipalities the option of excluding bond and note obligations from their petition. A conforming

change should limit the priority available to secure post petition credit pursuant to Section 364 to parity with pre petition and post petition general obligation bond and note obligations. A conforming change should limit the operation of Section 903 to indebtedness and creditors within the scope of the undismissed petition.

In addition, for Federal income tax purposes and for bond fund portfolio reasons, it may be advantageous to amend Section 1146 of the Internal Revenue Code to provide that no alteration to or exchange of municipal bond or note obligations pursuant to a plan shall constitute a reissuance.

In addition, this Committee should consider adding provisions to chapter 9 which require some type of good faith workout effort by municipalities prior to invoking the protection of that chapter.

QUESTION 3: Does Chapter 9 create incentives that adversely affect the municipal market?

ANSWER: Yes.

Filing of a Chapter 9 petition prevents holders of general obligation bonds and notes from seeking traditional remedies in State court and may be seen as staying, preventing or insulating municipalities and individual officers from State intervention, supervision and control. (See Bridgeport case, attached as Exhibit D). Connecticut passed legislation after that case to permit its municipalities to petition for relief under the Federal bankruptcy act only with the consent of the Governor.

See also my "Introductory Remarks" suggesting that the Federal bankruptcy code is being utilized for purposes other than to protect a "poor" municipality and without a clear "means" test may become simply a business choice for a municipality faced with fiscal, political or contractual pressure.

Consent: Section 903 provides that State composition procedures may not bind nonconsenting creditors, thus limiting effect of both state legislation and of any judgement entered under such legislation. (Origin of provision is Constitutional prohibition of states impairing contractual obligations. Although this issue is very complex, it should be reviewed in light of recent Supreme Court decisions).

Stay of litigation: Further disincentive to municipal officials resolving bankruptcy expeditiously, results from the fact that such officials are generally protected from litigation charging them personally with responsibility for the municipality's fiscal problems, by a stay ancillary to the stay for the municipality itself.

Under Section 362, courts have long recognized the power of bankruptcy courts to enjoin litigation which seeks to obtain a judgement against the estate or to interfere with property of the debtor. (citations omitted). Courts have extended this automatic stay to actions against key officers, directors, and employees of the debtor, on the grounds that the real objective of such litigation is the debtor, or that continuance of such action would burden the estate and frustrate reorganization. See, e.g. Johns-Mansville Corp. v. Asbestos Litigation Group (In re Johns-Mansville Corp.) 7 C.B.C. 2d. 1042 (B.Ct. S.D.N.Y. 1983)

QUESTION 4: Are there increased incentives for municipalities to declare bankruptcy in the future?

ANSWER: A precedent has been set but whether or not it will be followed depends in part on future events. See my "Introductory Remarks".

The fact that Orange County was able to attract a third party credit provider for its court approved super priority borrowing, reportedly at a substantial premium and at above-market interest rates, may encourage other municipal officers to risk market penalties, which may and, in any event, would be extracted on subsequent borrowings and over a period of time, in circumstances where short term concerns predominate.

QUESTION 5: Should Orange County have declared bankruptcy?

ANSWER: I have been advised not to comment on this question.

QUESTION 6: Do the Orange County losses and subsequent bankruptcy represent a future trend in state and local finance or represent an isolated incident?

ANSWER: From what I read in The Bond Buyer and other industry reporting, it appears that the Orange County circumstances are being considered an anomaly. However, depending on future events and results, declaration of bankruptcy will be considered by municipal officials as a business option under fiscal distress circumstances

acceptable to the municipal market, especially if the bond markets, once Orange County is out of the protection of the bankruptcy court, purchase uninsured bonds at the then prevailing market interest rate.

QUESTION 7: Are states taking adequate steps, including reevaluation of applicable state statutes, to improve the investment practices of state and local governments?

ANSWER: My impression is that investment practices of most state and local governments have always been governed by prudent person requirements, including, for example, secured deposits and repurchase agreements. The rating agencies have requested information from most of our clients and have generally been satisfied that the existing statutes, the governing indenture or resolution and the investments thereunder have met the requirements. I believe municipal officials with whom we work in most cases were already sensitive to risks associated with swaps and other derivative products and have statutory provision assuring supervision. For example, in Connecticut, the statute, which was enacted in April, 1993, to permit various authorities to execute agreements to moderate interest rate fluctuations requires the Authority to obtain the consent of the state treasurer prior to execution thereof and to document certain financial information with respect thereto. (See Exhibit E). For an update on legislation pending in California, see Exhibit F.

QUESTION 8: Should disclosure or other rules governing municipal debt issuance be changed to reflect municipal investment policies?

ANSWER: At least since Orange County this has become a part of most disclosure documents and due diligence.

Also, recent amendments to SEC Rule 15c2-12 and accompanying interpretive materials appear adequate to cover municipal investment policies particularly as such policies relate to funds which are pledged under the governing indenture wherein "investment obligations" are usually defined. I expect that the municipal market and rating agencies will require issuers to include as part of disclosure statements to articulate investment policy as operating data, within the meaning of such Rule 15c2-12, as well as statements of risk position at a point in time, particularly on

general obligation bond issues where there is not a master indenture.

QUESTION 9: How might the responsibilities of regulators (both federal and state), issuers, rating agencies, lawyers, and market-makers be altered to minimize the use of speculative investment policies, losses and bankruptcies of municipalities in the future?

ANSWER: Municipal market or rating agencies may require opinions on municipal authority to enter into investments. Conformance to articulated or statutory policies referred to in response to Question 8 should be audited.

EXHIBIT AExperience and Expertise of Hawkins, Delafield & Wood with Financially Embarrassed Municipalities

1. **State of New Jersey:** As a result of the depression, we assisted in drafting a comprehensive set of laws and since then have added several enhancements that provide overall budget and fiscal controls designed to require proper budgeting and to avoid speculation on future revenue resources and to provide dedicated revenue resources where fiscal distress is apparent (Qualified Bond Act) in order to maintain market access and State supervision to assure compliance. Thus, despite severe fiscal stress during recent periods in places such as Newark and Essex County, these municipalities have available statutes and State supportive mechanisms that have allowed market access and protected the taxpayers from the expense and fiscal restraints which result from the exercise of a bankruptcy option.

2. **Special Finance and Budget Act for the City of Yonkers:** In the mid 1970's the City of Yonkers avoided the option of bankruptcy and elected to impose on itself a comprehensive set of statutory requirements which we drafted, which passed without amendment in the State legislature and which permitted market access for bonding out its substantial accumulated deficits. Subsequently, the State intervened by imposing a State control board to assure compliance, thereby providing continual market access.

3. **City of Buffalo:** Statutory amendments to intercept tax revenues, establish reserve funds and eliminated the City's option to seek bankruptcy protection, thereby assuring market access for its bonds and providing essential services while the City was eliminating a significant general fund deficit and balancing its budget.

4. **City of Lackawanna:** Fiscal stress brought on by the closing of the only basic steel manufacturing plant in the State which was the major employer in the city - statutory amendments to intercept certain taxes and to permit sale of certain improvement facilities to the County of Erie thereby permitting market access for bonding out its short term notes.

5. **Municipal Assistance Corporation for The City of New York:** The combined skills and wisdom of the elected officials and concerned citizens converged to assist The City of New York in avoiding bankruptcy. The basic financial tool was rearranging the laws in New York so as to establish and permit MAC to capitalize the sales tax stream collected in The City of New York so as to provide cash to pay off maturing notes.

6. **Bridgeport, Connecticut:** At the request of the City a special act (modelled on the Yonkers Act) was passed by the State establishing the Bridgeport Financial Review Board (for which we serve as counsel) composed of State and City officials, imposing certain budgetary and financial controls, and providing for the issuance of City bonds to fund general fund deficits and capital improvements and which are secured by a State supported reserve fund. After the bonds were

issued, a new mayor led the City into filing for bankruptcy under the Federal bankruptcy code but the State intervened and successfully prevented the City of Bridgeport from utilizing the bankruptcy statute; the citizens of Bridgeport then elected a mayor who campaigned on a pledge to withdraw the City's petition for bankruptcy protection and forego any appeal from the bankruptcy judge's decision dismissing such petition.

7. **West Haven; Jewett City; P.A. 93-421:** Following Bridgeport, the State also passed similar legislations for the fiscal relief of the Town of West Haven and Jewett City and finally passed Public Act 93-421. the summary of which is as follows:

This act establishes a way for financially troubled municipalities to increase their bonds' attractiveness to prospective buyers. It also establishes a system for municipalities whose financial problems make it difficult to enter the bond market to receive state backing in return for state scrutiny or control of their finances.

It accomplishes the first end by allowing any municipality to assure bondholders that it will meet its debt service payments by creating a property tax intercept procedure. This requires the municipality to place sufficient property tax receipts in a special fund to make the principal, interest and

sinking fund payments due during the fiscal year.

It accomplishes the second by creating a two-tier structure in which municipalities voluntarily certify their financial problems in return for state financial support of their bond issues. The tiers are based on municipalities' bond ratings, their ability to obtain bond insurance, and their history of deficit financing.

In return for this state support, certified municipalities must submit to varying levels of state financial scrutiny. At the first level (Tier I), this involves reporting quarterly to the Municipal Finance Advisory Commission. Municipalities at the second level (Tier II) must prepare multi-year financial plans, report monthly to the advisory committee, and get its approval for their bond issues. The act allows the advisory committee to assess a civil penalty of up to \$10,000 against any municipal chief executive officer who fails to submit required information or reports.

The act prohibits any municipality from declaring bankruptcy, except with the governor's written consent. If he does agree

to a bankruptcy filing, he must report his reasons to the state treasurer and the Finance, Revenue and Bonding Committee.

It establishes conditions under which municipalities can issue bonds to cover operating deficits. And it allows municipalities to levy supplemental taxes, if necessary, to pay current year operating expenses.

I am also familiar with similar extensive state and local responses to avoid the Federal bankruptcy option in Cleveland, Ohio, Chelsea, Massachusetts, Philadelphia, Pennsylvania, East St. Louis, Illinois and Washington D.C.

Philip M. Dearborn

The Municipal Bankruptcy Dodge

What does it mean when a local government declares bankruptcy, as has now happened in Orange County, Calif.? To judge by the record so far of cases in which general purpose governments have declared bankruptcy, it means that the government is trying to avoid facing reality. It does not mean that the government is insolvent in the same way businesses are when they declare bankruptcy because they cannot pay creditors.

The municipal bankruptcy code provides that a government merely has to declare bankruptcy to set in motion a freeze of any lawsuits or claims against the government and a transfer of all actions in state courts to the federal courts. The code, therefore, has been used, in the few instances of municipal bankruptcy, to delay the need to take a politically distasteful action, or try to reduce a legal claim against the city or county.

In the South Tucson bankruptcy, the city did not want to pay a court award to a Tucson patrolman who had been injured. After exhausting all other appeals, the city hit on bankruptcy as a way to avoid paying, and it worked. The claimant eventually settled for less than his award to avoid prolonged litigation in bankruptcy court.

In the San Jose School District, a new school board did not want to give the raises in a contract negotiated by the prior board. When the teachers sued in state court, the board declared bankruptcy. The delay and potential for extended litigation eventually forced the union to renegotiate the contract.

In Bridgeport, the mayor was faced with an order of a state oversight board to balance the city's budget by raising taxes or reducing spending. When the

mayor and city council refused to do either, the oversight board threatened state court action. To avoid a state court order, the city declared bankruptcy. The case was thrown out of bankruptcy court because the city was not insolvent, and the city did what was necessary to balance its budget.

Now, Orange County, one of the richest in the United States, has incurred substantial losses through mismanagement by one of its officials. This is, and should be treated, as a California problem. The state created the problem by giving local governments the opportunity to make unwise investments. The county profited immensely for many years by gambling on the market, and should now face its losses. Orange County, and the state of California, have ample resources to see that no municipal bondholder loses any money, and that all creditors are paid.

However, to avoid either voluntarily making up the losses from county funds or having a state court order payments to creditors, the county has used the federal bankruptcy court to delay action. The mere filing of a petition by a local government in federal bankruptcy court, however invalid it may be, immediately enables a government to avoid taking any action to correct its problem. Eventually, a judge will consider whether the bankruptcy petition has merit. The Orange County case will probably be dismissed on the basis that the county is not insolvent, or had failed to get the required permission from the state to file the petition.

In the meantime, as in the other three cases cited above, public officials have used a federal law improperly to gain delay and improve their negotiating po-

sitions. More important, they have damaged their government's credit rating, cast doubt on other local governments' finances, failed to pay those the county owes, and caused excessive and unnecessary litigation.

Fortunately, the instances of local governments' declaring bankruptcy have been rare, but they may become more frequent as governments see their potential. To correct this problem, several changes need to be made.

First, federal bankruptcy courts should be prohibited from permitting even the filing of a municipal bankruptcy petition unless the petition carries the explicit approval of the governor of the state for that specific filing.

Second, after a legal filing, the bankruptcy court should be required to hold an immediate (five days) hearing to permit a preliminary determination of whether the government meets the other requirements for filing, in particular the insolvency requirement.

Third, the burden of proof for meeting the bankruptcy filing requirements should be placed on the government seeking to file.

Perhaps measures such as these will limit bankruptcy to those governments that are truly insolvent, and force other local government problems to be resolved locally, or in state legislatures or state courts, where they belong.

The writer authored a 1985 report, "Bankruptcies, Defaults, and Other Local Government Financial Emergencies." He testified as an expert witness against the municipalities in both the South Tucson and Bridgeport bankruptcy cases.

INVESTORS & INVESTING

INVESTMENT FORUM

Has Orange County Popularized Revenue Bonds?

In June outgoing Securities and Exchange Commission commissioner Richard Y. Roberts warned that an Orange County default could be "detracting," undermining investors' faith in general obligation bonds.

A month later, analysts and investors have mixed views on whether this has actually happened. Nor is there consensus on whether revenue bonds, with their clearly identifiable security, have gained favor.

Edward R. Evonoustas, senior vice president and analyst with Raymond James & Associates, said that while the municipal market has experienced a flight to quality, Orange County is not the driving force.

Given narrow quality spreads, flat tax talk, and other factors, "I think it's very difficult to isolate Orange County and say it is the catalyst for people focusing on essential services," he said.

Bentley Myer of William Blair & Co.

Orange County's refusal to pay its debt is a one-off event without wider implications for the municipal market, said Bentley Myer, senior vice president and portfolio manager of William Blair & Co.'s \$17 million Limited Term Tax-Free Fund.

"My sense of the Orange County situation is that it is more of an isolated incident than a general trend and that general obligation issuers will be more cautious about their obligation than before simply because they don't want to travel the route of testing the mar-

Two other analysts argued that, while Orange County has caused some investors to view revenue bonds more favorably, the turnaround will be temporary.

"A small group of buyers may now have some preference for revenue bonds, but I don't see any major shift," said Paul Williams, manager of investment strategy and research with John Nuveen & Co.

"I think the integrity of the municipal market is still relatively intact," said Brad W. Boile, senior municipal bond analyst with A. G. Edwards & Sons Inc. "People still think highly of GO debt, except when a credit becomes under pressure.

"Then you're going to make a move towards revenue bonds, because you feel safe knowing that there is a dedicated revenue stream."

—Jon Birger

Jeff Slater of General Reinsurance Corp.

General obligation bonds remain the least likely type of municipal debt to default, regardless of Orange County, according to Jeff Slater, vice president and portfolio manager for General Reinsurance Corp.

Revenue bonds, on the other hand, offer a little bit less rating volatility, he said.

"For example, you can look at the revenue stream and see they're going to cover the debt service, say, two times," he continued. "You know if it's a single-A revenue bond, it will always be a single-A revenue bond."

General obligation ratings, in contrast, depend on the economic fortunes of an entire municipality, not just a single project, he said.

"Look at California," Slater said. "Its GO debt was triple-A, and now it's down to single-A. But it's never going to default."

Though Orange County has not shaken Slater's faith in GOs, it has given him pause, he admitted.

"When a double-A county — a very wealthy county — defaults and walks away from its commitments, you have to take another look.

"I guess in the past people would treat revenue bonds — if you've got a GO and a revenue bond each rated double-A, you'll command more yield for the revenue bond," he said. "I think that's changed a little bit."

—Jon Birger



File photo

'Look at California. Its GO debt was triple-A, and now it's down to single-A.

But it's never going to default,' says Jeff Slater.

If Orange County eventually honors its debts, that change will probably be a temporary one, according to Slater.

—Jon Birger

EXHIBIT D

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the present value of \$2,700,000.00 and that its failure to accomplish that objective was in the nature of a ministerial error.⁶

Under the modification, the lump sum payment at the end of the fourteen year period payment is increased to \$2,700,000.00 from \$2,203,000.00. That change will increase the present value of the total payments by approximately \$125,000.00. As noted in the April 9 order, the present value of the debtor's proposed payments were insufficient by approximately \$125,000.00.⁷ Therefore, the debtor has satisfied § 1129(b)(2)(A)(i)(II).

III.

As noted *supra* at 329-330, the failure to satisfy § 1129(b)(2)(A)(i)(II) was the only defect in the Plan. The Modification remedies that defect, the Plan with the Modification is therefore CONFIRMED, and IT IS SO ORDERED.



In re CITY OF BRIDGEPORT, Debtor.

Bankruptcy No. 91-51519.

United States Bankruptcy Court,
D. Connecticut.

Aug. 1, 1991.

City filed Chapter 9 petition, and State of Connecticut objected. The Bankruptcy Court, Alan H.W. Shiff, J., held that: (1)

6. Moreover, although this decision does not turn on this observation, since there is a reasonably strong prospect that the property will be sold before the lump sum payment is due in fourteen years, it is likely that the relatively small difference between what was offered and what would be needed to give Pacific the present value of its claim was the result of computation error, not an intention to pay less.

7. The present value of the lump sum payment prior to the Modification was \$552,684.40:

city, which was in deep financial trouble and which projected a \$16 million budget deficit, failed to establish that it was "insolvent" at time it filed for bankruptcy, and thus was not eligible for Chapter 9 relief, and (2) determination of whether city is "insolvent" relies on cash flow analysis, rather than budget deficiency analysis.

Objection sustained.

1. Bankruptcy ⇐2236, 2255, 3481

City, whose Chapter 9 petition included allegation that it was qualified to file and entitled to benefits of Bankruptcy Code, had burden of proving that it was insolvent when it filed its petition, that its petition was filed in good faith, and that mayor was properly authorized to file petition. Bankr. Code, 11 U.S.C.A. §§ 109, 301; Fed. Rules Bankr. Proc. Rules 1001, 9009, 11 U.S.C.A.

2. Evidence ⇐91

Generally, burden of proof is imposed upon party who asserts affirmative of an issue.

3. Bankruptcy ⇐2236

City, which was in deep financial trouble and which projected a \$16 million budget deficit, failed to establish that it was "insolvent" at time it filed for bankruptcy, and thus was not eligible for Chapter 9 relief; city failed to show that it would be unable to pay its debts as they became due in its current financial year or in next fiscal year. Bankr. Code, 11 U.S.C.A. §§ 101(32)(C), (32)(C)(ii), 109(c)(3), 301; Fed. Rules Bankr. Proc. Rules 1001, 9009, 11 U.S.C.A.

See publication Words and Phrases for other judicial constructions and definitions.

$$\frac{2,203,000.00}{(1.025)^{14}} = \frac{2,203,000.00}{3.986} = 552,684.40$$

The present value of the lump sum payment under the Modification is \$677,370.80:

$$\frac{2,700,000.00}{3.986} = 677,370.80$$

The shortfall was precisely \$124,692.40, and the increase in the present value of the payments is \$124,686.40. However, such discounted future cash flow calculations are necessarily imprecise, relying as they do on predictions of future conditions, and I find that the debtor has satisfied § 1129(b)(2)(A)(i)(II).

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4. Bankruptcy \Leftarrow 2234, 3481

Although Chapter 9 offers a solution to chronic economic distress caused by costs and revenues spiraling in opposite directions, when city is insolvent and otherwise eligible to be a debtor, but Chapter 9 is unavailable to city simply because it is financially distressed. Bankr.Code, 11 U.S.C.A. §§ 101(32)(C), (32)(C)(ii), 109(c)(3), 301; Fed.Rules Bankr.Proc.Rules 1001, 9009, 11 U.S.C.A.

5. Bankruptcy \Leftarrow 2234

In determining whether city is "insolvent" as required to be eligible for Chapter 9 relief, prospective analysis is required, looking at whether city will be unable to pay its debts as they became due, rather than retrospective analysis requiring city's current failure or unwillingness or inability to pay its debts in fiscal crisis. Bankr.Code, 11 U.S.C.A. §§ 101(32)(C), (32)(C)(ii), 109(c)(3), 301; Fed.Rules Bankr.Proc.Rules 1001, 9009, 11 U.S.C.A.

6. Bankruptcy \Leftarrow 2234

Determination of whether city is "insolvent" as required to be eligible for Chapter 9 relief relies on cash flow analysis, rather than budget deficiency analysis. Bankr.Code, 11 U.S.C.A. §§ 101(32)(C), (32)(C)(ii), 109(c)(3), 301; Fed.Rules Bankr.Proc.Rules 1001, 9009, 11 U.S.C.A.

7. Bankruptcy \Leftarrow 2234

City, to be found "insolvent," as required for Chapter 9 eligibility, must prove

1. The Bridgeport Financial Review Board was established by the State in June, 1988, pursuant to Special Act No. 88-80, "to review the financial affairs of the town and city of Bridgeport, all in order to maintain access to public credit markets, to fund the city's accumulated deficits and to restore financial stability to the town and city of Bridgeport." Special Act No. 88-80, § 1. See *In re City of Bridgeport*, 128 B.R. 688 (Bankr.D.Conn.1991, B.J.), at 699-703, for a more detailed discussion of the powers and duties of the FRB.
2. Bankruptcy Code § 921(c) provides:
After any objection to the petition, the court, after notice and a hearing, may dismiss the petition if the debtor did not file the petition in good faith or if the petition does not meet the requirements of this title.
3. The State also objected on the ground that Bridgeport was not generally authorized to be a

that it will be unable to pay its debts as they become due in current fiscal year or, based on adopted budget, in its next fiscal year.

Barbara Brazzel-Massaró, City Atty., Richard D. Zeisler, James Berman, Robert M. Zeisler, Barbara L. Hankin, Roy W. Moss, Zeisler & Zeisler, P.C., Bridgeport, Conn., for City of Bridgeport.

Richard Blumenthal, Atty. Gen., Richard T. Couture, Joan E. Pilver, Asst. Atty. Gen., David G. Hetzel, Elliot N. Solomon, Hebb & Gitlin, Hartford, Conn., for State of Conn.

MEMORANDUM AND SECOND ORDER
ON THE OBJECTION OF THE
STATE OF CONNECTICUT TO
CHAPTER 9 PETITION

ALAN H.W. SHIFF, Bankruptcy Judge.

BACKGROUND

On June 6, 1991, the City of Bridgeport, Connecticut, filed a petition under chapter 9 of the Bankruptcy Code. On June 12, the State of Connecticut and the Bridgeport Financial Review Board¹ (together "the State") filed an objection to the petition, see 11 U.S.C. § 921(c),² asserting, *inter alia*,³ that Bridgeport was not insolvent when it filed its petition and that the petition was filed in bad faith.⁴ On June 21, the State

debtor under chapter 9 by state law. That objection was the subject of a June 26 hearing and was overruled in a July 22 Memorandum and Order, familiarity with which is assumed.

4. Code § 109(c) provides:

An entity may be a debtor under chapter 9 of this title if and only if such entity—

- (1) is a municipality;
- (2) is generally authorized to be a debtor under such chapter by State law, or by a governmental officer or organization empowered by State law to authorize such entity to be a debtor under such chapter;
- (3) is insolvent;
- (4) desires to effect a plan to adjust such debts; and

(5)(A) has obtained the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

filed an amended objection, asserting that the mayor of Bridgeport was not properly authorized to file the petition by the Bridgeport Common Council.

DISCUSSION

1.

Burden of Proof

[1] Bridgeport argues that the State has the burden of proof because it seeks dismissal of this case. The State responds that this court should follow the line of decisions under other chapters of the Code which hold that the burden of proving that an entity is eligible to be a debtor is on the party that files the petition.

Bankruptcy Rule 1001 provides in part:

The Bankruptcy Rules and Forms govern procedure in cases under title 11 of the United States Code.

Bankruptcy Rule 9009 provides in part:

The Official Forms prescribed by the Judicial Conference of the United States shall be observed and used with alterations as may be appropriate.

Official Form 1, entitled "Voluntary Petition", requires an affirmation that

[p]etitioner is qualified to file this petition and is entitled to the benefits of title 11, United States Code as a voluntary debtor.

Code § 301 states that "[a] voluntary case under a chapter of this title is commenced by the filing with the bankruptcy court of a petition under such chapter by an entity that may be a debtor under such chapter." Section 109 specifies who may be a debtor. It follows then that an entity which files a voluntary petition implicitly asserts that it meets the relevant requirements under § 109.

[2] The general rule is that the burden of proof is imposed upon the party who asserts the affirmative of an issue, *Lodge 743, Int'l Ass'n of Mach., AFL-CIO v.*

(B) has negotiated in good faith with creditors and has failed to obtain the agreement of creditors holding at least a majority in amount of the claims of each class that such entity intends to impair under a plan in a case under such chapter;

United Aircraft Corp., 299 F.Supp. 877, 890 (D.Conn.1969), *modified on other grounds*, 534 F.2d 422 (2d Cir.1975), and many courts have held that the burden of proving eligibility under § 109 is on the party filing the petition. *E.g.*, *Tim Wargo & Sons, Inc. v. Equitable Life Assurance Soc. of the U.S. (In re Tim Wargo & Sons, Inc.)*, 869 F.2d 1123, 1130 (8th Cir.1989); *Matter of Morgan Strawberry Farm*, 98 B.R. 584, 585 (Bankr.M.D.Fla.1989). As required, Bridgeport's petition includes an allegation that it is qualified to file and that it is entitled to the benefits of title 11. Accordingly, I conclude that Bridgeport has the burden of proving that it was insolvent when it filed its petition; that its petition was filed in good faith; and that the mayor was properly authorized to file the petition.

2.

Was Bridgeport Insolvent?

[3] Code § 109(c)(3) provides that a municipality may be a chapter 9 debtor "if and only if ... [it] is insolvent". See *supra* note 4. Section 101(32) provides:

"insolvent" means—

....
(C) with reference to a municipality, financial condition such that the municipality is—

- (i) generally not paying its debts as they become due unless such debts are the subject of a bona fide dispute; or
- (ii) unable to pay its debts as they become due....

It is undisputed that on June 6 Bridgeport was paying its debts as they became due. The issue here is whether Bridgeport was "unable to pay debts as they become due."

Connecticut has delegated home rule authority to its cities to provide for the health, safety, and general welfare of their

(C) is unable to negotiate with creditors because such negotiation is impracticable; or

(D) reasonably believes that a creditor may attempt to obtain a transfer that is avoidable under section 547 of this title.

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residents.⁵ It is commonly recognized that Bridgeport, like many cities in the northeast and other areas of the country, is financially distressed and has been for many years. The Chief of Police, Thomas J. Sweeney, testified that as of July 1, 1991, there were 341 police officers in Bridgeport, twenty-two less than the previous low point in the last forty years; that in 1990, his department received approximately 100,000 calls for service requiring the assistance of an officer; that 430 police officers are necessary to provide basic, adequate service; that there are neighborhoods in Bridgeport which have been surrendered to drug dealers and in which people are reluctant to leave their homes; that there were fifty-eight murders in Bridgeport in 1990; that his staff of twenty-three detectives, approximately half of what is needed, is so overworked that there is almost no investigation of property crime; that although Bridgeport has the second highest rate of automobile theft in the United States, only one detective investigates those crimes; and that response to emergency or so-called "hot" calls is often delayed because there is no available police officer. *Tr. July 17*, at 106-18.

The Director of Public Works, Michael Hudzik, testified that budgetary constraints required him to sharply reduce residential garbage collection which contributes to illegal dumping that cannot be collected, the effect of which creates a rodent and arson hazard; that snow plowing this winter will be minimal; that there is only one street sweeper to clean the approximately 275 miles of city streets; that there are eighteen custodians to clean 125 City-owned buildings; and that there are only two electricians to service all of the buildings and traffic lights. *Tr. July 17*, at 67-69.

Both Sweeney and Hudzik testified that cuts in their budgets below what is proposed in the 1991-1992 budget would put Bridgeport in a health and public safety emergency. *Tr. July 17*, at 106-18. See also *Bridgeport Exhibits C and D*. Bridgeport has recently closed two of its

four senior citizen centers; eliminated all recreation programs and maintenance for fourteen of the City's sixteen parks; and reduced the library budget by 60%, so that branch libraries are only open one day and the main branch is only open twenty hours per week. *Tr. July 16*, at 28-29.

Bridgeport's 1991-1992 budget projects a deficit of approximately \$16,000,000.00. *Bridgeport Exhibit R*. Bridgeport residents pay the highest effective taxes in the state, *Bridgeport Exhibit TTT*, App. 15, and it has been argued that anything more than a modest tax increase would be counterproductive. *Tr. July 18*, at 147-49, 292-93.

Although the State has challenged many of Bridgeport's specific claims, it is clear that state officials are concerned about its plight. The remedy for, not the fact of, Bridgeport's problems had been debated at the state and local level long before the petition was filed. Indeed, officials at the state and local level have continued to meet during the pendency of this case. *Tr. July 22*, at 37-41.

[4] In order to meet its obligations, each city establishes a budget each fiscal year which anticipates the expenditures for those mandated services and the revenue necessary to fund them. The budget process is an annual battle fought at the national, state, and local levels of government. The State's expert witness, Philip Dearborn, who has had extensive experience in municipal finance and government, testified that

[t]he process of budgeting is always a difficult one. All budgets start out initially out of balance.... [T]he demands for spending always exceed the resources that are available, and this leads to ... a conflict ... throughout the budget process, and it leads to very difficult times in balancing budgets....

Tr. July 19, at 163. The perennial question during that process is what should be the proper level, priority, and cost of governmental operations, and what should be a reasonable level of taxation, state aid, and

5. See Conn.Gen.Stat. §§ 7-148(c), 7-194.

other funds. The answer in the first instance must come from the political process, not the courts. If, however, a city is insolvent under § 109(c)(3), and if it is otherwise eligible to be a debtor, chapter 9 may be used. Chapter 9 offers a solution to chronic economic distress caused by costs and revenues spiraling in opposite directions, but Chapter 9 is not available to a city simply because it is financially distressed. Thus, the issue is not whether Bridgeport was in financial trouble, but rather whether it was insolvent when it filed.

retrospective or prospective analysis

[5] The State argues that "[i]t stands to reason that, since the city has been ... paying all of its debts, it is also 'able' to pay those debts." *Brief of State* at 13. It is further argued that "both clauses of § 101(32)(C) were written in the present tense to comprehensively cover a city's current failure or unwillingness or inability to pay its debts in a fiscal crisis." *Pre-Trial Memorandum of State* at 13 (emphasis added). The State therefore rejects an insolvency standard based on "a projected future inability to pay" as an unwarranted repudiation of the express language of § 101(32)(C). *Pre-Trial Memorandum of State* at 15. Bridgeport responds that § 101(32)(C)(ii) requires a prospective analysis. I agree with Bridgeport. See *Caruso Enter., Inc. v. U.S.A. Motel Corp.* (In re U.S.A. Motel Corp.), 450 F.2d 499, 503 (9th Cir.1971) ("[T]he statutory requirement of inability to meet debts as they mature is not limited to debts which have already matured."); *Matter of Hudson & Manhattan R.R. Co.*, 188 F.Supp. 195, 200 (S.D.N.Y.1955).⁷

If § 101(32)(C) were read as the State suggests, the second clause of that subsection would be a subcategory of the first, i.e., clause (ii) would merely provide an

explicit reason why, under clause (i), a city was not paying its debts as they became due. However, it is clear from the construction of (32)(C) that clause (ii) is separate from, not a part of, clause (i). The two parts of § 101(32)(C) are joined by the disjunctive "or". Code § 102(5) provides that "'or' is not exclusive...." The legislative history of § 102(5) states that "if a party 'may do (a) or (b)', then the party may do either or both. The party is not limited to a mutually exclusive choice between the two alternatives." S.Rep. No. 989, 95th Cong., 2d Sess. 28 (1978), U.S.Code Cong. & Admin.News 1978, pp. 5787, 5814. See also *In re Broad Assoc. Lim. Partnership*, 125 B.R. 707, 711 (Bankr.D.Conn.1991).

Moreover, the State's interpretation would render the second clause mere surplusage, but that result would be contrary to this court's obligation "to give effect, if possible, to every word Congress used." *Reiler v. Sonotone Corp.*, 442 U.S. 330, 339, 99 S.Ct. 2326, 2331, 60 L.Ed.2d 931 (1979). If "unable to pay" means, as the State argues, not paying, i.e., *current non-payment*, because of inability to pay, Congress could have omitted (ii) without changing the meaning of the statute.

The conclusion that § 101(32)(C)(ii) requires a prospective analysis also comports with the purpose of chapter 9. See *Chapman v. Houston Welfare Rights Org.*, 441 U.S. 600, 608, 99 S.Ct. 1905, 1911, 60 L.Ed.2d 508 (1979) ("As in all cases of statutory construction, our task is to interpret the words of these statutes in light of the purposes Congress sought to serve."). Cities cannot go out of business. Chapter 9 is intended to enable a financially distressed city to "continue to provide its residents with essential services such as police protection, fire protection, sewage and garbage removal, and schools ...," H.R.Rep.

6. See *supra* at 335 for text of § 101(32)(C).

7. Bankruptcy Act § 130 enumerated specific matters that had to be incorporated in a chapter X petition. Subsection (1) required that the petition state that "the corporation is ... unable to pay its debts as they mature...." That phrase is essentially the same as the definition

of municipal insolvency provided in Code § 101(32)(C)(ii), so that decisions construing that language in the Act are useful guides for the interpretation of the comparable language in the Code. See *Rosenbaum v. Kilson* (*Matter of Kilson*), 83 B.R. 198, 201 (Bankr.D.Conn. 1988).

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No. 1011, 100th Cong., 2d Sess. 2 (1988), U.S. Code Cong. & Admin. News 1988, pp. 4115, 4116, while it works out a plan to adjust its debts and obligations. A construction of § 101(32)(C) under which a city would not be able to seek chapter 9 protection unless and until it was actually not paying its bills could defeat that purpose, as actually not paying bills could lead to the non-delivery of services.

The State is correct that the reference point for the insolvency analysis is the petition date. See H.R. Rep. No. 1011, 100th Cong., 2d Sess. 5-6 (1988). That is, it must be determined as of that date whether Bridgeport will be unable to pay its debts as they become due.

budget gap or cash flow analysis

[6] Bridgeport offered evidence to prove that it will have a \$16,000,000.00 budget deficit in fiscal year 1991-1992. The City argues that since its expenditures will exceed its revenue, it has satisfied the burden of proving that it is insolvent. The State counters that if a prospective analysis is used, Bridgeport's solvency should be judged by a cash flow, not a budget deficiency, analysis. I agree with the State. Section 101(32)(C)(ii) defines insolvency by whether Bridgeport will be able to "pay its debts as they become due", not on whether it has a budget gap.

The State further argues that Bridgeport has sufficient cash to make up any shortfall in its 1991-1992 fiscal year budget. Again, I agree with the State, as it is uncontested that Bridgeport will not run out of cash this fiscal year (1991-1992). *Tr. July 17*, at 285-86; *Tr. July 19*, at 162.

On July 1, 1991, the first day of the 1991-1992 fiscal year, Bridgeport had \$27,908,513.00 in cash. *Bridgeport Exhibit S*. The bulk of that money was raised as part of a \$58,315,000.00 bond sale in January 1989. Approximately \$35,000,000.00 of the bond sale proceeds were used to eliminate an accumulated deficit. The remainder, according to Francisco Borges, the State Treasurer and former chairman of the Financial Review Board, was intended to be and has been used to pay operating costs

as they become due. *Tr. July 19*, at 89. As Borges put it, the surplus money was intended to be a contingency fund to give Bridgeport "a cushion to allow it to be able to meet its obligations when due, [without] having to do the variety of short term borrowings the City had traditionally done, all at a very high interest rate." *Id.* at 40.

Bridgeport intends to use the \$27,908,513.00 to fund its fiscal year 1991-1992 operating deficits. *Tr. July 17*, at 275. The City's cash flow analysis, which I find persuasive, *Tr. July 19*, at 162, projects that by using those funds, it will have a positive cash balance in every month of the 1991-1992 fiscal year and \$12,547,699.00 on June 30, 1992, the last day of that year. *Bridgeport Exhibit S*.

While any money used this fiscal year ultimately must be accounted for, contrary to Bridgeport's argument, it does not have to be replenished this fiscal year. *Tr. July 17*, at 276; *Tr. July 18*, at 109-10; *Tr. July 19*, at 40. In November, 1992, a completed audit will disclose the exact amount, if any, of Bridgeport's fiscal year 1991-1992 budget deficit. If in fact there is a budget gap, Bridgeport will be obligated to reimburse the contingency funds used to balance the budget, but it may do so in fiscal year 1992-1993 or fiscal year 1993-1994. *Tr. July 19*, at 40, 42-43. It is therefore apparent that Bridgeport will be able to pay its debts as they become due during this 1991-1992 fiscal year.

duration of cash flow analysis

[7] Bridgeport argues that even if a cash flow analysis is the proper test, it is unrefuted that it will run out of cash early next fiscal year. I disagree.

Although the beginning point of the analysis is the date the petition was filed, neither § 101(32)(C)(ii) nor its legislative history provide guidance on how far into the future it should go. Under § 130 of the Bankruptcy Act, see *supra* note 7, a chapter X debtor was required to prove that its inability to meet its debts in the future was "imminent and certain, not merely a possibility or speculation." *In re U.S.A. Motel Corp.*, *supra*, 450 F.2d at

503. See also *Matter of Hudson & Manhattan R.R. Co.*, *supra*, 138 F.Supp. at 200 ("If the maturity of the debt is imminent and the inability to meet it certain, the debtor is unable to meet debts as they mature, within the meaning of the statute.").

Moreover, courts construe statutes in a way that accounts for the practical consequences of potential interpretations. See *New York Comm'n on Cable T.V. v. Fed. Communications Comm'n.*, 571 F.2d 95, 98 (2d Cir.1978), *cert. denied*, 439 U.S. 820, 99 S.Ct. 85, 58 L.Ed.2d 112 (1978); *Alabama ex rel. Graddick v. Tennessee Valley Auth.*, 636 F.2d 1061, 1066 (5th Cir. 1981), *cert. denied*, 454 U.S. 837, 102 S.Ct. 142, 70 L.Ed.2d 118 (1981). Just as a proposed budget is an informed projection of future revenue and expense, an analysis of future cash flow is a projection of the availability of expected cash to meet expected expense. Obviously it is necessary for cities to make informed financial projections. It is just as obvious that the longer the projection, the less informed the conclusion.

A prediction at the commencement of this case that Bridgeport will be unable to pay its debts as they become due in the 1992-1993 fiscal year is unreliable. There are many reasons, not the least of which is the uncertainty of its cash position during a fiscal year for which there is not even a proposed budget. As Dearborn testified, "projections beyond ... two years, even the second year, but beyond two years, are totally unreliable, they never work out as the projections show, they virtually never even come close because of the fact that you simply can't know all the changes that are going to take place." *Tr. July 19*, at 166. There are many variables which may effect Bridgeport's fiscal condition in the 1992-1993 fiscal year: the health of the regional, state, and national economies; the level of state and federal aid to Bridgeport; potential concessions by labor unions; potential voluntary suspension of tax abatements; potential savings through efficiency; increased tax collection rates; and the success of any efforts to borrow funds to offset any budget gap.

I conclude that to be found insolvent a city must prove that it will be unable to pay its debts as they become due in its current fiscal year or, based on an adopted budget, in its next fiscal year. Bridgeport has not met that burden of proof.

It is worthy of note that even if a longer look at Bridgeport's cash flow were warranted, Bridgeport has not presented persuasive evidence that it will be unable to pay its debts at any time in the future, notwithstanding its assertion that it is unrefuted that it will run out of cash early in the 1992-1993 fiscal year. Bridgeport relies on the testimony of its finance director, Richard Robinson, that "depending upon how this year's audit comes and next year's, it's my opinion that it is ... very possible the City will run out of cash sometime during ... July, August, or September." *Tr. July 18*, at 87. In contrast, Dearborn testified "that going into [fiscal year 1992-1993], and my guess would be through 1993, that there should be [a] continued ... favorable cash position." *Tr. July 19*, at 162. Further, Bridgeport's claim that it will run out of cash in July, August, or September of 1992 is contradicted by its cash flow projections for the 1991-1992 fiscal year. Bridgeport projects that it will collect approximately \$65 million in property taxes in July and August of 1991, increasing its cash position from \$27,908,513.00 on July 1 to \$44,633,773.00 on August 31. On September 30, its cash position is projected to be \$32,629,972.00. *Bridgeport Exhibit S*. Thus, Bridgeport's available cash is at its highest during July, August, and September. There is no reason to believe, and none has been given by Bridgeport, why a similar pattern will not occur in fiscal year 1992-1993. See *Testimony of Philip Dearborn*, *Tr. July 19*, at 170-71.

CONCLUSION

The budget process which generates conflict and debate every year over the appropriate amount and source of revenue and expenditures is at the core of our democracy. Each year mayors confer, negotiate,

IN RE INVESTORS CENTER, INC.

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Cite as 129 B.R. 339 (Bankr. E.D.N.Y. 1991)

and debate with department heads; legislative bodies; special interest groups, including employee unions; and state and national officials and legislators. The process, described by Dearborn as "very difficult, ... in which you have to work ... between the pressure groups," *Tr. July 19*, at 172, may take months before a city budget is adopted. The final product is the result of a compromise forged by the representatives of many constituencies.

Bridgeport claims that it is caught in an economic bind caused, on the one hand, by unaffordable employee union contracts and inadequate state aid and, on the other, by the practical reality that it can neither cut essential services nor raise taxes to pay for them. The City argues that sustaining the State's objection is tantamount to the conclusion that Bridgeport is not entitled to bankruptcy relief because its financial condition is too good. On the surface that argument has appeal. Bridgeport has demonstrated that its ability to provide even minimal services to its residents is strained, *see supra* at 334-335, and that its financial condition might get worse if drastic steps are not taken soon. The flaw in Bridgeport's argument is that financial difficulties short of insolvency are not a basis for chapter 9 relief. If such conditions are to be a criteria for municipal bankruptcy Congress, not the courts, will have to make that change in § 109(c). The fact is that Bridgeport was not insolvent when it filed, and therefore has no choice but to continue with the budget and collective bargaining processes.

I agree with Bridgeport that a city should not have to wait until it runs out of money in order to qualify for bankruptcy protection. It must, however, demonstrate, as a condition precedent to filing, that in the near future it will run out of money and be unable to pay its debts as they become due. In the absence of that proof, it would be an unwarranted intrusion into the political and collective bargaining processes for a bankruptcy court to become involved in the resolution of that

city's economic problems. If Bridgeport can meet that burden of proof and it otherwise qualifies under § 109(c), the protection and relief provided by chapter 9 will be available.

Thus, while Bridgeport was undoubtedly in deep financial trouble when it filed its petition, it was not insolvent, and that, in the context of this proceeding, is the congressionally approved criteria for bankruptcy intervention. Accordingly, the State's objection to Bridgeport's petition on the ground that Bridgeport was not insolvent when it filed its petition is **SUSTAINED**, Bridgeport's petition is **DISMISSED**, and **IT IS SO ORDERED.**²



In re INVESTORS CENTER,
INC., Debtor.

Bankruptcy No. 089-0017-21.

United States Bankruptcy Court,
E.D. New York.

June 11, 1991.

Customers of insolvent brokerage objected to determinations made by trustee for liquidation of brokerage's business, and trustee moved to confirm his determinations. The Bankruptcy Court, Cecelia H. Goetz, J., held that: (1) customers who had written confirmations of sales of securities prior to filing of the Securities Investor Protection Corporation's (SIPC's) application to liquidate brokerage had claims for cash and not for securities; (2) purported cancellations of confirmed sales were not effective to negate claims for cash; and (3) customers' claims were not fully satisfied by transfer of securities positions and their accounts to brokerage's clearing agent; but (4) insofar as customers relied on sales

² As the State's objection is sustained on the ground that Bridgeport has not proven that it is

insolvent, I need not reach the State's third and fourth objections.

EXHIBIT E

Connecticut
GENERAL STATUTES ANNOTATED

*Under Arrangement of the Official
General Statutes of Connecticut*

Volume 2

Titles 1 to 3

1995

Cumulative Annual Pocket Part

Replacing 1994 Pocket Part in back of volume
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Includes

Laws through the February Regular, May Special,
May 25 Special, June Veto, July Special,
July 13 Special, October Special, and
November Special Sessions, 1994
Court Constructions through 650 A.2d 1239

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§ 1-123

PROVISIONS OF GENERAL APPLICATION

composition of the agency's work force by race, sex, and occupation and a description of the agency's affirmative action efforts; and (7) a description of planned activities for the current fiscal year.

(1988, P.A. 88-266, § 42, eff. Jan. 1, 1989.)

§ 1-124. Treasurer's approval required for state contribution to or guarantee of bonds, notes, borrowed money

(a) The Connecticut Development Authority, the Connecticut Health and Educational Facilities Authority, the Connecticut Higher Education Supplemental Loan Authority, the Connecticut Housing Finance Authority and the Connecticut Housing Authority shall not borrow any money or issue any bonds or notes which are guaranteed by the state of Connecticut or for which there is a capital reserve fund of any kind which is in any way contributed to or guaranteed by the state of Connecticut until and unless such borrowing or issuance is approved by the treasurer of the state or his deputy appointed pursuant to section 3-12. The approval of the state treasurer or his deputy shall be based on documentation provided by the authority that it has sufficient revenues to (1) pay the principal of and interest on the bonds and notes issued, (2) establish, increase and maintain any reserves deemed by the authority to be advisable to secure the payment of the principal of and interest on such bonds and notes, (3) pay the cost of maintaining, servicing and properly insuring the purpose for which the proceeds of the bonds and notes have been issued, if applicable, and (4) pay such other costs as may be required.

(b) To the extent the Connecticut Development Authority, Connecticut Innovations, Incorporated, Connecticut Higher Education Supplemental Loan Authority, Connecticut Housing Finance Authority, Connecticut Housing Authority, Connecticut Resources Recovery Authority or Connecticut Health and Educational Facilities Authority is permitted by statute and determines to exercise any power to moderate interest rate fluctuations or enter into any investment or program of investment or contract respecting interest rates, currency, cash flow or other similar agreement, including, but not limited to, interest rate or currency swap agreements, the effect of which is to subject a capital reserve fund which is in any way contributed to or guaranteed by the state of Connecticut, to potential liability, such determination shall not be effective until and unless the treasurer of the state or his deputy appointed pursuant to section 3-12 has approved such agreement or agreements. The approval of the state treasurer or his deputy shall be based on documentation provided by the authority that it has sufficient revenues to meet the financial obligations associated with the agreement or agreements.

(1988, P.A. 88-266, § 43, eff. Jan. 1, 1989; 1993, P.A. 93-33, § 3, eff. April 20, 1993.)

Historical and Statutory Notes

Amendments

1993 Amendment. 1993, P.A. 93-33, § 3, designated existing text as subsec. (a) and added subsec. (b).

§ 1-125. Directors, officers and employees not personally liable. Indemnification

The directors, officers and employees of the Connecticut Development Authority, Connecticut Innovations, Incorporated, Connecticut Higher Education Supplemental Loan Authority, Connecticut Housing Finance Authority, Connecticut Housing Authority, Connecticut Resources Recovery Authority, Connecticut Health and Educational Facilities Authority and Connecticut Coastline Port Authority and any person executing the bonds or notes of the agency shall not be liable personally on such bonds or notes or be subject to any personal liability or accountability by reason of the issuance thereof, nor shall any director or employee of the agency be personally liable for damage or injury, not wanton, reckless, wilful or malicious, caused in the performance of his or her duties and within the scope of his or her employment or appointment as such director, officer or employee. The agency shall protect, save harmless and indemnify its directors, officers or employees from financial loss and

EXHIBIT F
COMMITTEE ON REVENUE AND TAXATION

UPDATE ON LOCAL INVESTMENT LEGISLATION

The Senate approved a package of bills related to local investment policies on May 1. There has been no action on these bills in the Assembly. It is anticipated that the Assembly will take some action following the sales tax election in Orange County held on Tuesday, June 27. It is still unclear whether the Assembly will send the bills to policy committees or hear them as a committee of the whole. The current unrest in the Assembly will undoubtedly impact the outcome of these bills. We will continue to report any actions in the Legislative Bulletin.

The following bills have been approved by the Senate and await action by the Assembly:

1. SB 13XX (Kopp) - Delegation of Investment Authority: Competitive Bids
League Position: Oppose

SB 13XX prohibits a local agency from delegating investment authority to a treasurer for more than one year at a time. In addition it requires negotiated competitive bidding or competitive bidding to remain any financial service, including bond counsel. The measure also requires any decision involving investment or borrowing of \$100,000 or more be considered as a separate item of business on the agenda of the local agency legislative body.

SB 14XX (Kopp) - Prohibition of Specified Investment Securities
League Position: Oppose

SB 14XX prohibits the investment in derivatives, but would exclude money market mutual funds, structured notes consisting of callable or step-up securities or investments whose value is linked to a short-term index from the definition of prohibited derivatives. The bill would permit investment in repurchase agreements or reverse repurchase agreements if (1) the proceeds of the reverse repurchase agreements are invested solely to supplement the income normally received from these securities; (2) if repurchase agreements constitute no more than 10 percent of the surplus funds portfolio, have a maximum maturity of 91 days, and the market value of securities purchased are at 102 percent or greater of the dollars invested and are adjusted no less than quarterly; and (3) if reverse repurchase agreements constitute no more than 10 percent of the portfolio, have a maximum maturity of 91 days, proceeds are used solely for short-term cash needs and the value of the securities is marked to market daily. The bill would prohibit inverse floaters, seven day floaters and leveraging, and provides that no investment by a local agency shall mature in over five years, even with the approval of the legislative body. The bill provides public investment officials are "Unsophisticated Investors" and local agencies have the right to rescission for any investment transaction. In addition, it provides that investment law violations are a misdemeanor.

SB 15XX (Kopp) - Prudent Investor Standard
League Position: Watch

SB 15XX defines the "prudent investor" standard and places priority on safety, liquidity and yield in that order, as investment objectives. It would place a fiduciary responsibility on broker-dealers and advisors when dealing with public agencies.

SB 62 (Hayden) - Financial DisclosureLeague Position: **Watch**

SB 62 would ban contributions to local officials from bond, investment or financial advisors during negotiations and for two years thereafter. It also requires disclosure of any contributions during past two years before voting or making any decision about such services.

SB 364 (Johnston) - Reporting RequirementsLeague Position: **Support**

SB 364 would require a local agency treasurer to file an annual investment policy with the legislative body. It also requires the treasurer to file a quarterly report on all securities, investments and moneys of the local agency; a statement of compliance with the investment policy; and a statement of the local agency's ability to meet the pool's expenditure requirements for the next six months.

SB 861 (Craven) - Delegation of PowersLeague Position: **Support**

SB 861 provides that local agencies and their treasurers are trustees and fiduciaries. It also allows governing boards to delegate the authority to invest to the treasurer and the treasurer would assume full responsibility for those transactions until the governing board revokes its delegation.

SB 864 (Craven) - County Treasury Oversight CommitteeLeague Position: **Support**

SB 864 would require the county treasurer to prepare an annual investment policy and would require the county treasury oversight committee to review the report. It specifies the membership of the oversight committee.

SB 866 (Craven) - Investments May Not Exceed Terms of NotesLeague Position: **Support**

SB 866 would prohibit local agencies from investing the proceeds from tax anticipation warrants, revenue anticipation notes and grant anticipation notes or funds set aside for the repayment of notes, for a term that exceeds the term of the notes.

EXHIBIT G

RICHARD L. SIGAL. Partner. Preparatory Education - Phillips Academy (Andover) 1956; Yale University - B.A. 1960; Legal Education - University of Chicago Law School - J.D. 1963. Mr. Sigal is in his thirty-first year as a public finance attorney and has been a Partner since 1971. He has served for two years as Chairman of the Municipal Law Section of the New York State Bar Association and eleven years as a managing partner of the firm. Throughout his career he has served as Bond Counsel or Underwriter's Counsel on various state, municipal and public authority bond issues and has been a principal draftsman on a significant number of financial legislative enactments in various states, including the legislation establishing the New York City Municipal Assistance Corporation Act, the Special Finance and Budget Act for the City of Yonkers, New York, the New York State Local Government Assistance Corporation which recently completed the permanent financing of the \$5 billion Spring Borrowing requirements of the State of New York, and the Connecticut Special Capital Reserve Fund Program providing credit enhancement by that State for housing finance, solid waste resource recovery, economic development and various other revenue producing projects.

Mr. Sigal's work at the firm has involved all phases of the authorization, issuance and sale of general obligation and revenue bonds including advice and assistance with respect to (i) legislation and any litigation establishing the authority for the issuance of such bonds, (ii) negotiation and drafting documentation creating the obligation and the security for such bonds (e.g., bond resolution; trust indenture; service contracts), (iii) the official statement in connection with the offering of such bonds and (iv) the approving opinions as to the validity of the bonds, exemption from federal taxation of interest thereon and as to securities law matters.

Since 1973 Mr. Sigal has counseled state and local governments on many infrastructure financings including for the City of Los Angeles, California, Montgomery County, Maryland and Onondaga County, New York and the implementation of statewide programs for clean water in New York and Connecticut. Mr. Sigal is also considered an expert in successful workouts of financially-troubled local governments such as the City of Yonkers, New York and the City of Bridgeport, Connecticut.

Most recently, Mr. Sigal was the principal drafter of the enacted legislation for a ten-year, \$1 billion bond program for the rehabilitation, regional expansion and construction of new research facilities for the University of Connecticut, known as "UConn 2000." He is also spending considerable time of late (a) counselling municipal clients on the legality and prudence of various swap proposals and other innovative financial products, (b) developing proper secondary market disclosure agreements and methods for municipal and investment banking clients consistent with the recent SEC rules and releases and (c) creating new debt

instruments structured and secured by net value added incremental state and municipal revenue resources rather than the traditional real estate tax base. In addition, Mr. Sigal has been consulted for a variety of international projects related to the development of municipal bond markets and financing public infrastructure improvements in and for the Governments of Romania, Hungary and Bulgaria.

He is a decent tennis player, but, reputedly, a hopeless golfer.



TESTIMONY OF

**PAUL S. MACO, DIRECTOR
OFFICE OF MUNICIPAL SECURITIES
U.S. SECURITIES AND EXCHANGE COMMISSION**

**REGARDING
THE MUNICIPAL SECURITIES MARKET**

**BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON BANKING AND FINANCIAL SERVICES**

UNITED STATES HOUSE OF REPRESENTATIVES

JULY 26, 1995

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

TESTIMONY OF
PAUL S. MACO, DIRECTOR
OFFICE OF MUNICIPAL SECURITIES
U.S. SECURITIES AND EXCHANGE COMMISSION
CONCERNING THE MUNICIPAL SECURITIES MARKETS
BEFORE THE COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES
JULY 26, 1995

Chairman Baker and Members of the Committee:

I appreciate the opportunity to appear on behalf of the Securities and Exchange Commission ("Commission") with an overview of the activities of the Commission in the municipal securities markets, as well as a discussion of the events surrounding the bankruptcy filing of the County of Orange, California ("Orange County", or the "County"). These issues are of vital importance to Americans who invest in the municipal securities markets, to the state and local governments that need access to the municipal securities markets in order to provide financing for public works and services, as well as to the state and local taxpayers who stand behind municipal securities issuers and look to local government officials for the safe management of public funds.

The Commission's testimony today will (i) review the public record¹ concerning events surrounding the Orange County bankruptcy filing; (ii) make preliminary observations with respect to the effect the bankruptcy filings and actions taken in the bankruptcy proceeding may have upon the municipal securities markets and

disclosure practices; and (iii) make preliminary observations on state and local governments as investors in the securities markets. We also provide a review of the events leading up to the Orange County bankruptcy and of our initiatives with respect to the municipal securities markets in the appendices to our testimony.

I. THE ORANGE COUNTY BANKRUPTCY AND RELATED EFFECTS

On December 6, 1994, Orange County and the Orange County Investment Pools ("OCIP" or the "Pools")², an instrumentality of the County, filed for bankruptcy under Chapter 9 of the federal Bankruptcy Code (the "Code").³ These filings began the largest municipal bankruptcy in our nation's history. Although additional facts come to light daily, we can provide at this time a brief description of the circumstances in which, under provisions of California state law, Orange County and approximately 190 local government entities invested public moneys using a strategy that has resulted in an estimated loss of approximately \$1.7 billion dollars.⁴ A summary of the events leading up to the filings, based on the public record, is provided in Appendix A to this testimony.

A. Orange County Recovery Efforts.

Orange County's Pool losses included the failure to realize approximately \$152 million of budgeted interest income, for an overall budget deficit of \$190 million for fiscal year 1994-95.

The County prepared a comprehensive recovery plan (the "Recovery Plan") to address the budget deficit and OCIP losses and to fund certain of the Pool participants' principal losses.

Under the Recovery Plan, all creditors, including the holders of the County's debt, were ultimately to have been paid in full. However, the Recovery Plan was dependent upon several elements that have not been achieved. A key element, rejected by Orange County voters on June 27, 1995, was a proposed 1/2 cent increase in the sales tax, which would have provided additional annual revenue of an estimated \$130 million for the County general fund.

A second key element of the Recovery Plan appears to be in jeopardy. Issuance of \$500 million in new long-term bonds, supported by enhanced operations of the County's waste management system, achievement of which is now in doubt, was premised upon execution of new supply contracts.⁵

Two bond issues that were part of the Recovery Plan have been completed. On June 16, 1995, the County issued \$278,790,000 in 30-year tax-exempt recovery bonds, the proceeds of which were paid to OCIP participants as part of a comprehensive settlement agreement. On June 27, 1995, the County issued \$155 million in 20-year "Teeter" bonds (California financings repaid from delinquent property tax payments) that were used in part to refinance \$175 million in Teeter notes that were due and paid on June 30, 1995.

The County is working on an alternate Recovery Plan following the defeat of the proposed sales tax increase, many provisions of which would require state legislative approval.

1. The Rollover Agreement. Orange County had outstanding \$975 million in short-term notes maturing this summer. The Recovery Plan provided for retirement of a portion of this debt, but did not provide for payment, when due, of approximately \$800 million of notes. Rather, the County sought and received from holders an extension of the due date on these obligations until June 30, 1996. The bankruptcy court has given the County permission to enter into a Second Amended Stipulation of Settlement and Agreement Respecting Note Debt of the County of Orange (the "Rollover Agreement") with the Official Committee of Creditors of the County of Orange, which was approved by more than 99% of the County note holders (the "Note Debt holders") on July 7, 1995.⁶ The Rollover Agreement effectively applies to approximately \$800 million in County notes (the "Note Debt") maturing on or before August 10, 1995.⁷ Under the Rollover Agreement, among other matters, Note Debt holders agreed to extend the maturity of their Note Debt until June 30, 1996. In exchange, the County agrees (i) to allow the Note Debt as undisputed claims in the bankruptcy proceeding and to waive certain state law "Debt Limitation Defenses," in each instance subject to reservation by the County of certain rights; (ii) to pay on or before the original maturity dates of the Notes all accrued interest; (iii) going forward, to pay, monthly in arrears, a portion of interest due on the Note Debt, and to accrue the remainder as an administrative expense; and (iv) to increase the rate of interest on the Note Debt by .95%.⁸ Consequently, assuming the ruling of the bankruptcy court approving

all terms of the Rollover Agreement is not overturned on appeal, the maturity date of the Note Debt has been extended to June 30, 1996.

Two rating agencies, Moody's Investors Service and Standard & Poor's, have issued statements classifying the County's rollover proposal as tantamount to default.⁹

2. Challenge to the Validity of Certain Notes and Terms of Other Obligations. Orange County has reserved the right to contend that \$600 million in taxable 1994-95 notes were invalid at the time they were issued. The County also has reserved the right to contend that the pledge of the \$429 million in reserved funds held in connection with these notes is not a valid security interest.

Like many local governments in California and elsewhere, Orange County makes use of a financing structure called certificates of participation, or "COPs".¹⁰ The County also has reserved the right to characterize the COPs as debt rather than as lease transactions, with the result that the COPs holders' position in the bankruptcy proceeding could potentially be diminished.¹¹

To date, the County has not actually challenged the validity of the notes or the security interest (except with respect to the obligation to make monthly set-asides of revenue under the 1994-95 Tax and Revenue Anticipation Notes, Series A and Series B ("TRANS") as described below) or challenged existing reserves. Nor has the County attempted to recharacterize the COPs. It is not clear when, if ever, the County would exercise its reserved right to make such

challenges. A challenge to the validity of the Orange County notes or to the structure and characterization of the COPs could cause uncertainty in this segment of the municipal securities markets for California.¹²

3. Default. Given the effectiveness of the Rollover Agreement, the County has not failed to pay principal or interest on any due date of any of its outstanding publicly held obligations as of July 21, 1995. As noted earlier, however, two rating agencies have treated the Rollover Agreement as a default on the affected notes.¹³

The County is in default under the terms of a number of its debt obligations,¹⁴: the \$110,200,000 County of Orange, California Taxable Pension Obligation Bonds Series 1994 B¹⁵ and the 1994 Series A and 1994 Series B TRANS¹⁶, as well as a swap agreement relating to \$209,840,000 County of Orange, California Taxable Pension Obligation Bonds, Series 1994A.¹⁷ The County also is in technical default under various financing documents as a result of the bankruptcy filing.¹⁸ Lease payments on certain COPs have been made by draws on reserve funds in excess of \$16 million for those obligations without replenishment by the County, apparently placing the County in technical default with respect to these obligations as well.¹⁹

B. Chapter 9 Of The Federal Bankruptcy Code

The Orange County bankruptcy proceeding is the largest ever commenced under Chapter 9.²⁰ Of the handful of bankruptcies that have been filed under Chapter 9, most have involved small local government entities that did not begin to approach the level of complexity of Orange County. Consequently, many of the provisions of Chapter 9 have yet to be interpreted and applied in the context of a large municipality with a substantial amount of outstanding municipal debt. Indeed, the ultimate resolution of many issues arising in the Orange County bankruptcy proceeding may provide the first interpretation of these issues.

As a general matter, holders of municipal bonds have not fared well as the Orange County bankruptcy case has evolved. The normal operation of the bankruptcy laws, particularly the automatic stay, combined with provisions of law peculiar to a state, such as California constitutional and statutory debt limitation provisions, illustrate the types of conflicts affecting bond holders that may arise in a Chapter 9 proceeding.

Under the automatic stay of Sections 362 and 922 of the Code,²¹ creditors are precluded from taking action against a debtor to collect or recover on claims. This gives the debtor, in this instance, the County, time to reorganize its financial affairs and prepare a plan. However, California law restricts the ability of municipalities to repay borrowing incurred in one year with

revenues received in a subsequent year.²² Under these provisions, Orange County's \$975 million Note Debt due this summer is required to be repaid with revenues received during the fiscal year ending June 30, 1995.²³ The Recovery Plan did not identify funds sufficient to make such payments.

Under the Rollover Agreement, the County and its Note Debt holders seek to resolve this conflict by extending the debt and entering into a stipulation in which the County waives all defenses and objections to allowance of the Note Debt based upon the California debt limitation provisions. The bankruptcy court order approving the Rollover Agreement has been appealed by other creditors of the County. The Committee of Pool Participants asked the bankruptcy court for a stay, which was denied, of the Rollover Agreement pending their appeal. The Commission argued against the imposition of a stay, on the ground of potential harm to the markets.

Holders of the TRANS have also encountered difficulties in the bankruptcy proceeding. Orange County issued \$200 million in TRANS in the summer of 1994, to be paid back with revenues received and set aside on a monthly basis over the course of the 1994-95 fiscal year. After filing for bankruptcy, Orange County stopped making the monthly set-aside payments, arguing that under Section 552 of the Code, the lien on the revenues dedicated to the TRANS received after the petition was filed did not survive the bankruptcy filing.²⁴ The bankruptcy court agreed with the County, holding that the County was not required to make the set-aside payments.

As a result, only \$28 million in reserves accumulated prior to the bankruptcy filing are available to pay holders of the \$200 million in TRANS. The bankruptcy court's decision recently was reversed on appeal by the district court, and the County has appealed this ruling to the Court of Appeals for the Ninth Circuit.

The Orange County experience provides a fruitful area for the Bankruptcy Review Commission²⁵ in its investigation and study of issues and problems relating to the Code. Proceedings in the case have already revealed problems and uncertainties in the municipal securities area. The ultimate resolution in the bankruptcy proceeding of these and other issues relating to the rights of municipal securities holders may identify the need for amendments to Chapter 9 to reduce uncertainties remaining in the municipal securities markets. Accordingly, it would be premature at this time to try to recommend changes that should be made to Chapter 9.

II. PRELIMINARY OBSERVATIONS ON MARKET RESPONSE TO THE BANKRUPTCY

A. The Municipal Markets After Orange County.

1. The General Obligation Bond. The municipal markets are and likely will remain attractive places for the savings of investors, particularly retail investors who find the tax-exempt interest income of these securities appealing. The lasting effect of the bankruptcy and any default on the relationship between issuers and investors in this \$1.16 trillion market most likely

will manifest itself in the need for more discriminating investigation by the market (and corresponding disclosure) of the legal structure supporting the repayment obligation and perhaps in higher financing costs and less flexibility for municipal issuers as well.

Until the Orange County bankruptcy, municipal general obligations often were presumed to carry the "full faith and credit"²⁶ of the municipality; i.e., the issuer would do what is necessary to repay the borrower. That assumption in many cases was based on "faith" rather than any legal credit obligation or repayment right, because the ability of an investor to force an issuer to raise taxes and divert revenues to repay debt when due varies from state to state. In some jurisdictions, the power to raise taxes or access general revenues of the issuer may be beyond the power of local elected officials. A municipality's concern about its reputation for credit-worthiness and maintenance of its ability to easily and cheaply access the debt markets may motivate an issuer's timely payment of its debt, as much as any legal obligation.

The constitutional and statutory provisions of many states typically restrict the capacity of municipal governments to incur indebtedness, limiting increases in the debt burden and possible credit crisis that may otherwise result.²⁷ Revenue bonds and other project type financing, in which investors look to a dedicated revenue stream from a government enterprise or independent authority outside state constitutional restrictions for repayment

have, over time, become a common way to overcome constitutional and statutory hurdles to state and local borrowing.²⁸ Essential government functions, such as water and sewer, waste disposal, and public transportation, are increasingly financed by an isolated source of repayment as compared to the many revenue sources available in a general obligation financing.²⁹ Often, these types of financings present many of the same investment risks as corporate enterprises.

The municipal markets also have facilitated efforts by local governments to finance the capital improvements necessary for schools, public safety, fire protection, courts and prisons, through financing techniques that are not characterized as "debt" of the municipality within the meaning of state constitutions and statutes. By avoiding characterization as debt, these obligations also are not subject to state debt limitations. These techniques have included lease structures that are subject to annual appropriation, including certificates of participation in the revenues generated by the leases on local government buildings and other capital assets.

The rights reserved by Orange County to challenge the characterization of such instruments may question whether the only real security behind some of these innovative financing structures is the good faith of the local officials and their electorate to continue to make contemplated payments and refrain from challenging the enforceability of the instruments. Thus, investors may be subject to a risk relating to an issuer's or electorate's

"willingness to pay" that goes to the heart of the many and varied financing structures not subject to constitutional debt limitations that permeate the municipal securities markets today.

Orange County's bankruptcy filing also has highlighted the ability of a municipality to seek protection from creditors under Chapter 9 to avoid repayment of its obligations and to set aside the liens and security interests in repayment funds relied upon by investors. If Orange County successfully avoids the repayment of its outstanding debt, the markets will have to assess whether other, less affluent, issuers will likewise take advantage of Chapter 9 to solve a financial crisis without having to make the unpopular decisions to raise taxes or cut services.

If, as a result of the Orange County experience, investors no longer attribute a high level of security to state and local government general obligation bonds, but rather view them as being like any other debt obligation, a municipality's access to the markets will turn solely on the strength of the legal structure of the financing and of the revenue stream available for repayment of the bonds. As a result, a revenue bond with a statutory lien on revenues sufficient to service the debt obligation, that is able to survive a bankruptcy filing, may prove a stronger credit than a general obligation bond.³⁰ The traditional notion that an issuer's general obligation is its strongest credit will thus have been turned upside down. Indeed, with the proliferation of revenue financings utilizing every segregable source of revenue, the holder of a "general" obligation bond may find itself last in line for

repayment, with essentially the same rights as an unsecured creditor.

After the Orange County bankruptcy, investors may begin to devote their resources to differentiating among varying issues of general obligation bonds, alternate financing structures, and security interests representing the repayment obligation on the bond based on the perception that an issuer's willingness to pay may be an element of investment risk. Because of assumptions that state and local governments would consider themselves morally obligated to pay their debts, the municipal securities markets have not made any significant pricing distinctions among general obligation issuers based on the strength of the remedies available to investors. Nor has the market fully differentiated credits on the basis of the ability of their repayment arrangements to survive bankruptcy, because no municipality of significant size had sought protection under the Code prior to Orange County. As noted by one market participant, "'When is a GO really a GO' will be asked more often in light of Orange County."³¹

These additional risks faced by investors may result in immediate increases in financing costs to issuers. The market may insist on compensation for any legal risk inherent in the financing structure, as well as the costs incurred to analyze properly those risks. Investors may insist on credit enhancement, such as insurance or a letter of credit, rather than developing the resources necessary for analysis of the legal risks underlying each individual credit. As a result, issuers may incur the additional

costs of providing that enhancement. Similarly, issuers may lose flexibility in designing innovative financing structures if the strength of the lien or the legal authority to issue the bonds is untested. Lease financings based on a municipality's willingness to fund essential services on an annual basis likewise will suffer, particularly because leases may be subject to legal challenge and repudiation by the municipality, and because the status of leases in bankruptcy proceedings is, as yet, untested.

The municipalities most likely to experience the effects of the Orange County default are issuers with weaker credits. As is normally the case following a market disruption, a "flight to quality" may occur in the municipal securities markets. Thus, the stronger issuers may actually benefit by the increased demand for their securities, while the weaker credits will have difficulty raising funds at affordable costs.

2. Effect of the Orange County Bankruptcy on Money Market Funds. At the time Orange County filed for bankruptcy protection, most of the Orange County Note Debt was held by money market funds, and thus indirectly by thousands of small investors. Money market funds are mutual funds that seek to maintain a stable net asset value, typically at \$1.00 per share. They are widely used as a substitute for bank deposits by shareholders who depend on the stability of their share value. As a result of Orange County's bankruptcy, prices for the Note Debt declined and several funds that held the Note Debt were faced with the prospect of pricing

their shares below \$1 per share.

Under Commission rules, money market funds are strictly limited to investing in short-term high quality securities whose issuers are very unlikely to default.³² At the time of Orange County's bankruptcy, its securities were rated by the rating agencies in their highest rating category and were eligible for investment by money market funds. Thus, neither advisers to money market funds nor their shareholders had any reason to expect that all of the Note Debt would not be paid in full when due.

Money market funds are typically advised by large advisory firms, subsidiaries of broker-dealers, banks or other financial firms. These firms are not legally obligated to guarantee or otherwise maintain the \$1.00 share price of the funds they advise. Many advisers, however, when faced with the prospect of repricing the value of their shares below \$1.00 took voluntary actions to support the funds' share prices. These actions included buying the Note Debt from the funds at their par values, plus accrued interest, or providing some type of credit support for the Note Debt.³³ To date, the Commission is aware of 38 money market funds holding, in the aggregate, \$543 million of Note Debt whose advisers have taken steps to protect their net asset values. Because the advisers to their funds absorbed or agreed to absorb the losses, no money market fund shareholder lost money as a result of the Orange County bankruptcy. In the future, advisers may refuse or be unable to absorb losses and many small investors in money market funds may experience unexpected losses as a result. Since 1991, all money

market funds have been required to disclose on the cover page of their prospectuses that an investment in the fund is not insured or guaranteed by the federal government. Nevertheless, the Commission is concerned that such losses may undermine the confidence investors have in money market funds.

3. Disclosure of Repayment Risks. Orange County has demonstrated again to the market the importance of reliable information concerning the issuer and its securities, even in the case of short-term, general obligation, investment grade rated debt. To properly analyze the repayment risks, in addition to financial information concerning the governmental issuer or enterprise, investors need information, presented in a clear and understandable fashion, regarding the nature of the issuer's repayment obligation. "Institutional buyers can more thoroughly research an issuer and laws protecting their debt, but a retail investor lacks access to this information and may lump together different credits."³⁴

In its March 1994 interpretive release on the disclosure obligations of municipal issuers and dealers under the anti-fraud provisions of the federal securities laws (the "Interpretive Release"),³⁵ the Commission reminded issuers of their obligations to properly describe the terms of the security and the risks of repayment, and to disclose any legal risks concerning the issuer's authority to issue the securities. The Interpretive Release recommended wider implementation of disclosure guidelines

promulgated by the Government Finance Officers Association (the "GFOA").³⁶

The GFOA Guidelines call for:

- A description of the securities being offered, including complete information regarding the purposes of the offering, the plan of financing, the security and sources of repayment, and the priority of the securities, as well as the pertinent provisions of the state constitution, statutes, resolutions and such other documentation that authorize or limit the issuance of securities or the adoption, execution, delivery and performance of the basic documentation;
- A description of the government issuer or enterprise, including information about the ability of the issuer to impose and collect taxes and other receipts that can be used to discharge the issuer's obligations, including, in the case of a limited obligation of an issuer or enterprise, a discussion of the limitations;
- A description of the issuer's outstanding debt, including the authority to incur debt, limitations on debt or any tax limit of the issuer or enterprise, the legal source of the limit, and any unused borrowing or taxation margin; and
- A description of the basic documentation, such as indentures, trust agreements and resolutions authorizing the issuance and establishing the rights of the parties.

As stated in the Interpretive Release, these guidelines provide a generally comprehensive road map for disclosure in offering statements for municipal securities offerings.

The Interpretive Release is one of several key components of the Commission's initiatives to improve the municipal securities markets, which are described in greater detail in Appendix B.

III. STATE AND LOCAL GOVERNMENT INVESTMENT PRACTICES**A. Management of Public Funds.**

Our markets have recently undergone dramatic changes. Complex instruments have been developed that are capable of producing both breathtaking returns and losses. The three basics of public fund management, however, have not changed. They are, in order of importance, safety, liquidity, and, only then, yield.

In the complex markets of the 1990s, assuring safety is no longer as simple as examining credit quality. When investment terms and liquidity needs are mismatched, a volatile market can quickly eviscerate investments with even the most impeccable credit rating.

1. **Questionable State and Local Government Investment Strategies.** Recent disclosure documents issued by Orange County reveal that the County budget for its recently completed fiscal year looked to income from County funds invested in the OCIP to provide \$164 million, or approximately one-third of the amount of its discretionary budget.

In addition to the losses that have most recently occurred in Orange County, a number of other state and municipal entities also have suffered losses due to investments of the funds that they manage in derivative products and other types of financial

products.³⁷ The aggregate loss attributed to these entities is approximately \$590 million.³⁸ The entities that have suffered losses range from states, counties and cities to state colleges. While no one instance of loss approaches the magnitude of loss in Orange County, the numerous instances of loss raise important questions as to the adequacy of existing measures safeguarding public funds.

As recently as March 31, 1995, the California State Auditor found, in a post-Orange County bankruptcy review of the management of county investment pools in California,³⁹ that the counties were applying investment strategies that were inappropriate for short-term investment pools.⁴⁰ Among other things, the Auditor's June 1995 Report found that several counties held concentrations of structured notes in excess of 30% of their respective portfolios as of March 31, 1995; four counties leveraged their portfolios by more than 40% sometime during 1994, with one county (not Orange County) leveraging its portfolio as much as 80%; and six counties managed portfolios of investments with maturities averaging 2.5 years or more during 1994. The Auditor's June 1995 Report notes "the average maturity for one county's investments was an astounding 27.9 years."⁴¹

The Auditor's June 1995 Report also states:

Furthermore, some counties are using agents, who in many cases also act as the securities custodians for the same counties, to execute securities lending and/or reverse repurchase transactions on behalf of the counties. Agents acting on behalf of three counties we reviewed performed hundreds of millions of dollars worth of securities lending and reverse repurchase transactions that current regulations and guidelines fail to address.

Therefore, these transactions are not reported to oversight agencies and pool participants, were not reflected in the counties' financial statements or clearly disclosed in footnotes, and were not considered by the counties when determining compliance with pertinent investment laws and county policies.⁴²

Such comments reinforce the need for state and local governments to periodically revisit existing investment standards and laws intended to protect public funds to be sure they remain up-to-date and address current market practices.

2. Commission Oversight of State and Local Government Investments. The public has a right to expect that money will be available when needed to meet the civic needs for which they paid their taxes. When such funds can generate additional revenue in the interim, so much the better. However, a budget balanced on anticipated high investment returns may prove troublesome in the event of sudden market changes. Using the treasury function as a profit center is as risky for public officials as for corporate managers.

The Commission generally does not have, nor does it seek, the ability to regulate investment decisions by municipalities or other end-users of securities.⁴³ Investors seeking higher than average returns generally undertake higher than average risks. That decision generally should be made by the investor. In the case of state and local public instrumentalities, investment decisions should be made with the guidance and oversight of state and local governments.

Section 2(b) of the Investment Company Act excludes from

federal registration and regulation state and local governments and investment pools operated by one or more of these governmental entities.⁴⁴ The broad wording of this exclusion strongly indicates that Congress anticipated that state and local governments would establish and participate in investment pools as a means to effectuate government functions, and concluded that the federal government should not regulate those pools as investment companies. Consistent with the statutory language and purpose of Section 2(b), the exclusion has been construed broadly by the Commission staff.⁴⁵

OCIP is not registered under the Investment Company Act.⁴⁶ Presumably, the determination not to register under the Investment Company Act was made on the basis of the Section 2(b) exclusion.⁴⁷

The Commission believes that state and local governments should have the authority to manage their cash reserves and monies in government custody either individually or collectively. Further, the Commission believes that state and local governments or the pools created to serve this function should be able to rely on the exclusion in Section 2(b) of the Investment Company Act. State and local governments are in the best position to regulate the manner in which municipal funds are managed. In the Commission's view, absent special facts, requiring municipal entities to operate in compliance with the Investment Company Act would represent unnecessary federal intervention into state and local affairs. If Congress determines that the Commission should regulate these pools, it would have to amend the Investment Company Act to give the Commission the necessary authority and provide

additional resources.⁴⁸

B. State and Local Government Investment Policies.

1. **Prudent Management of Public Funds.** The Commission is working with state and local government organizations to encourage sound municipal investment policies. The Commission believes that the federal securities laws should not constrain the authority of state and local governments to manage their cash reserves and moneys in government custody either individually or collectively.

There are three important steps that can help assure safety: a written investment policy, sound internal controls, and independent oversight. A written and publicly available investment policy, coupled with current internal portfolio information, reinforces accountability. But without an independent review of actual performance on a frequent basis, a written investment policy can quickly be reduced to words without substance.

Investment practices of municipalities, including the types of permitted investments, are controlled by state law. City Councils, boards, and supervisory bodies should review their lists of authorized investments regularly, and monitor the results closely. State and local legislative bodies should periodically review their statutory framework with a view to evaluating changing market conditions. Surprising investment gains should set off alarms every bit as loudly as surprising losses.

Frequent valuation, or marking securities to market, is a wise

component of oversight, especially where a high degree of liquidity is needed. Greater "transparency" such as will result from recent efforts to improve price transparency, will help; ready access to trade and quote information will facilitate mark-to-market calculations and increase the accuracy of independent reviews of performance.⁴⁹

2. Industry Initiatives and Proposals. This turbulent year has produced some thoughtful advice. For example, the GFOA has been active in expressing its views. The GFOA has developed policy statements in the areas of reverse repurchase agreements, leveraging and prudent investment practice for cash management and market risk (volatility ratings). The GFOA also has approved, in concept, a recommended valuation process that would require states, local jurisdictions and investment pools to provide for the marking-to-market of the assets in their investment portfolios at set intervals.⁵⁰ In addition, in late June, the GFOA released a model investment policy designed to assist state and local governments in formulating an investment policy that is appropriate for their specific purposes, and complies with state and local laws, regulations and other policies concerning the investment of public funds.⁵¹ The model investment policy outlines the objectives, standards of care, internal controls, investment practices, and valuation policies that should be included in the formulation of a written investment policy.⁵²

The National Association of State Treasurers ("NAST")

recently conducted a survey of the 50 states with respect to their practices relating to local government investment pools ("LGIPs"). The survey is to be complemented by an update of NAST's 1989 Policy Statement with respect to local government investment pools.⁵³ NAST is also sponsoring a week-long institute specifically designed to address key issues facing financial officers of state and local governments.

The Commission applauds these organizations and all of the other segments of the industry that have taken the initiative to develop strategies and policies designed to create a safer market for public funds and encourages them to continue in their efforts.

Regulators and industry participants alike share the view that internal controls are an essential element in the management of risks associated with derivatives. Recent experiences with derivative products have prompted various groups to produce useful guidance regarding the design and implementation of internal management and control systems. Although this guidance is directed towards dealers, there are lessons for end-users of derivatives as well.

In March 1994, for instance, the Commission, the Commodity Futures Trading Commission, and the U. K. Securities and Investments Board issued a joint statement setting forth an agenda for the oversight of the over-the-counter ("OTC") derivatives market.⁵⁴ Recognizing the size and global nature of the OTC derivatives market, the joint statement is intended to provide a framework for enhanced regulatory cooperation. The joint statement

highlights the importance of securities and futures firms having effective management controls for OTC derivative products, and the need for regulatory authorities to encourage the development of such standards. In July 1994, the International Organization of Securities Commissions ("IOSCO") issued a report identifying, for firms with active OTC derivatives business, those management control mechanisms which regulators should seek to promote.⁵⁵ At the same time that IOSCO issued its report, the Basle Committee on Banking Supervision issued a similar report providing guidance on management control mechanisms with respect to the derivatives activities of banks.⁵⁶

Members of the industry also have developed guidance regarding internal controls. In a recent report prepared by the Derivatives Policy Group, six firms that are significant market participants set out a framework for the voluntary oversight of their OTC derivatives activities.⁵⁷ The report adopts as an element of the framework the implementation of internal management controls for monitoring and measuring the various risks to which a firm may be exposed as a result of dealings in OTC derivative products, and the inclusion of an external audit and verification process. The Group of Thirty, comprising a broad cross-section of industry participants, also drafted a report offering twenty recommendations to help dealers and end-users manage derivatives activities.⁵⁸ The first of these recommendations stresses that derivatives should be used in a manner consistent with firms' overall risk management and capital policies approved by their boards. The report further

recommends that policies governing derivatives use should be clearly defined, that senior management should approve procedures and controls to implement these policies, and that management at all levels should enforce them.

The recurring themes of these reports are the need for internal control mechanisms for the monitoring and measuring of risks and the need for an external audit and verification process. Much consideration and professional expertise has gone into each of these reports. Their guidance regarding internal controls for firms may be useful in other contexts, and particularly, may prove helpful to state and local governments that are end-users of derivatives, and are considering internal management and control policies for their securities activities.

3. Government Securities Transactions. The Orange County bankruptcy, as well as other recent events, also has raised the issue of sales practices; specifically, what rights and obligations exist and flow between sellers and buyers of securities. In the world of corporate and municipal securities, the duties of broker-dealers have been defined for some time. Broker-dealers that recommend the purchase or sale of a security, including a derivative security, are subject to the anti-fraud provisions of the federal securities laws, and to the suitability and other "fair dealing" rules of the securities self-regulatory organizations ("SROs").³⁹ The anti-fraud provisions prohibit a broker-dealer from making false or misleading statements. SRO rules prohibit a

broker-dealer from making a recommendation to a customer unless the broker-dealer has reasonable grounds for believing that the recommendation is suitable for the particular customer.⁶⁰ This prohibition, which is codified in the Rules of Fair Practice of the National Association of Securities Dealers ("NASD") and the rules of the Municipal Securities Rulemaking Board (the "MSRB"), previously did not apply to government securities.

In 1993, with the passage of the Government Securities Act Amendments, Congress gave the NASD the authority, for the first time, to impose sales practice rules on government securities.⁶¹ In the past year, the NASD has drafted two proposed interpretations of its suitability rule, in an effort to codify in a single rule a standard that would apply to all equity and debt transactions, except municipals.⁶² The NASD solicited comment from its members on these proposals, and received significant input from the investment community. The Commission anticipates receiving a rule proposal from the NASD regarding this matter in the next few weeks. The Commission also affirms the view expressed in the 1993 Government Securities Act Amendments: there should be a sales practice rule for government securities, just as there currently exist sales practice rules for buying and selling corporate and municipal securities.

Although sales practice rules play a vital role in the federal securities regulatory scheme, it is important for each party to the trade to act in a responsible manner. For example, all customers should take responsibility for understanding the product they are

buying. It would be foolish for a consumer to buy a race car that he or she didn't know how to operate; the same is true for a very complex financial investment: if you don't know how it's going to work, now as well as tomorrow, then you need to figure it out before you make the purchase, or decline to enter into the trade.

IV. CONCLUSION

Mr. Chairman, the events in Orange County and investment losses involving public funds by other issuers of municipal securities appropriately draw attention to the need for accurate and adequate disclosure in the municipal securities markets and for effective, modern safeguards for the investment of public funds.

Improved disclosure will not prevent municipal defaults or all market disruptions, since even public reporting companies can become insolvent due to poor management or adverse market conditions. However, the increased efficiency in the markets derived from improved issuer disclosure will benefit not only investors, by alerting them to potential problems earlier, but municipal issuers and their taxpayers as well, who should benefit from lower financing costs. Improved disclosure practices as called for by the amendments to Rule 15c2-12 and the Interpretive Release also may provide the incidental benefit of deterring unwarranted speculative activity by local government officials that, if fully disclosed, could harm the issuer's credit rating or otherwise impair its ability to obtain financing. Improved

disclosure in the municipal markets therefore may result not only in better markets, but also may result in better management of government funds.

Additionally, we believe that, as a general matter, regulation of state and local government investment practices is best left to state and local governments. However, we also believe that at the federal level, we have both the opportunity and the obligation to encourage implementation of sound measures to assure proper management of public funds at the local government level. Investment risk is not confined to one market; it also is not isolated in one type of investor. Rather, investment risk and the need to manage it properly is the common denominator for all markets and all market participants. Investors, dealers and regulators in our national and international markets are developing helpful methods of risk management that may be useful and instructive to state and local governments and their officials responsible for protecting public money. At the federal level, we must do our best to promote awareness of market risks and the tools to manage risks by seeking opportunities to educate and assist state and local government officials.

I thank the Chairman and the members of this Committee for the opportunity to address these issues here today.

TESTIMONY OF THE
SECURITIES AND EXCHANGE COMMISSION

ENDNOTES

1. The information contained in this statement concerning the events surrounding the bankruptcy filings by Orange County is based on publicly available information. The Commission is currently conducting an investigation into a number of aspects of these events. This statement does not discuss non-public matters relating to that investigation or that may become the subject of actions by the Commission or by other authorities.
2. See Appendix A infra, at A-4 and accompanying text.
3. 11 U.S.C. §§ 901 et seq.
4. California State Auditor Bureau of State Audits, Orange County: Treasurer's Investment Strategy Was Excessively Risky and Violated the Public Trust, March 1995 ("Auditor's March 1995 Report").
5. See Salomon Brothers and Hennigan, Mercer & Bennett, "Financial and Legal Update, Presentation from the Office of the CEO," July 18, 1995 at 6.
6. See infra, page 8.
7. The Rollover Agreement effectively applies to the following note issues: \$600,000,000 County of Orange California 1994-95 Taxable Notes, due July 10, 1995; \$169,000,000 County of Orange California 1994-95 Tax and Revenue Anticipation Notes - Series A, due July 19, 1995; and \$31,000,000 County of Orange California 1994-95 Tax and Revenue Anticipation Notes - Series B, due August 10, 1995. While the Rollover Agreement also by its terms applies to \$111,000,000 County of Orange 1994-95 (Teeter Plan) Taxable Notes, due June 30, 1995 and \$64,000,000 County of Orange 1994-95 (Teeter Plan) Tax-Exempt Notes, due June 30, 1995, such notes were paid in full on their due date and are no longer outstanding.
8. Some non-Note Debt holder creditors argue that the Rollover Agreement may raise a problem under the debt limit provisions of the California Constitution. Under the Rollover Agreement, the County, subject to certain reservations, waives its right to challenge the validity of the rollover Note Debt and certain long-term debt issues under California law. The California Constitution requires 2/3 voter approval of debt

- that exceeds a locality's income and revenues for any given year. Cal. Const. Art XVI, § 18. Consequently, the debt must be repaid out of same year funds. This requirement will not be satisfied if the Note Debt is rolled over until June 30, 1996, and paid off with revenues received during fiscal year 1996. Thus, the County has agreed to waive its right to challenge payment of the Note Debt. The waiver may not, however, affect the rights of others to challenge the payments.
9. See Moody's Investor Service, "Moody's Views Orange County's Proposed Extension of Notes as a Default," Moody's News, July 5, 1995; Standard and Poor's Corporation, "Defeated Orange County Sales Tax Means Defaults," Standard and Poor's Creditwire, June 28, 1995.
 10. A "certificate of participation" or "COP" is a security that evidences an undivided fractional interest in an underlying lease or installment sale agreement. A COP entitles its owner to a proportionate share of a lease (or an installment sale) agreement. California Debt Advisory Commission, Guidelines For Leases and Certificates of Participation, (1993) at 4.
 11. This could be harmful to COPs holders if the value of the collateral (*i.e.*, the public facility financed through the COPs) is less than the outstanding principal. The transaction would only be treated as a secured claim up to the value of the collateral; the remainder would be an unsecured claim. See 11 U.S.C. § 506.
 12. The County has not reserved the right to challenge the validity of the other outstanding 1994-95 short-term debt, which are two issues of tax and revenue anticipation notes. However, it has reserved the right to challenge the amount, validity, and enforceability of the security interests and reserves held in connection with these notes.
 13. See supra, note 9 and accompanying text.
 14. See \$278,790,000 County of Orange, California Refunding Recovery Bonds 1995 Series A Official Statement dated June 13, 1995 at 16.
 15. The bonds provide for puts on seven-days notice to the Pools. The Pools has defaulted on its obligation to purchase such bonds pursuant to the puts. See Orange County Special Financing Authority \$32,375,000 Teeter Plan Revenue Bonds, 1995 Series A (Taxable); \$20,625,000 Teeter Plan Revenue Bonds, 1995 Series B; \$34,000,000 Teeter Plan Revenue Bonds, Series C; \$34,000,000 Teeter Plan Revenue Bonds, 1995 Series D; and \$34,000,000 Teeter Plan Revenue Bonds, 1995 Series E Official Statement (the "Teeter Bonds Official Statement") dated June 27, 1995 at 51.

16. The County is in default on its obligations under the 1994 Series A and 1994 Series B TRAns to set aside pledged amounts in advance to pay principal and interest at maturity. See Teeter Bonds Official Statement at 51.
17. In connection with the issuance of the County of Orange, California Taxable Pension Obligation Bonds, Series 1994A, the County entered into an interest rate swap agreement with Credit Suisse Financial Products ("CSFP"). The County currently is in default under the terms of the swap agreement and has not paid to CSFP the termination payment specified in the swap agreement. See Teeter Bonds Official Statement at 51.
18. See Teeter Bonds Official Statement, supra at 51.
19. See Teeter Bonds Official Statement, supra at 51.
20. 11 U.S.C. §§ 901 et seq.
21. 11 U.S.C. § 362; 11 U.S.C. § 922.
22. Cal. Const. Art. XVI, § 18; Cal. Gov't Code § 25256.
23. See United States Bankruptcy Court Central District of California, Case No. SA 94-22272-JR, Memorandum of Points and Authorities Submitted by the Official Committee of Creditors of the County of Orange in Support of "Stipulation of Settlement and Agreement Respecting Allowance and Treatment of Certain Indebtedness, Liabilities, and Other Obligations of the County of Orange."
24. 11 U.S.C. § 552.
25. The Bankruptcy Reform Act of 1994, P.L. No. 103-394, 108 Stat. 4106 (1994).
26. "Full faith and credit" means that the full taxing and borrowing power, plus revenue other than taxes, is pledged in the payment of interest and the repayment of principal of a bond issued by a government entity. U.S. government securities and general obligation bonds of state and local governments are backed by this pledge. Barron's Dictionary of Finance and Investment Terms 150 (2d ed. 1987).
27. See e.g. Cal. Const. Art. XVI, § 1 (limitation on the creation of debts or liabilities by the State of California); Cal. Gov't Code § 25256 (limitation on the contracting of debts or liabilities by a county); N.Y. Const. Art. VIII, § 2 (limitation on contracting indebtedness by city unless it pledges its "faith and credit" for the principal of the

- indebtedness); See also McQuillin Mun. Corp. § 41.04 (3rd ed.)
28. The total dollar amount of all revenue bonds issued in 1994 was approximately \$106.7 billion, contrasted with total general obligation bonds issued of \$58 billion. Comparable figures for 1984 were \$74 billion and \$28 billion, respectively. "A Decade of Municipal Finance," The Bond Buyer, July 14, 1995, p. 27; The Bond Buyer, 1994 Yearbook, (1994), p. 10.
 29. Id.
 30. See, e.g. Jon Birger, "Franklin Manager Doubts 'Full Faith and Credit' of GOs," The Bond Buyer, July 20, 1995, at 1. "Has Orange County Popularized Revenue Bonds?" Investment Forum, The Bond Buyer, July 20, 1995, at 8.
 31. McEntee, "Orange County Losses Cast Shadow Over Darkened Southeast Market," The Bond Buyer, July 6, 1995 (quoting Jim Vogel, Senior Vice president, First Tennessee Bank).
 32. See Rule 2a-7 under the Investment Company Act of 1940.
 33. Many of these actions involved affiliated transactions between a fund and its adviser or a related party that are prohibited by section 17 of the Investment Company Act of 1940. The Commission's Division of Investment Management, as it has done in the past in similar instances, granted "no-action" relief with respect to a number of transactions involving Orange County Notes.
 34. See McEntee, supra.
 35. Securities and Exchange Act Rel. No. 7049 (March 9, 1994) 59 FR 12748 (the "Interpretive Release").
 36. Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (Jan. 1991) ("GFOA Guidelines").
 37. See David Morris, "Officials in Escambia County, Fla., Wrangle to Take Over a Troubled Investment Fund," The Bond Buyer, June 8, 1995, at 7; Darrell Preston, "Texas College Refunds Bonds Just in Time to Pay Debt Service," The Bond Buyer, June 2, 1995, at 3; Ruth Simon, "Why Your Town Could Get Stung Like Orange County," Money, Feb. 1995 at 20; Patrick Lee, "Orange County Not Alone in Money Woes Devalued Bonds," L.A. Times, Dec. 10, 1994, at D1; Aaron Pressman, "Betting on Rates Hurt Many Municipalities in 1994," The Reuter Eur. Bus. Rpt., Dec. 5, 1994; John O'Dell, "Derivatives: Risky Business; County Heads Long List of Losers in the Derivatives Game; Investments: Dozens of Public Entities Have Lost Hundreds of

Millions of Dollars. As long as Fund Managers Seek Big Payoffs, There Will be More, Industry Insiders Say," L.A. Times, Dec. 2, 1994, at A22; Leah Nathan Spiro and Nanette Byrnes, "Today, Orange County...", Bus. Wk., Dec. 19, 1994, at 28.

38. Id.
39. California State Auditor Bureau of State Audits, County Investments: Treasurers Should Avoid Risky Investment Strategies (June 1995) ("Auditor's June 1995 Report").
40. See Auditor's June 1995 Report, supra at S-1.
41. Auditor's June 1995 Report, supra at S-1.
42. Auditor's June 1995 Report, supra at S-2. The report noted various factors allowing this "off-book" treatment:
- For example, there are no current requirements for county treasurers to inform pool participants of securities lending transactions. Also, since the California Government Code does not specifically authorize securities lending, it also does not specifically state how these transactions relate to requirements stated in the code. In addition, there is no currently applicable standard for reporting on securities lending transactions issued by the Government Accounting Standards Board related to external financial reports. Id.
43. The Commission, under Rule 2a-7 under the Investment Company Act of 1940, places significant restrictions on the types and quality of securities that may be purchased by money market mutual funds. These restrictions are intended to assure that money market fund investment policies are consistent with the maintenance of a stable net asset value. In the case of other types of investment companies, the Commission seeks to assure that investment objectives and policies are fully and clearly disclosed to investors. In addition, investments by investment companies are subject to leverage restrictions and liquidity requirements. See Investment Company Act of 1940 Section 18, 15 U.S.C. § 80a-18 (leverage restrictions) and Investment Company Act of 1940 Rel. No. 18612 (March 12, 1992), 57 FR 9828 (March 20, 1992) (limits on investments in illiquid securities).
44. Section 2(b) of the Investment Company Act of 1940 states, in relevant part, that:

[n]o provision in [the Investment Company Act] shall apply to, or be deemed to include . . . a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty

15 U.S.C. § 80a-2(b). Section 2(b) also exempts from registration and regulation the United States and certain investment pools created by the federal government, its agencies and instrumentalities.

45. On a number of occasions, the staff has agreed that state and local governments can rely upon the broad Section 2(b) exclusion to operate or participate in pools for the collective investment of cash balances (e.g., proceeds from tax collections and bond offerings) without registering or complying with the regulatory requirements of the Investment Company Act of 1940. See Minnesota School District Liquid Asset Fund Plus (pub. avail. Feb. 27, 1985); Illinois School District Liquid Asset Fund Plus (pub. avail. June 15, 1984); Pennsylvania School District Liquid Asset Trust (pub. avail. Mar. 3, 1982); Pennsylvania Local Government Investment Trust (pub. avail. Mar. 2, 1981); State of New Jersey Cash Management Fund (pub. avail. Jan. 30, 1978); Massachusetts Municipal Depository Trust (pub. avail. May 23, 1977). In the Minnesota School District Liquid Asset Fund Plus letter, the staff noted that, having stated its views on a number of occasions, it would no longer respond to letters on this issue.

In fact, the staff has never formally taken the position that a pool sponsored directly by a municipality is not eligible for the Section 2(b) exclusion. The staff has informally taken the view, however, that an instrumentality of a state agency, or an instrumentality of a state instrumentality, is outside the scope of Section 2(b), and thus may not rely on the section's exclusion.

46. In addition, Citron, the former Orange County Treasurer, is not now, and to our knowledge has never been, registered under the Investment Advisers Act of 1940. Section 202(b) of that Act excludes from regulation any officer of a municipality acting in the course of his official duties. 15 U.S.C. § 80b-2(b). As Treasurer of Orange County, Citron was an officer of the County and appears to have been acting in the course of his official duties in his management of the Orange County funds.

47. To meet the Section 2(b) exclusion, the Pools would have to be "instrumentalities" of Orange County or other municipalities. We understand that the Pools were not specifically designated as instrumentalities of Orange County under California law. Even though the Pools may not be organized as separate legal entities, the Pools may be considered instrumentalities under Section 2(b) if they have been operated to carry out governmental functions of the participating municipalities. The Commission staff has indicated that an entity may be considered an instrumentality under the Investment Company Act even if it is not designated as a public instrumentality under municipal law. Compare Massachusetts Municipal Depository Trust (Trust specifically designated as an instrumentality of the Commonwealth of Massachusetts) with Pennsylvania Local Government Investment Trust (whether Trust is designated as a public instrumentality not specified).
48. If Congress were to determine that federal regulation of municipal pools is warranted, the Commission would need to review the provisions of the Investment Company Act of 1940 to determine whether all of the provisions of the Act should be applied to municipal pools and whether additional provisions would be necessary.
49. While enhanced price transparency is needed throughout the debt markets, including the corporate debt market, the need is most acute in the municipal bond market, given the broad and diverse investor base in that market. In a completely transparent market, all market participants have equal and immediate access to all quotations, including the size of the quotations, and to reports of prices and all volumes in all trades effected in the market. Price transparency enhances market liquidity and depth, and fosters investor confidence, while a lack of price information impairs market pricing mechanisms, weakens competition, and prevents investors from monitoring the quality of their executions.

There are significant structural differences between the secondary market for municipal debt when compared to the secondary market for other debt issues. Although there exist over one million different municipal securities issues, only an average of 180 issues trade actively in the secondary market at any given time. Further, most trading activity in municipal securities issues occurs shortly after issuance. Municipal securities also are priced very differently from equity issues, based in part on the way they trade. Nevertheless, these differences should not preclude last sale reporting to public investors and market participants for actively traded municipal securities. The Commission therefore is overseeing the development and implementation by the MSRB and market participants of proposals to make pricing information available to investors. See Appendix B.

50. Government Finance Officers Association, "Memorandum: 1995 Winter Meeting of the GFOA Committee on Cash Management," ("GFOA Memo") (Feb. 22, 1995).
51. Government Finance Officers Association, "Government Finance Officers Association Sample Investment Policy" (June 21, 1995); see also Girard Miller, Investing Public Funds, Government Finance Officers Association (1986).
52. Id.
53. Testimony of National Association of State Treasurers, presented by Robert Seale, President of National Association of State Treasurers, "State and Local Government Cash Management Practices" before the Senate Committee on Banking, Housing and Urban Affairs (Jan. 6, 1994).
54. Securities and Exchange Commission, Commodity Futures Trading Commission, U.K. Securities and Investments Board, OTC Derivatives Oversight: Statement of the Securities and Exchange Commission, the Commodity Futures Trading Commission and the U. K. Securities and Investments Board (March 1994).
55. Technical Committee of the International Organization of Securities Commissions, Operational and Financial Risk Management Control Mechanisms for Over-the-Counter Derivatives Activities of Regulated Securities Firms (July 1994).
56. Basle Committee on Banking Supervision, Risk Management Guidelines for Derivatives (July 1994).
57. Derivatives Policy Group, Framework for Voluntary Oversight: A Framework for Voluntary Oversight of the OTC Derivatives Activities of Securities Firm Affiliates to Promote Confidence and Stability in Financial Markets (March 1995).
58. Group of Thirty, Derivatives: Practices and Principles (July 21, 1993); Group of Thirty, Derivatives: Practices and Principles, Follow-up Surveys of Industry Practices (December 1994).
59. See, e.g., NASD Rules of Fair Practice, Art. III, Sec. 2.
60. Id. See also NYSE Rule 450.
61. Pub. L. No. 103-202, 107 Stat. 2344.
62. See NASD Notice to Members 94-62 (August 1994); NASD Notice to Members 95-21 (April 1995).

APPENDIX AEvents Leading to the Orange County Bankruptcy

1. The Orange County Investment Pools. As stated in a recent Official Statement for County bonds, "[T]he County's financial health was closely tied to the Pool both because of its dependence on the Pool for interest income and because essentially all of the County's liquid assets were invested in the Pool. While the adopted County Operating Budget ... for Fiscal Year 1994-95 equaled \$3.7 billion and the County General Fund Budget ... represented \$1.6 billion of that amount, the discretionary portion of the General Fund Budget ... was \$462.5 million. The largest portion (\$164 million) of that amount was expected to come from investment income on County funds in the Pool."¹

The Orange County Treasurer managed money for 190 ^ separate governmental agencies (the "Participants").² By the beginning of December 1994, the Participants had deposited approximately \$7.6 billion with the Orange County Treasurer.³ The Participants included approximately:

28 cities in Orange County and 6 cities outside of Orange County, 32 school districts, 5 community college districts and 53 special district accounts, of which four are outside of Orange County . . . 31 different agencies that are governed by [the Orange County Board of Supervisors] . . . also very large sums of money that are sent to [the County Treasury] by the municipal and superior court systems throughout Orange County until needed.⁴

At least one city, Fullerton, as well as Orange County, enabled its employees to place their retirement accounts with the

County Treasurer.⁵ Moneys belonging to school districts and other government agencies within Orange County apparently were required to be on deposit in the County Treasury.⁶ Other local agencies "that have their own treasurer and are not required by law to invest with the County Treasurer"⁷ elected to deposit moneys with the Orange County Treasurer.⁸ In addition, the clerk of the County's superior court on behalf of 430 minors had approximately \$6.9 million on deposit with the Treasurer and invested in the OCIP.⁹ Some local agencies, including Orange County as well as several school districts, apparently issued one year notes solely to invest the borrowed funds in the OCIP. In 1994, Orange County issued \$600,000,000 in taxable debt to invest in the OCIP and twelve other Participants issued taxable debt totaling \$562.2 million to invest in the OCIP.¹⁰

2. Investment Strategy. Until December 5, 1994, Robert L. Citron ("Citron or the "Treasurer"), the elected Treasurer of Orange County, and Matthew R. Raabe, the appointed Assistant Treasurer, managed OCIP.¹¹ Citron had been the Treasurer of Orange County for over 20 years. Until the recent bankruptcy filings, Citron's investment strategy was to use reverse repurchase agreements¹² in "a strategy that utilize[d] leverage and . . . the use of structured or floating interest rate securities that enabled an approximate leverage figure of 2 to 1."¹³ This strategy, as characterized in a September 1993 report to the Orange County Board of Supervisors, was "predicated on interest earning rates

[continuing] to remain low for a minimum of the next three years."¹⁴ Citron reported a return of 8.5% for fiscal year 1993; and 7.74% for fiscal year 1994.¹⁵

An estimated \$7.6 billion in deposits with the County Treasurer had been leveraged to over \$20.6 billion,¹⁶ including an estimated \$8 billion in structured notes. A significant portion of the OCIP appears to have been invested in four-year notes and structured notes issued by federal government sponsored entities ("GSEs"), such as Fannie Mae and Freddie Mac.¹⁷ Some of these securities were "structured" to provide a rate of return that was equal to a fixed rate less a multiple of a floating rate index, commonly called "inverse floaters."¹⁸ This rate feature makes the market value of the inverse floaters much more sensitive to interest rate fluctuations than traditional fixed or floating rate obligations. If interest rates decrease or remain stable, the inverse floaters provide a high rate of return. In the few years of declining rates prior to early 1994, this would have contributed to the high rate of return achieved by the OCIP. When rates increase, however, the interest return is reduced sharply, causing a corresponding drop in the market or "liquidation" value of the note.

The numerous increases in short-term rates throughout 1994 had a dramatically negative effect upon rate sensitive structured notes such as inverse floaters. Such notes carry limited credit risk; Orange County's difficulties occurred without a single default by an issuer of the structured notes. In OCIP, however, the

investments were not an isolated play on interest rates; they apparently were combined with securities, subject to reverse repurchase agreements at short-term rates, to take long-term rate positions. This, in turn, produced a portfolio highly sensitive to interest rate movements.

As rates increased, the returns on long-term obligations no longer exceeded the cost of funds used to acquire them and their market value declined, as did the market value of the inverse floaters. Where long-term obligations were used as securities subject to reverse repurchase agreements, the decline in market value required additional commitments of securities (similar to posting additional collateral) subject to reverse repurchase agreements. The requests for withdrawal of deposited funds, combined with the negative interest return under the reverse repurchase agreements, apparently generated a cash-flow squeeze which precipitated the Orange County bankruptcy.

3. The Assets of the OCIP as of December 1, 1994. As of November 30, 1994, the Treasurer had received approximately \$7.6 billion in deposits from various government agencies within and outside the County.¹⁹ The County combined its funds and the other Participant's funds in a "Commingled Investment Pool," a "Commingled Bond Investment Pool," and in specific investment accounts (collectively, the "Pools") for investment purposes.²⁰ Additionally, the OCIP had outstanding approximately \$12.5 billion in reverse repurchase agreements to which approximately \$14 billion

in securities were subject, boosting the total securities holdings to approximately \$20 billion.²¹

4. The OCIP's Losses and The County's Bankruptcy. On December 1, 1994, Orange County publicly disclosed that the OCIP had suffered a "paper" loss of approximately \$1.5 billion. On December 6, Orange County did not meet a substantial obligation under reverse repurchase agreements to CS First Boston ("First Boston"), and First Boston proceeded to liquidate approximately \$2.6 billion of securities it held subject to reverse repurchase agreements with Orange County. Reportedly, other firms began to sell securities subject to reverse repurchase agreements with the County. Later that day, Orange County and the OCIP each filed a petition for bankruptcy under Chapter 9 of the Bankruptcy Code ("Chapter 9").²² By Friday, December 9, 1994, a substantial part of the securities underlying Orange County's reverse repurchase agreements were reported to have been liquidated by the counterparties.²³

The bankruptcy of a local government with a substantial amount and diversity of outstanding municipal bonds presents a host of important issues. The Orange County bankruptcy proceedings are the largest ever commenced under Chapter 9. Of the handful of bankruptcies that have been filed under Chapter 9, most have involved small local governments. These previous filings did not begin to approach the level of complexity presented by Orange County. Consequently, many of the provisions of Chapter 9 have yet

to be interpreted and applied in the context of a large municipality with a substantial amount of outstanding municipal bond debt.²⁴ Furthermore, the approximately 190 local agencies invested in the bankrupt OCIP also are, in many instances, issuers of municipal bonds. Consequently, decisions in the bankruptcy proceeding may affect holders of municipal bonds issued by OCIP participants.²⁵

APPENDIX AENDNOTES

1. See \$278,790,000 County of Orange, California Refunding Recovery Bonds 1995 Series A Official Statement dated June 13, 1995, at 17.
2. See Auditor's March 1995 Report, supra.
3. G. Bruce Knecht "Derivatives Lead To Huge Loss in Public Fund," Wall St. J., December 2, 1994, A3. A report entitled "Valuation of County of Orange Investment Portfolio" released by Orange County financial advisors after the bankruptcy filing lists the "Amount Contributed by Fund Investors" as \$7.42 billion as of December 12, 1994.
4. County of Orange, California Office of the Treasurer-Tax Collector Annual 1993-1994 Summary Financial Statement, September 26, 1994 ("Treasurer's 1994 Report").
5. Jessica Crosby, "Fullerton Workers' Savings at Risk; CITIES: 78 Employees Have Deferred Savings in County Fund," Orange County Reg., December 22, 1994, at 18.
6. See, e.g., Cal. Educ. Code § 35010; see also Auditor's March 1995 Report, supra.
7. County of Orange, Office of the Treasurer-Tax Collector Annual 1992-93 Financial Statement, September 10, 1993 ("Treasurer's 1993 Report").
8. Cal. Gov't Code § 53684.
9. Auditor's March 1995 Report; see also H.G. Reza, "Injured Children's Families Fear Losses in Bond Fiasco," L.A. Times, December 18, 1994, at A1.
10. Auditor's March 1995 Report; see also United States Bankruptcy Court Central District of California, Case No. SA 94-22272-JR, Ex Parte Motion of County of Orange Pursuant to Local Bankruptcy Rule 113(1) for Emergency Order Authorizing Certain Payments of Amounts Equal to Interest on Bond Obligations of County due January 1995; Declaration of Gedale B. Horowitz in Support Thereof; see also Betsy Bates and Marilyn Kalfus "Analysis: grim view for schools," Orange County Reg., December 22, 1994.

11. See Cal. Gov't Code § 53684 (authorizing county treasurers to invest funds). On December 5, 1994, Citron resigned as county treasurer and was temporarily replaced by his deputy, Matthew R. Raabe.
12. A "repurchase agreement" provides for the "sale" of securities (generally government securities) by a dealer to a customer, with a simultaneous agreement by the customer to "resell" the securities back to the dealer on a date certain or on demand, generally not more than one year after the original transaction. "Reverse repurchase agreements" are repurchase agreements initiated by the dealer, where the dealer agrees to "buy" securities from the customer in exchange for funds and the customer simultaneously agrees to "buy back" the securities at a later date certain or on demand by the dealer.
13. Treasurer's 1993 Report, supra.
14. Id.
15. See Treasurer's 1993 Report, supra 9, and Treasurer's 1994 Report, n.6 supra. Orange County's investment fund averaged annual returns of 10 percent annually over the past 15 years. Sallie Hofmeister, "Many Questions, but Too Late," N.Y. Times, December 6, 1994, at D1.
16. This "leveraged borrowing," as press accounts characterize the Orange County holdings, likely reflects the significant amount of reverse repurchase agreements. Municipal securities and government securities are exempted securities for purposes of §§ 7 and 11 of the Securities Exchange Act of 1934 and Regulations G, T, U and X, promulgated thereunder, which govern extensions of credit to purchase or maintain ownership of securities. The requirement that a customer must deposit a certain amount of cash or eligible securities in his or her account is known as a "margin" requirement.

The original justifications for controls on margin included protecting "the margin purchaser by making it impossible for him to buy securities on too thin a margin." Stock Exchange Practices, Report of Senate Comm. on Banking & Currency, S. Rep. No. 1455, 73rd Cong., 2d Sess. 11 (1934). At that time, government securities were issued predominantly in the form of traditional, interest bearing bonds. Unlike corporate and municipal issues, government debt posed no credit risk to investors, allowing the federal government to borrow at a lower cost than individuals, corporations, or municipalities. Borrowing by investors to purchase government securities therefore was not an issue of concern to the drafters of the Securities Exchange Act of 1934.

More recently, there has been a proliferation of government

securities which are more complex, and riskier, than the traditional bonds on which they are based. "These instruments include mortgage-backed securities and real estate mortgage investment conduits ("REMICs") issued or guaranteed by government agencies or GSEs, zero-coupon instruments such as STRIPS [separate trading of registered interest and principal], agency mortgage-backed securities stripped into interest-only and principal-only pieces, and over-the-counter options on government securities." Department of the Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, Joint Report on the Government Securities Market (January 1992). The ability of GSEs to package pools of mortgages into different REMIC tranches, for example, has permitted investors to earn rates of return which were higher than those of the mortgage securities underlying the REMIC itself, and higher than the rate at which investors can borrow. In addition, the strong demand for high yield instruments issued by well-capitalized GSEs, combined with the tremendous volume of mortgages GSEs bought and resold in the secondary mortgage markets, enabled the GSEs to reduce their borrowing costs through structured notes designed to meet the specific demands of investors.

State and local governments, in particular, invest heavily in government securities, due to their reliance on such investments as "safe" obligations. H.R. Rep. No. 103-255, 103rd Cong., 1st Sess., at 32 (1993). State and local governments therefore may face a disproportionate portion of the risk posed by these investments, which although perceived generally to pose no credit risk, may actually pose other significant risks to the investor.

17. See Leslie Wayne, "Big County Is Facing Huge Loss," N.Y. Times, December 2, 1994, at D1; Laura Jereski, "Orange County Fund Losses Put at \$2.5 Billion," Wall St. J., December 12, 1994, at A3.
18. "Inverse floaters" are one of a variety of structured notes. Others include instruments which return an amount of principle at maturity that may vary in accordance with other indices.
19. See Auditor's March 1995 Report, supra.
20. See Auditor's March 1995 Report, supra; see also Michael A. Hiltzik "Portfolio of 'Safer' Bonds Held Some of the Most Risky," L.A. Times, December 28, 1994, at A3.
21. Press accounts describe the reverse repurchase agreements in terms of loans collateralized by pledged securities. See Jereski, supra.

22. The bankruptcy filing by the OCIP was dismissed by order of the bankruptcy judge on May 22, 1995, by holding that the OCIP was not eligible for Chapter 9 relief because it was not a municipality and it had not been specifically authorized to file under Chapter 9. In re County of Orange, a political subdivision of the State of California; Orange County Investment Pools, an instrumentality of the County of Orange (Bankr. C. D. Cal. May 22, 1995).
23. N.Y. Times (December 10, 1994) at 39. According to the New York Times, all of the repurchase agreement counterparties, with the exception of Merrill Lynch, Pierce, Fenner & Smith and Donaldson, Lufkin & Jenrette had liquidated their securities subject to reverse repurchase agreements by December 10, 1994.
24. Based on the County's unaudited financial statements for fiscal year 1994, Orange County has approximately \$1,673,926,358 of outstanding long-term debt in addition to approximate \$1.5 billion County and County-related short-term notes. The long-term debt is composed of general obligation bonds, certificates of participation ("COPs"), revenue bonds, tax allocation bonds, and assessment district bonds maturing this summer.
25. Pursuant to a comprehensive settlement agreement approved by the bankruptcy court, approximately 77% of the initial investment in the OCIP was returned to OCIP participants. An additional 13% was made available to certain school districts and other OCIP participants from the proceeds of a \$278,790,000 issue of Recovery Bonds.

APPENDIX BMUNICIPAL MARKET INITIATIVES

On March 9, 1994, the Commission initiated a broad-ranging program to improve the quality of and access to municipal securities disclosure in the secondary market by (i) issuing its Interpretive Release interpreting existing disclosure obligations applicable to municipal securities;¹ (ii) issuing a release proposing rule amendments obligating municipal securities brokers and dealers to obtain assurances that issuers have agreed to provide continuing disclosure;² and (iii) proposing a rule requiring disclosure of mark-ups in riskless principal transactions.³

1. Regulation of the Municipal Securities Markets. The market for municipal securities was largely unregulated at the federal level until the 1970s. Both the Securities Act and the Exchange Act were enacted with provisions containing broad exemptions⁴ for municipal securities from their provisions, except for the anti-fraud provisions. Municipal securities received special exemptions at that time due not only to considerations of federal-state comity, but also to the absence of perceived abuses in the municipal securities markets as compared to the corporate market. Furthermore, the typical investors in municipal securities in the 1930s were institutional investors.

In the past few decades, however, this situation has changed.

In the 1970s, in response to abusive practices by dealers in municipal securities, as well as to the increasing number of retail investors in this market, Congress established a limited regulatory scheme for the municipal securities markets. The Securities Acts Amendments of 1975⁵ included provisions for the mandatory registration of municipal securities brokers and dealers and the creation of the MSRB.

2. Rule 15c2-12. In 1989, acting in response to consistently slow dissemination of information in connection with municipal securities offerings, the Commission adopted Exchange Act Rule 15c2-12,⁶ which requires dealers to obtain and review issuers' official statements prior to selling bonds, and to provide official statements to customers and potential customers. Specifically, prior to recent amendments discussed below, Rule 15c2-12 required an underwriter of municipal securities (i) to obtain and review an issuer's official statement that, except for certain information, is "deemed final" by an issuer, prior to making a purchase, offer, or sale of municipal securities; (ii) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists) to potential customers; (iii) to deliver to customers, upon request, copies of the final official statement for a specified period of time; and (iv) to contract to receive, within a specified time, sufficient copies of the issuer's final official statement to comply with the rule's delivery requirement, and the requirements of MSRB rules.

At the time of the proposal and adoption of Rule 15c2-12, the Commission also issued an interpretation concerning the due diligence obligations of underwriters of municipal securities.⁷ Underwriters, of course, play an integral role in the distribution of information. In its interpretation, the Commission emphasized that underwriters of municipal securities have an obligation to have a reasonable basis for recommending municipal securities, and in fulfilling that obligation, to review the accuracy of the offering statements with which they are associated.⁸

3. The Staff Report on the Municipal Securities Markets.

In 1993, the Commission's Division of Market Regulation conducted a comprehensive review of the municipal securities markets. Its findings, published in the September 1993 Staff Report on the Municipal Securities Market ("Staff Report"),⁹ underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets, notwithstanding voluntary industry initiatives to improve disclosure. In response to Chairman Arthur Levitt's request for a recommended "market-participant sponsored solution" regarding these disclosure issues, participants in the municipal securities industry have worked with the Commission every step of the way toward the important goal of enhancing investor protection through improved municipal securities disclosure.

4. The Interpretive Release. The Interpretive Release, published in March 1994, provided the municipal securities markets

with an overview of existing disclosure obligations of market participants under the anti-fraud provisions of the federal securities laws in connection with both primary and secondary municipal market disclosure. The Interpretive Release was intended to encourage the ongoing efforts of market participants to improve disclosure practices, and provided guidance to assist market participants in meeting their obligations under the anti-fraud provisions. As the starting point for its review of existing law, the Interpretive Release noted that the disclosure documents used by municipal issuers in primary offerings of municipal securities, such as official statements, are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading. While acknowledging significant improvement in disclosure practices in recent years as a result of voluntary initiatives, the Commission identified several areas of primary market disclosure that needed increased attention.

The Interpretive Release stated that municipal issuers must give greater consideration to disclosure issues arising from their activities as end-users of derivative products.¹⁰ When either the issuer or the revenues securing an issue of municipal securities is exposed to investment related market risks, the disclosure documents need to discuss the market risks of such exposure, the strategies used to alter such risks, and the exposure to both market risk and credit risk resulting from risk alteration

strategies.¹¹

With respect to accounting disclosure, the Interpretive Release pointed out that sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities. The Interpretive Release encouraged the use of audited financial statements and an explanation of accounting principles followed in the preparation of financial statements, unless statements were prepared in accordance with generally accepted accounting principles ("GAAP").¹² In order to avoid providing investors with an outdated, and therefore potentially misleading, picture of the issuer's financial condition and results of operations, the Interpretive Release indicated that audited financial statements should be available as soon as practicable.¹³ The Interpretive Release also stated that unaudited financial statements for the most recent fiscal year and other current financial information should be provided in the interim prior to completion of the audit.¹⁴

In addition, the Interpretive Release pointed out that narrative explanations of data may be necessary where a numerical presentation alone is not sufficient to permit an investor to judge the financial and operating condition of the issuer or obligor.¹⁵ Moreover, issuers must assess whether the probable future impact of currently known facts mandates disclosure. Disclosure of such currently known conditions and their future impact is critical to informed decision-making.

The Interpretive Release also addressed questions of conflicts of interest, and noted that information about financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.¹⁶ Failure to disclose material information concerning such relationships, arrangements, or practices may render misleading statements made in connection with the offering process, including statements in the official statement about the use of proceeds, underwriters' compensation, and other expenses of the offering.¹⁷

The Interpretive Release reminded issuers of the application of the anti-fraud provisions of the federal securities laws to statements to the market, and emphasized the importance of municipal issuers' establishing practices and procedures to disclose material information subsequent to the initial offering on a timely and continuous basis, as a way of minimizing the risk of misleading investors with incomplete or outdated information that is otherwise made available by the municipal issuer. In addition to periodic information, to assure that participants in the secondary market base their investment decisions on current information, the Interpretive Release called for timely disclosure of events that materially reflect on the credit-worthiness of municipal securities issuers and obligors and the terms of their securities, including principal and interest payment delinquencies, as well as nonpayment related defaults; unscheduled draws on reserves or credit enhancements; matters affecting collateral; and

rating changes.

5. Amendments to Rule 15c2-12. Concurrent with the publication of the Interpretive Release, the Commission published a release that requested comment on proposed amendments to Rule 15c2-12,¹⁸ designed to enhance the quality, timing, and dissemination of disclosure in the municipal securities markets by placing certain requirements on brokers, dealers, and municipal securities dealers. On November 10, 1994, the Commission adopted these amendments in final form,¹⁹ with modifications that had their origin in extensive cooperation from industry groups, and the thoughts and suggestions contained in over 390 comment letters.²⁰

The amendments reinforce current market practices that generally have provided good quality official statements, and extend those practices to the secondary market. Specifically, the amendments require underwriters to reasonably determine that an issuer or obligor has undertaken to provide annual financial information; audited financial statements, when and if available; notices of eleven specified events, if material; and notice of a failure to provide annual financial information, with respect to those persons who are committed by contract or other arrangement to support payment of all or a part of the obligations on the municipal securities, and for whom financial or operating data is presented in the final official statement.

Underwriters will be required to reasonably determine that the undertakings specify the identity of each person for which annual

financial information and notices of material events will be provided (either by name or by the objective criteria used to select such person), as well as the type of financial information and operating data to be provided as part of the annual financial information; the accounting principles to be used in the preparation of financial statements, including whether audited financial statements will be provided; the date on which annual financial information for the previous year will be provided; and to whom it will be provided.

The amendments rely on the parties to an initial offering of municipal securities to establish which parties will provide ongoing secondary market disclosure, and what information is material to an understanding of the securities being offered. Under the amendments, the financial information and operating data in the final official statement will determine the type of financial information and operating data to be provided on an ongoing basis pursuant to the undertakings, and the persons about which that data will relate. This approach is designed to provide meaningful secondary market disclosure under standards that are flexible, yet enforceable. The approach is consistent with that traditionally followed by the Commission with respect to official statement disclosure, which relies on market discipline and general anti-fraud considerations to ensure that disclosure provided is meaningful.

6. Information Repositories. Under provisions of Rule 15c2-12 as originally adopted, underwriters must deliver final official statements to potential customers for a 90-day period after the close of the underwriting period. The underwriters' 90 day delivery obligation is shortened to 25 days if the final official statement can be obtained from a Nationally Recognized Municipal Securities Information Repository ("NRMSIR"). Therefore, prior to the recent amendments to Rule 15c2-12, NRMSIRs essentially served the function of disseminators of official statements on behalf of underwriters. Under Rule 15c2-12 as originally adopted, three private vendors were designated by the Commission as NRMSIRs through no-action letters. These three NRMSIRs were the American Banker-Bond Buyer, the J.J. Kenny Company, and Bloomberg, L.P.

As a result of the amendments to Rule 15c2-12, NRMSIRs will play an expanded role in the collection and dissemination of secondary market information. Under the amendments, issuers' disclosure undertakings call for annual financial information to be provided to each NRMSIR and the appropriate state information depository ("SID"), if any. In addition, notices of material events, including notices of a failure to provide annual financial information, will be provided to each NRMSIR or the MSRB, and to the appropriate SID. Therefore, in addition to the collection and dissemination of final official statements, NRMSIRs will collect and disseminate annual financial information and notices of material events. The Commission determined that the three existing NRMSIRs should reapply to the Commission for recognition, taking

the expanded information collection and dissemination requirements into account, in order to continue to function as NRMSIRs. These vendors received no-action letters recognizing them as NRMSIRs under the new standards on June 23, 1995. Two new information vendors, Disclosure Inc. and Moody's Investors Services, also received no-action letters recognizing them as NRMSIRs. Although they are not required to do so under Rule 15c2-12, in addition to accepting and disseminating final official statements, annual financial information, and notices of material events, NRMSIRs provide other current market information about municipal issuers to the primary and secondary municipal markets.²¹

Interest also has been expressed by states and private entities within states in being designated as SIDs. Under the amendments, a SID would be a depository operated or designated by the state that receives information from all issuers within the state, and makes this information available promptly to the public (including NRMSIRs) on a contemporaneous basis. Based on a number of informal inquiries, it appears that many states are seriously considering the possibility of establishing state based depositories.²²

7. Secondary Market Transactions. The amendments also prohibit brokers, dealers, and municipal securities dealers from recommending the purchase or sale of municipal securities to which the underwriting prohibition applied unless they have in place procedures that provide reasonable assurance that they will receive

promptly any notices of material events regarding these securities. For example, a dealer could rely on a vendor system that electronically reported all material events to the dealer when they occurred, if these reports were made available to persons responsible for the recommendations.

Although the amendments only create specific receipt obligations with respect to material event notices, annual financial information disseminated into the marketplace must be taken into account by dealers in making recommendations to investors in order to meet their obligations under MSRB rules G-17, G-19, and G-30, and their existing obligation to have a reasonable basis on which to recommend securities to investors.²³ Material event notices are the type of information required to be disclosed to a customer pursuant to MSRB rule G-17.²⁴

8. Exemptions. The amendments provide an exemption that reflects the concerns of small and infrequent issuers of municipal securities. If neither the issuer nor any obligated person is obligated with respect to more than \$10 million in municipal securities outstanding following an offering, the offering will be exempt from the amendments on the condition that an issuer or obligated person makes a limited undertaking to provide upon request, or annually to a SID, at least the financial information or operating data that is customarily prepared, and made publicly available. In addition, the undertaking must meet the amendment's requirement regarding notices of material events. According to one

commenter on the proposed amendments,²⁵ in 1993, 71% of the approximately 52,000 municipal issuers had under \$10,000,000 in outstanding municipal securities. Because over 20% of the total issuances in 1993 were under the \$1 million principal amount threshold for application of the rule generally, a significant percentage of offerings would remain totally exempt from the amendments.²⁶

The pre-existing exemptions for offerings that are limited placements, short-term securities, and securities with demand features remain. The amendments add an exemption from the annual information requirement for offerings of securities with maturities of less than 18 months.

9. Effective Dates. The amendments are being phased in over a short period of time to allow municipal issuers and underwriters the time to put necessary procedures in place to comply with the new rules. The requirement that underwriters reasonably determine that an issuer or obligor has undertaken to provide disclosure went into effect on July 3, 1995. The limited undertaking conditions of the small issuer exemption will be effective for offerings commencing on or after January 1, 1996. The requirement that brokers, dealers, and municipal securities dealers have procedures in place that provide reasonable assurance that they will receive promptly any notices of material events regarding the securities they recommend for purchase or sale also will go into effect on January 1, 1996.

APPENDIX BENDNOTES

1. Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049 (March 9, 1994), 59 FR 12748.
2. Securities Exchange Act Rel. No. 34961 (Nov. 10, 1994), 59 FR 59590.
3. Securities Exchange Act Rel. No. 34962 (Nov. 10, 1994), at 59 FR 59611. At the same time that the Commission approved the amendments to rule 15c2-12, as discussed below, it determined to postpone the adoption of the proposal to require confirmation disclosure of mark-ups and mark-downs in riskless principal transactions. This decision was based in part on the Municipal Securities Rulemaking Board ("MSRB") and the Public Securities Association ("PSA") commitment to sponsor initiatives to improve price transparency in the municipal securities markets. On November 9, 1994, the Commission approved an MSRB initiative to improve price transparency that, once fully implemented, will make public reports of prices for all retail transactions in municipal securities on a same-day basis or sooner. In a related effort, the PSA has contracted with two information vendors to use the data supplied by the MSRB daily report to create two new services. Bloomberg, L.P. has contracted with the PSA to provide a generic yield scale of representative prices to be published in newspapers and other print media. Since May, 1995, J.J. Kenny\S&P has operated an 800 telephone number service that will report both contemporary and historical municipal securities transaction data.
4. See Securities Act of 1933 Section 3(a)(2), 15 U.S.C. § 77c(a)(2) (exemption from registration requirements and civil liability provisions of the Securities Act); Securities Exchange Act of 1934 Section 3(a)(12), 15 U.S.C. § 78c(a)(12) (defining exempted securities to include municipal securities).
5. Pub. L. No. 94-29, 89 Stat. 131 (1975). The 1975 Amendments did not create a regulatory regime for municipal issuers or impose any new requirements on municipal issuers. Indeed, Section 15B of the Exchange Act expressly limited the Commission's and the MSRB's ability to establish municipal issuer disclosure requirements. Section 15B(d)(1) of the Exchange Act prohibits the Commission and the MSRB from requiring municipal securities issuers, either directly or indirectly, to file any application, report, or document with the Commission or the MSRB prior to any sale by the issuer.

This section does not, by its terms, preclude the Commission from promulgating disclosure standards in municipal offerings, although there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers. Section 15B(d)(2) of the Exchange Act prohibits the MSRB, either directly or indirectly, from requiring issuers to furnish investors or the MSRB with any "report, document, or information" not generally available from a source other than the issuer. This section was intended to make clear that the legislation was not designed to subject states, cities, counties, or any other municipal authorities, to any disclosure requirements that might be devised by the MSRB. These sections are collectively known as the "Tower Amendment." Division of Market Regulation, Securities and Exchange Commission, Staff Report on the Municipal Securities Market (Sept. 1993), supra at Appendix A.

6. 17 CFR § 240.15c2-12. See Securities Exchange Act Rel. No. 26100 (Sept. 22, 1988), 53 FR 37778 ("1988 Release"); Securities Exchange Act Rel. No. 26985 (June 28, 1989), 54 FR 28799 ("1989 Release"). Rule 15c2-12 also contains specific exemptions for three types of municipal securities offerings.
7. See 1988 Release at 53 FR 37787; 1989 Release at 54 FR 28811.
8. Id. Soon after the Commission's adoption of Rule 15c2-12, the MSRB adopted MSRB rule G-36, which requires brokers, dealers, and municipal securities dealers acting as underwriters in primary offerings of municipal securities to send copies of the issuer's final official statement to the MSRB. The MSRB also developed its Municipal Securities Information Library ("MSIL") system, which currently collects information and disseminates it to market participants and information vendors.
9. Division of Market Regulation, Securities and Exchange Commission, Staff Report on the Municipal Securities Market (Sept. 1993).
10. Interpretive Release at 59 FR 12751-52.
11. Id.
12. Id. at 59 FR 12752. The Interpretive Release noted that 46 states required, or are in the process of establishing a requirement, that the state's government financial statements be presented in accordance with GAAP. State Comptrollers: Technical Activities and Functions (1992 Edition).
13. The Interpretive Release noted that an appropriate period appeared to be within six months of the close of the fiscal year, based upon the Commission's understanding of prevailing

practice. However, many commenters responding to the solicitation of comments on the companion rulemaking discussed below took the position that for many municipal issuers, it was not reasonable to require that they obtain audited financial statements within six months.

14. Interpretive Release at 59 FR 12753.
15. Id.
16. Id. at 59 FR 12751.
17. Id.
18. Securities Exchange Act Rel. No. 33742 (March 9, 1994), 59 FR 12759.
19. Securities Exchange Act Rel. No. 34961 (Nov. 10, 1994), 59 FR 59590.
20. These comment letters represented the comments of over 475 groups and individuals. The comment letters and a summary of the comment letters prepared by Commission staff are contained in Public File No. S7-5-94. See also Public File No. S7-4-94.
21. NRMSIRs are not the only source of information in the municipal market. The MSRB's MSIL system currently collects information and disseminates it to market participants and information vendors. As noted in endnote 8 above, MSRB rule G-36 requires brokers, dealers, and municipal securities dealers acting as underwriters in primary offerings of municipal securities to send copies of the issuer's final official statement to the MSRB. The Official Statement and Advance Refunding Document-Paper Submission System ("OS/ARD") of the MSIL collects and makes available on magnetic tape and on paper official statements and advanced refunding notices. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194. As a part of the MSIL system, the MSRB commenced operation of its Continuing Disclosure Information ("CDI") pilot system in January, 1993. The CDI system is a central repository for voluntarily submitted continuing disclosure documents relating to outstanding municipal securities issues. Securities Exchange Act Release No. 30556 (April 6, 1992), 57 FR 12534. Neither the MSIL, OS/ARD system nor the CDI system is recognized as a NRMSIR; the Commission has previously stated that it would consider the competitive implications of a MSRB request for NRMSIR recognition. See Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333, 23337 n.26.

22. See Letter from Elizabeth MacGregor, Branch Chief, Division of Market Regulation, Securities and Exchange Commission, to Ann V. Butterworth, Director of Bond Finance, State of Tennessee (March 2, 1995); Letter from Robert Colby, Deputy Director, Division of Market Regulation, Securities and Exchange Commission, to Frieda K. Wallison, Esq., Jones, Day, Reavis & Pogue (July 7, 1995).
23. MSRB rule G-17 requires dealers to disclose material facts of a transaction to the customer, MSRB rule G-19 requires dealers to ensure that any transaction recommended to the customer is suitable for that customer, and MSRB rule G-30 requires dealers to ensure that the prices set for customer transactions are fair and reasonable.
24. See MSRB Manual (CCH) ¶ 3581.30 (interpreting MSRB rule G-17 to require that a dealer disclose, at or prior to sale, all material facts concerning a transaction, including a complete description of the security). See also 1988 Release at n.50 and accompanying text.
25. See Comment Letter of the Bond Buyer (July 14, 1994).
26. Id.



**TESTIMONY OF CHRISTOPHER A. TAYLOR
EXECUTIVE DIRECTOR OF THE
MUNICIPAL SECURITIES RULEMAKING BOARD**

BEFORE THE

**SUBCOMMITTEE ON CAPITAL MARKETS,
SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES**

JULY 26, 1995

**Materials Provided By The
MUNICIPAL SECURITIES RULEMAKING BOARD**

Summary of Major Points

The Board's rulemaking authority extends only to securities dealers and only to their municipal securities activities. The main focus of the Board and its rules is the protection of municipal securities investors. The Board does not have authority to write rules governing the activities of municipalities, either in their capacity as issuers of municipal securities or as investors in securities.

- The Board has taken a number of initiatives to increase disclosure in the municipal securities market, including creation of the MSIL system as a central repository of official statements. In addition, since January 1993, the Continuing Disclosure Information System has offered issuers and trustees a means of voluntarily disseminating short, time-sensitive, continuing disclosure notices to the market and the public. Moreover, the Board's Transaction Reporting Program, which began operation in January 1995, provides the public, for the first time, with daily information about certain municipal securities transactions, and will provide enforcement agencies with a database of all trades for their surveillance activities.
- General obligation bonds -- bonds secured by the full faith and credit of an issuer with taxing power -- have been considered to be the most secure of all municipal issues because governments have the power to levy taxes to meet payments of principal and interest. The rate of default of general obligation bonds has been exceptionally low. General obligation bonds are desired by investors who seek to minimize risk and the secure nature of these bonds also lowers the interest cost for the issuer.
- When municipalities with a large amount of outstanding general obligation debt are faced with financial difficulties, most have taken steps to stave off default in order to avoid the stigma of default and bankruptcy and to allow access to the capital markets at a reasonable cost in the future. These municipalities are often assisted by the state to avoid any interruption of debt service payments.
- It is too early to tell if Orange County is an isolated incident or the beginning of a fundamental change in how municipalities view their commitment to general obligation bondholders. If Orange County defaults without lasting adverse consequences, other issuers may be more likely to default in the future. If, after monitoring the situation, it appears that Orange County is not an isolated instance, and the principles behind general obligation bonds or investor perception of the safety and liquidity of such securities has changed, the Board would take steps to require additional dealer disclosure to inform investors of these changes. As a result, the suitability of investment in such securities, and their price, would be affected.

The current uncertainty regarding the intentions of Orange County has had a negative effect on the market. A rapid resolution through a credible plan of action will not only resolve the bankruptcy issues and restore credibility to Orange County, but will instill confidence in this large and important market.

**Testimony of Christopher A. Taylor
Executive Director of the
Municipal Securities Rulemaking Board**

Before the

**Subcommittee on Capital Markets,
Securities, and Government Sponsored Enterprises**

July 26, 1995

Chairman Baker and Members of the Subcommittee:

As Executive Director of the Municipal Securities Rulemaking Board, I appreciate the opportunity to testify before the Subcommittee concerning the municipal securities market.

Background On The MSRB

The MSRB's rulemaking authority extends only to securities dealers and only to their municipal securities activities. The main focus of the MSRB and its rules is the protection of municipal securities investors. The Board does not have authority to write rules governing the activities of municipalities, either in their capacity as issuers of municipal securities or as investors in securities. So too, the Board has no role in municipal bankruptcies. The Board, however, is very concerned about the Orange County situation and its impact on the municipal securities market.

Since 1987, the Board has made significant progress on systems for providing market participants with more information regarding the description and value of municipal securities, and more information about the issuers of those securities.

The official statement for a new issue contains the issuer's disclosure of the terms of the issue and the issuer's financial condition at issuance. The Board concluded that there was a need for a central, comprehensive collection of official statements for municipal securities issues so that any interested person could obtain complete information about the features of municipal securities. In 1990, the Board adopted rules requiring underwriters to provide copies of official statements to the Board. The Board's Municipal Securities Information Library™ ("MSIL™") System serves as a central repository for these official statements, making them available to the market and the public in both electronic and paper form. Currently, the MSIL System contains more than 60,000 official statements.

While official statements are important to understanding an issue of municipal securities, the Board concluded that ongoing information about municipal securities and municipal securities issuers also is vitally important to the long-term health and liquidity of the market. From a regulatory perspective, such information plays a critical role in helping dealers fulfill their customer protection responsibilities in the secondary market. If issuers do not publicly disclose material developments affecting their securities after issuance, then dealers cannot inform their customers of such information or make the necessary suitability determinations and pricing decisions.

In order to facilitate the flow of communications from issuers to the market, in 1990, the Board filed a plan with the Securities and Exchange Commission ("SEC") to expand the MSIL System to accept certain types of continuing disclosure information voluntarily provided by issuers and trustees. After SEC approval of this plan in 1992, the Board's Continuing Disclosure Information System ("CDI System") began operation. Since January 1993, this system has offered issuers and trustees a means of voluntarily disseminating short, time-sensitive, continuing disclosure notices to the market and the public.

Recent amendments to SEC Rule 15c2-12 have provided an opportunity for expanded use of the CDI System. The amendments to Rule 15c2-12, among other things, prohibit dealers from underwriting an issuance of municipal securities without having reasonably determined that an issuer has undertaken to provide annual financial information and notices of specified material events. Such material events are precisely the type of information that the Board's CDI System is designed to accept and disseminate. The amendments effectively require issuers to provide such disclosures either to the CDI System or to each of a number of other repositories designated by the SEC. The Board recently revised its CDI System to facilitate use of the System by issuers and allow for more and longer disclosure notices to be disseminated.

Because the new amendments have been in effect only for a few weeks, questions remain as to the level of issuer compliance and the efficiency of information dissemination to the market. Even so, we believe these new requirements will greatly improve the amount and timeliness of information available to the municipal securities market and the general public.

The Board looks forward to greatly increased use of the System in the years ahead. The Board commends the SEC on its efforts to improve issuer disclosure in this market and supports the SEC's amendments.

In an additional step to increase disclosure to market participants, in 1993 the Board announced plans to undertake a Transaction Reporting Program to collect and publish information on municipal securities transactions. The Board has been publicly reporting transaction information for certain interdealer trades in municipal securities since January 1995 and plans to expand the program to capture institutional and retail customer trades and report them closer to the time of trade. The Board believes that the program will provide substantial benefits to the municipal market, including more accurate valuation of individual securities, and enhanced surveillance of the municipal market, particularly in the areas of sales practices, pricing, and fair dealing with customers. The goal is to collect and make available transaction information that is both comprehensive and contemporaneous. The Transaction Reporting Program is a first step toward providing transparency to all market participants and toward creating a comprehensive surveillance database of actual transaction data for use by the agencies responsible for enforcing Board rules.

General Obligation Bonds

In the United States, there are approximately 80,000 state and local governments, about 50,000 of which have issued municipal securities. The market is unique among the world's

major capital markets because the number of issuers is so large -- no other direct capital market encompasses so many borrowers. Issuers include states, counties, special districts, cities, towns, and school districts. Total municipal debt outstanding through the first quarter of 1995 is approximately \$1.2 trillion. Municipal securities are issued to finance capital projects such as transportation, education, hospital, housing, public power, and water and sewer systems. Debt issuance has become an important management tool for many municipalities, allowing flexibility in arranging finances and meeting annual budget considerations.

General obligation bonds -- bonds secured by the full faith and credit of an issuer with taxing power -- have been considered to be the most secure of all municipal issues because governments have the power to levy taxes to meet payments of principal and interest. Full faith and credit has been interpreted to mean that the issuer will use all available taxes and other revenue sources to the extent necessary to raise the funds needed to repay the principal and interest on the bonds when they become due. General obligation bonds usually are paid from ad valorem property taxes. In some states, municipalities may only issue general obligation bonds secured by the full faith and credit of the municipality and are not allowed to finance projects with other types of bonds.

The quality of general obligation bonds is based on constitutional, statutory, or charter provisions which assure that sufficient taxes will be collected to pay debt service on the bonds. For example, state law may require that principal and interest payable during the fiscal year shall be a mandated part of the budget or that debt service shall be paid before operating expenses.

There may also be procedures to require the segregation of tax receipts for debt service from funds available for general purposes to assure that there can be no appropriation for any purpose other than the repayment of the bonds.

Historically, the default rate for general obligation bonds has been exceptionally low. Not only are these bonds desired by investors who seek to minimize risk through the safety of principal backed by the full faith and credit of the taxing power of the issuer, but the secure nature of the bonds also lowers the interest cost for the issuer.

Issuers Facing Financial Difficulties

When municipalities with a large amount of outstanding general obligation debt are faced with financial difficulties, most have taken steps to stave off default in order to avoid the stigma of default and bankruptcy and to allow access to the capital markets at a reasonable cost in the future. Recognizing the importance of their obligation to bondholders, these municipalities are often assisted by the state to avoid any interruption of debt service payments. In such situations, states have played a key role in the oversight and segregation of revenues to ensure that all debt payments are made. Indeed, state-created agencies have allowed troubled municipalities to work out their financial problems under state supervision while assuring bondholders that they will be paid any amounts owed to them.

For example, in 1975, New York City was unable to meet its short term obligations and

was unable to market its debt. The state created a financing authority, the Municipal Assistance Corporation, which was designed to have a dedicated source of revenue. The state also imposed restrictions on the city to attain fiscal discipline and recover credibility.

In addition, the City of Philadelphia faced severe financial problems in 1991. With a large long-term operating deficit, and short-term notes about to mature which the market indicated could not be refinanced, the city faced the prospect of declaring default. The state stepped in to create an authority to raise money and impose fiscal restraints. New sales and use taxes and a form of income tax were also imposed.

Board Interest In Orange County

The Board has been viewing the events in Orange County with interest. It is too early to tell if Orange County is an isolated incident or the beginning of a fundamental change in how municipalities view their commitment to general obligation bondholders. A number of other issuers in difficult financial situations may determine their own courses of action based on the outcome of Orange County. If Orange County defaults without lasting adverse consequences, other issuers may be more likely to default in the future. Investors then may lose confidence in the market, and the market for new issue and outstanding general obligation bonds will suffer.

Indeed, other issuers in California have already incurred negative effects from the actions of Orange County. It was recently reported that several counties in California have had difficulty

selling notes this summer and have had to pay higher interest rates to generate sales. In particular, one recent offering of short-term notes (which went on the market the day after Orange County residents defeated the tax increase) could not be sold without the issuer obtaining credit enhancement in the form of a letter of credit. These difficulties have been attributed to a lack of confidence in California issuers in the wake of Orange County's actions with respect to its general obligation debt.

If, after monitoring the situation, it appears that Orange County is not an isolated instance, and the principles behind general obligation bonds or investor perception of the safety and liquidity of such securities has changed, the Board would take steps to require additional dealer disclosure to inform investors of these changes. As a result, the suitability of investment in such securities, and their price, would be affected.

The current uncertainty regarding the intentions of Orange County has had a negative effect on the market. A rapid resolution through a credible plan of action will not only resolve the bankruptcy issues and restore credibility to Orange County, but will instill confidence in this large and important market.

**COMMITTEE ON BANKING AND FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND GOVERNMENT-SPONSORED ENTERPRISES,
U.S. HOUSE OF REPRESENTATIVES**

***DEVELOPMENTS IN THE
MUNICIPAL FINANCE MARKET***

**TESTIMONY OF
DANIEL N. HEIMOWITZ,
EXECUTIVE VICE PRESIDENT/DIRECTOR, PUBLIC FINANCE
MOODY'S INVESTORS SERVICE, INC.**

July 26, 1995

TESTIMONY
OF
DANIEL N. HEIMOWITZ,
EXECUTIVE VICE PRESIDENT/DIRECTOR, PUBLIC FINANCE
MOODY'S INVESTORS SERVICE, INC.
BEFORE THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES,
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND GOVERNMENT-SPONSORED ENTERPRISES,
U.S. HOUSE OF REPRESENTATIVES
July 26, 1995

*DEVELOPMENTS IN THE
MUNICIPAL FINANCE MARKET*

Chairman Baker, Members of the Committee, good afternoon.

I am Daniel Heimowitz, Director of the Public Finance Department of Moody's Investors Service. I would like to thank the Committee for inviting me to speak today on a topic of great significance to me professionally and to the industry in which I work.

Moody's is a publisher of rating opinions. Moody's has been publishing opinions on bonds since 1909 and now maintains 56,000 ratings on the debt obligations of 22,000 municipal issuers. A rating is not a prediction of an outcome in a particular case. It is the expression of an opinion about the relative likelihood of different possible future outcomes.

With regard to Orange County, Moody's issued rating opinions on a range of the County's securities, having rated the County's debt since 1938. We have continued to follow the Orange County situation closely since the December 6, 1994 bankruptcy filing and have issued numerous credit comments updating the market on the status of events as they have unfolded. (Moody's comments and press releases on the events in Orange County and an explanation of Moody's bond ratings have been provided to the Committee.)

After the Federal Government's own securities, Municipal Bonds are the most default-free of publicly offered bonds. The low cost and relative ease of market access for issuers large and small reflects that strong track record. Municipal issuer practices are generally sound, with adherence to good management practices and attention to maintaining creditworthiness even under fiscal pressures. Defaults on debts issued by established municipalities and paid out of general municipal resources are extremely rare. Consequently, prior events offer limited precedent, making it difficult to predict the ultimate market impact of the Orange County events.

The three areas that I would like to discuss today relating to Orange County are:

1. Orange County's investment practices and the level of the County's investment losses;
2. Orange County's decision to file for bankruptcy and its subsequent difficulties in addressing its financial crisis; and
3. Orange County's actions and inactions with respect to repaying its own debt, including its threat of debt invalidation.

These points, in turn, address issues raised by the Committee, including the likelihood that other municipalities may follow Orange County's lead, and whether the events surrounding Orange County's collapse will alter beliefs or practices fundamental to the municipal marketplace.

I. Orange County's Investment Practices and the Level of Orange County's Investment Losses

In rating general obligation bonds and other debt paid from general resources, similar to the debt issued by Orange County, Moody's weighs and relies on current and historical evidence regarding a municipality's economy, financial performance, debt burden, fiscal management and administrative skill. This information is provided by issuers in a number of forms, including the Official Statements that accompany municipal bonds and the audited financial statements prepared by professionals retained by municipal issuers.

While Moody's, along with other market participants, the County's own management, the State of California, the almost 200 local governments investing in the County's Pool, and the SEC, among others, was aware of the above-market rate of earnings reported by the Orange County Pool over an extended period of time, we were shocked by the unprecedented magnitude of the Orange County investment loss. The County's debt was not directly linked to the investment practices of the Pool, rather, the County's debt was secured by the County's general resources.

Orange County is one of the wealthiest counties in the nation. In assessing the County's general resources, Moody's focused on the strong and diverse economic base of the County as an indication of the County's general economic wherewithal and ability to repay debt obligations. Prior to the events of late 1994, Orange County had moderate levels of debt and a history of sound fiscal management that was reflected in growing operating reserves that had accumulated over time. It was viewed, and its representatives, Messrs. Citron and Raabe, presented it, as a sophisticated investor. These were all positive credit factors that supported Moody's ratings, which were in the A to Aa range.

With regard to the Orange County Investment Pool, the County was acting as a fiduciary, investing on behalf of other local governments, and therefore, it was required to follow "prudent person" investment rules. The Orange County Investment Pool was audited every year by the County's auditors, and a review of the Pool's investment practices and guidelines was regularly included in the footnotes to the County's financial statements. In addition, the County publicly reported the average annual earnings of the Pool. There had been no history of the Pool's ever having to liquidate securities to meet the needs of any of its participating entities. The County also asserted that its Investment

Pool had more than ample liquidity to meet its obligations and that it would not have to sell securities and realize losses to meet such liquidity needs. The fact of regular audits and Official Statement disclosures showing solid results over the course of many years pointed to favorable management.

Given these factors, nothing led us to believe that Orange County's investment practices were, or would be, a threat to repayment of its own debt or the debt issued by local governments investing in the County Pool. Our experience with other local governments and municipalities that took investment risk and incurred losses has been — without exception — that they stepped up and made payments on their debt obligations. For example, in the mid-1980's following the failure of a number of securities dealers, some municipalities which had invested in repurchase agreements with the failed institutions, including Toledo, Ohio; San Jose, California; Beaumont, Texas; Tempe, Arizona; Pompano Beach, Florida; and the New York State Dormitory Authority, suffered investment losses. No debt payments, however, were delayed or otherwise impaired. Much more recently, Cuyahoga County, Ohio, experienced losses in excess of \$100 million in a county-managed investment pool quite similar in nature to the Orange County Pool. Cuyahoga County acted responsibly by recognizing its losses, swiftly liquidating the pool and paying off pool participants in full out of its own resources. This is the behavior the market has grown to expect and by which Orange County was and is being measured.

Orange County incurred losses through commonly used investment practices: leverage, duration, and the use of derivatives. Consistent with the idea that Orange County's behavior was beyond the historical norm, in our December 1994 nationwide survey of the investment practices of over 1,400 local government units, we found that, while some localities engaged in practices similar to those used by Orange County, none used those techniques to the same degree or in the same dollar magnitude. (A copy of our December 1994 survey has been provided to the Committee.)

Even though Orange County presents a unique situation, we have nevertheless responded to these events by requiring changes in the information that all issuers and their financial professionals must provide in support of their investment practices and by giving investment practices greater weight and requiring closer, more continuous scrutiny. To this end, particular focus is being given to investment objectives, controls, risk limits, and monitoring and oversight capabilities. In these areas, we will still continue to rely upon the information provided to us by the issuer.

The market continually adjusts to new information, resulting in improved relative risk assessment. The supplementing and deepening of our analytic criteria in light of experience is nothing new and is crucial to the art of issuing rating opinions that take into account the changing world of credit risks and the evolving needs of the marketplace. As with prior fiscal crises, the Orange County experience has brought to the public a greater understanding and appreciation of risk, which in turn has focused individual issuers, states and industry associations, for example, the Government Finance Officers Association; the National Association of Counties; the National Association of State Auditors, Controllers and Treasurers; and the Public Securities Association; on better investment practices and improved investment disclosure. We encourage these efforts.

It must be remembered that a rating is not a prediction of an outcome in a particular case. It is the expression of an opinion about the relative likelihood of different possible future outcomes. Ratings are expressions of opinion about risk, not statements of, or even predictions about, facts. There is not now, nor can there ever be, a science or orthodoxy for debt ratings. In the most basic sense, all bonds perform in a binary manner. They either pay on time or default and cause a loss. If the future could be known, there might be only two ratings for bonds: good and bad. Because the future cannot be known, however, credit analysis must reside in the realm of opinion, not fact. The essence of credit rating is the soundness of judgment that groups bonds into similar bands of risk.

II. Orange County's Decision to File for Bankruptcy

Until Orange County's bankruptcy filing, the market had no prior experience with a large, sophisticated, and very wealthy general purpose, municipal government's operating in bankruptcy. Given the enormous stigma as well as the complexities of operating under bankruptcy, there is no reason at this time to believe that a bankruptcy filing will be viewed as an attractive alternative to addressing the fiscal challenges faced by municipal governments. In the municipal arena, bankruptcy has been unthinkable and an option of last resort, unlike its use in the corporate sector, where it is sometimes utilized as a viable business strategy. Moody's and others in the municipal finance industry are following the bankruptcy proceedings closely to see how, in fact, Chapter 9 will work and what, if any, implications its operation may have on the analysis of the creditworthiness of municipal issuers. There are no clear implications at this time.

A broader, related concern raised by the bankruptcy filing is how difficult it has been for Orange County to deal with its fiscal crisis. The restrictive system of tax and revenue limitations, a substantial level of mandated service provision, and the need to gain voter approval for most new revenue and debt initiatives appear to give the County very limited latitude to address its current emergency. The State of California is not legally obligated to pay Orange County's debt, and we have never based ratings upon the assumption that a state will bail out its localities. Nevertheless, in other fiscal crises such as those in Philadelphia or New York, states have taken a central role by establishing financial control boards and other oversight mechanisms, or by enacting special revenue or debt authorizations. It was this track record that was often cited by market participants who may have believed that the State of California, despite its own fiscal and legal constraints, would ultimately step in to assure Orange County's timely debt repayment. The extreme magnitude of the Orange County experience has heightened the municipal market's awareness of investment risk and resulted in a greater appreciation of the very real fiscal constraints under which the states and their localities operate.

III. The Effect of Orange County on the Trust Between Issuers and Investors

A far more difficult adjustment will be necessary if Orange County's actions and inactions result in an undermining or erosion of the trust between issuers and investors, which is a fundamental underpinning of the municipal market. Since the December 6 bankruptcy filing, the market has looked for Orange County to reaffirm unequivocally its intention to make good on its debt obligations in full. The County has been less than forthcoming in taking responsibility for the consequences of its own actions, and, indeed, has implied that its own investment losses might justify less than full recognition of its obligations to its creditors. As such, we were disappointed by the resounding rejection of the sales tax proposal. Presented as a means for the County to make good on its obligations, it received at best lukewarm support from most County officials, and was actively opposed by a number of city councils. We believe that these events are beginning to fray the edges of public trust.

Far greater potential damage to public trust will occur if Orange County follows through on its threats to invalidate certain debt obligations. Irrespective of the legal means that the County may use in an attempt to justify not paying its debt, such

justifications would be an attempt to put a moral gloss on what really amounts to a way to stiff its creditors. Any such attempt will give the market substantial pause and could be extremely disruptive. It would be naïve to think that Orange County can surgically extract itself from certain obligations which in retrospect it wished it had not undertaken without causing substantial damage to itself and undermining the basic trust intrinsic to the system by which state and local governments issue debt.

The municipal market has been an accommodating market, providing issuers access to capital at relatively low cost. While much of this borrowing is still done through the issuance of general obligation debt, due to debt limitations much general purpose borrowing is now increasingly reliant on other types of debt instruments as well. It is particularly these types of transactions, which derive their legal underpinnings not from state constitutions but from state statutes, court rulings, and practices that have been developed over many years, that now would appear to be vulnerable.

In truth, the likelihood that Orange County would be successful in any attempt at debt invalidation seems remote. The State's vocal opposition to debt invalidation and the judicial hurdles which the County would need to overcome make it questionable whether the County would even start down this road. These actions have increased the atmosphere of anxiety and mistrust already created by the bankruptcy, and exacerbated by the County's inability to make timely payment on its debt maturing this summer. Simply the threat of debt invalidation shifts our analytical perspective by creating an environment of mistrust.

Should the market begin to believe that issuers will take an opportunistic attitude to their own obligations, sending their lawyers out after the fact to comb through the documents to find some creative justification and basis for not paying obligations that were consciously undertaken, then the result may be that the market will accept only the strongest, most legally tested instruments. This could severely limit or eliminate access to the public market for many municipal issuers, large and small.

IV. Conclusion

The fact that governments do not disappear, and that the vast majority of governments are accountable to their citizens and strive to maintain their creditworthiness and therefore their access to a continuing source of capital, are accepted truths that foster

market confidence. The trust of the marketplace has been appropriately earned and, as a result, the market is rigorous yet accommodating. The market has adjusted, and will continue to adjust, to events in Orange County. If the County takes any actions which undermine this trust, it would likely call for a rethinking of the fundamental underpinnings of the public finance markets.

Biography
Daniel N. Heimowitz
Executive Vice President
and Director
Public Finance Department
Moody's Investors Service

Daniel N. Heimowitz is Executive Vice President and Director of the Public Finance Department, Moody's Investors Service, responsible for all Public Finance rating services and analytic rating groups.

Dan joined Moody's in 1977. In 1986 he was appointed Managing Director responsible for the Public Finance Department's ratings group and in 1989 to his current position. During his career at Moody's, Dan started and managed the Department's structured finance and insured issue ratings groups, and has also managed the development of the Department's administrative and analytical databases, as well as the Department's automated analyst workstations.

An active participant in the public finance industry, Dan is a member of the Governmental Accounting Standards Advisory Council; is President of the Municipal Forum of New York and serves on committees of the Public Securities Association and the Governmental Accounting Standards Board. He is a member of the Municipal Analysts Group of New York, and Society of Municipal Analyst .

Dan received his M.A. in City Planning from Harvard University and his B.A. degree in Economics and Geography from Clark University. He was born and grew up in New York City and presently resides with his wife and two children in Manhattan.



Moody's Investors Service

Public Finance Department

Key To Moody's Municipal Ratings

DEFINITIONS OF LONG-TERM RATINGS

Aaa

Bonds that are rated **Aaa** are judged to be of the best quality. They carry the smallest degree of investment risk and are generally referred to as "gilt edge." Interest payments are protected by a large or by an exceptionally stable margin and principal is secure. While the various protective elements are likely to change, such changes as can be visualized are most unlikely to impair the fundamentally strong position of such issues.

Aa

Bonds that are rated **Aa** are judged to be of high quality by all standards. Together with the **Aaa** group they comprise what are generally known as high grade bonds. They are rated lower than the best bonds because margins of protection may not be as large as in **Aaa** securities or fluctuation of protective elements may be of greater amplitude or there may be other elements present that make the long-term risks appear somewhat larger than in **Aaa** securities.

A

Bonds that are rated **A** possess many favorable investment attributes and are to be considered as upper medium grade obligations. Factors giving security to principal and interest are considered adequate, but elements may be present that suggest a susceptibility to impairment some time in the future.

Baa

Bonds that are rated **Baa** are considered as medium grade obligations, i.e., they are neither highly protected nor poorly secured. Interest payments and principal security appear adequate for the present but certain protective elements may be lacking or may be characteristically unreliable over any great length of time. Such bonds lack outstanding investment characteristics and in fact have speculative characteristics as well.

Ba

Bonds that are rated **Ba** are judged to have speculative elements; their future cannot be considered as well assured. Often the protection of interest and principal payments may be very moderate, and thereby not well safeguarded during both good and bad times over the future. Uncertainty of position characterizes bonds in this class.

B

Bonds that are rated **B** generally lack characteristics of the desirable investment. Assurance of interest and principal payments or maintenance of other terms of the contract over any long period of time may be small.

Caa

Bonds that are rated **Caa** are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.

Ca

Bonds that are rated **Ca** represent obligations that are speculative in a high degree. Such issues are often in default or have other marked shortcomings.

C

Bonds that are rated **C** are the lowest rated class of bonds, and issues so rated can be regarded as having extremely poor prospects of ever attaining any real investment standing.

DEFINITIONS OF SHORT-TERM RATINGS

MIG 1/VMIG 1

This designation denotes best quality. There is present strong protection by established cash flows, superior liquidity support or demonstrated broad-based access to the market for refinancing.

MIG 2/VMIG 2

This designation denotes high quality. Margins of protection are ample although not so large as in the preceding group.

MIG 3/VMIG 3

This designation denotes favorable quality. All security elements are accounted for but there is lacking the undeniable strength of the preceding grades. Liquidity and cash flow protection may be narrow and market access for refinancing is likely to be less well established.

MIG 4/VMIG 4

This designation denotes adequate quality. Protection commonly regarded as required of an investment security is present and although not distinctly or predominantly speculative, there is specific risk.

SG

This designation denotes speculative quality. Debt instruments in this category lack margins of protection.



Moody's Investors Service

Public Finance Department

Key To Moody's Municipal Ratings

MOODY'S RATING SYSTEM

Moody's ratings provide investors with a simple system of gradation by which the relative credit qualities of debt instruments may be noted. Definitions for each rating category appear on the reserve side.

Long-Term Ratings

There are nine basic rating categories for long-term obligations. They range from **Aaa** (highest quality) to **C** (lowest quality). Those bonds within the **Aa**, **A**, **Baa**, **Ba** and **B** categories that Moody's believes possess the strongest credit attributes within those categories are designated by the symbols **Aa1**, **A1**, **Baa1**, **Ba1** and **B1**.

Advance refunded issues that are secured by escrowed funds held in cash, held in trust, reinvested in direct non-callable United States government obligations or non-callable obligations unconditionally guaranteed by the U.S. government are identified with a hatchmark (#) symbol, i.e., **#Aaa**.

Moody's assigns conditional ratings to bonds for which the security depends upon the completion of some act or the fulfillment of some condition. These are bonds secured by: (a) earnings of projects under construction, (b) earnings of projects unseasoned in operating experience, (c) rentals that begin when facilities are completed, or (d) payments to which some other limiting condition attaches. The parenthetical rating denotes probable credit stature upon completion of construction or elimination of basis of condition, e.g., **Con. (Baa)**.

Issues that are subject to a periodic reoffer and resale in the secondary market in a "dutch auction" are assigned a long-term rating based only on Moody's assessment of the ability and willingness of the issuer to make timely principal and interest payments. Moody's expresses no opinion as to the ability of the holder to sell the security in a secondary market "dutch auction." Such issues are identified by the insertion of the words "dutch auction" into the name of the issue.

Short-Term Ratings

There are four rating categories for short-term obligations that define an investment grade situation. These are designated Moody's Investment Grade, or **MIG 1** (best quality)

through **MIG 4** (adequate quality). Moody's assigns the rating **SG** to credit-supported financings that have been identified as speculative quality investments. The **SG** designation applies to short-term debt instruments and tender features that derive full credit support from a financial institution whose short-term debt is rated **NP** (Not Prime) by Moody's Corporate Department.

Similar to our short-term **MIG** ratings are Moody's commercial paper ratings. Moody's assigns "Prime" ratings to commercial paper, ranging from **P-1** at the high end to **P-3** at the low end. Commercial paper issues not considered by Moody's to fall within these investment-grade categories are rated **NP**.

In the case of variable rate demand obligations (VRDOs), a two-component rating is assigned. The first component represents an evaluation of the degree of risk associated with scheduled principal and interest payments, and the other represents an evaluation of the degree of risk associated with the demand feature. The short-term rating assigned to the demand feature of VRDOs is designated as **VMIG**. When either the long- or short-term aspect of a VRDO is not rated, that piece is designated **NR**, e.g., **Aaa/NR** or **NR/VMIG 1**.

Short-term issues or the features associated with **MIG**, **VMIG**, or **SG** ratings are identified by date of issue, date of maturity or maturities or rating expiration date and description to distinguish each rating from other ratings. Each rating designation is unique with no implication as to any other similar issue of the same obligor. **MIG** ratings terminate at the retirement of the obligation while **VMIG** rating expiration will be a function of each issue's specific structural or credit features.

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Rating News

ORANGE COUNTY, CALIFORNIA RATINGS SUSPENDED

New York, NY -- December 6, 1994 -- Effective today, December 6, 1994 Moody's Investors Service suspended the ratings on all uninsured, unenhanced debt obligations of Orange County, California. Orange County officials have confirmed at 8:30 p.m. EST today that they have filed for bankruptcy in Orange County under Chapter 9 of the United States Bankruptcy Code. At this time there is little precedent to draw upon to predict the degree to which the Federal bankruptcy court will protect debt holders.

The following ratings are suspended:

<u>Issuer</u>	<u>Prior Rating</u>
Orange County, CA	Aa1
Orange County, CA (TRANS) 1993-94 (Taxable) Teeter Plan	P-1
Orange County, CA (TRANS) 1994-95 (Pooled)	MIG 1
Orange County, CA (TRANS) 1994-95 (Taxable Notes)	P-1
Orange County, CA (TRANS) 1994-95 (Taxable) Teeter Plan	P-1
Orange County, CA (TRANS) 1994-95, Series A	MIG 1
Orange County, CA (TRANS) 1994-95, Series B	MIG 1

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<u>Issuer</u>	<u>Prior Rating</u>
Orange County, CA Airport Revenue Bonds	A1
Orange County Civic Center Auth., CA Santa Ana Lease Rental 1972 Rfdg.	A1
Orange County, CA Pension Obligation (Taxable), Series A	A1
Orange County, CA Pension Obligation (Taxable), Series B	A1/MMIG 1
Orange County, CA Pub. Fac. Corp., CA Certificates of Participation, Series 1986 Dtd. 7-1-86	Con. (A1)
Orange County, CA Pub. Fac. Corp., CA Certificates of Participation, Series 1988 Dtd. 12-1-88	A
Orange County, CA 1994-95 (Teeter Plan) Tax-Exempt Notes	MIG 1
Orange County, CA-California Financial Services (1990 Equip. Proj.) Certificates of Participation dtd. 1-1-91	Con. (A)

We will follow with further clarification tomorrow.

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MOODY'S REPORTS INITIAL FINDINGS OF MEETINGS WITH ORANGE COUNTY AND STATE OF CALIFORNIA OFFICIALS

New York, NY -- December 8, 1994 -- Moody's Investors Service today conducted extensive meetings with officials of Orange County, the State of California, as well as the major participants in the Orange County Investment Pool (OCIP). Both the County and the OCIP filed for bankruptcy protection under Chapter 9 of the Federal Bankruptcy Code on December 6th. The discussions with County officials and pool participants focused on the impact of the bankruptcy filings on the County, related entities and participants in the OCIP, and their ability to meet ongoing operating and debt servicing requirements. State officials informed us that they are actively monitoring the situation, but are not directly involved at this time.

Immediate concerns exist with respect to school districts and community college districts participating in the investment pool. However, County officials report that scheduled payroll distributions to the districts will take place tomorrow, Friday, December 9. Not yet confirmed are distributions to districts of certain Revenue Limit Funds, representing property taxes collected by the County, on December 20, an important funding source for ongoing operations. Additionally, certain other districts have previously issued Tax and Revenue Anticipation Notes, which may require partial segregation of funds in December for notes maturing later in the fiscal year. Moody's will closely monitor events to determine whether these near-term requirements are fulfilled.

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We have been informed that the County has created a new fund to accumulate property taxes as received. We look to the creation of the fund as a possible mechanism to protect revenues critical to the repayment of tax-backed obligations of the County and other participants in the OCIP, which includes general obligation bonds, tax allocation bonds and tax and revenue anticipation notes. However, it is too early to evaluate whether the new fund will provide an effective mechanism within the context of events that have unfolded in the County. Ratings on these obligations remain under review pending receipt of additional information on the OCIP, including clarification of the full extent of investment losses suffered to date and a review of cashflow data for each pool participant.

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Rating News

MOODY'S LOWERS RATING ON ORANGE COUNTY, CALIFORNIA TAXABLE PENSION OBLIGATION BONDS, SERIES B

New York, NY -- December 8, 1994 -- Moody's Investors Service has announced that it has reinstated and lowered to Caa the rating on the \$110 million Orange County Taxable Pension Obligation Bonds, Series B. The County has informed Moody's that it has defaulted on these bonds due to the Orange County Investment Pool's inability to allow the County access to its unrestricted funds in an amount sufficient to redeem tendered bonds.

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MOODY'S PROVIDES PRELIMINARY ASSESSMENT OF MAJOR CREDIT ISSUES IN ORANGE COUNTY, CALIFORNIA BANKRUPTCY

New York, New York -- December 12, 1994 -- On December 8, Daniel Heimowitz, Executive Vice President-Director, Public Finance, and other senior Moody's officials met with high-level Orange County officials and, in Sacramento, with senior State officials who are actively monitoring the situation. Moody's representatives also met with five of the largest participants in the Orange County Investment Pool. Our meetings and the other developments and actions since the December 6th bankruptcy filing of Orange County and the Orange County Investment Pool, allow us to make some preliminary assessments of the situation. Many factors critical to understanding the extent to which debt holders of County and other pool participants' obligations will be affected are yet to be determined. Critical information needed for a better assessment of the situation is now being sought and may be available in the near term including an assessment of the investment pool's condition, projections of County and participant upcoming cash requirements and expected cash in-flows, and the extent, if any, of available cash resources held outside the pool. Proceedings under the County and pool bankruptcy filings, the potential for additional bankruptcy filings by other participants and the impact of other legal actions by creditors, vendors, employees and among the participating local governments are just some of the many undetermined factors that will create uncertainty for some time.

(Continued)

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The appointment by the County supervisors on December 8, of former State Treasurer, Thomas Hayes, to the position of Chairman of the financial restructuring team should be a positive step towards clarifying the situation. Mr. Hayes will lead the County's team and will have authority over the County's investment pool. In a similar vein, the hiring of Salomon Brothers, as financial advisor, to evaluate the securities currently in the investment pool and to assist the County in restructuring the pool should contribute to the process.

Illiquidity Poses Concern for Debt Service

The outlook for investors in County and other pool participants' debt obligations is highly uncertain as a consequence of the crisis precipitated by the reported investment pool losses. The most immediate concern for debt holders relates to the impact on the liquidity of the County and other participating governments. The County's default on Thursday, December 8th, on \$110 million Orange County Taxable Pension Obligation Bonds, Series B (demand bonds), is the most severe debt holder consequence to date. These bonds are currently rated Caa. Sanitation Districts 1,2,3,5,6,7,11,13, and 14 of Orange County have reportedly avoided default on their taxable commercial paper notes through dealer intervention but the \$46 million outstanding commercial paper remains a sizable claim against the pool that will place recurring pressure; at this time there remains the potential of a default. This commercial paper program is currently rated Not Prime.

Beginning in late December and January there are semi-annual interest and maturing principal requirements on the County's and other pool participants' outstanding long-term debts. Some of the monies intended to pay upcoming debt service were undoubtedly accumulated and invested in the pool. Moody's has compiled, for publication today, a schedule of upcoming debt service

requirements for all rated issuers. Outstanding long-term debt obligations include general obligation bonds, Mello-Roos bonds, tax allocation bonds, lease obligations, revenue bonds, and fixed rate pension obligation bonds. We are also in discussion with each rated issuer to determine its cash condition. We expect to publish the results of these surveys shortly. Beyond the cash concerns of meeting debt service payments on long-term obligations are questions about the legal standing and payment priorities. It remains to be clarified how these obligations will be treated.

Another concern is the extent to which unexpended construction proceeds are invested in the investment pool because of the impact on project completion or developer reimbursement. This could be a concern for Mello-Roos bonds, tax allocation bonds, lease obligations and revenue bonds. We are in the process of contacting each issuer to discuss project status and the effect, if any, that construction delay and loss of proceeds will have on the ability to meet debt service.

Since rated outstanding tax and revenue anticipation notes (TRANs) mature during June 1995 or beyond, and segregation for repayment typically occurs in December or later as property taxes are collected, there may be time to accumulate cash and take other actions necessary to protect investors. The pool's bankruptcy filing occurred just prior to the first major receipt of property taxes on December 10, when most TRAN proceeds have typically been expended and TRAN issuers' cash balances are at their lowest. The supervisors recently took an important step by creating a new investment fund to receive all property taxes to be collected by the County for all taxing jurisdictions. County officials presented to us that once it is fully operational, the new fund's purpose is to receive taxes and allow appropriate accounting for those monies separate

from the bankruptcy filing. It will be determined after our detailed review of each of the participants' cash flow requirements how these flows will affect each participants' ability to cover its various tax supported obligations including TRANs.

Teeter Plan TRANs, unlike traditional TRANs, rely upon collections of tax delinquencies. We will be looking at cash flow projections going forward to determine to what extent the pool was being relied upon for potential shortfalls in collection of delinquent taxes prior to note maturity. Also, delinquencies collected to date would have been deposited in the pool and we will verify the extent of these collections and their potential impact on note repayment.

Orange County TRANs (pooled 1994-95) is a pool of traditional California school district TRANs. This issue is further secured with liquidity protection by the County investment pool to the extent of cash flow insufficiency from any of the school districts. We are in the process of gathering cash flows from each of the participating school districts to determine if there will be any need to rely upon that liquidity protection.

The \$600 million taxable TRANs issued by the County and the \$485 million other taxable TRANs issued by various pool participants were issued solely for investment arbitrage purposes and intended to be paid from these invested original proceeds. Absent some extraordinary intervention, taxable TRANs are extremely vulnerable to the pool's illiquidity and eventual loss allocation.

Notwithstanding the flow of revenues described in the resolution for each of the individually secured taxable and tax-exempt TRANs, there may be legal questions as to how each note's specific segregation and revenue pledge will

be prioritized relative to each other note and to all other general fund obligations.

Bankruptcy Issues

There are many uncertainties relating to the Chapter 9 bankruptcy. Because of questions as to the legal ability of the parties to avail themselves of the protection of Chapter 9, the limited precedent of Chapter 9 bankruptcy filings, and the resulting uncertainties of interpretation, we cannot speculate as to how and when these issues will be resolved and what impact they will have on debt repayment.

Magnitude of Losses to be Determined

Yet to be determined is the magnitude of the losses of the investment pool and how those losses will be allocated among participants. County staff is currently gathering and analyzing the information necessary to address these questions. No specific plans for restructuring the pool have been announced. At this point, the priorities for payment of claims against the pool have also not been determined. The pool, which is subdivided into a commingled pool and a bond pool, contains some one thousand accounts for various purposes. Sorting out priorities for payment is expected to be a complex process.

While pool losses are still undetermined, of fundamental concern is the County and pool participants' ultimate willingness to recognize their losses and their ability to address those losses once allocated. Limited available taxing margins, some recent positioning by public officials to the effect that this crisis will not lead to tax increases and substantial reliance by many governments on pool investment earnings are some of the many obstacles to the long-term resolution

of the crises. Recognition and apportionment of pool investment losses will require cooperation and compromise on the part of the participants and, importantly, discussions among groups of affected local officials has already begun. However, it is also noted that the approximately 185 participating governments operate in a manner basically independent from one another and their relationships to the County are primarily geographic, as the County has little direct say or influence over any of their operations.

State Role

The State is actively monitoring the situation and officials are giving consideration to alternative ways that they can provide assistance. However, direct State intervention is not currently forthcoming. The individual county pools are independent, neither supervised nor protected by the State. It is understandable that the State expresses a basic concern about taking on any direct responsibility for pool losses. It is also noted that the State's own budget problems place considerable liquidity pressures on State resources and limit its flexibility to offer support given the magnitude of the reported Orange County losses. However, because pool participants are subdivisions of the State, the State has a fundamental interest in insuring that its subdivisions can carry on their core governmental functions. The State has indicated that any active involvement could only come if the State were requested to do so and no such request has reportedly yet been made.

Long-term Outlook

A more satisfactory outcome for investors must ultimately look to the many fundamental credit strengths collectively represented by these issuers. These include a strong, growing economic base which has begun to recover from the Southern California recession and a long history of sound budgeting and

financial management with virtually no history of prior fiscal distress by any of the participants. It should be recognized that failure to promptly and effectively act to stem a rash of additional defaults may threaten access to needed additional investment which could potentially have a long term economic consequence that is as damaging as the current financial crisis.

Moody's is in frequent contact with County officials and we will provide appropriate informational updates and ongoing analysis of the implications for bondholders.

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ORANGE COUNTY, CALIFORNIA UPCOMING DEBT SERVICE PAYMENTS

New York, New York - December 14, 1994 - Moody's is reviewing the ability of Orange County to make upcoming scheduled debt service payments. This review is part of Moody's ongoing assessment of the impact of the Orange County bankruptcy filing on the county investment pool participants.

Orange County has two series of debt obligations with interest payment dates scheduled for January 1, 1995. These are:

Issue	Prior Rating (1)
Certificates of Participation dated 7/1/86	A1
County Improvement General Obligation Bonds	Aa1

(1) These ratings were suspended on December 6, 1994.

County officials report that it is unlikely that the transfer of funds to the trustee for the \$488,175 interest payment on the Certificates of Participation will take place as scheduled for December 15, 1994. However, county officials indicate that they are making all efforts to meet the January 1 debt service payment date. It is unclear how the county's bankruptcy filing will impact the county's ability to make these debt service payments.

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MOODY'S CONDUCTS FOLLOW-UP MEETINGS IN ORANGE COUNTY, CALIFORNIA

New York, NY — December 15, 1994 — Today senior officials of Moody's Investors Service met with various representatives of Orange County, California including Tom Hayes and other Senior officials and their advisors. The purpose of our trip was to get an updated assessment of the situation and to continue discussions regarding the status of outstanding debt obligations in light of the losses incurred by the County Investment Pool and the bankruptcy filings of the Pool and the County. We expressed concerns about immediate cashflow needs for upcoming debt service payments as well as future steps necessary to protect debtholder security.

Among the topics discussed with County officials were the size of the investment losses and the strategy to stabilize and liquidate the investment portfolio, the availability of cash resources and the alternatives for Interim disbursements of cash to meet compelling needs of the participants, including cashflow necessary to meet upcoming debt service. Issues relating to repayment of debt obligations remain complicated by the bankruptcy filings and will likely be subject to a great deal of discussion and legal interpretation before they can be resolved.

We also had discussions regarding the longer-term outlook for the County and the participants relative to the ultimate allocation of losses and some of the possible alternative means available to address those losses. Moody's officials emphasized that default avoidance will be a critical element in our credit evaluation of the County and the other participants as they attempt to deal with this situation and restore confidence in their creditworthiness.

We expect to comment at greater length shortly about our current analysis of the status of various debt obligations.

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MOODY'S ASSESSES IMPACT ON SHORT-TERM DEBT OF BANKRUPTCY FILINGS BY ORANGE COUNTY, CALIFORNIA AND THE COUNTY INVESTMENT POOL

New York, New York - December 21, 1994 -

FUTURE PAYMENT STATUS OF NOTES DEPENDS ON STATE LAW, CASH FLOW AND BANKRUPTCY FACTORS

There are four major types of short-term debt affected by the investment losses of the Orange County, California investment pool and the filing for bankruptcies of Orange County and the investment pool. These are: tax-exempt Tax and Revenue Anticipation Notes (TRANs); taxable TRANs; tax-exempt and taxable Teeter notes of Orange County; and the Orange County tax-exempt pooled TRANs issued for local school districts. A list of affected issues is attached.

Whether or not any given issue is paid in full and on time may depend on the interaction of three factors: state law affecting the notes' pledged security and priority of payment; cash available or to be received that the issuer may use for payment of the notes; and the legal effects on both of the other variables of the county and investment pool bankruptcy filings. Given the sparse language of Chapter 9 of the Bankruptcy Code and the lack of relevant precedents for judicial interpretation of its provisions, there may be a variety of claims and conflicts among general creditors, investment pool participants, underlying units of government, and other interested parties that could result in substantial disputes requiring time to resolve. The uncertainty is heightened at this time by the fact that the county has not yet expressed its intentions to its creditors through the filing of its reorganization plan.

(Continued)

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PROJECTED CASH FLOWS WILL DETERMINE CREDIT QUALITY OF INVESTMENT POOL PARTICIPANTS' (OTHER THAN THE COUNTY) CASH FLOW TAX-EXEMPT TRAns

There have been notable developments related to the repayment outlook for the cash flow tax-exempt TRAns issued by pool participants (other than Orange County). The TRAns are secured by a first lien on certain unrestricted revenue as described in the authorizing statute and each participant's note resolution. In addition, each of the notes is a general obligation of the issuer.

While it is possible that cash received post-bankruptcy by Orange County investment pool participants may continue to be subject to the bankruptcy proceedings, there so far appears to be broad-based support for efforts to separate pool participants' (other than the county's) post-bankruptcy cash receipts and make them available for the issuers' use, including payment of their TRAns.

To these ends, the county supervisors have recently created a new investment fund to receive all property taxes to be collected by the county for all its taxing jurisdictions. County officials have indicated that the new fund's purpose is to receive taxes and allow appropriate accounting for those monies separate from the bankruptcy filings. Moody's has been informed that all tax receipts in the new fund will be invested in short-term Treasury obligations.

Since outstanding cash flow TRAns rated by Moody's mature during June 1995 or later, and property tax segregation for the cash flow notes typically occurs in December or later, there may be time to accumulate cash and take other actions necessary to protect investors. The pool's bankruptcy filing occurred just prior to the first major receipt of property taxes on December 10, at a time when most TRAn proceeds have typically been expended and TRAn issuer cash balances are at their lowest. Assuming that post-bankruptcy receipts are not made subject to the bankruptcy and assuming no challenges to their state law lien and priority of payments, our analysis will focus on funds available for payment at maturity. While we have requested revised cash flows from the investment pool participants, most cash flows received to date show only receipts and disbursements of monies in the new fund for the next 90 days; the cash flows do not include any funds from the old investment pool. Once we receive, verify, and analyze more complete participant cash flows, we should be able to complete the review of the outstanding cash flow TRAns.

INVESTMENT POOL LOSS ALLOCATION AND STATUTORY CLAIMS WILL DETERMINE CREDIT QUALITY OF TAXABLE TRANS OF INVESTMENT POOL PARTICIPANTS (OTHER THAN THE COUNTY)

The situation for taxable TRANS, in which pool participants other than the county borrowed money in the taxable markets and invested the proceeds in the county investment pool, is considerably less certain. Unlike the tax-exempt TRANS, these taxable TRANS had a fully funded payment source, the invested proceeds plus fully funded interest, that was present from the date of issuance, and a specific lien on that source. It is also important to note that, unlike the tax-exempt cash flow TRANS, the 1994-95 tax and revenue receipts of the issuer were not pledged to the taxable TRANS. Finally, like the non-county tax-exempt cash flow TRANS, the taxable TRANS are backed by the issuer's general obligation.

Because these TRANS proceeds were invested in the pool and the pool has availed itself of the protection of Chapter 9, the likelihood of payment of the taxable TRANS is highly dependent upon the bankruptcy proceedings and how the losses from the investment pool will be allocated. It is clear that the investment pool has sustained substantial losses. However, because of uncertainties as to the survival of state law liens and priority of payments subsequent to bankruptcy, it is not at all clear whether investment pool participants will be able to obtain the full value of their pledged security from the pool or, if not paid in full, it is not clear when, how, and the amount of payments that will be made to them.

SPECIAL CONCERNS FOR THOSE ISSUERS OF TAX-EXEMPT TRANS WHICH ALSO HAVE TAXABLE TRANS OUTSTANDING

Should investment pool distributions be insufficient to pay the taxable TRANS, the presence of general obligation backing for the taxable TRANS may put pressure on the issuer to pay the notes from other lawfully available funds. Any payment of the taxable TRANS from an issuer's general funds could jeopardize the overall financial situation for the issuer. Additionally, while the lien of the tax-exempt TRANS on 1994-95 taxes and revenues is clear, should there be a default on an issuer's taxable TRANS, it is conceivable that the holders of the defaulted TRANS will seek access to the taxes and revenues pledged to the tax-exempt TRANS. Resolution of the legal issues may create delays that could affect timely payment of the tax-exempt TRANS for those issuers with outstanding taxable TRANS.

We are following up with the four issuers of rated taxable TRANs other than the county, as well as with Montebello, which has a rated tax-exempt TRAN as well as a taxable TRAN not rated by Moody's, in order to determine their plans should they receive less money from any investment pool distribution than the amount required to pay the taxable TRANs at maturity.

COUNTY'S BANKRUPTCY FILINGS BRING SIGNIFICANT UNCERTAINTY TO STATUS OF ORANGE COUNTY'S OWN TAX-EXEMPT TRANs, TAXABLE TRANs, AND TEETER NOTES

As direct obligations of the bankrupt party, the legal and financial positions of the county's own cash flow TRANs, taxable TRANs, and Teeter Notes, both tax-exempt and taxable, is considerably more uncertain than those of the other pool participants. Again, the lack of specific language in Chapter 9 to resolve survival of lien and priority of payment issues, the lack of precedents for the court's use in resolving these same issues, and the current lack of a county reorganization plan all combine to prevent easy determination of the credit standing of the various county notes.

Prior to the bankruptcy filings, the legal security for the various notes was reasonably well-established pursuant to state law. The county's tax-exempt TRANs are secured by 1994-95 tax and revenue receipts, with general obligation backing. The county's taxable TRANs are secured by note proceeds, invested in the investment pool, together with an amount sufficient to pay estimated interest, again with general obligation backing. The Teeter notes are primarily secured by delinquent tax payments received in 1994-95. Like the taxable TRANs, they are granted no claim on 1994-95 taxes and revenues under the authorizing resolutions but are secured by a pledge of lawfully available county funds. In addition, they have a standby note purchase agreement with the investment pool.

The bankruptcy filing has raised a number of issues as to the legal status and priority of payment of each of those liens. The post-bankruptcy cash flow needed to pay the tax-exempt TRANs and Teeter notes may be subject to bankruptcy proceedings which will make it more difficult to establish a post-bankruptcy set-aside that goes unchallenged. While the taxable TRANs may have a better legal claim in bankruptcy to the funds in the investment pool, the lien may prove a hollow one since the investment pool may provide insufficient funds to fully pay them.

Because of their much more limited initial pledged security, the Teeter notes effectively have only a claim against lawfully available county funds. While the Teeter notes have a claim against the county's Tax Loss Reserve Fund, this fund, too, was invested in the county pool and is exposed to some share of the

losses. The legal status of the investment pool standby note purchase agreement is uncertain; the enforceability opinion on the standby note purchase agreement provided at the time of sale declined to offer an opinion on its enforceability in the event of bankruptcy. Finally, the *taxable* Teeter notes may have a claim over the *tax-exempt* Teeters under state law prioritization of payments, should these liens survive.

Since there are many unresolved legal issues relating to the bankruptcy filing and the resulting uncertainties of interpretation as to the survival of the state statutory liens and priority of payments, it is not currently possible to determine how and when these issues will be resolved and what impact their resolution will have on note repayment.

UNRESOLVED LEGAL ISSUES STILL AFFECT CREDIT QUALITY FOR COUNTY'S SCHOOL DISTRICT TRANs POOL

The situation for the county's 1994-95 Pooled TRANs is also less than clear. The mechanism behind the financing was the county's purchase of TRANs from underlying school districts as an investment and the county's sale of Pooled TRANs to investors. The pledge to the investors is a lien on the revenues received by the county from the school district TRANs. To enhance credit for the pooled financing, the county pool agreed to provide additional funds under a standby note purchase agreement to cover shortfalls in the event underlying school district TRANs are not paid.

Like other tax-exempt TRANs, the tax receipts for the school districts may flow through the newly established fund and may be sufficient to pay each participating school district's TRAN obligations to the county. We will analyze each participant's updated cash flows to determine the combined cash adequacy for the Pooled TRANs. However, because of the nature of the mechanism under bankruptcy, questions arise as to whether the cash received from the school district TRANs will flow through to the investors in the Pooled TRANs or whether the school district payments will be deemed the county's monies. These issues will also require time to resolve.

Finally, should there be insufficiency of funds available from the districts to pay the underlying TRANs, the standby note purchase agreement may not be legally enforceable against the investment pool. Like the similar agreement for the Teeter notes, counsel to the county declined to opine as to whether the agreement was enforceable in the event of a bankruptcy. In addition, even if it is enforceable, the pool may not have sufficient funds available to meet its obligations under the agreement.

Conclusion

The relative rarity of municipal bankruptcy filings has left many fundamental questions unanswerable at this time. We expect to be going forward with our analysis of each participant's cash flows as meaningful information becomes available, and to update our analysis as we receive clarification on the many outstanding unresolved issues.

ISSUER NAME	RATING	PRINCIPAL AMOUNT (\$000)	PAYMENT DATE	INTEREST PAYMENT DATE
Anaheim (TRANS) 1994	MIG 1	24,500	7/28/95	7/28/95
Anaheim Taxable Notes 1994 [2]	MIG 1	95,000	4/4/95	4/4/95
Atascadero (TRANS) 1994-95	MIG 2	1,300	7/12/95	7/12/95
Fullerton (TRANS) 1994	MIG 1	4,500	7/31/95	7/31/95
Garden Grove Sanitation District (TRANS) 1993-94 [2]	MIG 1	5,075	5/1/95	5/1/95
Huntington Beach- Huntington Beach Public Finance Authority (TRANS) 1994-95	MIG 1	15,000	10/1/95	10/1/95
La Habra (TRANS) 1994	MIG 1	2,200	6/30/95	6/30/95
Montebello (TRANS) 1994	MIG 1	6,000	9/29/95	9/29/95
Orange County (TRANS) 1994-95 (Pooled)	[1]	299,660	7/28/95	7/28/95
Orange County (TRANS) 1994-95 (Taxable Notes) [2]	[1]	600,000	7/10/95	1/3/95
Orange County (TRANS) 1994-95 (Taxable Notes) Teeter Plan	[1]	111,000	6/30/95	1/3/95
Orange County 1994-1995 (Teeter Plan) Tax- Exempt Notes	[1]	64,000	6/30/95	1/3/95
Orange County (TRANS) 1994-95 Ser. A	[1]	169,000	7/19/95	7/19/95
Orange County (TRANS) 1994-95 Ser. B	[1]	31,000	8/10/95	1/3/95
Orange County Flood Control District Taxable 1994-95 Notes [2]	P-1	100,000	8/1/95	1/3/95
Placentia-Yorba Linda Unif. S.D. 1994-95 Taxable Notes [2]	P-1	50,000	8/24/95	1/3/95
Seal Beach (TRANS) 1994	MIG 1	2,100	7/5/95	7/5/95

[1] Suspended.

[2] Taxable TRANS.

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Rating News

MOODY'S CONDUCTS NATIONWIDE SURVEILLANCE SURVEY OF MUNICIPAL INVESTMENT PRACTICES

New York, New York-- December 22, 1994-- Today, Moody's Investors Service released the results of its recently conducted surveys on the investment exposure of California counties and on the investment exposure of significant issuers of municipal debt elsewhere in the United States. In the wake of the Orange County bankruptcy, Moody's has undertaken these surveys of selected issuers around the country to determine whether there are investment practices similar to Orange County's that could lead to losses severe enough to affect the credit rating of a rated borrower. The results of these surveys confirmed that, as a general rule: 1) government issuers follow conservative investment strategies, and 2) do not leverage to speculate on interest rate fluctuations. In the survey of California counties, this was generally true but Moody's has identified six counties which require further review and monitoring. Results of the California counties survey are detailed in a release being issued simultaneously with this release.

In the course of the nationwide survey Moody's contacted approximately 1450 issuers throughout the country, which together have over \$470 billion in outstanding rated debt. The survey was designed primarily as a screen to quickly identify investment practices involving leveraging, derivative instruments

(Continued)

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and other investment strategies sensitive to recent interest rate changes which might give rise to potential credit concerns. Given the survey's large scale and time sensitivity, it was not intended as a general evaluation of the appropriateness of specific investments or particular investment strategies.

Use of Derivatives and Leveraging Not Seen as a Widespread Concern

In Orange County, the aggressive use of leveraging to enhance yield and the presence of substantial unhedged positions in highly interest rate sensitive derivative instruments resulted in market value losses, collateral calls forcing realization of those market value losses, and, finally, demands for withdrawal by voluntary participants in the County's investment pool. The survey has not identified any rated issuer who is engaged in an investment strategy based on the type and magnitude of leveraging used by Orange County. Most issuers have represented that either they do not engage in leveraging strategies or are not authorized to borrow for investment purposes. Many of those issuers who have indicated they are involved in reverse repurchase agreements or securities lending have represented to us that these agreements amount to a very small portion of their investment portfolios, are valued frequently and are of short duration.

Our survey found that some municipal investment strategies are not sufficiently adaptable to the type of market changes that are taking place. Some issuers have reported that they have "unrealized" losses on investments, from both traditional long term bonds and derivatives that are sensitive to interest rate swings, but most have matched the maturities of such investments to cash flow needs and plan to hold the securities to maturity. Losses resulting from investments, particularly "unrealized" losses, are evaluated by Moody's in the context of the credit as a whole. The concern with "unrealized" losses has

traditionally been and continues to be the need of an issuer to liquidate the securities and experience the actual loss. Losses are realized when there is a mismatch between the duration of investments in the portfolio and either normal cash flow requirements or unanticipated withdrawals requiring liquidation of investments prior to their maturity.

Although many issuers that Moody's surveyed have some portion of their portfolio invested in derivatives or interest rate sensitive collateralized mortgage obligations, it is not necessarily the investment itself, but how the product is managed which determines whether there is cause for credit concern. With proper understanding and management and a clear sense of priorities for the entire portfolio based on the general principals of safety of principal first, liquidity second and yield last, generally no credit issues are raised.

As a result of our survey, only a limited number of credits have been flagged for further review. While Moody's anticipates few, if any, rating actions as a result of this survey, a more extensive review is being conducted in those limited instances to determine if there is any effect on the credit position of the rated debt obligation. Our survey also found that fund managers, governmental depositors, and elected officials who are sponsors or overseers of municipal investments have been prompted by the Orange County situation to assess their positions and to reevaluate their investment policies.

Going forward Moody's will review and revise, as necessary, our approach to monitoring the evaluation of investment practices by debt issuers in the public finance market place. This effort will extend to consideration of the information required for review, the criteria employed in our analysis and the method of dissemination of this information to investors.

How the Survey Was Conducted

Moody's surveyed issuers at all levels of government in all 50 states and Puerto Rico. The scope of the survey was determined on a state by state basis. In all instances, issuers with rated short-term notes were contacted. All 50 states and Puerto Rico were contacted about the investment practices for state-managed funds. In addition, Moody's questioned state officials in the 29 states that manage pooled investments on behalf of localities. In certain circumstances, state officials responsible for oversight of local investment practices were contacted. All major issuers in each state were included in the survey, including the largest cities and other issuers with significant amounts of outstanding debt. Where Moody's identified local investment pooling practices, the official responsible for the investment of the pooled funds was questioned. In some instances, financial advisors or major bond counsel were called to generally confirm the nature of the investment practices within their state. Included in the survey were 48 state housing agencies, 280 hospitals and 44 universities with outstanding rated debt. In addition, Canadian provinces, as well as large Canadian municipalities and regional municipalities, which together have over US\$ 200 billion of rated debt outstanding were also contacted as part of our survey. The results of the survey reported in this release do not include any reviews done for Orange County or participants in the Orange County Investment Pool. Results of these reviews have been and will continue to be reported on in separate releases.

The survey was conducted by telephone and, in almost all cases, the official(s) directly responsible for the investment activity of the entity was questioned. Each issuer was asked a series of questions concerning their level of investment activity in derivatives and other interest rate sensitive securities, including collateralized mortgage obligations, inverse floeters, and structured notes. Issuers were also questioned about the existence and extent of any leveraging

practices. In addition, each issuer was asked if they had realized or anticipate realizing any losses as a result of selling securities for cash flow needs. Each issuer was also questioned about the magnitude of any current unrealized losses.

We are still awaiting responses from a few issuers contacted as part of this survey. We will continue to follow up in these instances and will report our findings, as necessary.

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Rating News

Moody's Assesses Investment Risk of California County Pools

New York, New York - December 22, 1994. Because of the large investment losses incurred by the Orange County Investment Pool, which resulted in the Pool and the County subsequently filing for bankruptcy, Moody's has undertaken a survey of the other 57 county investment pools in California to update our assessments of their vulnerability to similar events. *While various pools have undertaken different strategies relative to their tolerance of investment risk, we have not identified any other county pool in California that exhibits the high risk characteristics of Orange County.* As a result, no rating action, including placing any ratings under review, has been taken at this time.

In Orange County, the aggressive use of leveraging to enhance yield and substantial, unhedged positions in derivative instruments which were highly sensitive to increases in interest rates resulted in market value losses, collateral calls which forced realization of those market value losses, and finally, demands for withdrawal of their funds by participants who were not mandated to be in the pool. Our survey focuses on the extent to which these same risks exist in the 57 other pools.

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(2)

For our survey, Moody's analysts contacted and spoke with officials from all 57 counties. Of these, officials from 37 counties reported that there was no use of reverse repurchase agreements or derivatives in their county pool. Officials from 14 counties reported some use of either leverage or derivatives, although the amounts were generally moderate; we will be following up at a later date but see no immediate need for concern.

Six counties reported a significantly more aggressive use of either leverage or derivatives, or both. These counties are: Monterey, Placer, San Bernardino, San Diego, Solano, and Sonoma. For those counties, we have had extensive discussions and obtained some degree of documentation of their portfolios and listings of participants in the pool. We should note that most county treasurers consider it a statutory requirement that schools deposit 100% of their funds with the county treasurer. However, one county has indicated that a school may invest up to 20% of its funds in the State's Local Agency Investment Fund (LAIF); we are following up to clarify the investment requirements for school districts.

While the managers of each of these pools report that they have developed or are beginning to develop strategies to address the risks posed by the nature of their pools, we will be having further discussions or meetings with managers of these pools in order to verify information which they have provided to us in order to better assess their strategies. To date, the officials responsible for the pools have been very forthcoming in their willingness to discuss their investment strategies and the current status of their portfolio.

(3)

The key aspects of these six county pools are highlighted below.

Monterey County

The county's investment strategy of using reverse purchase agreements and derivatives for yield enhancement has exposed the investment pool to a level of risk in a rising interest rate environment. It is important to note that all participants are mandatory so there is minimal risk of unplanned liquidation demands. According to county officials, the reverse repurchase position is \$237 million and these have experienced no margin calls. Officials also report these transactions have been segregated into a separate pool which could decrease the risk of unplanned liquidation demands. The other 'core portfolio' is reported to have a book value of \$338 million and a December 1, 1995 market value of \$322 million. We are requesting additional information and are planning to meet with county officials to obtain further documentation of their reported strategies to address risks in the portfolio and verify separation of the two pools to ensure satisfactory liquidity levels.

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Placer County

The county's pool had an unleveraged book value of \$378 million as of December 15, with an additional \$68 million in securities financed with reverse repurchase agreements.

(4)

The county has been significantly reducing its use of reverse repurchase agreements as interest rates have risen over the past year. Approximately 42% of the pool is invested in derivative securities, about 3/4 of which are in an inverse rate mode. Less than 10% of the deposits represents voluntary participants.

Approximately 25% of the portfolio, or \$140 million, is invested in short term or liquid investments, which officials assert is more than sufficient to meet current cash flow projections and potential unplanned withdrawals. Because of the complex nature of the county's portfolio, we will meet with county officials to better understand the county's investment risk management program.

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San Bernardino County

The county's investment pool, totaling nearly \$2.5 billion, has been managed with a relatively aggressive use of leverage to enhance yield. The county's portfolio includes more than \$800 million of reverse repurchase agreements. The county has also issued a \$300 million taxable note for arbitrage purposes (not rated by Moody's). While the degree of leverage is high, the County reports that it has been reducing its reverse repurchase agreement position in light of recent market developments; on December 13, \$46.75 million of these agreements were not rolled over. County officials have stated to Moody's that the reverse repos are restricted to 90 days and also report that these positions required margin calls during 1994 of \$18.4 million through November 30.

(5)

The low level of non-mandatory participants in the pool mitigates the risk that the pool will have to liquidate securities and realize paper losses. The largest voluntary depositor, Chino Hills, has \$66 million in the pool and the city has reportedly indicated its intent to maintain these funds in the pool.

We will be following up with county officials to monitor their reported changes in strategy regarding reverse repurchase agreements and to gain additional information to evaluate the pool's liquidity position.

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San Diego County

The San Diego County Investment pool has invested in a significant amount of interest rate sensitive instruments and has sustained paper losses of about 10.7%. While the pool does not have leveraged investments such as reverse repurchase agreements, the pool's voluntary participants account for about 25% of the portfolio, which makes the pool vulnerable to early withdrawals by these participants. The County Employees Retirement Fund, whose obligation to invest in the pool is not yet clear, accounts for an additional 14.5%. The county and the major participants of the pool are reportedly taking steps to regulate demands on the pool to prevent realizing losses on the sale of investments. Because of the risks presented by the use of structured notes and other interest rate sensitive securities, as well as a significant proportion of discretionary

(6)

participants, Moody's will monitor performance of the pool closely, and plans to meet with appropriate officials to further assess their strategies.

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Solano County

Solano County has an aggressive investment strategy, with use of about \$182 million in reverse repurchase agreements and significant use of derivatives on a pool with market value of \$427 million as of November 30, 1994. Further, the weighted average maturity of the pool's investments is relatively long at 875 days. Officials responsible for managing the pool have indicated to Moody's that they have begun to shorten the maturity of their investments.

While the county's investment strategies have exposed the pool to rising interest rates and have required cash for collateral calls, it is important to note that there are no discretionary participants in the pool which could cause unexpected, large withdrawals of funds. We plan to hold further discussions with county officials to verify their investment plans, to discuss the degree of exposure resulting from the derivative positions, and to evaluate the County's strategy to assure necessary future liquidity.

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(7)

Sonoma County

The county utilizes a significant amount of reverse repurchase agreements and derivatives to enhance the overall portfolio yield. Derivatives including floaters and inverse floaters represent approximately \$322 million of the total portfolio value of \$565 million. Since December 5, there have been two margin calls of \$1.6 million on the reverse positions which were satisfied with cash and securities on hand.

The county has approximately eight voluntary city participants in the investment pool with a total investment of approximately \$75 million. According to the county, no participant has requested unusual withdrawals from the fund and each is continuing to make deposits. In light of the exposure to possible additional margin calls and the inclusion of voluntary participants which could request immediate withdrawal, we will continue to monitor the overall performance of the portfolio and the county's liquidity position.

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Rating News

MOODY'S PROVIDES UPDATE ON SCHEDULED JANUARY 3 DEBT SERVICE PAYMENTS FOR ORANGE COUNTY, CALIFORNIA AND COUNTY SCHOOL DISTRICTS

New York, New York - December 29, 1994 - The Orange County Board of Supervisors today took several actions to provide for debt service payments coming due on January 3. However, it is not clear that these actions, taken just five days before the required payment date to bondholders, were approved in time to allow timely payment of debt obligations. The county's actions appear to represent a first step toward acknowledging that, while operating under the bankruptcy filing, debt obligations will be a priority. At the same time, the county's decision to forego segregating funds for the repayment of the 1994-95 Tax and Revenue Anticipation Notes, as well as its decision to utilize the reserve fund to make payment on the Certificates of Participation, Series 1986, underscores the fact that the position of debtholders remains very tenuous. The ratings on the county's obligations were suspended on December 6, when the county and the investment pool filed for bankruptcy because of large investment losses by the pool.

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(2)

County Actions Regarding Debt Repayment

Moody's has been informed by officials of Orange County that today the Board of Supervisors authorized its bankruptcy counsel to seek permission from the Bankruptcy Court to withdraw sufficient funds from the county investment pool to make county interest payments coming due on January 3. However, such payments are subject to approval by the bankruptcy judge, and, according to county officials, it is not clear that such approval will be obtained in time to allow debt service payments to be made when due on January 3. It is not clear what are the legal repercussions, if any, should interest payments be late. These payments are for interest on: 1994-95 Tax and Revenue Anticipation Notes, Series B; 1994-95 Taxable TRAns; Taxable and Tax-Exempt Teeter Notes; General Obligation Improvement Bonds; and Sanitation District No. 12 Sewer Bonds.

County officials have also informed us that the county will not follow the provisions of the resolution for the \$169 million 1994-95 Tax and Revenue Anticipation Notes, which require segregation of funds for note repayment of \$34.7 million in December and \$18.7 million in January. While the county's failure to set aside these monies raises serious concerns, the note resolution requires that "any deficiency shall be satisfied and made up from any other moneys of the County lawfully available...". It is too early to tell whether the county will be able to make up these amounts to make full and timely payment at note maturity on July 19, 1995.

County officials have also informed us that the \$488,175 debt service payment due on January 3 for the Certificates of Participation, Series 1986, will be made from debt service reserve funds held separately by the trustee. After this payment, approximately \$3.65 million will remain in the reserve fund.

(3)

The county also has a monthly interest payment due on its Series B Pension Obligation Bonds. Although the county indicated that interest is scheduled to be paid from a fully funded escrow account held outside the pool, the county could not confirm whether the January 3 interest payment will be made.

Update On School Districts' Debt

Officials from the county and the county board of education have confirmed that full and timely payment will be made on five school district obligations. While the districts are not bankrupt, their funds were held by the county investment pool and have been largely frozen. The January 3 payments will be made from district revenues received after the pool's bankruptcy filing; these post-bankruptcy revenues had been segregated into a new pool.

Finally, we have been informed that for pool participants other than the county, funds for respective tax and revenue anticipation notes will be segregated in accordance with the respective resolutions from post-petition monies of the participants.

(4)

Debt Service Due January 3**Orange County**¹

Certificates of Participation, Series 1986
General Obligation Improvement Bonds
Pension Obligation Bonds Series B
1994-95 Taxable and Tax-Exempt Teeter Notes
1994-95 Taxable Tax and Revenue
 Anticipation Notes
1994-95 Tax and Revenue Anticipation
 Notes, Series B
Sanitation District No. 12 Sewer Bonds

School Districts²

Centralia School District
Irvine Unified School District
Placentia-Yorba Linda Unified School District,
 1994-95 Taxable Notes
Santa Ana Unified School District
Yorba Linda School District (now Placentia-
 Yorba Linda Unified School District)

¹ Interest payments.

² General obligation, unlimited tax bonds unless otherwise noted.

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Rating News

MOODY'S LOWERS THE RATINGS ON SHORT-TERM AND LONG-TERM OBLIGATIONS OF ORANGE COUNTY, CALIFORNIA

New York, New York -- January 6, 1995 -- Effective today, Moody's Investors Service reinstated and lowered the ratings on a number of the short-term and long-term obligations of Orange County, California. These ratings were suspended on December 6, 1994 pending clarification of the County's intention and ability to pay debt service under bankruptcy. While some of the county's recent actions show attentiveness to meeting its debt obligations, it is now clear that the county's ability to fully pay debt service on its long-term obligations is severely strained and, absent extraordinary intervention, there is no ability to pay notes maturing in June and July 1995. With little assurance of payment of interest and principal on the County's obligations for the foreseeable future, we are now reinstating and lowering the long-term ratings on the county's obligations listed below to Caa. The ratings on various short-term obligations listed below have been reinstated and lowered to SG (Speculative Grade) and **Not Prime**. The rating on the Pension Obligation Bonds, Series B, which was also suspended on December 6th, was reinstated and lowered on December 8th to Caa because of the investment pool's inability to honor the tender feature of the bonds.

(Continued)

The information herein has been obtained from sources believed to be accurate and reliable, but because of the possibility of human and mechanical error, its accuracy or completeness is not guaranteed. Moody's ratings are opinions, not recommendations to buy or sell, and their accuracy is not guaranteed. A rating should be weighed solely as one factor in an investment decision, and you should make your own study and evaluation of any issuer whose securities or debt obligations you consider buying or selling. Most issuers of corporate bonds, municipal bonds and notes, preferred stock, and commercial paper which are rated by Moody's Investors Service, Inc. have, prior to receiving the rating, agreed to pay a fee to Moody's for the appraisal and rating services. The fee ranges from \$1,000 to \$125,000.

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(2)

Uncertain Outlook For County Debt

Moody's analysts met recently with county officials and their advisors who provided new cash flow projections through June 30, 1995, indicating that receipts received after the bankruptcy filing would not be sufficient to pay the county's operations and debt service, even if significant budget cuts are achieved. The new cash flow projections make it clear that in the interim, debt service payments are very much in jeopardy. County officials have indicated to Moody's that decisions on future debt service payments will be made on a case-by-case basis.

Recent actions are indicative of the continued precarious position of debt holders. The county has now made provisions for bondholders to receive debt service payments which were due January 3, curing the default which had occurred due to the lack of timely payment. The county chose to pay debt service on the 1986 Certificates of Participation from its debt service reserve fund. It has also chosen not to make two segregation payments required for the 1994-95 Tax and Revenue Anticipation Notes. These actions are symptomatic of the severe cash flow problems the county is experiencing.

There appears to be support among some county representatives and in the Orange County business community to make the efforts necessary to avoid debt payment defaults. Some county officials have suggested that solutions to the county's cash flow problems can be found, possibly by restructuring debt, seeking agreements with bondholders to extend debt payments, or undertaking a new financing to consolidate county obligations. However, no specific proposals have been made, there are legal and political obstacles to such proposals, and in any case it will be difficult to create financial capacity to support any significant new debt obligation.

(3)

The county's financial situation is very precarious and the \$172 million shortfall between this year's projected revenues and expenditures is substantial. The county has lost close to \$160 million in budgeted interest earnings and the Board has voiced its opposition to seeking other revenue options. While the Board has approved \$40 million in spending cuts, substantial additional cuts will be difficult to achieve this late in the fiscal year. Moody's will continue to monitor the county's efforts to find solutions to its cash flow problems, balance operations, and endeavor to meet its short and long-term debt obligations.

Ratings remain suspended on two obligations: the Orange County Airport Revenue Bonds and the 1994-95 Pooled TRAns. The Orange County airport enterprise system has established a separate fund for revenues received after the bankruptcy filing to provide for operations and debt service. The status of the rating will be reviewed once we have assessed the impact on the airport's operations and capital program of the airport's losses on its funds invested in the county investment pool. The rating on the pooled TRAns issued on behalf of various school districts will be reviewed once we have clarified the legal status of the pool under bankruptcy. In addition, we will need to review updated cash flows of the participating school districts.

Below are listed the ratings affected by today's actions. We will follow up shortly with a more detailed description of each of the County's obligations and report on the status of their debt service payments.

(4)

Series	Rating		Amount
	Rating	Prior To Suspension	
Orange County General Obligation Bonds	Caa	Aa1	\$ 785
Orange County Taxable Pension Obligation Bonds, Series A	Caa	A1	209,840
Orange County-Orange County Public Facilities Corporation, Certificates of Participation Series '86, dtd. 7/1/86	Con. (Caa)	Con. (A1)	13,485
Orange County-Orange County Public Facilities Corporation, Certificates of Participation Series '88, dtd. 12/1/88	Caa	A	81,615
Orange County-California Financial Services (1990 Equipment Project) Certificates of Participation, dtd. 1/1/91	Con. (Caa)	Con. (A)	11,975
Orange County Civic Center Authority-Santa Ana Lease Rental 1972 Refunding	Caa	A1	785
Orange County Development Agency Santa Ana Heights Project Area Tax Allocation Bonds.	Caa	Baa1	57,435
Orange County TRANS 1994-95 Series A	[1]BG	MIG 1	169,000
Orange County TRANS 1994-95 Series B	[1]BG	MIG 1	31,000
Orange County 1994-95 Taxable Notes	Not Prime	P-1	600,000
Orange County 1994-95 Taxable (Teeter-Plan) Notes	Not Prime	F-1	111,000
Orange County 1994-95 Tax-Exempt (Teeter-Plan) Notes	[1]BG	MIG 1	64,000

[1]Speculative Grade.

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STATUS OF ORANGE COUNTY, CALIFORNIA DEBT

New York, New York - January 11, 1995 - On January 6, 1995, Moody's Investors Service reinstated and lowered the ratings on a number of the short-term and long-term obligations of Orange County, California. These ratings were suspended on December 6, 1994 pending clarification of the county's intention and ability to pay debt service under bankruptcy. The rating revisions reflect the county's reduced ability to meet debt service requirements. It is clear that absent extraordinary intervention, there is no ability to pay notes maturing in June and July 1995. The following is a brief summary of each of the county's obligations and our understanding of the status of their debt service payments.

Orange County Debt Issues	Moody's Rating	Description
General Obligation Bonds \$785,000	Caa (revised from Aa1)	General Obligation Improvement Bonds. Interest payment due January 1, paid January 5. Semiannual debt service payment due July 1, 1995.
Pension Obligation Series A (Taxable) \$209,840,000	Caa (revised from A1)	Default on Series B cross-defaults Series A under single resolution. Full year's debt service for 1994-95 set aside with trustee. Semiannual interest payment due March 1.

(Continued)

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Orange County Debt Issues	Moody's Rating	Description
Pension Obligation Series B (Taxable) \$110,000,000	Caa (revised from A1/VMIG 1)	Bonds in default due to inability of County to meet bond tender on December 8 because of pool bankruptcy. Full year's debt service for 1994-95 set aside with trustee. Interest payment due January 3 paid January 5.
Public Facilities Corporation Certificates of Participation dated 7/1/86 \$13,485,000	Con.(Caa) (revised from Con.(A1))	Debt service payment due January 3 made from reserve fund held by trustee. Approximately \$3.6 million remains in reserve fund. Next debt service payment of \$3.6 million is due July 1.
Public Facilities Corporation Certificates of Participation dated 12/1/88 \$81,615,000	Caa (revised from A)	Solid Waste Management System Certificates of Participation. Next interest payment due June 1, 1994. Approximately \$8.3 million in debt service reserve fund held by trustee.
California Financial Services (1990 Equipment Project) Certificates of Participation dated 1/1/91 \$11,975,000	Con.(Caa) (revised from Con.(A))	Certificates issued under Master Lease Program for equipment acquisition. \$1.3 million interest payment due March 1, 1995, required to be transferred to trustee February 10. Approximately \$1 million in debt service reserve fund held by trustee.
Redevelopment Agency Santa Ana Heights Project Area Tax Allocation Bonds \$57,435,000	Caa (revised from Baa1)	Tax increment revenues may be protected under bankruptcy; however, redevelopment agency debt is included in bankruptcy filing as a debt of the county. We are trying to clarify legal status.
1994-95 TRANS Series A \$169,000,000	Speculative Grade (revised from MIG 1)	Annual cash flow borrowing. Principal and interest due at note maturity on July 28, 1995. Monthly segregation of note principal began as scheduled in September 1994 but was invested in the pool. County did not meet segregation pledge for December and does not expect to segregate for January.

Orange County Debt Issues	Moody's Rating	Description
1994-95 TRANs Series B \$31,000,000	Speculative Grade (revised from MIG 1)	Variable rate portion of annual cash flow borrowing. Note matures August 10, 1995. Segregation pledge is for June only. Interest payments due first business day of each month. January 3 interest payment paid January 5.
1994-95 Taxable Notes \$600,000,000	Not Prime (revised from P-1)	Principal due July 10, 1995 payable from funds deposited upon closing, together with interest requirements, in County investment pool. Interest payments due first business day of each month. January 3 interest payment paid January 5.
1994-95 Teeter Plan Tax-Exempt Notes \$64,000,000	Speculative Grade (revised from MIG 1)	Payable first from delinquent tax receipts then from Standby Bond Purchase Agreement with County investment pool. Interest payments due first business day of each month. January 3 interest payment paid January 5.
1994-95 Teeter Plan Taxable Notes \$111,000,000	Not Prime (revised from P-1)	Payable first from delinquent tax receipts then from Standby Bond Purchase Agreement with County investment pool. Interest payments due first business day of each month. January 3 interest payment paid January 5.
Airport Revenue Bonds \$133,040,000	Suspended	Rating remains suspended until legal status and sufficiency of pledged revenues under bankruptcy are determined. Airport made semiannual debt service payment on January 3. Airport had made five of six monthly transfers to the trustee prior to bankruptcy filing. Paid sixth month from revenues received after the filing.
1994-95 Pooled TRANs \$299,660,000	Suspended	Rating remains suspended until legal status of pledged revenues under bankruptcy is determined. Security for TRANs is payments from school districts and Standby Note Purchase Agreement from county pool. Notes are due July 28, 1995.

Rating Definitions

Caa: Bonds which are rated Caa are of poor standing. Such issues may be in default or there may be present elements of danger with respect to principal or interest.

Con. (...): Bonds for which the security depends upon the completion of some act or the fulfillment of some condition are rated conditionally.

Speculative Grade: This designation denotes speculative quality. Debt instruments in this category lack margins of protection.

Not Prime: Issuers rated Not Prime do not fall within any of the Prime rating categories.

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**MOODY'S CONTINUES TO MONITOR ORANGE COUNTY,
CALIFORNIA DEBT SERVICE OBLIGATIONS;
DELAYED NOTE INTEREST PAYMENTS DUE
FEBRUARY 1 APPEAR PROBABLE**

New York, New York - January 31, 1995 - Orange County has the following debt service payments scheduled for February 1, 1995:

Series	Rating	Debt Service
TRAN's 1994-95 Series B	SG	[2]\$103,403
1994-95 Taxable Notes	Not Prime	[2]\$2,888,690
1994-95 Teeter Plan Tax-Exempt Notes	SG	[2]\$212,734
1994-95 Teeter Plan Taxable Notes	Not Prime	[2]\$534,408
Pension Obligation Bonds, Series B	Caa	[3]
Certificates of Participation dated 11/15/91	[1]Aaa	[4]2,654,030

[1] AMBAC insured.

[2] Monthly interest payment.

[3] Monthly interest payment. Amount due unavailable.

[4] Semi-annual debt service payment.

(Continued)

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The county has taken steps to pay February 1 debt service ; however, as was the case with January debt service payments, the county's actions are unlikely to result in payment on several of its obligations in a timely manner. The county has filed a petition with bankruptcy court to make interest payments on its Tax and Revenue Anticipation Notes, Taxable Notes, and Teeter Notes (taxable and tax-exempt). The petition is similar to one filed for January debt service payments. The court allowed debt service payments in January as requested; however, debt service due January 3 was paid on January 5. It is Moody's understanding that the bankruptcy judge is not scheduled to review this petition until February 1. Assuming the judge approves these debt service payments, it is still unlikely that noteholders will receive their payments on time. County officials have indicated that monthly interest payment on the Pension Obligation Bonds; Series B will be paid from funds already with the Trustee.

The county's inability to make timely payments is indicative of the ongoing precarious position of debt holders. The county filed the petition for payment of February 1 debt service on January 10, 1995. The county did not request emergency action on its petition, indicated to Moody's that absent such request it would take three weeks for the bankruptcy court to respond. In order to make the March 1 interest payments on the above note obligations, the county will need to petition the bankruptcy court by February 8. The county has not indicated to date whether or not it will file this petition and if it does, when such filing will take place.

Further, as was the case with the 1986 Certificates of Participation, the county intends to pay debt service on its 1991 Certificates of Participation from its debt service reserve fund. The county also continues to disregard segregation requirements for the 1994-95 Tax and Revenue Anticipation Notes. These actions are symptomatic of the severe cash flow problems the county is experiencing.

Moody's Investors Service continues to monitor Orange County, California's efforts toward resolving its financial crisis following the bankruptcy filings of the County and its investment pool. Moody's has previously lowered the ratings on the County's long-term debt to **Caa** and on its short-term debt to either **Not Prime** or **Speculative Grade (SG)**. Despite the fact that the county's ratings are now below investment grade, Moody's believes that the county is obligated to make all efforts to meet ongoing debt service requirements.

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Rating News

Credit Implications of Orange County, California Proposal to Allocate Assets of Bankrupt Investment Pool

New York, New York - February 15, 1995 - A voluntary settlement to allocate funds from the Orange County Investment Pool (OCIP) has been proposed by County business leaders and endorsed by the Orange County Board of Supervisors. The proposal represents a potential step forward in reducing the uncertainty surrounding the financial status of pool participants, and ultimately in clarifying the impact of the bankruptcy filing on holders of debt issued by the County and the pool participants. While the proposal does not guarantee any participant 100% of its investment, an early settlement would provide recovery of a sizable portion of each participant's funds far sooner than is likely to be the case if a litigation strategy is pursued. In this sense, the proposal is a positive step as it could give participants access to sizable amounts of their cash held in the OCIP as well as clarify the county's exposure and provide a starting point for developing the county's plan for meeting its obligations. From a rating perspective, the key question is whether this or any proposed settlement is sufficient to enable each participant to meet its debt obligations. The value of the non-cash elements of the settlement described more fully below, cannot be evaluated at this time.

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(2)

Moody's is currently reviewing the credit quality of the outstanding debt of the pool participants. Moody's will continue to review participants based on the situation as it currently stands, i.e. that they have access to no more than 30% of their funds for emergency purposes. For some participants, access to additional cash, as proposed, would be critical to their ability to meet upcoming debt service requirements, particularly for those which issued taxable notes. Some participants exhibit adequate cash flow to support debt service without access to funds invested in OCIP. However, even some participants which demonstrate an ability to meet debt service payments may ultimately experience credit rating downgrades if a final pool settlement results in less than full restoration of cash originally invested in the OCIP.

Outline of Settlement Proposal

The proposal would provide participants with 77% of their investments in cash; the remainder would be provided through a combination of long-term securities, or "recovery notes," to be issued by the County and through claims on future revenues, including proceeds of successful litigation. The plan offers a higher proportion of recovery notes, which the county considers to be equivalent to cash, to school districts than to non-school participants. The plan provides for an allocation of 77% of cash for all types of funds invested, so that distributions would be the same for operating funds, debt service funds, construction funds, and taxable note proceeds issued for arbitrage.

School districts would receive 13% of their investments in recovery notes, whereas non-school participants would receive only 3%. A joint powers agency would be formed to monetize the securities which would be structured with the intention that pool participants would be able to sell them immediately at par.

(3)

The proposal does not provide sufficient information for Moody's to render an opinion as to the credit quality of such notes nor likelihood that they could be converted easily to cash at par value. The security for these notes could also be converted at the County's option if a mechanism is implemented to intercept County revenues to repay debt. Participants will also have various claims on future revenues of the County to be derived from litigation. Moody's does not have an opinion on the merits, potential for success, or timing of any such litigation.

The proposal requires a minimum acceptance level of 80% of the pool participants holding at least 90% of the investments (both exclude the county). Non-school participants may choose a second option which would allow them to receive 77% of their original investment in cash, waive their rights to the recovery notes and other county revenues, and instead seek recovery of remaining monies through litigation against the County. The proposal may be modified or rejected. It is subject to final approval by the bankruptcy judge, a process which reportedly will require forty days.

Potential Impact of Settlement Proposal on Holders of Orange County Debt

The proposal, if accepted, is only one step in resolving the fiscal crisis faced by the County, although it would better define the County's exposure to the losses of the pool as well as its obligations to pool participants. The proposal does not address the obligation of the County to its bond and noteholders nor does it propose any means for the County to meet sizable debt service payments coming due within the next months. However, the proposal initiates

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an important process: that of addressing the allocation of investment losses and defining what the County's own losses and related obligations will be. As these issues are resolved, the County can move forward on a number of other important problems, including addressing its financial problems and identifying the means by which to repay long and short-term obligations. While the newly appointed Chief Executive Officer, William Popejoy, has been reported to be in support of avoiding defaults of the County's debt, the Supervisors of Orange County have not yet reversed their stated opposition to raising taxes if necessary to meet all of the County's obligations, including obligations to debt holders. With almost \$1 billion in note principal coming due between now and August, Moody's has significant concerns about the County's ability to meet its obligations to noteholders. The County has taken steps necessary to meet monthly interest payments on these notes; however, absent significant restructuring of its debt or identification of new revenues, the County is unlikely to be able to retire those notes at maturity.

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MOODY'S EVALUATES IMPACT OF FEDERAL BANKRUPTCY COURT RULING ON ORANGE COUNTY, CALIFORNIA TAX AND REVENUE ANTICIPATION NOTES

New York, New York - February 27, 1995 - On February 23, the Federal Bankruptcy Court in Santa Ana, California ruled that the requirement to segregate funds for repayment of Orange County's \$169 million Series A Tax and Revenue Anticipation Notes (TRANS), as covenanted in the Note Resolution, is not enforceable under bankruptcy. This ruling affirms the county's practice since it filed for bankruptcy on December 6, 1994, of not setting aside funds for note repayment and, as a result, the ruling does nothing to change the repayment prospects for the TRANS, due July 28, 1995. Moody's remains concerned about the county's ability to implement a solution to avoid default, given the short timeframe and magnitude of the notes coming due. The TRANS are currently rated SG.

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The court's ruling addresses a commonly used credit feature of California TRANS, that of setting aside funds for repayment ahead of note maturity. Notwithstanding the court ruling, Moody's believes the requirement to segregate note repayment funds for California TRANS has been and will continue to be a positive credit feature for other California TRAN issuers, as it imposes a basic cash management discipline on the issuer. The court's ruling could have the greatest impact on those financially stressed issuers where segregation may otherwise serve to enhance credit quality, but where concerns about bankruptcy may now diminish the analytical value of segregation.

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MOODY'S CONTINUES TO MONITOR ORANGE COUNTY, CALIFORNIA DEBT SERVICE OBLIGATIONS

Bankruptcy Court Releases Funds in Time for March 1 Payments

New York, New York - March 1, 1995 - The Federal Bankruptcy Court, upon petition by Orange County, has granted a motion authorizing payments on obligations due March 1. The order was entered February 27. Unlike the January and February debt service payments, the county has acted in a sufficiently timely manner to allow payment of debt service to bondholders on the due date; in the two prior months, filing beyond the deadline for timely consideration by the bankruptcy judge delayed payment until shortly after the due date.

Orange County has the following debt service payments scheduled for March 1, 1995:

Series	Rating	Debt Service (\$000)
TRANS, 1994-95 Series B	SG	\$101
1994-95 Taxable Notes	Not Prime	\$2,830
1994-95 Teeter Plan Tax-Exempt Notes	SG	\$ 208
1994-95 Teeter Plan Taxable Notes	Not Prime	\$ 523
Public Facility Corp. COPs Series 1993 A (Master Lease Program), dated 2/1/93	Aaa[1]	\$ 600
Pension Obligation (Taxable), Series A	Caa	\$8,207
Pension Obligation (Taxable), Series B	Caa	\$ 428

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Series	Rating	Debt Service (\$000)
California Financial Services (1990 Equipment Project) COPs dated 1/1/91	Con. (Caa)	\$419
Orange Co. Development Agency--Santa Ana Heights Project Tax Allocation Bonds	Caa	\$ 1,705
Orange Co. Development Agency--Financing Authority Tax Allocation Revenue (NDAPP), Series A	Aaa[2]	\$ 864
Orange Co. Development Agency--Financing Authority Tax Allocation Revenue (NDAPP), Series B	Aaa[2]	\$ 85
Master Lease Schedule 1, dated 9/1/88	NR	\$965

[1] FSA Insured.

[2] MBIA Insured.

According to county officials, payment on obligations that have other available funds, such as reserve funds or excess interest earnings, will be paid from the other funds rather than from current revenues. Thus, payments on the various COPs will be made from funds on hand with the trustees. In addition, the county reports that it will make payment on three assessment district and ten Mello-Roos district bonds from assessment and special tax revenues collected since the bankruptcy as well as from some funds on hand with the trustees.

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ORANGE COUNTY, CALIFORNIA EVALUATES ASSET SALES AND PRIVATIZATION OPTIONS TO HELP WITH FINANCIAL RECOVERY

Proposal Would Provide Only Very Limited Contributions To Recovery

New York, New York -- March 10, 1995 -- On March 9, 1995, Orange County, California Chief Executive Officer William Popejoy announced several options for privatizing services and selling county assets to help the county in its financial recovery. The county filed for bankruptcy on December 6, 1994, because of \$1.7 billion in losses in its investment pool. Moody's believes that investors should not rely on these efforts being completed in time to help pay the \$1.0 billion in debt service due by August 10. Further, as the CEO indicated, these options would provide only limited financial resources in the long-term relative to the size of the county's problems; some proposals would require legislative changes or would incur offsetting expenses.

Continued

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Among the sales proposed by Popejoy were 12 assets which could generate between \$28 and \$33 million within one to 12 months. Only two of the assets were considered likely to be sold within one to three months; the remainder would take from three to 12, assuming buyers could be found. The CEO also discussed sale leasebacks, including the county administrative building, which could contribute from \$60 to \$71 million in one-time revenues. However, these transactions would also create new annual lease expenses of almost \$16 million which, given the current distressed budget, would be very difficult to support.

While selling the John Wayne Airport and the county's three landfills were also discussed, these are not attractive options, particularly in the short-term. Sales of these assets would require addressing significant legal hurdles as well as repaying \$253 million and \$82 million in debt respectively. Popejoy suggested that the county would be better served by reserving these assets to provide collateral for other potential unspecified transactions.

Popejoy also made clear that privatization of county services would not realize significant savings, in part because of the county's existing efforts as well as the statutory impediments to privatizing certain functions. He listed ten proposals, the most significant would contract out for management of the county's investment pool. Estimates of annual cost savings are less than \$1 million; many options did not yet have estimates for savings.

The CEO's presentation to the Board of Supervisors is part of an ongoing, bi-weekly set of presentations to explore various solutions to the county's financial problems. A prior session outlined the \$187 million in budget cuts and over 1,000 layoffs which will be needed to balance the 1995-96 budget. These sessions are an effort on behalf of the new CEO to inform the Board and the public of the depth and different dimensions of the county's bankruptcy, with the intent of forming a public consensus and support for the solutions. However, as we have stated frequently, Moody's remains very concerned about the county's ability to avoid defaults on its short-term obligations coming due in June, July, and August, given the very short timeframe and the many financial, logistical, and legal obstacles still to be overcome.

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MOODY'S EVALUATES RECENT ANNOUNCEMENTS BY ORANGE COUNTY, CALIFORNIA

County's Willingness and Ability to Avoid Default Still in Question

New York, New York - March 20, 1995 - Recent actions and announcements by Orange County have contributed to confusion about the county's intention in honoring its debt commitments and otherwise resolving its current financial crisis. The proposed one year deferral of repayments on short-term general obligation indebtedness is particularly troubling, as are statements that the county may seek to invalidate a portion of that indebtedness. Like the county's earlier decision not to segregate tax receipts originally pledged for payment of outstanding tax and revenue anticipation notes (TRANS), the deferral proposal heightens concern about the county's true intentions and ability to avoid default.

The county has a prime opportunity to clarify its intentions to honor its debt obligations with the recent announcement of a sales tax increase that may be put to the voters. Following extensive study of alternatives, the county's Chief Executive and the county's professional advisors are recommending the one half sales tax as an essential piece of a recovery plan. The county supervisors need to strongly support placing the tax on the ballot and then, with other county leaders, urge its passage by the voters in June. The county must move strongly and clearly in this direction and make the difficult decisions which can help avoid default. County leaders need to make much more explicit that the county's proposed debt deferral does not represent an alternative strategy, but is an attempt to identify contingencies in the event that the many pieces of a workout plan may not be finalized in the short time frame remaining.

Continued

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The following comment discusses Moody's reaction to these two recent proposals by Orange County. In addition, Moody's has outlined the complexities of potential solutions to the county's eventual recovery.

Sales Tax Proposal

The announcement that on March 28 the County Board of Supervisors will consider placing a one half cent sales tax before the voters is an opportunity for the county to finally demonstrate its commitment to solving its financial problems. Although voter approval is far from assured, strong approval and unambiguous endorsement by the Board for the tax increase would send a clear and positive sign that the county is ready to move forward to resolve its problems. This may enable other elements of the workout plan to coalesce more quickly and help the county win support and cooperation from key parties, including creditors and the state.

The Board's rejection, deferral of action, or a decision to put the issue before the voters but without any leadership endorsement of the tax increase, would be an indication that there is not yet a willingness among county supervisors to acknowledge the depth of the county's problems nor a commitment to avoiding default.

While a number of potential actions, including budget cuts, a revenue intercept, leveraging county assets, and seeking state guarantees, have been proposed, the resolve and leadership necessary to craft these elements into a workable, comprehensive solution has yet to be demonstrated. Because time is short and the details of any proposal will be legally and financially complex, it is quite possible that these proposals will not move forward quickly enough to avoid default on the over \$1 billion in debt coming due this summer.

County Debt Extension

On March 16, the county proposed a mechanism for a one-year renewal of its short-term bonded indebtedness. The county expects to seek bankruptcy court approval of a stipulation approving the renewal proposal and hopes to achieve consensus among bondholders. However, the proposal does not make clear the county's intent. If the proposed mechanism represents a forced extension, with holders given only the alternative of nonpayment, then this proposal should be viewed as equivalent to default. If, however, in the face of a credible workout plan,

noteholders are asked to voluntarily extend their debt and are adequately compensated in order to provide sufficient time for the plan to be implemented, then setting up a mechanism for voluntary extension may be a realistic contingency plan. Proposal of such a mechanism recognizes that one of the cornerstones of the county's potential recovery, the one half cent sales tax, must first gain approval from the Board of Supervisors and then the electorate. Even if approved by the Board, gaining voter approval is highly uncertain and the final outcome will not be known before June 27, when the earliest election can be held. A voluntary extension, accompanied by a plan to provide cash payment to those noteholders who choose not to extend, may be a realistic contingency that noteholders find preferable to a payment default.

Two particularly disturbing elements of the county's debt extension proposal are the county's plans to reserve the right to challenge the validity and enforceability of the \$600 million taxable notes and to challenge the allocation of available repayment reserves among the various note accounts invested in the pool. These two provisions constitute a strategy for a future assault on the taxable notes, as they would allow the county to invalidate the taxable notes and invade the \$481 million now set aside for their repayment to divert for other uses. These provisions, if pursued, would totally undermine any hopes the county may entertain to regain credibility in the financial community, even if the invaded funds were used to entirely repay other bondholders. Moody's strongly believes that there should be no distinction made among the different classes of general obligation debt and believes the county must continue to make all efforts to provide full payment for all its obligations.

County Workout Options are Complicated and Multi-faceted

The remainder of our report outlines our understanding of the status of the three major components to a county recovery and workout plan. The first, allocating pool losses among participants, appears near final solution. Now the county must develop a credible plan to restructure its debt and then develop a means to resolve its short and long-term financial problems.

Pool Settlement Would Be Important First Step

The settlement of pool losses under consideration provides all pool participants with approximately 77% of their investment in the pool in cash. The county would give participants "recovery notes" to provide school districts an additional 13% of their investments, and other participants an additional 3%. The county would make up the balance with a combination of debt and claims on future revenues.

The recovery notes, totaling \$255 million, would have a senior claim on county debt service. It is our understanding that to make the settlement proposal more attractive, the county is working to assure that the recovery notes would be truly marketable securities at full par value. This may require structuring the notes with a sufficiently strong legal pledge and source of revenues that would not only hold up during bankruptcy, but also survive bankruptcy. Another element may be to seek a guarantee from third parties or identify one or more key purchasers of the notes.

On March 17, the Pool Creditors Committee announced that they have agreed in concept to the settlement. Final details are being worked on, and formal agreement will require approval by 80% of the participants representing 90% of the funds (excluding the county) to approve the plan. It is our understanding that it will then take the bankruptcy judge 30 to 45 days to review and approve or deny the plan.

If the settlement is finalized and approved by the federal bankruptcy court, the county will then know the extent of its liabilities, available cash, and thus the magnitude of its problem in repaying debt obligations and restoring funds lost in the pool.

County Cannot Repay Debt Without Significant Restructuring of Obligations

If the allocation of investment pool losses is settled as proposed, then the county will have access to its cash but will still face a substantial shortfall in resources to repay its short and long-term debt. To provide full and timely payment, the county will need to refinance and restructure its debt. As discussed earlier, the county may resort to a negotiated deferral of debt service until a workout plan can be finalized.

Key to a debt restructuring will be the identification of credible revenue sources for repayment of debt. In addition, the pledged security will need to be valid in bankruptcy as well as under California statute. Two major revenue options that have been discussed are a one half cent sales tax which would free up a like amount of revenue for debt and claims repayment, and leveraging the county's solid waste system. If adequate and reliable new revenues are enacted, a mechanism for protecting and isolating the revenue stream may be helpful. A state intercept of pledged revenues for debt service is being considered by the California legislature.

Additionally the bankruptcy court has very strong powers to approve financings and dedicate revenue sources to debt repayment. It remains to be seen what approaches the county will use and whether or not it will take advantage of debtor in possession financing mechanisms to refinance its considerable obligations. Because municipal financings under bankruptcy are virtually unknown, there is little precedent for how the county should properly structure its future obligations. However, to the extent that a workout plan envisions use of unprecedented revenue sources for unprecedented purposes, transactions may benefit from seeking judicial validation as well as approval by the bankruptcy court. Depending on the details of the particular proposals, validation may be a requirement of a rating review.

New Revenue Sources Necessary to Maintain Basic Government Functions

The final piece of the restructuring package involves reestablishing county government as a viable entity. Although there will be significant downsizing, the county needs to be able to define and go forward with essential government functions. The county's General Fund has been decimated by the loss of interest income and the county is proposing severe cuts in its 1995-96 budget. Using general revenues to secure new debt will further reduce resources available to the General Fund. The restructuring package must address both the 1994-95 deficit, as well as the structural budget gap carried into future years.

The new county executive, William Popejoy, has publicly stated that raising the sales tax is the only means of completing a package to restructure county government and meet all obligations to bondholders and pool participants. A half cent increase in the sales tax is projected to generate approximately \$134 million annually. It is difficult to envision a successful financial recovery without passage of the sales tax, as there would not be sufficient general fund revenues for the county to support the additional debt and maintain any semblance of governmental functions.

County Has Limited Time to Implement Workout Solution

The three elements of the county's restructuring plan are each essential and need to move forward together. Neither the county nor the pool participants can reasonably expect to budget for fiscal 1995-96 without settling the allocation of pool losses. While it will be virtually impossible for the county to make full and timely payment on its debt as currently structured, it is still possible to put into place a workout solution to ultimately satisfy its obligations in full. However, using general revenues to support new debt without successfully replacing revenues taken from the General Fund would require the dismantling of most general government functions.

If a vote on the sales tax is not successful, the probable scenario is that the county will default on its debt obligations. While the county appears to have the potential to generate the resources required to solve its problems, it remains to be seen if there is the political will to take painful, necessary steps to solve its problems in a timely manner.

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ORANGE COUNTY, CALIFORNIA PROPOSES RECOVERY PLAN

Major Obstacles Could Hinder Its Implementation

New York, New York - March 31, 1995 - Four months after its December 7th bankruptcy filing, Orange County has made public a plan for financial recovery. The plan results from the efforts of the county's legal and financial advisors with the backing of the new Chief Executive Officer. County supervisors have not yet endorsed the plan and although they voted to seek voter approval of a half cent sales tax, at least two of the Supervisors have expressed personal reservations against this central element of the overall financial recovery plan. The plan, if implemented, would allow the county to reach several goals:

- make pool participants whole in the long-run;
- pay off bond and note holders so that the county retains access to capital markets; and
- continue to provide county residents with a level of service consistent with maintaining public health and safety.

Continued

While the plan's goals are laudable and its components together provide the economic capacity to move the county out of its current fiscal problems, successful implementation is far from assured. As proposed it would not achieve the critical objective of default avoidance. The purpose of this comment is to review the elements of the plan and identify potential obstacles to its implementation.

Their Best Case Scenario Does Not Assure Default Avoidance

Even if all of the elements of the announced recovery plan are put into place as expeditiously as possible, it appears impossible for the county to make full and timely debt service payments this summer. The county would additionally need to negotiate a debt deferral with noteholders or obtain some sort of bridge financing to avoid default. A debt deferral, achieved through voluntary extension or renewal negotiated through a consensual process with existing noteholders, could represent a necessary and acceptable element of the recovery. Any such negotiations could last almost to the notes' maturity dates, as noteholders will likely want to know the outcome of the sales tax vote prior to agreeing to any debt deferral. A forced extension would be viewed by Moody's as equivalent to a payment default, and as such, is not an acceptable alternative. The Teeter notes may have the best potential to avoid default as they could be refinanced separately on a self-sustaining basis.

A review of each of the plan's elements illustrates how difficult this process will continue to be over the coming months.

The Problem

The county has identified a deficit of almost \$2 billion. This deficit includes the loss of funds invested in the pool by the county and the pool participants as well as the county's budget shortfall due to the loss of interest income in 1994-95. Because of the deficit, the county will be unable to repay \$1 billion in short-term debt coming due this summer. The recovery plan attempts to eliminate this deficit through a combination of debt restructuring and fee increases. The county has also made extensive budget cuts to balance its budget going forward.

The county is also considering asset sales and privatization as two additional means of raising revenues and reducing expenditures; however, neither of these options are viable in the short-term. While such alternatives may provide meaningful relief over the long-term, they will take a long time to implement and their financial potential is currently undetermined.

Another alternative under consideration by the Supervisors is to redirect the Measure M sales tax that finances transportation programs. The Measure M sales tax is pledged to bonds of the Orange County Transportation Authority (OCTA), a legally distinct entity from the county. Redirecting these revenues would violate that authority's bond indentures and may require 2/3 voter approval, OCTA Board approval, as well as that of the participating cities. Any actions taken to divert Measure M funds must occur in conjunction with the defeasance of outstanding debt or must be accomplished in such a way as to protect existing bondholders. Otherwise, this would have severe negative consequences on the OCTA credit rating; proposals to borrow funds from OCTA would similarly negatively affect the Authority's credit quality.

While it is a worthwhile exercise for the county to pursue other options and sources of revenue, there is a risk that these efforts may distract from the urgency of passing a sales tax and implementing the other elements of the proposed recovery plan.

The Restructuring Plan

The critical components of the recovery plan are four new debt issues, an increase in solid waste tipping fees, an increase in the sales tax, and significant General Fund budget restructuring.

- Recovery Notes - \$234 million of bonds which will provide pool participants with a greater percentage of their investments in the pool. If settlement accord is reached, the participants will receive between 75% and 86% of their investments in cash. Recovery notes will be used to make school districts 90% whole and non-school participants 80% whole.
- Teeter Notes - \$150 million of notes to restructure the existing Teeter program. The Teeter plan is an alternative property tax distribution methodology that provides taxing entities within the county with 100% of taxes due in exchange for relinquishing penalties and interest on delinquent taxes. The Teeter program would be restructured as a self-sustaining revolving fund operated by a Joint Powers Agency separate from the county.

- **Motor Vehicle License Fees** - \$750 million of bonds. This is a key element in repaying the county's deficit; however, as the MVLF currently is a major revenue source for the General Fund, its diversion to support debt would require identification of a replacement revenue so that General Fund operations can continue. The proposed sales tax increase is designed to replace the loss of MVLF to the General Fund.
- **Waste Management System** - \$500 million of revenue bonds to refund outstanding solid waste bonds as well as to fund the deficit. Leveraging the system to this degree requires both rate increases and importation of out-of-county garbage to Orange County landfills.
- **1995-96 General Fund Budget** - Proposed budget represents a 41% reduction in discretionary spending, from \$463 million in 1994-95 to \$275 million in 1995-96. Annualized reductions of approximately \$70 million have been made in the current fiscal year. The balance is to come from significant program and personnel reductions.

Pool Participants Are Not Enthusiastic About Proposed Settlement

The county has made some progress in reaching agreement with pool participants over allocation of the remaining assets in the pool. The creditors committee representing the participants has agreed to the proposal; however, the settlement must still be voted on by the pool members and is subject to bankruptcy court approval. Of some concern is the sentiment that the proposal has been forced on the participants; that is, if they do not agree to this particular settlement which includes surrendering certain legal rights, they will not even receive their pro-rata portion of the remaining pool assets in a timely manner.

The recovery notes are a critical element of the pool settlement. The county has indicated to pool participants that they will be able to convert these notes to cash. If the county cannot provide a means of converting them to cash by June 5, the participants have the option to accept their pro-rata portion of the pool's remaining assets while pursuing litigation for the balance, or to walk away from the agreement altogether. The latter would result in a long, complicated litigation which would delay indefinitely the county's emergence from Chapter 9 as well as potentially pushing some of the pool participants into insolvency themselves.

There are many obstacles to monetizing the recovery notes. These notes will not have a specific revenue stream pledged to them; rather, they will have a "super priority lien" on the county's General Fund. Although intended to be strong security derived from the powers of the bankruptcy court, this is an untested notion in the municipal market and it remains to be seen what level of security a bondholder could take from this pledge. Further, the super priority lien subordinates debt service on the notes to General Fund operations which will be severely stressed in the coming years.

Without Sales Tax, County is Limited in Ability to Implement Other Recovery Elements

The proposed half cent increase in the sales tax will allow the county to maintain governmental operations while diverting an existing General Fund revenue source to debt service on bonds. Without this increase, it is unlikely that the county will be able to proceed with a critical element of its recovery plan, the issuance of bonds backed by Motor Vehicle License Fees. The proposed 1995-96 budget already represents draconian reductions in service to county residents. It is unlikely that General Fund operations could even continue if Motor Vehicle License Fees, which provide approximately \$100 million of the remaining \$275 million budget, are diverted without a replacement revenue source.

On March 28, the County Board of Supervisors voted unanimously, but with strongly expressed reservations, to seek voter authorization of a sales tax increase. The tax measure, Measure R, will be placed before voters at a special election to be held June 27. If passed, the tax would not be collected until January 1, 1996. Voter approval of Measure R is far from assured. Based on the experiences of other entities in the state that have voted increases in the sales tax, advisors to the county believe that the increase will likely be subject to legal challenge, a process which could delay its implementation.

Passage of the sales tax in June would be important verification that county leaders and residents are serious about meeting their obligations to bondholders and resolving this fiscal crisis.

Credit Strength of Motor Vehicle License Fee Backed Bonds Depends on Passage of Legislation

If the sales tax passes and is found to be valid, the county will have the capacity to divert its existing stream of Motor Vehicle License Fees to support up to \$750 million in bonds. The recovery plan includes two changes in state law designed to enhance security to bondholders. The first strengthens the existing state intercept program to provide money directly to the trustee or paying agent on the debt. The second attempts to provide greater protection against future bankruptcy by providing a statutory lien on pledged revenues.

The legislative package does not appear to be progressing very quickly through the legislature. The final version of the intercept must still be enacted and it is too early to evaluate whether it will work properly from legal and administrative viewpoints. Even if the legislation is passed in a timely manner, it does not guarantee a level of security sufficient to provide an investment grade rating on the bonds to be issued.

Leveraging of Solid Waste System

The other significant source of funding for the recovery plan involves fully leveraging the integrated waste management system. In order to achieve the financing goals, the county would have to both raise tipping fees and increase the amount of garbage sent to its landfills by importing garbage from outside of Orange County. Since this cannot be relied upon in the near term, the county's financing plans should not anticipate receiving increased revenues from imported garbage. The county would also have to refund outstanding debt of the enterprise system.

The county asserts that raising tipping fees would be financially feasible because the current \$23 per ton rate is low for southern California and the surrounding counties also prohibit importation of garbage to their landfills. Raising the fee only requires a majority vote by county supervisors. There already appears to be some resistance by cities in the county to raising these fees since refuse collection is often subsidized by city General Funds. Early action on this fee increase would be an appropriate step since it is one source of additional financing that is completely within the county's control.

Importing garbage from outside the county would require the rescinding of an existing ordinance that prohibits such importation. It would also require environmental approval that could take an indefinite amount of time.

Teeter Plan Revisions Require Legislative Changes

The refinancing of outstanding Teeter Notes could proceed without implementing the rest of the recovery plan. This would allow full payment of \$175 million of outstanding notes, generate approximately \$10 million annually for the county's General Fund, and release reserves of approximately \$60 million. The proposed legislative changes in the program appear to be reasonable and could be utilized by other counties in the state. The primary obstacle to the Teeter revisions is the danger that the legislative changes do not move forward in a timely manner.

The county must focus on getting its legislative "tool box" through the state legislature in order to achieve this and other elements of its recovery plan.

Conclusion

Given the numerous obstacles to the successful implementation of this plan, the outlook for the county's noteholders is not good. The county can make good faith efforts to achieve its goals; however, it must also design contingencies to accommodate timing problems, and develop alternatives in case key elements of the program are not successful. To date, the county has not suggested alternative courses of action to be used if this recovery plan is either not fully implemented or is not implemented in time to avoid default.

The financial markets and State officials have called for the county to take appropriate action to resolve its own financial problems. However, a breakdown in the recovery process has implications that go beyond the county and its own noteholders. The State of California may have to reconsider its role and take a more active and direct role to prevent sizable defaults and potential disruption of the municipal market in California.

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OBSTACLES ENDANGER ORANGE COUNTY, CALIFORNIA RECOVERY PLAN

Less Than Full Payment Should Not Be An Option

New York, New York - April 28, 1995 - Moody's has expressed concern that Orange County, California will not be able to take remedial actions sufficient to make full and timely payment on its General Obligation debt. This concern speaks first to the difficulties posed by the magnitude of its investment losses and its high level of short-term indebtedness, and second to the considerable legal constraints specific to California that must be overcome in crafting an appropriate solution. While the difficult nature of the circumstances and the reality of the governing constraints necessitate a deliberate and complex restructuring, it is nevertheless totally unacceptable to have any objective other than full and timely payment of all debt obligations.

The county is publicly pursuing a plan to reach an economically sufficient solution; however, its implementation of the components of this plan seems to be less aggressive than otherwise required for timely execution.

Continued

The county also appears to be positioning itself for an alternative plan, one that is based on less than full repayment of debt obligations. The failure to endorse the sales tax, delay on other required measures, and settling with pool participants for less than full payment, seem to represent a potential strategy to gain leverage on noteholders to accept less than a full settlement. While this strategy may allow the county to operate under bankruptcy and eventually emerge from bankruptcy, such blatant disregard for the sanctity of general obligation debt repayment would irreparably damage the county's creditworthiness. Until such time as the county makes provisions to fully repay its outstanding debt, it will not be able to access the credit market relying on its own credit worthiness. Any borrowing to provide new resources or to help the county out of its fiscal crisis must be financially and legally insulated.

Full Restructuring Complex, Outcome Uncertain

Orange County's outside advisors, investment bankers, and lawyers have put forward a proposal to resolve the County's bankruptcy. This proposal attempts to reach three goals: providing participants in the county investment pool with 100% of their investment over time; repaying county debt holders; and maintaining basic levels of government service for county residents.

County supervisors, county residents, and the California legislature must take several steps in order for the recovery plan to be fully implemented.

- The investment pool settlement, which has been agreed to by the county and the participants, is subject to bankruptcy court approval and potential challenges by other county creditors.
- The county must find a means of monetizing so-called recovery notes which will be given to investment pool participants to increase their recovery of lost invested funds.

- The county supervisors must increase solid waste fees and complete a financial feasibility study of the system. They also must rescind an ordinance against importation of out-of-county garbage. Importing garbage will also require a lengthy feasibility study and environmental approvals.
- The voters must approve a half cent increase in the sales tax.
- County supervisors must actively pursue a legislative agenda and gain state legislative support for changes in the Teeter Program and the motor vehicle intercept mechanism.
- The county must devise a debt repayment plan.

If the county is able to implement all of these elements in a timely manner, it will have devised a recovery plan that offers an economically sufficient solution. Although it remains unlikely that the County will be able to make full and timely debt payments this summer, the ability to obtain a voluntary debt payment deferral from noteholders or to obtain some sort of take-out bridge financing to avoid default would be greatly enhanced by implementation of the rest of the recovery plan. Some of the key elements of the plan are within the control of the county supervisors.

To date they have taken some important steps, including placing the sales tax vote on the ballot and approving the 1995-96 budget. However, additional actions are necessary to demonstrate their commitment to resolving their fiscal crisis and meeting their obligations to noteholders. The county's inability or perhaps unwillingness to make substantial progress on the elements of the plan raises a number of concerns.

Solid Waste Financing Slows

The lack of progress to date on the solid waste component of the plan typifies the county's greater emphasis on political considerations rather than on a timely and financially feasible solution to its problems. The county has proposed an

increase in fees and the importation of garbage at its landfills. The resulting net revenues are expected to support net bond proceeds of about \$360 million which would be used to repay noteholders. The county's approval to study the importation of garbage and to raise the landfill gate fees has been postponed several times.

These delays result, in part, from the county's efforts to ease the political ramifications of the fee increases and imported garbage. However, the county has been discussing a solid waste financing as part of its recovery plan for several months, which should have included the early stages of developing host city support. Consultant reports support the fee increases. Positive action on the fee increase now would represent a good faith effort from the county to make the plan work as well as provide the system with the resources for its infrastructure before it is leveraged in the county's recovery plan.

Sales Tax Vote Does Not Have Strong Board Support

Passage of a half cent increase in the sales tax has been presented as the linchpin of the recovery plan. Without the increased revenues to support the General Fund, the county cannot divert Motor Vehicle License Fees from the General Fund to secure new bonds that would be used to refinance the county's debt and obligations to pool participants. The sales tax increase is subject to voter approval as well as potential legal challenge. Some members of the Board of Supervisors remain frozen in their unwillingness to actively support the measure. The Board of Supervisors' posture to "let the voters decide" is hardly a demonstration of a determined willingness to pay.

The vote is not scheduled to take place until June 27, leaving virtually no time to implement alternative plans to avoid default if the vote is unsuccessful. The county has very few options if the sales tax increase is defeated. It is not at all certain that the state of California would step in at that point to protect

noteholders. In fact, there are not many avenues for the state to interfere in such a way as to prevent default. The county appears to have designed a recovery plan that, absent passage of the sales tax, has as its only option giving creditors less than full payment.

Pool Settlement Sets the Stage for Partial Payment

The county's pool settlement proposal gets some funds to participants quickly and requires the county to make up investment losses over time, but participants must give up legal claims against the county in order to accept the settlement. If participants do not relinquish some or all of their claims, depending on which option they choose, and agree to the settlement, they will have to pursue a lengthy and expensive litigation strategy in order to receive even a pro-rata share of the remaining pool assets. A sufficient number of pool participants approved the proposed settlement and the bankruptcy court has scheduled a hearing on the settlement for May 2. For those selecting Option A, the settlement promises up to \$0.14 per \$1.00 invested in the pool in Recovery Notes. The Recovery Notes, as detailed in the settlement agreement, have a "superpriority lien" over the administrative costs of the bankruptcy. However, they cannot interfere with the county's ability to provide for the health, safety and welfare of its citizens in an already tight 1995-96 budget. The County agrees to provide the credit support for the automatic liquidation of those Notes by June 5. The county's failure to monetize the notes returns the parties to a litigious posture.

Alternate Strategy Could Take County in Wrong Direction

The pool settlement, with less than full payment and the extraction of concessions from participants, may represent an ominous precedent for debtholders. At the same time that the county claims to be attempting to repay all of its creditors, it is also identifying as legitimate strategies the invalidation or elimination of noteholder rights. This includes either invalidating the claim that Taxable TRAN holders have on proceeds of those notes invested in the pool, or even contesting the validity of the Taxable TRAN issuance itself. These notes were issued with a valid note counsel opinion and should be paid according to their terms. The county has also suggested that without the County's acquiescence, holders of tax-exempt TRANs may have no valid claim beyond fiscal 1994-95 revenues. Surfacing the potential for diminished or invalidated claims may be an attempt to provide the county with leverage in a negotiation for acceptance of less than full repayment in the event that an economic solution is not at hand.

Conclusion

Orange County is obligated, as are all municipal issuers, to devise a plan to avoid defaulting on its obligations to bondholders. With political will, this county has the means to support such a plan. After five months in bankruptcy, the county is pursuing two divergent paths with no clear statement of its intentions. On the one hand, it has developed various mechanisms to attempt to raise money to pay off its short-term debt obligations. On the other hand, the county has been unnecessarily late making debt service payments, has used reserve funds to make payments on some debt, and has negated its pledge to set aside funds for note repayment. These three negative actions are more consistent with corporate bankruptcy practices than with a local government approach to public debt. A corporate approach should be viewed with extreme caution since one common result of a corporate restructuring -- liquidation of the bankrupt entity -- is clearly inconsistent with traditional public policy goals. The county's objective should be to rehabilitate itself and continue to function as a municipal government. Payment default or any attempt to repudiate debt is clearly at odds with that approach.

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ORANGE COUNTY, CALIFORNIA: CONSEQUENCE OF DEFAULT ON EVALUATING CALIFORNIA DEBT

New York, New York - May 17, 1995 - *On May 16, 1995, the California Senate Special Committee on Local Government Investments held a special hearing on the Orange County, California bankruptcy. Daniel N. Heimowitz, Executive Vice President and Director of Public Finance, presented testimony on the consequence of a default by the county and how it would affect Moody's evaluation of California debt. The following testimony was delivered.*

Senator Craven, Senator Killea, members of the committee, good afternoon.

At the outset, I would like to thank the committee for inviting me to speak with you today. As you may hear from me and others the nature of repercussions from the Orange County situation are at this juncture a matter of speculation and deduction, but I commend the committee for contemplating the future rather than waiting to dissect the past.

Continued

It is difficult to predict the market impact of default. Municipal bonds are, after the federal government's own securities, the most default-free of publicly offered debt. The low cost and relative ease of market access for issuers and issues large and small, reflects that strong track record. Most municipal defaults have stemmed from some kind of project failure. Defaults on debt paid out of general municipal resources are extremely rare. Therefore, prior events offer limited precedent.

My firm, Moody's Investors Service, is a rating agency engaged in evaluating creditworthiness — that is the likelihood of debt repayment on time and in full in accordance with legal promises made to debtholders. I will largely confine my remarks to concerns relating to creditworthiness, and not about debt marketability, although market access, particularly for issuers reliant on short-term financings, is an important aspect of a creditworthiness assessment.

I will also qualify my statement by noting that the concerns I will discuss are broad generalizations while credit ratings are arrived at by thorough examination of the unique circumstances presented by each borrower for each of its separately secured debt issues.

Orange County's bankruptcy has already redefined credit assessment and the view of local government finance to a substantial degree.

Issuer investment practices in California and elsewhere are being subjected to closer scrutiny and issuers are being asked to provide much more information than they had previously. That a local government's investment portfolio could amass such losses as those incurred by Orange County speaks both to the volatility of its investments and investment strategy and to the inadequacy of monitoring and reporting mechanisms. The information that was presented regarding investments has proven insufficient. Future credit reviews will have a

higher disclosure standard in this regard and issuers who choose to seek higher investment returns through riskier investment practices may do so at the consequence of lower ratings on their own debt.

Also, there is a growing belief that the structural underpinnings of local government finance here in California are fragile and fairly unforgiving. The post Proposition 13 limits give Orange County few options to deal with a fiscal emergency. While the circumstances and magnitudes in this instance are extreme, extreme cases tend to expose a system's relative weakness or resiliency. This system has not proven resilient. While no wholesale reassessment of California local credit is currently being undertaken by Moody's, the lessons learned from Orange County will have to be considered and reflected in future rating decisions for all California local debt.

These first two concerns – the need for closer scrutiny of investment practices and a greater weight placed on the limitations of the state's local government financing structure– may result in greater borrowing cost for all issuers. There is an appropriate cost if in fact the Orange County situation has alerted analysts and investors to the true risk profile of California local debt issues.

Much of the future impact of the Orange County bankruptcy will depend on the outcome of events yet to unfold, but I think it is appropriate to consider the consequences of some of the potential outcomes. I will comment first on the spillover effects for California borrowers generally and then comment specifically about how alternative outcomes may affect assessment of Orange County's future creditworthiness.

Should Orange County find a means to refinance, or otherwise pay all of its short-term debts at maturity, I believe, in general, confidence in municipal credit will be restored in a short time. Timely repayment of this debt under the most

difficult of circumstances will reaffirm an old market adage that general obligation debt gets paid come hell or high water.

The county may default on its debt due to its inability to take adequate and timely revenue raising and debt issuance actions sufficient to pay off or refinance maturing debt. The constraints and limitations preventing the county from acting will forever be viewed as systemic weaknesses that prevent California localities from appropriately responding to adversity. The market learns from adversity. For example disclosure requirements have forever been tightened since the New York City default and the WPPSS defaults led to significantly tighter legal protections for many types of debt.

Should the county default, the limited role played thus far by the state will also contribute to a reconsideration of the confidence placed in California local government credit. Orange County is a political subdivision of the state. Much of its governmental functions relates to the operation of state funded and mandated programs, and the role of its treasury as the designated investment vehicle for certain other state political subdivisions within the Orange County boundaries is a matter of state statute. I would also point out that the only real connection between the county and the cities, school districts, and special districts within its boundaries is overlapping geography. A county is, in no way, designated as a superior level of government or otherwise involved in local operations that are subject to state authority. Given Orange County's essential role in carrying out state purposes, the limited scrutiny by the state prior to the bankruptcy and the ineffectiveness of limitations intended to protect public investments, a default would put to rest any belief that the state would provide a fiscal backstop for its localities. It has also been suggested to us that the state is actually quite limited in how it could help. It is not clear the state could act to issue debt for Orange County, guarantee any county obligations, invest state funds through a purchase of county debt or authorize a revenue to be collected

in Orange County to support a debt refinancing. While states are not in any sense on the hook to secure local debt issues, other states have nevertheless stepped up in cases of adversity. New York State was quite active with respect to New York City's recovery after its 1975 default, the state of Ohio was directly involved following the 1978 default by Cleveland and the creation of the Chicago School Finance Authority and the Philadelphia intergovernmental Cooperation Authority in 1992 represent significant state responses to local fiscal crises.

Recognition of limited local flexibility and the inability and/or hesitance on the part of the state to get involved in the Orange County situation may lead to greater wariness and more credit scrutiny, but I am not suggesting that the state's position is inappropriate as it is wholly consistent with the understanding of available legal protection for Orange County's debt. We all understand the state has no legal obligation to county creditors.

The more frightening prospect, which should be of concern to the state and is of far greater concern to Moody's, is that Orange County might actually follow through on its threats to repudiate a portion of its tax and revenue anticipation note debt. The repudiation of municipal debt has little precedent in the twentieth century.

Given its intense visibility, any attempt by Orange County to repudiate its debt could be extremely chilling. The only basis for repudiation would be that the bonds were illegally issued. The county would not only have to deny its own legislative actions in issuing debt, and its county counsel opinions opining to the enforceability of the obligations, but it would also have to challenge the underlying legal underpinnings of the obligation. No formal argument has yet been laid out, but it has been suggested that the debt was not properly authorized under the state constitution or statutes. That would be a very dangerous argument. The state constitution says little about debt, primarily a

short limitation drafted in the 1870s following that decade's railroad bond defaults. Public finance in California is based on an extremely complicated web of legal theories, some of which are found in the statutes, many of which have evolved through court decisions over the past 100 years. About three fourths of the public financing done in California, by the state itself as well as its cities, counties, school districts, and special districts, is not defined by the Constitution. This includes lease financings which allow local governments to rent-to-own public facilities and numerous enterprise-based financings for water, sewer and public power, and some of the short-term note offerings that allow the state to bridge the cycles of revenues at tax-exempt rates. It would be naive to think that Orange County can surgically extract itself from obligations which, in retrospect, it wished it not had undertaken, without damaging the system by which state and local governments manage their resources in this state. By starting to pull on this one thread, it threatens to unravel the complicated fabric of California public finance.

One of the first victims of this assault would logically be the county itself. Its own recovery plan is filled with extremely creative financing techniques, all of which fall outside the definition of debt defined by the constitution or the tools created by statute. It is beyond our comprehension how the county could, in one breath, seek the investment community's support for such innovative investment instruments at the same time that it threatens to stab them in the back for having invested in securities which, frankly, are much more straightforward than the proposed tort settlement recovery warrants and refunding recovery bonds it seeks to issue.

In truth, the likelihood that Orange County would be successful in any attempt at repudiation seems remote. But it starts the county on a slippery slope which it cannot control, and which will cost all state and local governments in California

by increasing the atmosphere of anxiety and mistrust already created by the bankruptcy, and which would be exacerbated by a default this summer.

Simply the threat of repudiation by the county, following within two years the Richmond Unified School District's attempted repudiation, shifts our analytical perspective by creating an environment of mistrust. Public financings are heavily documented transactions, and rely on the one hundred years of statute, court rulings and practice alluded to above. The system has worked, restraining public obligations within carefully controlled parameters, while allowing public access to the lowest cost capital markets. But if the borrowers in that market are likely to take an opportunistic attitude to these obligations, sending their lawyers out after the fact to comb through the small print, then perhaps the existing system should not be relied upon anymore. If every action is subject to challenge, you must look more skeptically, perhaps more cynically, at every element of the government obligation.

Participants in the U.S. municipal market have always expressed a basic trust so long as that trust is not breached. Issuers, after all, enjoy and benefit from the financing independence afforded them through access to a market source of capital at competitive market interest rates. The fact that governments don't go away, that they are accountable to their citizens and that they strive to maintain their creditworthiness and therefore their access to a continuing source of capital, are accepted truths that foster market confidence. The trust element in the market has manifested itself in a rigorous, but yet accommodating market. The market itself is not tightly regulated with issuers falling outside direct SEC jurisdiction. Financial disclosure standards have improved slowly, but are still not on par with the regulated corporate market. Issuers bring an enormous variety of securities to the market — many of which limit the issuer's liability and are designed to facilitate a borrowing yet circumvent legal restrictions that prevent the financing from being undertaken on a full faith and credit basis. An often

discussed, but seldom seen underpinning of this market, is the notion of market discipline — that if a borrower fails to honor its commitment and demonstrate a willingness to do all it can to avoid default, the penalty would be lack of market access for an undetermined period. New York City did not borrow on its own behalf for six years after default and Cleveland for five. Philadelphia lost market access for three years due to its serious fiscal difficulties, and it never defaulted. However, these concepts of trust and market discipline have eroded over time and following the Orange County bankruptcy may be forever discarded as quaint concepts of the past. It appears that Orange County, even in bankruptcy and without any clear sign that it will avoid default or that it is even fully committed to trying to avoid default, can, at a price, continue to have access to the market. For some additional yield or a sufficient insurance premium, market participants appear ready to be accommodating.

Moody's rating position regarding future Orange County borrowings will be strict but not punitive. We will evaluate the risks as we understand them and appropriately reflect these risks in our ratings. While the county is in bankruptcy and with the threat of imminent payment default on the notes, and because the county avoided statutory set-asides for noteholders and invaded bondholder reserves to meet debt service payments, we are looking at each of the county's newly proposed financings as having to be structured as truly independent of the county. While current proposals for recovery notes and Teeter notes include some distancing from the county, they may not be sufficiently well structured to merit ratings higher than the county's current default level. At this juncture, it would be totally inappropriate for us to place any weight on the belief that the county will, if not compelled, act to honor its obligations or act in ways that will maintain future market access.

Paradoxically, the potential market access available to Orange County, even in bankruptcy, may be representative of the likelihood of higher borrowing costs for

everyone else in the state. With no comfort derived from market imposed discipline and tougher standards with less presumption of willingness to pay and more exacting attention to legal and financial nuances, there will likely be higher transaction costs and higher standards for attaining creditworthiness.

We at Moody's are extremely concerned about the long-term consequences of the events that have already transpired, and are even more concerned about events that may transpire shortly. Some have accused Wall Street of false hysteria. We don't think that accusation is fair. We think the concerns are very real, are likely to be lingering, and that the perceptions of the risks associated with investing in California governments, in particular, will translate into investors seeking higher returns for those risks. That is how an efficient market would operate. Of course, we could be wrong, but it seems to us to be foolish public policy to gamble against the market.

One final thought. There may be people who feel the current system of public finance, which relies on extra-constitutional and extra-statutory legal authority, is inappropriate, and would therefore see the Orange County mess as a good thing. While we would not agree with this position on the current structure of public finance, there is plenty of room for disagreement on matters of public policy. However, to allow public law and policy, which affects all levels of government in California, to be crafted by a county in bankruptcy, by default and by litigation, would be inappropriate. It would also likely be unsuccessful in achieving any goal short of costing state and local government more money.

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MOODY'S RAISES QUESTIONS ON ORANGE COUNTY, CALIFORNIA REFUNDING RECOVERY BONDS

Obligations Enter Little Charted Waters in California

New York, New York - May 24, 1995 - Orange County, California, is moving forward with several bond issues designed to facilitate the county's recovery from the fiscal crisis that precipitated its December 6, 1994 bankruptcy filing. Permanent financing of the Recovery Notes is a priority in the county's financing plan. These obligations will fund part of the county's settlement with the school districts and other local agencies that participated in the Orange County Investment Pool (OCIP). In the settlement agreement, the county is obliged to make the notes equivalent to cash by June 16th. Refunding Recovery Bonds, the county's initial and preferred mechanism, are encountering challenges from county creditors. The form of the permanent financing is in flux as the county attempts to devise a marketable security.

Moody's analysis of the Refunding Recovery Bonds, like any of our ratings, is multi-tiered. First is the fundamental issue of the authority of the issuer to issue the debt. We look to an unqualified opinion of recognized bond counsel that states that the debt is authorized under state law and is a valid and legally binding obligation of the issuer, without relying on bankruptcy court proceedings. The second tier of analysis reviews the security provided to the bondholder. In the case of Orange County, this question centers on the ability to insulate the new debt from the general credit of the county. Third, we look at the particular credit aspects of the issuer, such as finances, coverage, debt levels and management.

Continued

Before Moody's can assess the security or credit quality of the bonds, the first-tier conclusion on the validity of the debt must be established. While validity is often clear for municipal bonds, Orange County's authority to issue the Refunding Recovery Bonds is less clear. Thus, Orange County is pursuing proceedings through the state court system to receive a judgment on the validity of the debt. If successful, the county would move ahead with the sale of the bonds with the current structure and security, presumably in June. Moody's believes that the untested nature of municipal bankruptcy and the unique state law issues that drive the nature of the bonds warrant a full discussion of the uncertainties that might otherwise go unaddressed in the county's urgency to move forward with the settlement.

Orange County Explores New Territory with Recovery Refunding Bonds

Under the California constitution, debt issued by local governments must be approved by two-thirds of the voters, unless the bonds meet the criteria for an exception. One such exception is obligations that result from an "involuntary obligation imposed by law." The Findings of Fact and Conclusions of Law entered by the bankruptcy court in connection with the settlement of the pool states that the claims settled by the agreement are "claims arising in tort or pursuant to obligations otherwise imposed by law." The county is seeking a judicial determination that the warrants (the obligation to pay the pool participants) and the bonds (that would refund the warrants) result from an involuntary obligation imposed by law and, thus, fall within the judicial exception to the constitutional debt limitation.

Moody's has expressed concern to Orange County and its advisory team about the application of the constitutional exception for obligations imposed by law to the Recovery Refunding Bonds. These questions include:

Are the Warrants and Bond Obligations Imposed by Law?

If the "tort judgment" contemplated by the Settlement Agreement and approved by the bankruptcy court order is not an obligation imposed by law, the county's obligations under the Settlement Agreement would be invalid as contrary to the constitutional debt limitation and the applicable California statutes would not authorize issuance of the warrants. Even if the tort judgment were to constitute an obligation imposed by law, the county's financing mechanism might not necessarily constitute such an obligation.

The California cases have all involved obligations imposed by action of the legislature or state courts. None address the issue of whether an obligation imposed by law may be imposed by a federal bankruptcy court on a political subdivision of a sovereign state, or what the effect of the county's consent to

such an obligation may mean to its voluntary nature. The bankruptcy code protects debtor municipalities from intrusion on their operations. The obligations might be construed as such an intrusion and thus not under the purview of the court or subject to repudiation by the county at a later date if budgetary pressures became too severe.

Is Orange County's Obligation to Issue the Recovery Bonds to Pool Participants Voluntary or Involuntary?

The California courts have repeatedly stated that an obligation imposed by law must be involuntary to fall within the judicial exception. The judicial exception has developed in cases involving (1) specific statutory duties imposed by law and (2) liabilities imposed as a result of tort judgments. Obligations that a county voluntarily incurs are not entitled to be treated as obligations imposed by law and would be subject to the constitutional debt limitation, unless otherwise excepted.

The facts and circumstances related to Orange County's bankruptcy and subsequent actions appear to involve voluntary as well as involuntary conduct. The Settlement Agreement represents a negotiated arrangement among the county and pool participants before adversarial proceedings had developed to any meaningful extent. Even the findings of the bankruptcy court acknowledge that the agreement between the county and the pool participants was consensual.

None of the pool participants who will receive the warrants under the settlement pursued litigation against the county. The agreement has been crafted to characterize the claims against the county as sounding in tort, but fails to identify those torts. The torts that may be alleged against the county are unlikely to fall clearly within the judicially determined tort liabilities at issue in the California decisions. In addition, to the extent that claims against the county are based on breaches of trust, they may not constitute torts. Under these circumstances, the California cases do not clearly support the conclusion that the county's actions are "involuntary" within the meaning of the judicial exception.

Validation Proceedings -- Benefits and Limitations

The California code of civil procedure provides a process by which questions of municipal authority can be addressed by the state courts through a validation process. A municipality files a complaint seeking a court determination of the validity of the municipality's action under state law and gives notice to the public. The court considers the municipality's arguments and, if no party challenges the validation, typically enters a default judgment.

Municipal governments have used the validation process when issuing debt under the exception of an "obligation imposed by law." The principal court cases related to the debt limitation exception for "obligations imposed by law" date back to 1919. In the absence of more recent court rulings, bond counsel have sought judicial validation of transactions through a judgment in superior court. There is limited case law on the validation process itself, and the California Supreme Court has not opined on the constitutionality of the validation process.

Orange County has filed a complaint in Superior Court seeking validation of the warrants and refunding bonds to be issued as exceptions to the constitutional debt limitation as an obligation imposed by law. Moody's raises the following questions:

What assurances does the validation proceeding provide on the validity and enforceability of the warrants and the bonds?

Validation is an interpretive process. Its scope is limited to rely on interpretations of existing law. Validation does not authorize the courts to confer municipal power where such power does not exist under state law or where such power may exceed constitutional limitations. Validation has been used in several states, including California, to provide a judicial determination that clarifies ambiguities and inconsistencies in bond related statutes and constitutional provisions, particularly in the absence of a sufficient body of case law on which bond counsel might otherwise rely. Moody's has rated debt of California municipalities that has been validated by state superior court.

The facts related to Orange County and its bankruptcy and the issues that are sought to be resolved through a judgment obtained in a validation proceeding raise significant legal issues. It appears that the validation proceeding is using the bankruptcy court order to confer municipal power on the county that does not otherwise exist or to validate an obligation that may fundamentally violate constitutional restrictions.

Is a judgment subject to collateral attack?

California's Validation Act contains a broad provision that cuts off all rights of any person to contest a validation judgment on issues that were or could have been raised in the validation proceeding. This broad statutory provision clearly precludes a future effort to overturn a court's validation judgment with respect to matters of statutory interpretation. However, several issues of constitutional significance are raised by the statutory validation procedures and the facts related to the County and its bankruptcy, including whether the validation proceedings can cut off the right of an interested person to claim that the bonds violate the state constitution. Without conclusive determinations from the

California Supreme Court on the validation process, future challenges might be successfully brought against the validity of the obligations.

Satisfactory answers to these questions, accompanied by an unqualified bond counsel opinion, may provide Moody's with sufficient comfort that these bonds are valid and legally binding obligations of the county. This would satisfy the first tier of the analytic process. However, an investment grade rating would require closer scrutiny of the structure and credit quality of the obligations.

To Achieve Investment Grade Status, Bonds Must be Insulated From Orange County . . .

If Moody's can obtain comfort as to the validity of the Recovery Bonds, there are many levels of credit quality that must be examined. Moody's currently rates the long-term debt of Orange County below investment grade at the **Caa** level. Even if the county is successful in emerging from bankruptcy, it will face severe financial pressures going forward due to the loss of interest earnings which supported the General Fund, the loss of accumulated reserves in the investment pool, and expense of new obligations to repay pool participants, as represented by the Recovery Bonds. As such, it is unlikely that the county's credit position will be significantly strengthened in the near future.

Given the County's current weak credit position, it may seek to find ways of strengthening the credit quality of new bond issues through unique security features or issuance structures. It is Moody's position that any future bond issues will have to be both financially and legally insulated from the county in order to achieve a credit rating better than the county's existing credit rating. We would look for a specific pledge of a revenue stream to bondholders providing a lien that would survive a future bankruptcy filing by the county. Otherwise, repayment of the bonds could be subject to budgetary pressures for the provision of health, safety and welfare, services with which the bankruptcy court cannot interfere.

. . . And Bonds Must Possess the Credit Qualities of Investment Grade Debt

Finally, once Orange County has satisfied concerns over the validity of the bonds and the ability of such bonds to withstand future county fiscal distress, it must still demonstrate that it has the ability and willingness to repay that debt. This will be indicated by the quality of the revenue stream backing the bonds and the legal security provided to bondholders through the various provisions of the bond indenture. Moody's will look to traditional indicators such as overall debt levels, coverage of debt service by the pledged revenue stream, the ability to issue parity debt, and the impact of the debt issuance on other county operations as well as on the holders of outstanding debt.

In the case of the Recovery Bonds, which will be paid from the county's General Fund, there could be a negative effect on existing certificate of participation holders whose debt may be subordinated to the new debt. Further, the diversion of a General Fund revenue source without replacement by the increased sales tax, should that not receive the required voter approval, could impair already reduced General Fund operations. These are not indicators of investment grade credit quality.

Conclusion

Municipal bankruptcy is relatively unknown territory. The Recovery Refunding Bonds, the first financing proposed by Orange County in its plan to emerge from bankruptcy, go deeper still into untested areas of state law. The interaction of municipal bankruptcy and state law will be key to Moody's analysis of the validity of the obligations and will start with Moody's looking for the unqualified opinion of bond counsel that any obligations issued by the county are valid and legally binding under state law. Only from there can we assess the credit quality of the obligations based on their structure, security provisions and other fundamental credit characteristics.

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Rating News

Moody's Addresses Credit Quality of Orange Co., CA, Refunding Recovery Bonds

NEW YORK, NEW YORK - JUNE 12, 1995

Orange County, California, plans to sell \$295 million Refunding Recovery Bonds tomorrow, June 13. Moody's will rate the bonds **Aaa** based upon an insurance policy provided by MBIA, although aspects of the insured transaction warrant further discussion. In addition, Moody's is providing comment on the underlying credit quality of the bonds. The bonds represent one component of the county's attempted recovery plan and, as such, have a bearing on the outcome of this unprecedented bankruptcy. Moody's continues to watch these developments closely, and we will continue to comment on all financings, whether credit enhanced or not, for the implications on the county and more broadly on the public finance market:

Aaa Rating Based on MBIA Claims Paying Ability and Commitment

The Refunding Recovery Bonds will be used to partly compensate for losses to participants in the Orange County Investment Pool. The county's deadline for meeting that obligation is June 16. The Superior Court of California entered its default judgment on validation proceedings for the bonds on Monday, June 5, that the bonds are valid obligations issued in accordance with state law. The county presently plans to deliver the bonds on June 16 in accordance with its deadline to participants. This transaction is fully insured, and we have received assurance from MBIA that the policy covers the validity of the underlying bond obligation.

Underlying Credit Quality Linked to Well-Below Investment Grade Debt Outstanding

The Refunding Recovery Bonds must be examined in the context of the county's bankruptcy and present state of distress. As we have stated previously, any new debt obligation of the county would have to be financially and legally insulated from the county to have credit quality above the county's current long term debt rating of **Caa**. Under the current circumstances, the credit quality of the Refunding Recovery Bonds, absent the insurance, would be substantially below investment grade for reasons outlined below. The bonds present appropriate elements of protection, but there is a presumption that current problems will be solved: either the sales tax will be approved by voters, or the county will have sufficient budget flexibility in the future, notwithstanding legal pressure and uncertainty of access to the markets for cash flow. In fact, events to date point in the opposite direction and include the county's threat of debt repudiation.

Legal Structure Uses Bankruptcy Tools and State Intercept

The bond indenture provides five levels of security:

(1) The bonds have a general obligation pledge, payable from all lawfully available funds. The county cannot raise taxes to pay debt service.

(Continued)

Moody's Addresses Credit Quality of Orange Co., CA, Refunding Recovery Bonds

- (2) Debt service has a super administrative priority claim under Section 364(c)(1) of the Bankruptcy Code. This claim would expire when the county emerges from bankruptcy.
- (3) Under Section 364(c)(2) of the Bankruptcy Code, debt service has a priority lien over the interests of other general creditors, including existing debt holders.
- (4) In addition, the county has pledged to the payment of the bonds the Motor Vehicle License Fees collected by the state and distributed by formula to cities and counties.
- (5) The county has elected in the indenture to have the state intercept the Motor Vehicle License Fees and provide them directly to the trustee for payment on the bonds. This mechanism results from legislation (SB-8) recently enacted by the state to assist Orange County.

Limitations on Security

The indenture provides an enhanced degree of security to bondholders. However, its value is limited. First, Chapter 9 bankruptcy is intended to enable the municipal entity to continue operations while addressing its claims. The superpriority lien and senior claims granted to the bonds are thus subordinate to the county's operating costs, particularly its obligations to meet the health, safety and welfare needs of its residents. The bankruptcy court cannot interfere with the exercise of these police powers. Further, the county has specifically made the superpriority lien junior to payment of the county's attorneys and consultants.

The pledge of the Motor Vehicle License Fees to the bonds dedicates a revenue stream that averages \$90 million per year to the repayment of the bonds. The intercept recently approved by the legislature provides a mechanism that potentially removes the county from the flow of funds to the bondholders; however, the intercept as enacted in SB-8 does not protect bondholders against future bankruptcy. Further, the state is not limited in its ability to alter the funding formula and divert revenues from the county.

Given the potentially competing interests of the debt service and the county's operational obligations, these security features must be examined in the context of the county's ability to afford the debt. Orange County's discretionary general fund budget for fiscal 1996 is 40% lower than the 1995 budget with a 16% decrease in staff planned, yielding reduced services throughout the county. These cuts are untested, and could impair the county's ability to meet the fundamental health, safety and welfare obligations to its constituents. Difficulty meeting these operational requirements could result in litigation that might interrupt the flow of funds for debt service on these bonds.

Even if the county is successful with its budget cuts, they remain inadequate to meet all obligations. Without the 1/2 cent increase in the sales tax, which voters will consider on June 27, the county does not have a viable plan to repay all its debt. The sales tax continues to receive no support from the Board of Supervisors, and passage is far from certain.

The lack of effort by the county in paying the Recovery Bonds is most evident in the debt's structure. The up front cost of the debt is minimal. The county will pay interest only for the next five years, and only begin principal amortization in the sixth year. Teeter bonds will be issued shortly to refund outstanding notes and provide revenues to the county. These revenues result in a zero net cost for the Recovery Bonds in 1996.

Credit Quality Reflects Ability and Effort

While the Refunding Recovery Bonds are separately secured from the county's other obligations now rated **Caa** or **SG** (Speculative Grade), they are not insulated financially and legally from the county. Their credit quality remains entwined with the county's other obligations. We cannot review the credit quality of one obligation in isolation while the county is approaching default on other obligations.

The county has proposed an extension with holders of other notes due this summer, while retaining its rights to invalidate certain of these obligations. The county also continues to use reserve funds to make payments on its certificates of participation and, again, has retained the right to seek to invalidate of these obligations. The sales tax that could make the county's recovery plan achievable may lack the support needed for a successful vote. Without an intensive effort by the county to address its revenue requirements and honor all of its debt

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Moody's Addresses Credit Quality of Orange Co., CA, Refunding Recovery Bonds

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obligations, the credit quality on the Refunding Recovery Bonds, absent credit enhancement, is consistent with the county's other obligations, which are well below investment grade.

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Rating News

Moody's Comments on Orange County, California Teeter Bond Credit Quality

NEW YORK, NEW YORK - JUNE 23, 1995

Orange County, California, plans to sell \$155 million Teeter Plan Revenue Bonds on June 27 through a newly formed Joint Powers Agency, the Orange County Special Financing Authority. The bonds will be secured by an irrevocable direct-pay letter of credit to be issued by The Industrial Bank of Japan, Limited. Although the rating on the bonds will reflect the credit quality of the IBJ letter of credit, Moody's is providing comment on the underlying credit quality of the bonds. As with the Refunding Recovery Bonds sold on June 13, the Teeter Bonds represent another component of the county's attempted recovery plan. Moody's continues to monitor the county's proposals and we will comment on all financings, whether credit enhanced or not, for the implications on the county and more broadly on the public finance market.

Teeter Bond Structure

The county is issuing the 1995 Teeter Bonds in part to refund \$175 million of outstanding 1994-95 Taxable and Tax-Exempt Teeter Notes. The balance of the funds needed to retire the notes will come from money available in the existing Teeter Fund. The one-year notes mature June 30, 1995 (\$111 million taxable notes and \$64 million tax-exempt notes) and were backed by a standby purchase agreement with the Orange County Investment Pool. The county must issue the 1995 Teeter Bonds in order to avoid defaulting on the 1994 Teeter notes. Bond proceeds will also be used to purchase new property tax receivables and to fund in part the Tax Loss Reserve Fund.

Credit Quality of Bonds Issued by Joint Powers Agency Derived from Below Investment Grade Participants

As with other bonds being issued by Orange County, the Teeter Bonds must be examined in the context of the county's bankruptcy. Moody's has stated previously that any new debt obligation of the county would have to be financially and legally insulated from the county to have credit quality above the county's long-term debt rating of Caa.

The county has attempted to insulate the Teeter Bonds from the county by selling the property tax receivables to the Authority and having the Authority issue the debt. While this approach does achieve some degree of separation, the county is not making a "true sale" of receivables to the Authority, retains significant control over the Authority, and the county will act as servicer for the receivables. As a result, the Authority is not fully insulated from the current or any future bankruptcy of the county. Therefore, the credit quality of bonds issued by the Authority would reflect the credit quality of the Authority's participants.

(Continued)

June 23, 1995

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Moody's Comments on Orange County, California
Teeter Bond Credit Quality

Certain elements of the bond structure — its economics, legal provisions, and the lien provided to bondholders — do indicate stronger credit quality than the county currently provides to its other long-term debt. However, the exposure to bankruptcy risk results in credit quality, absent the letter of credit, that would be below investment grade for the reasons outlined below.

Teeter Bonds to Be Issued through New Joint Powers Agency

The Teeter program is a method of distributing secured property taxes to local taxing agencies. Participating agencies, which include the county, all school districts, and other cities and special districts who have chosen to participate, receive the full amount of their share of property taxes on the secured roll, including property taxes that become delinquent which are yet to be collected. The county forwards the delinquent taxes to the other entities in exchange for the right to collect delinquencies with interest and penalties. The county issues debt to fund the payments owed to the agencies and repays that debt through the collected tax delinquencies, interest and penalties.

The county is issuing the bonds through the Orange County Special Financing Authority, which is a joint powers authority consisting of Orange County and the Orange County Development Agency. The primary reasons for financing through the joint powers authority are to separate the Teeter Program from the operations of Orange County, and to allow the issuance of longer-term bonds than the county would be permitted to issue itself for this program. Historically, counties were limited to issuing one-year notes to finance the Teeter Plan, but now can issue seven-year debt. There are no limits on the maturity of the bonds if issued by the JPA.

Links between County and Authority Limit Ability to "Bankruptcy Proof"

Although the county intends the Teeter Program to economically self-supporting, there remain significant linkages between the county and the Authority, such that a future bankruptcy filing by the county could impair the Authority's ability to make timely debt service payments.

The Authority is made up of the county and the County Development Agency. The County Board of Supervisors acts as the Board for both the Development Agency and the Joint Powers Agency. County staff acts as the staff of the Development Agency and will be the staff of the JPA. The county will be the servicer with respect to the delinquent tax payments and the receivables. The county is not making a "true sale" of the receivables to the Authority.

Future County Fiscal Distress Could Impair Authority Debt Service Payments

Although the bond documents say that the county is selling the receivables to the Authority, the transaction more closely resembles a secured transaction; that is, the county is giving the authority a lien on the asset rather than selling the asset outright. Since the county is not transferring all right, title and interest in the receivables after the sale to the Authority as it would in a true sale, the receivables would be subject to the jurisdiction of a bankruptcy court both in the current bankruptcy and in the event of a subsequent bankruptcy. The court could determine that the sale arrangement, for purposes of bankruptcy law, constitutes debt of the county. This would subject debt service payments to an automatic stay unless the consent of the bankruptcy court is obtained to make debt service payments even from funds held by the trustee.

Bondholders will have a lien on the delinquent tax revenues and associated interest and penalties. This lien would survive the current and any future bankruptcy filing so that bondholders would ultimately receive full payment if the revenue stream is adequate. However, timely payment could be interrupted in a subsequent county bankruptcy.

The county will also act as the Servicer of the Teeter Program. It will be responsible for collecting delinquent taxes and transferring them to the Authority. Any future insolvency or bankruptcy could impair the county's ability to adequately perform its obligations under the Servicing Agreement. Further, in a bankruptcy filing, the county could reject the Sale and Servicing Agreement itself as an executory contract.

The county is also retaining some of the benefits associated with the revenue stream since it will be receiving up to \$10 million annually for the General Fund. However, the county is not taking on any obligation to make debt

service payments on the Teeter Bonds from any sources other than the delinquent taxes, penalties, interest, and tax loss reserve fund.

Teeter Expected to Be Self-Supporting Revolving Program

Pursuant to the Sale and Servicing Agreement, the county will sell its current and future property tax receivables to the Authority. The Authority will use the delinquent tax, interest and penalty revenues derived from that sale to (1) pay debt service on the bonds; (2) purchase new tax receivables each year; and (3) transfer excess funds not to exceed \$10 million to the county's General Fund.

The projected cash flow appears to be sufficient to make all of the above payments. The county has a five-year collection cycle, after which delinquent property is foreclosed and sold. The county typically recoups taxes, penalties and interest exceeding the full amount of the original delinquent taxes within three years. Amounts collected in the fourth and fifth year are excess revenues that the county can use for any purpose and are essentially compensation for the risk taken by the county in advancing full property tax revenues to participating agencies.

The proposed Teeter structure appears to work economically. The existing revenue stream is adequate to support debt service and annual purchases of receivables while generating excess to be transferred to the county. In fact, the issuance of the bonds using the proposed structure could be used by the county to meet its other obligations since it will enhance General Fund resources.

Legal Provisions

The county is also pledging to bondholders the Tax Loss Reserve Fund (TLRF). All counties that participate in the Teeter Plan are required to maintain a TLR in prescribed amounts in case the sale of foreclosed property does not fully cover delinquent taxes. Historically, the TLR has not been pledged to bondholders. Orange County proposed this legislative change which was enacted in SB 7, the legislation which also allowed for the transfer of the TLR from the county to the Special Financing Authority.

Other legal provisions include an additional bonds test that requires the county to maintain a 1.15 asset-to-liability ratio for the Teeter Program, a limit on and a coverage test for the amount of excess revenues that can be transferred to the county, and a requirement to maintain a minimum fund balance in the Teeter Fund. Exclusive of the implications of the county's bankruptcy and current legal and financial problems, these legal provisions do provide some protection for bondholders over the life of these bonds.

Teeter Bonds Potentially Stronger than County's Direct Debt but Still Not Investment Grade

The Teeter bonds exhibit some characteristics that support a credit rating above that of the county's direct debt, including the lien and other legal protections provided to bondholders, and the self-supporting nature of the revolving revenue stream. However, while the county is fiscally distressed, in bankruptcy, and threatening to repudiate debt, the Teeter Bonds would be below investment grade due to the close relationship between the county and the Authority and the lack of a true sale of the assets by the county to the Authority.

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Rating News

Moody's Comments on Failure of Orange County, California Sales Tax Vote

NEW YORK, NEW YORK -

New York, New York, June 28, 1995 - The overwhelming rejection by the Orange County, California voters of the proposal to increase the sales and use tax by one half of one percent represents a major setback to the county's creditors as well as to the county's desire to emerge from bankruptcy. It has been clear from the start of this fiscal crisis that the county would need significant new revenues. At this time, the county's alternatives are not obvious since it will be difficult to sustain further budget reductions and California counties have only a limited ability to raise revenues. It is difficult to envision any option that could be implemented in the near term that would not be subject to nearly insurmountable political and legal challenges. Moody's is concerned that the county is moving ever closer to acting on its often cited threat of debt repudiation.

If the tax increase had been approved, a temporary extension of the \$800 million remaining notes (\$600 million in taxable notes due July 10, \$169 million in Series A notes due July 19, and \$31 million in Series B notes due August 19) may have been achieved voluntarily. However, as noteholders have no better prospects of getting paid next year than they have today, any extension sought under the current circumstances will only be achieved under the threat of repudiation, which Moody's would view as tantamount to a default. The rejection of the sales tax increase sends a clear message that the voters of Orange County have effectively disavowed their general obligation debt. Absent extraordinary intervention, we now expect a default or forced extension on the July 10 note maturities, at which time further rating downgrades would be forthcoming. In the worse case, the County may even choose to repudiate the notes.

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Moody's Comments on Failure of Orange County, California Sales Tax Vote

It is hardly surprising that the \$1.8 billion investment loss would lead to a cash insufficiency, preventing the timely payment on all short-term debt. What is outrageous and unprecedented is that in the six months since the bankruptcy filing, Orange County has utterly failed to take responsibility for its own actions and their consequences, and has demonstrated anything but the unflinching commitment to full restitution to its creditors that is expected of any government. Through the threat of repudiating its debt, the county seems bent on inflicting long-lasting damage to its governmental reputation and creditworthiness, and is demonstrating near-total disregard for the damage this will also inflict on the hard-won trust generally awarded to other municipal borrowers.

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Rating News

Moody's Views Orange County's Proposed Extension of Notes as a Default

New York, New York - June 30, 1995 - Orange County's plan to extend the maturities on some of its notes due this summer received bankruptcy court approval on Tuesday, June 27. Noteholders will vote by July 7 on whether to accept the proposed extension.

It appears that the county's perspective is to seek the extension because it does not have the resources to fully repay the noteholders at this time. Thus, the rollover, which would affirm the county's obligation on the notes, is an effort at accommodating the municipal market to maintain access for the county. It is important to note that the county, because it is in bankruptcy, is under no obligation to make payment on the notes by the stated due dates. From Moody's perspective, the county's affirmation of its obligations should be unconditional and outside the terms of an extension agreement. An extension agreement should be intended to compensate creditors for their consideration.

If the county had offered noteholders a voluntary workout plan that adequately compensated those who accepted an extension and offered others payment from available cash, it could have represented a realistic contingency in the attempt to gain order during a difficult period in the county's bankruptcy. Instead, as discussed below, the county is agreeing that payment on the notes is not limited to revenues from fiscal year 1994-95, in contrast to the state constitution's debt limitation provisions. But the county offers no significant compensation to noteholders for extending the maturity and the county's wavier may still be subject to challenge. The county, in effect, is attempting to pressure noteholders to accept extension through the threat of nonpayment.

In addition, the county has not identified any potential revenue streams to repay the debt next year. The half cent sales tax vote failed on Tuesday, and expected increased revenues at its landfill through imported garbage are unlikely. These revenue streams would have supported debt that could have financed a means by which to pay noteholders next year. Now the prospects for an economically sufficient plan remain dismal for the coming year.

The following is a review of the evolution of the extension agreement, its terms and its shortcomings.

The Dilemma

The county has \$800 million in short-term notes due in July and August that would be affected by the rollover, comprised of \$600 million Taxable Notes due July 10; \$169 million Tax and Revenue Anticipation Notes, Series A, due July 19; and \$31 million Tax and Revenue Anticipation Notes, Series B, due August 10. The Taxable Notes were issued to provide arbitrage earnings to the county as a source of operating revenues; the Tax and Revenue Anticipation Notes were issued to finance the county's cash flow requirements for the 1994-95 fiscal year. The county has other notes not affected by the agreement which it expects to repay from various sources.

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June 30, 1995

Moody's Views Orange County's Proposed Extension of Notes as a Default

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Teeter Notes, due June 30, are expected to be repaid with the proceeds of Teeter Bonds sold this week; Pooled TRANs are expected to be repaid with the money school districts have set aside.

The county's dilemma from the pool's losses was two fold: the investment income It expected for operations has not been realized, and the money set aside to repay some of the notes was reduced by the investment losses. In sum, the county does not have the resources to meet its financial obligations at this time, including the payment obligation on the notes.

With the filing of the bankruptcy and loss of investment income, the county elected to not make set asides as promised when it sold the Series A&B TRANs. This action was contested by the noteholders, but was upheld by the bankruptcy court. Thus, while funds would have normally been set aside for TRAN repayment throughout the fiscal year as revenues were collected, no post-petition set asides were made by the county. Only \$29 million in pre-petition set asides remain.

The Taxable Notes were issued by the county to provide money to generate investment income. The proceeds of the Taxable Notes were invested in the Orange County Investment Pool, and were thus decimated by the pool's losses. The investments made with the proceeds of the Taxable Notes, which were specifically intended for note repayment, were valued at \$429 million when the pool was liquidated in late December, well below the \$600 million principal amount due.

The Proposal

After protracted negotiations, the county's final proposal seeks noteholder approval of the following:

- * Payment of interest on the current due dates (for the Taxable Notes and Series B TRANs, monthly variable rate interest payments have been made);

- * An extension of maturity on the full principal of all obligations to June 30, 1996;

Interest on the extended notes at existing rates, although a portion would be paid monthly and the balance would be paid at maturity;

- * A premium of 95 basis points on the note principal, payable at maturity.

The interest payments would be an administrative expense of the bankruptcy, which would provide them with a higher priority to some other creditors. However, any payments yet to be made remain subject to a later attack or renegotiation under the bankruptcy code.

In addition to the terms of the extension, the agreement and related documents addressed several legal issues. Key among these issues is the treatment of the extended short-term notes under California's debt limitation laws.

The County's Waiver of Right to Assert Constitutional Debt Limitations May Still Be Subject to Challenge

California law limits a local government's ability to incur obligations in one fiscal year that would be satisfied from income and revenues derived in future fiscal years. With certain exceptions, expenditures in any given fiscal year cannot exceed the resources available in that fiscal year to pay them. The issuance of short-term notes does not fall within that debt limitation because the revenues available during the fiscal year are expected to be sufficient to repay the notes.

The county has posited that its lack of resources for fiscal 1995 resulting from the investment losses may be interpreted as a loss of security for the notes issued during the year. The county has suggested that, given that the revenues for 1995 may be less than the potential expenditures — operating costs and repayment of TRANs - the county would be violating the debt limitations to carry over any liabilities into subsequent fiscal years.

As part of the stipulation, the county "agrees that each of the issues of the note debt . . . shall constitute a valid, fully liquidated and non-contingent, undisputed and enforceable claim against the county." It goes on to state that the County waives and releases all defenses and objections to any of the debt under the Bankruptcy Code or related to the application or operation of the state debt limitation provisions.

Basically, the county is saying to noteholders, "If you agree to extend for a year, we will agree that you have a valid claim not subject to the debt limitation." However, while the bankruptcy court has approved the county's waiver of these rights, another interested person, such as a taxpayer, could seek to invalidate the obligation as a violation of the constitutional debt limitation.

County Maintains Right to Repudiate the Taxable Notes

More troubling than the coercive nature of the extension agreement and the potential for third party objection is the county's insistence on retaining the right to seek to invalidate some of the obligations it is presently asking holders to extend. Specifically, the agreement would enable the county to retain the right to contend that the Taxable Notes did not constitute a valid and enforceable obligation of the county at the time of issuance. We find the county's attempted retention of this right in the context of an extension agreement to be unacceptable. Such action would set a dangerous precedent that would affect all California municipal issuers.

Difficult Decision

Noteholders are faced with the following, limited choices: accept the county's proposal, and have the county acknowledge some, but not all, of its obligations; or reject the county's proposal with the likelihood of default and litigation. Even with approval of the agreement by noteholders, given the county's lack of resources and retention of rights to repudiate the Taxable Notes, litigation may ensue.

The county could have demonstrated a good faith effort toward noteholders by releasing the accumulated reserves toward repayment of the notes. Instead, the county has chosen to retain the note reserve possibly to use the money for other county purposes or to reallocate among creditors. The extension merely offers noteholders what they already had, a pledge of the county to repay the obligations when due. The extension, as proposed, would be, in effect, a default on these obligations.

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June 30, 1995

Moody's Views Orange County's Proposed Extension of Notes as a Default

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Rating News

Moody's Reinstates and Confirms MIG 1 Rating on Orange County, California, 1994-95 Pooled TRANs

**Issued on Behalf of 27 School Districts
Funds for Note Repayment Fully Set Aside**

New York, New York - July 18, 1995 - Moody's Investors Service has reinstated and confirmed the **MIG 1** rating on \$299 million Orange County, California, 1994-95 Pooled Tax and Revenue Anticipation Notes, which mature July 28, 1995. The rating on the Pooled Notes was suspended on December 6 when Orange County filed for bankruptcy protection and the standby purchase agreement with the Orange County Investment Pool was no longer available to correct any shortfalls in school district repayments.

The county issued these notes on behalf of local school districts. Moody's confirmation reflects the fact that all funds required for note repayment have been set aside. To arrive at the rating reinstatement, Moody's also reviewed the legal structure of the notes in light of Orange County's bankruptcy and has received sufficient assurance from the county that the notes will be repaid from moneys the county receives from the school districts to repay their individual notes as outlined in the settlement agreement approved by the Bankruptcy Court.

Set Aside of Funds for Note Repayment Accomplished

Moody's has been advised by the Orange County Department of Education that all 27 school districts that issued TRANs to Orange County have made their full and final May segregation of funds for note repayment. All funds for principal and interest have been fully set aside and are held by the County in separate repayment accounts. These funds are intended to be used by the county to repay the 1994-95 Pooled Tax and Revenue Anticipation Notes. The districts' actions to meet this covenant prior to disbursements from the pool settlement was a positive step in affirming the obligation to noteholders.

Legal Status of School District Repayments Addressed through Investment Pool Settlement Agreement

The repayments from the school districts to the county are pledged by the county for the repayment of the Pooled TRANs. As outlined in the settlement agreement between the county and the pool participants, the county acknowledges that it has collected, and agrees to continue to collect, school district property taxes as security for the repayment of the Pooled TRANs, and will use those property taxes to repay the Pooled TRANs. According to the county, the bankruptcy court has approved the county's plan to pay the Pooled TRANs through the court's approval of the settlement agreement.

Ability to Withstand Pool Losses Appears to Vary by District

(Continued)

July 18, 1995

Moody's Reinstates and Confirms MIG 1 Rating on
Orange County, California, 1994-95 Pooled TRAns

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Despite the county's bankruptcy, the districts have been able to manage financially through receipt of post-bankruptcy revenues and cash distributions from the pool. The school districts received a pro-rata distribution of the cash in the Orange County Investment Pool on May 19 and the proceeds of Recovery Bonds on June 16, which together provided a total of \$0.90 for each \$1.00 invested in the pool. The remaining \$0.10 will be payable by the county as a general unsecured claim.

Cashflows provided by the districts demonstrate that each will be able to meet its obligations for the fiscal year, including TRAN repayment. However, a few districts are ending the year with cash balances that indicate limited flexibility. While no district has stated such an intention and our review of the cashflows indicates that such a scenario is unlikely, a bankruptcy filing by a school district prior to the repayment of the notes might result in a stay against that district's segregated funds, thus potentially precluding full payment to holders of the Pooled TRAns.

The California Department of Education's Second Interim Report for the 1994-95 school year identified Orange County school districts as having Qualified Certification. (Negative Certification is assigned to districts that will not meet their financial obligations for the remainder of 1994-95 or 1995-96; Qualified Certification is assigned to a district that may not meet its financial obligations for 1994-95, 1995-96, or 1996-97; Positive Certifications are given to districts that are expected to be able to meet their obligations.) However, a subsequent letter from the Orange County Department of Education indicated that after the second interim period which ended April 15, 1995, that office changed the certifications of all 27 districts to positive upon a subsequent review of the districts and release of cash and recovery payments from Orange County. The state has indicated that under state law, the districts will remain with qualified status because the law does not provide subsequent certifications after April 15th. However, the state views the districts as financially solvent for the current and two subsequent fiscal years.

July 18, 1995
 Moody's Reinstates and Confirms **MIG 1** Rating on
 Orange County, California, 1994-95 Pooled TRANs

Pooled TRANs Participants

School District	Amount Borrowed (\$000)	School District	Amount Borrowed (\$000)
Anaheim City	\$ 8,700	Los Alamitos Unified	\$ 3,500
Brea-Olinda Unified	3,300	Magnolia	5,000
Capistrano Unified	28,000	Newport Mesa Unified	22,300
Centralia Elementary	5,000	No. Orange Co. Comm. College	16,000
Coast Community College	15,000	Ocean View	5,000
Cypress	4,395	Orange Co. Board of Education	18,300
Fountain Valley	3,400	Orange Unified	17,400
Fullerton Elementary	5,000	Placentia-Yorba Linda Unified	18,500
Fullerton High	9,790	Saddleback Comm. College	14,800
Garden Grove Unified	20,000	Santa Ana Unified	33,900
Huntington Beach City	5,000	Savanna	2,200
Huntington Beach Union High	17,500	Tustin Unified	6,175
La Habra City	3,000	Westminster	5,000
Laguna Beach Unified	3,500	Total	\$299,660

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Testimony by Richard Larkin
Managing Director, Standard & Poor's
Before the Subcommittee on
Capital Markets, Securities, and Government Sponsored Enterprises
of the
Committee on Banking and Financial Services
United States House of Representatives
July 26, 1995

Introductory Remarks

Good morning, Mr. Chairman, members of the Subcommittee. I am Richard Larkin, a managing director with Standard & Poor's Public Finance Rating Services. On behalf of Standard & Poor's, I appreciate your invitation to testify on the municipal debt market in the aftermath of Orange County's default. Along with my testimony, I have included analytical commentaries previously published in Standard & Poor's CreditWeek Municipal which describe in greater detail our views on Orange County's bankruptcy filing, the lessons to be derived from it, and a comment describing our established guidelines for government investment pools seeking to preserve principal.

For the record, Standard & Poor's is a worldwide rating agency with U.S. offices in New York, Boston, Chicago, San Francisco, and Washington. Standard & Poor's is recognized by the Securities and Exchange Commission as a Nationally Recognized Statistical Rating Organization and has been rating bonds since 1916. Our Public

Finance department has approximately 200 analysts and support personnel who cover the range of municipal debt issues in the \$1.3 trillion market.

Virtually my entire professional experience has been with Standard & Poor's where I have been a municipal analyst for 20 years. At Standard & Poor's, I am chairman of the Municipal Criteria Committee, the policy-making board for municipal ratings criteria. I am currently the head of our department's structured finance ratings group and am responsible for overseeing the development and publication of criteria pertaining to municipal bank-supported debt, structured securities, derivative products, and pension fund ratings. In addition, I lead internal rating teams that follow developments in California, Massachusetts, Pennsylvania, Oregon, Washington, Maryland, New Hampshire, New York City and Philadelphia.

I am a member of the Municipal Analysts Group of New York and was a member of former Congressman Beryl Anthony's commission which reviewed and recommended revisions to tax law on municipal debt issuance. I have also served on the Government Finance Officers' Association National Task Force on State and Local Budgeting.

A Unique Event

Orange County's filing for Chapter 9 represents a unique event in the history of public finance. Unlike previous municipal fiscal crises, Orange County's collapse did not result from a difficult economy driven by falling property values or employment. The bankruptcy filing cannot be blamed on overbudgeting, unrealized projections of operating revenues and expenses, as was the case in New York City in 1975. Nor was

it attributable to the issuance of short-term debt in order to mask operating deficits, accounting lapses, or shortfalls. Finally, the County's difficulties did not result from cuts in state and federal aid, although the limits imposed by Proposition 13 have placed increased pressure on all California counties.

Rather, the Orange County filing for Chapter 9 stemmed from an investment policy which generated \$1.7 billion in losses for the county as well as for 180 governmental units. While other municipal market entities have incurred losses during the 1994 bond market downturn -- Cuyahoga County, Ohio; Odessa Junior College district, Texas, to name two -- they did not approach the magnitude of the losses as those realized by the Orange County pool. As a result, recent estimates indicate the general fund owes approximately \$1.6 billion to noteholders, pool investors, vendors, and other county funds. In addition, according to recent county forecasts, its discretionary budget of \$463 million will run a \$188 million deficit in fiscal 1996.

As the committee knows, Standard & Poor's considers the County's \$600 million in taxable notes which were due July 10 and \$169 million of tax revenue anticipation notes which were due July 19 in default, even though a majority of the noteholders agreed to a one-year maturity extension. Nevertheless, Standard & Poor's assigned the default ratings because, under well-established principles governing the bond market, the County was unable to repay principle under the terms of the note agreements at the time of origination. (We have also expressed doubts as to whether the county will be able to repay these notes when due in 1996) In this case, investors

were unilaterally confronted with the option of being paid back one year later at a .95% premium, or not be paid at all.

Municipal Finance Remains Strong

Despite Orange County's actions and its bankruptcy filing, Standard & Poor's believes the municipal issuers we rate are fiscally sound. So far, market concerns have been largely confined to investors in California municipal debt, although that will depend to a degree upon how the courts, county and state officials proceed in resolving the issues. Market investors will in time return to Orange County if officials adopt a realistic, workable plan. If, on the other hand, the county were to ultimately repudiate its debt, the repercussions would reverberate well beyond the county line. To date, investor wariness has been primarily confined to Orange County and the pool's passive investors who have remained current in honoring their obligations.

Signs of this wariness have been evident during the ongoing short-term note season, an annual occurrence in California municipal finance. California counties issue short-term tax and revenue anticipation notes to cover expenses during the summer and fall. Being extremely safe offerings, these issues typically receive Standard & Poor's highest short-term ratings based on the strength of the expected tax receipts, as has been the case this year. However, a few issuers have had to withdraw the issue and remarket them at higher yields or with credit supports, such as bank letters-of-credit or bond insurance. From that perspective, the Orange County bankruptcy has cost these counties millions of dollars in increased borrowing costs for short-term debt, even though their credit fundamentals remain as strong as they ever were.

As for Orange County itself, the County recently issued \$255 million in recovery notes and \$175 million in Teeter notes. In order to market the issues, both issues required credit enhancements, either a letter of credit or bond insurance. Even with those third-party protections, underwriters had to offer investors higher yields than comparable notes, in one case a full percentage point more.

Beyond Orange County and California, it remains too soon to tell whether a fundamental shift in the relationship between investors and municipal issuers will emerge. Absent a substantial body of case law, a definitive, long-term response to the question must wait until we see how the courts, the State of California, and county officials deal with these issues in the months ahead.

No Trend

Apart from Orange County's Chapter 9 filing, the \$1.3 trillion municipal debt market remains strong and liquid. The average unenhanced municipal rating is 'A' and some 40% of the market is insured.

Orange County's filing for Chapter 9 protection, Standard & Poor's believes, is noteworthy precisely because it is unique, an isolated event. In this instance, bankruptcy reversed the established principle of municipal finance that governments have a moral obligation to repay their debts based on their full faith and credit.

The overwhelming majority of state and local finance officials in the governments and agencies we rate understand and honor their obligations to bondholders. In our dealings with municipal officials every day, they have demonstrated their good

intentions through their provision of timely accurate information to Standard & Poor's, to investors, and the general public. We believe the Orange County precedent is an isolated event, a crack in an otherwise strong foundation. In order to maintain the security of the municipal finance market, to repair the crack before it spreads, it is important to ensure bondholders are made whole. The Orange County experience could lead to more municipal bankruptcies or it could convince governments that bankruptcy is not an option to be pursued. Only time will tell.

Standard & Poor's Rating Criteria

Standard & Poor's places great importance on its integrity, and on communicating with the public markets. Our rating criteria is an open book. While we are known for our letter grade ratings, we also publish extensively to inform the market about issuer strength and trends that could affect them. In order to make clear issuers understand our rating process and analytics, Standard & Poor's publishes its complete rating criteria and provides updates as we introduce new rating innovations, or market dynamics justify a change.

In the course of rating various offerings issued by the county, Standard & Poor's reviewed documents and met with county officials. As described in extensive detail in the attached CreditWeek Municipal comment, *Orange County: 'A Unique Disaster,'* by my colleague Jane Eddy, the information regarding the investment pool's strategy provided Standard & Poor's upon which we based our rating of county debt proved to be unreliable. (Standard & Poor's was never asked to rate the pool.) As the committee

knows, there are pending criminal investigations and the former treasurer has pled guilty to securities violations.

Standard & Poor's has a keen interest in supporting expanded market information. To that end, when an issuer requests an Standard & Poor's rating, they must also agree to provide current, timely information, including audited financial statements, to adhere to our surveillance requirements. This information must be supplied at least annually, more frequently if material events warrant. But, as Orange County demonstrated, disclosure cannot guard against fraud.

Government Investment Pools Generally Sound

From our experience, the majority of government investment pools are conservatively managed, although there have been some exceptions. From our perspective, derivatives can be a double-edged sword. If the asset manager is knowledgeable and uses appropriate derivatives, such as interest-rate swaps, caps, and forward purchase agreements, fund managers can reduce interest costs, interest rate risk, and refund bonds in advance synthetically. However, if used excessively, or to speculate on interest rate directions, derivatives can produce losses which lead to ratings downgrades, as was the case with Odessa Junior College District in Texas.

In our view, some of the riskier instruments include structured notes, such as inverse floaters, riskier mortgage derivatives, such as interest-only and principal-only, instruments and inverse-floater tranches of collateralized mortgage obligations.

Because of the issuers involved, these are secure investments from a default perspective, but are volatile investments highly sensitive to interest rate moves.

Standard & Poor's is surveying 7,000 issuers in order to evaluate investment pool practices around the country. We are currently gathering the data and expect to have the information available in the near future.

In conjunction with its survey, Standard & Poor's reissued its published guidelines for evaluating pool safety. In brief, a pool is considered to meet Standard & Poor's guidelines if:

- The portfolio's weighted average maturity is less than one year;
- The pool has adequate liquidity to meet its participants' projected cash flow needs;
- The pool's exposure to reverse repurchase agreements, securities lending programs, and other forms of leverage is less than 20% and reverse repos are used to meet unexpected cash flow needs, rather than to enhance yield.
- The pool has little or no exposure to risky structured notes (such as inverse floaters, range notes, and dual index notes) or risky mortgage derivatives (such as interest-only and principal-only strips, residual tranches and other instruments);
- The pool is limited to high-quality securities;
- And the pool's management is fully aware of the investment policy, portfolio risks, and the pool's investments are marked to market more than once a year, preferably monthly.

Orange County's Lessons

In moving past Orange County, what lessons have been learned? In brief, the lessons learned, as enumerated in a recent comment by Ms. Eddy and Steve Nelli, timely, accurate disclosure is an imperative. But no mandate for disclosure will prevent fraud or the dissemination of inaccurate information.

Short-term debt, when used to cover operating deficits, can lead to credit problems. When financial problems arise, as they have in Philadelphia, New York City, and Orange County, the difficulty of making large, bullet payment increases exponentially, especially when compared to just meeting normal operating and debt service expenditures.

Asset management of all municipal assets is an important factor in determining credit strength. As analysts we focus on the municipalities' investments, infrastructures, accrued receivables and liabilities, and pension fund management.

Investors cannot count on outside intervention if a city or county defaults. While state intervention remains a possibility for Orange County, the scale of such action is uncertain given the state's own fiscal problems.

California and a number of other states have implemented tax and revenue limits which may, or may not, be good public policy, but they have been partially responsible for rating downgrades. During the past three years, Standard & Poor's has lowered the long-term ratings of nine California counties, affecting \$4.8 billion in debt. The

downgrades were exacerbated by California's lengthy economic downturn. But these revenue limits further inhibit the counties' available options in restoring fiscal strength.

Again, Standard & Poor's continues to believe that the events we have witnessed are a rarity. That is not to say there will not be variations on the Orange County experience in other locations in other times in the future. But if there is a final lesson to be learned, it is that Orange County should not be allowed to become a model to be cloned in other jurisdictions. Rather, it should be seen as a fiscal experiment which went awry.

That concludes my testimony, and I would be happy to answer any questions you may have.

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WINTER/SPRING 1995

ORANGE COUNTY: 'A UNIQUE DISASTER'

S&P on April 12, 1995 hosted a conference to discuss Orange County, Calif.'s bankruptcy filing and its impact on the creditworthiness of municipal debt. The conference was attended by 150 investors, issuers, bankers, financial advisers, and state officials. The following article is adapted from a speech delivered by S&P director Jane Eddy. A speech about Orange County investment pool participants delivered by S&P director Steve Nelli can be found in the Credit Comments section.

It would be nice to be able to start by putting Orange County's situation in a context that allows comparison with historic precedent. However, Orange County's situation is unlike any other fiscal crisis.

The county's problems do not stem from economic stagnation—as was the case in Philadelphia in 1990 and Cleveland in 1978—or from overbudgeting or “cooking the budget books”—like New York City in 1975. Nor was it the result of issuing short-term debt to mask operating deficits or accounting lapses or shortfalls. Finally, the problems do not stem specifically from intergovernmental cuts, although the transfers made by the state in 1993 and 1994 of what previously were county funds and the limits imposed by Proposition 13 have pressured all California counties.

What occurred is a unique disaster, and the path taken thereafter—bankruptcy—an unprecedented approach. One of the truly unique facets of the Orange County ordeal is the way in which 180 governmental units have been involuntarily drawn into the bankruptcy of both the county and the pool.

Could the county have avoided taking the enormous step of filing for bankruptcy, an action that will raise questions over the long term about its willingness to honor its obligations? The issue of whether the county might have managed the situation by negotiating with the broker-dealers and pool investors remains unresolved and probably will never be fully answered. However, through the bankruptcy filing, county officials

sent the message that they did not necessarily intend to repay all the county's obligations. In most other cases of severe municipal fiscal stress—even those involving default—the debtor continued to try to pay its obligations and did not hint at any desire to abrogate them.

Should the county and its residents take substantial steps that signal their intention to fully honor their obligations, the impact of the filing might be lessened. But, the bankruptcy is an action creditors will continue to be mindful of, as the county has demonstrated that it views bankruptcy as an option, not necessarily even an option of last resort.

INFORMATION PROVIDED

Before discussing the outlook for the county's ratings, I would like to outline some of the information county officials provided to S&P and that we relied on in assigning and maintaining the county's debt ratings. Hopefully, this will answer some of the questions asked us and clarify the record. Unfortunately, a number of outstanding questions about the pool remain that preclude a full accounting of it currently.

S&P relied—as it has always done—on the accuracy and completeness of information provided by county officials when assigning ratings to the county's debt obligations. S&P frequently discussed the pool's condition with county officials, including the chief administrative officer (CAO), the assistant CAO for finance, the assistant treasurer, and the assistant auditor/controller and repeatedly was given assurances of its underlying strength. These officials addressed the questions S&P posed and provided purportedly reliable information. Unfortunately, this information did not foretell the collapse of the pool.

Last spring, county officials told S&P the pool was leveraged from about \$8 billion to \$20 billion. They described the mismatch between the term of the reverse repurchase agreements—generally six months—and the average maturity of their securities—2.1 years leveraged to a 3 1/2-year

ORANGE COUNTY COVERAGE

ORANGE COUNTY COVERAGE

duration. They explained that they could manage the exposure this strategy introduced because of the following:

First, no early liquidation of their securities was anticipated, as 75% of the funds were invested in the pool on a mandatory basis according to state law. Based on precedent and a survey of each involuntary member, the county had determined that, on average, these funds remained in the pool for five years. Of the 25% of funds invested on a voluntary basis, 50% was expected to be on deposit for five years or more, and 30% for three to five years. County officials claimed they had a track record of forecasting cash flow needs with a 95% accuracy. The term of the deposits was, therefore, anticipated to exceed the term of the securities which S&P understood were to be held to maturity.

Second, county officials asserted their ability to manage the pool's potential exposure because of their policy of maintaining a high level of liquidity. According to the information we were given, the liquidity position of the pool ranged between \$1 billion and \$1.8 billion from the end of 1993 through September 1994. In addition to these funds, during this period, the county claimed to have between \$200 million and \$700 million of unpledged securities on hand.

Third, county officials pointed to the high credit quality of the investments, with over 75% by par value in U.S. Treasury or agency obligations.

S&P was aware that a portion of the portfolio was invested in inverse floaters and other interest rate-sensitive derivatives. Given these positions and the mismatch between the duration of the reverse repurchase agreements and the securities, S&P was concerned about the sensitivity of the portfolio to rising interest rates.

Again, in response to our questions about these issues, county officials asserted that their investment strategy was not a cause for concern. In May, they told us that collateral calls of \$300 million—or 3.8% of the value of the unleveraged investments—had occurred since January 1994. They stated that the \$700 million then held as unpledged securities would fully cover collateral calls that might ensue upon an additional 100-basis-point increase in the six-month Treasury bill rate, which was the treasurer's benchmark. Furthermore, they stated that the county could manage even a 200-basis-point increase without selling securities at a loss. Should this scenario arise, the county said, it would use some of the \$1.5 billion of liquidity in the pool and/or some portion of the \$1 billion of revenues anticipated to be received through December 1994 to satisfy collateral calls or pay down the reverse repos.

Importantly, county officials also told S&P that they planned to hedge against interest rate swings and exercise the option, upon further interest rate increases, to unwind the reverse repurchase agreements.

The county's claim that the pool could withstand interest-rate movements seemed entirely reasonable, since the 112-basis-point increase in rates from January to May 1994 had led to only

\$300 million of collateral calls.

County officials told S&P that two pools existed: the bond fund and the commingled fund. S&P understood that the former was marked to market annually, while the latter was not formally marked to market. However, the county stated that it followed a practice of meeting frequently with several broker-dealers to assess the overall posture of the pool, allowing the county to manage the pool's position actively and prudently. They also asserted that the securities would be held to maturity.

Furthermore, S&P was assured that the board of supervisors understood and approved of the investment strategy.

Unfortunately, a huge question mark surrounds the collapse of the investment pool. S&P was provided purportedly reliable information indicating that the pool could manage the six-month Treasury bill interest rate movement of 105 basis points that occurred between May and November. Had that information been reliable, today we would be enjoying the luxury of discussing the baggage handling system at the Denver Airport instead of a potential \$1.1 billion default.

THE COUNTY TODAY

The current condition of the county is very tight. The county estimates that the general fund carries a \$2 billion IOU, representing monies owed to noteholders, pool investors, vendors, and other county funds. The county also forecasts that its \$463 million discretionary budget will have a \$188 million structural budgetary shortfall for fiscal 1996.

The county has proposed a plan to address both gaps. The plan includes the following elements:

- Selling \$750 million of bonds secured by an intercept on the motor vehicle license fees (MVL) the state collects for the county;
- Issuing \$500 million of debt backed by tip fees collected by the Integrated Waste Management District for trash disposal (about \$200 million of this financing cannot be effected, according to county estimates, for one to two years, given legal considerations);
- Refinancing \$175 million of Teeter notes coming due this June and stretching the amortization for up to 25 years—an action that could free up \$60 million in reserves;
- Providing pool participants with, on average, 76% of their prebankruptcy deposits from cash and short-term securities derived from the liquidation of the pool;
- Selling about \$240 million of so-called recovery notes backed by an enhanced general fund lien. This would provide school districts that invested in the pool with 90% of their prebankruptcy deposits and all other non-county entities 80%;
- Placing before voters a referendum to increase the sales tax by one-half cent;
- Establishing asset sales and sale-lease back arrangements; and

ORANGE COUNTY COVERAGE

• Cutting the discretionary portion of the general fund by around \$207 million, or 45% of its pre-bankruptcy levels.

The county also is pursuing legislative changes that might ease the cost of funding state mandates.

If it is fully enacted, the plan would raise \$1.4 billion from bonds—or \$1.2 billion over the next nine months—of which the county would receive just over \$1.1 billion in net proceeds. Assuming the successful sale of the bonds over the next nine months, county officials have stated that their first-priority payments among the \$2 billion of debts is to cover the shortfall of \$430 million due to noteholders and the estimated \$342 million owed to pool participants on a secured basis. Unfortunately, this statement must be heard in connection with the county's earlier and recently reiterated threat to challenge the constitutionality of its \$600 million of taxable notes in order to "legally default" on them. As I mentioned before, proceeds also would be dedicated to refunding the \$240 million of recovery notes, which the county hopes to monetize this spring. These three obligations add up to \$1 billion, close to the \$1.1 billion the county expects to receive on a net basis from bond sales. This leaves \$100 million to cover a gap of \$785 million for amounts due vendors, county losses in other funds and the subordinated repayment claims of pool members.

The county expects the sales tax increase to yield \$130 million per year, but only about \$60 million of these revenues would be available to pay the remaining claims; the net amount of the sales tax yield simply plugs the gap created by pledging the MVLF revenues to debt service on the expected \$750 million financing. For full repayment of all its IOUs, county officials are relying on litigation settlements, asset sales and other miscellaneous potential revenue sources.

The county estimates that asset sales and sale-leaseback financings could yield about \$100 million from the proposals that could be implemented with any certainty. Over the past few days, there has been more discussion about ceding ownership of the John Wayne Airport to the county transportation authority in exchange for financial assistance to the county of about \$200 million, on a net basis. We will evaluate the proposal with an eye to understanding what, if any, impact the transfer might have on airport bonds, the transportation authority's debt, and the compliance of the airport with FAA regulations.

THE PLAN'S VIABILITY

How achievable is this plan?

First, it requires many parties to cooperate. The state legislature has to amend current law to allow the stretching of the Teeter notes and possibly sign off on environmental permitting for the imposition of higher tip fees. County officials also believe the state must enact legislation strengthening the intercept mechanism to attract potential buyers of the MVLF-backed bonds. County officials hope that these legal changes will be adopted this spring.

Others who must cooperate include noteholders. The county does not believe it can issue the MVLF bonds unless the voters approve the sales tax increase on June 27 because of the ramifications for the general fund. They also do not believe they can sell the solid waste system bonds until the environmental permitting issues are settled. These factors push the timing of these bond sales past the note due dates and probably into fall or winter.

The county believes its current resources for repaying noteholders are short by \$430 million and asserts its inability to cover this gap without proceeds from the proposed long-term debt issues. For these reasons, the county has proposed extending the note maturities by a year and is trying to obtain the consent of its noteholders.

Other key players include county residents and the board of supervisors. A majority of county voters must approve the sales tax hike before it can be implemented. The adoption of the increase appears far from certain. For their part, the board still must adopt the tip fee adjustment, which increases these fees to \$35 per ton from \$22.75. This increase only covers debt service on \$300 million of debt, not the \$500 million described previously.

The second step, and a painful but necessary one to allow for the full \$500 million of bonds, requires the county to change laws to allow trash to be imported into the county. This is likely to be controversial, especially in the three cities where the landfills are located.

The board also has to enact the dramatic cuts necessary to balance the fiscal 1996 budget. The \$40 million of cuts made in fiscal 1995 have not yet been realized, although operating departments are optimistic about achieving their targets. Cuts of the magnitude required for fiscal 1996 will lead to significant losses in health care, public protection, and court- and library-related services among others. The significant spending reductions, especially in health care, result in losses of state and federal matching aid, amplifying the effective reductions. Whether these cuts are sustainable and ultimately acceptable remains to be proven. It is important to note that, even before the bankruptcy, the county's general fund operations were considered "lean" and overstaffing was not an issue.

Other participants critical to the plan are pool investors. It appears that the county will receive a quorum agreeing to the plan, but only if it can monetize the \$240 million of recovery notes by June 5. This requires the cooperation of the state, the public markets, other pool participants, or perhaps some combination of the three.

S&P'S VIEW

How does S&P view the plan? Naturally, we hope it is successfully adopted and implemented. Details on the financing structure for the bonds are sketchy; however, we would consider it essential that debt security provisions shield bondholders from the tremendous problems of the general fund in order to consider assigning in-

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vestment-grade ratings to future financings. General fund resources are terribly strained and probably will remain that way for some time. Competition for these limited resources will be great for a number of years.

Given the county's recent unwillingness to honor bond covenants, we are hard pressed to assume—as we might in other instances—that the county will honor its obligations to bondholders if difficult decisions about allocating monies becomes necessary, as is likely. A demonstrated lack of willingness to pay on the part of the county is a problem that will influence our evaluation of

the county's creditworthiness for a long time.

Furthermore, to create a potentially creditworthy obligation, the repayment revenue stream to bondholders must be bankruptcy-proof. Any security for the bonds must survive a subsequent bankruptcy without the possibility that an automatic stay could disrupt the flow of funds to bondholders. Again, it would be naive to assume that, once out of bankruptcy, the county would never again choose that option should tough times arise.

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ORANGE COUNTY POOL MEMBERS: VICTIMS OR ACCOMPLICES?

The following is an excerpt from a speech Steve Nelli, a director in S&P's Public Finance Department, delivered on April 12, 1995 at a conference on Orange County in San Francisco.

There are two broad ways to view Orange County investment pool participants:

- As innocent victims of the county's mistakes, or
- As willing participants who should rightly share in the blame and the losses.

Your view (which, realistically, can include a mixture of both perspectives) depends on whether you believe the participants received sufficient ongoing disclosure from the county to make informed investment decisions. Ultimately, all of our opinions will be determined by the outcomes of the ongoing local, state, and federal inquiries and law enforcement investigations into the collapse of the investment pool.

While it may still be too early to determine levels of responsibility, it's certainly not too early to evaluate the credit implications of the post-bankruptcy actions of the 57 S&P-rated pool participants. In general, S&P has been impressed by the rated participants' willingness to make tough decisions and desire to honor their contractual obligations. Furthermore, the rated participants, in conversations with S&P, have unanimously expressed an understanding that investors could impose short- and long-term risk penalties on them should they default. As a group, they have expressed a desire to avoid such a situation.

The participants easily could have blamed the county and crafted a rationale for defaulting on their obligations, or even worse, filing for bankruptcy protection. To their credit, none have expressed a desire—unless forced as a last resort—to use these options. The participants, instead, have sought solutions to their liquidity problems, including legislation in Sacramento, lines of letters of credit, and voluntary debt restructurings.

Default and bankruptcy are not the options of choice for the rated participants, and this should be reassuring to the debt market. The jury is still out on the "desirability" of bankruptcy as an option (particularly early on in the problem) for distressed credits, and the outcome in Orange County probably will influence future municipal

decisions. The key will be whether the county and its elected officials appear to benefit both immediately and in the long run from taking this bold step. Thus far, it does not appear that the pool participants desire to emulate the county's actions.

DISTRIBUTION PLAN

The county and the pool participants have reached a tentative agreement to distribute cash by mid-June. This will improve the likelihood of debt repayment by the participants. For most, the improvement in credit quality will be dramatic.

However, even if the plan is implemented fully, there could be problems for certain issuers in repaying all their obligations in full and on time. The problem credits will likely be entities with extremely large short-term debt transactions maturing in the summer. Restructurings and supplemental sources of liquidity could be necessary to avoid defaults for these issuers.

Participants have varying degrees of exposure to both ultimate principal losses and the liquidity strain caused by the bankruptcy court's freeze on pool assets.

The degree of exposure is largely determined by the interplay of four key factors:

- Level of cash and securities held outside the pool,
- Timing of debt service payments, particularly TRAns,
- Alternative sources of liquidity, and
- Revenue and expenditure flexibility.

Now, let us examine these factors as they apply to different types of issuers.

Cities. Rated cities vary widely in their pool exposure and creditworthiness. For instance, Anaheim, Irvine, and Placentia all have significant taxable note, TRAN, and COP transactions outstanding. However, Anaheim held only 20% of its cash and investments in the pool at the time of the bankruptcy filing, while Irvine (66%) and Placentia (91%) had most of their assets invested in the pool.

Anaheim, which recently was able to retire its taxable notes, has had its G.O. rating affirmed at 'AA', although it remains on CreditWatch with negative implications. However, its G.O. rating,

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- The contract requires Florida to meet debt service, and the state further recognizes that Standard & Poor's rating on the outstanding certificates reflects the creditworthiness of the state as an obligor, not just the limited contractual relationship between the state and the corporation;
- The state will have personnel at the facility to monitor the daily operations of the prison, which should reduce the risk that the privately operated prison will be run significantly differently from a public facility;
- The facility is, technically, a state prison and is simply being operated privately, which makes the state liable for meeting operating standards. This is very different from the normal privatization model, where prisoners are sent to an entirely private prison and the corporation—not the government—is responsible for meeting health and safety standards;
- The state is responsible for maintaining insurance on the facility, and, if damage occurs, investors should be protected with either an early redemption with insurance proceeds or

through annual lease payments if proceeds are used to repair the facility; and

- The state Department of Corrections retains the right to step in and operate the prison, should it be unsatisfied with the private management; therefore, with or without the private manager, the legislative appropriation for the facility should be in place to protect investors.
- The Florida example demonstrates how a government can privatize services and still offer investors sufficient protections to achieve an investment-grade rating. Such protections should lower costs by enabling the corporation to borrow construction funds at the government's lower cost of capital. The government, however, must realize, that it will have to take on more risk than it might in a typical per diem privatization. Investors, likewise, should be careful, as the riot at the Elizabeth facility demonstrates the inordinate amount of risk that can lurk in securitized private leases, compared with typical municipal financings.

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CALIF. COUNTY POOL EVALUATION SUMMARIZED

After examining 25 California county investment pools in the wake of Orange County's bankruptcy filing, Standard & Poor's has found that 13 do not satisfy its guidelines for investment of municipal operating funds. This is due to the pools' degrees of leverage, use of derivatives, and their portfolios' average maturities of more than a year.

Although it does not rate the pools, Standard & Poor's believes the pools' liquidity and risk levels are important factors in rating the issuers that participate in them. Rating actions for the counties and pool investors are not warranted at this time, because the cash flow projections for the pools suggest that they possess sufficient liquidity to meet normal operating requirements for all their participants without selling securities at a loss before maturity. However, the evaluation does not suggest that these pools are protected from future investment losses.

All of these pools include largely mandatory participants, and the counties have indicated that the risk of withdrawals by voluntary participants is remote. In addition, several pools have reduced their exposure to derivatives and reverse repurchase agreements (reverse repos) and improved their liquidity positions since Standard & Poor's examined them a few months ago. The drop in interest rates from the beginning of 1995 to May 31, 1995 also helped several of the pools recover their losses.

Some of the counties, such as San Diego, have taken advantage of the falling rates by selling part of their structured notes without realizing any losses. However, for pools that deviate significantly from the published guidelines, Standard &

Poor's will continue to monitor the pool's performance and cash position in light of the impact of the potential movements in interest rates on the pool and cash flow needs of participants.

Investment pool review summaries for Alameda, Contra Costa, Fresno, Kern, Monterey, San Luis Obispo, Santa Barbara, Solano, Sonoma, and Ventura were published in the June 12, 1995 *CreditWeek Municipal*; the San Diego County pool summary was published in the June 5, 1995 *CreditWeek Municipal*; and pool summaries of Los Angeles, Riverside, Sacramento, and San Bernardino counties were published in the June 19, 1995 *CreditWeek Municipal*.

POOL REVIEW METHODOLOGY

The pools were reviewed by analysts in the Public Finance Department to see if they met Standard & Poor's published guidelines for investment of operating funds. Pools that significantly exceeded Standard & Poor's guidelines were further scrutinized by the Managed Funds Department to assess their vulnerability to interest rate changes.

A pool is considered to meet the guidelines if:

- The weighted average maturity of the portfolio is less than one year;
- The pool has adequate liquidity to meet the projected cash flow needs of the voluntary and mandatory participants;
- The pool's exposure to reverse repurchase agreements, securities lending programs (see box), and other forms of leverage is less than 20% of the portfolio and reverse repos are

CREDIT COMMENTS

used to meet unexpected cash flow needs. If reverse repos are used to enhance yield, the proceeds should be invested in high-quality securities whose maturities match the term of the reverse repos. Similarly, the cash collateral received from lending securities should be invested in high-quality securities whose maturities match the term for which the securities are lent;

- The pool has little or no exposure to risky structured notes—such as inverse floaters, range notes, and dual index notes—and risky mortgage derivatives—such as interest-only and principal-only strips, inverse floater tranches, and residual tranches of CMOs;
- The pool is limited to high-quality securities; and
- The pool's management is fully aware of the investment policy and the portfolio risks and the pool's investments are marked to market more frequently than once a year (preferably once a month). This is less of a concern if the portfolio is very short.

INVESTMENT GUIDELINES

Twelve of the 25 pools reviewed are conservatively invested and meet Standard & Poor's operating fund investment guidelines. They are the Contra Costa, Fresno, Los Angeles, Madera, Merced, Mono, Santa Barbara, Santa Clara, Santa Cruz, San Luis Obispo, San Mateo, and Ventura

SECURITIES LENDING PROGRAM

Several county pools in California engage in securities lending programs to earn incremental returns on their portfolios. Examples of pools that have engaged or currently engage in securities lending are those of Sonoma, San Diego, Sacramento, and San Mateo. Sacramento discontinued its securities lending program as of June 12, 1995, and San Diego is in the process of ending its program.

Under the securities lending program, treasury and agency securities owned by the county pool are lent to a broker/dealer through an agent bank. The borrower of the securities posts cash, securities, or LOCs as collateral. The collateral typically is 102% of the market value of the lent securities.

The transaction is terminated when the borrower returns the securities to the lender or the lender recalls the securities from the borrower. The most common form of securities lending is where cash is posted as collateral by the borrower. During the term of the loan, the lender or the county has the use of the cash collateral. The county's agent bank invests the cash by purchasing other securities. For the use of cash the county or the lender pays a rebate (typically equal to money market rate of return on the cash minus lending fees) to the broker/dealer.

The county profits if its agent bank invests the cash collateral and earns a rate of return higher than the rebate. The profit typically is split between the agent bank and the county.

county investment pools. The Riverside, San Francisco, Sacramento, Butte, and Humboldt county pools generally meet Standard & Poor's guidelines but have average portfolio maturities longer than one year. They do not have any exposure to derivatives or reverse repos, and they have demonstrated that they have adequate liquidity to meet the operating cash flow needs of their participants. The Kern County investment pool also generally meets the guidelines, with a weighted average maturity of 271 days, but it has approximately 16% of its assets invested in structured notes.

The remaining seven pools deviated significantly from Standard & Poor's guidelines and have exposure to derivatives, reverse repos, or both, and their average portfolio maturities are longer than one year. These are the investment pools of San Diego, Solano, Sonoma, Placer, Alameda, San Bernardino, and Monterey counties.

CASH FLOWS

Projected monthly cash flows for each of the pools that deviated significantly from Standard & Poor's investment guidelines were examined. The cash flows for all of the pools indicate adequate liquidity. The cash flows demonstrate that, barring any unexpected or unreported disbursements, all of the pools have the ability to meet disbursements related to normal operating ex-

However, rewards do not come for free; securities lending programs have risks. Programs in which cash is received as collateral and is reinvested are similar to reverse repurchase agreements. As in reverse repos, the county is exposed to market risk and collateral call risk. The county must return the cash collateral at termination of the transaction. If the cash is invested in longer-term or lower-quality securities, the market value of the reinvestment may fall below that of the cash collateral if interest rates move up or the credit quality of the securities deteriorates.

This risk can be mitigated largely by investing the cash in high-quality securities that have the same maturity as the term of the securities loan. In addition, the securities that are lent are marked to market daily. If the lent securities decline in value, some of the cash collateral would have to be returned by the county.

The county also is exposed to counterparty credit risk. The borrower may be unable to or unwilling to return the securities to the county. The county, however, has the right to close out a loan in default. The county can take control of the collateral and buy securities in the open market. The county suffers losses if the collateral is not sufficient to buy back securities with similar characteristics as the lent securities. The county becomes a general unsecured creditor of the failed broker/dealer.

This risk can be mitigated by limiting the securities loans to high-quality counterparties.

CREDIT COMMENTS

Calif. County investment pool statistics

County	Valuation date	Book val (mil \$)	Market value (mil \$)	Wtd avg mat (days)	% in liq assets (maturit less than 90 days)	Lev (% of port)	Derivatives (% of port)	Type of derivatives	Mand part	Analyst
Alameda	4/28/95	1,223.9	1,174	556	44.3	0.0	30.0	Step-up & inv fltr	100	S. Schaffer (415) 765-5020
Butte	5/31/95	156.2	157.0	450	41.9	0.0	1.2	Inv fltrs	95	D. Fisher (212) 208-1358
Contra Costa	3/31/95	829.0	820.0	306	53.0	0.0	13.0	Inv fltrs step-ups	80	D. Brosen (212) 208-1811
Fresno	3/31/95	949.9	932.9	269	43.7	0.0	0.0	n a	100	J. Ing (415) 208-8791
Humboldt	5/25/95	133.3	134	863	21.4	0.0	0.0	n a	83	D. Fisher (212) 208-1358
Kern	4/30/95	852.8	841.4	271	53.0	0.0	16.0	Struct notes	90	S. Schaffer (415) 765-5020
Los Angeles	4/30/95	7,098.0	7,063.2	240	62.7	0.0	11.8	fltrs & step-ups	70	C. Irwin (415) 765-5010
Madera	5/17/95	97.0	97.0	400	50.0	0.0	4.1	fltrs	80	C. Irwin (415) 765-5010
Merced	5/31/95	159.3	159.3	167	65.5	4.0	7.0	Inv fltrs	97	C. Irwin (415) 765-5010
Mono	4/30/95	6.5	6.5	306	75.3	0.0	0.0	n a	100	C. Irwin (415) 765-5010
Monterey	5/11/95	544.0	528.6	858	30.0	50.0	38.0	Inv fltrs step-ups	100	S. Schaffer (415) 765-5020
Placer	4/30/95	441.3	421.5	749	26.6	18.0	72.0	Inv fltrs, fltrs, step-ups	95	R. Chun (212) 208-8509
Riverside	4/28/95	1,430.0	1,401.0	615	15.4	0.0	1.1	Inv fltrs	86	D. Stone (415) 765-5016
Sacramento*	5/31/95	1,231.8	1,214.8	655	47.4	0.0	0.0	n a	99	D. Stone (415) 765-5016
San Bernardino	5/31/95	2,130.4	2,054.3	685	41.8	19.8	22.8	Fltrs	96	R. Chun (212) 208-8509
San Diego*	4/30/95	2,950.2	2,725.0	938	23.0	21.7	23.0	Inv fltrs, yield curve rts	73	J. Thiemann (415) 765-5006
San Francisco	4/30/95	1,471.4	1,464.5	772	26.5	0.0	0.0	n a	100	J. Thiemann (415) 765-5006
San Louis Obispo	4/1/95	232.6	235.9	132	30.0	0.0	0.0	n a	100	T. Eng (415) 765-5019
San Mateo*	5/11/95	522.7	520.7	329	32.3	61.0	0.0	n a	75	T. Eng (415) 765-5019
Santa Barbara	5/1/95	417.9	418.2	310	24.5	0.0	0.0	n a	95	T. Eng (415) 765-5019
Santa Clara	4/30/95	1,304.0	1,300.0	247	44.0	0.0	5.4	Step-ups	88	R. Chun (212) 208-8509
Solano	5/1/95	285.1	272.9	1131	15.8	31.0	54.0	Inv fltrs	100	D. Stone (415) 765-5016
Sonoma*	4/28/95	705.0	681.3	748	17.3	5.6	49.7	Inv fltrs, dual index	94	T. Eng (415) 765-5019
Ventura	4/30/95	773.9	782.3	212	35.3	0.0	0.0	n a	96	S. Ulinski (212) 208-1765
Total		25,987.0	25,496.0	472	40.5	7.3	14.1		79	

*Leverage for San Diego, Sacramento, and San Mateo is due to securities lending programs. Sacramento unwound its securities lending program as of June 12, 1995. San Diego is in the process of unwinding its program. San Mateo mitigates the market risk associated with securities lending by investing the cash collateral in overnight repos. Sonoma has 43% of its securities lent out, but the county takes other securities instead of cash as collateral from its counterparty and market risk is therefore borne by the counterparty. However, Sonoma is exposed to the counterparty risk. NA—Not available; n a—Not applicable.

of their participants without selling the securities prior to maturity and realizing any losses. The cash inflows of the pool typically include tax collections, state appropriations, TRAN proceeds, other revenues of the county, maturing investments in the portfolio, and interest income generated by the portfolio. The cash disbursements typically include normal operating expenses such as payroll and maintenance expenses, note payments, and debt service payments.

POOL PARTICIPANT COMPOSITION

The investment pools typically hold operating funds of the county, school districts, special districts, cities, pension plans, transportation authorities, and other local entities. Mandatory participants are those mandated by California state statute to invest their operating funds with

the county treasurer. Mandatory participants in each of the pools typically include the county, the school districts, the county agencies, and special districts under the jurisdiction of the board of supervisors. The higher the mandatory participation the lower the risk of a run on the pool's assets.

All of the pools reviewed show that mandatory participants account for between 70% and 100% of the portfolio, which reduces the risk of the participants pulling their money out on a wholesale basis. The voluntary participants generally include cities, community colleges, and agencies and special districts not under the board of supervisors' jurisdiction.

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COLORADO SUPREME COURT RULING FAVORS BONDHOLDERS

The Colorado Supreme Court's ruling on June 19, 1995, affirming the December 1993 Arapahoe County District Court decision in favor of Littleton School District, is an important victory for all Colorado municipalities with outstanding G.O. bonds issued before passage of Amendment 1, and for secondary market buyers and sellers of those bonds. The ruling has significance for the Colorado municipal bond market because it upholds the right of municipalities to increase prop-

erty tax millage rates to pay debt service on G.O. bonds issued before Amendment 1.

Standard & Poor's has waited for final court rulings to clarify the impact of Amendment 1 on G.O. debt since the amendment passed in a statewide election on Nov. 4, 1992. No rating changes will result from the Littleton decision because its effect is to affirm the right of Colorado municipalities to levy unlimited taxes for payment of debt service on G.O. bonds. If the supreme court

TESTIMONY

submitted by

ROBERT DEAN POPE
Hunton & Williams
Richmond, Virginia

regarding

**Effects of the Orange County Financial Crisis on
Municipal Debt Market and Local Government Borrowing**

to

**Subcommittee on Capital Markets, Securities, and
Government Sponsored Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives**

July 26, 1995

Statement Submitted by Robert Dean Pope, July 26, 1995

Mr. Chairman and members, my name is Dean Pope. I am a partner in the Richmond office of the law firm of Hunton & Williams. I have practiced municipal finance law for more than 20 years. While my practice has been primarily centered in the Southeast, I have had considerable exposure to the problems that this Subcommittee is addressing today at the national level through my participation in the activities of the National Association of Bond Lawyers, as a member of the Anthony Commission on Public Finance, and as an advisor to the Committee on Governmental Debt and Fiscal Policy of the Government Finance Officers Association.

Summary. My testimony today reflects a belief that Orange County should not create a crisis in the municipal bond market. It will also address (1) the changes in recent years in the municipal bond market, (2) the growth of "subject to appropriation" and other types of obligations that are not traditional "full faith and credit" indebtedness, (3) the current state of disclosure to investors in the public finance area, (4) the limits of state statutes governing investment of public funds, (5) the status of "full faith and credit" obligations and the security they offer investors and (6) the importance of the states in protecting the integrity of the municipal bond market. It will reflect a belief that, with few exceptions, the issues raised by Orange County's problems are not federal issues and must be solved by Orange County and the State of California.

The Reaction To Orange County. The issues addressed by these hearings are of course complicated by the very nature of the federal system. We have 50 states with different public finance laws, each with multiple statutes governing cities, counties, towns, special districts and other governmental entities. Accordingly, generalizations on the law of public finance are suspect. There are, however, certain general principles both of law and of practice that are common to state and local governments in this country.

Everyone involved in public finance is concerned about Orange County and the reaction to it among the public, investors and regulators. Orange County raises important questions that often have been overlooked. The current answers to these questions, however, I believe, are generally reassuring. There are plenty of problems in the municipal bond world. Some of them relate to Orange County; some do not. There is, however, no great crisis in the

integrity of municipal bonds. If public officials and private investors show good judgment, there is no reason for there to be any such crisis. That is not to say that Orange County may not create costs for all local governments, especially in the short run, and especially in California. Orange County's problems obviously will create costs for itself and its citizens both now and in the future.

At least one of the problems raised by Orange County relates to an issue that is properly the concern of the Federal government, the issuance and sale of securities in the national securities markets. Many questions, however, are not matters of concern to the Federal government and are best solved by the states and localities. Orange County, by and large, is not a problem for the federal government to try to solve.

The Subcommittee has asked for information in particular on the effect of the Orange County crisis on general obligation bonds. Again, with the laws of 50 states applicable, there is no uniform description of a general obligation bond, but customarily it is a pledge of the locality's "full faith and credit" to prompt payment. It is the gilt-edge of municipal securities. Certainly in the part of the country where I practice law, I sense no negative reaction to general obligation credits as a result of Orange County. Investors still quite properly rely on the general obligation promise to pay as being the strongest that a local government can give and one upon which a local government defaults at its considerable peril.

The Modern Municipal Bond Market. I will return to the subject of general obligation bonds, but frankly I am more concerned about the other kinds of bonds in the municipal bond market than I am about general obligation bonds. Many people have not focused on how much the municipal bond world has changed in recent decades. Thirty years ago the entire universe of municipal bonds was reassuringly dull. By then the defaults of the 1930s, old-fashioned credit failures reflecting hard times, were gone. Most bonds were general obligation debt and most revenue bonds were secured by traditional governmental revenue-producing facilities such as water systems. Banks were substantial investors in the bonds of the localities they knew so well. Local governments were restrained by conservative investment bankers and by state laws that dramatically limited the ability of local governments to borrow money.

Over recent decades, the demand for new public services and especially the remarkable creativity of bankers, lawyers and financial advisors have multiplied many times the size and complexity of the municipal bond market.

Accordingly, investors must realize that the fact that a security is called a "municipal bond" provides little assurance as to what it really is or how credit worthy it is. I am still struck by how many people believe that anything called a municipal bond is a sound and suitable investment for anyone. Municipal bonds range from the thrice triple-A rated bonds of the Commonwealth of Virginia to unrated junk bonds secured solely by start-up retirement facilities not yet built.

Subject To Appropriation Debt and Moral Obligations. One particularly worrisome area is the huge increase of local government obligations that are not, legally speaking, indebtedness. I am referring to a variety of financing forms sometimes known as moral obligation bonds, "subject to appropriation bonds" and other arrangements in which the borrowing governmental entity does not pledge its "full faith and credit" and indeed does not technically incur debt, i.e., a binding obligation to pay in the future. Many of these obligations are sold in the form of tax-exempt certificates of participation or "COPs," giving the investor an undivided interest in a lease under which a municipal government is obligated, more or less, to make lease payments that will pay principal and interest on the COPs.

Here, as always in municipal finance, the complexity of state law makes generalization difficult. In at least one state, lease obligations are, almost, the equivalent of a general obligation, and in several states they are treated as debt subject to state law restrictions on its incurrence. Their enforceability may vary greatly.

But the following generalization is accurate in many cases. The locality wishes to borrow to finance a project. Traditional debt is either legally impossible because of debt limits or politically impossible because it requires a referendum or other approval that cannot be obtained in the current political environment, an environment in which voters regularly reject most proposals for more local government debt. So a lease or other arrangement is undertaken; the bonds or certificates of participation are not direct obligations of the locality but are payable from lease payments, which are normally subject

to annual appropriation. Because future city councils or county boards in theory can choose not to appropriate, the obligation is not "debt" and therefore not subject to the range of restrictions most states put on local government debt, restrictions designed precisely to keep local governments from getting in over their heads financially.

Some of these transactions have been undertaken for appropriate reasons. Others have been undertaken for the sole purpose of avoiding the debt limitations that are designed to prevent imprudent borrowing. In some cases these financings have been undertaken even after the voters have specifically turned down proposals to finance the project in question with traditional general obligation debt. This is part of a broader problem for local governments throughout the country. The public in general is reluctant to approve the borrowing for capital projects that elected officials in general regard as necessary.

There are several results of this practice of incurring debt that is not legally debt. One is that the projects end up costing the public more because of higher interest rates. The rating agencies have usually rated "subject to appropriation debt" one full credit rating below that of the general obligation credit of the borrower. Billions of dollars of these obligations have been sold. There is no simple way to describe them. Some involve meaningful credit pledges to protect the bondholder, including mortgage security and other direct obligations of the issuer that, while not long-term debt, may be enforceable for the benefit of bondholders. Some may be convertible in certain circumstances into a current legal obligation of the borrowing municipality to pay the debt. Others rely exclusively, or almost exclusively, on the belief that no local government would be foolish enough to exercise its legal right to walk away from its nonbinding obligations because such an ill-judged action would undermine its bond rating and therefore its ability to borrow at attractive rates. Several years ago a major municipal issuer came very close to defaulting on its COPs, i.e., exercising its legal right not to appropriate debt service payments. After much publicity and wailing and pressure from investors and rating agencies, the issuer made the decision to make the payment. After a brief blip, the market moved on as if the risk were gone.

This may be a time bomb ticking away in the municipal market. While most state and local governments that have used "subject to appropriation" debt

have not done so in amounts that threaten their creditworthiness, the protection of state laws on debt, the primary bulwark against reckless borrowing, is missing. It is true that both the bond market and the rating agencies exercise discipline over this process by taking into account such "non-debt debt" in credit evaluation. My home state of Virginia imposes strict rules on its use of such obligations. But what will happen when a municipality in financial difficulty has insufficient funds to pay all its "non-binding obligations" in addition to its general obligation indebtedness and the cost of essential public services? It is not difficult to guess what choices will be made.

A series of defaults on these kinds of obligations could quickly eliminate or substantially reduce the ability of localities to use this particular mode of financing. It also could create investment losses for thousands of investors who already own such securities. I am not suggesting that this will happen. I am not suggesting the state governments should eliminate this option entirely. I am suggesting that states should consider carefully what risks are created and what controls are appropriate. And investors should read carefully exactly what is behind the obligation to pay in such cases. Current practice suggests a disturbing gap between what local government officials believe is the appropriate level of borrowing and what state law or political reality permits. This in turn suggests that states ought to rethink the effectiveness of their restrictions on local government debt. Modifications may be in order both to encourage approval of appropriate borrowings and to eliminate or control financings that constitute evasion of state restrictions on debt. These decisions should not be made in Washington.

Disclosure. The disclosure of the special risks of municipal bonds to the national securities markets is a legitimate federal issue. Disclosure in the offering of municipal bonds has changed dramatically during my career. Practices 20 years ago reflected the perceived absence of risk and the simplicity of the market. Today, in my experience, most initial offering documents for municipal bonds provide thorough and complete disclosure on the credit and risks involved. The most nagging concern in recent years has been the unavailability of information in the secondary market, a subject that has been tackled directly by the Securities and Exchange Commission in the new provisions of Rule 15c2-12. These provisions will have a profound effect on municipal disclosure. While I cannot say that I approve of every provision of new Rule 15c2-12, most people involved in public finance are grateful and

relieved that the Securities and Exchange Commission and its staff have done such a thorough and conscientious job in attempting to understand the peculiarities of local government finance and to draft regulations that take into account those peculiarities.

That is not to say that the new rules do not create real costs, especially for smaller political subdivisions. They do, and in the minds of many local government officials, the new rules are yet another unfunded federal mandate. There will be problems in the implementation of the new system.

These new requirements should be given time to work in terms of the particular problem they address, i.e., the continuing availability of information to the market on existing municipal credits. It is, I believe, impossible to justify new regulatory initiatives on municipal disclosure until and unless current law has been tried and found wanting. While Orange County has focused attention on the need for disclosure on the investment policies of municipalities selling bonds to the public, that attention reflects the normal and appropriate continuing analysis of what is "material" about a credit and therefore should be told to an investor. Historically, the investment policies of localities were of little concern to investors. Orange County indicates that such policies may be extremely important, but there is no need to alter the concepts of "full disclosure" and "materiality." Nothing in the Orange County saga suggests any need for changes in the federal securities laws as they apply to municipalities.

While disclosure by and large has been good and is getting better, disclosure cannot ensure that investors will read and understand what is written. It cannot ensure wise investment decisions.

The whole theory of the Federal securities laws is that people can take risks, significant risks, if those risks are properly explained. As one who has spent much of his career producing bond disclosure, sometimes remarkably grim and negative disclosure, I wonder if some investors read any of it.

Sometimes I believe we could put in bold letters in a prospectus a statement that the bonds are unlikely to ever be paid under any circumstance, and they probably still would be bought.

This problem of ignored disclosure is sometimes exacerbated by overdisclosure. Lawyers and investment bankers are understandably reluctant ever to try to limit disclosure. When in doubt, disclose it, even if the result is a prospectus 100 pages long. But the risk, as the Securities and Exchange Commission pointed out in March, 1994, is "overly detailed, legalistic, and possibly obtuse disclosure." This remains a serious problem, especially for large municipal issuers that produce massive amounts of information.

Banks in the Municipal Market. I might add in passing that one of the unfortunate aspects of the Tax Reform Act of 1986 was the provision effectively excluding banks from the market for many municipal bonds by eliminating "bank deductibility" for such bonds generally. Local banks are often especially well situated to analyze local credits and to price them appropriately. For many years they provided smaller localities access to borrowing without large transaction costs and with little risk to the market. The change in tax law in 1986 that dramatically reduced bank participation in the market for bonds may, or may not, have been good tax policy, but it clearly was not good for smaller localities and the market for their bonds. I urge this Subcommittee to consider carefully how the beneficial participation of banks in local government finance can be encouraged.

Local Government Investments. Any discussion of the broader problems of the municipal bond world should not distract us from the fact that Orange County's problems, if not unique in every respect, have little to do with the problems most localities face. Orange County, a healthy and vibrant locality, got into trouble for one reason and one reason alone, a dangerously flawed investment strategy involving hundreds of millions of dollars at risk and a related dependence on investment income to balance its budget. I know of no local government in my region facing a situation remotely comparable to Orange County. In Virginia, the ghost of Harry Byrd is alive and well in terms of government fiscal policy. While some local governments have experienced losses as the result of investments, I am not aware of any case where their basic ability to pay their debts has been materially impaired by their investment policy. By and large they are quite properly solely in the business of being a local government, borrowing, not to make money, but to provide public

* SEC Release No. 33-7049, March 9, 1994, pp. 22-23.

services, and investing, not to make up revenue shortfalls, but to protect and enhance principal.

Orange County, however, has pointed out a basic problem with the laws, which all states have, governing the investment of public funds. Orange County suggests that these state statutes (1) should be considered in light of Orange County's experience and (2) are not, and can never be, a substitute for prudent judgment.

Most of these state statutes were drafted to ensure that investment of public funds be restricted to securities with a low credit risk, i.e., obligations where the party promising to pay could keep that promise. The statutes do that. They eliminate almost all risk of failure to repay as promised. These statutes, however, generally do not protect against the special risks that Orange County took in its derivative investments, the risks, not of creditworthiness, but of interest rate volatility. In simplest terms, these statutes usually address "credit risk" but not "market risk." This is understandable. When these statutes were written, such risks did not exist in any meaningful fashion for most local governments, both because they invested only in short-term investments and because highly leveraged derivative investments did not exist, at least in a form that made them qualified investments for local governments under state law.

One of the ironies is that the high-risk derivative securities purchased by some local governments were clearly qualified investments under many state statutes governing investment of public funds because the promise to pay was a highly rated promise to pay, even if the economic value of that promise was subject to dangerous decline.

Local governments investing in derivatives faced the same temptations as private investors. While the initial exposure to derivatives might be through an appropriate investment designed to hedge a particular risk, derivatives can become addictive. The pattern is understandable. Having first dabbled in derivatives to hedge a particular investment and having, as a result, made a pot-load of money, investors, public or private, have been tempted to buy more derivatives, not for the purpose of hedging, but simply to make more money.

This temptation for local governments has been exacerbated by an undue reliance on the state law on investments, by an assumption that any investment permitted by state law was a good investment. Here again, there is no substitute for prudence. Frankly, it is difficult for me to believe that any local finance official could not understand, and should not have understood, the risks inherent in derivative investment products with extended maturities.

It may be appropriate for states to consider some amendments in these statutes to address the market risk as well as the credit risk in investments of public funds. But no statute can ever eliminate the need for local government officials to exercise sound judgment in investing the public's money. The federal securities laws and related regulations appropriately impose on those who sell investments to local governments a responsibility to determine suitability. That responsibility must be carried out in light of the sophistication and expertise of the local government. But securities dealers are rightly offended when local officials, specially charged by law with responsibility for the investment of public funds, attempt to shift all responsibility for their imprudent acts onto those who filled their order requests and acted on their specific instructions.

Regulatory overreaction is also inappropriate. Neither state nor federal regulators should make it impossible for local governments to engage in the prudent use of derivative investment products. In many cases, such investments can reduce risk. Statutes and regulations cannot micromanage the investment practices of local government. Any law that permits the desirable level of flexibility inevitably will permit the imprudent to act unwisely.

Orange County and General Obligation Bonds. While other bond defaults, such as that by the Washington Public Power Supply System, have shaken the municipal bond market generally, Orange County has raised the specter of collapsed confidence in that bluest of blue chip obligations in the municipal market, the general obligation or "full faith and credit" bond. It is my understanding that the Orange County obligations in question are in fact not traditional full faith and credit obligations secured by taxing power, but they are apparently close enough to raise fears. And while I am no expert in municipal bankruptcy, any effort by a municipality to seek protection in bankruptcy has implications for general obligation bonds, a subject on which other witnesses will testify. Commissioner Richard Y. Roberts, who recently resigned from the

Securities and Exchange Commission, last month warned that Orange County could have a devastating effect on the municipal market by causing investors to question the sanctity of general obligation bonds.

This, of course, raises the question of what is a general obligation bond and what is its alleged sanctity. Ordinarily it is the highest promise a locality can give to its creditors. Here again we face the fact that there are 50 states, each with different laws. We also face the fact that there may be debt instruments that are treated by the market as the functional equivalent of general obligations but in fact are not. While there are differences from state to state, if you read the small print carefully, you should be able to identify a general obligation bond by its two salient features, first, a pledge of the full faith and credit of the municipality *i.e.*, of all of its available funds as opposed to a limited revenue stream, and second, an obligation to levy and collect taxes sufficient to pay the debt. This is the ultimate promise that local governments give.

By way of example, Tennessee Code Section 9-21-201 defines general obligation bonds as "those bonds in which the local government incurs a definite and absolute obligation by pledging the full faith, credit and unlimited taxing power of the local government as to all taxable property in the local government . . . to the payment of the principal of and interest on such bonds." The Tennessee statute, like many others, goes on to authorize, in Section 9-21-216, the holder of any bond by mandamus or other suit or action in court to compel local government officials to levy and collect taxes sufficient to make payment. That is the best that localities can give, and if it means what it says, it is very good indeed.

A number of states have gone even further in bolstering the security of the general obligation bonds of their localities by revenue intercept and other programs designed to ensure payment of general obligation debt. Attached hereto are descriptions of such programs in Virginia and North Carolina. They provide great comfort to municipal investors.

Bond lawyers and academics, at least, have long known that, despite the high reputation of general obligation bonds, there are practical limits to enforcing the promise of a government to pay. There has always been right much "faith" in "full faith and credit." Court cases going back to an era when

defaults were common indicate that there have always been devices for avoiding mandamus and other procedures to compel payment. Courts, even while honoring the principle of enforcement, sometimes have mitigated remedies in order to prevent hardship on the local government. We have always known that there was practical risk and that bondholders were unlikely to get paid before the police and firefighters. But courts, by and large, have made a genuine effort to enforce bondholder remedies and ensure the integrity of the pledge.

And localities have paid even in times of distress because they knew the market would remember their sins when they needed to borrow again. Officials in my home town of Richmond take great pride in recounting that, during the Civil War, the city smuggled gold through the Union lines to pay Yankee bondholders and therefore preserve Richmond's financial good name. That's the kind of behavior the bond market remembers.

Proper disclosure has always been appropriate to deal with the special risks in enforcing the debt of states and their political subdivisions. For example, in the sale of its general obligation bonds, the Commonwealth of Virginia routinely discloses that the principles of sovereign immunity and the limits on the ability of courts to force a payment by a state or an appropriation by a legislative body could limit the absolute promise of the Commonwealth. An example of this disclosure is attached. Despite the risks disclosed, the three national rating agencies rate Virginia's general obligation credit as triple A, quite appropriately, and the market essentially regards the risks described by such disclosure as not being material to the value of the bonds. Investors in general obligation bonds traditionally have assumed that these technical enforcement problems and unanswered questions about remedies create no material risk. In other words, they assume that a general obligation pledge is self-enforcing without delay. In most cases that assumption is correct.

What could happen that might result in a changing perception as to the value of general obligation credits throughout the country? This is an important question, because even a minor shift in the creditworthiness of general obligation bonds relative to other forms of public and private debt could cost local governments billions of dollars.

What could lead to this unfortunate result? One answer is a series of court decisions that go further than courts heretofore have in undermining the integrity of the "full faith and credit" pledge. The issue was fully engaged in a New York Court of Appeals decision relating to the Municipal Assistance Corporation, which was created in 1975 to assist New York City with its financial woes. In Flushing National Bank v. Municipal Assistance Corporation,* the majority found unconstitutional special state legislation that deprived holders of short-term notes of New York City of their right during a three-year moratorium to be paid when due on their "full faith and credit obligations." Under the legislation, the obligation to pay wasn't canceled; it was delayed. But the Court still said no. The court majority found a "full faith and credit" obligation an absolute promise to use in good faith the city's general revenue powers to produce sufficient funds to pay principal and interest when due. Any deviation from that, the court held, would be a violation of the pledge.

Court decisions like Flushing National Bank are one reason why full faith and credit obligations have enjoyed such broad acceptance in the market. The dissenting opinion in Flushing National Bank instead declared that the full faith and credit obligation must be subjected to a balancing act and found that a full faith and credit pledge "requires no more than that the city make a good faith effort to use its resources, credit and powers to pay its indebtedness." "This effort," the dissent argued, "must be measured in light of the city's over-all financial condition and its overall obligation to its citizens and others." While such a view may sound reasonable, it is a formula for disaster in the municipal market. Any such political and economic balancing act, taking place in an inherently political environment during time of financial stress, would destroy investor confidence. Investors inevitably will demand higher interest rates if repayment can easily be delayed or diluted in the name of public emergency by a local judge trying to balance the interest of investors with local government interests. Fortunately, I have no reason to believe that courts will make such decisions.

Orange County in fact suggests that the pressing problem with general obligation credits is not legal or even economic but political. As pointed out before, there has always been a fair amount of "faith" in "full faith and credit."

* 40 N.Y.2d 731, 358 N.E.2d 848 (1976).

There have always been opportunities for municipal borrowers, through bankruptcy or other proceedings, political and legal, to evade or delay the payment of their general obligation borrowings. Fortunately, few have ever attempted to do this. But Orange County clearly raises that concern in investors' minds. An editorial in The Financial Times on June 29, 1995, noted, somewhat sarcastically, that the "willingness of voters in Orange County to risk their municipality defaulting on its debts is a fine old American tradition." "The lesson," the editorial concluded, "is that lending decisions must now focus as much on the willingness to pay as on the ability to pay. In a nation with a strong and growing anti-tax, anti-government sentiment, willingness to pay may no longer be axiomatic."

That is perhaps an exaggerated comment, written by an editorialist who lives in England, where investors have elephant-like memories, as the State of Mississippi discovered several years ago when it found out that its ability to borrow funds in London was impaired by the fact that investors still remember Mississippi's last default -- which took place well before the Civil War. The view expressed by The Financial Times, however, should not be ignored. If Orange County remains an isolated case, the damage, while real, is likely to be limited in time and in location. If instead municipalities regularly test the limits of the law in avoiding or delaying their obligation to pay and if state governments and courts do not punish them for such transgressions, all of us will pay higher local taxes to reflect higher borrowing costs. The law may be able ultimately to make localities pay their debts. But the law alone can never ensure that payment will be prompt.

Here the role of the states will be critical. In the federal system, local governments are the creation of the states. States provide them with their powers, impose restrictions on them and control much of their money. It is the state that can impose severe discipline on localities that are tempted to avoid or delay paying what they promised. And each state has a strong vested interest in doing so because of the devastating effect of one bad apple on localities throughout that state.

So Orange County is a serious problem for the State of California. But it ought not to be a serious problem for the Commonwealth of Virginia or the State of Louisiana or the State of Alaska. Orange County also should be a reminder to investors that all municipal bonds are not created equal and that

disclosure should be read and understood. It also should encourage the local officials, financial advisors, bankers and lawyers who help prepare bond prospectuses to remember that the concepts of full disclosure and materiality must be examined constantly in light of new developments, such as risky investment policies by local governments. Orange County demonstrates that the quality and judgment of public officials are the foundations on which a locality's reputation in the bond market is constructed. Orange County is not a symbol for the deficiencies of the law, either state or federal. It is instead a sobering reminder that there is no substitute for sound decision-making by public officials.

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LIST OF ATTACHMENTS

Tennessee Code Sections on General Obligation Debt

Description of Virginia Intercept Program (Official Statement of Isle of Wight County dated May 16, 1995)

Description of Powers of North Carolina Local Government Commission

Disclosure on the security for general obligations of the Commonwealth of Virginia (Official Statement dated June 22, 1993)

TENNESSEE CODE SECTIONS
ON GENERAL OBLIGATION DEBT

(D) A brief description of the security for the debt obligation;

(E) An itemized description of the costs of issuance of the debt obligation including financial advisory fees, bond counsel fees, other legal fees, paying agent and registrar fees, trustee fees, credit enhancement fees, liquidity fees, remarketing agent fees, rating agency fees, underwriters' discount, printing and advertising fees, and other similar expenses; and

(F) A copy of the disclosure document, if any.

(2) The state funding board shall adopt by resolution a form to be used for the submission of such information. The director shall prepare an annual report to the general assembly containing information on public entity debt.

(c) Upon discovery by the public entity of a failure to timely file the information required by subsection (b), the public entity may immediately request permission from the director to permit a late filing of such information. In addition, upon discovery by the director of the failure of a public entity to file the information required by subsection (b), the director shall notify the public entity of such failure and the public entity may request permission from the director to permit a late filing of such information. The public entity may request permission for a late filing by submitting the required information. The director shall respond to the public entity within thirty (30) days following receipt of the request and shall grant the request upon a finding that all of the information required by this section has been filed with the director.

(d) The director shall maintain a current list of all public entities that have failed to respond to the director's notification of failure to file. The list of public entities who have failed to comply with the requirements of this section shall be a public record and the director shall immediately respond to any request concerning whether a public entity is currently on the list. Upon receipt of the information required by subsection (b) for any debt obligations for which such information is deficient, the director shall remove the public entity from the list and notify the public entity of its removal. If a public entity is on the director's list of public entities which have failed to comply with this section as described herein, no debt obligations may be issued by such public entity without submitting to the director all the information required by subsection (b) for any debt obligations for which such information is deficient and receiving notification from the director that such public entity has been removed from the list. [Acts 1989, ch. 402, § 1; T.C.A., § 7-53-312.]

Cross-References. Powers of corporations,
§ 48-3-308.

Section to Section References. This section is referred to in § 48-3-308.

PART 2—GENERAL OBLIGATION BONDS

9-21-201. Authorization for the issuance of general obligation bonds. — (a) Any local government is authorized to issue general obligation bonds under parts 1 and 2 of this chapter for a public works project. "General obligation bonds" mean those bonds in which the local government incurs a definite and absolute obligation by pledging the full faith, credit and unlimited taxing power of the local government as to all taxable property in the

local government or of a portion of the local government, if applicable, to the payment of the principal of and interest on such bonds.

(b) The bonds may be sold in such blocks as the governing body may by resolution determine. [Acts 1986, ch. 770, § 2-1.]

Section to Section References. This part is referred to in §§ 9-21-201 — 9-21-203, 9-21-206, 9-21-214 — 9-21-218.

9-21-202. Sale of general obligation bonds at below par value. — All general obligation bonds issued by any local government under the authority of parts 1 and 2 of this chapter shall be sold for not less than ninety-eight percent (98%) of par value and accrued interest as the governing body of the local government may direct. Nothing in this chapter shall be construed to prevent the sale of particular bonds constituting a part of a single issue or series of bonds at a price below that herein specified, as long as the total price paid by the purchaser for the entire issue or series of bonds offered for sale on any given date shall be not less than ninety-eight percent (98%) of par value of the entire issue or series of bonds and accrued interest; provided, however, if any part of such issue or series of such general obligation bonds are to be sold at a zero (0) rate of interest or at an original issue discount, such bonds may be sold at not less than ninety-eight percent (98%) of the original reoffering price of such discount bonds and accrued interest. [Acts 1986, ch. 770, § 2-2.]

9-21-203. Sale of general obligation bonds — Notices. — Any local government proposing to sell general obligation bonds under the provisions of parts 1 and 2 of this chapter is authorized to sell such bonds at a competitive public sale. The local government shall publish a notice of sale at least five (5) days prior to the date on which the bonds are to be sold, both in a newspaper having general circulation in the local government and in a financial newspaper published in New York, New York having national circulation. The notice of sale shall set forth the time, date and place of sale, the maximum amount of bonds to be sold, the maximum interest rate, the maximum discount, if any, in dollars or as a percentage of par value, that will be permitted, and the basis upon which the bonds will be awarded. Publishing a notice of sale in a financial newspaper published in New York, New York having national circulation shall not be required in any sale where the total amount of general obligation bonds to be sold is not greater than one million dollars (\$1,000,000). [Acts 1986, ch. 770, § 2-3.]

9-21-204. Sale of general obligation bonds to a state or federal agency. — If any general obligation bonds are to be sold pursuant to a commitment of a state or federal agency to purchase the same, such bonds may be sold at a private negotiated sale to the state or federal agency without the necessity of any public advertisement of the sale or of the approval of the state director of local finance. Seven (7) days before the adoption of the tax resolution, a notice of the meeting of the governing body at which such resolution

est on the bonds, shall be paid into the treasury of the local government and used to reimburse the treasury for any amounts paid out of the treasury to pay the principal of and interest on such bonds; and such moneys reimbursed to the treasury may be used, under the direction of the governing body of the local government, for any lawful corporate purpose for which taxes may be legally levied and collected. [Acts 1986, ch. 770, § 2-15.]

Section to Section Reference. This section is referred to in § 9-21-906.

9-21-216. Remedies of general obligation bondholders. — Any holder of general obligation bonds issued pursuant to the provisions of parts 1 and 2 of this chapter shall have the right, in addition to all other rights:

(1) By mandamus or other suit, action or proceeding in any court of competent jurisdiction to enforce such holder's rights against the local government, the governing body of the local government and any officer, agent, or employee of the local government, including, but not limited to, the right to require the local government, the governing body and any proper officer, agent or employee of the local government to assess, levy and collect taxes, and to fix and collect fees, rents, tolls, or other charges adequate to carry out any agreement as to, or pledge of, such taxes, fees, rents, tolls, or other charges, and to require the local government, the governing body of the local government and any officer, agent or employee of the local government to carry out any other covenants and agreements and to perform its and their duties under this chapter. No holder or holders of bonds payable exclusively from the revenues of a public works project shall ever have the right to compel the levying and collection of taxes to pay such bonds and the interest thereon; and

(2) By action or suit in equity to enjoin any acts or things which may be unlawful or a violation of the rights of such holder or holders of general obligation bonds. [Acts 1986, ch. 770, § 2-16.]

Section to Section Reference. This section is referred to in § 9-21-916.

PART 3—REVENUE BONDS

9-21-301. Authorization for the issuance of revenue bonds. — (a) Any local government is authorized to issue revenue bonds under parts 1 and 3 of this chapter for a public works project. Revenue bonds are defined as those bonds which are payable exclusively from the revenues of one (1) or more public works projects.

(b) The bonds may be sold in such blocks as the governing body may by resolution determine. [Acts 1986, ch. 770, § 3-1.]

Section to Section Reference. This part is referred to in §§ 9-21-301 — 9-21-304, 9-21-306, 9-21-308, 9-21-310.

(D) A brief description of the security for the debt obligation;

(E) An itemized description of the costs of issuance of the debt obligation including financial advisory fees, bond counsel fees, other legal fees, paying agent and registrar fees, trustee fees, credit enhancement fees, liquidity fees, remarketing agent fees, rating agency fees, underwriters' discount, printing and advertising fees, and other similar expenses; and

(F) A copy of the disclosure document, if any.

(2) The state funding board shall adopt by resolution a form to be used for the submission of such information. The director shall prepare an annual report to the general assembly containing information on public entity debt.

(c) Upon discovery by the public entity of a failure to timely file the information required by subsection (b), the public entity may immediately request permission from the director to permit a late filing of such information. In addition, upon discovery by the director of the failure of a public entity to file the information required by subsection (b), the director shall notify the public entity of such failure and the public entity may request permission from the director to permit a late filing of such information. The public entity may request permission for a late filing by submitting the required information. The director shall respond to the public entity within thirty (30) days following receipt of the request and shall grant the request upon a finding that all of the information required by this section has been filed with the director.

(d) The director shall maintain a current list of all public entities that have failed to respond to the director's notification of failure to file. The list of public entities who have failed to comply with the requirements of this section shall be a public record and the director shall immediately respond to any request concerning whether a public entity is currently on the list. Upon receipt of the information required by subsection (b) for any debt obligations for which such information is deficient, the director shall remove the public entity from the list and notify the public entity of its removal. If a public entity is on the director's list of public entities which have failed to comply with this section as described herein, no debt obligations may be issued by such public entity without submitting to the director all the information required by subsection (b) for any debt obligations for which such information is deficient and receiving notification from the director that such public entity has been removed from the list. [Acts 1989, ch. 402, § 1; T.C.A., § 7-53-312.]

Cross-References. Powers of corporations,
§ 48-3-308.

Section to Section References. This section is referred to in § 48-3-308.

PART 2—GENERAL OBLIGATION BONDS

9-21-201. Authorization for the issuance of general obligation bonds. — (a) Any local government is authorized to issue general obligation bonds under parts 1 and 2 of this chapter for a public works project. "General obligation bonds" mean those bonds in which the local government incurs a definite and absolute obligation by pledging the full faith, credit and unlimited taxing power of the local government as to all taxable property in the

local government or of a portion of the local government, if applicable, to the payment of the principal of and interest on such bonds.

(b) The bonds may be sold in such blocks as the governing body may by resolution determine. [Acts 1986, ch. 770, § 2-1.]

Section to Section References. This part is referred to in §§ 9-21-201 — 9-21-203, 9-21-206, 9-21-214 — 9-21-216.

9-21-202. Sale of general obligation bonds at below par value. — All general obligation bonds issued by any local government under the authority of parts 1 and 2 of this chapter shall be sold for not less than ninety-eight percent (98%) of par value and accrued interest as the governing body of the local government may direct. Nothing in this chapter shall be construed to prevent the sale of particular bonds constituting a part of a single issue or series of bonds at a price below that herein specified, as long as the total price paid by the purchaser for the entire issue or series of bonds offered for sale on any given date shall be not less than ninety-eight percent (98%) of par value of the entire issue or series of bonds and accrued interest; provided, however, if any part of such issue or series of such general obligation bonds are to be sold at a zero (0) rate of interest or at an original issue discount, such bonds may be sold at not less than ninety-eight percent (98%) of the original reoffering price of such discount bonds and accrued interest. [Acts 1986, ch. 770, § 2-2.]

9-21-203. Sale of general obligation bonds — Notices. — Any local government proposing to sell general obligation bonds under the provisions of parts 1 and 2 of this chapter is authorized to sell such bonds at a competitive public sale. The local government shall publish a notice of sale at least five (5) days prior to the date on which the bonds are to be sold, both in a newspaper having general circulation in the local government and in a financial newspaper published in New York, New York having national circulation. The notice of sale shall set forth the time, date and place of sale, the maximum amount of bonds to be sold, the maximum interest rate, the maximum discount, if any, in dollars or as a percentage of par value, that will be permitted, and the basis upon which the bonds will be awarded. Publishing a notice of sale in a financial newspaper published in New York, New York having national circulation shall not be required in any sale where the total amount of general obligation bonds to be sold is not greater than one million dollars (\$1,000,000). [Acts 1986, ch. 770, § 2-3.]

9-21-204. Sale of general obligation bonds to a state or federal agency. — If any general obligation bonds are to be sold pursuant to a commitment of a state or federal agency to purchase the same, such bonds may be sold at a private negotiated sale to the state or federal agency without the necessity of any public advertisement of the sale or of the approval of the state director of local finance. Seven (7) days before the adoption of the tax resolution, a notice of the meeting of the governing body at which such resolution

est on the bonds, shall be paid into the treasury of the local government and used to reimburse the treasury for any amounts paid out of the treasury to pay the principal of and interest on such bonds; and such moneys reimbursed to the treasury may be used, under the direction of the governing body of the local government, for any lawful corporate purpose for which taxes may be legally levied and collected. [Acts 1986, ch. 770, § 2-15.]

Section to Section Reference. This section is referred to in § 9-21-906.

9-21-216. Remedies of general obligation bondholders. — Any holder of general obligation bonds issued pursuant to the provisions of parts 1 and 2 of this chapter shall have the right, in addition to all other rights:

(1) By mandamus or other suit, action or proceeding in any court of competent jurisdiction to enforce such holder's rights against the local government, the governing body of the local government and any officer, agent, or employee of the local government, including, but not limited to, the right to require the local government, the governing body and any proper officer, agent or employee of the local government to assess, levy and collect taxes, and to fix and collect fees, rents, tolls, or other charges adequate to carry out any agreement as to, or pledge of, such taxes, fees, rents, tolls, or other charges, and to require the local government, the governing body of the local government and any officer, agent or employee of the local government to carry out any other covenants and agreements and to perform its and their duties under this chapter. No holder or holders of bonds payable exclusively from the revenues of a public works project shall ever have the right to compel the levying and collection of taxes to pay such bonds and the interest thereon; and

(2) By action or suit in equity to enjoin any acts or things which may be unlawful or a violation of the rights of such holder or holders of general obligation bonds. [Acts 1986, ch. 770, § 2-16.]

Section to Section Reference. This section is referred to in § 9-21-916.

PART 3—REVENUE BONDS

9-21-301. Authorization for the issuance of revenue bonds. — (a) Any local government is authorized to issue revenue bonds under parts 1 and 3 of this chapter for a public works project. Revenue bonds are defined as those bonds which are payable exclusively from the revenues of one (1) or more public works projects.

(b) The bonds may be sold in such blocks as the governing body may by resolution determine. [Acts 1986, ch. 770, § 3-1.]

Section to Section Reference. This part is referred to in §§ 9-21-301 — 9-21-304, 9-21-306, 9-21-308, 9-21-310.

DESCRIPTION OF VIRGINIA INTERCEPT PROGRAM

In the opinion of Bond Counsel, under existing law and subject to conditions described in the section herein "Tax Exemption," interest on the Bonds (1) will not be included in gross income for Federal income tax purposes, (2) will not be an item of tax preference for purposes of the Federal alternative minimum income tax imposed on individuals and corporations, and (3) will be exempt from income taxation by the Commonwealth of Virginia. Such interest may be included in the calculation of a corporation's alternative minimum income tax, and a holder may be subject to other Federal tax consequences as described in the section herein "Tax Exemption." Further, in the opinion of Bond Counsel, under existing law and subject to conditions described in the Section herein "Designation for Purchase by Financial Institutions," the Bonds will be qualified tax-exempt obligations within the meaning of Section 265(b)(3) of the Code relating to the deductibility by financial institutions of interest expense allocable to tax-exempt obligations.

NEW ISSUE/BOOK-ENTRY ONLY

RATINGS: Moody's: Aaa
Standard & Poor's: AAA
(See "Ratings" Herein)
Capital Guaranty Insured

COUNTY OF ISLE OF WIGHT, VIRGINIA
\$8,100,000 General Obligation School Bonds
Series of 1995
(Bank Qualified)

Dated: June 1, 1995

Due: July 1, as shown below

The Bonds (the "Bonds") will be general obligations of the County of Isle of Wight, Virginia (the "County"), for the payment of which its full faith and credit will be irrevocably pledged. The County Board of Supervisors is authorized and required, unless other funds are lawfully available and appropriated for timely payment of the Bonds, to levy and collect an annual ad valorem tax, over and above all other taxes authorized or limited by law and without limitation as to rate or amount, upon all locally taxable property within the County sufficient to pay when due the principal of and premium, if any, and interest on the Bonds.

Interest on the Bonds will be payable semiannually on January 1 and July 1 in each year, commencing on January 1, 1996, by check or draft mailed to the registered owner thereof. Principal of and premium, if any, on the Bonds will be payable upon presentation and surrender at the office of Citicorp Bank, Richmond, Virginia, the Bond Registrar and Paying Agent. The Bonds will be issuable only in the form of fully registered bonds, and, when issued, will be registered in the name of Code & Co., as nominee of The Depository Trust Company, New York, New York. DTC will act as securities depository for the Bonds.

Payment of principal of and interest on the Obligations when Due for Payment which is unpaid by reason of Nonpayment (as such terms are defined in the Financial Guaranty Bond) will be guaranteed by a Financial Guaranty Bond to be issued by Capital Guaranty Insurance Company simultaneously with the delivery of the Obligations.



Bonds maturing on or before July 1, 2005, are not subject to redemptions prior to maturity. Bonds maturing on or after July 1, 2006, are subject to redemptions prior to maturity at the option of the County on or after July 1, 2005, in whole or in part at any time at prices determined as set forth herein.

The Bonds will be dated June 1, 1995, and will mature on July 1 in years and amounts as follows:

AMOUNTS, MATURITIES, INTEREST RATES AND YIELDS OR PRICES

Yr	Amount	Rate	Yield or Price	Yr	Amount	Rate	Yield or Price
1996	\$ 150,000	4.18 %	100.000 %	2005	\$ 400,000	5.00 %	99.604 %
1997	200,000	4.25	100.000	2006	400,000	5.125	99.786
1998	200,000	4.40	100.000	2007	500,000	5.20	99.552
1999	250,000	6.10	105.903	2008	350,000	5.30	99.528
2000	250,000	6.10	106.959	2009	350,000	5.40	99.507
2001	250,000	6.10	107.601	2010	700,000	5.50	100.000
2002	300,000	6.10	108.035	2011	800,000	5.50	99.467
2003	400,000	6.10	108.272	2012	900,000	5.50	98.906
2004	400,000	4.90	99.633	2013	900,000	5.60	99.432

The Bonds are offered when, as and if issued and received by the Underwriters, subject to the approval of validity by Hunton & Williams, Richmond, Virginia, Bond Counsel to the County. It is expected that the Bonds will be available for delivery through the facilities of The Depository Trust Company, New York, New York, on or about June 1, 1995.

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

The date of this Official Statement is May 16, 1995.

The County has no responsibility or obligation to the Direct or Indirect Participants or the Beneficial Owners with respect to (A) the accuracy of any records maintained by DTC or any Direct or Indirect Participant; (B) the payment by any Direct or Indirect Participant of any amount due to any Beneficial Owner in respect of the principal of and premium, if any, and interest on the Bonds; (C) the delivery or timeliness of delivery by any Direct or Indirect Participant of any notice to any Beneficial Owner that is required or permitted under the terms of the Bond Resolution to be given to Bondholders; or (D) any other action taken by DTC, or its nominee, Cede & Co., as Bondholder, including the effectiveness of any action taken pursuant to an Omnibus Proxy.

So long as Cede & Co. is the registered owner of the Bonds, as nominee of DTC, references in this Official Statement to the Owners of the Bonds shall mean Cede & Co. and shall not mean the Beneficial Owners, and Cede & Co. will be treated as the only Bondholder of Bonds for all purposes under the Bond Resolution.

The County may enter into amendments to the agreement with DTC or successor agreements with a successor securities depository relating to the book-entry system to be maintained with respect to the Bonds without the consent of Beneficial Owners or Bondholders.

SECURITY AND SOURCES OF PAYMENT OF THE BONDS

The Bonds will be general obligations of the County for the payment of which its full faith and credit will be irrevocably pledged. The County Board of Supervisors is authorized and required, unless other funds are lawfully available and appropriated for timely payment of the Bonds, to levy and collect an annual ad valorem tax, over and above all other taxes authorized or limited by law and without limitation as to rate or amount, on all taxable property in the County sufficient to pay the principal of and premium, if any, and interest on the Bonds.

The County has never defaulted in payment of either principal of or interest on any indebtedness.

Bondholders' Remedies in the Event of Default

Section 15.1-227.61 of the Code of Virginia of 1950, as amended, provides that upon affidavit filed with the Governor of the Commonwealth of Virginia (the "Commonwealth") by any holder of or paying agent for a general obligation bond or note in default as to payment of principal of, premium, if any, or interest, the Governor shall conduct a summary investigation to his satisfaction and, if satisfied that such default has occurred, the Governor shall order the State Comptroller to withhold all funds appropriated and payable by the Commonwealth to the political subdivision so in default and apply such funds to payment of the defaulted principal, premium and interest.

Section 15.1-227.61 also provides for notice to the registered owners of such bonds or notes of the default and the availability of withheld funds. The State Comptroller advises that to date no order to withhold funds pursuant to Section 15.1-227.61, or its predecessor provision, Section 15.1-225, has ever been issued. Although neither Section 15.1-227.61, nor its predecessor provision, Section 15.1-225, has been approved by a Virginia court, the Attorney General of Virginia has ruled that appropriated funds may be withheld pursuant to that section. In fiscal year ended June 30, 1994, total direct appropriations paid by the Commonwealth to the County amounted to approximately \$1,410,518, which was deposited in the County's General Fund.

Neither the Bonds nor the proceedings with respect thereto specifically provide any remedies that would be available to a bondholder if the County defaults in the payment of principal of, premium, if any, or interest on the Bonds, nor do they contain any provision for the appointment of a trustee to protect and enforce the interests of the bondholders or noteholders upon the occurrence of such a default. Upon any default in the payment of principal, premium or interest, a bondholder or noteholder may, among other things, seek to obtain from an appropriate court a writ of mandamus requiring the County Board of Supervisors to levy and collect taxes as described above. The mandamus remedy, however, may be impracticable and difficult to enforce. Furthermore, the right to levy and collect taxes and to enforce payment of the Bonds may be limited by bankruptcy, insolvency, reorganization,

moratorium and similar laws and equitable principles, which may limit the specific enforcement of certain remedies.

Chapter 9 of the United States Bankruptcy Code (the "Bankruptcy Code") permits a municipality such as the County, if insolvent or otherwise unable to pay its debts as they become due, to file a voluntary petition for the adjustment of debts provided that such municipality is "specifically authorized, in its capacity as a municipality or by name, to be a debtor...." Bankruptcy Code, Section 109(c)(2). Current Virginia statutes do not expressly authorize the County or municipalities generally to file under Chapter 9. Chapter 9 does not authorize the filing of involuntary petitions against municipalities such as the County.

Bankruptcy proceedings by the County could have adverse effects on Bondholders, including (a) delay in enforcement of their remedies, (b) subordination of their claims to claims of those supplying goods and services to the County after the initiation of bankruptcy proceedings and to the administrative expenses of bankruptcy proceedings, and (c) imposition without their consent of a reorganization plan reducing or delaying payment of the Bonds. The Bankruptcy Code contains provisions intended to assure that, in any reorganization plan not accepted by at least a majority of a class of creditors such as the holders of general obligation bonds or notes, such creditors will have the benefit of their original claim or the "indubitable equivalent." The effect of these and other provisions of the Bankruptcy Code cannot be predicted and may be significantly affected by judicial interpretations.

DESCRIPTION OF BOND GUARANTY

A Financial Guaranty Bond ("Guaranty") will be issued by Capital Guaranty Insurance Company ("Capital Guaranty") simultaneously with the issuance and delivery of the Obligations which provides for the prompt payment of principal of and interest on the Obligations when Due for Payment (as defined below and in the Guaranty) to the extent that the Paying Agent has not received sufficient funds from the issuer or other Obligor (other than Capital Guaranty) responsible for payment of the Obligations. "Due for Payment" means, when referring to principal of the Obligations, the stated maturity date thereof or the date on which the principal becomes due for mandatory sinking fund redemption and does not refer to any earlier date on which payment of principal is due by reason of any other call for redemption, acceleration or other advancement of maturity. The term "Due for Payment" means, when referring to interest, the stated date for payment of interest.

To the extent the maturity of the Obligations may be accelerated upon a default, such acceleration may not occur without the prior written consent of Capital Guaranty. Notwithstanding any such acceleration, Capital Guaranty may continue to pay principal and interest on scheduled payment dates (i.e., when "Due for Payment"). In the event that Capital Guaranty shall make any payment of principal or of interest on the Obligations pursuant to the terms of the Guaranty, and the maturity of the Obligations is thereafter accelerated, Capital Guaranty may (but is not obligated to), at any time and at its sole option, pay Owners of the Obligations all or a portion of amounts due on such Obligations prior to the stated maturity dates thereof.

For specific information on the coverage provided, reference should be made to the text of the Guaranty, which has been reproduced in specimen form in Appendix B of this document. The Guaranty does not insure any payment to any investor to compensate for any loss or limitation of any tax exemption, either past or future. The Guaranty does not insure against nonpayment of principal or interest caused by the insolvency or negligence of the Paying Agent.

Capital Guaranty Insurance Company is a monoline stock insurance company incorporated in the State of Maryland, and is a wholly owned subsidiary of Capital Guaranty Corporation, a Maryland insurance holding company. Capital Guaranty Corporation is a publicly owned company whose shares are traded on the New York Stock Exchange. Other than their investment in Capital Guaranty Corporation, the investors of Capital Guaranty Corporation are not obligated to pay the debts of, or the claims against, Capital Guaranty Insurance Company.

The financial statement of Capital Guaranty in Appendix C of this document is incorporated herein by reference and reflects certain financial information prepared in accordance with statutory insurance accounting principles as was reported by Capital Guaranty to the Insurance Department of the State of Maryland.

DESCRIPTION OF POWERS OF NORTH CAROLINA
LOCAL GOVERNMENT COMMISSION

THE NORTH CAROLINA LOCAL GOVERNMENT COMMISSION

The Commission is composed of nine members: the State Treasurer, the Secretary of State, the State Auditor, the Secretary of Revenue, and five others by appointment (three by the Governor, one by the Lieutenant Governor, and one by the Speaker of the House of Representatives). The State Treasurer serves as Chairman and selects the Secretary of the Commission, who heads the administrative staff serving the Commission.

A major function of the Commission is the approval, sale and delivery of all North Carolina local government bonds and notes. A second key function is monitoring certain fiscal and accounting standards prescribed for units of local government by The Local Government Budget and Fiscal Control Act (see Appendix B). In addition, the Commission furnishes, upon request, on-site assistance to units of local government concerning existing financial and accounting systems as well as aid in establishing new systems. Further, educational programs and materials are provided for local officials concerning finance and cash management.

Before any unit of local government can incur bonded indebtedness, the proposed bond issue must be approved by the Commission. In determining whether to give such approval the Commission may consider, among other things, the unit's debt management procedures and policies, its compliance with The Local Government Budget and Fiscal Control Act, and its ability to service the proposed debt. All general obligation issues are customarily sold on the basis of formal sealed bids submitted at the Commission's offices in Raleigh and are subsequently delivered to the successful bidder by the Commission. The Commission maintains records for all units of all principal and interest payments coming due in the current and future years and monitors the payment by the units of their debt service through a system of monthly reports.

As a part of its role in assisting and monitoring the fiscal programs of units of local government, the Commission attempts to ensure that the units follow generally accepted accounting principles, systems and practices. The Commission's staff also counsels the units in treasury and cash management, budget preparation, and investment policies and procedures. Educational programs, in the form of seminars or classes, are also provided by the Commission in order to accomplish these tasks. The monitoring of the units' financial systems is accomplished through the examination and analysis of the annual audited financial statements and other required reports. The Local Government Budget and Fiscal Control Act requires each unit to have its accounts audited annually by a certified public accountant or by an accountant certified by the Commission as qualified to audit local government accounts (see Appendix B). A written contract must be submitted to the Secretary of the Commission for his approval prior to the commencement of the audit. As of this date, no audit contract to be performed by an accountant other than an independent certified public accountant has been approved.

The Commission has the statutory authority to impound the books and records of any unit of local government and assume full control of all its financial affairs if the unit defaults on any debt service payment or, in the opinion of the Commission, will default on a future debt service payment if the financial policies and practices of the unit are not improved. If the Commission elects to exercise this authority, it is vested with all of the powers of the unit's governing board as to the levy, of taxes, expenditure of money, adoption of budgets and all other financial powers conferred upon the governing board by law. Moreover, if a unit defaults on a required payment of principal or interest on its outstanding debt and remains in default for 90 days, the Commission may take such action as it deems advisable to investigate the unit's fiscal affairs and negotiate with its creditors in order to assist the unit in working out a plan for refinancing or adjusting such debt. The Commission is authorized to enter an order fining a plan to be equitable and within the ability of the unit to meet and to advise the unit to take the necessary steps to implement such plan. If the unit declines to do so within 90 days, the Commission may enter an order directing the unit to implement such plan and may apply for a court order to enforce such order. When a refinancing plan has been put into effect, the unit must make such financial reports to the Commission as required by the Commission and must obtain the approval of the Secretary of the Commission of its annual budget ordinance until the Commission is satisfied that the unit has performed or will perform the duties required of it in the refinancing plan and until agreements made with the unit's creditors have been performed in accordance with such plan.

DISCLOSURE ON THE SECURITY FOR GENERAL
OBLIGATIONS OF THE COMMONWEALTH OF VIRGINIA

**NEW ISSUE
BOOK-ENTRY ONLY**

Ratings: Fitch: AAA
Moody's: Aaa
Standard & Poor's: AAA
(See "Ratings" herein)

In the opinion of Bond Counsel, under existing law and subject to conditions described herein in the section entitled "Tax Matters," interest on the Bonds (a) will not be included in gross income for Federal income tax purposes, (b) will not be an item of tax preference for purposes of the Federal alternative minimum income tax imposed on individuals and corporations and (c) will be exempt from income taxation by the Commonwealth of Virginia and by any political subdivision thereof. Interest on the Bonds may be included in the calculation of a corporation's alternative minimum income tax, and a holder may be subject to other Federal tax consequences as described herein.



**\$100,000,000
COMMONWEALTH OF VIRGINIA
Public Facilities Bonds
1993 Series B**

Dated: June 15, 1993

Due: December 1, as shown below

The Bonds will be issued only in book-entry form initially registered in the name of Cede & Co., as nominee of The Depository Trust Company, New York, New York ("DTC"). DTC will act as securities depository of the Bonds. The Bonds will bear interest from June 15, 1993, payable semiannually on December 1 and June 1, commencing December 1, 1993.

The Bonds are subject to redemption prior to maturity as provided herein.

The Bonds will be general obligations of the Commonwealth of Virginia that are secured as to the payment of principal and interest by a pledge of its full faith and credit.

MATURITIES, AMOUNTS, INTEREST RATES AND YIELDS OR PRICES

<u>Maturity</u>	<u>Amount</u>	<u>Interest Rate</u>	<u>Yield or Price</u>	<u>Maturity</u>	<u>Amount</u>	<u>Interest Rate</u>	<u>Yield or Price</u>
1994	\$5,000,000	3.20%	2.40%	2003	\$5,000,000	4.70%	4.80%
1995	5,000,000	3.20	3.15	2004	5,000,000	4.80	4.90
1996	5,000,000	3.60	1.00	2005	5,000,000	4.90	5.00
1997	5,000,000	3.90	1.00	2006	5,000,000	5.00	5.10
1998	5,000,000	4.10	4.15	2007	5,000,000	5.10	5.15
1999	5,000,000	4.30	4.35	2008	5,000,000	5.15	5.20
2000	5,000,000	4.40	4.50	2009	5,000,000	5.20	5.25
2001	5,000,000	4.50	4.60	2010	5,000,000	5.25	5.30
2002	5,000,000	4.60	4.70	2011	5,000,000	5.25	5.30

\$10,000,000 5.25% Term Bonds Due December 1, 2013 - Priced to Yield 5.35%

Plus Accrued Interest from June 15, 1993

The Bonds are offered when, as and if issued, subject to the approval of validity by Hunton & Williams, Richmond, Virginia, Bond Counsel, as described herein, and to certain other conditions. It is expected that the Bonds will be available for delivery through the facilities of DTC in New York, New York, on or about June 29, 1993.

This cover page contains certain information for quick reference only. It is not a summary of this issue. Investors must read the entire Official Statement to obtain information essential to the making of an informed investment decision.

Dated: June 22, 1993

THE TREASURY BOARD MAY ENTER INTO AMENDMENTS TO THE AGREEMENT WITH DTC OR SUCCESSOR AGREEMENTS WITH A SUCCESSOR SECURITIES DEPOSITORY, RELATING TO THE BOOK-ENTRY SYSTEM TO BE MAINTAINED WITH RESPECT TO THE BONDS WITHOUT THE CONSENT OF BENEFICIAL OWNERS.

Optional Redemption

Bonds maturing on or before December 1, 2003 are not subject to optional redemption prior to maturity. Bonds maturing on or after December 1, 2004 are redeemable at the option of the Treasury Board on or after December 1, 2003, in whole or in part at any time, at the redemption prices set forth below (expressed as a percentage of the principal amount of the Bonds to be redeemed) plus interest accrued thereon to the date fixed for redemption:

Redemption Period (both dates inclusive)	Redemption Price
December 1, 2003 to November 30, 2004.....	102%
December 1, 2004 to November 30, 2005.....	101
December 1, 2005 and thereafter.....	100

Mandatory Redemption

Bonds maturing on December 1, 2013, are required to be redeemed prior to maturity, in part, on December 1 in the years and amounts and at a redemption price of 100% of the principal amount thereof plus interest accrued thereon to the date fixed for redemption as indicated below:

Year	Amount
2012	\$5,000,000
2013	5,000,000 (Final Maturity)

The Treasury Board may receive a credit against the redemption requirements for any Bonds subject to such requirements for Bonds of the same maturity that have been purchased and canceled or optionally redeemed before such redemption date and not previously applied as a credit against a mandatory sinking fund requirement.

Manner of Redemption

Whenever Bonds are to be redeemed, the State Treasurer shall cause notice of the call for redemption to be sent by registered or certified mail not less than 30 nor more than 60 days before the redemption date, to the registered owner of any Bond to be redeemed. If less than all of the Bonds are called for redemption, the Bonds to be redeemed shall be selected in such manner as may be determined by the State Treasurer to be in the best interest of the Commonwealth. If less than all of the Bonds of a single maturity are called for redemption, the Bonds to be redeemed shall be selected by lot. During the period that DTC or its nominee is registered owner of the Bonds, the State Treasurer shall not be responsible for mailing notices of redemption to the Beneficial Owners.

SECURITY FOR THE BONDS

Pledge of Full Faith and Credit

Each Act provides that "[t]he full faith and credit of the Commonwealth is hereby irrevocably pledged for the payment of the principal of and the interest on the bonds." Section 9(b) of Article X of the Constitution provides in part: "If sufficient funds are not appropriated in the budget for any fiscal year for the timely payment of the interest upon and installments of principal of [Section 9(b)] debt, there shall be set apart by direction of the Governor, from the first general fund revenues received during such fiscal year and thereafter, a sum sufficient to pay such interest and installments of principal." Each Act creates a sinking fund and provides for the annual deposit therein out of any available moneys in the General Fund of the State Treasury, or from any other source, a sum sufficient to pay the principal of and the interest on the bonds authorized therein becoming due in each year. Certain financial and demographic information concerning the Commonwealth is contained in Appendices A and B, respectively. The Commonwealth's financial statements for the year ended June 30, 1992, audited by the Auditor of Public Accounts, are included in Appendix C.

Remedies

Each Bond when duly issued and paid for will constitute a contract between the Commonwealth and the holder thereof.

In the event of a default in the payment of principal or of interest on any of the Bonds, legal remedies available to a bondholder to enforce payment against the Commonwealth would be limited by the doctrine of sovereign immunity and the 11th Amendment of the United States Constitution, which prevent suits against the Commonwealth without its consent. The Commonwealth has consented to suits in its own courts on its contractual obligations (Article 18, Chapter 3, Title 8.01 of the Code of Virginia of 1950, as amended). However, a court has no authority to enforce payment of any judgment against the Commonwealth by levy or execution against property of the Commonwealth as in the case of judgments against private persons. Any such judgment can only be satisfied by a special appropriation by the General Assembly.

Since the Governor's duty to set aside the first general fund revenues received to make payment on the Bonds in the event the General Assembly fails to appropriate the necessary funds is not discretionary, a bondholder may seek to obtain from an appropriate court a writ of mandamus requiring the Governor to perform his duty. The mandamus remedy, however, may be impracticable and difficult to enforce. The right to enforce payment of the Bonds may be limited by bankruptcy, insolvency, reorganization, moratorium and similar laws and equitable principles, which may limit the specific enforcement of certain remedies.

FUTURE GENERAL OBLIGATION BORROWING PLANS

The Treasury Board expects that no other general obligation debt will be issued before the end of the fiscal year. For an explanation of the types of general obligation debt in the Commonwealth, see Appendix A, "Indebtedness of the Commonwealth."

CONTINUING DISCLOSURE

Certain financial and demographic information concerning the Commonwealth is contained in Appendices A and B, respectively. The Commonwealth's financial statements for the year ended June 30, 1992, audited by the Auditor of Public Accounts, are included in Appendix C. The Commonwealth regularly prepares annual financial reports, which are available to requesting parties but not provided generally to bondholders except upon request. However, it does not expect to provide more frequent information on its finances and operations and has no obligation to provide any such interim information to the bondholders or any other party.

LITIGATION OF THE COMMONWEALTH

The Commonwealth, its officials and employees are named as defendants in legal proceedings which occur in the normal course of governmental operations, some involving substantial amounts. It is not possible at the present time to estimate the ultimate outcome or liability, if any, of the Commonwealth with respect to these lawsuits. However, the ultimate liability resulting from these suits is not expected to have a material, adverse effect on the financial condition of the Commonwealth.

In *Davis v. Michigan* (decided March 28, 1989), the United States Supreme Court ruled unconstitutional Michigan's statute exempting from state income tax the retirement benefits paid by the state or local governments and not exempting retirement benefits paid by the federal government. At the time of this ruling, Virginia exempted state and local but not federal government benefits. At a Special Session held in April 1989, the General Assembly approved an amendment to the Code of Virginia repealing the exemption of state and local retirement benefits and providing an exclusion for certain retirement income received by public and private pensioners.

Following the decision in *Davis*, five suits for refunds of Virginia income taxes, some with multiple plaintiffs, were filed by federal retirees. On February 12, 1990, the Circuit Court of the City of Alexandria ruled in favor of the Commonwealth and denied refunds to the taxpayers. On March 1, 1991, the Virginia Supreme Court affirmed the Circuit Court ruling. Petitions for review were filed in the United States Supreme Court. The United States Supreme Court remanded the cases to the Virginia Supreme Court for further consideration in light of *James B. Beam Distilling Co. v. Georgia* (decided June 20, 1991). On November 8, 1991, the Virginia Supreme Court affirmed its March 1, 1991 ruling denying refunds, and petitions for review were again filed in

U.S. HOUSE OF REPRESENTATIVES

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES,
AND GOVERNMENT SPONSORED ENTERPRISES OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES

◆

HEARINGS ON
DEBT ISSUANCE AND INVESTMENT PRACTICES
OF STATE AND LOCAL GOVERNMENT

◆

July 26, 1995

TESTIMONY OF JAMES E. SPIOTTO
PARTNER, CHAPMAN AND CUTLER

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APPENDICES

Appendix A — The Experiences of New York, Cleveland and Bridgeport, Connecticut

Appendix B — Chapter 9 Cases Filed

INTRODUCTORY REMARKS

• THE IMPORTANCE OF MUNICIPAL FINANCE IN THE UNITED STATES

Our system of federalism grants local governmental bodies the independence and the freedom to be able (with the consent of their citizens) to finance various necessary improvements through the issuance of municipal bonds. In most other countries, the local governmental body, regardless of the merits of such proposals, must first request approval, or financing itself, from the central government before the local government is able to proceed with such commonplace municipal improvements as bridges, sewers, roads, and public buildings. However, our Founding Fathers ordained that certain independence and power should be given to the states and their local government bodies.¹

During the late 1700s and early 1800s, a method of finance evolved whereby municipalities would issue their own debt obligations either based on their full faith and credit (general obligation bonds) or based upon the revenues to be collected by the municipal body in connection with the financed improvement (revenue bonds). This system of municipal finance has allowed citizens to determine, on a local basis, what improvements they desire and to finance such improvements without the need for federal financing or approval, and often without state financing or approval.

As our municipalities have grown and prospered, so has their need for continued financing. The confidence of the municipal bond market is essential, and municipalities traditionally have made every effort to honor their public debt obligations. States have enacted statutory provisions waiving sovereign rights in connection with financings to assure the bondholders that if they purchase the revenue bonds of municipalities within these states, the pledge of revenue to the bondholders cannot be diverted or terminated. These statutory provisions were not only for the benefit of bondholders but also for the citizens of the state, so that all municipalities could make use of municipal bond financing when necessary. Currently, both large and small municipalities are facing economic hardships, which can create uncertainty in the municipal bond market.² Ironically, during these times of financial crisis, a municipality needs the support of the municipal bond market the most.

¹ See The Federalist No. 31 (Alexander Hamilton). A more extensive discussion of this topic and Chapter 9 of the Bankruptcy Code can be found in the chapter written by James E. Spiotto which appears in the treatise *State and Local Government Debt Financing*, edited by Professor David Gelfand, published by Clark Boardman Callaghan.

² One group that compiles default statistics, the Bond Investors Association, reports that during the first half of this year, there have been 26 disclosed defaults in the municipal market totaling \$745 million. This is as compared with the \$451 million in defaults the Association found during the first two quarters of 1994. The Association has indicated that, by comparison, the total amount of corporate bonds that went into default in 1994 was approximately \$3.8 billion. This same group reported \$1.7 billion in new corporate defaults in January of 1995 alone. In the years 1900-1943 U.S. corporate bonds defaulted at an average annual rate of 1.7% of the outstanding; from 1944-65 at an annual rate of less than 1/10th of 1%; and after 1965 the annual default rate has risen to pre-1943 levels. Between 1839 and 1969 there were 6,195

• CHAPTER 9 OF THE BANKRUPTCY CODE

Chapter 9 of the Bankruptcy Code was not designed to be a problem for municipalities and the purchasers of their debt obligations. Indeed, Chapter 9 of the Bankruptcy Code can be an acceptable alternative to endless litigation for both fiscally troubled municipalities and the municipal bond market, provided the principles and practical realities of municipal financing are not disturbed. It has been used with success in Colorado and elsewhere to mitigate damage in the "special district" area of the municipal marketplace which grew out of overzealous real estate development (and lack thereof).

• THE SOURCE OF THE ORANGE COUNTY PROBLEM

The recent bankruptcy of Orange County has raised issues which challenge some basic principles. Ironically, the Orange County drama is being observed not just by other United States municipalities. The Orange County crisis is taking place at a time where there is increased interest in municipal finance by emerging Eastern European and third world countries. At a time when others are turning to the form of financing which has flourished in the United States, its creators are calling into question the most basic principle of such financing: the willingness of local governments to repay what they have borrowed.

Orange County is not the first large municipal issuer of public debt to experience severe financial difficulty. In recent years, Cleveland, New York City, Philadelphia, and Bridgeport, Connecticut also have grappled with serious financial crises and sometimes with defaults.³ Moreover, it is likely that Orange County will not be the last municipal issuer to experience distress. However, the manner in which Orange County, the State of California, the Federal Court System, the municipal bond market, and the Congress of the United States react to Orange County will have a significant impact on the future of municipal finance.

The investment losses suffered by Orange County are best attributed to the desperate efforts of a revenue-starved municipality which had faced shrinking revenues in relationship to expanding costs because of a constitutionally imposed tax cap (Proposition 13).⁴ The difficulty with an artificial and unrealistic tax cap and similar constitutional limits on taxation is that there are certain municipal services that are required and expected by the citizenry. If revenues available to municipalities are capped in an unrealistic and artificial way, obviously the ability of municipalities to supply those services is significantly curtailed.

recorded defaults of municipal issues. Between 1945 and 1970, municipal bonds in the principal amount of \$400,000,000 went into default. On the other hand, in just one year, 1970, over \$1,000,000,000 of corporate bonds went into default. See Spiotto, *The Problems of Indenture Trustees and Bondholders*, 1995 (Practising Law Institute).

³ A more detailed discussion of the problems of certain of those municipalities is attached as Appendix A.

⁴ Article XIII A § 1 of the California Constitution.

That is not to say that there should not be limits on the spending of public dollars or that taxation should be allowed to become an unlimited resource in the hands of a misguided or misdirected governmental body. It is merely to state the obvious fact that, when there is a ceiling on revenues unrelated to costs and expenses, there will be a tension.

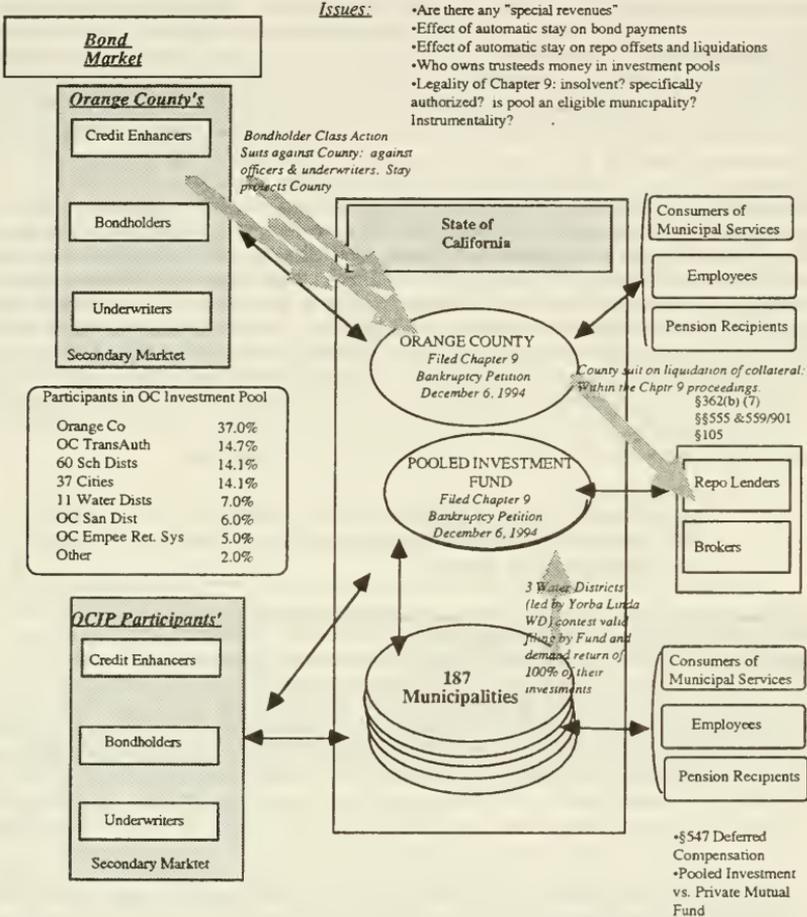
In essence, Orange County turned to "creative" investments in order to obtain non-tax dollars to make ends meet. Orange County had as its third largest revenue source the investment income from those creative investment vehicles — some \$172 million for the last fiscal year. Clearly, municipalities should not be forced to resort to a unique form of off-track betting in order to function, but such was in part a consequence of the adoption of Proposition 13. Mistakes with regard to unhedged derivative transactions have been discussed at length and described as imprudent and lethal to the fiscal health of a municipality. However, some comfort can be taken from the fact that Proposition 13 is not a national phenomenon, that exotic investment practices by local treasurers are far from universal, and that California is the home of some of the more unique and complex forms of municipal debt instruments because of the constitutional limitation on long-term debts (1 year or more). It is the convergence of the reverse repurchase agreement strategy and the somewhat unique nature of the obligations for borrowed money with strange names like "TRANS"⁵ and "COPs"⁶ that has made Orange County such a headache. The investment strategy and

⁵ "TRANS" means "Tax and Revenue Anticipation Notes" which are a type of short term obligation used to balance cash flow during a fiscal year. Generally a municipality receives most of its revenue in two or three months of a year (real estate tax bills being usually done in two installments) while it may have relatively level monthly expenditures. It is common, therefore, to do an annual borrowing in anticipation of receipts (and to invest any proceeds of the borrowing until needed to meet current expenditures). The tax law imposes limitations on the investment of those proceeds. Under state law, and particularly for California, if the obligations are short term, payable from receipts of the particular fiscal year, then such obligations are not "debt" for state constitutional purposes and do not require referendum authorization from voters. Purchasers of such obligations run a risk that available revenue from the fiscal year may not be sufficient or available at maturity and therefore statutes authorizing such TRANS often create a repayment fund which is to be filled with monthly receipts and pledge to repayment, secured by a statutory lien.

⁶ "COPs" means "Certificates of Participation" and refer to "individual participation interests," evidenced by certificates in a municipal lease or other municipal obligation. An entity other than the municipality will own a municipal asset and lease it to the municipality. The rent paid by the municipality will be treated as having a principal and interest component for federal tax purposes. If there are constitutional limitations imposed on incurring "debt," the municipality's lease obligation can avoid these debt limitations if it is a lease that is renewable each year. In such case, the more "essential" the leased property is to the municipality, the more likely it is to "renew" the lease and continue to make payments. For state constitutional purposes, however, it may be important that there be a legal right to abandon the property and cease making payments. Thus, each year the municipality must include the year's rent in its budget and appropriate money to pay that rent. Since much municipal property is not readily marketable to other people, the market depends upon the municipality continuing to lease the property until the COPs are paid. This "appropriation risk" is directly related to the municipality's "unwillingness to pay" generally. In California generally the long term lease is not treated as a debt as long as the municipality has the right to occupancy and use so the basic risks to owners of California COPs are risks of damage or destruction or a failure to complete construction of the leased asset.

the nature of the "debt that is not a debt" are flip sides of the coin that was used by local government to respond to Proposition 13.

ORANGE COUNTY: The Players



• THE IMPACT OF ORANGE COUNTY

Ultimately, the impact of Orange County on the municipal debt market as a whole will depend on how Orange County is resolved. If, at the end of the day, Orange County recognizes its responsibility, and despite the defeat of Resolution R, comes up with the revenue to pay in full the legitimate obligations which it has incurred, the municipal debt market may not extract a high price for the Orange County trauma. Recent statements by representatives of Orange County that its security holders will be paid 100¢ on the dollar are encouraging. But robbing other municipalities to pay Orange County bondholders is not a feasible plan. Rather, such a plan really transfers one financial crisis to numerous other municipal bodies. Indeed, one thing that the Orange County situation illustrates is the degree to which the financial offerings of various municipalities and the market participants with which they deal have become interrelated. If Orange County ultimately tries to utilize approaches similar to those exhibited by the issuers of high yield corporate debt who, in the late 80's and early 90's, tried to transfer the pain and suffering to the investing public by paying cents on the dollar, then we can expect a change in the municipal debt market. The municipal debt market could be transformed into a market similar to the corporate debt market, where issuers can, at various times, be excluded totally from the market, and the interest rate for the risk of non-payment will be significantly increased.⁷ One troubled high yield corporate bond issuer recently returned to the market at an interest rate of over fifteen percent. If, in the future, the municipal market refuses access to troubled credits or requires the payment of an additional 200, 300 or even 400 basis points over ten years, the costs will be significant and felt by those very communities which desperately need financing.

<p>I. HAS THERE BEEN A FUNDAMENTAL SHIFT IN THE CREDIT RELATIONSHIP BETWEEN ISSUERS OF STATE AND LOCAL DEBT AND INVESTORS IN DEBT?</p>
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• THE "WILLINGNESS TO PAY" ISSUE

It may be too early to determine whether a fundamental shift has occurred in the credit relationship between issuers of state and local debt and investors because of Orange County.⁸ Indeed, there may be other concerns which are just as important to the municipal market at the present time, particularly the threat of a tax law change which could affect the exemption for interest paid on the debt of all units of local government. However, there certainly is a general concern about the "willingness to pay" aspect of Orange County which

⁷ This consequence is more serious in the municipal market than it is in the corporate market. Municipalities raise capital only in debt markets; there is no municipal equity market possibility. And, because of the tax laws, banks are limited in their ability to benefit from the tax exemption and are therefore no longer major purchasers of tax-exempt securities issued by large municipal borrowers.

⁸ See the discussion of Orange County that begins on page 1 of *The Bond Buyer*, July 20, 1995.

has been absent from other fiscal crises of the past. Historically, the market has assumed that there would be a willingness on the part of municipalities to pay their obligations if possible. The problems of Cleveland, New York City, Philadelphia and Bridgeport were caused in part by the factors traditionally facing aging municipalities with shrinking revenues.⁹ Orange County is unique because it is a wealthy municipality which recently has not been reticent to express its disinterest in paying previously validly issued municipal debt. Very troublesome indeed was the position taken by Orange County and the bankruptcy court ruling that there was no requirement or ability to set aside pledged revenues for the payment of the Tax Anticipation Notes ("TRANS") even though the County's resolutions and state law specifically provided for such payment.¹⁰ The district court recently overturned that ruling, holding that a statutory lien survives the filing of a Chapter 9 petition.¹¹ The case is now on its way to the Ninth Circuit.

Undoubtedly, there is a concern in the marketplace in reaction to Orange County about the "willingness to pay" question. This same concern arose a number of years ago in connection with certificates of participation issued in Florida.¹² In both instances, the concern in the market arose when, after bonds were issued, the issuer asked voters to affirm or provide a new source of revenue to fulfill existing obligations. While the voters narrowly affirmed the obligation in Florida, the negative results on Proposition R are troubling the market. Such a situation, of course, is destructive of the bond holder trust. However, it may be the peculiarities of California's constitutional provisions and not necessarily Chapter 9, which have created the situation which has led to rebellion.

⁹ See Appendix A. A study of past financial difficulties is instructive, particularly regarding the levels of taxation during the Depression. The Advisory Commission on Intergovernmental Relations, in the study *City Financial Emergencies: The Intergovernmental Dimension*, 21 (1973), reports that, during the Depression, the property tax in Palm Beach rose to over 40% of assessed valuation, and in Asheville, North Carolina, the city's tax burden was 85% of assessed valuation. The same study comments on the percentage of taxation devoted to debt service during that time period. In West Palm Beach, only 7% of tax revenues went for the operation of the city, and the rest went to debt service. In the city of Detroit during the Depression, 76% of tax revenues went to debt service, and the tax delinquency rate was 36%.

¹⁰ *In re County of Orange*, 179 B.R. 185 (Bankr. 1995).

¹¹ *In re Orange County*, No. SACV 95-341-GLT [AR] (C.D. Ca. July 12, 1995).

¹² Brevard County, Florida issued COPs to finance the relocation and construction of a new County Government Center. The Project was controversial locally and in part contributed to the election of a new governing body which opposed the Project. The voters and the governing body sent tremors through the bond market by suggesting that they would exercise rights to not make the annual appropriations for rent. Ultimately, the voters approved the Project and the rent obligations in a close election.

• *THUS FAR, THE ORANGE COUNTY DEBATE HAS CENTERED ON SHORT-TERM DEBT*

Moreover, most of the dispute thus far in Orange County over Orange County's obligations for borrowed money have centered on short-term borrowings issued in anticipation of future receipts. One should note that these obligations are not the typical long-term general obligation bonds. General obligation bonds typically require either that they fall within some statutorily or constitutionally provided debt limit or that they are authorized by voter referendum. Because of Proposition 13, there are not very many California long-term general obligation bonds. California and its municipalities, including Orange County, have become large issuers of one year obligations. Such obligations are used to balance the cash flow needs of relatively regular monthly expenditures against receipts which are concentrated in two or three months of the year. Such obligations are not debt, but rather are current obligations payable solely from anticipated receipts during the particular fiscal year. Since they are not debt, they need not be authorized by referendum. They do contain the risk that if the receipts for the fiscal year are inadequate, then lawful payment is threatened. To protect against this risk, the state statutes authorizing such borrowings contain provisions to pledge and set aside receipts each month for the payment of the obligations. Most market participants believe that the state statute creates a "statutory lien" on that set aside money, and that a Chapter 9 proceeding cannot interfere with such statutory lien. Given the recent decision of the district court, reversing the bankruptcy court and holding that the lien securing the TRANS is a statutory lien which survived the filing of Orange County's Chapter 9 petition, this impression has been supported by court decision.¹³

• *THE NEED TO UNDERSTAND THE RAMIFICATIONS OF TAX CAPS*

One effect of Orange County is that the market may begin to fully analyze the implications of mandated tax caps such as Proposition 13. The issuance of debt that is not "debt" has become common as a result of Proposition 13. As previously alluded to, it was the tax cap mentality and the need to develop non-tax revenues that was a proximate cause of the creative investing in Orange County. The existence of such constitutional limitations may become a more prominent consideration in any analysis of the quality of a municipal obligation. Moreover, bond purchasers and other market participants may more carefully consider the real nature of the instrument being offered by the municipality and all the risks inherent in the security's structure.

Part of the Orange County problem may be that neither the governmental leaders nor the market faced up to the full implications of Proposition 13. When it was adopted, voters were sending a message to their political leaders: "don't incur unnecessary debt without a referendum and don't increase taxes without a referendum." There also were certain corollaries to that message such as "and don't expect a referendum to be successful" and "shrink

¹³ *In re Orange County*, No. SACV 95-341-GLT[AR] (C.D. Ca. July 12, 1995).

the size of government." Apparently not everyone got the message. Government services and expenditures have not been radically reduced. Voters continued to be skeptical and unhappy. Mechanisms to borrow money were developed which comply with the letter, if not the spirit, of Proposition 13; these obligations are lawful, but limited obligations. They are not the legal equivalent of a long term general obligation bond which was approved by referendum. In addition, that same Proposition 13 created a need to search for creative new revenue sources which made the aggressive investment style of the Orange County Investment Pool welcome and led many to overlook the important question of whether or not those investment returns were too good to be true.

• *THE UNANSWERED QUESTION*

But the problem that may be created by Orange County is that the special relationship which has existed for almost 200 years between issuers of municipal debt and the investing public could be irreparably damaged. If a municipality can file bankruptcy and contend that it is no longer obligated on bonds which it offered to the investing public, and if the municipality can continue to reserve its rights as to whether or not the bonds it issues are valid and binding obligations, then investing in municipal securities becomes a game of chance. Because of the commitment of municipalities in the past to repay their obligations, even when capital has been sparse, municipalities always have found a willing and accessible market. However, if that public feels that a municipality will only repay its debts when it is convenient or believes that the municipality can attempt to repudiate its prior obligations without regard to prior statements and assurances to the market, the relationship between municipal issuers and the market will be irreparably altered. The question is whether anything can be done by means of Federal legislation to remedy the problem. The Federal government cannot directly legislate a willingness to pay.

II. SHOULD CHAPTER 9 OF THE FEDERAL BANKRUPTCY CODE GOVERNING MUNICIPAL BANKRUPTCY BE CHANGED?

• *PREVIOUS AMENDMENTS TO CHAPTER 9*

In November of 1988, based upon a joint effort by, among others, the National League of Cities, the Government Finance Officers Association ("GFOA"), and the National Association of Bond Lawyers, substantive amendments to Chapter 9 were enacted which corrected some of the inconsistencies between existing bankruptcy law and municipal law. The Municipal Bankruptcy Amendments were designed to harmonize bankruptcy law with existing municipal law and financing practices. The focus included assurances that liens on "special revenues" not be extinguished, that pre-petition payments on bonds and notes be free from the taint of possible preference attack, and that revenue bonds not be transformed into general obligation bonds. Further, the Municipal Bankruptcy Amendments made general failure to pay debts the criterion for municipal insolvency and eligibility for filing. The purpose of these Municipal Bankruptcy Amendments was to ensure that troubled

municipalities would have access to the municipal market even at times of dire financial distress. The Bankruptcy Reform Act of 1994 responded to a split in lower court decisions with regard to the nature of the state authorization to be a debtor under Chapter 9 of the Bankruptcy Code. Previously, a municipality qualified as a Chapter 9 debtor if it was "generally authorized" as such by state law. Now a municipality will be authorized as a Chapter 9 debtor only if, by state law, it is specifically authorized in its capacity as a municipality or by name as a debtor under Chapter 9. Presently, most states do not specifically authorize municipalities to file a bankruptcy petition. Only twelve states have specifically authorized municipalities to file Chapter 9 petitions. Six other states expressly require approval by state authorities before a municipality may file, and at least one state has specifically forbidden its municipalities from filing Chapter 9 petitions.¹⁴

• ARE FURTHER AMENDMENTS NEEDED?

In the wake of Orange County, some have questioned whether there are additional amendments to the municipality bankruptcy law which are advisable. As with respect to all of the matters discussed, until the Orange County case is brought to a conclusion, it may be too early to decide that changes to the Bankruptcy Code are required. It may be that, as the case develops, what the market perceives as justice will be done. The most recent decision by the district court reversing the bankruptcy court on the issue of the statutory lien's validity and the continuing validity of the set aside provisions of the TRANS is the best example of why it is too early to make changes to the Code itself. However, at this relatively early stage of the proceedings, a few possible areas for consideration come to mind if fine-tuning of the Bankruptcy Code is advisable at all.

Any analysis must begin with an understanding of certain basic points about Chapter 9 of the Bankruptcy Code. First, its predecessor statute was adopted in response to crushing

¹⁴ Only twelve (12) states have specifically authorized their municipalities to file Chapter 9 petitions:

Ala. Code § 11-81-3.	Idaho Code § 67-3903.
Ariz. Rev. Stat. Ann. § 35-603.	Ky. Rev. Stat. Ann. § 66.400.
Ark. Code Ann. § 14-74-103.	Mont. Code Ann. § 7-7-4111.
Cal. Gov't. Code § 43739.	Okla. Stat. tit. 62, § 283.
Colo. Rev. Stat. § 32-1-140.	SC Code Ann. § 6-1-10.
Fla. Stat. § 218.01.	Tex. Local Gov't. Code Ann. § 140.001.

In addition, six (6) other states statutes expressly require approval by state authorities before a municipality may file under the federal bankruptcy laws:

La. Rev. Stat. Ann. § 39-619.	NC Gen. Stat. § 23-48.
MSA § 5.3188(222); MCL § 141.1222.	Ohio Rev. Code Ann. § 133.36
NJ Rev. Stat. § 52:27-40.	Pa. Stat. Ann. tit. 53, § 11701.261.

On the other hand, at least one (1) state has specifically forbidden municipalities from filing Chapter 9 petitions:

Ga. Code Ann. § 36-80-5.

litigation which arose out of the calamities of the Great Depression. It was understood that, at some point, some municipalities might simply find that it was impossible for them to pay 100¢ on the dollar for all of their obligations, and that accordingly the "fresh start" of a bankruptcy restructuring could be beneficial to all parties. Second, notwithstanding a desire at the Federal level to provide for a municipal fresh start via bankruptcy, under the U.S. Constitution, municipal government and the services provided and the obligations incurred by municipal government are matters to be determined by the states, not the federal government. The third point is that Chapter 9 does and must balance these first two points. Accordingly, no one can force a municipality into bankruptcy. Further, each state must make a decision as to whether or not, and upon what conditions, it will permit any or all of its municipalities to use the provisions of the Federal Bankruptcy Code.

• LIMITING ACCESS TO CHAPTER 9

Given the amendment that occurred in 1994, whereby it was clarified that the state must *specifically* authorize a municipality to be a debtor under Chapter 9, each state now has the responsibility to determine whether or not, for the sake of access to the municipal bond market, there should be limitations on the ability of municipalities within its borders to utilize municipal bankruptcy.¹⁵ A number of states require a municipality to have been subject to proceedings before a special commission or to participate in an elaborate hearing procedure before the municipality can adopt the bankruptcy route. While not an amendment to the Bankruptcy Code, more specific state legislation in this regard can be encouraged.

That is to say that much can be done by the states themselves to alleviate market fears. It is perfectly permissible for the states either to deny municipalities the ability to use Chapter 9 or to impose sensible conditions to such use. For example, in Chapter 9, only the debtor can propose a "plan of debt adjustment." Orange County has been in Chapter 9 since December 1994, and no feasible plan is yet in sight. That fact creates serious uncertainty. It would be relatively easy for a state to provide that no municipality can file a petition pursuant to Chapter 9 unless and until it had formulated a plan and had that plan reviewed and approved by an appropriate state agency. Such a provision might help the state to appropriately supervise the situation and assure that a particular financial problem for a single municipality does not become a problem for other of the state's municipalities.

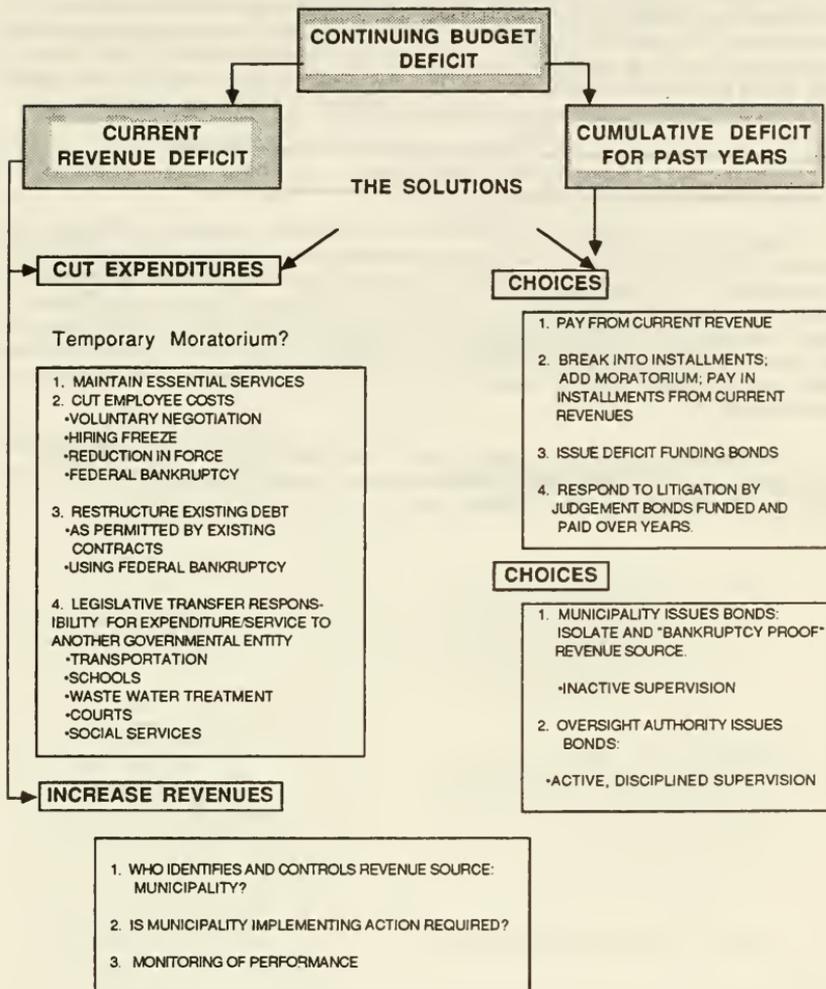
It might also be feasible for states to develop an interim step in the Chapter 9 process whereby a distressed municipality, having demonstrated to an appropriate state official that the distress was true and that a solution was possible, would be given interim protection from lawsuits for a limited period of time while a long-term plan was developed, on the condition that, to the extent possible, such municipality continued to meet its current obliga-

¹⁵ The filing by the Orange County Investment Pool ("*OCIP*") was dismissed because the court found that the OCIP was not a municipality within the meaning of Section 101(40) of the Bankruptcy Code. *In re Orange County*, 1995 WL 319205 (Bankr. C.D. Cal.). The court also found that OCIP was not specifically authorized to file.

tions to the municipal market on its instruments for borrowed money and its current operating expenses. This could be accomplished, for example, by means of a federal statute which stayed the effect of litigation against a municipality for six months if the governor of the state approved the request of the municipality for such a stay. A federal statute could permit a stay of an additional six months if so requested and approved by the governor as reasonable and necessary. This type of stay could give breathing room to a troubled municipality which now appears to be absent unless the protections of Chapter 9 are invoked.¹⁶ It could also assist local political leadership in its task of explaining the ramifications of a financial crisis to its electorate. This breathing room could help the municipality assess its options, current revenues, deficits, new revenue sources, and the elimination of unnecessary expenditures as shown in the following chart.

¹⁶ The stay envisioned here should not run afoul of constitutional requirements or violate Section 903 of the Bankruptcy Code. The stay is not an impairment of contract because the stay is granted as part of a voluntary debt restructuring. The product of a voluntary debt restructuring and negotiation with creditors could be, under certain circumstances, a prepackaged Chapter 9. If resort to Chapter 9 became necessary, it would not be a freefall bankruptcy but a filing in which the ultimate outcome was predictable. Chapter 9 could be of utility when an agreement was reached with the vast majority of the creditors of the municipality, but it was impossible to obtain one hundred percent voluntary consent. In such a case, the ability of the bankruptcy court to confirm a plan which bound all creditors would provide real value.

MUNICIPAL FINANCIAL CRISIS



It may be appropriate to encourage states to set up additional criteria which must be met before their municipalities can enter Chapter 9, since attempts to do so by Federal law could run afoul of constitutional prohibitions. Moreover, it may be that developing criteria on a state level for a state commission will result in more meaningful tests for that particular state. Based upon the criteria that are developed, the municipal bond market can then decide whether or not continued investment in the state in question is prudent and warranted.

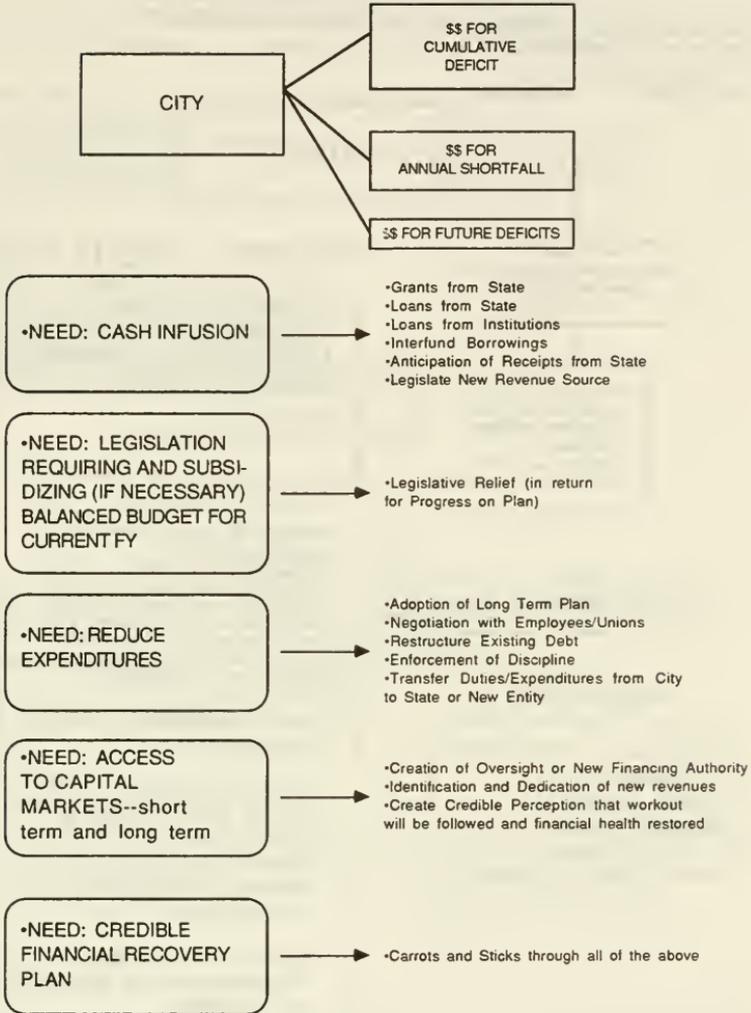
• *UNIFORM STATE RESTRUCTURING LEGISLATION*

Another possible approach might be the development of uniform laws for states to consider which would provide for a legislative alternative to an immediate Chapter 9 filing. A municipal deficit financing and oversight authority could be made part of the statute which would supervise the workout process and would have to approve any Chapter 9 filing. An example of such legislation has been adopted in Pennsylvania.¹⁷ Such state law can assure the market that there will never be a premature or surprise filing such as in the case of Orange County or that a municipality will act contrary to state law such as has taken place in California.

The first step in developing uniform state restructuring legislation is to understand the needs of financially distressed municipalities through an analysis of alternatives. The needs are graphically portrayed on the following chart.

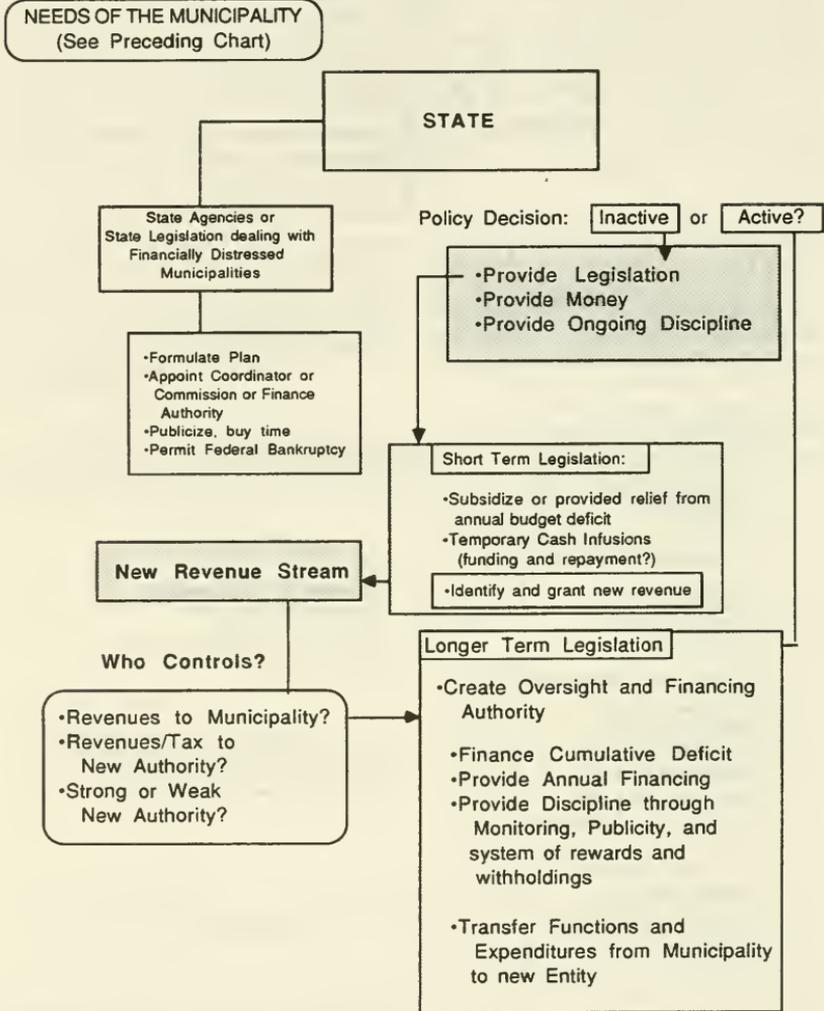
¹⁷ Pa. Stat. Ann. tit. 53 § 12720.101 *et seq.*

NEEDS OF A FINANCIALLY DISTRESSED CITY



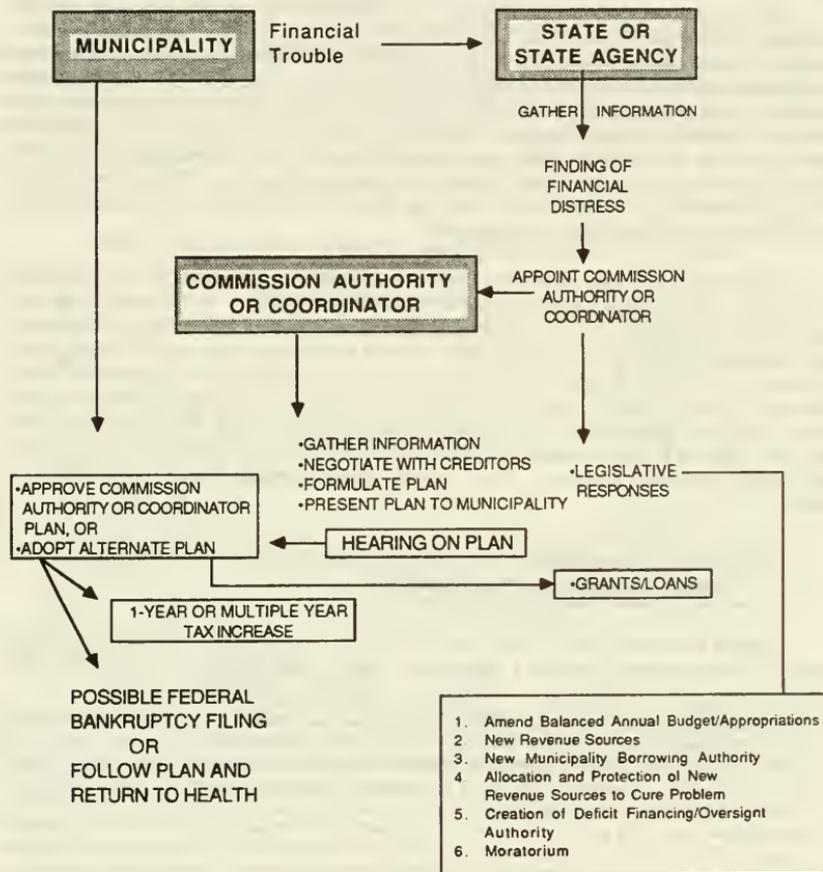
Then consideration should be given to the possible responses a state may make to a financially distressed municipality. The following chart summarizes those responses.

**RESPONSES BY THE STATE TO A
FINANCIALLY DISTRESSED MUNICIPALITY**



Finally, a structure for a successful rehabilitation of a municipality may very well involve an oversight or refinance authority which is a tried and true success story (New York City and Philadelphia). An outline of such an authority appears as follows.

SCENARIO FOR SUCCESSFUL MUNICIPAL FINANCIAL OVERSIGHT



Returning to the issue of the Code itself, over time some fine-tuning may be appropriate. No amendment appears to cry out for immediate adoption at this time. Additional Bankruptcy Code provisions may not be required at this time but certainly could be

studied.¹⁸ However, while such clarifications could be useful, it may be that a clearer understanding of the risks involved in a particular investment is what is called for. It appears that market expectations may not have been consistent with the realities of bankruptcy or state constitutional restrictions.

The requirement that municipalities act in a fashion consistent with state law already is embodied in Sections 903 and 904 of the Code. While a laundry list of additional points to clarify by statute can be expanded, the real problem with Chapter 9 is how it is interpreted by potential debtors. It is not the Bankruptcy Code as presently drafted that has created the problem. It is the application of the statute by certain individuals which has created concerns. Further, many problems may have been created by a lack of understanding of the meaning of the Bankruptcy Code and, in particular, the protections accorded special revenues and the nature of the debt instruments being invested in. What is needed is a clearer appreciation of the Bankruptcy Code, the affect of constitutional debt limitations, and the municipal finance vehicles being marketed.

It does not make sense to enact a Bankruptcy Code with provisions that are so restrictive that the statute offers no remedy to the troubled municipality. A Code which decrees that, under all circumstances, municipal bond holders will be paid 100 cents on the dollar as those payments become due is of little utility. Such a Code would have been a liability to the Colorado special districts and the restructuring of the widely held general obligation bonds. However, Chapter 9 should not be a remedy which permits avoidance of obligations just because they are inconvenient. New York, Philadelphia, Cleveland, Bridgeport and others have had difficult financial situations. They did not choose to repudiate their obligations; they worked with their creditors. They, and not Orange County, should be the models to follow.

III. DOES CHAPTER 9 CREATE INCENTIVES THAT ADVERSELY AFFECT THE MUNICIPAL MARKET?

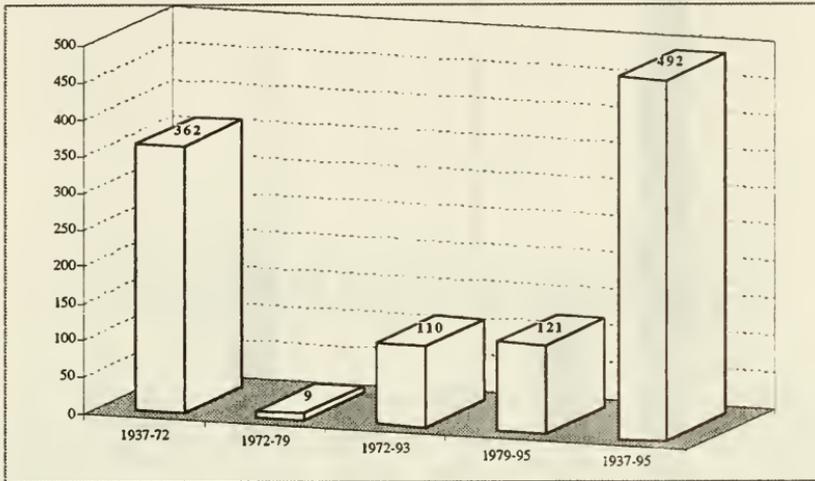
Chapter 9 was not intended to create an incentive to adversely affect the municipal market. It was structured to help a municipality which, because of a very desperate situa-

¹⁸ The following listing of topics is for discussion purposes and such should not be construed as indicating that the Bankruptcy Code is unclear or that any problem exists with the present Code. Such topics to be considered include the interplay between the automatic stay and the traditional rule that municipal obligations are payable constitutionally only out of the receipts of a particular year; reconciliation between the concepts of perfected liens on cash flows (tax receipts) and the concept of secured versus unsecured debt; clarifying the nature of a general obligation bonds entitled to full faith and credit vis-à-vis other creditors; incorporation of the repurchase agreement provisions and similar provisions of the Bankruptcy Code into Chapter 9 so lenders can liquidate collateral without worry; clarification by statute of the standard for modifying collective bargaining agreements and retirement benefits in a Chapter 9 context; and some consideration of the status of certificates of participation in the Chapter 9 process. At the time of the enactment of the Municipal Bankruptcy Amendments, it was not anticipated that state treasurers would be investing in repurchase agreement instruments. If that Code provision needs clarification with regard to Chapter 9, it could be accomplished.

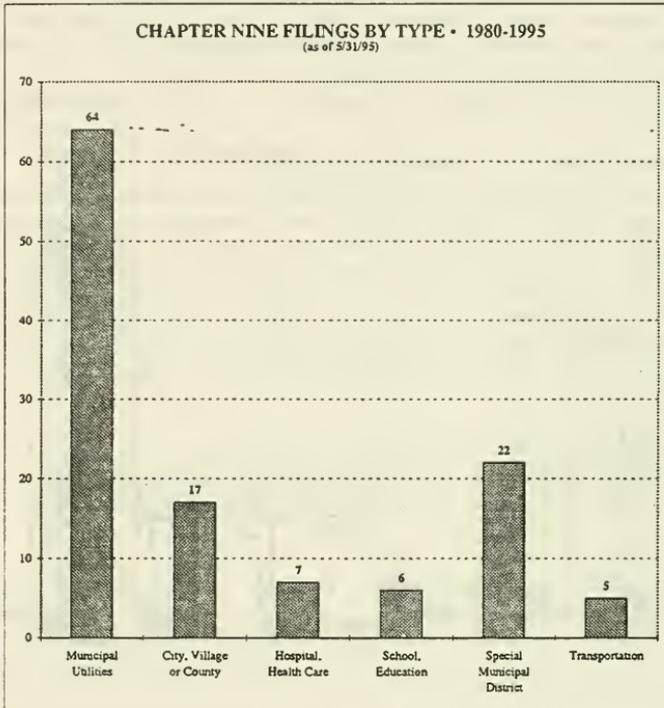
tion, needed a restructuring of its debt. In other words, Chapter 9 was designed as the last, not the first, resort when a municipality faces fiscal problems. It was not the inconvenience of paying but rather the sheer impossibility of being able to pay under the agreed upon time frames that Chapter 9 was intended to address; debt adjustment and not debt elimination was the goal.

In the past, Chapter 9 or its predecessor statute have been used sparingly — only 492 times since 1937. Between 1937 and 1972, there were three hundred and sixty two (362) cases filed pursuant to Chapter IX. These 362 cases involved admitted debts of approximately \$217 million. In these Chapter IX cases, the amount paid on such debt exceeded \$140 million and the amount of loss to bond holders was approximately \$77 million. Since 1937 to date, approximately 492 Chapter 9 petitions have been filed.

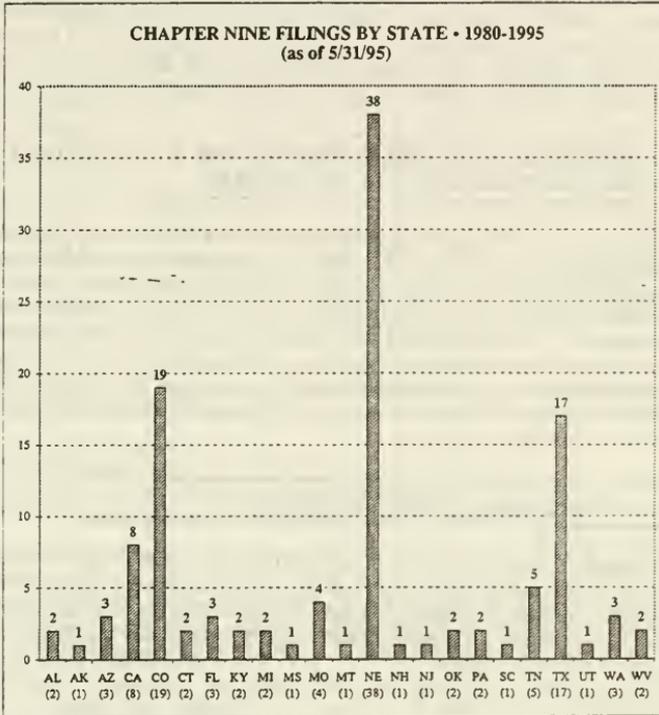
FREQUENCY OF MUNICIPAL BANKRUPTCIES • 1937-1995
(as of 5/31/95)



The municipal bodies that filed bankruptcy proceedings were for the most part, utilities, special taxing districts or small towns and cities that had little financial elasticity in times of economic hardship.



Obviously, some states have had more filings than others because of special tax districts which were the victim of economic downturns.



Attached as Appendix B is a list of the 121 Chapter 9 cases filed since the effective date of the Bankruptcy Reform Act of 1978. Generally, those Chapter 9 debtors have attempted to pay their bond obligations. Indeed, in the San Jose School District Chapter 9, the debtor made it clear from the outset that it did not intend to impair the obligations of its public bond holders and the municipality did pay the interest on the municipal bonds throughout the bankruptcy.¹⁹ There has been little in Chapter 9, as we have experienced it to date, that has adversely affected the municipal market.

On the other hand, the automatic stay which is part of the bankruptcy process is a powerful protection: creditors cannot bring suit against the municipality that has filed for a Chapter 9 protection. There is no statutory limitation on the time in which the debtor

¹⁹ *In re San Jose Unified School Dist.*, No. 5-83-02387-A-9 (B.C. N.D. Cal. 1983).

must produce a plan, and creditors are not permitted to propose a plan. Thus, it is theoretically possible that an entity that has no solution to its problems could hide in a Chapter 9 proceeding until the bankruptcy judge has lost patience. It also is possible that some debtor could perceive, based upon the Orange County matter, that there are protections or benefits available in a Chapter 9 proceeding. Time should prove those perceived benefits to have been illusory. But certainly, it is premature to determine that the effect of the existence of Chapter 9 in and of itself is so adverse to the market that it should be eliminated.

**IV. ARE THERE INCREASED INCENTIVES FOR MUNICIPALITIES TO
DECLARE BANKRUPTCY IN THE FUTURE?**

All eyes will be on Orange County for the next several years. Of great interest will be the price Orange County will pay if it takes the expedient road of denying past obligations, attempting to transfer the pain of past improper uses of revenues and bond proceeds to the bondholders, avoiding its responsibility for its debts or seeking to raid the revenues of other municipalities. If it is perceived that Orange County can do these things without a price, either in the capital markets or in the courts, then certain municipalities may wonder why they should go through extensive pain and suffering to meet their debts as they become due. Chapter 9 was enacted to provide a means for financially devastated municipalities to work their way out of their problems.

• *CHAPTER 9 HAS WORKED FOR SPECIAL DISTRICTS*

For example, Chapter 9 has been of real utility to the Colorado special districts where bonds were issued assuming they would be paid by real estate taxes but where development never occurred. The special districts and their creditors have found themselves in a death spiral where the application of procedures in a Chapter 9 for adjustment of debt may be the only real chance to find a solution. Similarly, prior to the enactment of the original municipal bankruptcy legislation following the Great Depression, there was no protection against annihilating litigation and endless disputes for troubled municipalities. Municipal bankruptcy, to provide debt adjustment and not debt elimination, was conceived of as a way to provide support to municipalities when all else fails. Traditionally, there has been a real stigma connected with the filing of municipal bankruptcy, and this stigma has kept such proceedings to a minimum. However, if a wealthy issuer such as Orange County is able to utilize the mechanism to avoid obligations it could meet with a minimum amount of inconvenience,²⁰ Chapter 9 certainly will be viewed in a new light. This would be a perversion of Chapter 9.

²⁰ In the case of *In re Sullivan County Regional Refuse Disposal District*, 165 B.R. 60 (Bankruptcy District D N.H. 1994), the court held that the failure of the debtors to impose a special assessment as they had a right to do, did not raise a question with respect to their insolvency. Rather, it was held that such failure to do so was relevant with regard to good faith.

• *ORANGE COUNTY WILL PROVIDE AN IMPORTANT TEST OF THE BENEFITS OF CHAPTER 9*

Previously, Chapter 9 had been viewed as a last resort because of the way in which the municipal market viewed Chapter 9. Moreover, there has not been extensive experience in the practical effect of a Chapter 9 proceeding on a large, multi-faceted municipality. Most of the Chapter 9 debtors to date have been special purpose corporations without the myriad of problems facing an operating municipal entity such as real "politics" with a large constituency, union issues, employee pension obligations and the need to deliver vital government services. If the Orange County case pends for a long period of time, other municipalities will more clearly be able to assess whether Chapter 9 was a vehicle which proved beneficial to a large municipal debtor or whether, given all of the circumstances, the Chapter 9 filing created as many problems as it solved.²¹ The municipal market has previously established that it will raise capital and lend into a troubled situation if it has the appearance that there is an ultimate willingness and ability to repay in full.

V. SHOULD ORANGE COUNTY HAVE DECLARED BANKRUPTCY?

• *IT CAN BE ASSERTED THAT THE CHAPTER 9 FILING WAS AN EXTREME STEP WHICH COULD HAVE BEEN AVOIDED*

Clearly Orange County and others knew prior to December 6, 1994 that there was a serious liquidity problem. Actions were taken to try to ameliorate the problems but, given market conditions and posturing by a number of the players, the situation deteriorated. As has been stated repeatedly, Orange County was not the typical Chapter 9 candidate. Orange County was not an aging metropolis with a shrinking tax base, failing infrastructure and seemingly insurmountable fiscal problems. Rather, Orange County faced a serious liquidity crisis on account of investments which were unwise, to say the least. If there had been a state agency charged with providing guidance to financially distressed municipalities within the state and which was a gatekeeper for access to Chapter 9, or if there had been a state mechanism whereby a troubled municipality could obtain a stay of litigation while working through a state commission to solve its problems, perhaps bankruptcy could have been averted. Obviously, the immediate goal of the bankruptcy was to prevent certain reverse repo participants from offsetting the securities held; if that was the goal, the filing was

²¹ One of the unknowns about any debt restructuring in bankruptcy will be whether or not the finished product will withstand subsequent challenges on a state constitutional level by taxpayers. It is entirely possible that the bankruptcy bar, the debtor and the bankruptcy court could spend the time and money to develop a plan and issue restructured obligations which are in whole or in part payable from taxes. It is then possible that after the bankruptcy proceeding is concluded, taxpayers will once again revolt, but that this next revolt will occur in the state courts and will challenge the state constitutional validity of the new taxes which are to pay off the restructured obligations. Everyone should be very careful about their current and ongoing perceptions about incentives until the Orange County matter is finally concluded.

ineffective. The other apparent purpose of the bankruptcy was to prevent litigation by bondholders and other creditors throughout the country, which indeed could have been annihilating. To that extent, the filing has been successful.

• *THERE SHOULD BE LESS DRASTIC WAYS TO OBTAIN RELIEF FROM LITIGATION*

As indicated above, relief from litigation was one of the reasons why municipal bankruptcy was developed as a concept following the problems experienced by municipalities during the Depression. In 1975, when the City of New York faced serious financial difficulties, a moratorium law was passed which attempted to limit court actions against the City. This law was later determined to be unconstitutional.²² However, the real benefit of that law was to give a breathing period to allow a municipality to attempt to solve its problems. As described in the previous section, serious consideration to state laws, supported by federal legislation, which encourage limited stays of litigation under specified circumstances, may be beneficial. While other municipalities, Philadelphia for example, have attempted to take action by developing remedial plans before the fiscal problem became too large to deal with, Orange County appears to have seized upon bankruptcy as an easy solution to a tough situation. It may be impossible to assess the ultimate success of the Orange County filing until the case is finally resolved. It certainly is fair to say that other large municipalities have not chosen the bankruptcy route when faced with similarly difficult issues. The manner in which Orange County is concluded, and in particular the price it pays and the pain ultimately suffered by the bondholders and other California municipal borrowers, all will dictate the final judgment as to the propriety of the filing.

VI. DO THE ORANGE COUNTY LOSSES AND SUBSEQUENT BANKRUPTCY REPRESENT A FUTURE TREND IN STATE AND LOCAL FINANCE OR REPRESENT AN ISOLATED INCIDENT?

• *SIMILAR SITUATIONS MAY BE FEW ALTHOUGH THE INVESTMENT POLICY OF ORANGE COUNTY MAY NOT BE UNIQUE*

As previously noted, Chapter 9 of the federal Bankruptcy Code can be an acceptable alternative both to fiscally troubled municipalities and the municipal bond market, provided the principles and practical realities of municipal financing are not disturbed. Prior to the Orange County filing, the vast majority of Chapter 9 filings have involved special purpose districts. Many of the special purpose districts were formed in the western states to finance infrastructure for residential real estate development. In the special district bankruptcies, the principal creditors are the holders of special district bonds, which are forms of special

²² *Flushing National Bank v. Municipal Assistance Corporation*, 390 N.Y.S.2d 22, 358 N.E.2d 848 (N.Y. App. 1976).

assessment bonds sometimes masquerading as general obligation bonds. Prior to the emergence of the investment problems suffered by Orange County, the clear trend was that Chapter 9 was utilized primarily by debtors with few creditors who needed to restructure bonded indebtedness, but who were unable to obtain the state law requisite consent of 100% of the creditors. Subsequent reports following the Orange County bankruptcy filing reveal speculation with regard to investment losses in other states such as West Virginia; Cuyahoga County, Ohio; the State of Wisconsin; and Escambia County, Florida. Nevertheless, it is hoped that the attitude exhibited by Orange County is an aberration.

• *ORANGE COUNTY COULD PROVIDE AN IMPORTANT LESSON OF WHAT TO AVOID*

The desperation caused when municipalities are faced with a tax cap (artificial caps on revenues) can lead to an investment policy doomed to failure. At the same time, it is the responsibility of municipal officers and those involved in the municipal bond market to ensure that municipal finance serves a legitimate public purpose. While others can and will comment at these hearings with regard to the investment policies and criteria of municipalities, it is clear that investment gimmicks and artificial mechanisms should be discouraged. Utilization of off balance sheet liability structures as well as methods of avoiding legitimate limitations on investments and financing can be dangerous. One of the beneficial aspects of the Orange County problem has been the opportunity for other municipalities and states to reflect on their investment policies. To the degree that such policies benefited from review and correction where appropriate, the troubles of Orange County have had a positive effect.

<p>VII. ARE STATES TAKING ADEQUATE STEPS, INCLUDING REEVALUATION OF APPLICABLE STATE STATUTES, TO IMPROVE THE INVESTMENT PRACTICES OF STATE AND LOCAL GOVERNMENT?</p>

Clearly, given the adverse publicity and litigation surrounding the Orange County debacle, investment practices are being scrutinized by state legislatures. It would not be unexpected to see increasing restrictions on exotic investments such as derivatives. On the other hand, some have argued against a blanket prohibition with respect to investment in derivatives as long as there is extensive disclosure. Individual state treasurers, rating agencies and bond insurers are developing investment policies and guidelines so that unsound investment practices are avoided in the future. In particular, the treasurer of the State of Ohio has been at the forefront of recommending sound investment practices. Historically, it has been assumed that municipalities invested their funds in a prudent way. It was artificial tax caps which, in large part, caused municipal officials to overreach. Now that attention has been focused on this problem, there has been extensive attention directed to investment practices on the state and local level. From the federal level, all investors, including municipal investors, can benefit from an increased focus on "suitability standards."

**VIII. SHOULD DISCLOSURE OR OTHER RULES GOVERNING
MUNICIPAL DEBT ISSUANCE BE CHANGED TO REFLECT
MUNICIPAL INVESTMENT POLICIES?**

• EXISTING LAW REQUIRES DISCLOSURE OF MATERIAL INFORMATION

Certainly, disclosure should reveal all material facts. To the extent municipalities, when issuing securities, fail to disclose all material facts, they already have a serious problem under existing law. The law governing disclosure as applied to municipal debt obligations appears to be reasonable and fair. However, as we all know, whether it is corporate or municipal debt, disclosure is only as good as the candor and quality of people involved in the transaction. Certainly after the Washington Public Power Supply System default and ensuing securities fraud litigation,²³ there was heightened awareness on the part of municipal issuers as to the importance of disclosure, particularly with regard to any legal questions presented by the transaction. Indeed, it was the WPPSS default which led in large part to the enactment of Rule 15c-2-12 and to its recent amendment.

*• REACTION TO THE ORANGE COUNTY PROBLEM AS IT RELATES TO
DISCLOSURE*

Because of the adverse publicity arising from the Orange County matter, some are reevaluating the detail which should be specifically required to be disclosed with respect to municipal investment policy. Municipal issuers already are required to disclose information that could affect the market's evaluation of their municipal bond issues under the securities law anti-fraud provisions. As previously alluded to, state investment issues generally fall under the jurisdiction of the states and not, for example, the Securities and Exchange Commission, with the exception of potential violations of the securities laws anti-fraud provisions. As is well known, the Tower Amendment prohibits the SEC and the Municipal Securities Rulemaking Board ("*MSRB*") from adopting rules requiring municipal issuers to file registration statements before their offerings are made.²⁴ The Amendment was added to the Securities and Exchange Act of 1934 when the *MSRB* was created in 1975. However, for example, the *GFOA* guidelines recommend continuing disclosure in the secondary market of material developments as well as for official statements.

The SEC's new amendment to Rule 15c-2-12 went into effect on July 1, 1995 and will require "obligated persons" with respect to municipal securities to make continuing disclosure to the municipal marketplace of material events. This new rule should be of significant help in assuring that investors in the municipal market have the current information

²³ *In re Washington Public Power Supply System Securities Fraud Litigation* (MDL No. 551).

²⁴ Section 15B(d)(2) of the Securities Exchange Act of 1934.

that they require. Market participants are currently in the process of analyzing and implementing what will be required for compliance with the new Rule, and Orange County with its problems is certainly on everyone's mind as this process takes place.

IX. HOW MIGHT THE RESPONSIBILITIES OF REGULATORS (BOTH FEDERAL AND STATE), ISSUERS, RATING AGENCIES, LAWYERS AND MARKET MAKERS BE ALTERED TO MINIMIZE THE USE OF SPECULATIVE INVESTMENT POLICIES, LOSSES AND BANKRUPTCIES OF MUNICIPALITIES IN THE FUTURE?

As noted above, the ability of units of local government to issue municipal debt has brought great rewards to our country, providing an infrastructure that is unparalleled. Now, the means of providing the capital which funded that infrastructure is being threatened because of the ability of a municipality to place itself in bankruptcy and contest the validity of its own obligations. The time has come when states need to ensure that speculative investment policies are not followed. Sometimes it is impossible to determine how speculative an investment is until the losses become clear. Obviously, higher than average benefits frequently bring higher than average risks. However, some investment policies are unsound at the outset and increased state supervision, perhaps even a pooling on the state level of cash and investments, could provide a uniform approach and comfort to the market. Surprise bankruptcy should be discouraged by state statutes, perhaps by following the Pennsylvania model or other states which require a municipality to work through a commission before filing. Such commissions may insist upon a balanced budget and demand actions to be taken which meet the needs of both a balanced budget and the municipality. Sometimes incentives are offered in the form of possible grants or loans from the state. That approach clearly would lead to fewer bankruptcies, if not the elimination of the fear that another major municipality or entity will go into a Chapter 9 proceeding without exhausting all other avenues. A uniform statute for adoption by the states which governs municipal financial distress could be developed. Legislation providing a temporary protection from litigation could be adopted. Some have suggested that simplifying the arbitrage regulations might lead to a greater understanding of just what was happening with regard to municipal investments. Other possible changes include requiring written investment policies and periodic marked-to-market practices. It cannot be forgotten that many municipalities received significant investment income by adopting sophisticated investment strategies. What needs to be done now is damage control when the strategies unexpectedly create problems.

CONCLUSION

To summarize, the following may be helpful to prevent the occurrence of another Orange County crisis:

- (1) Correct market perception and understanding of the structure of transactions and the risks inherent upon the occurrence of default and bankruptcy.
- (2) Provide a federal statutory means for municipalities to be shielded from annihilating litigation without resort to bankruptcy.
- (3) Discourage artificial and unrealistic tax caps by states which force local political leaders of cash-starved municipalities and market participants to employ speculative investment practices and to create unwieldy and difficult to understand borrowing structures.
- (4) Discourage waste in government but provide realistic levels of tax revenues to support necessary municipal services.
- (5) Strengthen state and local investment guidelines by reference to nationally recognized and respected models such as the GFOA guidelines.
- (6) Promote disclosure to the primary and secondary markets to avoid surprises and educate and inform the market of the true condition of the municipal issuer with more extensive review by municipal analysts.
- (7) Encourage states to set up municipal finance assistance commissions to work with financially troubled municipalities and to act as gatekeepers to Chapter 9. Ideally, such filings would be only after state efforts to remedy the situation had failed.
- (8) Encourage state statutes supported by federal legislation providing that municipalities cannot repudiate debt that they had previously represented to be validly issued.
- (9) Reaffirm the stigma of bankruptcy and discourage easy access to Chapter 9. Chapter 9 should be painful enough in the market and elsewhere to be truly only a last resort.

THE EXPERIENCES OF
NEW YORK, CLEVELAND
AND BRIDGEPORT, CONNECTICUT

APPENDIX A

THE NEW YORK AND CLEVELAND EXPERIENCES
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In the spring of 1975, New York City was unable to market its debt because the bond market had discovered that New York had, for more than ten years, been using questionable accounting and borrowing practices to eliminate its annual budget deficits.¹ The banks refused to renew short-term loans that were maturing or to loan additional cash to the city, and only state cash advances were keeping the city afloat. The city's spending for operating purposes exceeded operating revenues over several years, and the accumulated fund deficit could only be resolved by increasing amounts of short-term borrowing. New York City itself had no funds to meet its short-term obligations. According to at least one analysis, the causes of this revenue short-fall included changing population and economic characteristics, national economic difficulties, state and federal government action, and inaction and weaknesses in the political system itself.² New York nearly defaulted on the payment of its notes in October, 1975, and it was predicted that a default was likely in December in the absence of federal aid.³

At this time, the existing Chapter IX was examined to determine if it presented a viable solution for the problems facing New York City. It did not. Specifically, when filing a Chapter IX petition, a municipality had to show that a proposed plan of composition had been accepted by 51% in amount of its creditors,⁴ and the Act did not provide a mechanism for raising funds to pay the municipality's postpetition expenses. Further, the experience of Ranger, Texas and Ft. Lee, New Jersey, indicated the need for continuing court jurisdiction over execution and implementation of the Plan of Adjustment. In both Ranger and Ft. Lee, difficulties were experienced in the timely meeting of the requirements of the Plan. As referred to previously, Ranger's 1940 Plan was modified by subsequent proceedings in 1946 and 1971.

1 For a detailed study of the New York City fiscal crises see Shalala & Bellamy, *A State Saves a City: The New York Case*, 1976 Duke LJ 1119 (1976); United States Congress, House of Representatives Committee on Banking, Finance and Urban Affairs, Subcommittee on Economic Stabilization, Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York (95th Cong 1st Sess. August 1977).

2 Shalala & Bellamy, *A State Saves a City: The New York Case*, 1976 Duke LJ at 1119-1120.

3 New York Times, October 19, 1975, Section 4 at 1.

4 A major obstacle would be reaching the holders of bearer instruments. It was estimated that 160,000 individuals or families held \$4.89 billion in New York City bonds, about two-thirds of the \$7.35 billion in outstanding bonds. New York Times, October 19, 1975, at 48, Col. 2. Some may state that the registration requirements of TEFRA (the Tax Equity and Fiscal Responsibility Act of 1982, Pub L No. 97-248) should have solved these problems. However, as those experienced in registered bonds can attest, there are many situations where the bonds are held in nominee names (sometimes as many as 95% are in broker, bank or other nominee's names) and it is difficult to quickly and effectively communicate with bondholders.

Although New York City's then-existing financial crises were averted through use of a *deus ex machina* in the form of the State Municipal Assistance Corporation which issued securities on behalf of the City,⁵ the ineffectiveness of the old Chapter IX to a financially troubled major city provided the impetus for a substantial revision to municipal bankruptcy legislation. New York City's problems then and now are no different than most major metropolitan cities: increasing labor costs in a period of decreasing revenues. It is not unusual for 60%-75% of municipal budgets to be for labor costs.

In December of 1978, the city of Cleveland defaulted on \$15.5 million of bond anticipation notes. When a financial emergency was declared by the state auditor in 1980, Cleveland had overdue accounts payable in excess of \$36 million and a large general fund deficit. Again, as in the case of New York, general fund expenditures exceeded revenues. Further, it appeared that restricted funds had been used to meet general obligations. Cleveland was able to solve, at least for a time, its financial problems by borrowing \$15 million from the State of Ohio to pay overdue debts, and through the issuance and sale of \$36.2 million in bonds to Cleveland banks. Although the provisions relating to municipal debt adjustment had been amended following the New York case, a resort to municipal bankruptcy was not considered.⁶

CITY OF BRIDGEPORT, CONNECTICUT

In 1991, the City of Bridgeport, Connecticut created a stir in the municipal finance community by filing a petition under Chapter 9 of Federal Bankruptcy Code. Bridgeport was the first city of major proportions to so file and was the largest city in Connecticut. Unlike the special purpose district bankruptcies which have been common in recent years, Bridgeport is a "real" city with many different creditors with competing interests. Bridgeport had over \$200 million in long-term bondholders. At the same time, some 4,000 people were employed by the City pursuant to union contracts to deliver services to approximately 150,000 citizens. The financial problems of the City did not arise overnight. Previously, the State of Connecticut had enacted special legislation known as the State Act to recognize the otherwise illegal deficits of the City, to provide a financial oversight review board to supervise and discipline City finances and to provide certain financial assistance to

5 The 1970's did not have a monopoly on fiscal woes. In 1990, the New York State Financial Control Board noted the negative impact of the national and regional economics on the city's revenue base, the turmoil affecting one of the city's major revenue sources, Wall Street, and increased borrowing costs. The Financial Control Board, essentially dormant since the mid-1980's, can be reactivated if certain conditions are triggered, including the inability of the city to meet debt service payments. The Bond Buyer, November 30, 1990, pp. 1, 45.

6 For an analysis of the factors leading to the default see Feldstein, What Really Went Wrong in Cleveland in 1978, *The Municipal Bond Handbook* 687 (1983). Mr. Feldstein attributes some of the problems to the weaknesses caused by a mayor whose term of office was only two years and who had limited powers and by the city's limited taxing power.

the City.⁷ The State Act authorized the financing of the deficit and provided certain payments to be made by the State to bondholders of the City in order to enhance the credit-worthiness of the troubled City. This intercept mechanism which functions in connection with the oversight board review is not uncommon but could be subject to challenge in the Chapter 9 proceeding. After the City of Bridgeport filed for bankruptcy, the State of Connecticut moved to dismiss the bankruptcy petition on a number of grounds. Specifically, the State objected to the bankruptcy filing on the grounds that Bridgeport was not authorized to be a debtor under State law, was not insolvent, that the petition was filed in bad faith, and that the Mayor was not properly authorized by the Common Council to file the petition. The bankruptcy judge ruled on several of these issues. With respect to the argument that Bridgeport was not authorized to be a debtor under State law, the bankruptcy court rejected the argument of the State that for a city to be generally authorized to be a debtor, there must be express authorization in a state statute, i.e., specific words in the nature of bankruptcy or debt adjustment or reorganization. The court concluded that Bridgeport was generally authorized to be a debtor if State law delegated to it home rule authority over such matters as finances, property, borrowing and public services and the corresponding rights and powers necessary to achieve the purpose of such home rule.⁸ Referring to the general statute which provided that Connecticut municipalities shall have the power to sue and be sued and institute, prosecute and maintain and defend any action or proceeding in any court of competent jurisdiction, the bankruptcy court in Bridgeport concluded that bankruptcy was a proceeding within the scope of that statute. Further, the court concluded that the Special Act did not prohibit Bridgeport from being a debtor under Chapter 9.

However, after hearing extensive testimony, the court concluded that Bridgeport was not insolvent when it filed its petition and therefore the petition should be dismissed.⁹ As referred to above, the test for an insolvent municipality is that the municipality is generally not paying its debts as they become due or is unable to pay debts as they become due. It was undisputed that on the date of filing, Bridgeport was paying its debt as they became due. Therefore, the issue was whether on the date of filing Bridgeport was *unable* to pay debts as they became due. The court concluded that it had not been presented persuasive evidence that the City would be unable to pay its debts anytime in the future. While the court rejected the State's argument that the analysis of insolvency could not be prospective in nature, the court found that the evidence established that Bridgeport will not run out of cash during the fiscal year 1991-1992. The court disagreed that the cash flow analysis demonstrated that Bridgeport would run out of cash early next fiscal year. According to the court, financial difficulties short of insolvency are not a basis for Chapter 9 relief. Therefore, the court concluded that Bridgeport was not insolvent when the petition was filed, the petition must be dismissed and Bridgeport must continue with the budget and collective bargaining process.

7 The State Act, Special Act No. 88-80 signed by the Governor on June 8, 1988.

8 In re City of Bridgeport, 128 B.R. 688 (D. Conn. 1991).

9 In re City of Bridgeport, 129 B.R. 332 (D. Conn. 1991).

In summary, while the court agreed with Bridgeport that a city should not have to wait until it runs out of money in order to qualify for Chapter 9 protection, it must demonstrate as a condition precedent to filing that in the near future it will run out of money and be unable to pay its debts as they become due. Because of the election of a new Mayor in Bridgeport, it appears that pending appeals of these rulings will not be pursued. Therefore, there will be no review of these District Court rulings.

CHAPTER NINE CASES FILED

APPENDIX B

CHAPTER NINE CASES FILED

AS OF MAY 31, 1995

No.	YEAR	Code	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
1	1992	(B)	Town of North Courtland	N. Alabama	92-82747		
2	1991	(B)	City of Lipscomb	N. Alabama	91-3033	10/24/91	01/6/92
3	1986	(D)	Cooper River School District	Alaska	3-86-00830	02/17/88	04/11/88
4	1994	(E)	New Magma Irrigation & Drainage District	Arizona	94-00211-TUC-JMM		
5	1994	(E)	Central Arizona Irrigation and Drainage District	Arizona	94-02043-TUC-JMM		
6	1983	(B)	South Tuscon, Arizona	Arizona	83-00866	12/23/83 02/21/84 amendment 04/05/84 amendment	04/09/84 confirmation; case closed 03/23/88
7	1994	(B)	County of Orange	C. California	SA 94-22272-JR		
8	1994	(B)	Orange County Investment Pools				case dismissed 05/24/95
9	1990	(C)	Corning Hospital District	E. California	89-28568		
10	1986	(D)	Lassen Community College District	California	2-86-01379	01/12/89 05/30/89 amendment 01/24/91	07/24/91
11	1985	(C)	Monterey County Special Health Care Authority	N. California	85-00649	01/08/86	03/27/86
12	1983	(D)	San Jose School District	N. California	83-02387	02/07/84	case dismissed 05/8/84

A = Municipal Utilities; B = City, Village or County; C = Hospital/Health Care; D = School/Education; E = Special Municipal District; F = Transportation

No.	YEAR	Code	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
13	1991	(D)	Richmond Unified School District	N. California	91-42434	no plan filed	case closed 12/18/91
14	1981	(E)	The Management Institute of San Leandro	N. California	81-02265	no plan filed	case closed 08/21/85
15	1994	(E)	City of Colorado Springs Spring Creek General Improvement District	Colorado	94-15333-MSK	09/08/94	
16	1994	(E)	Aurora CentreTech Metropolitan District	Colorado	94-11247-PAC		
17	1993	(E)	Castle Pines North Metropolitan District	Colorado	93-21925-RJB		
18	1992	(D)	Ellicott School Building Authority	Colorado	92-20479		
19	1992	(E)	Powderhorn Metropolitan District No. II	Colorado	92-11439-SBB		
20	1991	(A)	Cottonwood Water and Sanitation District	Colorado	91-25763		
21	1991	(E)	Northern Metropolitan District, Adams County, Colorado	Colorado	91-26399-RJB		
22	1991	(E)	Castle Pines North Metropolitan District	Colorado	90-17548-RJB		
23	1991	(E)	Colorado Springs Cottonwood General Improvement District	Colorado	91-10684		
24	1991	(E)	Paint Brush Hills Metropolitan District	Colorado	90-18984-CEM		

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No.	YEAR	Code	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
25	1990	(E)	Wolf Creek Valley Metropolitan District No. II, Mineral County, Colorado	Colorado	90-11905		
26	1990	(E)	Wolf Creek Valley Metropolitan District No. IV, Mineral County, Colorado	Colorado	90-11906		
27	1990	(E)	Dawson Ridge Metropolitan District No. 1	Colorado	90-15400		
28	1990	(E)	Villages at Castle Rock Metropolitan District No. 7	Colorado	90-18922		
29	1990	(E)	Will-O-Wisp	Colorado	89-B.17447		
30	1989	(E)	Colorado Centre Metropolitan District	Colorado	89-16410	no plan filed as of 02/09/90	
31	1989	(E)	Villages at Castle Rock Metropolitan District No. 4	Colorado	89-16240	09/12/91	plan confirmed 12/17/91
32	1989	(E)	Hamilton Creek Metropolitan District, Summit County, Colorado	Colorado	89-07269	11/07/89	
33	1987	(A)	Eagles Nest Metropolitan District	Colorado	87-15212	as of 04/03/89 no plan filed	
34	1992	(F)	Westport Transit District	Connecticut	2-92-00404		
35	1991	(B)	City of Bridgeport	Connecticut	91-51519		case dismissed 08/01/91
36	1989	(F)	Lake Grady Road and Bridge District, Extension #1, Hillsborough County, Florida	Florida	89-4507-8P9	06/27/89	

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No.	YEAR	Case	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
37	1987	(F)	Lake Grady Road and Bridge District, Hillsborough County, Florida	Florida	87-1590	08/31/87	01/15/88
38	1987	(A)	Water & Sewer District "A" Pasco County, Florida	Florida	87-3218	03/04/87	07/20/87
39	1985	(A)	Bell County Garbage and Refuse Disposal District	Kentucky	85-143	05/08/88	case dismissed 06/30/88
40	1984	(A)	Whitley County Water District	E. Kentucky	84-00089	no plan filed	case dismissed 04/17/85
41	1992	(C)	Addison Hospital	Michigan	92-02336	06/25/93	
42	1987	(B)	Village of Merrill, Michigan	Michigan	87-09455	06/19/87	case dismissed 12/09/87
43	1987	(B)	City of Mound Bayou, Mississippi	Mississippi	87-00295-BKC-DN1	settled prior to filing plan	
44	1994	(B)	City of Kinloch, Missouri	E. Missouri	94-43315-399		
45	1984	(C)	Pulaski Memorial Hospital	Missouri	84-00082	08/14/85	10/10/85 confirmation; case closed 01/08/88
46	1984	(B)	Wellston City, Missouri	Missouri	84-01492	02/19/84	plan not confirmed; case closed 10/01/86
47	1992	(D)	Chilhowee R-IV School District	W. Missouri	92-42256-9-FWK	01/03/86 amendment	
48	1991	(E)	City of Columbia Falls, Montana Special Improvement Districts Nos. 25, 26, and 28	Montana	90-31775-9 91-31360-9 91-31355-9		
49	1992	(A)	Sanitary and Improvement District No. 113	Nebraska	92-81195	12/21/92	confirmed 03/18/93

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NO. YEAR	Code	DEVELOP	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN	
50	1992	(A)	Sanitary and Improvement District No. 284	Nebraska	92-80761	01/12/93	confirmed 03/26/93
51	1991	(A)	Sanitary and Improvement District No. 289	Nebraska	91-80274		
52	1991	(A)	Sanitary and Improvement District No. 89	Nebraska	91-80674		
53	1991	(A)	Sanitary and Improvement District No. 151	Nebraska	91-80989		
54	1990	(A)	Sanitary and Improvement District No. 235	Nebraska	90-80387		
55	1990	(A)	Sanitary and Improvement District No. 330	Nebraska	90-81351		
56	1989	(A)	Sanitary and Improvement District No. 257	Nebraska	89-81086		
57	1989	(A)	Sanitary and Improvement District No. 264	Nebraska	89-81343		
58	1988	(A)	Sanitary and Improvement District No. 252 of Douglas County, Nebraska	Nebraska	88-1427	02/21/89 05/12/89 amendment	
59	1988	(A)	Sanitary and Improvement District No. 52 of Sarpy County, Nebraska	Nebraska	88-1614	case filed 10/6/88; application for additional time to file plan filed 06/06/89; (plan was to be filed by 06/10/89)	

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No.	YEAR	COURT DISTRICT	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
60	1987	(A)	Sanitary and Improvement District No. 117 of Sarpy County, Nebraska	Nebraska	87-01724	05/28/87	05/26/88
61	1987	(A)	Sanitary and Improvement District No. 93 of Sarpy County, Nebraska	Nebraska	87-00062	01/09/87	12/14/87
62	1987	(A)	Sanitary and Improvement District No. 122 of Sarpy County, Nebraska	Nebraska	87-00178	01/22/87	05/29/87
63	1987	(A)	Sanitary and Improvement District No. 103 of Sarpy County, Nebraska	Nebraska	87-00826	03/18/87	11/07/88
64	1987	(A)	Sanitary and Improvement District No. 92 of Sarpy County, Nebraska	Nebraska	87-0250	08/14/87	
65	1987	(A)	Sanitary and Improvement District No. 75 of Sarpy County, Nebraska	Nebraska	87-01089	04/31/87	
66	1987	(A)	Sanitary and Improvement District No. 69 of Sarpy County, Nebraska	Nebraska		04/01/88	
67	1987	(A)	Sanitary and Improvement District No. 267 of Douglas County, Nebraska	Nebraska	87-00487	02/20/87	08/17/88
68	1987	(A)	Sanitary and Improvement District No. 253 of Douglas County, Nebraska	Nebraska	87-01878	06/12/87	04/11/88
69	1987	(A)	Sanitary and Improvement District No. 30N of Douglas County, Nebraska	Nebraska	87-02662	08/28/87	

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No.	YEAR	Case	DEPT.	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
70	1987	(A)	Sanitary and Improvement District No. 251 of Douglas County, Nebraska	Nebraska	87-02134	07/10/89	
71	1987	(A)	Sanitary and Improvement District No. 3 of Saunders City, Nebraska	Nebraska	87-00051	01/08/87	06/30/87
72	1987	(A)	Sanitary and Improvement District No. 6 of Platte County, Nebraska	Nebraska	87-00780	03/13/87	12/18/87
73	1986	(A)	Sanitary and Improvement District No. 67 of Sarpy County, Nebraska	Nebraska	86-02941	10/10/86	
74	1986	(A)	Sanitary and Improvement District No. 187 of Douglas County, Nebraska	Nebraska	86-1798	06/20/86	11/17/86
75	1986	(A)	Sanitary and Improvement District No. 97 of Sarpy County, Nebraska	Nebraska	86-00601	03/05/86	
76	1986	(A)	Sanitary and Improvement District No. 229 of Douglas County, Nebraska	Nebraska	86-1885	06/27/86 10/30/86 amendment	11/07/86
77	1986	(A)	Sanitary and Improvement District No. 87 of Douglas County, Nebraska	Nebraska	86-01738	06/20/86	11/17/86
78	1986	(A)	Sanitary and Improvement District No. 250 of Douglas County, Nebraska	Nebraska	86-01266	05/01/86	04/18/88
79	1986	(A)	Sanitary and Improvement District No. 4 of Saunders City, Nebraska	Nebraska	86-02126	07/25/86	11/17/86

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No.	YEAR	Code	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
80	1985	(A)	Sanitary & Improvement District No. 265 of Douglas County, Nebraska	Nebraska	85-2384	12/27/85 01/24/86 amendment 07/10/86 amendment	10/07/86
81	1985	(A)	Sanitary & Improvement District No. 7 of Lancaster County, Nebraska	Nebraska	85-0039	01/15/86 11/18/86 amendment 05/02/88 amendment 08/30/88 amendment 11/23/88 amendment 02/15/89 amendment 05/03/89 amendment 06/02/89 amendment	06/22/89
82	1985	(A)	Sanitary and Improvement District No. 65 of Sarpy County, Nebraska	Nebraska	85-756	05/01/86 09/02/86 amendment	10/30/86
83	1984	(A)	Sanitary & Improvement District No. 63 of Sarpy County, Nebraska	Nebraska	84-01263	06/29/84	03/11/85
84	1983	(A)	Sanitary & Improvement District No. 4 of Lancaster County, Nebraska	Nebraska	83-01456	10/06/83 04/17/84 amendment 06/18/84 amendment	08/02/84
85	1983	(A)	Sanitary & Improvement District No. 42 of Sarpy County, Nebraska	Nebraska	83-00956	06/02/83 07/27/84 amendment	09/26/84
86	1982	(A)	Sanitary & Improvement District No. 5 of Cass County, Nebraska	Nebraska	82-01671	11/01/83 10/24/86 amendment 11/12/86 amendment 01/22/87 amendment	02/26/87
87	1993	(E)	Sullivan County Regional Refuse Disposal District	New Hampshire	93-12640-JEY 93-12639		
88	1983	(C)	Jersey City Medical Center	N. Jersey	83-00829	03/29/85	08/06/87

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No. YEAR	Code	DEFOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
89	1989	(A)	Valliant Public Works Authority	E. Oklahoma	89-70108	
90	1982	(B)	Wapanucka, Oklahoma	E. Oklahoma	82-00231	no plan filed 10/14/83
91	1988	(B)	Borough of Shenandoah	Pennsylvania	88-20603	no plan filed
92	1981	(E)	North & South Shenango Joint Municipal Authority	W. Pennsylvania	81-00408	case dismissed 05/26/82
93	1988	(F)	Low Country Regional Transportation Authority	South Carolina	88-01944	case filed 06/24/88 - plan to be filed by 07/14/89
94	1994	(A)	East Sevier County Utility District	E. Tennessee	94-30103	
95	1991	(A)	Sale Creek Utility District	E. Tennessee	91-11216	04/24/91
96	1988	(B)	City of Copperhill	Tennessee	88-00710	case filed 3/22/88
97	1986	(F)	Chattanooga Area Regional Transportation Authority	Tennessee	1-86-00564	03/13/86
98	1982	(A)	Pleasant View Utility District of Cheatham County, Tenn.	Mdle. Tenn.	82-01139	case dismissed 05/19/83
99	1995	(A)	Montgomery County Municipal Utility District No. 42	S. Texas	95-41259	
100	1994	(A)	Greens Parkway Municipal Utility District	S. Texas	94-47421-H5-9	
101	1994	(A)	Harris County Municipal Utility Districts No. 202	S. Texas	94-42132-HA-9	
102	1994	(A)	Harris County Municipal Utility District No. 216	S. Texas	94-45424-H5-9	

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NO.	YEAR	COOK	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
103	1994	(A)	Rankin Road West Municipal Utility District	S. Texas	94-40920-H5-9		
104	1993	(A)	Montgomery County Municipal District No. 56	S. Texas	93-49490		
105	1993	(A)	Cypress Hill M.U.D. No. 1	S. Texas	93-48643-H4-9		
106	1993	(A)	Big Oaks Municipal Utility District	S. Texas	93-42397		
107	1993	(B)	Denton County Reclamation and Road District	E. Texas	93-40306	03/08/93	
108	1993	(A)	Harris County Municipal Utility	S. Texas	93-43120	04/21/93 08/23/93 amendment	
109	1992	(A)	Northwest Dallas County Flood Control District	N. Texas	392-31469-RCM	5/12/92	
110	1992	(B)	Southeast Williamson County Road	W. Texas	92-12887	11/10/92	confirmed 02/17/93
111	1992	(B)	Southwest Williamson County Road District No. 1	W. Texas	92-12274	04/16/92	confirmed 06/29/93
112	1988	(C)	South Eastland County Hospital District d/b/a Blackwell Hospital	Texas	88-10005	07/07/88 11/17/88 amendment	12/16/88
113	1987	(A)	Northwest Harris County Municipal Utility District No. 19	S. Texas	87-02498	03/10/87	Motion to Dismiss: Municipal Utility -- Because progress is being made on a consensual plan, the motion to dismiss is passed by agreement without prejudice to its resetting

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No.	YEAR	Code	DEBTOR	COURT DISTRICT	DOCKET NUMBER	PLAN OF ADJUSTMENT	CONFIRMATION OF PLAN
114	1980	(A)	Grimes County Municipal Utility District No. 1	S. Texas	80-010948	08/19/80	04/20/81
115	1992	(A)	West Harris County Municipal Utility District No. 7	S. Texas	92-45173-H4-9		
116	1990	(C)	Timpangos Community Mental Health	Utah	90-612		
117	1992	(A)	Jefferson County Solid Waste Authority	W. Virginia	92-30352	02/01/93 05/28/93 amendment	confirmed 08/11/93
118	1988	(A)	Arbuckle, WV Public Service District	W. Virginia	88-50151	06/09/88	
119	1985	(A)	Badger Mountain Irrigation District	E. Washington	85-03136-299	11/23/87	Cases open/plan not confirmed as of 2/12/90
120	1991	(A)	Whatcom County Water District	W. Washington	91-00941		
121	1991	(B)	City of North Bonneville	W. Washington	91-34125		

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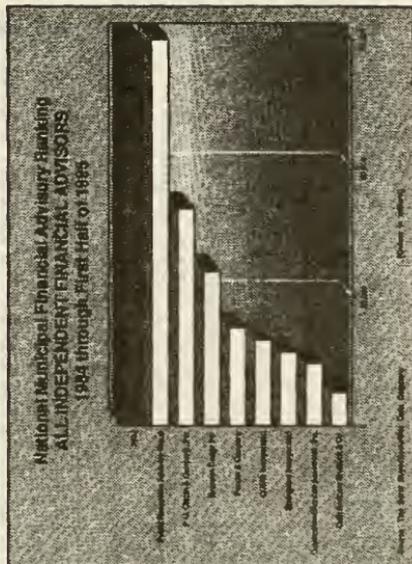
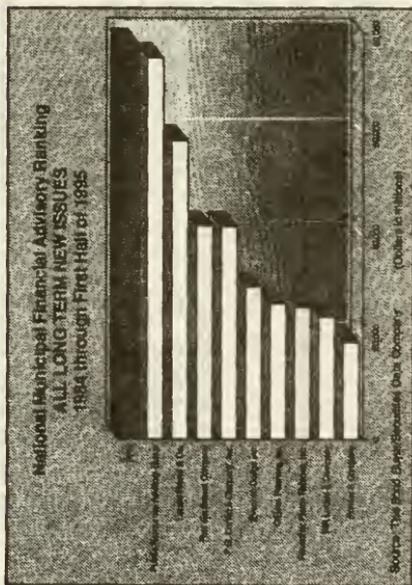
**U. S. House of Representatives
Committee on Banking and Financial Services**

Presenter

Marlin L. Mosby, Jr.
Managing Director
Public Financial Management, Inc.

Firm Background

Public Financial Management, Inc. was founded in 1975 in Philadelphia, Pennsylvania. Today PFM is the nation's leading municipal financial and investment advisory firm. As financial advisors, PFM engages in capital planning, revenue forecasting, and evaluation, resource allocation, and debt management policy, in addition to debt transaction management, including structuring, documentation, and execution. As investment managers, PFM brings a comprehensive spectrum of services to solve the problems which managing money raises. State-of-the-art accounting, timely and market driven portfolio management, and arbitrage compliance are among the diverse services which PFM offers through state oriented investment pools and individual client portfolios.



Mr. Mosby's Background

- 1985 to present - Financial Advisor at Public Financial Management, Inc.
- 1975 to 1983 - Director of Finance and Administration, City of Memphis, TN

Mr. Mosby works with state and local governments to develop financial plans for and raise capital for the construction of major infrastructure projects. Current clients include the City of Memphis, State of Wisconsin, Minnesota Public Facilities Authority, Maryland Clean Water Financing Administration, Colorado Water Resources and Power Development Authority and the Pennsylvania Infrastructure Investment Authority. While the Director of Finance and Administration for the City of Memphis, Mr. Mosby developed the City's first Treasury Management function and drafted the City's first formal debt and investment management policy statements.

Key Points

I.) U.S. financial markets are extremely efficient

II.) Market participants have different needs

III.) Public money managers are much like private money managers

IV.) If there is a role for the federal government it would be in the areas of disclosure and/or basic research.

U.S. Financial Markets are extremely efficient

A.) Efficiency based upon regulation of the flow of information

1. Prohibition of the use of some information

Insider information

Misleading information

2. Requirement that other information be provided

B.) Assumption is that given accurate information investors can make sound business decisions and that government's role is not to prevent all losses but to insure that market participants have access to important information.

Market Participants have very different needs

- A.) A security that is very conservative for one investor might be highly speculative for another investor.
- B.) Most derivatives were designed to meet the specific needs of a particular investor and in most cases were designed to reduce that investor risk profile.
- C.) The fact that most derivative products have real economic value to specific investors and are highly speculative to other investors makes it extremely difficult to regulate appropriate investments.

Public money managers are very much like private money managers.

- Their goal is to maximize yield within a given risk profile.
- They are inundated by individuals and firms trying to sell them investment securities.
- Regardless of how smart they are or how financially sophisticated they and their staff are they cannot stay on top of all the new investment products being created and marketed.
- Very few of them have the resources to research every new product presented to them.

If there is a role for federal government it would be in the areas of disclosure and / or basic research.

- This is very much what Mr. Arthur Levitt at the SEC has been saying for the past few months.
- The SEC is set up to set minimum disclosure guidelines and to either do or sponsor basic research.
 - Recent municipal secondary market disclosure guidelines is an example of how well that system can work.
 - Independent research would provide market participants with needed information upon which to make informed decision. This is especially important in a political environment where commercial banks, investment banks, insurance companies and other financial service providers are rightfully seen as outstanding corporate citizens and therefore hard to turn down when they are selling to the public entity.

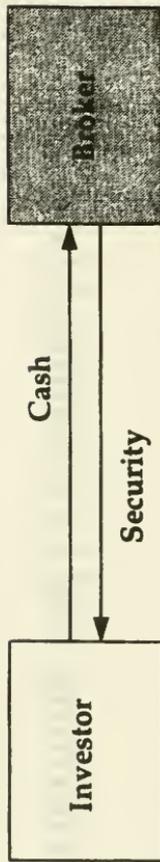
Summary

Determining and Evaluating Investment Risk

**Lessons from the Orange County,
California Bankruptcy**

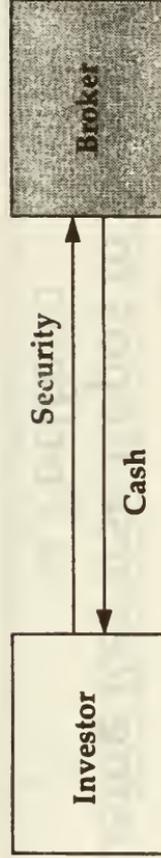
Repurchase Agreement

- Investor "buys" security and agrees to "sell" it back at a prespecified price
- Fixed yield for a fixed term
- The transactions is essentially a collateralized loan
- Market value of collateral equals or exceeds cash exchanged

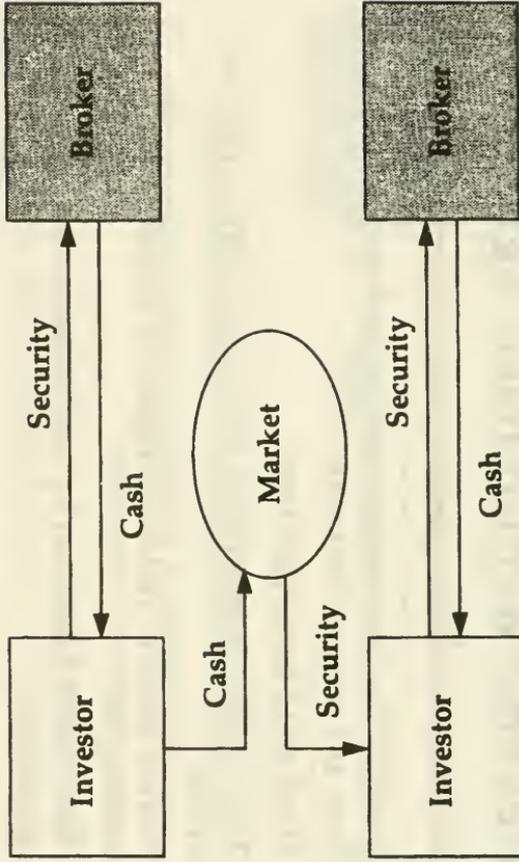


Reverse Repurchase Agreement

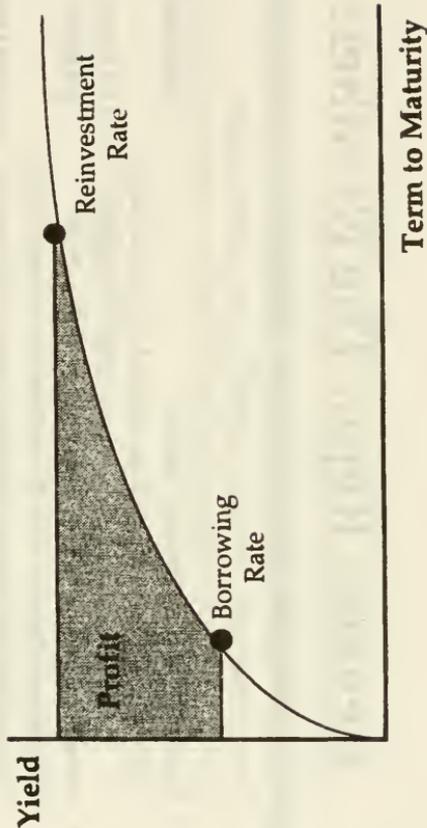
- Investor "sells" portfolio holding and agrees to "buy" it back at a prespecified price
- Fixed yield for a fixed term
- The investor is essentially borrowing money from the broker
- Market value of collateral equals or exceeds cash exchanged
- "Borrowed" funds can be used to meet cash flow needs or reinvested



Using Reverse Repos to Leverage a Portfolio



Leveraging a Portfolio to Earn Additional Income



Reverse Repo: The Numbers

- Investor buys 10 yr. Treasury Note (A) \$10,000,000
- Investor uses Treasury Note A as collateral on Reverse Repo
 - and receives cash equal to 98% of value of Treasury A (\$ 9,803,921)
- Investor buys 10 yr. Treasury Note (B) \$ 9,803,921
- Investor uses Treasury Note B as collateral on Reverse Repo
 - and receives cash equal to 98% of value of Treasury B (\$ 9,611,689)
- Investor buys 10 yr. Treasury Note (C) \$ 9,611,689
- Investor uses Treasury Note C as collateral on Reverse Repo
 - and receives cash equal to 98% of value of Treasury C (\$ 9,423,223)
- By leveraging the portfolio in this manner, the investor can turn a \$10,000,000 investment into portfolio of Treasury Notes worth \$29,415,610
- If cost of borrowing funds is less than the reinvestment rate, investor makes profit

Derivative Securities

- Any security where the value is linked to or derived from an underlying asset or benchmark (bonds, currency, or commodities)
 - mortgages
 - car loans
 - Treasuries (Repo)
 - S & P Index
 - South African Rand
- It can be very difficult to predict how complex derivative structures will react to changes in interest rates
- Derivative securities can have little or no credit risk, but contain significant levels of market risk

Floating Rate Notes (Floaters)

- Interest rate floats over a benchmark
 - U.S. Treasury obligation
 - LIBOR
 - Fed Funds
- Issued by agencies of the U.S. government and corporations
- Allow investors to obtain a variable rate of return
- Interest rate moves with market rates
- May have a cap or floor
- Market value may fluctuate if index does not track market perfectly or if spreads change

Example: 2 year SLMA Note pays 3-month T. Bill Rate re-set weekly

Structured Notes

- Allow investors to target specific investment risks and opportunities
- Step-up notes
 - first year coupon above going market rates
 - coupon "steps up" periodically to pay more as the note ages
 - call feature typical
 - Risks:
 - » coupon steps up at a slower rate than overall interest rate levels
 - » security may be called if yield on note outperforms the market
- Range Notes
 - pay coupon only if yield on another security is within a "range"

Inverse Floaters

- Rate of return is tied to index or benchmark
- Yield on inverse floater moves opposite the index
- If interest rates go up, the return on the inverse floater goes down
- Provide a very low interest rate when interest rates rise
- Market value can fluctuate severely
- Can magnify the affect of interest rate swings

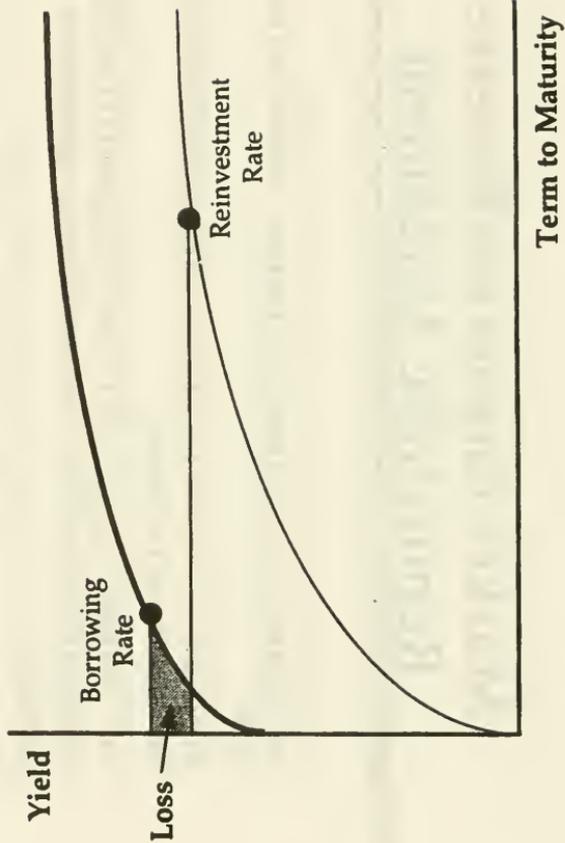
Example: 10% - 1 month LIBOR

- Rate on 1/1/94 6.1875%
- Rate on 2/8/95 3.875%

Market Impact on Reverse Repurchase Agreement

- As interest rates increase, the market value of collateral falls
- Investors in reverse repurchase agreements have to put up additional collateral
- Brokers have a legal right to sell collateral if the market value falls below 100% and additional collateral is not pledged
- Cost of "borrowing" funds increases as rates rise and may exceed the yield on longer term securities used as collateral

Effect of Yield Curve Shifts on Reverse Repo Strategy



The Numbers Unravel

- Investor owns 10 yr. Treasury Notes (A,B,C) \$29,415,610
- Investor uses Treasury Notes as collateral on reverse repos
 - Amount borrowed using reverses repos (\$28,838,833)
- If interest rates rise 100 basis points, value of portfolio falls
 - Market value of portfolio \$26,474,049
- Investor must pledge additional securities worth \$2,938,561 to collateralize reverse repos
- Increase in rates will also increase short-term borrowing costs and reduce or eliminate profits from strategy

Could the Losses Have Been Avoided?

- **Control**
 - Strict investment statutes
 - More restrictive investment policy
 - More oversight by Governing Board
 - Greater internal controls
 - Mark to market requirements
 - Use of appropriate pool accounting methodology
- **Better understanding of investment securities**
- **Acknowledgment that higher returns generally mean higher risk**
- **Sensitivity analysis to predict effect of increasing rates**

STATEMENT OF FGIC ADVISORS, INC.

to the

U.S. HOUSE OF REPRESENTATIVES
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND
GOVERNMENT SPONSORED ENTERPRISES
of the
COMMITTEE ON BANKING AND FINANCIAL SERVICES
REGARDING PUBLIC FUNDS MANAGEMENT

July 26, 1995

Contacts: Stephen A. Attanasio
Chief Operating Officer, Mutual Fund Management
FGIC Advisors, Inc.

Janet C. Corcoran
Senior Counsel
Financial Guaranty Insurance Company

Mr. Chairman and members of the Subcommittee, FGIC Advisors, Inc. (FGIC Advisors) is the advisor to "FGIC Public Trust," a family of no-load funds created specifically to serve the cash management needs of local governments and government entities. We are an affiliate of Financial Guaranty Insurance Company (FGIC), one of the largest municipal bond insurers in the country and a subsidiary of GE Capital Corporation. Our investment products specifically serve the municipal and local government marketplace. Over the past 11 years, our affiliate FGIC has created long-term relationships with the financial officers of states, counties and municipalities across the nation. It is on this foundation of strong relationships and understanding of the financial needs of municipalities that FGIC Advisors is built.

Mr. Chairman, we appreciate the opportunity to submit to you our opinions. FGIC Advisors would like to commend you and your Subcommittee for your efforts to identify solutions to the growing problem of detrimental investment losses at the state and local government levels. FGIC Advisors suggests that to find such solutions, the Subcommittee should focus on increasing disclosure requirements and internal control mechanisms (meaning a system of checks and balances) for local government operated investment pools.

The investment loss of the Orange County, California investment pool marked a turning point in the ongoing examination of government investment losses, not only because of the tremendous dollar amount of the loss, but because, in our opinion, it highlighted the fact that government investment losses can best be prevented with better and more frequent disclosure of information to pool participants.

FGIC Advisors understands that investment needs of local governments vary, and therefore some may engage -- successfully -- in high-risk strategies that comply with their ability to sustain such risk. Even *without* the option to invest in derivatives, government investors can find themselves in a dangerous situation simply by

purchasing long-term, triple-A rated securities in combination with borrowed funds. We are not suggesting that governments be barred from pursuing a high-risk, high-reward investment strategy. We are, however, suggesting that the state governments work together to eliminate the iron wall of secrecy that separates state and local government pool participants from the information they need to make an accurate comparison of the pool's objectives *to their own*.

This is especially important for those municipalities and municipal entities which are *required* to invest in their state or county investment pool. Under the current system, these entities lack not only the appropriate information to determine whether or not the strategy and investments of their pool is appropriate for their needs, but also lack the opportunity to withdraw their funds should they so choose.

FGIC Advisors would submit to the Subcommittee that one way to ensure treasurers and their pool participants receive the necessary information to make investment decisions appropriate for their needs is to mandate disclosure rules based upon those required by the Securities and Exchange Commission (SEC) for SEC-registered investment company products.

Why use SEC disclosure requirements as the standard? SEC requirements are the most widely-accepted disclosure and internal control guidelines currently available. They are not designed to be a static set of regulations, but are continually monitored and reviewed to ensure they address current needs and issues. In addition, the SEC has a significant amount of experience with investment company products and how the volatility of the financial markets can influence the value of pooled investment products.

A case in point is the evolution of SEC Rule 2a-7. This is a *standard* rule that applies to the operation of *all* SEC-registered money market funds. Among the regulations put forth by this rule, it mandates that the average weighted maturity of the investments in money market funds cannot exceed 90 days, so as to help maintain a constant net asset value of one dollar per share. This 90 day limit was instated after

the SEC discovered that the original average maturity of 120 days was too long for most money market funds to maintain their ability to pay back one dollar per every dollar invested. This is a simple example of how the SEC is in a strong position to examine the effects of the marketplace and adjust operating procedures accordingly.

But most important, SEC-registered funds are created to operate and provide liquidity in a crisis environment. They are designed to offer this liquidity under the worst market conditions. State and county pools are all too frequently designed to function based on assumptions both with regard to market conditions and the participants' liquidity needs. They are structured to assume that the funds flowing into them will be sufficient to sustain a strategy whereby the pool invests in long-term, high-yield, high-risk securities.

Given all this, one may wonder -- "Why haven't SEC disclosure requirements been adopted by investment pools in the first place?" As a means of answering that question, we would like to take a moment to provide the Subcommittee with a brief description of how states have allowed independent parameters to develop for different types of investment pools. Then we would like to move on to our list of specific recommendations.

A Brief Description of the Creation of Investment Pools

Generally, investment pools were created in one of two ways: they were either based on the structure of state and county "cooperatives," or they were created by state legislation to operate independent of cooperatives and to be managed usually by state treasurers.

State and county "cooperatives" were originally created as a means for municipalities to take advantage of their state's buying power by pooling their money together to buy goods or services, such as school text books or office supplies. Given

the original purpose of these cooperatives, the level of regulation necessary for purchasing financial securities was not implemented into their structure.

Municipalities had traditionally relied on taxes, federal and state aid, and high returns on their local bank certificates of deposit (CDs) to fund such services as libraries, hospitals, police and fire protection. But in the past twenty years, with diminished CD returns, slashed state and federal aid budgets and voters' tolerance for taxes decreasing rapidly, counties and municipalities sought ways to increase their returns on their investments as a means of funding needed services for their growing populations.

Local governments began seeking investment alternatives to banks and insurance companies -- their traditional investment vendors -- because of industry-wide financial crises hitting these two areas. One of those alternatives consisted of using the legal structure of cooperatives as a means for developing "investment pools" to expand local government purchasing power beyond goods and services and into financial securities. These pools were exempt from SEC-registration.

Another alternative consisted of the states establishing provisions for themselves and their counties to manage their money independent of the cooperative structure. These pools were also exempt from SEC registration and typically were managed and underwritten by treasurers who were not necessarily investment professionals.

Initially, the investments available to both state and county pools and cooperative-based pools consisted mostly of short- to intermediate-term fixed-rate government securities and some agency debentures. In the past decade, however, high-yielding, complicated investment products became available. These products included mortgage-backed securities, asset-backed securities and derivatives of stocks, bonds or commodities.

Many state and local pools, the participants of which were feeling the financial pressure of decreased aid and tax revenues, sought higher returns on their investments by investing in these new, high-yielding securities. In many situations, some state and local government pools even borrowed money to engage in arbitrage strategies. Unfortunately, many treasurers invested *before* gaining a full understanding of the risks involved in these new products.

The Need for Greater Disclosure Increases, But Is Not Met

Generally, both types of investment pools sought to combine the money of their participants (generally municipalities) to gain greater buying power and ultimately achieve a greater return on the pooled money. However, the nature of financial investing is different from pooling money to buy books, with a set of risks that need to be fully understood in order to protect oneself from substantial monetary losses.

But a system for understanding those risks simply was not in place. Initial state requirements for disclosure of investment pool activities were minimal, with infrequent reporting of the pool's value, portfolio composition and performance. This level of disclosure may have been appropriate for the era in which investment pool portfolios consisted only of short-term fixed government securities, but as more high-risk, high-return products became available, their potential risks exacerbated the need for standardized, frequent disclosure requirements similar to those already being followed by SEC-registered products. This level of disclosure would provide investors with the opportunity to understand the risks and withdraw their funds as they may deem necessary.

States have always had the sole authority for mandating disclosure requirements of the investment pools operating within their jurisdiction. In addition, states enacted legislation to exempt their own investment pools from SEC registration. Some have attributed this decision to the idea that the SEC-registration process can be

cumbersome and expensive. In some situations perhaps the states just didn't understand the intrinsic benefits of SEC disclosure and internal control requirements.

In any case, most states have the responsibility of legislating the activities of its municipalities and it is not illogical for them to assume that their respective state regulatory agencies are capable of monitoring these situations.

Another major flaw in the structure of some of the unregistered investment pools is that they are not designed as money market funds, but are often regarded as money market funds by pool participants. In many cases, investment pool participants believe that if they invest one dollar, they will receive at least one dollar when they withdraw. But the fact is, investment pools are not required to comply with Rule 2a-7. As mentioned earlier, this rule applies to all money market funds, and mandates such funds to maintain certain standards, including a 90-day maturity limit on investments so as to help maintain a constant net asset value of one dollar. FGIC Advisors believes that this potential for investment pools to "break the buck" would come as a surprise to many pool participants.

The detrimental government investment losses that have surfaced over the past few years have sent a clear message: the current system of voluntary, non-standard investment disclosure at the state and local level needs to be changed.

Reasons Why SEC Disclosure Guidelines Should be the Basis for New Investment Pool Disclosure Standards

We've suggested that SEC disclosure guidelines be used as a foundation for creating new disclosure requirements for investment pools, and provided you with general reasons why the SEC guidelines are the most widely accepted. Now we would like to outline some specifics about the structure of SEC-registered products, and point to the operational characteristics that we believe should be considered for adoption.

To start with, only SEC-registered funds fall under the direct jurisdiction of three federal laws:

1. The Securities Act of 1933, which mandates specific disclosure to participants;
2. The Securities Exchange Act of 1934, which sets anti-fraud rules regarding purchase and redemption of fund shares, and;
3. The Investment Advisers and Investment Company Acts of 1940, which regulates mutual funds and their advisers.

These three federal laws are additionally enforced by SEC regulations, which require certain operating standards be met and maintained. SEC-registered products are also subject to state laws in the states in which the products are sold.

In addition, there are six essential operational characteristics of SEC-registered funds that make them a valuable investment option:

1. They are required to report standardized performance calculations, which provide for easy comparison of funds;
2. They are required to disseminate timely and accurate information regarding their holdings, performance, management and general investment policy;
3. They are required to have their investment policies and activities supervised by a board of trustees, at least 40 percent of which must consist of independent representatives. "Independent" is defined as those persons who have no relationship to vendors of the funds, and are not participants in the funds;
4. They must maintain the daily liquidity of their shares;
5. SEC-registered money market funds and other investment company products are required to value their portfolios on a daily basis. And finally;
6. Any individual who wishes to sell SEC-registered products must earn a license with the National Association of Securities Dealers (NASD). These procedures ensure that the sales agents of an SEC-registered product have full knowledge of their responsibilities and agree to be accountable for their sales activities.

These six qualities collectively ensure that registered funds remain liquid investments and distribute timely and accurate information about their *value*. All registered mutual funds, by law, must stand ready to redeem any or all of their shares on any day the funds are open for business. As additional protection for investors, all mandatory disclosure and operational requirements are outlined in the funds' prospectuses, which are updated annually.

With all these benefits to investors, it is often difficult to understand why SEC-registered investment products are not available to local governments in 24 states. Clearly this type of investment would be most appropriate for small to medium sized municipalities who are seeking a low-risk, liquid investment for their short-term cash. Consideration should be given to expanding the availability of SEC-registered products to local government investors.

Which SEC Regulations Should be Considered for Adoption?

FGIC Advisors would recommend to the Subcommittee that consideration be given to adopting the following SEC disclosure regulations as requirements for investment pools and other permissible government investments:

- Mandatory reporting on the part of investment pools of the market value of their portfolio, on a daily basis. Most state and county investment pools are not required to value their portfolios on a daily basis. Some managers of certain state and county investment pools have acknowledged that, should a requirement be imposed on them to price their portfolios daily, their respective pools would suffer substantial book losses. What is most shocking is the admission by some pool managers that, had they been required to price their portfolios daily from the beginning, they would have employed *entirely different and much more conservative* investment strategies. Their entire investment policy would have been

changed, simply because of a requirement to convey additional, important information.

- Mandatory adherence to standardized performance calculations. The SEC has created its own standard calculations for registered funds. If this action was adopted, investment pools could base their calculations on the SEC's method, which is reported by independent firms such as Lipper Analytical Services or Morningstar. Past performance should not be sold by the funds' sponsors as a prediction of future performance -- for government investors, a pool's stellar performance yesterday is no indication that it will return principal to its participants today.
- Mandatory liquidity, meaning investors have the ability to exit the pool if need be. Most important, this includes understanding the terms of exit -- the investors must fully understand how and when to expect the proceeds of their redemptions.
- Mandatory dissemination of information regarding the pool's investment objectives, holdings, maturity, duration and liquidity on a frequent and scheduled basis.
- Mandatory disclosure of any investment strategy employed that entails the use of borrowed funds, and the amount of such borrowed funds. This requirement serves to reveal the amount of risk commensurate with a given investment strategy.
- Mandatory supervision of investment policies and activities by a board of trustees, with at least 40 percent of its members being "independent" as we defined earlier. It would be their *fiduciary responsibility* to monitor the investment pool's manager to ensure his or her investments are consistent with the needs and objectives of the pool's participants.
- Mandatory licensing of the pool's sales force with the NASD to ensure accountability and compliance with sales practices approved and monitored by the NASD.

- Mandatory dissemination of the credentials of the pool's manager and members of the board of trustees.

In addition, we recommend that the states go *beyond* these SEC requirements to offer an extra element of protection and disclosure: mandatory dissemination of the pool's performance under various interest rate scenarios. This is information that is required by the rating agencies when a fund seeks to be rated. This concept is also consistent with the recent recommendation made by the Government Finance Officers Association in its testimony to the Senate Committee on Banking, Housing and Urban Affairs on January 6, 1995.

The time has come for the federal government to protect local government investors in the same manner in which it strives to protect individual investors. In the opinion of FGIC Advisors, an examination of the ever increasing list of government investment losses shows that the most effective way to prevent a national catastrophe is to arm each government investor with the information necessary to make an accurate assessment of the appropriateness of an investment.

In conclusion, it is our opinion that the tax-exempt marketplace increasingly understands and values the need for timely and accurate disclosure. It is this understanding that prompts the tax-exempt marketplace to continually seek new ways to use technology and legislation to improve upon its disclosure processes. As a member of this marketplace, FGIC Advisors, Inc. appreciates this opportunity to share our suggestions for providing greater disclosure for government investors, and we stand available to serve this Subcommittee further as it continues its search for a solution. Thank You.



OKLAHOMA MUNICIPAL LEAGUE, INC.

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July 25, 1995

The Honorable J.C. Watts, Jr.
U.S. House of Representatives
1713 Longworth House Office Building
Washington DC 20515-3604

Dear Representative Watts:

Julie Reding from your office has contacted me relative to the upcoming hearings on debt issuance and investment practices of state and local governments.

Although I can understand the federal government's concern when investments of local government entities go sour, I would like to urge caution before developing any regulatory language.

As I'm sure you're aware, the Oklahoma statutes set forth very rigid requirements regulating investment practices for cities and towns, counties and schools in Oklahoma. For your information, I'm enclosing a copy of Title 62 §348.1 and §348.3, both dealing with those regulations.

Due to these regulations having been in place for a number of years and due to regulation on investments by local governing entities in our state for a long time, I'm not aware of any problems experienced by municipal governments, in particular, dealing with their investment practices. I have been working with cities and towns for well over 35 years in Oklahoma.

I feel that the Orange County California situation which has brought this problem to light is a very rare occurrence among local governments throughout the United States. Again, I would just respectfully urge you to proceed with caution as you represent the viewpoints of city and town officials in your district and throughout our state. We believe that we have adequate control already in place and do not need additional controls, especially from the federal government.

I would also like to express disappointment that one of the largest organizations representing cities and towns in the United States, the National League of Cities, was not invited to offer testimony during the hearings. At least I did not see them listed on the lists provided by Julie.

Thank you for requesting our input on this important matter. We appreciate your representation of the citizens in our state and know that you will do the right thing in this particular matter.

Very truly yours,

Bill

William A. Meyer, CAE
Executive Director

Enclosure
WAM/js

Serving the Officials of Oklahoma's Cities & Towns

County, shall issue a receipt to the owner of such property and the owner of such warrants or bonds to the extent of all such improvement taxes and liens on said property, whether due or to become due, to the amount of the face of such warrants or bonds tendered in payment, including the interest due thereon, and thereupon said Clerk of such City or Town or the County Treasurer of such County shall cancel said warrants or bonds, so delivered in discharge of such assessments or liens, or endorse said payment on said warrant or bond in case the amount due on said assessment at said time is less than the face value of said warrants or bonds so tendered.

Laws 1933, c. 58, p. 106, § 2, emerg. eff. April 17, 1933.
Municipal Corporations 621.

Validity

Section 341 et seq. of this title, are invalid with respect to bonds issued prior to enactment of statute. Davis v. McCasland, 182 Okl. 49, 75 P.2d 1118 (1938).

§ 343. Assessment or installments delinquent—Discharge of lien

In the event any such paving or improvement assessments or installments thereof mentioned in Sections 1 and 2 of this Act¹ are delinquent and in the hands of the County Treasurer of the County in which such City or Town is located, for collection, then said receipt issued by the Clerk of such City or Town, as provided by Section 2 of this Act, may be presented by the holder thereof to the county treasurer of such county who shall thereupon endorse upon his records the satisfaction and discharge of the paving or improvement taxes upon the property for the installments described in such receipt, and thereafter such property shall be free and discharged of and from all further lien for such assessments or installments thereof.

Laws 1933, c. 58, p. 106, § 3, emerg. eff. April 17, 1933.

¹ Sections 241, 242 of this title.

Municipal Corporations 519(5).

Validity

Section 341 et seq. of this title, are invalid with respect to bonds issued prior to enactment of statute. Davis v. McCasland, 182 Okl. 49, 75 P.2d 1118 (1938).

§ 344. Penalties—Delinquent Assessments—Credited to Funds

All penalties hereafter collected and all penalties heretofore collected, which may be identified, by any County Treasurer of the State of Oklahoma, on any delinquent assessments for any drainage district, and shall be used only in the payment of the warrants or bonds and the interest thereon, issued for the construction of the improvement for which such assessments were made.

Laws 1933, c. 58, p. 106, § 4, emerg. eff. April 17, 1933.

Drains 66.

Validity

Section 341 et seq. of this title, are invalid with respect to bonds issued prior to enactment of statute. Davis v. McCasland, 182 Okl. 49, 75 P.2d 1118 (1938).

§ 345. Intent of Act—Face Value of warrants or bonds

It is the intent and purpose of this Act to allow the owner of any paving, drainage or street improvement warrants or bonds heretofore or hereafter issued, as described in Sections 1 and 2 of this Act,¹ to use the same to the extent of their face value in the payment and satisfaction of the paving, drainage and street improvement assessments which have been levied upon his property located in the paving, drainage, or street improvement district in and for such such paving, drainage or improvement warrants or bonds were issued in payment, whether such assessments or installments are due or to become due, and to the extent of the face value of such warrants or bonds tendered in payment thereof, and to cause all penalties hereafter collected, and all such penalties heretofore collected, which may be identified, by the County Treasurer on such drainage assessments to be credited to and placed in the funds of such district from which only the warrants and bonds of such district and the interest thereon, issued for the construction of said improvements, may be paid and discharged.

Laws 1933, c. 58, p. 106, § 5, emerg. eff. April 17, 1933.

¹ Sections 241, 242 of this title.

Municipal Corporations 521.

Validity

Section 341 et seq. of this title, are invalid with respect to bonds issued prior to enactment of statute. Davis v. McCasland, 182 Okl. 49, 75 P.2d 1118 (1938).

§ 346. Partial invalidity, effect

If any part of this Act¹ is for any reason declared void, such invalidity shall not affect the validity of the remaining portions of this Act.

Laws 1933, c. 58, p. 106, § 6, emerg. eff. April 17, 1933.

¹ Section 241 et seq. of this title.

Statutes 64(5).

Validity

Section 341 et seq. of this title, are invalid with respect to bonds issued prior to enactment of statute. Davis v. McCasland, 182 Okl. 49, 75 P.2d 1118 (1938).

INVESTMENT OF FUNDS

§ 348.1. Authorized Investments—Disposition of Income

Except as otherwise provided for by law, a county treasurer, when authorized by the board of county commissioners by a written investment policy, ordinance or resolution or the treasurer of any city, town, or school district when authorized by the appropriate governing body by a written investment policy, ordinance or resolution, shall invest monies in the custody of the treasurer in:

1. direct obligations of the United States Government, its agencies or instrumentalities to the payment of which the full faith and credit of the Government of the United States is pledged; or

2. collateralized or insured certificates of deposits of savings and loan associations, banks, savings banks and credit unions located in this state, when the certificates of deposit are secured by acceptable collateral as provided in Section 516.3 of this title, or fully insured certificates of deposit at banks, savings banks, savings and loan associations and credit unions located out of state; or

3. savings accounts or savings certificates of savings and loan associations, banks, and credit unions, to the extent that the accounts or certificates are fully insured by the Federal Deposit Insurance Corporation; or

4. investments as authorized by Section 348.3 of this title which are fully collateralized in investments specified in paragraphs 1 through 3 of this section, and where the collateral has been deposited with a trustee or custodian bank in an irrevocable trust or escrow account established for such purpose; or

5. county, municipal or school district direct debt obligation for which an ad valorem tax may be levied or bond and revenue anticipation notes, money judgments against such county, municipality or school district ordered by a court of record or bonds or bond and revenue anticipation notes issued by a public trust for which such county, municipality or school district is a beneficiary thereof;

All collateral pledged to secure public funds shall be valued at no more than market value. The income received from that investment may be placed in the general fund of the governmental subdivision to be used for general governmental operations, the sinking fund, the building fund, or the fund from which the investment was made.

Laws 1948, p. 144, § 1, emerg. eff. Feb. 28, 1948; Laws 1955, p. 347, § 1, emerg. eff. Feb. 8, 1955; Laws 1955, pp. 347, 348, §§ 1, 2, emerg. eff. May 23, 1955; Laws 1958, c. 49, § 1, emerg. eff. May 2, 1958; Laws 1967, c. 356, § 1, emerg. eff. May 18, 1967; Laws 1970, c. 310, § 1, emerg. eff. April 23, 1970; Laws 1971, c. 69, § 1, emerg. eff. April 12, 1971; Laws 1974, c. 120, § 1, emerg. eff. May 1, 1974; Laws 1983, c. 141, § 1, emerg. eff. May 23, 1983; Laws 1984, c. 12, § 1, eff. Nov. 1, 1984; Laws 1988, c. 319, § 13, eff. Sept. 30, 1988; Laws 1991, c. 124, § 20, eff. July 1, 1991.

Counties = 164.

Municipal Corporations = 684.

§ 348.2. Repealed by Laws 1991, c. 124, § 35, eff. July 1, 1991.

From:

Laws 1948, p. 144, § 2.
Laws 1955, p. 347, § 2.
Laws 1955, p. 348, § 3.

§ 348.3. Cities and counties—Written investment policies—Authorized investments

A. In addition to the investments authorized by Section 348.1 of Title 62 of the Oklahoma Statutes, the governing body of a city with a population of not less than three hundred thousand (300,000) persons according to the latest Federal Decennial Census or of a county with a population of not less than four hundred thousand (400,000) persons according to the latest Federal Decennial Census may adopt a written investment policy directing the investment of the funds of the city or county and any of its public trusts or authorities. If such a policy is adopted by the governing body, such funds shall be invested pursuant to the provisions of the policy. The written policy shall address liquidity, diversification, safety of principal, yield, maturity and quality and capability of investment management, with primary emphasis on safety and liquidity. To the extent practicable, taking into account the need to use sound investment judgment, the written investment policies shall include provision for utilization of a system of competitive bidding in the investment of municipal funds. Such system shall be designed to maximize yield within each class of investment instrument, consistent with the safety of the funds invested.

B. The written investment policy may authorize the city treasurer or county treasurer to purchase and invest in any or all of the following:

1. Obligations of the United States government, its agencies and instrumentalities;

2. Collateralized or insured certificates of deposit and other evidences of deposit at banks, savings banks, savings and loan associations and credit unions located in this state, or fully insured certificates of deposit at banks, savings banks, savings and loan associations and credit unions located out of state;

3. Negotiable certificates of deposit issued by a nationally or state-chartered bank, a savings bank, a savings and loan association or a state-licensed branch of a foreign bank. Purchases of negotiable certificates of deposit shall not exceed ten percent (10%) of the surplus funds of the city or county which may be invested pursuant to this section. Not more than one-half (1/2) of the ten percent (10%) limit shall be invested in any one financial institution specified in this paragraph;

4. Prime banker's acceptances which are eligible for purchase by the Federal Reserve System and which do not exceed two hundred seventy (270) days' maturity. Purchases of prime banker's acceptances shall not exceed ten percent (10%) of the surplus funds of the city or county which may be invested pursuant to this section. Not more than one-half (1/2) of the ten percent (10%) limit shall be invested in any one commercial bank pursuant to this paragraph;

5. Prime commercial paper which shall not have a maturity that exceeds one hundred eighty (180) days nor represent more than ten percent (10%) of the outstanding paper of an issuing corporation. Purchases of prime commercial paper shall not exceed seven and one-half percent (7 1/2%) of the surplus funds of the city or county which may be invested pursuant to this section; and

6. Repurchase agreements that have underlying collateral consisting of those items specified in paragraphs 1 through 5 of this subsection.

C. Investments shall be made with judgment and care, under circumstances then prevailing, which persons of prudence, discretion and intelligence exercise in the management of their own affairs, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

Laws 1987, c. 194, § 14, operative July 1, 1987; Laws 1991, c. 124, § 21, eff. July 1, 1991.

Former § 348.3, derived from Laws 1943, p. 144, § 8, which defined "governing board", was repealed by Laws 1966, p. 248, § 2.

§ 348.4. Securities lending program—Cities or counties which qualify—Collateral requirements

A. As used in this section:

1. "Securities lending program" means any program, arrangement or agreement whereby the city or the county deposits securities with a trust company or a state or national bank for the purpose of such institution lending such securities to a borrower approved by a city treasurer or county treasurer in return for a fee or charge paid by such borrower for the use of such securities; and

2. "Market value" shall mean on any date the average of the bid and asked prices for such security for the business day preceding the date on which such determination is made, in the principal market on which such securities were traded or quoted in the Wall Street Journal, plus any coupon interest accrued but not yet due and owing at the date of determination.

B. The governing body of a city with a population of not less than three hundred thousand (300,000) persons according to the latest Federal Decennial Census or of a county with a population of not less than four hundred thousand (400,000) persons according to the latest Federal Decennial Census may authorize and direct the city treasurer or county treasurer to enter into a securities lending program with a trust company or a state or national bank and to loan any securities held by such city or county pursuant to any investment of the funds of the city or county in the investments authorized by Section 348.1 or 348.3 of Title 62 of the Oklahoma Statutes.

C. Any securities lending program entered into by the city treasurer or county treasurer shall provide that the borrower shall deposit with the securities lending institution, for the benefit of "a city or county, collateral consisting of cash or securities insured by the United States government acceptable to the city treasurer or county treasurer. The collateral shall have a market value equal to one hundred percent (100%) of the principal amount of any securities being loaned to such borrower and shall be revalued and adjusted accordingly on each banking day.

Laws 1989, c. 342, § 1, eff. Nov. 1, 1989.

ISSUE AND SALE OF BONDS

§ 351. Sales of bonds must net par value and interest

It shall be unlawful for any board of county commissioners, city council or city commissioners, town council, township board, school district board, board of education or any other officer of any such municipal corporations, or any officer of any other political corporation, or subdivision of this state, to sell, agree to sell or contract to sell any bonds issued by a vote of the people for any sum less than par with accrued interest added, and any and all commission allowed any firm, person or corporation for the sale of such bonds must, after being deducted from the sum total for which said bonds are sold, leave in the treasury the sum equal to the par value and accrued interest thereof.

Laws 1913, c. 165, p. 379, § 1.

C.S. 1921, § 4281; S.L. 1981, § 5327.

Municipal Corporations §921(1).

Construction and application

Application of Oklahoma Turnpike Authority, 206 Okl. 817, 246 P.2d 527 (1948); Town of Okarche v. Connelly Bros., 175 Okl. 238, 51 P.2d 946 (1936); Aaronson v. Smiley, 143 Okl. 23, 295 P. 59 (1930); Town of Buffalo v. Walker, 196 Okl. 8, 257 P. 766 (1927).

§ 352. Sale at less than par—Penalties—Removal—Liability on bond

Any member of any board of county commissioners, any member of any city council, or member of any board of city commissioners, any member of any town council, any member of any township board, any member of any city board of education, any member of any school district board, and any other officer of any of the aforesaid political corporations or subdivisions of this state, or any other officer of any political corporation or subdivision of this state, who shall sell, or agree to sell, or contract to sell at less than par, any bonds of his respective county, city, town, township, school district, or other political corporation or subdivision, shall be guilty of a misdemeanor, forfeit and be removed from office, and in addition, be liable on his official bond for the difference between the sum



MATT FONG

Treasurer
State of California

September 20, 1995

Honorable Richard H. Baker
 Chairman, Subcommittee on Capital Markets,
 Securities and Government Sponsored Enterprises
 c/o Ted Beason
 2129 Rayburn House Office Building
 Washington, D.C. 20515

Dear Representative Baker:

Thank you for your letter of August 4, 1995 seeking additional input to questions from the subcommittee's July 26 hearing. I believe that the subcommittee's intention to conduct further review of the federal bankruptcy code, municipal disclosure and state oversight of municipal investment practices is appropriate and I encourage you to call upon my office for assistance you may need.

In regard to risk involved with certain investment products, I believe that it is possible for us to eliminate the risk factor that is present in municipal investing. However, we should attempt to minimize this risk through our efforts to educate and train municipal Treasurers, and by providing better information about derivatives and other forms of structured financings. On the other hand, I do support reasonable limitations on the use of certain types of investment instruments within a local government's investment portfolio. Any attempt to completely eliminate certain investment instruments will quickly become outdated as the market evolves, so we must rely upon local officials to exercise common sense through prudent investment policies.

On the issue of municipal bankruptcy, California, along with several other states, now allows municipalities to access the federal bankruptcy statutes at their own discretion. I am sponsoring legislation, now pending in the California Legislature, to require a review and state approval by the state fiscal officers prior to any declaration of bankruptcy by a municipal government. I believe that the potential financial consequences of the bankruptcy process for other municipalities in the state justify a state interest in this act.

Future Orange County fiscal collapses and subsequent bankruptcies should be eliminated with the reforms passed this year in the California Legislature.

Please call upon me if I may be of any further assistance.

Warmest regards,


 Matt Fong
 State Treasurer

MF:RB



CALIFORNIA STATE AUDITOR

KURT R. SJOBERG
STATE AUDITOR

MARIANNE P. EVASHENK
CHIEF DEPUTY STATE AUDITOR

August 11, 1995

Mr. Ted Beason, Staff Member
Committee on Banking and Financial Services
U. S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Mr. Beason:

Congressman Richard Baker has asked that I submit a written response to several questions regarding my recent testimony on local government investment practices. For ease of responding, I have provided my comments in a question and answer format.

Question #1: *You have recommended to the state legislature that municipalities limit the use of derivatives and other structured investments. Would you agree, therefore, that certain complex instruments, while not to blame themselves, increase the risk that a Treasurer may misuse them or not understand them?*

Answer #1: Yes, I agree that certain complex investments increase the risk of misuse or misunderstanding by Treasurers. Because many of these derivative investments are structured from AAA-rated, government securities, it is often difficult to even identify them as volatile investments. Therefore, outside scrutiny is less effective and could lead a Treasurer to misuse them. Further, the market risk and coupon rate of many of the structured investments are difficult to determine. Consequently, many Treasurers who purchased them were unaware that they were difficult to price and sell, and that they placed principal and interest at risk.

Question #2: *Should the law require the State, not the municipality, to assert that bankruptcy is a last resort after all rational and feasible alternatives have been fully explored?*

Answer #2: Since we have not done any audit work on the use of Chapter 9 bankruptcy, I do not believe I can provide any insight into this issue.

BUREAU OF STATE AUDITS

660 J Street, Suite 300, Sacramento, California 95814 Telephone: (916) 445-0255 Fax: (916) 327-0019

Mr. Ted Beason, Staff Member
Committee on Banking and Financial Services
August 11, 1995
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Question #3: *When you drew up your recommendation for legislative action, did you study the investment limitations used by other states?*

Answer #3: To a limited degree we contacted a few states regarding their current and pending investment limitations, however, we did not believe any fit the California local-state government model very well. The states we contacted were Ohio, Texas, and Maryland. We also contacted the Government Finance Officers Association, the California State Treasurer's Office, and the major rating agencies for input. Their ideas were considered when we drafted our recommendations.

Question #4: *What have you done to reduce risk in the county you identified in your audit which had a leverage factor of 29 to 1?*

Answer #4: The county you are referring to is Colusa County, located in a rural farming area 40 miles north of Sacramento. We found that Colusa County's investment portfolio had an average weighted maturity during 1994 of 28.4 years, and it had a duration analysis factor of 24.2, as of March 1995. This duration factor means that a 1 percent rise in future interest rates would equate to a 24.2 percent decline in the value of its investment portfolio. In our June 1995 report, we recommended that the county treasurer sell his high risk, long-term holdings as soon as practical. As an independently elected local official, he did not agree with our audit findings, but stated he had independently decided in December 1994, to divest himself of his derivative holdings. We will track the county's progress at liquidation over the next 12 months.

In conclusion, we believe that the subject of your subcommittee's hearing was timely and important. It was an honor to be asked to provide the California Bureau of State Audit's findings and recommendations. Please feel free to contact me for any other information concerning my testimony.

Sincerely,



KURT R. SJÖBERG
State Auditor

UNIVERSITY OF CALIFORNIA, IRVINE

BERKELEY • DAVIS • IRVINE • LOS ANGELES • RIVERSIDE • SAN DIEGO • SAN FRANCISCO



SANTA BARBARA • SANTA CRUZ

DEPARTMENT OF POLITICS AND SOCIETY
SCHOOL OF SOCIAL SCIENCES
IRVINE, CALIFORNIA 92717

July 27, 1995

The Honorable Richard H. Baker
Committee on Banking and Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515-6050
FAX 202-225-3692

Dear Congressman Baker:

Thank you so much for the opportunity to participate in hearings before the House Banking Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises regarding the Orange County bankruptcy.

Per your invitation yesterday (July 26, 1995), I would like to submit a few brief responses to questions posed and responses given during our panel.

(1) Regarding the need for greater disclosure. State Treasurer Fong indicated that disclosure would be a "remedy" to many of the problems which results in the filing of Chapter 9 bankruptcy by Orange County on December 6, 1994. I disagree. Disclosure is at best a necessary condition to a remedy, but it is not the remedy itself. Disclosure is a means, but absent accountability for the actions pursued by public authorities, disclosure alone is basically useless.

One question has continued to plague me since the county filed for bankruptcy: If John Moorlach, a local CPA and GOP political activist, was able to get information sufficient to raise concerns about the prudence of Mr. Citron's investment strategies, why was this information unavailable to the S.E.C., Moody's, Standard and Poor's, Merrill Lynch, the California State Auditor, the State Treasurer, and the Board of Supervisors? How was Moorlach able to get access to information not available to any other private or public entity with an interest in Orange County's investment portfolio?

We had disclosure long before the Orange County bankruptcy, courtesy of the information laid out by Mr. Moorlach long before the bankruptcy filing on December 6, 1994. The disclosure didn't do any good however because the watch dogs didn't bark.

(2) Regarding the creation of an "oversight board" for Orange County's investments. Orange County had an oversight board already prior to the bankruptcy. It's called the Board of Supervisors, five individuals, elected by districts, and paid handsomely to work full-time on the public's behalf. The Board of Supervisors failed to exercise their statutory authority and responsible to oversee the Treasurer's Office. Indeed, as I said in my testimony, by their own admission, members of the Board did not even know they had the statutory authority to supervise the Treasurer's Office until this was brought to their attention by reporters from the Orange County Register. There's no reason to believe a group of volunteers would be any more capable or skilled at overseeing county investments than the full-time, duly elected members of the Board of Supervisors.

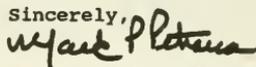
(3) Regarding the prudence of Orange County's Chapter 9 bankruptcy filing on December 6, 1994. Permit me to emphasize two points made in my written testimony. First, other non-bankruptcy options were provided by a financial consultant in the county's employ. Board members claim they were never informed of these options. As reported in the Orange County Register, the consultant claims otherwise. Second, only one day following payments to investors in the Orange County Investment Pool, U.S. Bankruptcy Judge John E. Ryan said the \$5.7 billion pool was ineligible for bankruptcy. Of course, since an elite group of businessmen in the county had already formulated a plan to liquidate the pool (in secret I might add) and since pool participants had already agreed to the take-it-or-leave-it settlement agreement (a cohesion contract if there ever was one) Judge Ryan's decision was without any impact. Judge Ryan's ruling should be of great consequence to other local governments with financial problems similar to those in Orange County.

In my opinion Congressman Baker, the Board of Supervisors was so completely disengaged from the county's financial investments that they were caught completely off-guard by changes in the financial markets. They panicked and filed for bankruptcy without extensive deliberation or evaluation of all available options.

If you deem it appropriate, I hope you will consider making these additional remarks part of the formal record for the hearing which took place on July 26, 1995.

Once again, I thank you for the opportunity to participate in these hearings and remain available to you and your staff for any informational needs which may arise as your deliberations on this matter proceed.

Sincerely,



Mark P. Petracca
Associate Professor

Tel. (714) 824-5175

QUESTION FOR MR. PETRACCA
 CAPITAL MARKETS SUBCOMMITTEE HEARING ON MUNICIPALITIES

>As an outspoken citizen, taxpayer, and stakeholder in Orange County, what do you intend to do about Orange County's unpaid debts?

Since I am not a public official, the most I can do in response to the county's unpaid debt is to help develop and subsequently advocate a sensible bankruptcy recovery plan. In my view, such a plan should include a number of important elements:

>A reopening of the pool settlement and the subsequent readjustment of payment priorities (e.g., public schools and county vendors should be guaranteed a repayment of 100 cents on the dollar, while other government investors should be repaid at a lower rate).

>Maximum debt forgiveness by special districts with funds in the OCIP (e.g., the OCTA and TCA) and on the part of cities which borrowed additional funds to invest in the pool (e.g., Anaheim and Irvine). Additional debt forgiveness--at a somewhat lower rate--should be brokered on behalf of those remaining municipalities with funds previously invested in the OCIP.

>The prioritization of current bondholders based on the date of purchase--relative to the Chapter 9 bankruptcy filing. I do not believe we owe speculators, who purchased bonds after December 6th when Orange County's debt was being liquidated and restructured, 100 cents on the dollar.

>Diversion of Measure M transit funds to provide the funds necessary to refinance the debt owed to pre-bankruptcy bondholders. I would prefer this to be done by the voters of Orange County rather than by the State Legislature.

>Pursue the leveraging and carefully selected sale of county assets.

>Evaluate various proposals for the reform of Orange County government (e.g., from the County Grand Jury, the Charter Commission, and "Partnership 2001") to achieve the goals identified in my formal testimony. These include the restoration of trust and faith in county government and the establishment of countervailing power therein.

There are serious limits to what a private citizen--a Democrat at that--can do to bring about fundamental change in the financial affairs and structure of governance in Orange County. We're I an elected official, a member of the OC Business Council, a member of the Lincoln Club, or even an employee of a large landowner/developer there might be much that I could accomplish directly. However, until the Board of Supervisors pursues an inclusive approach to county governance, many of us with ideas for change and reform will necessarily remain limited to service as critics of the current regime. This is a responsible I take very seriously and will pursue with great vigor in the weeks and months ahead.

Mark P. Petracca

Mark P. Petracca
 August 13, 1995



UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF MUNICIPAL
SECURITIES

August 25, 1995

The Honorable Richard H. Baker
Subcommittee on Capital
Markets, Securities & Government
Sponsored Enterprises of the
Committee on Banking and Financial
Services
U.S. House of Representatives
One Hundred Fourth Congress
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Baker:

Thank you for the opportunity to appear as a witness at the July 26th hearing of the Subcommittee for Capital Markets, Securities and Government Sponsored Enterprises. I am writing in response to questions raised by you in your letter of August 4, 1995, regarding further consideration by the Subcommittee relating to Chapter 9 of the federal bankruptcy code, the adequacy and timeliness of municipal disclosure, and state oversight of governmental investment practices. I have set forth below your questions together with the staff's responses.

1. What would be the benefits of standardized reporting requirements across the country? What would be the drawbacks?

As set forth in our written testimony of July 26, 1994,¹ in 1993, the Commission's Division of Market Regulation conducted a comprehensive review of the municipal securities market, which underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets.² The Interpretive Release³ published by

¹ Testimony of Paul S. Maco, Director, Office of Municipal Securities, U.S. Securities and Exchange Commission, Regarding the Municipal Securities Market, Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Committee on Banking and Financial Services, United States House of Representatives (July 26, 1995) at B-3.

² Staff Report on the Municipal Securities Market, Division of Market Regulation, Securities and Exchange Commission (Sept. 1993).

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the Commission in March 1994, while acknowledging significant improvement in disclosure practices in recent years, identified several areas of primary market disclosure that needed increased attention.

Standardized reporting requirements would have the benefit of facilitating comparison of municipal credits by investors and would benefit issuers by providing guidance as to their disclosure responsibilities. Uniform disclosure standards are available through industry disclosure guidelines, such as those promulgated by the Government Finance Officers Association, as well as accounting standards promulgated by the Government Accounting Standards Board.⁴ We anticipate that the increased focus on municipal disclosure resulting from our recent initiatives will lead to wider acceptance of these standards. Of course, compliance with standardized disclosure requirements would never excuse non-compliance with the overlying antifraud provisions of the federal securities laws.

Uniform standards, however, may not be feasible. In addition to the 50 states, the District of Columbia, Guam, Puerto Rico and the Virgin Islands, the municipal securities market consists of a variety of issuers organized under, and often unique to, the laws of each of the 50 states. As noted in the Joint Response to the Commission's recent proposed amendments to Rule 15c2-12, "each state's system has evolved over the years in response to unique economic and political circumstances."⁵ Mindful of this complexity, the Commission's

³ Statement of the Commission regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Exchange Act Rel. No. 33741 (March 9, 1994) 59 FR 12748 (the "Interpretive Release").

⁴ In addition, the National Federation of Municipal Analysts has published voluntary disclosure guidelines covering industry specific sectors. See Disclosure Handbook for Municipal Securities 1992 Update, National Federation of Municipal Analysts (Nov. 1992).

⁵ Joint Response to the Securities and Exchange Commission on Releases Concerning Municipal Securities Market Disclosure, prepared by American Bankers Association's Corporate Trust Committee; American Public Power Association; Association of Local Housing Finance Agencies; Council of Infrastructure Financing

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amendments to Rule 15c2-12 were aimed at "providing issuers with significant flexibility to determine the appropriate nature of that disclosure."⁶

Before amending existing laws relating to municipal securities, the Commission recommends that the recent disclosure initiatives be given a chance to take hold.⁷ If the recent reforms do not achieve the intended improvements in disclosure practices, then consideration of more extensive measures could be considered.

2. How can we call disclosure adequate when Orange County sells a bond issue in June of 1995 with many pages of unaudited financials from June 30, 1994? Given Orange County's problems, why did the market accept outdated financial information?

The Commission currently is conducting an investigation into a number of aspects of events preceding the bankruptcy filings by Orange County, California. It is not appropriate to discuss non-public matters that may relate to the investigation or that may become the subject of actions by the Commission or by other authorities. Therefore, the staff can comment only generally on the guidance that the Commission's recent initiatives provide for local government units regarding their disclosure obligations.

The Interpretive Release discusses the disclosure obligations of participants in the municipal securities

Authorities; Government Finance Officers Association; National Association of Counties; National Association of State Auditors, Comptrollers and Treasurers; National Council of State Housing Agencies; National Federation of Municipal Analysts; and Public Securities Association, August 11, 1994, p. 5. "It is virtually impossible to define uniform national rules with any specificity given the different types of issuers and obligations issued by separate borrowing entities." Id.

⁶ Securities Exchange Act Rel. No. 34961 (Nov. 10, 1994) 59 FR 59590.

⁷ Testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission, Concerning the Municipal Securities Market, Before the Committee on Commerce, U.S. House of Representatives (Jan. 12, 1995) at 30.

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markets under the antifraud provisions of the federal securities laws. Among other things, the Commission emphasized the need for a municipal securities issuer to provide ongoing and timely disclosure of its financial condition.

The Commission also stated in the Interpretive Release that after extensive discussion with market participants, it appeared that, for the most part, audited financial statements of municipal issuers for the most recently completed fiscal year are available within six months after fiscal year end. The Commission also endorsed the use of unaudited and interim financial information in the absence of current audited annual statements. Nevertheless, the market routinely will accept an offering without audited or interim financial information. Indeed, when the Commission proposed that municipal issuers provide audited financial statements on an annual basis, many commenters stated a strong objection that such a requirement could not be applied to all issuers. In many cases, municipal issuers are only audited by the state auditor every two or three years. Thus, any requirement for audited financial statements could have an adverse impact on an issuer's ability to gain access to the public markets.

3. The SEC has seemed reluctant in the past to bring anti-fraud actions against municipal issuers based on misleading disclosures. Is there a role for more aggressive enforcement in this area?

Where the Commission finds that investors have been defrauded, it will not hesitate to take enforcement action. The Commission believes that its enforcement program is an indispensable part of its efforts to improve disclosure in this area. In one of his earliest public pronouncements, Chairman Levitt identified the municipal securities market as an area of heightened interest for the Commission.⁸ Reflecting this emphasis, the Director of the Commission's

⁸ Testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission, Concerning the Municipal Securities Market, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U. S. House of Representatives (Sept. 8, 1993).

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Division of Enforcement, William R. McLucas, stated earlier this year that the municipal securities area was a top priority for the Division.⁹

Since June 1994, the Commission has instituted six enforcement actions that involved participants in either the primary or secondary municipal securities market. Four actions were brought in federal court, and two were filed as administrative proceedings before the Commission. Each of those enforcement actions charged the defendants or respondents with one or more violations of various antifraud provisions of the federal securities laws or violations of certain rules of the Municipal Securities Rulemaking Board (the "MSRB") that the Commission enforces. All but one of the enforcement actions discussed above involved, in part, material misstatements or failure to disclose some material fact to investors in an offering of municipal securities.¹⁰ The individuals and firms charged represent a broad cross-

⁹ See SEC Official Says Bond Enforcement Major Priority, The Bond Buyer (Jan. 26, 1995).

¹⁰ Securities and Exchange Commission v. Stifel, Nicolaus and Company, Inc., (W.D. Okla.), Lit. Rel. No. 14587 (Aug. 3, 1995); Securities and Exchange Commission v. Michael Goodman and Harold Tzinberg, (E.D. Minn.), Lit. Rel. No. 14471 (April 19, 1995); In the Matter of Joseph LeGrotte, Securities Act Rel. No. 7200, Securities Exchange Act Rel. No. 36036, Administrative Proceeding File No. 3-8763 (July 31, 1995); In the Matter of Sidney Gould, Securities Act Rel. No. 7201, Securities Exchange Act Rel. No. 36037, Administrative Proceeding File No. 3-8764 (July 31, 1995); Securities and Exchange Commission v. Nicholas A. Rudi, Joseph C. Salema, Public Capital Advisors, Inc., George A. Tuttle Jr. and Alexander S. Williams, (S.D.N.Y.), Lit. Rel. No. 14421 (Feb. 23, 1995); Securities and Exchange Commission v. Terry D. Busbee and Preston Bynum, (N.D. Fla.), Lit. Rel. No. 14387 (Jan. 23, 1995) and Lit. Rel. No. 14508 (May 24, 1995); In the Matter of Thorn, Alvis, Welch, Inc., John E. Thorn, Jr., and Derryl W. Peden, Securities Act Rel. No. 7069, Securities Exchange Act Rel. No. 34248, Administrative Proceeding File No. 3-8400 (June 23, 1994); and In the Matter of Derryl W. Peden, Securities Act Rel. No. 7069, Securities Exchange Act Rel. No. 35045, Administrative Proceeding File No. 3-8400 (Dec. 2, 1994).

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section of market participants and include underwriters of municipal securities and their employees, a municipal securities broker, financial advisors, underwriters' counsel and bond counsel. At the same time, the Division has provided substantial assistance in two criminal actions where a total of four individuals were charged, three of whom have pled guilty.

In addition, without commenting about any particular matter, the Division of Enforcement has more than twenty investigations underway that involve different aspects of the municipal securities markets. While it is not possible at this time to say how many of those investigations will result in enforcement actions, the matters under investigation include possible false and misleading disclosure by municipal securities issuers.

4. The SEC's emerging municipal securities regulatory framework seems to put a substantial amount of the responsibility for mistaken or misleading disclosures by municipalities on the shoulders of market participants like underwriter[s] and dealers. Is this a deliberate policy decision or is it merely because the securities laws are drafted to give you so little jurisdiction over municipal issuers relative to market professionals? Would you like more authority to directly regulate municipal disclosure?

The regulatory scheme applicable to municipal securities represents a deliberate policy, undertaken pursuant to the Commission's antifraud and municipal securities dealer authority, to prevent abuses in connection with the purchase and sale of municipal securities. Brokers, dealers, and municipal securities dealers serve as the link between the issuers whose securities they sell and the investors to whom they recommend securities. Investors, especially individual investors, place their reliance on these securities professionals for recommendations regarding municipal securities. Brokers, dealers, and municipal securities dealers, in recommending the purchase or sale of securities, are subject to both sales practice standards arising from the antifraud provisions of the federal securities laws,¹¹ and the

¹¹ The courts and the Commission have long emphasized that, under the general antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 15(c) (1) and (2) of the Securities Exchange Act of 1934 ("Exchange Act"), a broker-dealer recommending securities to

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suitability and other fair dealing rules of the MSRB.¹² Issuers of municipal securities also are subject to the antifraud provisions of the federal securities laws.¹³ The focus of the municipal securities regulatory scheme on deterring fraudulent practices associated with the purchase and sale of these securities represents a careful balancing of the relative burdens associated with such deterrence on issuers, brokers, dealers, and municipal securities dealers in light of the Commission's authority.

investors implies by its recommendation that it has an adequate basis for the recommendation. Consistent with this view, in 1988, the Commission issued an interpretation regarding underwriters' obligations to have a reasonable basis for recommendations, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which they are associated. See Securities Exchange Act Rel. No. 26100 (Sept. 22, 1988) 53 FR 37778.

¹² MSRB rule G-19 requires brokers, dealers, and municipal securities dealers that recommend any municipal securities transactions to have reasonable grounds, based upon information available from the issuer and facts disclosed by the customer or otherwise known about the customer, for believing the recommendation is suitable. See MSRB Manual (CCH) ¶ 3591. MSRB rule G-19 also requires such brokers and dealers to make reasonable efforts to obtain information from non-institutional customers concerning the customer's financial status, tax status, investment objectives, and other similar information. Id. Rule G-17 requires brokers, dealers, and municipal securities dealers to deal fairly with all persons. See MSRB Manual (CCH) ¶ 3581. The MSRB has interpreted rule G-17 to require that a dealer disclose all material facts concerning the transaction which could affect the customer's investment decision and not omit any material facts which would render other statements misleading. See MSRB Manual (CCH) ¶ 3581.30. MSRB rule G-30 requires brokers, dealers, and municipal securities dealers to ensure that the prices set for customer transactions are fair and reasonable. See MSRB Manual (CCH) ¶ 3646.

¹³ Section 17(a) of the Securities Act and Section 10(b) Exchange Act apply to issuers of municipal securities.

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As Chairman Levitt has stated in testimony before Congress,¹⁴ the Commission's municipal disclosure initiatives provide a foundation for substantial enhancement of disclosure and offering practices in the municipal securities market. The amendments to Rule 15c2-12 are consistent with the Commission's authority to promulgate rules and regulations to define, and prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices. Legislative action to change the largely exempt status of municipal securities issuers under the federal securities disclosure laws would have profound effects on the municipal market, and, given the 52,000 issuers of municipal securities, could require significant resources to administer.

As indicated in the Interpretive Release, the Commission supports legislation addressing the exempt status of conduit securities under the federal securities laws. Bonds used to finance a project which is to be used in the trade or business of a private entity are, from an investment standpoint, equivalent to corporate debt securities issued by the underlying obligor, in which the investor looks, and can only look, to a private entity for repayment. Investors need the same disclosure regarding the underlying municipal corporate obligor under the same regulatory and liability scheme.

5. Merrill Lynch appears to have played different, and potentially conflicting, roles in its relationship with Orange County. What concerns exist when the same firm plays potentially conflicting roles including certain combinations of the following: underwriting offerings made for investment purposes, lending the issuer money to purchase investments, acting as financial advisor, and selling the issuer investment products?

Brokers, dealers, and municipal securities dealers participate in a broad range of financial and business relationships, arrangements, and practices in the course of their dealings with issuers. Many of these arrangements are customary and appropriate. For example, it is common for dealers to arrange repurchase agreements that effectively finance government securities purchased from such dealers.

¹⁴ Testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission, Concerning the Municipal Securities Market, Before the Committee on Commerce, U.S. House of Representatives (Jan. 12, 1995) at 30.

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Nevertheless, the combination of some functions, particularly dealer activities and financial advisory functions may, without careful consideration, result in conflicts of interest, breaches of duty, or less than arm's length transactions.¹⁵ Because of the infinite variation in relationships with issuers, brokers, dealers, and municipal securities dealers must be aware of duties that arise in the course of their dealings with issuers, and must prudently manage their activities to avoid these problems. Similarly, issuers must develop appropriate internal controls and guidelines to assure themselves that they are obtaining the best possible services at appropriate prices and without undue risks, including risks created by conflicts of interest.¹⁶

Existing rules call for certain disclosure by offering participants. MSRB rule G-23¹⁷ establishes ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities. Specifically, rule G-23 requires that financial advisory relationships, including the basis for compensation, be set forth in writing; sets forth the conditions under which a broker, dealer, or municipal securities dealer may act as an underwriter for an issuer with which it has a financial advisory relationship; and requires disclosure to customers of the existence of dual financial advisory and underwriting relationships.

¹⁵ See Securities and Exchange Commission v. Stifel, Nicolaus and Company, Inc., (W.D. Okla.), Lit. Rel. No. 14587 (Aug. 3, 1995) (acceptance by underwriter of undisclosed payments from third parties that sold investments to municipal bond issuers).

¹⁶ See MSRB Reports, Vol. 11, No. 3 (Sept. 1991) at 11 (MSRB statement encouraging underwriters and state and local governments to maintain the integrity of the process of selecting parties involved in the underwriting of municipal securities); MSRB Reports, Vol. 13, No. 3 (June 1993) at 15 (MSRB determination to meet with issuer groups to discuss whether measures could be adopted by issuers or state legislatures to ensure that political contributions do not influence the underwriter selection process).

¹⁷ See MSRB Manual (CCH) ¶ 3611.

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August 25, 1995
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In addition, the Interpretive Release addressed questions of conflict of interest, and noted that information about financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of the offering. Failure to disclose material information concerning such relationships, arrangements, or practices may render misleading statements made in connection with the offering process, including statements in the official statement about use of proceeds, underwriters' compensation, and other expenses of the offering.

I hope these answers are responsive to your questions. Please do not hesitate to contact me if we can provide you and the Subcommittee with further information.

Sincerely,

Paul S. Maco
Paul S. Maco
Director
Office of Municipal Securities



September 19, 1995

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital
Markets, Securities, and Government
Sponsored Enterprises
United States House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Baker:

Thank you for allowing me the opportunity to testify before the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises during the hearing on July 26, 1995. I am glad to respond to the additional questions in your letter of August 4, 1995.

* * *

Question: What would be the benefits of standardized reporting requirements across the country? What would be the drawbacks?

Response: The SEC has begun to standardize issuer disclosure requirements. Under recent amendments to Securities and Exchange Commission Rule 15c2-12, issuers must provide notice of 11 specified material events to the Board and to national information repositories. The specification of 11 material events will provide for some uniformity in the type of information to be disclosed to the market, although the format is left to the discretion of the issuer. The amendments also provide for annual financial information to be disclosed by issuers. The Commission defined annual financial information to be financial information or operating data, provided at least annually, of the type included in the final official statement with respect to a person obligated to repay the bonds. This definition gives issuers flexibility to determine the format and content of the financial information to be provided. Hopefully, these requirements will give issuers sufficient guidance regarding the type and amount of information to disclose to the market while allowing them to adapt these requirements to their specific situation. While this flexibility is a benefit to issuers, investors must receive useful, timely information. The Board believes that, prior to additional efforts to standardize requirements, it is preferable to see if the SEC's flexible approach results in needed information reaching the investor community.

* * *

Question: At present, the Bankruptcy Code leaves to the States whether its municipal entities can avail themselves of the Federal Bankruptcy process. Should the law require a municipality to confer with the State government before commencing bankruptcy?

Question: What do you think of Mr. Spiotto's suggestion that a uniform statute be adopted by all states which governs municipal financial distress?

Question: Should the law require the State, not the municipality, to assert that bankruptcy is a last resort after all rational and feasible alternatives have been fully explored?

Response: This response addresses these three questions which are joined by the common subject matter of municipal bankruptcy. The Board's rulemaking authority extends only to securities dealers and only to their municipal securities activities. The main focus of the Board and its rules is the protection of municipal securities investors. The Board does not have authority to write rules governing the activities of municipalities. Similarly, the Board has no role, or expertise that would be helpful to the Subcommittee, in municipal bankruptcies. However, the Board is concerned that uncertainty regarding the intentions of municipal issuers toward their general obligation debt has had a negative effect on the market, and would be in favor of any procedure that would provide for greater stability and confidence in this large and important market.

* * *

Question: How can we call disclosure adequate when Orange County sells a bond issue in June of 1995 with many pages of unaudited financials from June 30, 1994? Given Orange County's problems, why did the market accept outdated financial information?

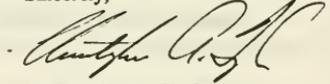
Response: Until recent Commission approval of amendments its Rule 15c2-12 dealing with secondary market disclosure, the municipal securities market could review only the information voluntarily provided by issuers in order to determine whether to purchase the securities. Rule 15c2-12 now requires issuers to provide annual financial information, which may be unaudited. However, if audited financial statements are prepared, they must be made available to the market. The financial information must be made available once a year, but the timing of release during the year is left to the judgment of the issuer. When the issuer commits to provide financial information, it must specify the type of financial information and operating data to be provided, specify the accounting principles under which the financial information will be prepared, state whether the annual financial information will be audited, and specify the date on which the annual financial information will be provided. Hopefully, the new requirements will improve issuer disclosure of financial information to the market.

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* * *

I am pleased to have been able to respond to further questions regarding the municipal securities market. Please feel free to call upon me again if I may be of any further assistance.

Sincerely,



Christopher A. Taylor
Executive Director

QUESTIONS FOR MR. HEIMOWITZ
CAPITAL MARKETS SUBCOMMITTEE HEARING ON MUNICIPALITIES

1. A significant portion of the Orange County Investment Pool was invested in Government Sponsored Enterprise structured notes. Such notes carry low credit risk but high market risk. Such notes, therefore, carry a triple-A rating, which can be misleading to investors. Could you please comment? Should such notes also carry some sort of market-risk rating?
2. How can we call disclosure adequate when Orange County sells a bond issue in June of 1995 with many pages of unaudited financials from June 30, 1994? Given Orange County's problems, why did the market accept outdated financial information?
3. What percentage of Orange County's revenues came from investment returns? How did the rating agencies take the magnitude of that percentage into account?
4. Do the rating agencies look into whether municipalities have a game-plan for financial emergencies -- for example, refinancing, special taxes like sales and airline ticket taxes, privatization, sale of assets, differentiation in levels of staffing, etc.?
5. At the time of Orange County's bankruptcy, its securities were rated by the agencies in their highest rating category and were eligible for investment by money market funds. It was well-known before the bankruptcy that the Orange County Investment Pool was highly leveraged and invested in derivatives. This included information in annual reports and information regarding the riskiness of funds during Citron's reelection campaign in 1994. Why didn't the other public information regarding the riskiness of the Pool have an impact on your ratings?

**Moody's Investors Service**

Daniel N. Heimowitz
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September 14, 1995

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital
Markets, Securities & GSEs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Baker:

Thank you for your letter of August 4 and the opportunity to provide the Subcommittee with additional information. Set forth below are Moody's responses to the additional questions posed by the Subcommittee. The enclosed materials are referenced in our responses to those questions.

1. With regard to the market risks of GSE structured notes, we assume that your question relates to the market generally and not Orange County (where we are not aware of any facts which would indicate that County officials were confused as to the characteristics and risks of these instruments). Moody's has commented on this aspect of GSE structured notes, and we have enclosed some of our more recent statements on the subject.
2. With specific regard to the Refunding Recovery Bonds and Teeter Plan Revenue Bonds offered and sold by the County this summer, Moody's rating did not reflect security provided by Orange County. Rather, as discussed in our rating opinions (copies of which are enclosed), security for the Recovery Bonds was provided by MBIA insurance while the Teeter Bonds were secured by a letter of credit provided by the Industrial Bank of Japan.

With regard to the June 1995 Refunding Recovery Bonds, based on information received from the County and its representatives, it was Moody's understanding that the bankruptcy filing delayed the completion of the County's audit. Generally, in the absence of audited figures, it is accepted practice in the market to review the most recently available financial results and to then review such figures in light of prior audited financial results.

- 3-4 The financial data presented by Orange County and its representatives included figures for interest on the County's investments, including those in the Pool. The County's Official Statements, including, for example, the July 1994 TRANs Official Statement, generally summarized sources of the County's revenues, as did the County's audited financials, which were generally attached as exhibits to the Official Statements.

A municipality's ability to raise revenues and/or reduce or control expenditures is always part of our evaluation of creditworthiness. As with most municipalities we rate, Moody's discussed with Orange County officials what contingency plans existed for dealing with shortfalls in interest or other budgeted revenues or increases in expenditures. As noted in our rating opinions on Orange County, the County had a good track record of meeting budget targets, making timely budget adjustments when needed, and generating surpluses and maintaining or building operating reserves even during times when the State of California was increasingly diverting property tax revenues.

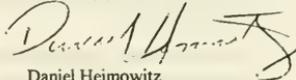
5. The basis for Moody's ratings of Orange County's securities (which was generally in the A to Aa range) is set forth in Moody's rating opinions (which were exhibits to my written testimony to the Subcommittee) and also was summarized at pages 3-4 of my written submission to the Subcommittee. As we have said, Moody's relies on the information that is disclosed to us by the issuer, its underwriter, bond counsel and other professionals. Moody's did not rate the Pool. In rating the County's obligations, Moody's took into account many factors affecting the County's general creditworthiness, including the County's historical financial performance, its strong and diverse economic base, its moderate levels of debt, and a history of sound fiscal management that was reflected in stable and growing reserves.

Congressman Richard H. Baker

Page 3

Once again, thank you for giving Moody's the opportunity to provide information to the Subcommittee on the important issues raised by the events in Orange County. Also enclosed is a corrected copy of the transcript of my testimony.

Very truly yours,

A handwritten signature in cursive script, appearing to read "Daniel Heimowitz", written in dark ink.

Daniel Heimowitz

Enclosures



July 1995

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The Credit Risk of a Foreign Exchange Forward Transaction

- Introduction & Motivation
- Background: The FX Forward and Credit Risk
- Analysis of the FX Forward Contract
- Credit Exposure at Arbitrary Confidence Levels
- Summary

Introduction & Motivation

The purchaser of a conventional note or bond bears the risk that the issuer will fail to honor its contractual obligation to pay coupons and principal. This "credit risk" has two components: the probability of issuer default and the severity of loss upon default. The second component is relatively straightforward. The investor stands to lose the entire market value of the debt security which we shall take to be par. Though the creditors in bankruptcy proceedings often receive a non-zero recovery, debtholders should consider the entire par value to be "at risk."

Let us define the "credit exposure" as the potential loss to the investor in the event of issuer default. Then the purchaser of a \$ 1000, twenty-year, non-amortizing bond has credit exposure of \$ 1000 for the next twenty years to the issuer. The issuer, of course, has no credit exposure to the investor since the investor has no future obligation (i.e., required payment) on which to default.

Consider as well that an **equity** investor has no credit exposure to the equity issuer since the issuer has no schedule of mandated payments. Such an investment can certainly fare poorly, but the risk is not credit risk.

See L. Carty, D. Lieberman, and J.S. Fons, "Corporate Bond Defaults and Default Rates 19780-1994," Moody's Special Report, January 1995.

continued on page 3

Structured Derivative Products

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2 Special Comment

Typical financial contracts (otherwise known as "derivative transactions") include option purchases and forwards and swaps on interest rates, commodity prices, foreign exchange rates, and equities. Most financial contracts specify scheduled payments to and from each party to the contract. Thus, unlike debt securities, financial contracts generally expose both parties to the credit risk of the other.

Though one may reasonably infer the probability of counterparty default from a *Moody's* counterparty (or senior debt) rating, the severity of loss upon default can vary widely. For example, two parties may enter an at-market interest rate swap "today". If one of the parties defaults tomorrow, there will be no credit loss since the swap value is zero (neglecting the single-day movement). But if one party defaults in six months, what will the loss to the remaining party be? The answer, of course, is we don't know. The loss will be zero if the swap is in-the-money to the defaulting party and it will be the swap value, if otherwise. Since we have no certain knowledge of market variables at future times, the extent of potential loss is uncertain. Hence, estimation of the loss upon counterparty default is not nearly as straightforward for financial contracts as it is for the loss to the investor in a conventional bond default.

To assess the severity of loss in derivative transactions, then, financial practitioners must develop models for the evolution of the market value of these contracts over time. The calculation of the expected loss severity with these models is quite complex, varies considerably with the nature of the contract and the specific terms thereof, and requires significant expertise and sophistication regarding the stochastic evolution of correlated market variables. *Monte Carlo* simulation provides the best framework for such calculations since it readily permits the incorporation of intricate and detailed models for yield curve fluctuations, exchange rate movements, et cetera. Investment bank risk analysts routinely employ *Monte Carlo* simulation in their assessments of credit risk exposure as well as in their approximations of market risk and exotic instrument pricing.

The *Monte Carlo* simulation itself, unfortunately, is an operational risk. The algorithm merely reports a numerical answer and thus imparts very little "intuitive feel" to the analyst. The computer programs, usually **C** or **FORTRAN**, that perform the *Monte Carlo* simulations often contain errors and the analyst must be ever vigilant in his/her assessment and reporting of simulation results.

One tool in the "debugging" of any computer program is the definition of a simple problem that one may solve analytically (i.e., in terms of closed-form equations). One simply runs the program to determine if it gives the correct answer as given by the analytical solution. This Special Comment poses a simple problem, the foreign exchange (FX) forward transaction, and provides the analytical solution for the credit risk exposure. The FX forward provides a good case study since such transactions generate high credit risk levels and since a common contract, the cross-currency swap, is a netted pool of FX forwards and interest rate swaps.

Background: The FX Forward and Credit Risk

Let us imagine that we enter a forward contract to buy F units of a foreign currency for one US dollar at a time T in the future. Clearly, if we enter this contract "today", then the parameter F (the "forward exchange rate") is set to the value that gives the forward contract zero value. But we shall allow F to be arbitrary in order to compute the credit exposure of an existing contract that is potentially in-the-money or out-of-the-money.

The credit risk "thought process" is to worry about the prospect that the contract will move in our favor. If, say, six months down the road the forward has positive value to us and the counterparty defaults, then we suffer the loss of this contract (minus any recovery). If, on the other hand, the forward has negative value when the counterparty defaults, we suffer no explicit loss (though a bankruptcy court may compel us to settle the contract prematurely with a cash payment).

There are three market variables that impact the value of the FX forward contract: the yield curves of the two currencies and the spot exchange rate. In practice, fluctuations in the spot exchange rate dominate those of the yield curves. Hence, we shall take the yield curves to be constant. (One should exercise caution with this simplification with highly correlated currencies - such as the US and Canadian dollars.)

[2] The statement that the loss equals the swap value when the swap is out-of-the-money to the defaulting party assumes zero recovery for the non-defaulting party. In reality, the latter should recover value at par passu primum with other senior, unsecured creditors.

Analysis of the FX Forward Contract

With no further ado, let us write the equations that relate the FX forward value to the market variables. With r and q the constant, continuously compounded risk-free interest rates for US dollars and the foreign currency, respectively, and ϕ_0 the current spot exchange rate in units of foreign currency per dollar, the current forward value per (US) dollar of notional is

$$V_0 = -e^{-rt} + F e^{-qt} / \phi_0 \quad (1)$$

where, again, F is the forward exchange rate (in units of foreign currency per dollar).

To analyse credit exposure, we must contemplate what the value of this contract may be in the future. Thus, we write the value of the forward at time t from the present as

$$V(t) = -e^{-r(t-t)} + F e^{-q(t-t)} / \phi(t) \quad (2)$$

The forward exchange rate remains fixed by nature of the contract while we've merely assumed for convenience that the interest rates r and q are constant. Obviously, we do not know what $\phi(t)$ will be. But we do know the probability density function (pdf) for this market variable and thus we know the pdf for the forward contract value $V(t)$.

As a first step in writing this pdf for the contract value at future points in time, it is helpful to make a "change of variables". Let us define a new variable γ in terms of existing variables and parameters by

$$F = \gamma \phi_0 e^{-(r-q)t} \quad (3)$$

Alternatively, we may refer to equation (1) and write this as

$$\gamma = 1 + e^{rt} V_0 \quad (4)$$

This new variable γ is dimensionless and has a convenient interpretation in terms of the value of the forward contract. If γ is equal to one, the contract has zero value. Alternatively, when γ is greater or less than one the contract is in-the-money and out-of-the-money, respectively.

Substituting the variable γ for F in this manner changes the forward value equation to

$$V(t) = e^{-r(t-t)} \left[-1 + \gamma \phi_0 e^{-(r-q)t} / \phi(t) \right] \quad (5)$$

The intrepid reader will wonder why we bothered to complicate the issue in replacing F by γ . Our reply is that efficient market theory dictates that the quantity

$$\log \left[\phi_0 e^{-(r-q)t} / \phi(t) \right]$$

has a normal density function with mean value $-\sigma^2 t/2$ and variance $\sigma^2 t$ where σ is the annualised volatility of the exchange rate (typically at or above 10% for the most important currency pairs).

Credit Exposure at Arbitrary Confidence Levels

We can define the quantity $V_c(t)$ as the value of the forward FX contract at a time t in the future that is α standard deviations (of the logarithm of the exchange rate) above the median. More precisely, $V_c(t)$ is the forward contract value at time t in the future at a particular confidence level. The chosen value of α prescribes the confidence level. For example, an α of 1.65 implies 95% confidence

level. Further, α values of 2.0 and 3.0 correspond, respectively, to 97.73% and 99.87% confidence levels. The mathematical expression for $V_s(t)$ is

$$V_s(t) = e^{-\alpha t} \left[-1 + \gamma \exp \left(\frac{-\sigma^2 t}{2} + \alpha \sigma \sqrt{t} \right) \right] \quad (6)$$

With a foreign exchange forward, of course, the peak exposure will occur at contract termination: $t = T$. The depiction at arbitrary t is helpful if one wishes to integrate (i.e., average) the time dependence. For typical values of volatility and maturity, it is not advisable to approximate the credit exposure by the square root of time.

Though the technique is approximate, it is remarkably useful. First, we incorporate effortlessly the possibility that the contract has non-zero initial value. Most credit risk computation methods consist of two pieces: initial value and potential change in value. Such a decomposition is often misleading since the pieces are not independent of one another. Second, one may quickly ascertain the credit risk for the reverse transaction in which we would sell foreign currency forward (instead of buying forward). The risks can be quite asymmetrical. (There is more credit risk, expressed in USD, in buying foreign currency forward than in selling forward.) The "sell forward" version of $V_s(t)$ is simply the negative of the "buy forward" version of equation (6) with " α " replaced by " $-\alpha$ ".

Summary

Accurate determination of the credit exposure of typical financial contracts represents one of the greatest challenges of quantitative finance. *Monte Carlo* simulation represents the state-of-the-art for this credit assessment due to its inherent ability to incorporate sophisticated stochastic models. Yet the potential for operational risk in the form of computer program errors is large.

We provide an analytical solution for the credit exposure of a simple and typical derivative contract: the foreign exchange forward. To serve our purpose of an analytical treatment, we specified flat and constant yield curves in the two currencies. Equation (6) embodies the final result and permits all risk analysts to compare their *Monte Carlo* simulations with the "correct answer."

The Credit Risk of a Foreign Exchange Forward Transaction**Special Comment**

02937



Moody's Investors Service
Global Credit Research

February 1995

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Structured Notes and the Investor's Risk ^[1]

- Introduction
- Definition of Structured Notes
- Examples of Structured Notes
- Risks of Structured Notes
- Summary

Introduction

Structured notes are receiving intense scrutiny. They bring the risks and the rewards of derivative instruments to a broad range of investors: large and small; sophisticated and unsophisticated. Their utility for increasing risks in investment portfolios gains notoriety in well publicized financial events. The Securities and Exchange Commission (SEC) has stated publicly that it will soon propose appropriate risk measures for structured notes.

In response to numerous requests for basic information, this Special Comment defines structured notes, details a variety of examples, and discusses the risks of these instruments. Many structured notes (e.g., floating-rate notes and callable notes) are actually quite common and are well accepted by investors at all levels. Furthermore, some structured notes may actually exhibit less market risk than their conventional counterparts. On the other hand, structured notes are newsworthy for good reason. They accommodate virtually any risk position or market view that an investor may wish to take with the result that some structured notes are far more volatile than their maturities may suggest.

^[1]This Special Comment derives from a presentation entitled "Structured Notes!" delivered at the November 1994 Moody's Investors Service "Speakers' Corner" Future Moody's publications will address this subject in more quantitative and historical detail.

continued on page 3

Structured Derivative Products

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2 Special Comment

Definition of Structured Notes

A conventional note (or bond) is a debt instrument in which the investor expects to receive a specific payment (par) at maturity as well as periodic, fixed-rate interest (coupon) payments. A structured note is simply a derivative instrument of some sort added to (or embedded in) a conventional note. As a result, the final principal payment, the coupons, the note maturity or all three are no longer predetermined quantities; rather they depend on a market variable.^[2]

The definition of the preceding paragraph focuses, as does the remainder of this exposition, on the class of structured notes arising from conventional notes. There also exist structured notes based on "mortgage notes" or "mortgage bonds".^[3] A conventional mortgage bond passes through both principal and interest payments from an underlying pool of mortgages. Derivative variants of this prescription (i.e., embedding derivatives to modify the coupons, selectively passing only principal or only interest, subordinating some claims on principal and interest to other claims, et cetera) produce structured notes.

Since a (nonmortgage) structured note is a conventional note with one or several embedded derivatives, there is literally no limit to the types of structured notes one may design. The following enumeration offers three broad properties of structured notes:

- Coupon-linked structured notes.
- Principal-linked structured notes.
- Extension-linked structured notes.

A specific note may have any combination of these properties.

It will soon become clear that our definition is quite expansive in that it pins the "structured note" designation on various mundane, nonthreatening, debt instruments. Some market participants object to this broad brush in that they would add "high risk" and "complex" to the qualifiers for a structured note definition. But this practice is analogous to defining "snakes" as "only those snakes that are dangerous to people." The additional qualifiers are imprecise, *ad hoc*, and detrimental to a deeper understanding of exotic instruments and their risks.

Coupon-Linked Structured Notes

Moody's defines structured notes in which the periodic coupon payment is not a fixed value (e.g., 8 %) as "coupon-linked." They are equivalent to conventional notes (with fixed coupons) plus a swap of some kind in which the noteholder effectively pays the fixed coupons and in turn receives another consideration. That other "consideration" is most often a series of payments on the coupon dates that vary according to one or more market variables.

The single constraint of this new coupon payment is that it must never be negative (which would imply a mandatory payment from the noteholder to the issuer). An investor in a coupon-linked structure desires a debt investment with a more customized risk profile (i.e., more or less risk than a conventional note). The maturity and par repayment of the note remain unchanged.

Principal-Linked Structured Notes

In purely principal-linked structured notes, the maturity and fixed coupon payments are unaltered. The issuer's repayment obligation at maturity, however, is no longer the face value of the note. Rather, this repayment may be a simple or a complex function of prevailing market variables or of the precise values of market variables during the life of the note. Investors generally request principal-linkage features in order to take specific derivative positions for hedging or speculation purposes. The associated note structure acts as collateral for the derivative position.

[2] There exist prominent structured note issuers with whom we've spoken who might object that this definition is too broad. As the reader shall find in a subsequent discussion of specific examples, we include several common and well-understood instruments within the family of structured notes (e.g., floating-rate notes and callable notes/bonds). Some issuers object that only "risky" and/or "complex" debt issues should be considered structured notes.

[3] The convention in much of the financial industry is to refer to such mortgage-based instruments as "mortgage derivatives" and to reserve the term "structured note" for non-mortgage instruments. Since "structured note" is often applied in the broader sense, however, we discuss this implementation here.

Extension-Linked Structured Notes

Extension-linked notes contain options or other mechanisms that either reduce or extend the maturity of the note or impose an amortization schedule on the note face value. The principal repayment obligation, as well as the fixed coupon (on remaining face value), remain unchanged. Most commonly, either the issuer or the investor have the option to terminate the note before maturity.

Examples of Structured Notes

Here we present an illustrative compendium of examples of structured notes, which leads the reader to observe that many "structured notes" are quite common and inoffensive in the sense that the risks are less than or comparable to those of conventional notes.

Floating-Rate Note

We shall begin with the most benign example. Suppose one adds a bid-side (i.e., "pay fixed") swap to the conventional note so that the swap payments match the note coupon payments in time. In effect, the investor then receives the coupon payment, immediately transfers all or part of the coupon as a fixed swap payment, and receives LIBOR, (London Inter-Bank Offer Rate), as per the swap agreement.

As a result, this structured note returns par at maturity and pays a coupon equal to LIBOR plus a spread (the difference between the underlying note coupon and the fixed swap payment). Hence, the market variable upon which the coupon payment depends is LIBOR. We call this case "benign" for two reasons.

First, most investors would immediately recognize this "swapped note" to be the familiar floating-rate note (FRN). Second, appending the swap greatly reduces the note price sensitivity to yield curve fluctuations. This structured note is arguably much safer than the underlying conventional note (per our later discussion of the risks of structured debt). Figure 1 illustrates the cash flows of a typical FRN.

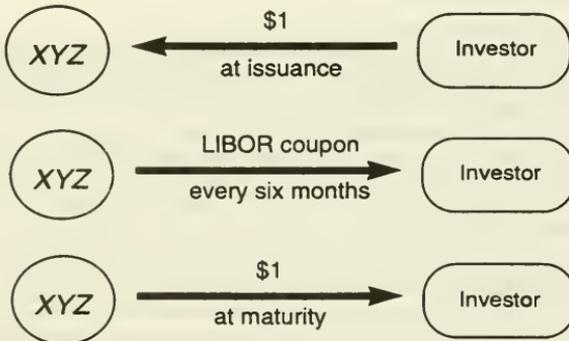


Figure 1

Callable Note

Callable notes and bonds are ubiquitous in the marketplace. The call feature is an embedded option that gives the issuer the right to redeem the note at a fixed price (generally par) at one or several points in time before maturity. Like the FRN, the callable note is less volatile than its conventional counterpart. To establish that point, consider the investor's vantage point. The conventional note will rise (fall) in value as interest rates fall (rise). The value of the call option behaves similarly. That is, it rises (falls) when interest rates fall (rise). But the investor is short the call option. Hence, the value of the callable note, which is an extension-linked structured note, is the value of the corresponding conventional note minus the value of the note call option.

Step-Up Callable Note

The step-up callable is another extension-linked note that varies slightly from the previous callable note. It has a scheduled increase in the coupon that coincides with the first call date. Therefore, if the issuer elects not to call the note, the investor receives an increased coupon until maturity or call. Again, one will see that the step-up callable will have a lower sensitivity to interest rate fluctuations than the comparable conventional note. Yet a further variation on this theme is to specify multiple step-up dates within the call period.

Inverse Floater

Suppose that we now create a coupon-linked structured note by pairing a conventional note with an offer-side (i.e., "pay floating") swap. (Recall that the low volatility FRN consisted of a conventional note plus a bid-side swap.) The investor's coupons now consist of a large fixed rate (the underlying note coupon plus the swap fixed rate) minus LIBOR. **This structured note is an "inverse floater" because its coupon decreases as LIBOR increases.** The price sensitivity of this note will be significantly greater than that of a conventional note because the coupon decreases, instead of remaining fixed, while interest rates rise. (See Figure 2 for cash flows of a typical inverse floater.)

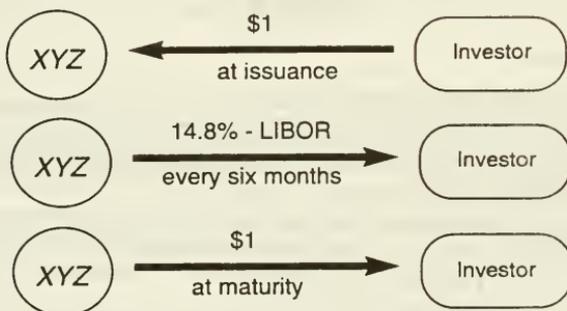
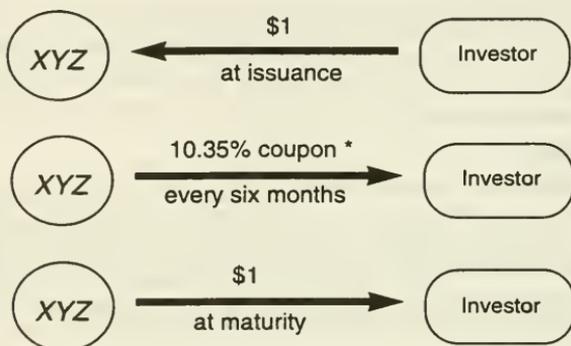


Figure 2

Corridor Note

The corridor note (or "range bond") is a coupon-linked structure in which the coupon is initially set to an above-market value. The coupon remains at the high value as long as LIBOR remains within a predesignated "corridor" (or "range" or "band"). For every day that LIBOR is outside this corridor, the coupon accrues at a value of zero. Hence, the true coupon for any payment period will lie somewhere between zero and the initial value.^[4]

The investor has essentially sold digital caps and floors on LIBOR. While dependent on the precise corridor, the volatility of the corridor note will always be greater than that of the corresponding conventional note. (See Figure 3 for typical cash flows of a corridor note.)



* as long as 6-month LIBOR is between 6% and 9% (the "corridor")...otherwise the coupon is zero

Figure 3

Gold Forward Note

Next consider a one-year, principal-linked structured note in which the investor receives fixed, semi-annual coupons of, say, 5% and at maturity receives par plus 1 % of the difference between 450 and the prevailing gold spot price (quoted in dollars per ounce). If, for example, spot gold is precisely 450 at maturity, the investor receives par. If gold is 400 or 500, respectively, the investor recoups 150 % of par or 50 % of par.

Clearly, both the investor's receipt of principal at maturity and the structured note value before maturity are highly volatile and dependent on the gold price. **This structured note embeds a gold forward as the derivative component.** Typically one might also give the investor a gold cap struck at 550 so that the investor would never owe money at maturity. The investor would likely pay for the cap in the form of a lower-than-market coupon.

Instead of gold, of course, this example could have emphasized a dependence on oil, the yen-dollar exchange rate, a general commodity index, or some other variable. An investor might seek this note for hedging or for speculation purposes. Furthermore, investors are frequently fund managers who may not be permitted to invest directly in commodities but are not yet forbidden to purchase what appear to be debt instruments with the desired commodity exposure. (See Figure 4 for the potential structure of a gold forward note.)

[4] J. M. Pimbley and D. A. Curry, "Credit and Market Risks of Corridor Notes/Swaps", *Moody's Investors Service Special Comment*, September 1994.

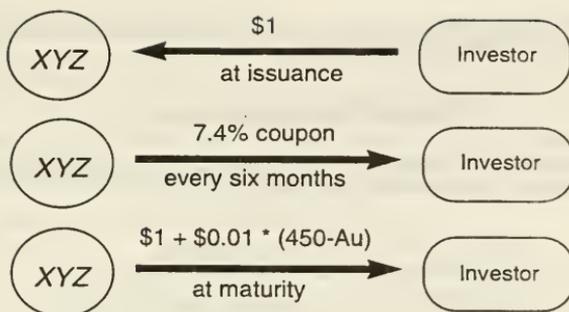


Figure 4

"Wolf-in-Sheep's-Clothing" Note

Unfortunately, a structured note may seek to obscure the true risk of an investment. Here we find a particularly blatant example. Consider a highly rated issuer who promises to pay a high, fixed coupon as long as another (lowly rated) corporate issuer is not in default. Furthermore, the highly rated issuer will pay the face value of the note at maturity only if this other corporate is undeclared. Both the coupons and the principal repayment are credit derivatives in that they depend on an external credit quality. Hence, this note is both coupon-linked and principal-linked.

The most sensible manner in which the highly-rated issuer will create this investment is simply to buy underlying debt of the lowly rated corporate and pass through the coupons minus a spread. There may be no rational, economic motive for structuring the transaction in this manner. Rather, the issuer, the dealer, and, possibly, the investor may expect that the rating agencies will assign the (highly rated) issuer's debt rating to the structured note. If so, a fund manager whose guidelines permit the purchase only of investment-grade debt would be able to buy this structured note and, presumably, earn coupons substantially greater than those of conventional investment-grade instruments.

"Immature-at-Maturity" Note

Next consider a similar ploy. A dealer buys Aaa five-year notes and places them in a bankruptcy-remote trust. The dealer then offers to investors a one-year structured note that passes through the coupons of the five-year notes in the trust, minus a spread. Upon maturity of the one-year note, the investors get the market value of the longer maturity notes. This is a principal-linked note since the payment at maturity is dictated by a market variable (the value of the longer-term notes).

The likely investor in this note is the fund manager who is not permitted to purchase fixed-coupon notes with a maturity greater than a specified limit (e.g., one year). This note gives this investor the ability to satisfy the maturity limit and gain exposure to a five-year risk.

Index Amortizing Note

A conventional amortizing note has a predetermined schedule of principal payments over the note maturity. (Market participants refer to conventional notes as "bullets" since they require total principal repayment at one point in time ... maturity.) With index amortizers, however, the principal payment schedule is uncertain. The schedule varies with an index such as the LIBOR setting on specified dates. Thus, neither the issuer nor the investor owns an option. The note is neither callable nor puttable. The principal steps down in accordance with a formula based on the index.

The risk of such an extension-linked structure may be greater or less than that of a conventional note depending on the precise amortization indexation. These notes typically hedge a mortgage

position in that the investor chooses the schedule relating the index to the amortization to mimic the expected behavior of mortgage prepayments.

Risks of Structured Notes

A discussion of the risks of structured notes is also well served by a segmentation of product type into "coupon-linked", "principal-linked", and "extension-linked":

- Coupon-linked notes have interest rate risk
- Principal-linked notes have other derivative risks
- Extension-linked notes generally have interest rate risk
- All structured notes have varying degrees of liquidity risk

Coupon-linked notes have interest rate risk

Coupon-linked notes almost invariably specify coupons that are functions of a benchmark interest rate such as six-month LIBOR. That is, the risk of coupon-linked notes, like that of conventional notes, is primarily interest rate risk. The most prominent exception to coupon dependence on LIBOR or a similar interest rate variable is that of the "wolf-in-sheep's-clothing" note whereby the coupon dependence is a credit issue. Other counterexamples include structures with coupons tied to specific commodities, a commodity index, or to an equity index.

The nature and extent of the risk of a coupon-linked note vary with the coupon prescription. As a baseline discussion, consider the risk of a conventional note (i.e., with fixed coupons). The value of such a note at any time prior to maturity is simply the present value of all future coupons and principal payments. One computes the "present value" of future cash flows with the issuer's current yield curve which, in turn, constitutes the general level of interest rates and the issuer's credit quality. The value of a conventional note falls as interest rates rise due to the diminished present values of all future payments.

Alternatively, one might observe that an increase in general interest rate levels implies that a particular issuer must increase the coupon of a conventional debt instrument that it wishes to sell today at par above the coupon of a previous issue. An investor who purchased this previous issue at par in the low interest rate environment must therefore have suffered a market value loss.

Coupon-linked structured notes ordinarily have variable coupons for which this straightforward thought process is not applicable. Imagine first a floating-rate note (FRN) with a coupon of LIBOR. (We take the issuer credit spread to the LIBOR/swap yield curve to be zero.) As interest rates rise, the present value of a fixed future cash flow falls as per our previous discussion. But the increase in the investor's coupons acts to increase the value of the FRN. To a large extent the two tendencies cancel each other and the net interest rate risk of a FRN is much less than that of a conventional note of equal maturity.

Another view of this risk reduction emerges from the decomposition of the FRN into a conventional note and a bid-side swap. The investor's note falls in value as rates rise while the bid-side (pay fixed, receive floating) swap increases in value.

Having found reduced market risk in the FRN, let us consider the inverse floater. This note specifies a coupon equal to a high fixed rate minus LIBOR (or another interest rate benchmark). As interest rates rise, then, the coupon for the inverse floater falls (as LIBOR will generally rise with other rates). Thus, we see that the inverse floater will fall in value for **two** reasons as interest rates rise: greater "discounting" in the present value calculation; and the explicit fall in coupon levels. With no further analysis, we can certainly conclude that the inverse floater is more risky than the conventional note (and obviously much more so than the FRN).

"Derivative decomposition" of the inverse floater is quite useful. This debt instrument is a conventional note plus an offer-side (pay floating, receive fixed) swap. Both the conventional note and offer-side swap fall in value as rates rise. From our earlier analysis of the FRN, we know that the swap and fixed-coupon note sensitivities are roughly equal. Thus, the inverse floater has about

twice the market risk of a conventional note.

The corridor note is our last and most sophisticated example in this category. Our corridor note description of this article, as well as a prior communication,¹⁵ show that the investor is short a series of caps and floors on a benchmark interest rate such as LIBOR. Interest rate movements that bring either the caps or the floors "into the money" will decrease the value of the corridor note to the investor. This observation is fascinating since it implies both that the corridor note risk exceeds that of the conventional note and that the risk profile is asymmetric.¹⁶ The degree of corridor note appreciation as rates fall will be much less than the degree of note depreciation as rates rise. The above-market coupon of the corridor note compensates the investor for this skewed risk exposure.

Principal-linked notes have other derivative risks

Principal-linked structured notes specify a principal payment at maturity that depends on a market variable. It is generally the case that the risk of this uncertain maturity payment is comparable to or greater than the (interest rate) risk of a conventional note of equal maturity and coupon payments. The "immature-at-maturity" note in a previous example embeds a large degree of interest rate risk in the maturity payment because this principal repayment is essentially a forward contract on the five-year underlying note. The settlement price of the forward contract varies with this long-term note value which, in turn, is primarily interest rate risk and secondarily credit quality transition risk.

Unlike the "immature-at-maturity" note, most principal-linked notes consist of derivatives based on market variables other than interest rates. An investor seeks a specific market position in gold, oil, foreign exchange, and other commodities, and simply employs the structured note as the vehicle for this position (thereby avoiding the need for the issuer/dealer to take the investor's credit risk). The "gold forward" note, discussed earlier, typifies these instruments. Not surprisingly, the risks of such notes are similar to those of the risks of the embedded derivative transaction. The interest rate risk of the structured note remains comparable with the (interest rate) risk of a conventional note of the same maturity, but the additional derivative risk is often dominant.

Extension-linked notes generally have interest rate risk

In principle it would be possible to design structured notes which amortize early or extend beyond a desired maturity based on the behavior of a noninterest rate, market variable. We have never seen such an example in practice, though. Extension-linkage generally refers to standard (issuer) call and (investor) put features or to index amortizing provisions in which the "index" is invariably an interest rate variable.

With regard to call and put features, we've already commented that issuer-callable (and investor-puttable) notes have less interest rate risk than conventional notes of equal maturity and coupon payments. From the investor's perspective, a callable note is a conventional note and a short call option. The conventional note will rise (fall) in value as interest rates fall (rise). The value of the call option also rises (falls) when interest rates fall (rise). Hence, the value of the callable note, which is the value of the corresponding conventional note minus the value of the note call option, has offsetting components. The call option reduces the total market risk.

Index amortizing notes tend to be more difficult to assess in this manner because the amortization schedule is not as clear as that of the callable note. Nevertheless, imagine such a note in which the principal amortizes in a well-defined manner based on the value of LIBOR at each coupon payment date. Let's say that the principal falls if LIBOR is less than a target value (which may differ at each amortization date). If interest rates (e.g., LIBOR as well) rises, the note falls in value due to the ubiquitous "discounting" and falls in value as well due to the effective extension of the note maturity in a rising rate environment. Thus, the index amortizing note volatility is greater than that of the conventional note of similar duration.

All structured notes have varying degrees of liquidity risk

Structured notes of all types are inherently customized securities. Investors and dealers often collaborate to design the embedded market view and risk profile. It is not at all unusual for a sin-

[5] J.M. Pimbley and D.A. Curry, "Credit and Market Risks of Corridor Notes/Swaps", Moody's Investors Service Special Comment, September 1994

[6] The simulation results of the article of footnote 5 demonstrate this asymmetry

gle investor to buy an entire structured note issue.

This tailoring of the debt instrument, which is clearly to the investor's benefit at inception, vastly limits the secondary market into which the investor may wish to sell the notes prior to maturity. Very few investors in the market choose to assume the risks of all but the simplest products (e.g., LIBOR floating-rate notes and standard callables). Rather, any secondary market depends almost completely on the willingness of investment banks to purchase the structured notes and swap out the exotic features. The original dealer often agrees to make such a market. The number of other market makers, and hence the number of competing bids an investor may receive, vary with the nature of the risk. A gold forward note, for example, will have a larger secondary market (and, thus, more efficient pricing) than a note that pays principal based on the Thai baht - US dollar exchange rate.

Summary

Structured notes are state-of-the-art debt instruments that generate considerable controversy due to their novelty, complexity, and, in some cases, heightened risk to the investor. By careful definition of these "new" investments, we found that some existing, well understood, low-risk products are, in fact, "structured notes."

Conversely, many structured notes embed much more risk than one finds in comparable conventional notes. Market awareness of these risks is essential. In both the definition of structured notes and delineation of the risks, it is helpful to distinguish coupon-linked, principal-linked, and extension-linked variants. By their nature, principal-linked notes tend to have the greatest risk and the most exotic (i.e., noninterest rate) risk because the note structure exists primarily as a "delivery vehicle" for the embedded derivative.



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Market Risk of the Step-Up Callable Structured Note

- Introduction
- Description
- Pricing
- Market Risk
- Market Risk Implications

Introduction

Structured notes are conventional debt instruments with embedded derivative transactions (generally forwards and options).^[1] The derivative components of structured notes impact significantly the nature and magnitude of the market risk of the security.^[2] Investors should therefore be thoroughly conversant with the derivatives lurking within the assets they plan to purchase. Failure to acquire this expertise may lead investors to pay excessive prices for structured notes and to expose themselves to unsuitable market risks.

One of the most prevalent structured notes is the "multi-step-up callable" for which the government-sponsored enterprises (GSEs) appear to be the primary issuers. This article describes this "step-up" callable and its elder cousins: the "plain vanilla" callable and puttable debt instruments. We find that a thorough understanding of these investments requires the ability to price the embedded derivative transactions. Armed with an approximate pricing methodology, we design and execute a *Monte Carlo* simulation to assess the market risk of these structured notes.

We conclude that the volatility of the market value of these callable and puttable notes is actually less than that of the underlying conventional notes. While not surprising in hindsight, a valuable lesson from this exercise is that embedded derivatives can decrease, as well as increase, risk. Moody's offers this analysis as a service to the investor community. Subsequent articles will focus on the risks of other structured notes and mortgage derivatives.

[1] See J.M. Pimbley and D.A. Curry, "Structured Notes and the Investor's Risk," *Moody's Special Comment*, March 1995

[2] See J.M. Pimbley and D.A. Curry, "Credit and Market Risks of Corridor Notes/Swaps," *Moody's Special Comment*, September 1994

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Description

Conventional callable and puttable debt instruments have proliferated for decades. In a callable note, the issuer has the right to redeem the note at a fixed price during a defined period prior to maturity. The issuer must declare this defined period and the redemption price upon sale of the securities.

Though not as common, puttable notes also have a long history. Such securities give the investor the right to sell the note back to the issuer at a fixed price during a defined period. Clearly, without any further thought, one may conclude that a puttable note must be more expensive than a similar instrument without the put provision since this latter feature must have value to the investor. By the same token, investors pay less for a callable note due to the call provision ceded to the issuer.

Let us now consider the multi-step-up callable note. The concept is a straightforward extension of the conventional callable. The underlying note has a variable, not fixed, coupon that increases with time. As in most callable notes, the step-up is callable at all coupon dates beyond the first call. This first call generally coincides with the first scheduled increase in the coupon. The issuer may prefer the step-up callable note over the conventional callable note since the initial (lowest) coupon of the former will be less than that of the latter.^[3]

Pricing

The investor who purchases a callable bond risks having the bond called if interest rates fall sufficiently by a call date so that the underlying bond (without the call provision) would trade above the call price. The issuer is long the option and the investor is short. The call price is at par or above and the issuer may call the bond at any coupon date from the earliest call to maturity.

If the call price is at par, say, then the bond call option is equivalent to an option on a swap. As justification, consider that the issuer may buy the bond for par at a call date. Suppose instead that the issuer had an option to enter a swap to receive a fixed rate equal to the bond coupon and pay a LIBOR-plus-a-spread floating rate. If the issuer invokes the swap, the issuer will have converted the fixed-coupon bond to a floating-rate bond. If the spread in the swap is equal to the issuer's credit spread (measured with respect to the LIBOR/swap curve), this new floating-rate bond will trade at par. Hence, the option on the swap allows the issuer to convert the bond to a par-value instrument.

Since both the call option of the bond and the option on the swap produce the same result (a par-value investment), the values of the two options must be identical. Hence, we consider the call option problem to be a swaption problem.

Unfortunately, we've neglected the issue of the credit spread. That is, the issuer might choose to call the bond due to a narrowing of its credit spread even when the yield curve has not fallen significantly. We are not aware of any treatment of the call option that incorporates the credit spread. We shall ignore it as well. As we demonstrate in Appendix I, the value of the credit spread option is significantly less than that of the interest rate option when the issuer credit quality is high (eg., Aa or Aaa). The credit portion becomes increasingly relevant as the issuer debt rating declines.

The bond put option is analogous. The investor's long put option is equivalent to a long position in an option to enter a pay fixed, receive floating swap.

[3] While possibly valid in some circumstances, this intuitive explanation of why an issuer might prefer the step-up callable note to the conventional callable misses a key facet of the structured note market. Issuers usually "swap out" the derivatives embedded in their structured debt issues. With the callable or step-up callable notes, then, the issuer would likely sell the embedded swaption to a counterparty - often the dealer for the debt issue - at issuance. Hence, the choice of whether to issue the callable or step-up (or any other possibility) depends on what investors are willing to buy at the price most favorable to the issuer.

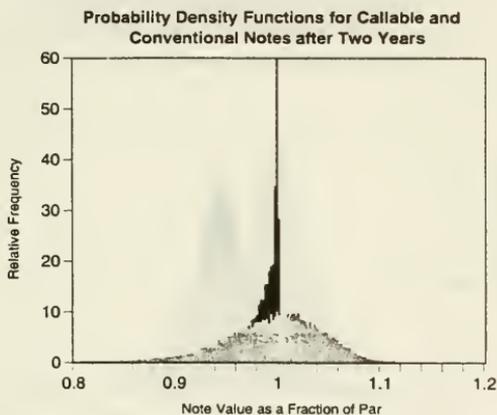
Like the callable note, the step-up callable note is simply an underlying note (with variable coupons, though) and a short (to the investor) option on a swap. The fixed-rate legs of this swap match the variable note coupons. Hence the requisite analysis for pricing and for market risk assessment is equivalent to that for the conventional callable and puttable notes. Appendix II describes in detail our analytical approach to the embedded swaptions that comprise callable, puttable, and step-up callable structured notes. The most prominent conceptual assumptions are that the party long the option will invariably exercise when it is economically advantageous to do so and that the "Black framework" is valid. The model accepts a term structure of volatility and appears robust, consistent, and sensible.

Market Risk

A simple and useful measure of market (interest rate) risk is the "effective duration" of a debt security. Adding either a call or put provision will generally reduce this duration measure, and hence the market risk, significantly. While a useful indicator, however, the duration is not a complete risk assessment tool.

To improve this risk measurement, we ask what will be the "likely values" of conventional, callable, and puttable notes at some point in the future. Clearly we can compile at best "probability density functions" for future values of these instruments. We generate these functions with a *Monte Carlo* simulation of the term structure of interest rates. This simulation allows the yield curve to vary stochastically (i.e., probabilistically) with imperfect correlation among different points on the curve and with an input term structure of volatility. At each point in time the algorithm re-prices the note and all embedded swaptions. Each *Monte Carlo* trial generates a different note price. By running tens of thousands of such trials one maps out a plot (the probability density function) of the relative frequency of occurrence of each particular potential note value.

A comparison of a conventional and callable note appears below:⁴



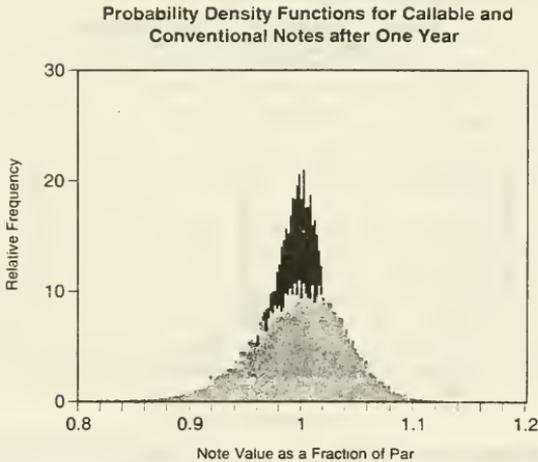
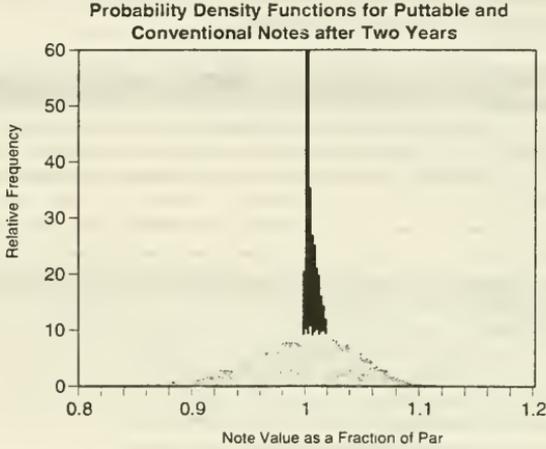
This figure describes the range of values of the five-year notes three years prior to scheduled

[4] The effective duration is the negative (calculus) derivative of the security price with respect to a parallel shift in the yield curve.

[5] The conventional note pays a semi-annual coupon of 7.28% while the callable note coupon is 8.24%. The issuer may call the latter after two years or at any coupon date thereafter at par. Both instruments have five-year maturities and have values near par with a A issuer and the LIBOR/swap yield curve of late March 1995.

maturity (i.e., two years after issuance). The conventional note coupon is set at the value (7.28%) consistent with an initial value of par. We chose this two-year point as that moment in time immediately following the first call date of the callable note. In fact, a value of par for this callable note implies that the bond was indeed called at par. The callable note density function has the sharp peak at par and "zero probability" at note values greater than par while the conventional note has the gradual density function that is nearly symmetric about par.

Next we consider the puttable note:^[6]



The situation of the first of these two graphs is reversed. The puttable note will have a value of par after two years only if the investor has just put the note at par. Otherwise, the market value of

[6] The conventional note pays a semi-annual coupon of 7.28% while the puttable note coupon is 5.81%. The investor may put the note later after two years or at any coupon date thereafter at par. Both instruments have five year maturities and have values near par with a Aa issuer and the LIBOR/swap yield curve of late March 1995.

this note will be above par.

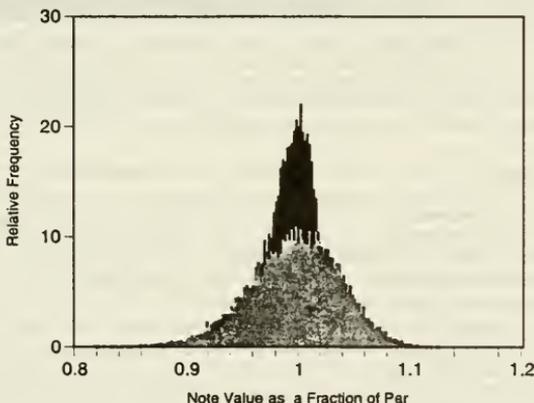
Clearly the abrupt cut-off feature of the callable and puttable note density functions results from our choice of the time (two years) coinciding with the first call/put exercise date. The impact of the call/put provision on the note price is still significant at times prior to the sequence of exercise dates as demonstrated by the second of the two preceding graphs.

The callable note probability density function is still narrower and more peaked than that for the conventional note. Further, though difficult to see in this reproduction, the callable note distribution remains asymmetric. That is, the likely values are not evenly distributed about par but rather are skewed to sub-par values. Both tendencies are less pronounced when compared with the earlier distributions after two years since there is significant "time value" remaining in the swaption at one year after issuance.

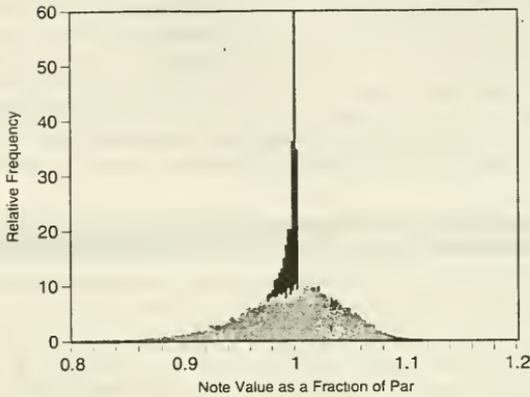
The Multi-Step-Up Callable Note

As a specific example of the step-up callable note, imagine a five-year note with semi-annual coupons with value near par "today". Consistent with the example in Appendix II, the issuer may call the note at par in two years or at any coupon date thereafter. Let the scheduled coupon be 8.1% for the first two years, 8.4% for the third year, 8.8% for the fourth year, and 9.25% for the fifth year. Thus, the first call date matches the point at which the coupon steps up from 8.1% to 8.4%. Again, this particular choice of coupon schedule implies an initial debt instrument value of par (with the market yield curve of March 1995). The issuer's beginning coupon of 8.1% is less than the 8.24% fixed coupon of the earlier plain vanilla callable note. Below we attach plots of the probability density functions for this step-up callable note value after one and two years:

Probability Density Functions for Step-Up Callable and Conventional Notes after One Year



Probability Density Functions for Step-Up Callable and Conventional Notes after Two Years



Our earlier observations regarding the probability density function of the "plain vanilla" callable note apply here as well. The impact of the step-up feature is two-fold. First, the investor's downside is slightly diminished in the step-up callable (which is a reasonable benefit given the investor's lower coupon of 8.1%). Second, and quite related, is the observation that the issuer is more likely to call the step-up note after two years than it is to call the standard callable note. The issuer has more incentive to avoid paying the next 8.4 % coupon than to avoid the 8.24% coupon of the standard structure.

Market Risk Implications

The figures in this memorandum paint a clear picture. The variance in future values of callable and step-up callable notes is significantly less than that of corresponding conventional notes. (This statement stems from our association of the width of the security price probability density function with the variance of these prices.) By any sensible measure, then, a "volatility rating" or "market risk rating" on a step-up callable structured note will not indicate that this instrument has enhanced market risk.

One may certainly argue that we've considered a very narrow range of examples for such a sweeping observation. But the result is arguable in much simpler terms. An investor who buys a fixed-coupon note has interest rate risk. In selling the call provision to the issuer, the investor is short an instrument (the American put swaption) with the same (direction of) interest rate sensitivity as the underlying fixed-coupon note. Thus, the presence of the call provision reduces the investor's net long position on the yield curve. The same tautology reveals that puttable notes are less volatile than conventional, fixed-coupon notes as well.

As a parting shot, one often hears callable notes have "re-investment risk". That is, the issuer will opt to call a note when interest rates have fallen in order to replace its funding at lower cost. The issuer thereby compels the investor to accept his/her investment back at a time when interest rates for re-investment are low. Though technically correct, these statements do not imply, as many people suppose, that callable notes have "more" risk than conventional notes. Just the opposite is true. A callable note has smaller day-to-day fluctuations in market value than does its conventional counterpart.

Appendix I: Credit Spread Option Value

We noted earlier that we have not incorporated in our valuation of the bond call and put provisions the component due to varying credit spread of the issuer. That is, a bond value may rise above a strike level and be called, or fall below a strike level and be put to the issuer, due to fluctuations in the credit spread instead of interest rates. This appendix approximates the credit spread contribution for the purpose of gauging the inaccuracy in omitting this term in our earlier analysis.

As a crude exercise for estimating the issuer's credit spread option value in its call provision, we first take the forward credit spread equal to the initial value (an oversimplification). We then employ the standard Black put option valuation with an expiration of two years for comparison with the European swaption example of the memorandum. With a volatility of 40% that loosely reflects our experience with credit spreads, we find the option value to be 50 bp per 100 bp of original spread. That is, if the initial spread is 100 bp (typical of a Baa or A issuer), then the option value is 50 bp. If the initial spread is 20 bp (typical of a Aaa issuer), then the option value is 10 bp and so on. In this simple approach, the credit spread option embedded in the investor's put provision is identical (since the option is at-the-money with our assumption that the present and forward credit spreads are equal).

In Appendix II we find typical European swaption values to be 116 bp and 177 bp for the call and put provisions, respectively. Hence, the 10 bp spread option of a Aaa issuer has only a small, though not completely negligible, impact on the total swaption value. If the issuer were of speculative grade (spread of 300 bp or more), however, the credit component would equal or exceed that due to interest rate fluctuations.

The message is clearly that it appears reasonable to omit the credit spread contribution when the issuer is of high credit quality (e.g., Aa or Aaa). Such an omission becomes less and less tenable as credit quality declines. We expect that this statement holds when comparing the American credit spread option with the American interest rate swaption.

Appendix II: Pricing the Embedded Swaption

The European Swaption valuation is the first step

We shall refer to the interest rate swaption in question as "American" even though we must qualify this adjective with two comments. First, it might be more precise to use the term "Bermudan" to denote the feature that the option is exercisable at a fixed set of dates in the future and not at any arbitrary time. It appears to be accepted market practice to retain "American".

Second, both "American" and "Bermudan" are somewhat misleading in that the terms fail to convey the point that the option payout changes at each expiration date when the holder chooses not to exercise the option. That is, if the option holder exercises the swaption "today", he/she receives the value of the underlying swap. If the holder declines to exercise, the underlying swap of the swaption changes.

As a "warm-up exercise", let us consider the simpler case of a European swaption. Imagine a five-year note with semi-annual coupons that is callable in two years and at no time thereafter. The existence of only one call date is unusual. As discussed previously, the issuer is long an option on a swap to receive fixed and pay floating. With only a single call date, the swaption is European.

We adopt a "Black-type" valuation framework for the European swaption. The underlying swap extends from year two to year five (with the first payment exchange at two years and six months). Let F be the forward value at year two of all fixed swap payments. Let X be the forward value at year two of all floating swap payments. Further, z is the "zero coupon discount factor" for payments made at the option exercise date (at year two) and t is the time until expiration. The volatility of the sum of floating payments is σ .

[7] Observe that the equivalent swaption for bond c is a floating rate option is a put option. That is, the issuer has the option to "sell" the swap (i.e., receive the fixed rate in exchange for the floating rate) to the investor/writer. Conversely, the equivalent swaption for a bond p is a floating rate option is a call option.

The option payout is $\max\{0, X - F\}$. Given the similarity to equity and foreign exchange options and the plausibility of a log-normal process for the sum of floating payments, we argue that the option value is simply the Black expression:⁷

$$\text{Swaption value} = z B_p(X, F, \sigma, t) \quad (1)$$

where the "Black put function" B_p is

$$B_p = X \Phi(-d + \sigma\sqrt{t}) - F \Phi(-d) \quad (2)$$

$$\text{with } d = \left[\log(F/X) + \frac{\sigma^2 t}{2} \right] / \sigma\sqrt{t}$$

$$\text{and } \Phi(x) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^x du e^{-u^2/2}$$

For the corresponding investor's bond put option with only one exercise date, the swaption payout is $\max\{0, F - X\}$. Here the bond put option value is a similar Black expression:

$$\text{Swaption value} = z B_c(X, F, \sigma, t) \quad (3)$$

where the "Black call function" B_c is

$$B_c = F \Phi(d) - X \Phi(d - \sigma\sqrt{t}) \quad (4)$$

The application of a Black-Scholes framework is somewhat crude in that the forward value of the sum of fixed-rate payments is not truly a constant value as is the strike of a conventional option. This sum of fixed-rate payments is not constant since the yield curve with which the future payments are discounted fluctuates. A consolation is that this fixed-rate payment term is significantly more stable than the floating-rate payment counterpart.

Further, the market legitimizes the Black-Scholes view of swaptions by quoting "swaption volatility" to express the value of a particular swaption. In fact, it would make sense for the swaption volatility σ to be less than, but nearly equal to, a typical volatility for a forward six-month LIBOR rate. The validity of this prediction qualitatively vindicates the Black-Scholes framework.

We shall briefly quote numerical results for the unusual call and put provisions of this section. Without such provisions, a Aa issuer would set the semi-annual coupon at or near 7.28 % to sell the five-year notes at par. The issuer's option to call the notes at par after two years (and at no time thereafter) has a value of 116 bp upon evaluating equations (1) and (2). To sell these callable notes at par, the issuer would raise the coupon to 7.67 %.

If instead the investor has the option to put the note at par after two years (and at no time thereafter), equations (3) and (4) place this option value at 177 bp. The investor should expect a reduced coupon of 6.64 % to compensate the issuer for the put option. The upward slope of the yield curve renders the put option more valuable than the call option.

The next level is the American swaption

To some extent the previous section was largely irrelevant because all issuer call and investor put provisions of which we are aware are of the "American" variety as opposed to "European". Still, the European framework provides an intuitive and analytical foundation upon which we shall build the valuation scheme for the American swaption.

[8] Numerical results of this memorandum employ the USD swap and Treasury yield curves of late March 1995.

When we say that the true call provision is "American", what we mean is that the issuer has the option at each call date except the last to call the bond at the pre-designated price or to wait until the next call date. That is, the issuer's decision is not simply to call now or never call (as in the European example of the earlier section).

This observation raises two points. First, the American swaption must be more valuable than its European counterpart since the latter invokes "all-or-nothing" while the former is "all-or-something". Second, for both the current valuation and subsequent *Monte Carlo* simulations, we must consider what will be the rational exercise criterion. For the European swaption, the issuer will exercise when the underlying swap has positive value. For the American swaption, the issuer may choose to accept the underlying swap or an American swaption of reduced maturity. The American swaption exercise decision, then, rests on the relative values of the swap and diminished maturity swaption. The issuer will exercise the swaption if and only if the swap has greater value than the diminished swaption.

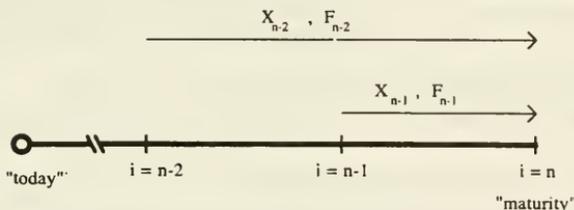
We develop "backward recursion" for the American swaption

This section develops a valuation technique for the American swaption. As a broad overview, we find it easiest to work backwards. That is, imagine we have a five-year note with semi-annual coupons that the issuer may call at year two or at any coupon date thereafter. We first find the value of the swaption with exercise date at 4.5 years after issuance (i.e., just six months prior to maturity). Given this 4.5 year swaption value, we find the value of the swaption exercisable at 4 years. Then we get the swaption value at 3.5 years and so on until we reach the true (first) exercise date at 2 years.

Why do we proceed in this manner? Though it may not be obvious, it greatly simplifies the problem. The value of the American swaption at any point in time depends on the values of the "subordinate" swaptions associated with subsequent call dates. Thus, it is sensible to compute these "subsequent call date swaptions" first.

The derivation that follows harbors an approximation above and beyond that of the Black-Scholes construct. One may defend the approximation qualitatively on the grounds that we substitute a mean value term within an integrand and that the subsequent integration reduces the error due to cancellation of over-compensating and under-compensating regimes. But qualitative assurances are not sufficient. We provide a more detailed error discussion at the point we introduce the approximation.

Consider the illustrative sketch below which may help explain our notation:



The points in time labelled " $i = n - 2$ ", " $i = n - 1$ " and " $i = n$ " denote the final three coupon payment dates with the last date also coinciding with bond maturity. The symbols X_{n-1} and F_{n-1} stand

[9] We choose to explicitly write only the time-dependence as an argument of Π merely to simplify equations that follow. It is understood that this swaption value varies with volatility and fixed and floating payments as well.

for the fixed and (expected) floating payments, respectively, in the final coupon period of the bond. Likewise, X_{n-2} and F_{n-2} signify the sums of expected fixed and floating payments over the final two coupon periods.

Our "backward marching" (or "backward recursion") method begins by valuing the last swaption with exercise time at $i = n - 1$. This swaption is effectively European since there are no "trailing" swaptions. Hence the value of the (put) swaption for a bond call option — which we call $\Pi_{n-1}(t_{n-1})$ — replicates the European swaption expression of equation (1):¹⁰

$$\Pi_{n-1}(t_{n-1}) = z_{n-1} B_p(X_{n-1}, F_{n-1}, \sigma, t_{n-1}) \quad (5)$$

where t_{n-1} and z_{n-1} are, respectively, the time to the call date (at $i = n - 1$) and the zero coupon discount factor for payments made at this call date. Similarly, the value of a (call) swaption for a bond put option, $\Gamma_{n-1}(t_{n-1})$ replicates equation (3):

$$\Gamma_{n-1}(t_{n-1}) = z_{n-1} B_c(X_{n-1}, F_{n-1}, \sigma, t_{n-1}) \quad (6)$$

We now move to the penultimate swaption values: $\Pi_{n-2}(t_{n-2})$ and $\Gamma_{n-2}(t_{n-2})$. At exercise (i.e., when t_{n-2} is zero), the swaption payouts are:

$$\begin{aligned} \Pi_{n-2}(0) &= \max [X_{n-2} - F_{n-2}, \Pi_{n-1}(\Delta)] \text{ and} \\ \Gamma_{n-2}(0) &= \max [F_{n-2} - X_{n-2}, \Gamma_{n-1}(\Delta)] \end{aligned}$$

The Δ in these equations is the time period between coupon payments (i.e., one-half year in our current example). At exercise, the option holder will enter the underlying swap if the first of the two bracketed terms exceeds the second. If instead the second term exceeds the first, then the subordinate swaption has more value than the current swap and the holder's rational decision will be to defer exercise of the swaption.

The greater challenge lies in deriving this penultimate swaption value prior to expiration. As is typical of option pricing endeavors, we write the (put) swaption value for the bond call provision as the present value of the swaption payout weighted with the risk-neutral probability density function (pdf) of the forward floating rates:

$$\begin{aligned} \Pi_{n-2}(t_{n-2}) &= \\ z_{n-2} \int_0^{\infty} d\eta_{n-1} \int_0^{\infty} d\eta_{n-2} p(\eta_{n-2}, \eta_{n-1}; F_{n-2}, F_{n-1}) &\max [X_{n-2} - \eta_{n-2}, \Pi_{n-1}(\Delta)] \end{aligned}$$

By writing

$$\max [X_{n-2} - \eta_{n-2}, \Pi_{n-1}(\Delta)] = \Pi_{n-1}(\Delta) + \max [X_{n-2} - \eta_{n-2} - \Pi_{n-1}(\Delta), 0]$$

we find

$$\begin{aligned} \Pi_{n-2}(t_{n-2}) &= \Pi_{n-1}(t_{n-1}) + \\ z_{n-2} \int_0^{\infty} d\eta_{n-1} \int_0^{\infty} d\eta_{n-2} p(\eta_{n-2}, \eta_{n-1}; F_{n-2}, F_{n-1}) &\max [X_{n-2} - \eta_{n-2} - \Pi_{n-1}(\Delta), 0] \end{aligned}$$

We now reach the point of our analytical approximation. The $\Pi_{n-1}(\Delta)$ within the integrand is a function of the floating rate variable of integration η_{n-1} . Yet it provides a tremendous simplification, to say nothing of an elegant result, to make the replacement.

$$\Pi_{n-1}(\Delta) \Rightarrow \frac{\Pi_{n-1}(t_{n-1})}{z_{n-2}}$$

The term on the right-hand side above is just "today's" value of the swaption to be exercised at $i = n - 1$ divided by the zero coupon discount factor. Hence, this right-hand side is the forward value of the put swaption. The substitution is essentially that of replacing a variable within the integrand by a mean value.

What effect does this substitution have on the eventual accuracy of the swaption value? When the swaption is far in-the-money, the approximation should be exceedingly accurate since the integrals of the two quantities

$$\Pi_{n-1}(\Delta) \text{ and } \frac{\Pi_{n-1}(t_{n-1})}{z_{n-2}}$$

multiplied by $p(\eta_{n-2}, \eta_{n-1}; F_{n-2}, F_{n-1})$ are equal. Also, the case in which the swaption is far out-of-the-money presents no difficulty since the integral contribution to the swaption value, even if inaccurate, will be much less than the contribution of the subordinate swaption value (i.e., the additive term). The remaining case is that of the swaption at-the-money. Here the approximation will overestimate the integral term by an amount that is difficult to quantify without performing direct comparisons with presumably accurate numerical simulations. As an estimate, it appears the error could approach or exceed ten percent of the true swaption value. A comforting feature is that the backward recursion technique we develop here will tend to damp error growth. That is, an overestimate of the swaption value at one step will depress the value of the swaption with the next earlier exercise date.

With this approximate substitution, we get

$$\Pi_{n-2}(t_{n-2}) = \Pi_{n-1}(t_{n-1}) + B_2[X_{n-1} - \Pi_{n-1}(t_{n-1}), F_{n-1}, t_{n-1}] \quad (7)$$

where $X_i = z_i X$, and $F_i = z_i F$. This is great! The penultimate swaption value is a simple function of the subordinate swaption value and has the interpretation as just a modified European swaption. The progression for valuing the swaptions expiring at $i = n - 3$, $i = n - 4$ and so on is trivial. Given the subordinate swaption at i , the value of the swaption at $i - 1$ is just

$$\Pi_{i-1}(t_{i-1}) = \Pi_i(t_i) + B_i[X_{i+1} - \Pi_i(t_i), F_{i+1}, t_{i+1}] \quad (8)$$

The corresponding expression for the (call) swaption pertaining to the bond put provision is

$$\Gamma_{i-1}(t_{i-1}) = \Gamma_i(t_i) + B_i[X_{i+1} + \Gamma_i(t_i), F_{i+1}, t_{i+1}] \quad (9)$$

The call/put option algorithms have appealing properties

Equations (5) and (8) describe completely the technique for valuing the American put swaption while equations (6) and (9) serve the same purpose for the call swaption. The key idea is that one first values the last piece of the swaption as European and then progressively adds new components moving backward until one reaches the true first exercise date.

This construction has several distinct advantages. First, it is easy to implement. Though it may seem unwieldy in its recursive form, bear in mind that such pricing formulae are always evaluated in computer codes and spreadsheet programs. Hence, this American swaption valuation is only slightly more cumbersome than European swaption valuation.

Second, the form of the recursion (equations (8) and (9)) clearly shows, for example, that put or call American swaptions with first exercise at two years are more valuable than those with first exercise at any time greater than two years. This property is fairly obvious without the mathematics, but it is nonetheless heartening to see it replicated so painlessly by our approximate valuation. Further, it is clear that if the nearest swap is well out-of-the-money so that swaption exercise at the upcoming call/put date is highly unlikely, the swaption valuation essentially reduces to that of the subordinate swaption.

Third, the recursive expressions easily admit the possibility that the bond call/put provision may require a premium. That is, the call price may be above par or the put price below par. For a call

price premium ξ_i , we simply add this amount (discounted to present value) to the floating rate

"payment". We make a similar adjustment for a put price premium ζ_i . Equations (8) and (9) become:

$$\Pi_{i-1}(t_{i-1}) = \Pi_i(t_i) + B_i \left[\bar{X}_{i-1} - \Pi_i(t_i) \cdot \bar{F}_{i-1} + \xi_{i-1}, t_{i-1} \right] \quad (8a)$$

$$\Gamma_{i-1}(t_{i-1}) = \Gamma_i(t_i) + B_i \left[\bar{X}_{i-1} + \Gamma_i(t_i) + \zeta_{i-1}, \bar{F}_{i-1}, t_{i-1} \right] \quad (9a)$$

Finally, the formulation lends itself well to flexibility in the input specifications. That is, there is no additional labor required to impose a term structure of (swaption) volatility or to vary the call/put premium and strike level at each exercise date.

Preliminary Results

As a preliminary demonstration of the results of this analysis, let us consider again the call and put provisions of the earlier section on European swaptions. We imagine a **Aa** issuer that would set the semi-annual coupon on five-year notes at or near 7.28 % to sell the debt issue at par. The issuer's option to call the notes at par after two years (or at any coupon date thereafter) has a value of 243 bp upon evaluation of the recursion of equation (8). To sell these callable notes at par, the issuer would raise the coupon to 8.24 %. (The comparable European swaption values were 116 bp and 7.67 %.)

If instead the investor has the option to put the note at par after two years (or at any coupon date thereafter), the recursion of equation (9) places this option value at 377 bp. The investor should expect a reduced coupon of 5.81 % to compensate the issuer for the put option. The upward slope of the yield curve again renders the put option more valuable than the call option. (The comparable European swaption values were 177 bp and 6.64 %.)

These examples produce drastic changes in the coupon level due to the high value of the call/put provisions. More typically, such bond call and put options would specify premiums that would reduce the option values and hence produce less dramatic changes in coupons.

The call/put provisions were more than twice as valuable in the "American form" than in the "European form". The inequality is sensible from a qualitative standpoint since the party long the option has much more flexibility (i.e., option value) in the American exercise mode. The two-to-one ratio in option value will change with any modification in the terms and conditions of the swaption.



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Credit and Market Risks of Corridor Notes/Swaps

New exotic derivatives magnify profit and loss and leave some investors ignorant of their increased downside risk. Corporate issuers and financial firms have recently created a new class of derivative instruments to provide investors with high yields and commensurately high risks. The "corridor note" (or "range note/bond"), a specific example of a "structured note", and "accrual range floater" (or "corridor") swap are similar in form to conventional notes and swaps. But the investor receives an above-market note coupon or generous swap terms in exchange for agreeing to forgo coupon or swap payments in the event that LIBOR (the London InterBank Offer Rate) falls outside prescribed bounds (the "corridor").

Pricing these products is challenging. The potential exists for the investor to seriously underestimate the "corridor risk" in evaluating both the note and swap variants.* The most widely publicised losses are those of the BankAmerica Pacific Horizon Prime fund (\$67.9M capital injection) and the Piper Jaffray *Institutional Government Income Portfolio* (reported 23% fall in the \$3.5B fund value). The bulk of the losses in the latter stemmed from mortgage derivatives. In this *Comment* we examine the risk of corridor notes and swaps in detail with the aid of analytical pricing methods and *Monte Carlo* simulations.

Though we do flesh out some credit risk issues, our emphasis is primarily market risk. *Moody's* offers this analysis as a service to the investor community. Subsequent articles will focus on the risks of other structured notes and mortgage derivatives. The complex nature of these instruments in concert with an investment grade credit rating of the issuer (e.g., Aaa government agencies) obscure the extent of the investors' risk. We wish to banish this obscurity.

Description

- The corridor note coupon varies with daily LIBOR settings
- The corridor-enhanced FRN coupon has more LIBOR sensitivity
- A range floater swap netted with a standard note produces a corridor-enhanced FRN
- A range floater swap netted with a floating rate note produces a corridor note
- The corridor note is similar to binary LIBOR municipal bonds
- Other notes and swaps have variable corridor ranges

The corridor note coupon varies with daily LIBOR settings

A typical corridor note might have a two year maturity and pay an 8.5% coupon semi-annually. (For simplicity, we shall consider the issuer to be highly rated so that its yield curve is equivalent to the LIBOR/swap yield curve. The specific numerical values we employ throughout this report are appropriate for the USD interest rate environment of early August 1994.) The market coupon for a conventional note is more than two hundred basis points lower at 6.4%. But the investor receives the high coupon only when (six month) LIBOR is in the range 4.5% to 7.5%. (Note that "today's" LIBOR is 5.25%.) The true coupon is computed on a daily accrual basis. Thus, if LIBOR falls inside the range for half of the days of the semi-annual coupon period and outside for the other half, the investor receives only half the 8.5% coupon. *Mitsubishi Finance* recently issued a corridor note of this type.

* The Securities and Exchange Commission (in a 30 June 1994 letter from the Director of the Division of Investment Management to the General Counsel of the Investment Company Institute), Office of the Comptroller of the Currency (in "Purchases of Structured Notes," OCC AL 94-2, 21 July 1994), and the Federal Reserve (in "Supervisory Policies Relating to Structured Notes," SR 94-45, 5 August 1994) have issued advisory warnings to banks on the risks of structured notes such as corridor notes. See the Swaps Monitor issues of 4 July, 18 July, 1 August, and 15 August 1994 as well as the 11 July and 18 July 1994 issues of Derivatives Week

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Structured Derivative Products

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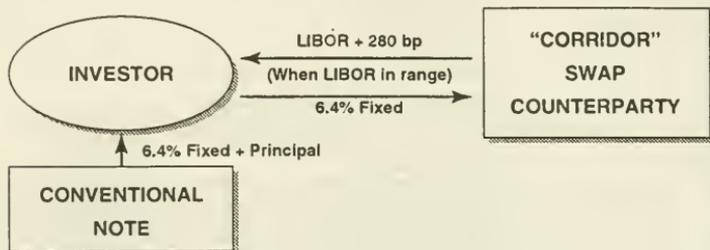
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The corridor-enhanced FRN coupon has more LIBOR sensitivity

Or consider a "corridor-enhanced" floating rate note (FRN) of the same maturity in which the four coupon payments are LIBOR plus 280 basis points when LIBOR is between 4.5% and 7.5% and zero otherwise (computed, as before, on a daily accrual basis). The 280 basis point spread here and the 210 basis point spread (8.5% minus 6.4%) of the previous example arise from our analysis of the corridor note value we discuss in the next section. Both notes should trade at par with these spreads.

A range floater swap and a note produce a corridor-enhanced FRN

An investor may generate his/her own synthetic corridor-enhanced FRN by adding a type of "accrual range floater" swap to a conventional, fixed coupon note. The investor would pay fixed (6.4%) in this two year, at-the-money swap and receive LIBOR plus 280 basis points when LIBOR is within the corridor range of 4.5% to 7.5%. The swap payment to the investor, like the coupon payment of the associated note, follows a daily accrual calculation. See the diagram below:



A range floater and standard FRN make a corridor note

By the same token, the investor may synthesise the corridor note by pairing a conventional FRN (which pays LIBOR for each coupon) with an offer-side accrual range floater in which the investor pays LIBOR and receives 8.5% when LIBOR is inside the corridor and zero when LIBOR is outside. We shall base the remainder of this comment on these four cases (two notes and two swaps).

The corridor note is similar to binary LIBOR municipal bonds

The impact of the LIBOR setting on a note/bond coupon is also evident, though much more pronounced, in the binary LIBOR municipal bond ("Goldman Embeds Binary Structure in New York Muni Deal," *Derivatives Week*, 20 December 1993 and "Street Adds Equity Derivatives, Accrual Notes to Muni Market," *Derivatives Week*, 10 January 1994). This binary bond coupon is quite generous for an initial period but falls to zero for the remainder of the bond tenor if LIBOR on a specific date exceeds the strike level. The prescription of all future coupons based on a single day's LIBOR setting distinguishes the binary bond from the corridor note. The analysis of the former is more straightforward than that of the latter.

Other notes and swaps have variable corridor ranges

There also exist notes and swaps of this sort in which the corridor range is not constant. When the note maturity or swap tenor exceeds two years, it actually makes more sense to specify a corridor that varies with time due to the upward slope of the yield curve (and hence forward rates). Of greater interest is a corridor that varies with LIBOR. PEMEX (*Petroleas Mexicanos*) recently issued a three year note in which a "floating corridor" spans the range from LIBOR minus 25 basis points to LIBOR plus 50 basis points where the LIBOR-dependent corridor is set at each coupon payment.

Pricing

- Standard Monte Carlo pricing is insufficient for our study
- The corridor note contains daily digital caps and floors
- Investors underestimate the corridor risk
- The corridor-enhanced FRN also has standard caps and floors

Standard Monte Carlo pricing is insufficient for our study

A Monte Carlo simulation would provide the most expedient pricing method for these sorts of transac-

tions due to their complexity. The financial engineer's custom software would permit the yield curve to vary in a risk-neutral manner over the two year tenor, record all coupon payments based on the LIBOR history, and repeat the process for tens of thousands of *Monte Carlo* trials to get expected values with high confidence.* But this methodology is computationally too expensive for our analysis. We wish not only to price the note or swap today but also to examine the *probability density function* for note and swap values at future times. Construction of this density function requires its own Monte Carlo simulation. The "nesting" of multiple levels of *Monte Carlo* simulation is prohibitive. Hence, we must work to define the mathematical expressions relevant to pricing these note and swap variants given all data including time to maturity, current yield curve and past history of LIBOR to eliminate one level of stochastic simulation.

The corridor note contains daily digital caps and floors

Of the two notes and two swaps described in the previous section, it is sufficient to look simply at the swaps. The two corridor notes are simply conventional notes, which we already know how to price, added to the swaps. Let us consider in particular the offer-side swap in which the investor pays LIBOR and receives a fixed rate accrued at 8.5% for LIBOR in the corridor and accrued at zero when LIBOR is outside.

Furthermore, we momentarily simplify the problem by ignoring the accrual feature. In this hypothetical case, the investor receives precisely 8.5% for LIBOR (measured only at the beginning of the semi-annual period) inside the corridor and precisely zero for LIBOR outside. We re-write this description of what the investor receives as follows:

Investor receives 8.5% (all LIBOR settings)
 Investor pays 8.5% if LIBOR > 7.5%
 Investor pays 8.5% if LIBOR < 4.5%

The reader may easily verify that the net result of these three statements is what we had previously pronounced: that the investor receives 8.5% if and only if LIBOR is in the corridor (from 4.5% to 7.5%).

But the three-statement version is actually more useful. One recognises the payments of the second and third lines as those of a digital cap and digital floor, respectively, with payout 8.5%.** The investor is short the options. Thus, our simulation need only price correctly these digital caps and floors. This requirement is fairly standard in the industry. One analyses the yield curve to get the appropriate forward rate (which doubles as the risk-neutral expected value of LIBOR) and inserts a volatility value into a digital option valuation expression. Caps are calls, of course, on the value of LIBOR while floors are puts. The appendix lists the appropriate mathematical formulae for conventional and digital caps and floors.

As we stated above, this formulation gives great weight to the LIBOR setting at the beginning of the (semi-annual) payment period. The payout of each cap and floor is either zero or 8.5% for the entire half year period. We must now relax the simplification in which we omitted the accrual aspect of the payment determination. Instead of specifying only one cap and floor for each period, we have in fact a cap and floor for each day. Every digital option within a payment period pays its contribution at the end of the period. Our simulations do not literally specify a cap and floor for every day. Rather, we space ten to twenty cap/floor combinations within each period.

Investors underestimate the corridor risk

Before we continue, we note that this is the point at which investors generally underestimate the "corridor risk". It is quite possible that the forward curve (of risk-neutral expected LIBOR values) lies entirely within the corridor over the swap tenor. Thus, the total *intrinsic value* of the digital options the investor has sold is zero. The investor may therefore have the erroneous impression that he/she is likely to receive the full coupon for the life of the swap. In fact, though, the *time value* of the digital options is quite high. And it is precisely this component of the option value that is most difficult to estimate.***

The corridor-enhanced FRN also has standard caps and floors

Let us now consider the other swap variant. The investor pays fixed (the market two-year swap rate of 6.4%) and receives LIBOR plus the 280 basis point spread when LIBOR is within the corridor. Again,

* The "risk-neutral" evolution is appropriate for pricing such derivative products. The future expected value of the underlying market variable is today's forward value.

** A "digital" or "binary" option pays a fixed amount upon exercise that is independent of the underlying asset value or interest rate as long as the "exercise condition" has been met. For example, a digital equity put option pays a fixed amount when the equity value finishes lower than the strike.

*** The "intrinsic value" of an option is simply the option payout formula evaluated with the present forward asset value or interest rate. The "time value" is the remainder of the total option value.

the investor receives nothing on a daily accrual basis when LIBOR is outside the corridor. As before, we seek to re-write the payment the investor receives:

Investor receives $\text{LIBOR} + 2.8\%$ (all LIBOR settings)
 Investor pays $\text{LIBOR} - 7.5\%$ if $\text{LIBOR} > 7.5\%$
 Investor pays $7.5\% + 2.8\%$ if $\text{LIBOR} > 7.5\%$
 Investor receives $4.5\% - \text{LIBOR}$ if $\text{LIBOR} < 4.5\%$
 Investor pays $4.5\% + 2.8\%$ if $\text{LIBOR} < 4.5\%$

The complexity of this case is greater than that of its predecessor. In order to "capture" the payout of LIBOR plus 280 basis points in terms of standard caps and floors, we must employ two caps and two floors. The conventional cap pays LIBOR minus *strike*. The digital cap pays whatever fixed amount we specify. To get our desired payout, then, we must set this digital fixed amount to *strike* plus 280 basis points. The same comments pertain to the floor. Careful consideration reveals that the investor is actually long the conventional floor. Thus, we now have four options: a short conventional cap, a short digital cap, a long conventional floor and a short digital floor.

Our simulation then would ideally specify a conventional swap loaded with four daily options - which we again approximate as ten to twenty sets of options per payment period. Pricing the individual options presents no difficulty. We merely aggregate them and combine payments at the end of each period.

We mentioned earlier that we shall not explicitly consider variable corridors (either pre-determined or tied to LIBOR). Let us comment at this point that a variable but pre-determined corridor range requires only sensible adjustments to option strike levels and (digital) payouts. When the corridor limits are tied to LIBOR, the caps and floors acquire a "resettable" or "forward-start" nature that one may easily incorporate into the mathematical valuations.

Credit and Market Risks

- Credit risk is the expected loss of the corridor derivatives
- The pdf (probability density function) provides a snapshot of market risk
- Our simulations give pdf's of accrual range floater swaps
- The range floater has significant probability of severe losses
- The corridor note pdf's are similar to those of the swaps

Credit risk is the expected loss of the corridor derivatives

The credit risk of a conventional note or bond measures the expected loss the investor will suffer due to incomplete principal and/or coupon payments. A corridor note or corridor-enhanced FRN simply carries the issuer's credit rating. One requires a custom credit risk analysis primarily for the associated (accrual range floater) swaps. A mutual fund, for example, that synthesizes its own corridor note with a conventional note and the corresponding swap must compute the composite credit risk as the sum of expected losses on the two components.* Likewise the investment bank that transacts the swap with the fund must measure its credit exposure to the fund.

The pdf provides a snapshot of market risk

Market risk is relevant for both the notes and swaps. Our approach will be to calculate the probability density function for (which is really just a histogram of) note and swap values at an intermediate time between issuance and maturity. Since our examples have two year tenors, we examine the distribution of note and swap values immediately after the coupon and swap payments at twelve months. This point in time gives roughly the greatest variance in values emerging from the competing factors of time to maturity and extent of yield curve movements.

The previous section disclosed our ability to value these swaps and notes. The more arduous task of creating the probability density function requires that we simulate the yield curve fluctuations over time and value the swaps and notes at each point along the way. For the sake of clarity, we do not consider the note issuer credit spread as a separate variable in this analysis. Inclusion of the credit spread is not difficult, but it would obscure our comparative analysis. The credit spread is common to conventional and corridor notes.

* The "expected loss" is the sum of credit losses in all conceivable scenarios (e.g., note default, swap default, joint default of both the note and swap, et cetera) weighted with the probability of each scenario.

Our simulations give pdf's of accrual range floater swaps

We begin with "today's" LIBOR/swap yield curve. Our program takes adjustable time steps (generally of about one week) and varies each point on the yield curve with historical volatilities and correlations. The changes in yield values (apart from drift implied by forward rates) are taken to be log-normal. We continue a repetitive process by which we take steps in time, adjust the entire yield curve and re-value the swaps and notes with the embedded caps and floors. We continue the time steps until we reach the end of our simulation time (which in this case would be just more than a year). A simulation over the full two years would be uninspiring since the note price would finish at par (in the absence of default) and the swap value would return to zero.

Figure 1 Distributions of Two Year Swap Values after One Year

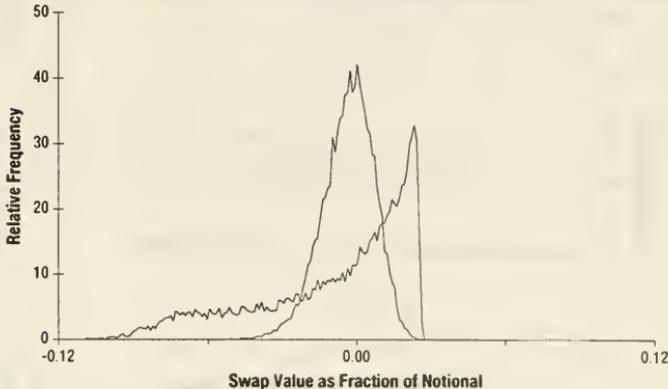


Figure 1 plots the probability density functions for two offer-side swaps resulting from fifteen thousand Monte Carlo trials. The curve that is nearly symmetric and has its peak near zero swap value corresponds to a standard swap in which the investor pays LIBOR semi-annually and receives the market fixed rate of 6.4%. The second curve, with peak position to the right of the standard swap, describes the accrual range floater swap in which the investor pays LIBOR and receives 8.5% fixed or zero depending on whether or not LIBOR is within its corridor.

The density function for the standard swap coincides nicely with one's intuition. The distribution is very slightly skewed to negative values as one expects in an offer-side swap based on an upward sloping yield curve. While there exists no law of economics requiring the swap value distribution to be symmetric, the rough symmetry of the standard swap is certainly plausible since there is no reason to suspect a marked asymmetry. Clearly the portion of the density function with swap value greater than zero corresponds to Monte Carlo-generated market environments with low LIBOR levels while the portion with swap value less than zero corresponds to high LIBOR levels.

The range floater has significant probability of severe losses

But the accrual range floater swap is a different story entirely. The peak at approximately two percent of the swap notional represents the investor's position if LIBOR essentially does remain well within its corridor over the course of the first year. But this upside cuts off abruptly above two percent.* Both positive and negative deviations of the yield curve tend to decrease the swap value and hence produce the extended downside tail on the distribution. Negative swap values arise both from LIBOR moving outside the corridor and from increased option values as LIBOR simply approaches the corridor boundaries.

These probability density functions make the point clearly. The investor has a greater upside potential in the accrual range floater relative to the standard swap but also a greater exposure to loss. In a

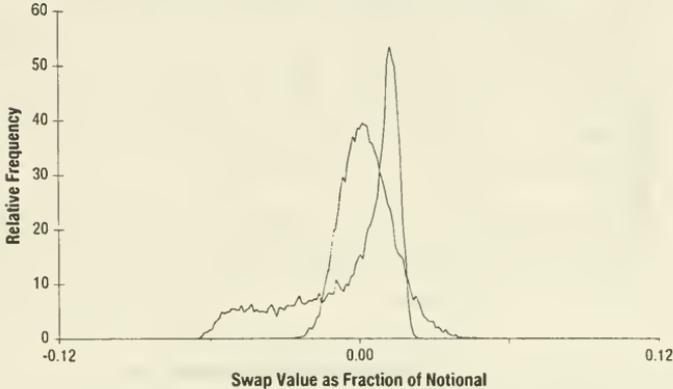
* The sharp cut-off is eminently reasonable. From the investor's point of view, the best scenario is that LIBOR is within the bottom half of the corridor range. If we could ignore the time value of the short floors and caps, we see that the investor will receive two 4% payments in the final two semi-annual cash flows when LIBOR is near the 4.5% lower band of the corridor. That is, the investor pays 4.5% and receives 6.5% (both multiplied by one-half since the payment period is half a year). If LIBOR falls below 4.5%, then the investor will not receive the full 6.5%. Thus, ignoring the time value of floors and caps, the swap cannot possibly be worth more than 4% of notional with one year remaining. Factoring in the value of the short floors and caps, it is certainly plausible that the distribution of values for this range floater swap should cut off at about 3% of notional.

\$ 100 m swap, the investor has significant probability (about 14%) of experiencing a loss after one year of more than \$ 6 m. The probability of a loss of this magnitude in the associated standard swap, on the other hand, is essentially zero (less than 0.01%).

Or consider the investment bank that has engaged the investor in this swap. The bank has credit risk when the swap is out-of-the-money to the investor. The expected loss to the bank should the investor default on a standard swap after one year is 0.7% of the notional. The expected loss on the accrual range floater swap is **three times greater** at 2% of notional. Furthermore, this more exotic swap is less amenable to credit enhancement in the form of a loss reserve fund due to the long loss tail of the swap value distribution.

Figure 2 provides the probability density functions for two bid-side swaps.

Figure 2 Distributions of Two Year Swap Values After One Year



The more symmetric of the two curves depicts the standard swap in which the investor pays the 6.4% market fixed rate and receives LIBOR. In the accrual range floater version, the investor pays this 6.4% rate and receives LIBOR plus 280 basis points accrued only when LIBOR is within the corridor. Many of the qualitative observations for the first example concerning the shapes of the distributions hold here as well. The downside is somewhat more limited in this case since the investor's worst scenario is that he/she ends up paying the fixed rate and receiving nothing. In the earlier swap, the investor might also have received nothing but would additionally pay (a potentially increasing) LIBOR.

The diminished downside risk is also evident in the expected losses (credit risk) of the bank transacting the swap with the investor. These values are 0.4% and 1.3% of the notional, respectively, for the standard and accrual range floater bid-side swaps. This result is consistent with the observation that a party has greater credit risk with a counterparty when it is bid-side in a swap as opposed to offer-side. The investment bank is offer-side in this example of the investor's bid-side swap.

The corridor note pdf's are similar to those of the swaps

We now consider two fixed coupon notes: a conventional note paying a 6.4% coupon and the corridor note that pays 8.5% accrued when LIBOR is within the corridor range. The probability density functions appear in Figure 3.

The distribution for the conventional bond is the more symmetric of the two curves. It is not surprising that the general shape of the corridor note distribution is similar to that of the offer-side accrual range floater swap of our first example. The corridor note is just a conventional note "swapped" with the range floater. Here we simply see the additional interest rate risk of the underlying note. The earlier observations are still valid. The investor in the corridor note will find his/her note value at less than 94% of par after one year with probability 14%.

As a final example, in Figure 4 we show the density function for the corridor-enhanced FRN in comparison with the fixed coupon note.

The distribution for this version of the corridor note is similar to that of the previous version with the exception that this distribution is somewhat more sharply peaked. This result is sensible since the coupon of this note is LIBOR plus 280 basis points accrued when LIBOR is within the corridor. Thus, it has more "character" of a conventional FRN (the coupon of which would simply be LIBOR). Floating rate notes, of course, have very little price variation. In fact, we chose not to plot the conventional FRN

Figure 3

Distributions of Two Year Note Values After One Year

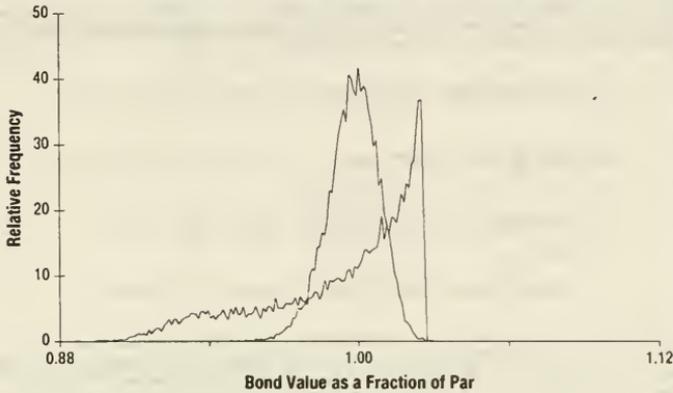
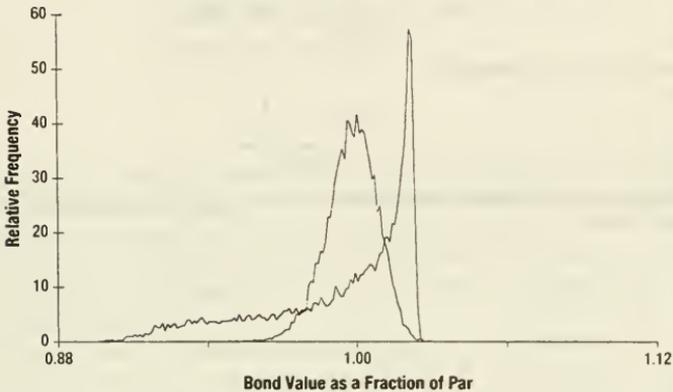


Figure 4

Distributions of Two Year Note Values After One Year



probability density function here since it simply shows a narrow spike at par. (For this FRN, the time at which the price variance is maximised would be just prior to a coupon payment/reset.)

As a final remark, we chose to scrutinise two-year notes and swaps, as opposed to those with longer tenor, for two reasons. We were able to leave the problem as uncluttered as possible with a single corridor specification. Also, essentially all the notes and swaps of this nature we've seen have been limited to this two year tenor/maturity. But it is certainly clear that such instruments in longer tenors would have correspondingly greater price uncertainties.

Summary

We've performed a quantitative analysis of the market and credit risks of several types of "corridor notes" and "accrual range floater swaps". We find that it is indeed the case that one may possibly enjoy higher returns, but a clear downside exists in the form of an extended tail in the oddly skewed, non-intuitive price distribution. This downside is relatively impervious to (reserve fund) credit enhancement and implies significant probability of severe market losses.

APPENDIX: Cap and Floor Valuations

Mathematical expressions for valuing conventional and digital caps and floors are widely understood and accepted in the finance community (although there do exist unresolved theoretical issues concerning interest rate options). The relevant formulae are:

$$\text{Conventional Cap : } zcdf * \text{ period} * [F\Phi(d) - X\Phi(d - \sigma\sqrt{t})]$$

$$\text{Conventional Floor : } zcdf * \text{ period} * [-F\Phi(-d) + X\Phi(-d + \sigma\sqrt{t})]$$

$$\text{Digital Cap : } zcdf * \text{ period} * \text{payout} * \Phi(d - \sigma\sqrt{t})$$

$$\text{Digital Floor : } zcdf * \text{ period} * \text{payout} * \Phi(-d + \sigma\sqrt{t})$$

There are several terms in these equations that we must define. The time until option expiration (which is generally less than the time until option payment) is t and $zcdf$ is the zero coupon discount factor for the payment time. The period measured in years "controlled" by the cap or floor is $period$. The digital payout (e.g., 8.5 %) is $payout$. F and X stand for the forward LIBOR setting at option expiration and strike rate, respectively. The character σ is the LIBOR volatility. $\Phi(x)$ is the standard normal cumulative density function

$$\Phi(x) = \frac{1}{\sqrt{2\pi}} \int_{-\infty}^x du \exp(-u^2/2)$$

and the parameter d is defined to be

$$d = \frac{\log(F/X) + \frac{1}{2} \sigma^2 t}{\sigma \sqrt{t}}$$

where "log" denotes the natural logarithm. Further, one should multiply all option values above by the swap notional.



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Are Pension Plans Ready for Structured GICs?

- Opinion
- How Conventional GICs Work
- And Now, Structured GICs
- Pitfalls of Structured GICs

Opinion

Conventional guaranteed investment contracts (GICs) serve a valuable role in the financial markets by permitting investors (primarily municipalities and pension plans) to accommodate their uncertain future need of funds. It now appears that a new market in what are called "structured GICs" is emerging. Although they offer undeniable advantages in flexibility, Moody's believes that structured GICs also bear new dangers that are quite similar to those of structured notes.

The responsible fiduciaries will best dispel these new dangers — such as determining their ultimate suitability of risks for the municipal taxpayer/pension plan participant, and the inability of the municipal and pension plan fund managers to price the investment contract accurately — by fully disclosing all structured GIC activities.

continued on page 3

Structured Derivative Products

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How Conventional GICs Work

Guaranteed investment contracts (GICs) are customized financial instruments that generally allow investors to put all or part of their investment back to the issuer at face value if and when the investor has a demonstrated need for the funds. This put provision^[1] (also known as a "draw" capability) is primarily beneficial to investors with cash to invest today but with uncertain investment horizons.

Investors in GICs: Municipalities

For example, a municipality may be flush with the proceeds of a recent bond issue. The expenses for which the municipality raised capital may not come due for two to three years (as in an extended construction project). Further, the precise timing of the expenses will likely be uncertain.

In this scenario, even investments in usually "safe" Treasury notes are not acceptable because a forced sale of such assets prior to maturity as a result of an unexpected early expense may result in a market loss. (That is, the market value of the assets prior to maturity may be less than face value due to an adverse interest rate environment.)

Investors in GICs: Employee Pension Plans

Employee pension plans offer another example of current cash and uncertain future needs. One estimate places the aggregate volume of these plans in the United States in excess of \$300 B.^[2]

Pension plans face uncertain draws when employees leave the affiliated company or when they simply elect new investment options for their retirement funds. Again, investing the entire net worth of a pension plan in conventional instruments does not protect the plan from the possibility of market losses due to draw-induced, premature sales of the assets.

Privately negotiated GICs resolve this dilemma. An issuer and investor jointly agree on an investment that resembles a conventional, fixed- or floating-coupon note/bond in virtually all respects save for the investor's unusual draw provision.

Such instruments must by their nature be customized and private. It would not make sense for the investor to buy a conventional asset with an embedded put option striking at par simply because the investor may have no desire for protection from adverse interest rate movements.

Rather, the investor needs protection from its own financial circumstances (e.g., early municipal expenses or withdrawal of pension plan participant). One protection the investor relies on is that most GIC issuers bear Moody's ratings of Aa3 or above.

And Now, Structured GICs

We've recently learned^[3] of an innovation in the GIC market: structured GICs. Like a structured note,^[4] a structured GIC differs from a conventional GIC in that it harbors a derivative transaction of some sort. There is literally no limit on the types of structured GICs that dealers and issuers may create.

To shorten the discussion, we shall simply state that **an issuer may transform virtually any structured note concept to a structured GIC**. The specific example of our footnote, for example, pays coupons tied to the difference between an actively managed high-yield bond fund return and the return of an investment-grade bond fund.

It is likely that structured GICs will never be principal-linked (as opposed to coupon-linked or extension-linked) due to the fundamental GIC property that the investor may draw the remaining principal upon demonstrated financial need. The investor may still suffer losses or gains due to dena-

[1] The provision is not equivalent to a put option. An investor would exercise a put option whenever such an action would provide economic benefit. The intent of the "put provision" of a GIC is to give the investor access to his/her funds (at face value) when the investor can document the need for the funds.

[2] Figures compiled by Access Research, Greenwich & Associates, Eager & Associates, and the GIC Stable Value Association support this estimate.

[3] Ciba-Geigy Wood by Novel J.P. Morgan Synthetic GIC Structure. "Derivatives Week IV(6), page 1, 13 February 1995.

[4] See, for example, J.M. Pimbley and D.A. Curry, "Structured Notes and the Investor's Risk," Moody's Investors Service Special Comment, February 1995.

tives embedded in the coupons or extension features.

Structured GICs will have many of the advantages and disadvantages of structured notes:

- They will allow the investor to further customize the instrument to get a precisely defined risk-return profile in addition to the draw provision.
- The risk of a structured GIC may be less than that, or greater than that, of the corresponding conventional GIC.
- The structured GIC may embed a derivative transaction that efficiently hedges an entirely different exposure to which the municipality or pension plan may be subject.

However, there is one major difference between structured notes and structured GICs: the diminished liquidity of structured notes does not translate to a similar shortcoming of structured GICs because GICs, with their inherent customization, do not have a secondary market.

Pitfalls of Structured GICs

Unfortunately, structured GICs have potentially negative ramifications as well:

- *Unsuitability of risk:* The existence of such extreme investment flexibility under the rubric of guaranteed investment contract may tempt financial proprietors to assume risks (either in character or in magnitude) that are neither apparent to, nor appropriate for, the ultimate affected parties: municipal taxpayers or pension plan participants. The investor and issuer could dispel this "suitability" concern by full disclosure of all structured GIC activity. **However, this level of disclosure does not yet exist, even in the worlds of structured notes and derivative transactions.**
- *Investor financial sophistication.* Investors in conventional GICs are free to get multiple offers (quotes) for their business. Thus, the investor need not have intimate knowledge of the GIC market and/or the overall state of the economy. They need merely consider the coupon offered by a GIC issuer and the contract's Moody's rating.

But it is unlikely that structured GICs will have multiple offers. Intelligent investing therefore demands that the investor possess the requisite financial and quantitative skills to determine the fair price for proposed GIC structures. Most investors, including municipalities and pension plans, generally do not have this expertise for all but the simplest instruments.

Moody's **Municipal** Credit Report

Orange County Special Financing
 Authority, California
 (LOC: Industrial Bank of Japan)

July 5, 1995

New Issue Update

Special Tax (Letter of Credit)

Moody's rating: A1/VMIG 1

Teeter Plan Revenue Bonds, 1995 Series A and B
 (LOC: Industrial Bank of Japan)

(Rating expires June 10, 2002, upon conversion to fixed, defeasance or earlier termination of letter of credit)

Moody's rating: A1

Teeter Plan Revenue Bonds, 1995 Series C, D & E
 (LOC: Industrial Bank of Japan)

(Rating expires June 10, 2002, upon conversion to fixed, defeasance or earlier termination of letter of credit)

credit comment: Moody's A1/VMIG 1 rating on the Orange County Special Financing Authority Teeter Plan Revenue Bonds, 1995 Series A and E is and the A1 rating on the Teeter Plan Revenue Bonds, 1995 Series C through E is based upon an evaluation of the following:

- The letter of credit provided by Industrial Bank of Japan (IBJ) which is sized for full principal plus 205 days of interest at the rate of 12.00%. The

letter of credit will be drawn upon to make payments of principal, interest, and purchase price.

- The mechanics of the transaction and the adequate legal protections which ensure that timely debt service payments will be made to investors.
- Moody's evaluation of the creditworthiness of the bank issuing the letter of credit.

This update supplements the Credit Comment published in *Moody's Rating Recap* on June 26. The update was prepared in conjunction with the June 27,

1995, negotiated sale of \$155,000,000 Teeter Plan Revenue Bonds, 1995 Series A through E.

key facts:

Form of Letter of Credit: Direct pay.
 Expiration of Letter of Credit: June 15, 2002
 Substitution: If the Trustee has not received written confirmation from Moody's that substitution will not result in a lowering or withdrawal of the rating the bonds will be subject to mandatory tender.
 Initial Interest Rate Determination Method: The initial mode for all series is the term mode.
 Alternate Interest Modes: Daily, Weekly, Monthly, Quarterly, Semiannual, Commercial Paper, and Fixed.

Interest Payable: In the daily, weekly and monthly modes, interest is payable on the first business day of the month; in the quarterly mode, on the first business day of the third month; in the term, semiannual, and fixed modes, on the first business day of the sixth month; and in the commercial paper mode, on the first day after each period.

Conversion: At the option of the Authority. The bonds are subject to mandatory tender on the conversion date (except when converting between the daily and weekly modes). No conversion from the term



Orange County Special Financing
 Authority, California
 (LOC: Industrial Bank of Japan)

modes are permitted for an series prior to the initial mandatory tender date for such series.

Tender Option: In the daily mode, on any business day. In the weekly mode, on a business day with seven days notice. In the Monthly, Quarterly, or semiannual modes, on any Interest Payment Date with five days notice. In the term modes, on the last Interest Payment Date in the term mode with fifteen days notice.

Mandatory Tender: Upon (1) Initial Mandatory Tender Dates - Series A and B November 1, 1998; Series C November 1, 1999; Series D November 1, 2000; Series E November 1, 2001, (2) the day immediately following the last day of the commercial paper mode, (3) on each conversion date (except when converting between daily and weekly modes),

(4) on the fifth day prior to the expiration of the letter of credit if an extension or substitution has not occurred or if the substitution will result in the lowering or withdrawal of the rating, (5) on the eleventh day following the Trustee's receipt of notice of an event of default under the Reimbursement Agreement which directs the Trustee to subject the bonds to mandatory tender.

Mandatory Redemption: Upon the occurrence of an Amortization Event the bonds will be subject to mandatory redemption on any Payment Date at par. **Termination of the Letter of Credit:** Upon (1) June 15, 2002, (2) Bank honors Final Payment Drawing, (3) Bank honors Final Purchase Drawing, (4) bank's receipt of Surrender Certificate from Trustee.

analysis:

The bonds are being issued to finance the purchase of the Initially Transferred Assets (Assets). These Assets are comprised of receivables including delinquent tax payments associated with the Teeter Plan.

Letter of Credit

The letter of credit is currently sized for \$155,000,000 principal amount and 205 days of interest at 12%. The trustee will draw upon the letter of credit in order to ensure full and timely payment to bondholders.

Mechanics and Legal Protections

The trustee will draw upon the letter of credit provided by IBJ in accordance with its terms in order to ensure the full and timely payment of principal, interest and purchase price. In the daily mode, draws presented by 9:00 a.m. (Los Angeles time) will be honored by 1:00 p.m. (Los Angeles time) that same business day. In all other modes, draws presented by 10:00 a.m. (Los Angeles time) will be honored by 1:00 p.m. (Los Angeles time) on the next business day. The funds will be immediately transferred from

the Trustee to the Tender Agent in order to pay bondholders by 1:30 p.m. (Los Angeles time).

Moody's Evaluation of the Creditworthiness of the Letter of Credit Bank

Moody's rates the Industrial Bank of Japan long-term deposits A1 and its short-term P-1. Wholesale (i.e., long-term and trust) banks are expected to face increasing competitive pressures as financial deregulation proceeds. We believe that IBJ's domestic entry into new business areas, such as securities and trust business, will not fully offset the erosion of its traditional franchise caused by deregulation.

Recent Results

Core profitability declined sharply in the half-year phase in of an accounting change. Securities transactions shifted to a modest net gain, from a net loss in the same period in 1992. Although reported nonperformers in relation to capital are relatively low compared with levels at other Japanese banks, this figure does not include restructured loans. The BIS total capital ratio was 9.3%, double that of Tier 1.

Orange County Special Financing
Authority, California
(LOC: Industrial Bank of Japan)

sale information: Legal Name of Issuer: Orange County Special Financing Authority
Security: Limited obligations of the Authority payable solely from revenues consisting of delinquent tax payments paid by taxpayers under the County's Tee-ter Plan program, additionally secured by a letter of credit.
Date of Bonds: June 1, 1995
Denomination: \$5,000 and integral multiples thereof.
Delivery: June 30, 1995
Maturity (\$000s)
Date: November 1, 2014
Amount: \$155,000
Optional Call Features: On any payment date with surplus funds in the debt service account.

Key Contacts:
Trustee: First Interstate Bank of California, Los Angeles (213)614-2399.
Remarketing Agent: Goldman Sachs Co., San Francisco (415) 393-7542.
Tender Agent: First Interstate Bank of California, Los Angeles (213)614-2399.
Bond Counsel: Willkie Farr & Gallagher, New York (212) 821-8000.
Letter of Credit Enforceability Counsel: Pillsbury Madison & Sutro, Los Angeles (213) 488-7100.
Foreign Enforceability Counsel: Tokyo Kokusai Law Offices, Tokyo 03-3584-6508.
Preference Counsel: Willkie Farr & Gallagher, New York (212) 821-8000.
Managing Underwriter: Goldman Sachs & Co, San Francisco (415) 393-7542.

analyst: Heather Singer
(212) 553-7937

Orange County Special Financing
Authority, California
(LOC: Industrial Bank of Japan)

debt factors:	Additional bonds may be issued pursuant to the indenture dated June 1, 1995 provided the Authority has received written confirmation from Moody's that	the rating on the outstanding bonds will not be lowered or withdrawn as a result of such action.
structure:	<p>Purpose of Borrowing: The bonds are being issued to finance the purchase of the Initially Transferred Assets (Assets). These Assets are comprised of receivables including delinquent tax payments associated with the Teeter Plan.</p> <p>Flow of Funds: The trustee will draw upon the letter of credit provided by IBI in accordance with its terms in order to ensure the full and timely payment of principal, interest and purchase price. In the daily mode, draws presented by 9:00 a.m. (Los Angeles time) will be honored by 1:00 p.m. (Los Angeles time) the same business day. In all other modes, draws presented by 10:00 a.m. (Los Angeles time) will be honored by 1:00 p.m. (Los Angeles time) on the next business day. The funds will be immediately transferred from the Trustee to the Tender Agent in order to pay bondholders by 1:30 (Los Angeles time).</p>	<p>Letter of Credit: The letter of credit is currently sized for \$155,000,000 principal amount and 205 days of interest at 12%. The trustee will draw upon the letter of credit in order to ensure full and timely payment to bondholders.</p> <p>Authorized Investments: The letter of credit monies are held uninvested or invested in government obligations which mature within thirty days or when needed.</p> <p>Events of Default: Upon the occurrence of the following: (1) failure to pay principal, interest or purchase price; (2) a covenant breach by the Authority; (3) bankruptcy filing by the Authority; (4) failure to maintain required deposits in the Reserve Fund; (5) failure to maintain required cash balances in the Revenue Fund.</p>

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Rating News

Moody's Addresses Credit Quality of Orange Co., CA, Refunding Recovery Bonds

NEW YORK, NEW YORK - JUNE 12, 1995

Orange County, California, plans to sell \$295 million Refunding Recovery Bonds tomorrow, June 13. Moody's will rate the bonds **Aaa** based upon an insurance policy provided by MBIA, although aspects of the insured transaction warrant further discussion. In addition, Moody's is providing comment on the underlying credit quality of the bonds. The bonds represent one component of the county's attempted recovery plan and, as such, have a bearing on the outcome of this unprecedented bankruptcy. Moody's continues to watch these developments closely, and we will continue to comment on all financings, whether credit enhanced or not, for the implications on the county and more broadly on the public finance market.

Aaa Rating Based on MBIA Claims Paying Ability and Commitment

The Refunding Recovery Bonds will be used to partly compensate for losses to participants in the Orange County Investment Pool. The county's deadline for meeting that obligation is June 16. The Superior Court of California entered its default judgment on validation proceedings for the bonds on Monday, June 5, that the bonds are valid obligations issued in accordance with state law. The county presently plans to deliver the bonds on June 16 in accordance with its deadline to participants. This transaction is fully insured, and we have received assurance from MBIA that the policy covers the validity of the underlying bond obligation.

Underlying Credit Quality Linked to Well-Below Investment Grade Debt Outstanding

The Refunding Recovery Bonds must be examined in the context of the county's bankruptcy and present state of distress. As we have stated previously, any new debt obligation of the county would have to be financially and legally insulated from the county to have credit quality above the county's current long term debt rating of **Caa**. Under the current circumstances, the credit quality of the Refunding Recovery Bonds, absent the insurance, would be substantially below investment grade for reasons outlined below. The bonds present appropriate elements of protection, but there is a presumption that current problems will be solved: either the sales tax will be approved by voters, or the county will have sufficient budget flexibility in the future, notwithstanding legal pressure and uncertainty of access to the markets for cash flow. In fact, events to date point in the opposite direction and include the county's threat of debt repudiation.

Legal Structure Uses Bankruptcy Tools and State Intercept

The bond indenture provides five levels of security:

(1) The bonds have a general obligation pledge, payable from all lawfully available funds. The county cannot raise taxes to pay debt service.

(Continued)

(2) Debt service has a super administrative priority claim under Section 364(c)(1) of the Bankruptcy Code. This claim would expire when the county emerges from bankruptcy.

(3) Under Section 364(c)(2) of the Bankruptcy Code, debt service has a priority lien over the interests of other general creditors, including existing debt holders.

(4) In addition, the county has pledged to the payment of the bonds the Motor Vehicle License Fees collected by the state and distributed by formula to cities and counties.

(5) The county has elected in the indenture to have the state intercept the Motor Vehicle License Fees and provide them directly to the trustee for payment on the bonds. This mechanism results from legislation (SB-8) recently enacted by the state to assist Orange County.

Limitations on Security

The indenture provides an enhanced degree of security to bondholders. However, its value is limited. First, Chapter 9 bankruptcy is intended to enable the municipal entity to continue operations while addressing its claims. The superpriority lien and senior claims granted to the bonds are thus subordinate to the county's operating costs, particularly its obligations to meet the health, safety and welfare needs of its residents. The bankruptcy court cannot interfere with the exercise of these police powers. Further, the county has specifically made the superpriority lien junior to payment of the county's attorneys and consultants.

The pledge of the Motor Vehicle License Fees to the bonds dedicates a revenue stream that averages \$90 million per year to the repayment of the bonds. The intercept recently approved by the legislature provides a mechanism that potentially removes the county from the flow of funds to the bondholders; however, the intercept as enacted in SB-8 does not protect bondholders against future bankruptcy. Further, the state is not limited in its ability to alter the funding formula and divert revenues from the county.

Given the potentially competing interests of the debt service and the county's operational obligations, these security features must be examined in the context of the county's ability to afford the debt. Orange County's discretionary general fund budget for fiscal 1996 is 40% lower than the 1995 budget with a 16% decrease in staff planned, yielding reduced services throughout the county. These cuts are untested, and could impair the county's ability to meet the fundamental health, safety and welfare obligations to its constituents. Difficulty meeting these operational requirements could result in litigation that might interrupt the flow of funds for debt service on these bonds.

Even if the county is successful with its budget cuts, they remain inadequate to meet all obligations. Without the 1/2 cent increase in the sales tax, which voters will consider on June 27, the county does not have a viable plan to repay all its debt. The sales tax continues to receive no support from the Board of Supervisors, and passage is far from certain.

The lack of effort by the county in paying the Recovery Bonds is most evident in the debt's structure. The up front cost of the debt is minimal. The county will pay interest only for the next five years, and only begin principal amortization in the sixth year. Teeter bonds will be issued shortly to refund outstanding notes and provide revenues to the county. These revenues result in a zero net cost for the Recovery Bonds in 1996.

Credit Quality Reflects Ability and Effort

While the Refunding Recovery Bonds are separately secured from the county's other obligations now rated **Caa** or **SB** (Speculative Grade), they are not insulated financially and legally from the county. Their credit quality remains entwined with the county's other obligations. We cannot review the credit quality of one obligation in isolation while the county is approaching default on other obligations.

The county has proposed an extension with holders of other notes due this summer, while retaining its rights to invalidate certain of these obligations. The county also continues to use reserve funds to make payments on its certificates of participation and, again, has retained the right to seek to invalidate of these obligations. The sales tax that could make the county's recovery plan achievable may lack the support needed for a successful vote. Without an intensive effort by the county to address its revenue requirements and honor all of its debt

June 12, 1995

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Moody's Addresses Credit Quality of Orange Co., CA, Refunding Recovery Bonds

obligations, the credit quality on the Refunding Recovery Bonds, absent credit enhancement, is consistent with the county's other obligations, which are well below investment grade.

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Rating News

MOODY'S RAISES QUESTIONS ON ORANGE COUNTY, CALIFORNIA REFUNDING RECOVERY BONDS

Obligations Enter Little Charted Waters in California

New York, New York - May 24, 1995 - Orange County, California, is moving forward with several bond issues designed to facilitate the county's recovery from the fiscal crisis that precipitated its December 6, 1994 bankruptcy filing. Permanent financing of the Recovery Notes is a priority in the county's financing plan. These obligations will fund part of the county's settlement with the school districts and other local agencies that participated in the Orange County Investment Pool (OCIP). In the settlement agreement, the county is obliged to make the notes equivalent to cash by June 16th. Refunding Recovery Bonds, the county's initial and preferred mechanism, are encountering challenges from county creditors. The form of the permanent financing is in flux as the county attempts to devise a marketable security.

Moody's analysis of the Refunding Recovery Bonds, like any of our ratings, is multi-tiered. First is the fundamental issue of the authority of the issuer to issue the debt. We look to an unqualified opinion of recognized bond counsel that states that the debt is authorized under state law and is a valid and legally binding obligation of the issuer, without relying on bankruptcy court proceedings. The second tier of analysis reviews the security provided to the bondholder. In the case of Orange County, this question centers on the ability to insulate the new debt from the general credit of the county. Third, we look at the particular credit aspects of the issuer, such as finances, coverage, debt levels and management.

Continued

Before Moody's can assess the security or credit quality of the bonds, the first-tier conclusion on the validity of the debt must be established. While validity is often clear for municipal bonds, Orange County's authority to issue the Refunding Recovery Bonds is less clear. Thus, Orange County is pursuing proceedings through the state court system to receive a judgment on the validity of the debt. If successful, the county would move ahead with the sale of the bonds with the current structure and security, presumably in June. Moody's believes that the untested nature of municipal bankruptcy and the unique state law issues that drive the nature of the bonds warrant a full discussion of the uncertainties that might otherwise go unaddressed in the county's urgency to move forward with the settlement.

Orange County Explores New Territory with Recovery Refunding Bonds

Under the California constitution, debt issued by local governments must be approved by two-thirds of the voters, unless the bonds meet the criteria for an exception. One such exception is obligations that result from an "involuntary obligation imposed by law." The Findings of Fact and Conclusions of Law entered by the bankruptcy court in connection with the settlement of the pool states that the claims settled by the agreement are "claims arising in tort or pursuant to obligations otherwise imposed by law." The county is seeking a judicial determination that the warrants (the obligation to pay the pool participants) and the bonds (that would refund the warrants) result from an involuntary obligation imposed by law and, thus, fall within the judicial exception to the constitutional debt limitation.

Moody's has expressed concern to Orange County and its advisory team about the application of the constitutional exception for obligations imposed by law to the Recovery Refunding Bonds. These questions include:

Are the Warrants and Bond Obligations Imposed by Law?

If the "tort judgment" contemplated by the Settlement Agreement and approved by the bankruptcy court order is not an obligation imposed by law, the county's obligations under the Settlement Agreement would be invalid as contrary to the constitutional debt limitation and the applicable California statutes would not authorize issuance of the warrants. Even if the tort judgment were to constitute an obligation imposed by law, the county's financing mechanism might not necessarily constitute such an obligation.

The California cases have all involved obligations imposed by action of the legislature or state courts. None address the issue of whether an obligation imposed by law may be imposed by a federal bankruptcy court on a political subdivision of a sovereign state, or what the effect of the county's consent to

such an obligation may mean to its voluntary nature. The bankruptcy code protects debtor municipalities from intrusion on their operations. The obligations might be construed as such an intrusion and thus not under the purview of the court or subject to repudiation by the county at a later date if budgetary pressures became too severe.

Is Orange County's Obligation to Issue the Recovery Bonds to Pool Participants Voluntary or Involuntary?

The California courts have repeatedly stated that an obligation imposed by law must be involuntary to fall within the judicial exception. The judicial exception has developed in cases involving (1) specific statutory duties imposed by law and (2) liabilities imposed as a result of tort judgments. Obligations that a county voluntarily incurs are not entitled to be treated as obligations imposed by law and would be subject to the constitutional debt limitation, unless otherwise excepted

The facts and circumstances related to Orange County's bankruptcy and subsequent actions appear to involve voluntary as well as involuntary conduct. The Settlement Agreement represents a negotiated arrangement among the county and pool participants before adversarial proceedings had developed to any meaningful extent. Even the findings of the bankruptcy court acknowledge that the agreement between the county and the pool participants was consensual

None of the pool participants who will receive the warrants under the settlement pursued litigation against the county. The agreement has been crafted to characterize the claims against the county as sounding in tort, but fails to identify those torts. The torts that may be alleged against the county are unlikely to fall clearly within the judicially determined tort liabilities at issue in the California decisions. In addition, to the extent that claims against the county are based on breaches of trust, they may not constitute torts. Under these circumstances, the California cases do not clearly support the conclusion that the county's actions are "involuntary" within the meaning of the judicial exception.

Validation Proceedings -- Benefits and Limitations

The California code of civil procedure provides a process by which questions of municipal authority can be addressed by the state courts through a validation process. A municipality files a complaint seeking a court determination of the validity of the municipality's action under state law and gives notice to the public. The court considers the municipality's arguments and, if no party challenges the validation, typically enters a default judgment.

Municipal governments have used the validation process when issuing debt under the exception of an "obligation imposed by law." The principal court cases related to the debt limitation exception for "obligations imposed by law" date back to 1919. In the absence of more recent court rulings, bond counsel have sought judicial validation of transactions through a judgment in superior court. There is limited case law on the validation process itself, and the California Supreme Court has not opined on the constitutionality of the validation process.

Orange County has filed a complaint in Superior Court seeking validation of the warrants and refunding bonds to be issued as exceptions to the constitutional debt limitation as an obligation imposed by law. Moody's raises the following questions:

What assurances does the validation proceeding provide on the validity and enforceability of the warrants and the bonds?

Validation is an interpretive process. Its scope is limited to rely on interpretations of existing law. Validation does not authorize the courts to confer municipal power where such power does not exist under state law or where such power may exceed constitutional limitations. Validation has been used in several states, including California, to provide a judicial determination that clarifies ambiguities and inconsistencies in bond related statutes and constitutional provisions, particularly in the absence of a sufficient body of case law on which bond counsel might otherwise rely. Moody's has rated debt of California municipalities that has been validated by state superior court.

The facts related to Orange County and its bankruptcy and the issues that are sought to be resolved through a judgment obtained in a validation proceeding raise significant legal issues. It appears that the validation proceeding is using the bankruptcy court order to confer municipal power on the county that does not otherwise exist or to validate an obligation that may fundamentally violate constitutional restrictions.

Is a judgment subject to collateral attack?

California's Validation Act contains a broad provision that cuts off all rights of any person to contest a validation judgment on issues that were or could have been raised in the validation proceeding. This broad statutory provision clearly precludes a future effort to overturn a court's validation judgment with respect to matters of statutory interpretation. However, several issues of constitutional significance are raised by the statutory validation procedures and the facts related to the County and its bankruptcy, including whether the validation proceedings can cut off the right of an interested person to claim that the bonds violate the state constitution. Without conclusive determinations from the

California Supreme Court on the validation process, future challenges might be successfully brought against the validity of the obligations.

Satisfactory answers to these questions, accompanied by an unqualified bond counsel opinion, may provide Moody's with sufficient comfort that these bonds are valid and legally binding obligations of the county. This would satisfy the first tier of the analytic process. However, an investment grade rating would require closer scrutiny of the structure and credit quality of the obligations.

To Achieve Investment Grade Status, Bonds Must be Insulated From Orange County . . .

If Moody's can obtain comfort as to the validity of the Recovery Bonds, there are many levels of credit quality that must be examined. Moody's currently rates the long-term debt of Orange County below investment grade at the Caa level. Even if the county is successful in emerging from bankruptcy, it will face severe financial pressures going forward due to the loss of interest earnings which supported the General Fund, the loss of accumulated reserves in the investment pool, and expense of new obligations to repay pool participants, as represented by the Recovery Bonds. As such, it is unlikely that the county's credit position will be significantly strengthened in the near future.

Given the County's current weak credit position, it may seek to find ways of strengthening the credit quality of new bond issues through unique security features or issuance structures. It is Moody's position that any future bond issues will have to be both financially and legally insulated from the county in order to achieve a credit rating better than the county's existing credit rating. We would look for a specific pledge of a revenue stream to bondholders providing a lien that would survive a future bankruptcy filing by the county. Otherwise, repayment of the bonds could be subject to budgetary pressures for the provision of health, safety and welfare, services with which the bankruptcy court cannot interfere.

. . . And Bonds Must Possess the Credit Qualities of Investment Grade Debt

Finally, once Orange County has satisfied concerns over the validity of the bonds and the ability of such bonds to withstand future county fiscal distress, it must still demonstrate that it has the ability and willingness to repay that debt. This will be indicated by the quality of the revenue stream backing the bonds and the legal security provided to bondholders through the various provisions of the bond indenture. Moody's will look to traditional indicators such as overall debt levels, coverage of debt service by the pledged revenue stream, the ability to issue parity debt, and the impact of the debt issuance on other county operations as well as on the holders of outstanding debt.

In the case of the Recovery Bonds, which will be paid from the county's General Fund, there could be a negative effect on existing certificate of participation holders whose debt may be subordinated to the new debt. Further, the diversion of a General Fund revenue source without replacement by the increased sales tax, should that not receive the required voter approval, could impair already reduced General Fund operations. These are not indicators of investment grade credit quality.

Conclusion

Municipal bankruptcy is relatively unknown territory. The Recovery Refunding Bonds, the first financing proposed by Orange County in its plan to emerge from bankruptcy, go deeper still into untested areas of state law. The interaction of municipal bankruptcy and state law will be key to Moody's analysis of the validity of the obligations and will start with Moody's looking for the unqualified opinion of bond counsel that any obligations issued by the county are valid and legally binding under state law. Only from there can we assess the credit quality of the obligations based on their structure, security provisions and other fundamental credit characteristics.

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Rating News

Moody's Comments on Orange County, California Teeter Bond Credit Quality

NEW YORK, NEW YORK - JUNE 23, 1995

Orange County, California, plans to sell \$155 million Teeter Plan Revenue Bonds on June 27 through a newly formed Joint Powers Agency, the Orange County Special Financing Authority. The bonds will be secured by an irrevocable direct-pay letter of credit to be issued by The Industrial Bank of Japan, Limited. Although the rating on the bonds will reflect the credit quality of the IBJ letter of credit, Moody's is providing comment on the underlying credit quality of the bonds. As with the Refunding Recovery Bonds sold on June 13, the Teeter Bonds represent another component of the county's attempted recovery plan. Moody's continues to monitor the county's proposals and we will comment on all financings, whether credit enhanced or not, for the implications on the county and more broadly on the public finance market.

Teeter Bond Structure

The county is issuing the 1995 Teeter Bonds in part to refund \$175 million of outstanding 1994-95 Taxable and Tax-Exempt Teeter Notes. The balance of the funds needed to retire the notes will come from money available in the existing Teeter Fund. The one-year notes mature June 30, 1995 (\$111 million taxable notes and \$64 million tax-exempt notes) and were backed by a standby purchase agreement with the Orange County Investment Pool. The county must issue the 1995 Teeter Bonds in order to avoid defaulting on the 1994 Teeter notes. Bond proceeds will also be used to purchase new property tax receivables and to fund in part the Tax Loss Reserve Fund.

Credit Quality of Bonds Issued by Joint Powers Agency Derived from Below Investment Grade Participants

As with other bonds being issued by Orange County, the Teeter Bonds must be examined in the context of the county's bankruptcy. Moody's has stated previously that any new debt obligation of the county would have to be financially and legally insulated from the county to have credit quality above the county's long-term debt rating of Caa.

The county has attempted to insulate the Teeter Bonds from the county by selling the property tax receivables to the Authority and having the Authority issue the debt. While this approach does achieve some degree of separation, the county is not making a "true sale" of receivables to the Authority, retains significant control over the Authority, and the county will act as servicer for the receivables. As a result, the Authority is not fully insulated from the current or any future bankruptcy of the county. Therefore, the credit quality of bonds issued by the Authority would reflect the credit quality of the Authority's participants.

(Continued)

Certain elements of the bond structure — its economics, legal provisions, and the lien provided to bondholders — do indicate stronger credit quality than the county currently provides to its other long-term debt. However, the exposure to bankruptcy risk results in credit quality, absent the letter of credit, that would be below investment grade for the reasons outlined below.

Teeter Bonds to Be Issued through New Joint Powers Agency

The Teeter program is a method of distributing secured property taxes to local taxing agencies. Participating agencies, which include the county, all school districts, and other cities and special districts who have chosen to participate, receive the full amount of their share of property taxes on the secured roll, including property taxes that become delinquent which are yet to be collected. The county forwards the delinquent taxes to the other entities in exchange for the right to collect delinquencies with interest and penalties. The county issues debt to fund the payments owed to the agencies and repays that debt through the collected tax delinquencies, interest and penalties.

The county is issuing the bonds through the Orange County Special Financing Authority, which is a joint powers authority consisting of Orange County and the Orange County Development Agency. The primary reasons for financing through the joint powers authority are to separate the Teeter Program from the operations of Orange County, and to allow the issuance of longer-term bonds than the county would be permitted to issue itself for this program. Historically, counties were limited to issuing one-year notes to finance the Teeter Plan, but now can issue seven-year debt. There are no limits on the maturity of the bonds if issued by the JPA.

Links between County and Authority Limit Ability to "Bankruptcy Proof"

Although the county intends the Teeter Program to economically self-supporting, there remain significant linkages between the county and the Authority, such that a future bankruptcy filing by the county could impair the Authority's ability to make timely debt service payments.

The Authority is made up of the county and the County Development Agency. The County Board of Supervisors acts as the Board for both the Development Agency and the Joint Powers Agency. County staff acts as the staff of the Development Agency and will be the staff of the JPA. The county will be the servicer with respect to the delinquent tax payments and the receivables. The county is not making a "true sale" of the receivables to the Authority.

Future County Fiscal Distress Could Impair Authority Debt Service Payments

Although the bond documents say that the county is selling the receivables to the Authority, the transaction more closely resembles a secured transaction; that is, the county is giving the authority a lien on the asset rather than selling the asset outright. Since the county is not transferring all right, title and interest in the receivables after the sale to the Authority as it would in a true sale, the receivables would be subject to the jurisdiction of a bankruptcy court both in the current bankruptcy and in the event of a subsequent bankruptcy. The court could determine that the sale arrangement, for purposes of bankruptcy law, constitutes debt of the county. This would subject debt service payments to an automatic stay unless the consent of the bankruptcy court is obtained to make debt service payments even from funds held by the trustee.

Bondholders will have a lien on the delinquent tax revenues and associated interest and penalties. This lien would survive the current and any future bankruptcy filing so that bondholders would ultimately receive full payment if the revenue stream is adequate. However, timely payment could be interrupted in a subsequent county bankruptcy.

The county will also act as the Servicer of the Teeter Program. It will be responsible for collecting delinquent taxes and transferring them to the Authority. Any future insolvency or bankruptcy could impair the county's ability to adequately perform its obligations under the Servicing Agreement. Further, in a bankruptcy filing, the county could reject the Sale and Servicing Agreement itself as an executory contract.

The county is also retaining some of the benefits associated with the revenue stream since it will be receiving up to \$10 million annually for the General Fund. However, the county is not taking on any obligation to make debt

June 23, 1995

Moody's Comments on Orange County, California
Teeter Bond Credit Quality

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service payments on the Teeter Bonds from any sources other than the delinquent taxes, penalties, interest, and tax loss reserve fund.

Teeter Expected to Be Self-Supporting Revolving Program

Pursuant to the Sale and Servicing Agreement, the county will sell its current and future property tax receivables to the Authority. The Authority will use the delinquent tax, interest and penalty revenues derived from that sale to (1) pay debt service on the bonds; (2) purchase new tax receivables each year; and (3) transfer excess funds not to exceed \$10 million to the county's General Fund.

The projected cash flow appears to be sufficient to make all of the above payments. The county has a five-year collection cycle, after which delinquent property is foreclosed and sold. The county typically recoups taxes, penalties and interest exceeding the full amount of the original delinquent taxes within three years. Amounts collected in the fourth and fifth year are excess revenues that the county can use for any purpose and are essentially compensation for the risk taken by the county in advancing full property tax revenues to participating agencies.

The proposed Teeter structure appears to work economically. The existing revenue stream is adequate to support debt service and annual purchases of receivables while generating excess to be transferred to the county. In fact, the issuance of the bonds using the proposed structure could be used by the county to meet its other obligations since it will enhance General Fund resources.

Legal Provisions

The county is also pledging to bondholders the Tax Loss Reserve Fund (TLRF). All counties that participate in the Teeter Plan are required to maintain a TLRF in prescribed amounts in case the sale of foreclosed property does not fully cover delinquent taxes. Historically, the TLRF has not been pledged to bondholders. Orange County proposed this legislative change which was enacted in SB 7, the legislation which also allowed for the transfer of the TLRF from the county to the Special Financing Authority.

Other legal provisions include an additional bonds test that requires the county to maintain a 1.15 asset-to-liability ratio for the Teeter Program, a limit on and a coverage test for the amount of excess revenues that can be transferred to the county, and a requirement to maintain a minimum fund balance in the Teeter Fund. Exclusive of the implications of the county's bankruptcy and current legal and financial problems, these legal provisions do provide some protection for bondholders over the life of these bonds.

Teeter Bonds Potentially Stronger than County's Direct Debt but Still Not Investment Grade

The Teeter bonds exhibit some characteristics that support a credit rating above that of the county's direct debt, including the lien and other legal protections provided to bondholders, and the self-supporting nature of the revolving revenue stream. However, while the county is fiscally distressed, in bankruptcy, and threatening to repudiate debt, the Teeter Bonds would be below investment grade due to the close relationship between the county and the Authority and the lack of a true sale of the assets by the county to the Authority.

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HOUSE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES & GSEs
HEARINGS, JULY 26, 1995
FOLLOW-UP QUESTIONS TO RICHARD LARKIN, STANDARD & POOR'S

QUESTION NO. 1:

A significant portion of the Orange County Investment pool was invested in government Sponsored Enterprise Structured notes. Such notes carry low credit risk but high market risk. Such notes, therefore, carry a triple-A rating, which can be misleading to investors. Could you please comment? Should such notes also carry some sort of market-risk rating?

ANSWER TO QUESTION NO. 1:

S&P was not requested to rate such Federal Government Sponsored Enterprises structured notes; but S&P has recently taken steps to alert investors that structured notes carry some market risk because of vulnerability to interest rates. In mid-1994, S&P announced a new policy of assigning an "r" designation to certain securities rated by S&P that demonstrate greater than usual market risk characteristics -- for example -- because of their derivative structure. A copy of that policy is attached to this response. In addition, in January 1995, S&P published an article in CreditWeek, under the heading Credit Comments, concerning government securities. The article points out that the term "government securities" applies to a wide variety of issues, each with special characteristics. Therefore, investors ought to be aware of any increased market risk associated with particular government securities. This article is also attached to this response.

QUESTION NO. 2:

How can S&P call disclosure adequate when Orange County sells a bond issue in June of 1995 with many pages of unaudited financials from June 30, 1994? Given Orange County's problems, why did the market accept outdated financial information?

ANSWER TO QUESTION NO. 2:

S&P cannot speculate about how or why the market responded to the June 1995 Orange County bond issue. However, it is a matter of record that the June 1995 Orange County bond sales were guaranteed by a municipal bond insurance company and a bank letter of credit. The market may have considered these additional facts in weighing how much consideration to give to the unaudited financials.

QUESTION NO. 3:

You stated in your written testimony that the Orange County bankruptcy has cost other counties millions of dollars in increased borrowing costs for short-term debt, even though their credit fundamentals remain as strong as they ever were. This is an important observation. Do you expect this to continue?

ANSWER TO QUESTION NO. 3:

S&P has not specifically followed market trends concerning the borrowing costs of counties. S&P's prior statements -- concerning increased borrowing costs -- were simply based on public comments by issuers and on reports in the news media.

S&P is unable to predict the future effects of Orange County's bankruptcy. However, S&P has observed other major financial crises within the past twenty years, including those in New York City, Philadelphia, Massachusetts, and others. These historic examples suggest that until a distressed issuer starts to stabilize or improve, other issuers with similar characteristics pay a higher risk premium on their net interest costs, regardless of their own credit quality.

QUESTION NO. 4:

You also stated in your testimony that S&P reissued its published guidelines for evaluating pool safety. What rating would Orange County have received under these reissued guidelines?

ANSWER TO QUESTION NO. 4:

S&P "issued" published guidelines for evaluating pool safety; S&P did not "reissue" such guidelines. The guidelines are not formal requirements. Instead they are merely benchmarks that may cause S&P to make further inquiry about an issuer if its profile varies significantly from the guidelines.

Orange County's investment policies did cause S&P to ask numerous questions of Orange County, and S&P received what it believed to be satisfactory answers at the time. Unfortunately, since Orange County's bankruptcy filing, it has become clear that S&P did not receive adequate or reliable information in response to many of its questions. The rating of a particular issuer takes into consideration many factors. For these reasons, S&P is unable to state what rating Orange County would have received under these guidelines.

QUESTION NO. 5:

What percentage of Orange County's revenue came from investment returns? How did the rating agencies take the magnitude of that percentage into account?

ANSWER TO QUESTION NO. 5:

S&P did consider and monitor the magnitude of the percentage of Orange County's revenues that came from investment returns. As per the 1994-95 budget, adopted in June 1994, Orange County's investment earnings were estimated to be the following amounts and percentages of the total estimated revenues for 1993, 1994, and 1995:

Year	Rev. from use of money	(\$ millions) Total revenue	% of Total revenue
92-3	\$ 96.3	\$1,733.0	5.5%
93-4	\$235.6	\$1,983.7	11.9%
94-5	\$179.0	\$2,069.8	8.6%

1993-4 was a year of relatively higher investment earnings for Orange County, partly due to the increase in the use of taxable notes for investment purposes. Orange County was planning a larger taxable note issue for 1995. However, there was a lower assumption of investment earnings projected for 1994-5. In addition, Orange County indicated that its average return on funds for 1993-4 was 6.25%, plus approximately \$50 million from high yield investments from a \$400 million taxable note transaction that year.

Further, Orange County indicated in its June 1994 budget that it had allocated \$141 million to a fund for economic uncertainties as a carry-over reserve fund balance. That fund could be used to temper the effects of any unexpected revenue shortfall, and it represented about a 6.8% budget cushion, which is well above average for city or county governments.

QUESTION NO. 6:

Do the rating agencies look into whether municipalities have a game-plan for financial emergencies -- for example, refinancing, special taxes like sales and airline ticket taxes, privatization, sale of assets, differentiation in levels of staffing, etc.?

ANSWER TO QUESTION NO. 6:

S&P could request such a "game-plan" if particular circumstances made that appropriate. S&P does try to identify potential budgetary risks, such as overly optimistic revenue

assumptions, or unrealistic cost estimates. However, a "gameplan" would not typically be requested from issuers with a long history of stable financial operations and maintenance of fund balance reserves against unexpected developments. On the other hand, as issuers reduce their fund balance reserves or begin to expend more than their annual revenues, or begin to "liberalize" their revenue or expenditure assumptions, S&P analysts will undertake an analysis of revenue-raising and expense cutting flexibility. S&P could inquire about "contingency plans" and their likelihood of achievement if a municipality's finances deteriorated significantly. Some contingency plans are under the sole control and discretion of the municipality (such as raising taxes and fees within legal limits, or reducing discretionary spending). These plans are given more weight in S&P's financial analysis than are contingency plans based on expectations of state revenue increases, spending relief on mandated programs or bond refinancing for budget relief. These latter plans require the continued good will of lenders to renegotiate or underwrite new debt.

QUESTION NO. 7:

At the time of Orange County's bankruptcy, its securities were rated by the agencies in their highest rating category and were eligible for investment by money market funds. It was well-known before the bankruptcy that the Orange County Investment Pool was highly leveraged and invested in derivatives. This included information in annual reports and information regarding the riskiness of funds during Citron's reelection campaign in 1994. And, you stated that the information he received regarding the Orange County Pool's strategy proved to be unreliable. How was the information unreliable? Why didn't the other public information regarding the riskiness of the Pool have an impact on your ratings?

ANSWER TO QUESTION NO. 7:

The April 24, 1995 issue of CreditWeek Municipal contains S&P's analysis of Orange County's investment position. The publication reveals the areas in which S&P believes that information provided to it was unreliable. Attached to this response are pertinent portions of that publication.

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CREDIT COMMENTS

'r' ADDED TO VOLATILE DERIVATIVE/HYBRID RATINGS

"Adoption of the 'r' symbol is one of many steps S&P has taken recently to increase the market's awareness of the growing number of risks incorporated into today's securities."

S&P will begin highlighting certain derivative and hybrid securities by attaching an 'r' symbol to its ratings to alert investors that the instruments may experience high volatility or dramatic fluctuations in their expected returns because of market risk.

Because S&P's debt ratings address credit risk only, the addition of the 'r' symbol neither modifies nor changes ratings. S&P is applying the new symbol to certain derivatives and hybrid securities to clarify its rating definitions for investors.

Since the new 'r' symbol's principal function is to serve as an investor alert, S&P intends to continue its efforts to develop market-risk measures that quantify noncredit risks. Ultimately, S&P hopes to develop a systematic approach to quantify market risk on an individual security basis.

In introducing the 'r' symbol, Leo C. O'Neill, president of S&P's Ratings Group, said: "Our paramount goal in establishing the 'r' symbol is to ensure that investors—large and small—understand that our ratings define and illuminate the degree of credit risk, but do not speak to other significant risks. By identifying certain securities with our 'r' symbol, we hope to alert investors that their returns may be markedly affected by noncredit factors beyond what would be defined by credit ratings.

"The market has used ratings as a proxy for total return, even though ratings primarily address credit risk," said Mr. O'Neill. "However, with many derivatives and hybrid obligations, a calculation of expected return based primarily on ratings may be misleading."

The 'r' symbol will be used when S&P believes that noncredit risks may have a significant impact on an obligation's valuation. For example, expected return can be affected by equity or commodity risk, unknown and possibly severe prepayment risk, or currency risk.

The absence of an 'r' symbol should not be taken as an indication that an obligation will exhibit no volatility or variability in total return.

GROWING RISKS

Adoption of the 'r' symbol is one of many steps S&P has taken recently to increase the market's awareness of the growing number of risks incorporated into today's securities. S&P has continually expressed concern about the adequacy of disclosure and of investor understanding of ratings that address the obligor's ability to repay its obligation.

Earlier this year, S&P introduced a new rating system for mutual bond funds, designed to help investors gauge the market risks that can affect the value of their investments. In addition, last year S&P conducted a survey of the hybrid debt market to determine whether its ratings were accurately understood by key market participants in these instruments.

In addition to applying the 'r' symbol to appropriate new issues, S&P has identified more than 800 outstanding issues that warrant the notation being attached to their existing ratings. S&P believes these issues may experience a high degree of volatility or variability in their expected returns due to noncredit risks. By adopting the 'r' symbol, S&P will not be liberalizing its current approach to ratings. All market sectors will be affected by the new policy. A list of affected securities will be published in the July 18, 1994 *Credit Week*.

SMALL MARKET SEGMENT

When derivative and hybrid securities were first created, they occupied a small segment of the market and were used primarily by sophisticated investors. However, there is now growing evidence that derivative and hybrid securities are being used in mutual funds and other investment vehicles that have a much broader investor base. Government and regulatory authorities also have voiced concern about investor understanding of these complicated instruments.

The 'r' symbol is attached to derivative, hybrid and certain other obligations that S&P believes may experience high volatility or high variability in expected returns due to noncredit risks created by the terms of the obligation. Examples of such obligations are:

- Securities whose principal or interest return is indexed to equities, commodities or currencies;
- Certain swaps and options; and
- Interest only and principal only mortgage securities.

The 'r' symbol is attached for some of the following types of securities:

- Interest-only and principal-only mortgage securities, because of their extreme variability caused by mortgage prepayments;
- Mortgage residuals, if the issue contains elements of risk associated with either IOs or POs. (Most mortgage residuals would not be included, because they predominantly are

"S&P is not indicating that securities designated with an 'r' symbol are not acceptable investments, it is simply saying that they carry risks other than credit risk that need to be examined as part of the investor decision-making process."

- short-term issues with fixed payment expectations.);
- Structured notes whose interest payments are derived from a swap that could terminate at any time. While the total return of a terminating swap could be positive, it may not be what the investor was expecting;
 - Debt or preferred stock whose terms provide for the automatic conversion to common stock, because the buyer could be better or worse off with the common stock at the end of the set period. However, conventional convertible debt will not be highlighted with a symbol, because it only converts if it benefits the investor.
 - Debt issued by a corporation or government whose principal is dependent upon the performance of an index that could either rise or fall, such as debt repayment tied to the stock market or currency exchange rates. However, an obligation that can only benefit the investor, and cannot reduce expected repayment, will not be assigned an 'r';
 - Leveraged inverse floaters that do not move parallel to an index, but expand and contract relative to the index, depending upon the terms, will receive an 'r' because of its additional risk;
 - Obligations with interest rates linked to non-interest related indices, such as the price performance of a basket of stocks; and
 - Obligations with fixed interest rates, if the rate has been reduced in anticipation of gains from a third-party noncredit related source. For instance, some bonds are sold at rates well below market rates, because there is an expectation of additional returns from a third-party source, such as tax credits, a pledge of a percentage of the company's revenues, or the positive performance of some index. Bonds with provisions like those would receive an

'r', because the instrument passes additional risk of earning a market rate of return to the investor.

Securities will be added or deleted from the list receiving the 'r' designation based largely on the degree of investor understanding of the risks associated with certain hybrid and derivative instruments. S&P will not assign an 'r' to an issue that is indexed to a commonly used interest rate, such as LIBOR, or Cost of Funds Index (COFI).

While S&P is identifying issues that may exhibit significant noncredit risk, such issues may be prudent and appropriate securities for certain investors. For example, sophisticated investors often use derivative and hybrid securities to hedge some preexisting risk in their portfolios, reducing their overall exposure. S&P is not indicating that securities designated with an 'r' symbol are not acceptable investments, it is simply saying that they carry risks other than credit risk that need to be examined as part of the investor decision-making process.

As noted earlier, S&P is continuing to review its outstanding issues to identify the derivative and hybrid securities that warrant the 'r' symbol. During the course of the review, S&P will adjust any issues that warrant an 'r' and will review any outstanding security upon request.

Before announcing the new 'r' symbol, S&P surveyed a cross section of market participants, including issuers, investors and government/regulatory authorities. As S&P continues to review its practices relating to derivatives and hybrids, it will issue additional notices to the investor community. Most importantly, S&P welcomes comment on its activities as it responds to the dynamic needs of the fixed-income marketplace.

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BELL ATLANTIC/NYNEX DEAL HAS NO RATINGS IMPACT

Bell Atlantic Corp.'s ('A+' implied senior rating) and NYNEX Corp.'s ('A' senior unsecured debt) agreement to combine their cellular mobile telephone businesses will have no near-term impact on credit quality. The conversion of outright ownership of individual cellular units into equity positions of comparable value in a single combined cellular venture does not change the fundamental economics of the companies' investments.

The creditworthiness of the joint venture, and its longer-term impact on the partners' credit quality, will be mainly a function of the financial strength and operating performance of the joint venture as the business evolves. Since the two companies will contribute assets with significant market value (estimated at \$13 billion by the companies) to the joint venture, S&P would also

consider parent support in any rating of joint venture debt.

The joint venture entity, to be owned 62.35% by Bell Atlantic and 37.65% by NYNEX initially, will be managed 50/50 by the companies. Each company intends to account for its investment in the joint venture using the equity method. The two cellular operations combined, have about 55 million POPs (population of a cellular service area multiplied by ownership percentage), 1.8 million customers, and annual revenues of \$1.2 billion. After elimination of overlapping markets, the joint venture will rank among the top three U.S. cellular companies, with more than 50 million POPs.

The companies continue to seek additional partners for the wireless joint venture, particularly with respect their plan to bid aggressively

CREDIT COMMENTS

GOVERNMENT SECURITIES' DIVERSITY REQUIRES ANALYSIS

"It is important to recognize that the term 'government securities' applies to a wide variety of issues that may have provisions such as call features, payment delays, or interest-rate formulas, and investors must scrutinize them closely."

Over the past year, government securities have received attention in a number of news articles, and recent investor losses have brought a new focus to specific characteristics of these investments. Even without dramatic examples, it is important to recognize that the term "government securities" applies to a wide variety of issues that may have provisions such as call features, payment delays, or interest-rate formulas, and investors must scrutinize them closely. The terms of securities in today's capital markets have become more complex, generally, and investors should review all aspects of a security before purchasing it.

S&P believes the obligations of the U.S. and certain other issuers, whose securities would be classified as government securities, are of very strong credit quality. However, a credit opinion does not take into consideration noncredit factors, such as market risk, which are a part of the overall investment decision. Investors should examine the terms of any security carefully to be sure that it meets their needs.

The term "government securities" is often associated with exemptions under the Securities and Exchange Act of 1934. Included are:

- Direct obligations of, or obligations guaranteed as to principal or interest by, the U.S.;
- Securities issued or guaranteed by corporations that are designated by the Secretary of the Treasury for exemption where there is a public interest; and
- Securities issued by or guaranteed by any corporation that are specifically exempted by Congress in a federal statute.

Securities that qualify as government securities are issued or guaranteed by more than 15 different entities/agencies of the U.S. government and corporations created by acts of Congress. Some are backed by the full faith and credit of the U.S., and some are not. While many issues continue to be straight-forward debt, the world of government securities has become increasingly complex and diverse.

The most common examples of government securities are direct issues by the U.S. government, but also include direct issues or issues guaranteed by agencies or corporations such as GNMA and the Agency for International Development (AID). Debt issued by government-sponsored enterprises (GSEs) such as FNMA, the Student Loan Marketing Association (SLMA), and the Federal Home Loan Bank System are government securities. Some are issued as straight debt,

some as mortgage backed securities (MBS), and others as structured notes.

Structured notes have generated much of the attention this year. The term "structured notes" is used to describe debt that is customized for the investor. Some link payment of principal to a nonfixed source such as the price of a currency or index. More typically, in today's market, structured notes pay interest linked to dual indices, or a formula specifically designed for the investor.

MBS have always been subject to prepayment risk, but certain MBS magnify this risk with interest-only and principal-only classes. More recently, MBS have taken on new complexity, as REMIC structures are used to back new issues known as re-REMICs. The terms of one re-REMIC issued by FNMA provide for interest payments only if there is sufficient cash flow from the collateral. Interest payments may not be made, depending on the performances of the underlying REMICs. Accrued interest may be made up subsequently if excess cash flow is available.

The universe of government securities is dynamic. Many of the complex MBS and structured notes were not issued 10 years ago. As economic and other conditions change, the types of debt issued and the terms of the issues also may change going forward.

U.S. GOVERNMENT-BACKED OBLIGATIONS

The direct and guaranteed obligations of the U.S. government, where the securities are backed by the full faith and credit of the U.S., are considered "AAA". Full faith and credit, when used with federal government securities, is an explicit obligation to which the full tax and other revenues of the federal government are pledged to the payment of an obligation. However, a full faith and credit pledge does not always mean timely payment of principal and interest or call protection—the federal government is only committed to pay under the terms and conditions of the specific offering or the guarantee.

The U.S. issues the vast majority of its obligations through the Department of the Treasury. Most of these issues are noncallable bills, notes, and bonds. However, not all Treasuries are noncallable. The Treasury has issued callable bonds, and Treasury bonds with call features are outstanding.

GNMA guarantees timely payment of principal and interest, backed by the full faith and credit of the U.S. However, these are MBS and are sub-

CREDIT COMMENTS

ject to prepayment. Unscheduled prepayments of principal on the underlying mortgages are passed through to the investor. Recently, GNMA has begun to issue REMIC securities, some of which contain interest-only and principal-only classes.

The U. S. Maritime Administration guarantees principal and interest on bonds, and that guarantee is backed by the full faith and credit of the U.S. Interest is paid semiannually. An optional redemption is provided for principal on any mandatory sinking fund payment date and also upon 30-60-days' notice. In the event of a default, the Maritime Administration can either continue paying on the bonds or accelerate the issue.

AID guarantees payment on notes issued in the capital markets, and that guarantee is backed by the full faith and credit of the U.S. Payment on the notes is guaranteed by AID. If payment is not made by the borrower, AID will pay the guaranteed amount within three business days following receipt of notice.

ISSUES WITHOUT EXPLICIT U.S. BACKING

S&P has assigned a limited number of ratings, on request, to issues that are not backed by the full faith and credit of the U.S. government. Rated issues include the two 1989 Tennessee Valley Authority issues, certain debt issued by the Federal Home Loan Banks, FNMA, and FHLMC, and a small number of MBS issued by FHLMC.

While the majority of these securities are not rated, S&P does view securities issued by certain government-sponsored entities to be of high credit quality, and these securities are included as eligible investments in structured transactions rated as high as 'AAA'. The U.S. government has no legal obligation to support these securities. S&P's assessment of these securities are based on links to the federal government and evidence of support for the outstanding securities. The analysis S&P uses to come to a conclusion is specifically for the securities issued by these GSEs and is not a default risk analysis for the agency or corporation (*S&P's full criteria are available upon request*).

GSEs are the largest issuers of government securities that are not explicitly backed by the U.S. government. While historically GSE debt issues have been discount notes and other fixed-rate instruments, more recently certain GSEs have issued debt with embedded derivatives. Many of these issues are drawn from medium-term note programs. In addition, the housing-related GSEs, FNMA and FHLMC, issue MBS. MBS contain prepayment risk, but specific tranches of MBS structures issued by these GSEs may have addi-

tional market risk or market risk driven by prepayment risk.

All of the entities issue debt and other obligations to meet business and financing needs. As economic, business, and other conditions change, the types and terms of the securities they issue may change. For example, the housing GSEs have increasingly issued callable debt in the past several years to finance mortgage purchases.

The Federal Home Loan Bank System issues structured notes that contain market risk along with credit risk. In a recent offering of a global debt program, the Federal Home Loan Bank System provided for a wide variety of issuances. Principal may be repaid at par, a specified amount above or below par, or an amount based on one or more interest-rate or exchange-rate indices, or otherwise. While the information memorandum provides this general information on the program, investors should review the specific terms of each bond issuance prior to investing.

A popular security in the MBS area and in other instruments is the inverse floater. For example, one class of a FHLMC REMIC issue pays variable-rate interest at 24.085% minus the product of the Seven-Year Treasury Index and 2.14. Interest payments would not be greater than 23.55% and not less than 0% on that class. Thus, payments float inversely with current market rates, declining in a rising interest-rate environment and increasing in a falling interest-rate environment.

QUALIFIED INVESTMENTS FOR 'AAA' FINANCINGS

The diversity of government securities offers a wide variety of investments. S&P maintains a list of categories of securities that are eligible investments by trustees in 'AAA' rated structured transactions. Securities backed by the full faith and credit of the U.S. government all have 'AAA' credit quality. S&P must review other securities that are not backed by the full faith and credit of the U.S. government for credit quality prior to inclusion on its list. But not all government securities are appropriate for every investment, and some may not be appropriate at all for structured financings. Securities such as stripped MBS that are purchased at prices exceeding principal amounts and securities that do not have a fixed par value or whose terms do not promise a fixed dollar amount at maturity or call date would not be considered eligible investments. While these securities may be appropriate investments under other circumstances, structured financings need the certainty of fixed principal payments.

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"S&P maintains a list of categories of securities that are eligible investments by trustees in 'AAA' rated structured transactions. Securities backed by the full faith and credit of the U.S. government all have 'AAA' credit quality."

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APRIL 24, 1995

ORANGE COUNTY: 'A UNIQUE DISASTER'



S&P on April 12, 1995 hosted a conference to discuss Orange County, Calif.'s bankruptcy filing and its impact on the creditworthiness of municipal debt.

The conference was attended by 150 investors, issuers, bankers, financial advisers, and state officials. The following article is adapted from a speech delivered by S&P director Jane Eddy. A speech about Orange County investment pool participants delivered by S&P director Steve Nelli can be found in the Credit Comments section.

It would be nice to be able to start by putting Orange County's situation in a context that allows comparison with historic precedent. However, Orange County's situation is unlike any other fiscal crisis.

The county's problems do not stem from economic stag-

nation—as was the case in Philadelphia in 1990 and Cleveland in 1978—or from overbudgeting or “cooking the budget books”—like New York City in 1975. Nor was it the result of issuing short-term debt to mask operating deficits or accounting lapses or shortfalls. Finally, the problems do not stem specifically from intergovernmental cuts, although the transfers made by the state in 1993 and 1994 of what previously were county funds and the limits imposed by Proposition 13 have pressured all California counties.

What occurred is a unique disaster, and the path taken thereafter—bankruptcy—an unprecedented approach. One of the truly unique facets of the Orange County or-

deal is the way in which 180 governmental units have been involuntarily drawn into the bankruptcy of both the county and the pool.

Could the county have avoided taking the enormous step of filing for bankruptcy, an action that will raise questions over the long term about its willingness to honor its obligations? The issue of whether the county might have managed the situation by negotiating with the broker-dealers and pool investors remains unresolved and probably will never be fully answered.

However, through the bankruptcy filing, county officials sent the message that they did not necessarily intend to repay all the

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HIGHLIGHTS

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ORANGE COUNTY POOL PARTICIPANTS: VICTIMS OR ACCOMPLICES?

At a recent conference on Orange County, Calif.'s bankruptcy, S&P director Steve Nelli discussed the role of participants in the county's investment pool. Excerpts from his speech are reproduced here.

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THREE MAJOR CATHOLIC HEALTH SYSTEMS PROPOSE MERGER

Three of the nation's major Catholic health systems late last week announced the signing of a letter of intent to evaluate consolidation of the three systems by the end of 1995.

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SOME DEFAULTS ON CALIFORNIA SPECIAL DISTRICT DEBT SEEN

While most California Mello-Roos and special district debt remains current, defaults have begun to creep up, as S&P predicted several years ago. Most of the troubled districts are not rated by S&P.

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TEXAS RULING ALLOWS LEASING FOR SCHOOLS

A Texas Supreme Court ruling that upheld the state's school financing system lets school districts take advantage of 1993 legislation that permits them to enter lease agreements to address major capital needs.

(SEE PAGE 3 FOR A COMPLETE LIST OF ISSUE CONTENTS.)

ORANGE COUNTY: 'A UNIQUE DISASTER'

county's obligations. In most other cases of severe municipal fiscal stress—even those involving default—the debt or continued to try to pay its obligations and did not hint at any desire to abrogate them.

Should the county and its residents take substantial steps that signal their intention to fully honor their obligations, the impact of the filing might be lessened. But, the bankruptcy is an action creditors will continue to be mindful of, as the county has demonstrated that it views bankruptcy as an option, not necessarily even an option of last resort.

INFORMATION PROVIDED

Before discussing the outlook for the county's ratings, I would like to outline some of the information county officials provided to S&P and that we relied on in assigning and maintaining the county's debt ratings. Hopefully, this will answer some of the questions asked us and clarify the record. Unfortunately, a number of outstanding questions about the pool remain that preclude a full accounting of it currently.

S&P relied—as it has always done—on the accuracy and completeness of information provided by county officials when assigning ratings to the county's debt obligations. S&P frequently discussed the pool's condition with county officials, including the chief administrative officer (CAO), the assistant CAO for finance, the assistant treasurer, and the assistant auditor/controller and repeatedly was given assurances of its underlying strength. These officials addressed the questions S&P posed and provided purportedly reliable information. Unfortunately, this information did not foretell the collapse of the pool.

Last spring, county officials told S&P the pool was

leveraged from about \$8 billion to \$20 billion. They described the mismatch between the term of the reverse repurchase agreements—generally six months—and the average maturity of their securities—2.1 years leveraged to a 3 1/2-year duration. They explained that they could manage the exposure this strategy introduced because of the following:

First, no early liquidation of their securities was anticipated, as 75% of the funds were invested in the pool on a mandatory basis according to state law. Based on precedent and a survey of each involuntary member, the county had determined that, on average, these funds remained in the pool for five years. Of the 25% of funds invested on a voluntary basis, 50% was expected to be on deposit for five years or more, and 30% for three to five years. County officials claimed they had a track record of forecasting cash flow needs with a 95% accuracy. The term of the deposits was, therefore, anticipated to exceed the term of the securities which S&P understood were to be held to maturity.

Second, county officials asserted their ability to manage the pool's potential exposure because of their policy of maintaining a high level of liquidity. According to the information we were given, the liquidity position of the pool ranged between \$1 billion and \$1.8 billion from the end of 1993 through September 1994. In addition to these funds, during this period, the county claimed to have between \$200 million and \$700 million of unpledged securities on hand.

Third, county officials pointed to the high credit quality of the investments, with over 75% by par value in U.S. Treasury or agency obligations.

S&P was aware that a portion of the portfolio was invested in inverse floaters and other interest rate-sensitive derivatives. Given these positions and the mismatch between the duration of the reverse repurchase agreements and the securities, S&P was concerned about the sensitivity of the portfolio to rising interest rates.

Again, in response to our questions about these issues, county officials asserted that their investment strategy was not a cause for concern. In May, they told us that collateral calls of \$300 million—or 3.8% of the value of the unleveraged investments—had occurred since January 1994. They stated that the \$700 million then held as unpledged securities would fully cover collateral calls that might ensue upon an additional 100-basis-point increase in the six-month Treasury bill rate, which was the treasurer's benchmark. Furthermore, they stated that the county could manage even a 200-basis-point increase without selling securities at a loss.

Should this scenario arise, the county said, it would use some of the \$1.5 billion of liquidity in the pool and/or some portion of the \$1 billion of revenues anticipated to be received through December 1994 to satisfy collateral calls or pay down the reverse repos.

Importantly, county officials also told S&P that they planned to hedge against interest rate swings and exercise the option, upon further interest rate increases, to unwind the reverse repurchase agreements.

The county's claim that the pool could withstand interest-rate movements seemed entirely reasonable, since the 112-basis-point increase in rates from January to May 1994 had led to only

ORANGE COUNTY: 'A UNIQUE DISASTER'

\$300 million of collateral calls.

County officials told S&P that two pools existed: the bond fund and the commingled fund. S&P understood that the former was marked to market annually, while the latter was not formally marked to market. However, the county stated that it followed a practice of meeting frequently with several broker-dealers to assess the overall posture of the pool, allowing the county to manage the pool's position actively and prudently. They also asserted that the securities would be held to maturity.

Furthermore, S&P was assured that the board of supervisors understood and approved of the investment strategy.

Unfortunately, a huge question mark surrounds the collapse of the investment pool. S&P was provided purportedly reliable information indicating that the pool could manage the six-month Treasury bill interest rate movement of 105 basis points that occurred between May and November. Had that information been reliable, today we would be enjoying the luxury of discussing the baggage handling system at the Denver Airport instead of a potential \$1.1 billion default.

THE COUNTY TODAY

The current condition of the county is very tight. The county estimates that the general fund carries a \$2 billion IOU, representing monies owed to noteholders, pool investors, vendors, and other county funds. The county also forecasts that its \$463 million discretionary budget will have a \$188 million structural budgetary shortfall for fiscal 1996.

The county has proposed a plan to address both gaps. The plan includes the following elements:

- Selling \$750 million of bonds secured by an in-

tercept on the motor vehicle license fees (MVLFF) the state collects for the county;

- Issuing \$500 million of debt backed by tip fees collected by the Integrated Waste Management District for trash disposal (about \$200 million of this financing cannot be effected, according to county estimates, for one to two years, given legal considerations);
- Refinancing \$175 million of Teeter notes coming due this June and stretching the amortization for up to 25 years—an action that could free up \$60 million in reserves;
- Providing pool participants with, on average, 76% of their prebankruptcy deposits from cash and short-term securities derived from the liquidation of the pool;
- Selling about \$240 million of so-called recovery notes backed by an enhanced general fund lien. This would provide school districts that invested in the pool with 90% of their pre-bankruptcy deposits and all other non-county entities 80%;
- Placing before voters a referendum to increase the sales tax by one-half cent;
- Establishing asset sales and sale-lease back arrangements; and
- Cutting the discretionary portion of the general fund by around \$207 million, or 45% of its pre-bankruptcy levels.

The county also is pursuing legislative changes that might ease the cost of funding state mandates.

If it is fully enacted, the plan would raise \$1.4 billion from bonds—or \$1.2 billion over the next nine months—of which the county would receive just over \$1.1 billion

in net proceeds. Assuming the successful sale of the bonds over the next nine months, county officials have stated that their first-priority payments among the \$2 billion of debts is to cover the shortfall of \$430 million due to noteholders and the estimated \$342 million owed to pool participants on a secured basis. Unfortunately, this statement must be heard in connection with the county's earlier and recently reiterated threat to challenge the constitutionality of its \$600 million of taxable notes in order to "legally default" on them. As I mentioned before, proceeds also would be dedicated to refunding the \$240 million of recovery notes, which the county hopes to monetize this spring. These three obligations add up to \$1 billion, close to the \$1.1 billion the county expects to receive on a net basis from bond sales. This leaves \$100 million to cover a gap of \$785 million for amounts due vendors, county losses in other funds and the subordinated repayment claims of pool members.

The county expects the sales tax increase to yield \$130 million per year, but only about \$60 million of these revenues would be available to pay the remaining claims; the net amount of the sales tax yield simply plugs the gap created by pledging the MVLFF revenues to debt service on the expected \$750 million financing. For full repayment of all its IOUs, county officials are relying on litigation settlements, asset sales and other miscellaneous potential revenue sources.

The county estimates that asset sales and sale-lease-back financings could yield about \$100 million from the proposals that could be implemented with any certainty. Over the past few days, there has been more discussion about ceding

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ownership of the John Wayne Airport to the county transportation authority in exchange for financial assistance to the county of about \$200 million, on a net basis. We will evaluate the proposal with an eye to understanding what, if any, impact the transfer might have on airport bonds, the transportation authority's debt, and the compliance of the airport with FAA regulations.

THE PLAN'S VIABILITY

How achievable is this plan?

First, it requires many parties to cooperate. The state legislature has to amend current law to allow the stretching of the Teeter notes and possibly sign off on environmental permitting for the imposition of higher tip fees. County officials also believe the state must enact legislation strengthening the intercept mechanism to attract potential buyers of the MVLF-backed bonds. County officials hope that these legal changes will be adopted this spring.

Others who must cooperate include noteholders. The county does not believe it can issue the MVLF bonds unless the voters approve the sales tax increase on June 27 because of the ramifications for the general fund. They also do not believe they can sell the solid waste system bonds until the environmental permitting issues are settled. These factors push the timing of these bond sales past the note due dates and probably into fall or winter.

The county believes its current resources for repaying noteholders are short by \$430 million and asserts its inability to cover this gap without proceeds from the proposed long-term debt issues. For these reasons, the county has proposed extending the note maturities by a year and is trying to obtain the consent of its noteholders.

Other key players include county residents and the board of supervisors. A majority of county voters must approve the sales tax hike before it can be implemented. The adoption of the increase appears far from certain. For their part, the board still must adopt the tip fee adjustment, which increases these fees to \$35 per ton from \$22.75. This increase only covers debt service on \$300 million of debt, not the \$500 million described previously.

The second step, and a painful but necessary one to allow for the full \$500 million of bonds, requires the county to change laws to allow trash to be imported into the county. This is likely to be controversial, especially in the three cities where the landfills are located.

The board also has to enact the dramatic cuts necessary to balance the fiscal 1996 budget. The \$40 million of cuts made in fiscal 1995 have not yet been realized, although operating departments are optimistic about achieving their targets. Cuts of the magnitude required for fiscal 1996 will lead to significant losses in health care, public protection, and court- and library-related services among others. The significant spending reductions, especially in health care, result in losses of state and federal matching aid, amplifying the effective reductions. Whether these cuts are sustainable and ultimately acceptable remains to be proven. It is important to note that, even before the bankruptcy, the county's general fund operations were considered "lean" and overstaffing was not an issue.

Other participants critical to the plan are pool investors. It appears that the county will receive a quorum agreeing to the plan, but only if it can monetize the \$240 million of recovery notes by June 5. This re-

quires the cooperation of the state, the public markets, other pool participants, or perhaps some combination of the three.

S&P'S VIEW

How does S&P view the plan? Naturally, we hope it is successfully adopted and implemented. Details on the financing structure for the bonds are sketchy; however, we would consider it essential that debt security provisions shield bondholders from the tremendous problems of the general fund in order to consider assigning investment-grade ratings to future financings. General fund resources are terribly strained and probably will remain that way for some time. Competition for these limited resources will be great for a number of years.

Given the county's recent unwillingness to honor bond covenants, we are hard pressed to assume—as we might in other instances—that the county will honor its obligations to bondholders if difficult decisions about allocating monies becomes necessary, as is likely. A demonstrated lack of willingness to pay on the part of the county is a problem that will influence our evaluation of the county's creditworthiness for a long time.

Furthermore, to create a potentially creditworthy obligation, the repayment revenue stream to bondholders must be bankruptcy-proof. Any security for the bonds must survive a subsequent bankruptcy without the possibility that an automatic stay could disrupt the flow of funds to bondholders. Again, it would be naive to assume that, once out of bankruptcy, the county would never again choose that option should tough times arise.

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QUESTIONS FOLLOWING THE HEARINGS ON
DEBT ISSUANCE AND INVESTMENT PRACTICES
OF STATE AND LOCAL GOVERNMENT

◆

August 31, 1995

RESPONSE OF JAMES E. SPIOTTO
PARTNER, CHAPMAN AND CUTLER

1. SHOULD THE LAW REQUIRE THE STATE, NOT THE MUNICIPALITY, TO ASSERT THAT BANKRUPTCY IS A LAST RESORT AFTER ALL RATIONAL AND FEASIBLE ALTERNATIVES HAVE BEEN FULLY EXPLORED?

In the aftermath of Orange County, there appears to be a strong feeling in many quarters that Chapter 9 indeed should be viewed as a last resort. Even prior to the Orange County crisis, six states had expressly required approval by state authorities before a municipality could file a petition under Chapter 9 of the Bankruptcy Code.¹ It must be assumed, as supported by the extensive press coverage given the Orange County Chapter 9 filing, that states are becoming increasingly aware of the potential problem of unfettered access to Chapter 9. In order for a municipality to be able to successfully seek the benefits of Chapter 9, its state must affirmatively act to adopt legislation. A summary review indicates that thirty-one states have not yet acted so that a Chapter 9 proceeding in those states should not be lawful at this time. This is probably an excellent state of affairs because it has the salutary effect of requiring state action and involvement in any municipal financial crisis in those states. If a financial crisis were to develop for a municipality in one of those states,

¹ Only twelve (12) states have specifically authorized their municipalities to file Chapter 9 petitions:

Ala. Code § 11-81-3.	Idaho Code § 67-3903.
Ariz. Rev. Stat. Ann. § 35-603.	Ky. Rev. Stat. Ann. § 66.400.
Ark. Code Ann. § 14-74-103.	Mont. Code Ann. § 7-7-4111.
Cal. Gov't. Code § 43739.	Okla. Stat. tit. 62, § 283.
Colo. Rev. Stat. § 32-1-140.	SC Code Ann. § 6-1-10.
Fla. Stat. § 218.01.	Tex. Local Gov't. Code Ann. § 140.001.

In addition, six (6) other states statutes expressly require approval by state authorities before a municipality may file under the federal bankruptcy laws:

La. Rev. Stat. Ann. § 39-619.	NC Gen. Stat. § 23-48.
MSA § 5.3188(222); MCL § 141.1222.	Ohio Rev. Code Ann. § 133.36
NJ Rev. Stat. § 52:27-40.	Pa. Stat. Ann. tit. 53, § 11701.261.

On the other hand, at least one (1) state has specifically forbidden municipalities from filing Chapter 9 petitions:

Ga. Code Ann. § 36-80-5.

that municipality would have to seek State legislation before such municipality could be a Chapter 9 debtor. In light of Orange County, it is likely that the state political process would at least publicize the financial problems before the municipality could commence a Chapter 9 case, so that the market would not be surprised. That same political process should also compel the state legislature to balance the interests of both the debtor and its creditors and other constituents. Thus, the current lack of appropriate state enabling legislation in sixty percent (60%) of the states may have the effect of providing an implicit, built in "cooling off period."

As mentioned in my written testimony prepared for the Hearings on Debt Issuance and Investment Practices of State and Local Government, dated July 26, 1995 ("*Written Testimony*"), the Bankruptcy Reform Act of 1994 responded to a split in lower court decisions with regard to the nature of the state authorization to be a debtor under Chapter 9 of the Bankruptcy Code. Previously, a municipality qualified as a Chapter 9 debtor if it was "generally authorized" as such by state law. Now, pursuant to Section 109, a municipality may be a Chapter 9 debtor only if, by state law, it is "specifically authorized" in its capacity as a municipality or by name to be a debtor under Chapter 9. This 1994 Amendment can be viewed as an invitation by Congress to the states to develop state legislation creating an orderly process in which the state itself will supervise a municipal financial crisis.

As a result, the existing Bankruptcy Code does acknowledge that the financial integrity of municipal debt is primarily a state responsibility. While it might be prudent first to allow the states to respond to the 1994 invitation of legislation on proper safeguards for access to Chapter 9, certainly Congress could revisit the concepts of "specifically authorized" in Section 109 of the Bankruptcy Code. It could establish more specific requirements as

preconditions for a Chapter 9 filing which would compel the state to become more actively involved in a municipal financial crisis.

As a troubled financial situation evolves into a crisis and just prior to any filing of a Chapter 9 proceeding, there are some competing interests that should be balanced. The debtor needs protection from litigation and enforcement of claims so that it can develop an overall solution. The creditors, and constituent taxpayer-citizens, required accurate information to be disclosed about the financial situation, possible solutions, and possible time frames.

A possible modification to Chapter 9 could permit resort to Chapter 9 only if a governmental officer or organization empowered by state law had specifically reviewed the financial condition of the municipality and had specifically authorized the entity to be a debtor under Chapter 9. Such a state approval process could require that the prospective debtor also submit a proposed plan of adjustment to the state as part of this state precondition-approval process: such a requirement should have the effect of forcing the municipality to have a proposed solution to its problems, which of necessity under state "sunshine laws" should be publicly aired, before it receives the powerful protection provided by Chapter 9's automatic stay on litigation and the enforcement of claims. Additionally, there is an element in municipal finance which is not present in other types of finance which could be addressed by the state in this approval process: municipal obligations must pass muster under state constitutional limitations on the power of municipalities to incur debt and tax citizens. A Federal bankruptcy court may not be the appropriate forum in which to resolve such state constitutional issues. In an attempt to assist in the resolution of such issues, the state approval for a Chapter 9 filing could be required to be accompanied by a statement of state legal officials or attorneys employed by the state to the effect that the

actions proposed to be taken by the debtor in effectuating a plan of adjustment were legal under existing state law, including the constitution of such state.² In the absence of such state oversight and approval, it could be required that the bankruptcy court find that the filing was made in good faith and not for the purpose of repudiating indebtedness which otherwise had been sold in interstate commerce to the investing public as valid, binding and legal. However, a statutory change in the Bankruptcy Code should not be necessary if the states are willing to take such action on their own.

In my written testimony, I suggested two possible reforms which would not require any extensive revision of Chapter 9 and which should not be inconsistent with the Tenth Amendment. The first suggestion was for a Federal statute which would stay the effect of litigation against a financially distressed municipality for a period of six months if the governor of the state approved the request for such a stay. There is more discussion of this suggestion in my response to your next question. The second suggestion was for the development and encouragement of uniform state laws which would provide a legislative alternative to an immediate Chapter 9 filing. I believe that as states are faced with municipal financial problems, they will look to some of the models provided by existing legislation in New Jersey, New York, Ohio and Pennsylvania which have been successfully applied.

A potential criticism of additional statutory limitations on access to Chapter 9 is that they effectively eliminate the benefits and protections of Chapter 9, in particular the relief provided by the automatic stay and ability to modify contracts without the consent of all the

² Consistent with this strengthening of the states' role in overseeing municipal investments, amendments to the Code could include a requirement for more state involvement in municipal disclosure in the limited area where a municipality seeks the protection of Chapter 9. A state could be required to provide a certificate as to the accuracy of the disclosure submitted to the market by any of its municipalities that are in Chapter 9. Through this certification process, the state could encourage appropriate disclosure guidelines by troubled municipalities.

parties to that contract. Until the Orange County bankruptcy is concluded and the ramifications beyond that Debtor have been thoroughly studied, more drastic changes probably should be kept to a minimum.

If it would be of assistance to you, we would be happy to prepare some suggested federal or state legislation on a temporary litigation moratorium. We also would be happy to furnish you with copies of existing state legislation dealing with supervision of municipal financial crises, and, if you like, to comment on that legislation.

2. DO THE PROBLEMS IN ORANGE COUNTY SUGGEST THAT CHAPTER 9'S HALT ON LAWSUITS AGAINST THE FILING MUNICIPALITY COULD BECOME A MAJOR INCENTIVE FOR TROUBLED LOCAL GOVERNMENTS TO DECLARE BANKRUPTCY?

In fact, the legislative history surrounding the enactment of the original municipal debt adjustment legislation during the 1930s indicates that the desire for relief from annihilating litigation led to the passage of the original Chapter IX. Municipalities suggested to Congress at that time that they be allowed to adjust their debt in a formal proceeding under federal bankruptcy protection in order to avoid the costs, expense and uncertainty of litigation. The automatic stay and the shelter from litigation that the existing Chapter 9 affords a debtor is a major part of the benefit of Chapter 9. There is no question that the benefit of the automatic stay is a major incentive in a Chapter 9 filing.

When a municipality finds itself in financial difficulty, it, like any other entity in financial distress, must determine how to address its problems. Many times this involves a decision as to which creditors to pay and which creditors to rebuff. Eventually, those creditors who remain unpaid take legal remedies which distract the municipality's energies, resources and personnel. Litigation is expensive, time-consuming and compounds the problems of a municipality. Chapter 9 can bring litigation to a halt. However, just as the automatic stay can be of benefit to a municipality, a municipality can use a Chapter 9 proceeding to hide from its problems. Although the judge in a Chapter 9 case can set a deadline for the filing of a plan pursuant to Section 941, there is no deadline for proposing a plan in the statute itself, and some municipalities have remained in Chapter 9 for considerable time. Moreover, disgruntled creditors cannot propose an alternative plan.

As a result, in my written testimony, I suggested that state legislation short of Chapter 9 could be developed on the state level, in conjunction with parallel federal legislation. This legislation would allow for a stay of litigation against a municipality for a

six-month period pending a resolution of the municipality's problems, with the possibility of renewal where appropriate. The stay could be granted by the designated state official or agency, and could apply to any piece of litigation against a municipality once the authorized state official finds that a financial emergency exists. Legislation which would, on a state level, provide relief from litigation, in conjunction with the efforts of a state oversight or refinancing authority, appears to be more constructive than an immediate retreat to Chapter 9. New York State tried to create some of the same benefits for the City with its moratorium law prohibiting suits on the City's notes in conjunction with an exchange of the short-term notes for long-term debt. The legal problem with that moratorium³ was that it attempted to force a resolution on the debtholders as opposed to halting lawsuits pending a consensual resolution on a creditor-by-creditor basis or a refinancing that would pay the noteholders over time. The stay envisioned in my testimony should not run afoul of Constitutional requirements or violate Section 903 of the Bankruptcy Code which reserves to the states the power to control municipalities. The stay is not an impairment of contract because the stay is granted as part of a voluntary debt restructuring. The product of a voluntary debt restructuring in negotiations with creditors could be, under certain circumstances, a prepackaged Chapter 9. If resort to Chapter 9 became necessary, it would not be a freerfall bankruptcy but a filing in which the ultimate outcome is predictable. The stay of six months or more could give breathing room to a troubled municipality which now appears to be absent unless the protections of Chapter 9 are invoked. It could also assist local political leadership in its task of explaining the ramifications of a financial crisis to its electorate.

³ The law was declared unconstitutional in *Flushing National Bank v. Municipal Assistance Corporation*, 390 N.Y.S.2d 22, 358 N.E.2d 848 (N.Y. App. 1976).

3. AS YOU AND SEVERAL OTHER WITNESSES HAVE MENTIONED IN YOUR WRITTEN TESTIMONY, ORANGE COUNTY HAS RESERVED THE RIGHT TO REPUDIATE CERTAIN TAXABLE DEBT THAT THE COUNTY INITIALLY REPRESENTED WAS A LEGAL, BINDING AND VALID OBLIGATION. IS THERE, IN YOUR OPINION, A NEED FOR STATE STATUTES THAT REAFFIRM AND ENFORCE SUCH REPRESENTATIONS OF VALIDITY AND LEGALITY AGAINST LATER REPUDIATION BY A MUNICIPALITY?

The validity of a municipal obligation is a unique and often difficult issue, particularly when the obligation is of a type that is payable from taxes and is viewed as a "traditional obligation." As previously stated, such an obligation must pass muster under the limitations of the relevant state constitution. There are two sides to the validity question: on the one hand, creditors who have given money to a municipality in exchange for an evidence of indebtedness should be repaid in the manner bargained for; on the other hand, taxpayers should be protected by the provisions of their state constitution from illegal acts taken by political leaders in providing a particular unlawful source of payment. (The Chicago School Board situation illustrates some of the dilemmas that can arise for the federal and state courts and for the bondholders.)⁴

Under our system of Federalism, no one can propose that the taxpayers of a troubled municipality should be forced to bear any tax that is unlawful under their state constitution. However, a municipality which has received fair consideration in exchange for an evidence of indebtedness which that municipality represented to be valid and lawful should not be permitted to avoid its repayment obligation. In particular, it should not be permitted to use proceedings under the Bankruptcy Code to invalidate what it represented as valid. Indeed, an issuer of an "invalid obligation" should be subject to a fraud claim under state and federal

⁴ In *Burman v. Board of Education of the City of Chicago*, 360 Ill. 535, 196 N.E. 464 (Ill. 1935), the court struck down bail-out legislation pursuant to which long-term general obligation bonds were issued to refund unpaid warrants. The court held that since the original warrants were not debt, were non-recourse obligations and were payable solely out of the tax revenues to the extent such tax receipts were available in the particular year, such warrants could not be validly refunded with debt at the expense of taxpayers.

securities laws in an amount that at least equals the amount of the "invalid" obligation. It is possible that state constitutional provisions may ultimately require that the source of payment of such an obligation must be changed in order to comply with the state constitution, but the claim itself must not be permitted to be wiped out by proceedings in the Bankruptcy Court. The Bankruptcy Code should recognize that, while a designated source of repayment may be unlawful under the state constitution, if the debtor has received consideration, the evidence of that indebtedness nonetheless represents a valid claim against such debtor in any Chapter 9 proceeding. This approach is consistent with Article 8 of the Uniform Commercial Code.

For some time, there have been efforts made to ensure that municipal securities, which purportedly were validly issued, could not be challenged after issuance as being invalid or not binding on the issuer. In the 1860's, at least 13 states repudiated their indebtedness following the Civil War, and the municipal market, by the force of its purchasing power, required states to examine their statutes to provide assurances and remedies to bondholders that the debt issued would be honored. Bond counsel and credit rating agencies are the outgrowth of the concern that there be no technical reasons to permit a governmental issuer to claim that what it had represented to be a legal, binding and valid obligation could be repudiated because of some legal or structural flaw. Further, court validation proceedings (particularly in the southern states which had the history of 19th century debt repudiation) have sometimes been used to provide assurance to the market that what is issued is valid, binding and legal. However, most issuers do not want to go through the time and expense of a court-approved validation proceeding except in those situations which dictate a court order as a necessity.

As a general rule, the premise of the municipal market has always been that municipal debt is honored by the municipality and that there rarely, if ever, is any question about a previously-issued security being legal, valid and binding. As a result, credits which in other markets would be viewed as poor receive better treatment in the municipal market because of the general tradition and assurance that municipalities generally live up to their obligations. It would be appropriate to assure the market that no one will enter into a Chapter 9 proceeding to assert that securities which previously had been represented to be legal, valid and binding obligations were unenforceable. As noted above, there could be added to the Federal Bankruptcy Code a provision that the Bankruptcy Court could not enforce any determination by the municipality or otherwise that an obligation was not valid, binding and legal if the municipality had previously represented in interstate commerce that the security was a legitimate obligation.

Section 202 of Article 8 of the Uniform Commercial Code already provides some limited investor protection against assertions that the securities are invalid if those securities are in the hands of a good faith purchaser for value. States could clarify the Uniform Commercial Code in their jurisdictions so that a representation by the municipal issuer or the delivery of a customary bond counsel opinion to the effect that the issuer had the statutory authority takes precedence over any subsequent statutory analysis to the contrary.

At the same time, even attempted repudiation will not mean that the municipality should escape all liability for money borrowed in a bankruptcy, as may very well be demonstrated in the Orange County case. Even if a contract claim is deemed unenforceable because of some alleged lack of authority, there will be allegations and claims of unjust enrichment, fraudulent misrepresentation, negligent representation and, obviously, various forms of federal and state securities laws. Given the broad definition of "claim" in the

Bankruptcy Code, each of these potential causes of action could lead to bankruptcy claims against the municipality in at least the amount of the debt that had been issued. Therefore, the municipality's total obligations may not be reduced by an attempt to repudiate the indebtedness, although the nature of the claims could change. Further, if the municipality actually received the proceeds for its use and benefit, it is inescapable as a legal matter that the municipality will have to return the funds or pay some claim for participating in what the market could only term as a fraud.

KENNETH E. BENTSEN, JR.
25TH DISTRICT, TEXAS

COMMITTEES
BANKING AND FINANCIAL SERVICES
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND GOVERNMENT SPONSORED ENTERPRISES

SMALL BUSINESS
SUBCOMMITTEE ON TAX AND FINANCE
SUBCOMMITTEE ON REGULATION AND PAPERWORK
REGIONAL WHIP

Congress of the United States
House of Representatives
Washington, DC 20515-4325

August 3, 1995

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2440 TEXAS PARKWAY
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MISSOURI CITY, TX 77459

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The Honorable Richard H. Baker
Chairman
Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
2129 Rayburn House Office Building
Washington, DC 20515

Dear Mr. Chairman:

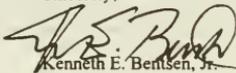
I am writing to request that you include the enclosed materials in the Subcommittee Hearing Transcript on Derivatives from July 26 and 27, 1995.

The materials that I submit are written correspondence between Merrill Lynch and former-Treasurer Robert Citron with Orange County related to the Orange County bankruptcy case. These letters demonstrate that both parties were aware of the risks associated with the derivative securities that Orange County invested in. I believe that it is critical that these letters should be included in the official record of this hearing to clarify all interested parties' intent. During the hearing, I referred to these materials in questions to witnesses and I would like the hearing record to include the actual documents that I spoke about.

Thank you for your consideration of this request. I certainly enjoyed participating in these hearings and look forward to working with you on future securities issues.

With kindest personal regards,

Sincerely,



Kenneth E. Bentsen, Jr.

Member of Congress

KEB:be

Merrill Lynch,
Pierce, Fenner & Smith Inc.
World Financial Center
North Tower
New York, New York 10281-1323
212 449 1000



Merrill Lynch

March 31, 1993

Mr. Robert L. Citron
Orange County Treasurer
630 N. Broadway, Room 209
Santa Ana, CA 92702

Dear Bob,

Enclosed please find an inventory of the structured Medium Term Notes sold by Merrill Lynch to, and currently owned by, Orange County. According to my records, this is a complete list as of the date of this letter. The attached schedule reflects our bids as of the close of business, March 31, 1993. If you are interested in selling any or all of your portfolio we would be pleased to update these bids, subject to changed conditions in the marketplace.

As we have discussed in the past, the prices of these securities can fluctuate. I would like to reiterate that the market for these notes will be affected by a number of factors independent of the creditworthiness of the issuers and the value of the applicable currency or interest rate index. Secondary market bids may be affected by the volatility of the applicable currency or interest rate index, the time remaining to maturity of each note, the amount outstanding of such notes and general interest rate movements.

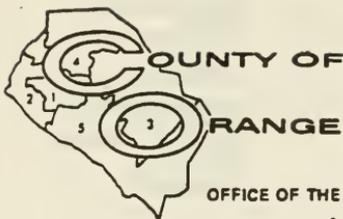
While the notes which Orange County owns have been structured to avoid principal risk at maturity, the price fluctuation of these notes prior to maturity may be volatile due to leverage. For example, a 5 year leveraged security with a coupon of 15% - 2 (6 month LIBOR) will have price volatility comparable to three 5 year Treasuries due to the fact that 3 fixed rate notes are used in the creation of the security. It is important to keep in mind that despite a relatively constant or rising current yield, the ultimate price of the note is derived from a multiple of the final maturity's comparable Treasury.

Please review the enclosed periodic Derivative Pricing Report and contact me immediately if there are questions. Subject to the terms set forth above, we would then be receptive to your response to any or all of these bids for a period of 30 days from the date of this letter.

Sincerely,

Michael G. Stameason
Director
Municipality Unit

MGS:dac



ROBERT L. "BOB" CITRON
COUNTY TREASURER-TAX COLLECTOR

ADMINISTRATION
FINANCE BUILDING
RM. 209, 120 W. BROADWAY
P.O. BOX 4515
SANTA ANA, CALIFORNIA 92702

(714) 834-2811

OFFICE OF THE TREASURER-TAX COLLECTOR

April 26, 1993

Mr. Michael G. Stamenson
Director, Municipality Unit
Merrill Lynch
Pierce, Fenner & Smith, Inc.
101 California Street, Suite 1400
San Francisco, CA 94111

Dear Mike:

This is in reply to your letter of March 31, 1993. Thank you for offering to make a secondary market for repurchase of derivative securities that we have previously purchased from you. At this point in time, and even projecting into the far future, we do not believe that we would be interested in selling these derivative securities. We have always been aware that Merrill Lynch would maintain a secondary market in all securities that we have purchased from them.

Your letter explained the alleged volatile interest coupon structure of these derivatives. We have always been aware of the vicissitudenary nature of the derivative securities that we have mainly bought from Merrill Lynch and others. Although there may be an alleged interest rate risk in these type of securities, we believe because of future low interest rates that the securities that we now own may be even more valuable than they are today. In fact, Mike, it was only after extensive consultation with highly placed Merrill Lynch officials by conference call, in person, and in writing well over a year ago that we felt secure in investing an even larger percentage of our portfolio in derivative securities. I would estimate that 95% of these securities were purchased from Merrill Lynch and 5% from other dealers.

Sincerely,

Robert L. Citron
County Treasurer-Tax Collector

RLC:jg

cc: Matthew R. Raabe
Assistant Treasurer

Michael G. Stammen
 Director
 Municipalities Unit

Institutional Sales

101 California Street
 Suite 1400
 San Francisco, California 94111
 415 274 7085

June 16, 1993



Mr. Robert L. Citron
 Treasurer
 Orange County Treasurer
 630 N. Broadway, Room 209
 Santa Ana, CA 92702

Dear Bob:

Thank you for your prompt response to my memo dated March 31, 1993. We understand that you do not wish to sell your derivative securities at this time and consider the investment a long-term investment. However, we would like to comment on Merrill's ability to "maintain a secondary market in all securities that we have purchased from them". While we certainly endeavor to maintain secondary markets in securities we sell, we are not allowed to guarantee the existence of any secondary market and would not want any investor to be under the impression that we would. We have always taken pride in the liquidity provided by our trading desks, but could not legally and do not represent that such a market would be in effect at any point in the future or what prices might be applicable. I belabor this point to emphasize that our March 31 bid letter was a specific offer to repurchase derivative securities Merrill had sold to you in the past.

In addition, I appreciate that you are aware of the risks involved in purchasing derivative securities and your expectation of low or lower interest rates in the future. I am also aware of our discussions with economists and market strategists at Merrill Lynch, but would not and could not represent that Orange County should base its' portfolio strategy exclusively on Merrill interest rate projections. The reason for our March bid letter was to allow Orange County the opportunity to lower its' risk profile in derivative securities at a profit. While no one knows for certain the direction of interest rates, we thought it appropriate to advise Orange County of the profitable market opportunity at this time. While the decision is yours to make, it was our hope to assist you in bringing the O.C. portfolio in line with a risk profile that is less leveraged and better positioned to perform in the event of unanticipated movements in interest rates.

The success of Orange County's investment portfolio, under your management, has been outstanding. We wish you continued success and offer any resources at Merrill that might help you in the future. Please feel free to call me at any point to discuss any of these issues and opportunities in the future.

With regards,

 A handwritten signature in dark ink, appearing to read 'Mike Stammen', written over a horizontal line.

Mike Stammen

MGS:mk

MR. SIGAL'S ANSWERS TO QUESTIONS
CAPITAL MARKETS SUBCOMMITTEE HEARING ON MUNICIPALITIES

1. Should the law require the State, not the municipality, to assert that bankruptcy is a last resort after all rational and feasible alternatives have been fully explored?

Yes. A municipality is, generally speaking, a creature of the State and derives all powers from the State. Accordingly, I believe that the law should require that the State, not the municipality, provide by law that bankruptcy should be the last resort and only after appropriate alternatives have been fully explored, including utilizing the municipal borrowing power as well as its taxing power. In other words, if the municipality (or a municipal assistance public authority) has access to the financial markets through the borrowing power and therefore can settle out any deficit or judgment, it can achieve a work-out without resorting to bankruptcy. In effect, that is exactly what New York City, Yonkers and others have done when facing significant fiscal distress.

2. Under what conditions was your contract with Orange County terminated?

Under the condition that it no longer required the legal services of our independent bond counsel firm.

3. Did Orange County officials declare bankruptcy to keep from getting sued? If so, is it your impression that filing for bankruptcy has proven to be an effective way for Orange County to limit its litigation expenses?

We were retained by Orange County only after it declared bankruptcy and, therefore, cannot answer the first question. With respect to the second question, I have no information with respect thereto.

4. Do the problems in Orange County suggest that Chapter 9's halt on lawsuits against the filing municipality could become a major incentive for troubled local governments to declare bankruptcy?

In general, I believe that a troubled local government should not declare bankruptcy unless it has explored all of its options. Certainly, I can imagine a certain category of lawsuits such as those relating to environmental pollution or the like which, if alleged as a complaint in major amounts against a municipality, may suggest that bankruptcy is the only solution whereas losses (such as cumulative operating deficits or investment losses) that are more quantifiable and able to be ascertained provide the municipality with the

opportunity to explore financing options without resorting to bankruptcy. In other words, if the liability exposure of the lawsuits are ascertainable, then the municipality has at least the ability to consider a financing option. However, if the extent of liability exposure in connection with the lawsuits cannot quite be determined, then it may be analogous to certain private corporation situations such as with respect to asbestos, etc., wherein bankruptcy may be the only viable alternative. Therefore, the question becomes academic, if the bankruptcy law is amended to require filing only as a last resort after all rational and feasible alternatives have been fully explored, as discussed in question 1, then the nature of the lawsuit or lawsuits would determine whether or not bankruptcy is the only viable alternative.

5. As several witnesses mentioned in their written testimony, Orange County has reserved the right to repudiate certain taxable debt that the County initially represented as a legal, binding and valid obligation. Is there, in your opinion, a need for state statutes that reaffirm and enforce such representations of validity and legality against later repudiation by a municipality?

In my opinion, there is no need for state or federal statutes to reaffirm and enforce representations of validity and legality against later repudiation by a municipality because, the last time I looked, there is still a federal constitutional provision precluding states and municipalities from impairing their contracts. Repudiation, in its technical sense, is a revoking of a valid contract which I do not believe is permitted by the Federal Constitution nor allowed in bankruptcy court as such. As I understand it, the bankruptcy court does not repudiate contracts as such but determines how much will be paid on such contracts, etc. In California there is a concept of "certificates of participation" which by their terms are not legal, binding and valid obligations in the same sense as a general obligation bond for which a municipality has pledged its full faith and credit. Accordingly, in California there needs to be careful analysis of the debt instrument itself to determine the actual terms of the obligation. For example, there can be a valid obligation to pay, subject to appropriation; if the municipality fails to appropriate, then there is no "repudiation" of that obligation in the technical sense in that the holder of the certificate took the risk that the municipality would not appropriate the debt service. This obviously has credit rating concerns and results for such a municipality but it is not technically a repudiation of its legal obligation. It may be on this question that there is some confusion about the actual obligations that Orange County issued.

APPENDIX

July 27, 1995

(695)

TESTIMONY

of the

GOVERNMENT FINANCE OFFICERS ASSOCIATION

presented by

TIMOTHY H. RIORDAN

President

Government Finance Officers Association

and

Finance Director

City of Dayton, Ohio

on

**State and Local Government Cash Management and
Debt Administration Practices**

presented to

**Subcommittee on Capital Markets, Securities, and
Government Sponsored Enterprises**

Committee on Banking and Financial Services

U.S. House of Representatives

July 27, 1995

**Summary of Testimony
of
Timothy H. Riordan, President
Government Finance Officers Association
and
Director of Finance
City of Dayton, Ohio**

Introduction

GFOA is a professional association of state and local government officials whose responsibilities include all the disciplines related to public finance. GFOA's 10,000 government members include both elected and appointed state and local government officials.

The GFOA testimony emphasizes five major points about state and local government cash management and debt administration practices.

1. The current regulatory framework, which includes local policies, state laws and federal oversight, has successfully governed cash management and debt administration practices and provided adequate investor and taxpayer protection.
2. GFOA believes the problems experienced in Orange County, California have many causes, but are primarily rooted in an investment strategy that was seriously flawed. It is clearly an issue of importance, but it is not an issue justifying federal intervention in state and local government cash management and debt administration practices. The problems in Orange County do not reflect a national trend.
3. State and local governments have taken and should continue to take steps to improve local cash management and debt administration by adopting sound financial policies. GFOA strongly urges S-L-Y investing. Safety and liquidity must be given priority over yield when investing public funds. GFOA also recommends that governments reaffirm their commitment to full and timely repayment of all debt.
4. GFOA is working to facilitate self-regulation of local financial practices. It will continue to undertake various projects to assist state and local governments improve their practices, including publications, training programs, technical assistance and adoption of best practice statements. For example, a year ago GFOA urged its members to use extreme caution when investing in derivatives. In addition, GFOA will continue to work with Congress, federal agencies and the private sector to further these objectives.

5. The federal government should confine its regulatory activities to regulation of markets, those who trade with state and local governments, and the instruments themselves.

Cash management can be defined as all activities undertaken to ensure maximum cash availability and maximum investment yield on a government's idle cash. These twin goals sometimes conflict with each other. Where such conflicts exist, GFOA cautions in all its literature and educational programs that safety and liquidity have a higher priority than yield.

The power to borrow is another of the most consequential activities undertaken in government finance. Borrowing permits state and local governments to raise the funds needed for large-scale capital projects and programs, as well as to meet their cash-flow needs. It is governed by special legal restraints and controls at all levels.

One of the functions implicitly reserved to the states by the Constitution is that of management of a state's own public finance activities and those of its political subdivisions. No local government may organize, perform any function, tax its citizens, or receive or spend money without the consent of the state. Thus, local governments, as political subdivisions of the states, look to state statutes and regulations for direction regarding permissible investments, debt financing, pension fund management and other functions. Federal intervention in cash management and debt administration would be a departure from the principles of federalism.

Suggestions for Improving Cash Management and Debt Administration

GFOA believes that there are many ways that participants in financial markets, including federal regulators, state policy makers, local officials and others, can improve state and local government investment and borrowing practices.

Local Actions. Local public officials are undertaking a review of their authorized investments and an analysis of their portfolios. They should be looking particularly at whether they have a written investment policy and if so, determining whether their policy addresses derivatives only generically (such as providing authority for U.S. government agencies) or more specifically (by description of particular products themselves). Local governments should develop debt policies and, if they have such policies, they should review them to make sure they are adequate and current.

State Roles. Many state governments are reviewing their policies and holdings at the state level for all state-administered funds as well as their state laws relating to local government investment policies and investment pools. We caution state legislatures not to overreact to the current environment by passing overly restrictive legislation that may tie the hands of local finance officials to engage in prudent yet flexible investing appropriate for a specific local jurisdiction. States should review their state laws governing debt administration and their other oversight and technical assistance activities to determine whether there are sufficient safeguards to avoid defaults, bankruptcies and other financial emergencies. States also should ensure that mechanisms and

procedures are in place for dealing with a financial emergency in one of its subdivisions, including determining under what circumstances a jurisdiction would be permitted to file for bankruptcy.

Federal Oversight. Among the recommendations GFOA makes to federal regulators regarding the regulation of markets, those who trade with state and local governments and the instruments themselves are expedited rulewriting on the part of the relevant regulators, strong enforcement of suitability rules, adoption of rules requiring improved disclosure by brokers and dealers of derivatives products to all customers, promotion of the use of volatility ratings and other evaluation tools, and monitoring of municipal market disclosure practices in light of new SEC rules and the SEC Interpretive Release on disclosure.

Congress can improve investor protection and debt administration by enacting investment adviser legislation, monitoring the sufficiency of sales practice rules written by federal regulators, ensuring that financial services legislation does not hinder the enforcement of sales practice rules, closing regulatory gaps related to securities firms and their affiliates regarding derivatives activities, continuing oversight of the derivatives market, passing balanced securities litigation reform legislation, reviewing federal bankruptcy laws, and refraining from imposing any new municipal bond disclosure requirements on state and local governments.

GFOA Activities. In addition to presenting testimony before both the House and Senate Banking Committees and monitoring investment and debt-related legislation and regulation, GFOA will continue to offer training, publications, recommended practices and policies that serve to educate its members. Examples of such recommended practices and policies are described in the next section. GFOA will continue to work with federal, state and local governments, as well as the private sector, to maintain confidence in the investment practices and debt administration of state and local governments and in the financial markets in general. The Association is committed to finding new ways of strengthening investment practices and promoting investor protection.

Overview of Cash Management Practices

For many years, the Association has undertaken a number of activities to promote good cash management practices. GFOA has supported model investment legislation for state and local governments, full disclosure for local government investment pools, legislation providing for sales practice rules for brokers and dealers of U.S. government securities, and legislation providing for more frequent inspections and more thorough oversight of investment advisers.

The Association has also developed a sample investment policy for state and local governments. Recommended practices have been adopted and promoted dealing with issues such as collateralization of public funds; precautions to take in investing in mutual funds; selection of investment advisers; recommended investment instruments for public funds; guidance for public entities considering the use of derivatives; market risk (volatility) ratings; risks associated with reverse repurchase agreements, leveraging, and prudent investment practices; support for mark-to-market practices for state and local government investment portfolios and investment pools;

development of master trust and custodial bank security lending programs; and support for written investment policies.

GFOA supports the clarification or issuance of suitability rules for derivatives to assure that the products recommended by a broker or dealer are appropriate for the state or local government entity. Suitability obligations on the part of brokers and dealers arise with respect to the relationship between a particular recommended instrument and a customer's constraints and affinity for risk. Because of the risk associated with some investment vehicles, a given instrument may not be appropriate for a specific investor. Given the characteristics and needs of a particular jurisdiction, even a profitable investment may be unsuitable.

It is GFOA's view that the Government Securities Act Amendments of 1993 already provide for a regulatory structure to be developed that encompasses many of the troublesome derivatives products now being used by investors. The National Association of Securities Dealers, Inc. (NASD) has just issued rules under this statute, and Congress should ensure that the final regulations, to be approved by the Securities and Exchange Commission, are consistent with Congressional intent and that "sophisticated" investors, including governments, are not excluded from suitability obligations.

Overview of Debt Administration

The act of borrowing is one of the most potent and profound activities undertaken in government finance and it encompasses such activities as deciding whether to incur debt and determining whether the jurisdiction has the fiscal capacity to repay the debt, selecting consulting specialists, obtaining public support for general obligation issues through a voter referendum, designing the structure of the debt, preparing the security agreement for bonds that are not backed by a pledge of the full faith and credit of the issuer, marketing the bonds, and managing the outstanding debt.

State governments have constitutional responsibilities over local governments' debt administration. Strong state supervision of debt practices is often accompanied by the fear that always exists that a local jurisdiction might over-commit itself and default on its repayment of debt, thereby impairing the efforts of other local units in a state, and perhaps the state itself, to obtain capital. State requirements may differ, however, depending on the type of government issuer and type of debt issued. Direct state involvement in local government debt management can take a variety of forms.

Local governments control their own debt practices through the adoption of debt policies that are developed within the context of existing state laws. Debt policies typically address types of debt to be issued, acceptable levels of indebtedness, permitted purposes, priorities among types of projects to be financed, policies regarding the use of tax-supported versus self-supporting (revenue) debt, the mix between the use of current revenues and borrowing to finance capital and other needs, and the appropriateness of and acceptable levels of short-term indebtedness. Debt policies are submitted to a jurisdiction's elected officials or governing body for consideration and approval.

While the federal government does not directly regulate state and local government borrowing practices, several federal laws significantly affect state and local issuers. The federal income tax code specifies the rules for determining if a state and local government bond may be issued on a tax-exempt basis and severely restricts bond issuance procedures and the investment of bond proceeds in higher yielding securities to limit arbitrage earnings.

State and local government securities have been subject to the antifraud provisions of the federal securities laws since the 1930s. The securities laws provide an exemption for these securities from the registration and information reporting requirements that apply to corporate securities, based primarily on the principle of intergovernmental comity. In general, federal regulatory efforts primarily have been focused on brokers and dealers of municipal securities through rules adopted by the Municipal Securities Rulemaking Board (MSRB), which was established by Congress in the mid-1970s. The Tower Amendment to the Securities Exchange Act of 1934 prohibits the MSRB and the SEC from requiring municipal issuers to file any document prior to the sale of the securities with the MSRB or the SEC. The MSRB was further prohibited from requiring any information to be furnished by an issuer to prospective purchasers after the securities have been sold.

SEC Rule 15c2-12, adopted in 1990, requires underwriters to obtain and review official statements for municipal issues they are underwriting, to make copies of those offering documents available to potential investors and to file those documents in the Municipal Securities Information Library, a central repository operated by the MSRB. Amendments to Rule 15c2-12 adopted last fall prohibit dealers from underwriting municipal securities of \$1.0 million or more unless the issuer or an obligated person has undertaken in a written agreement or contract to provide annual financial information, which includes financial and operating data, and material events disclosure on a timely basis.

Chapter 9 of the Federal Bankruptcy Laws is designed to provide a mechanism for a governmental entity to work with its creditors to adjust its debts. Chapter 9 recognizes the special circumstances of governmental financial emergencies and is primarily for the purpose of debt adjustment. A specific authorization by the state is necessary for a local government to file for bankruptcy. Additionally, the government seeking bankruptcy protection must demonstrate that it is insolvent, meaning that its liabilities exceed its assets.

GFOA has placed significant emphasis on the identification and use of best practices for debt administration, including support for the development of a comprehensive debt policy; undertaking a comprehensive analysis of debt capacity on a routine basis; factors to consider when undertaking an advance refunding of outstanding debt; the sale of derivatives products such as floaters, forwards, futures and options by state and local governments; support for a merit-based process for the selection of underwriters and other finance professionals; opposition to the issuance of tax-exempt securities for the sole or primary purpose of investing the proceeds in higher yielding taxable or tax-exempt obligations; support for comprehensive and timely disclosure in the primary and secondary

markets consistent with guidelines developed by GFOA; and selection of the sale of bonds on a competitive or negotiated basis.

Policy statements of the Association address such topics as support for commercial bank underwriting of municipal revenue bonds; elimination of the application of the alternative minimum tax on tax-exempt bonds; relief from overly burdensome tax code restrictions in the tax-exempt bond area; and support for balanced securities litigation reform legislation.

GFOA has undertaken or has planned several significant projects to improve state and local debt administration, including the provision of guidance to issuers about primary and secondary market disclosures in connection with the sale of bonds through its publication, Disclosure Guidelines for State and Local Government Securities; recognition for governments preparing financial reports consistent with generally accepted accounting principles (GAAP); and an upcoming videoconference on the new disclosure responsibilities of municipal issuers. GFOA has also compiled a reference guide for its members and other government officials that contains information about the new SEC rules that will facilitate their compliance efforts.

GFOA worked extensively with the SEC and other market participants in the development of recent amendments to SEC Rule 15c2-12 affecting secondary market disclosure practices. The Association supports the rule changes approved by the SEC last November. It believes no new regulation is needed and it strongly opposes repeal of the Tower Amendment.

The existing regulatory framework has performed admirably in deterring defaults and bankruptcies in view of the large number of issues coming to market each year of varying size and sophistication and the large number of governments that have issued debt. The SEC and others verify that municipal bankruptcies and defaults are rare. This is a direct result of state involvement, local governments' commitment to strong financial management, market forces and the stigma attached to such actions. In a recommended practice adopted in June by the GFOA, local governments are advised that their debt policies should explicitly recognize a long-term commitment to full and timely repayment of all debt as an intrinsic requirement for entry into the capital markets.

I. INTRODUCTION

Good morning Mr. Chairman and members of the Subcommittee. My name is Timothy H. Riordan. I am President of the Government Finance Officers Association (GFOA) and Finance Director of the City of Dayton, Ohio. GFOA is a professional association of state and local government officials whose responsibilities include all the disciplines related to public finance. Our Association is almost 100 years old, and our 10,000 government members include both elected and appointed state and local government officials. Our Association is honored to have this opportunity to appear before the Subcommittee on the Capital Markets, Securities, and Government Sponsored Enterprises.

Today, I want to emphasize five major points about state and local government cash management and debt administration practices.

1. The current regulatory framework, which includes local policies, state laws and federal oversight, has successfully governed cash management and debt administration practices and provided adequate investor and taxpayer protection.
2. GFOA believes the problems experienced in Orange County, California have many causes, but are primarily rooted in an investment strategy that was seriously flawed. It is clearly an issue of importance, but it is not an issue justifying federal intervention in state and local government cash management and debt administration practices. The problems in Orange County do not reflect a national trend.
3. State and local governments have taken and should continue to take steps to improve local cash management and debt administration by adopting sound financial policies. GFOA strongly urges S-L-Y investing. Safety and liquidity must be given priority over yield when investing public funds. GFOA also recommends that governments reaffirm their commitment to full and timely repayment of all debt.
4. GFOA is working to facilitate self-regulation of local financial practices. It will continue to undertake various projects to assist state and local governments improve their practices, including publications, training programs, technical assistance and adoption of best practice statements. For example, a year ago GFOA urged its members to use extreme caution when investing in derivatives. In addition, GFOA will continue to work with Congress, federal agencies and the private sector to further these objectives.
5. The federal government should confine its regulatory activities to regulation of markets, those who trade with state and local governments, and the instruments themselves.

II. SUGGESTIONS FOR IMPROVING CASH MANAGEMENT AND DEBT ADMINISTRATION

GFOA believes that there are ways that participants in financial markets can improve state and local government investment and borrowing practices. Local governments must concentrate their efforts on practices and policies, states must review their statutes and other forms of involvement and the federal government should focus on regulatory activities related to the markets, those who trade with state and local governments and the instruments themselves. What follows are suggestions for implementing improvements.

Local Governments

1. Given the current level of concern among state and local elected officials regarding investment policies and portfolio holdings, local public officials are undertaking reviews of their authorized investments and an analysis of their portfolios. They should be looking particularly at whether they have a written investment policy and if so, determining whether their policy addresses derivatives only generically (such as providing authority for U.S. government agencies) or more specifically (by description of particular products or characteristics of products).
2. Local governments should develop debt policies and, if they have such policies, they should review them to make sure they are adequate and current. Particular attention should be paid to the use of short-term debt, which if used inappropriately, can trigger financial difficulties.

State Governments

1. Many state governments are reviewing their policies and holdings at the state level for all state-administered funds as well as their state laws relating to local government investment policies and investment pools. States should also review their regulation of insurance company affiliates that are dealers of derivatives products to ensure that state insurance regulations are adequate with regard to these activities.
2. While GFOA believes such reviews are important, the Association cautions state legislatures not to overreact to the current environment by passing overly restrictive legislation that may tie the hands of local finance officials to engage in prudent yet flexible investing appropriate for a specific local jurisdiction. GFOA urges state governments to work closely with local public finance professionals in determining solutions to problems that may exist in their jurisdictions.
3. States should review their state laws governing debt administration and their other oversight and technical assistance activities to determine whether there are sufficient

safeguards to prevent defaults, bankruptcies and other financial emergencies. In the event that a local unit experiences financial difficulties, states also should ensure that mechanisms and procedures are in place for dealing with a financial emergency in one of its subdivisions, including determining under what circumstances a jurisdiction would be permitted to file for bankruptcy.

4. States also should carefully review their campaign disclosure laws in response to concerns about inappropriate linkages between campaign contributions and the selection of consultants who assist in municipal bond transactions. Information about political contributions should be collected on a timely basis and made easily accessible. In addition, steps should be taken to ensure that there is a full and fair accounting of the amount and sources of political contributions.

Federal Regulatory Agencies

1. Regulators should expedite rulewriting, provide strong enforcement of suitability rules, and take steps to improve transparency, which is disclosure of information regarding not only pricing but also fees and mark-ups on instruments.
2. Regulators should adopt rules requiring improved disclosure by brokers and dealers of derivatives products to all customers regarding the types of transactions being entered into and possible risks associated with those transactions. We suggest that requirements imposed on Bankers Trust Company by the Federal Reserve Board be applied routinely. These include getting prior approval to sell leveraged derivatives, disclosing to customers how the value of the contract will be affected by changes in the markets, ensuring that customers have the capability to understand the derivatives being marketed, agreeing not to sell complicated derivatives to unsophisticated customers, and disclosing to customers how profits and losses are calculated on each trade.
3. Regulators should encourage the use of volatility ratings and other evaluation tools in order to assist investors in gauging the risks associated with particular products.
4. Regulators should monitor municipal market disclosure practices in light of new SEC rules and the SEC Interpretive Release concerning disclosure responsibilities of issuers to ensure that state and local governments have ample guidance and assistance. In addition, SEC cooperation with market participants in the preparation of informational resources and the delivery of educational programs will be key to the successful implementation of the new SEC disclosure rules.

Congress

1. Expedient enactment of investment adviser legislation is essential in order to provide for more frequent inspection and additional oversight of those who hold themselves out as investment advisers to state and local governments and other investors.
2. The appropriate committees should exercise oversight of the sufficiency of sales practice rules written by federal regulators under authority of the Government Securities Act Amendments of 1993 to ensure that such rules are consistent with the directives of the legislation and accompanying committee directives.
3. Any financial services reform legislation exempting banks from regulation of broker/dealer activity with respect to certain securities activities or transferring regulation of newly acquired securities activities to the banking environment must ensure that such provisions do not hinder the enforcement of sales practice rules.
4. Regulatory gaps related to securities firms and their affiliates regarding derivatives activities should be closed in order for the activities of such affiliates to be subject to scrutiny as are their parent firms.
5. The appropriate committees must continue their oversight of the derivatives market to determine if additional legislation is needed regarding the creation or marketing of derivatives products.
6. Passage of balanced litigation reform legislation that protects investor rights and does not immunize from liability professionals who assist issuers is crucial to a safe marketplace.
7. Review of federal bankruptcy laws may need to be undertaken, as has been done periodically, if needed changes are identified as a result of the resolution of the Orange County bankruptcy and default.
8. Congress should refrain from imposing any new municipal bond disclosure requirements on state and local governments. The new SEC disclosure rules should be given a fair chance to be implemented and evaluated. The focus should be on SEC enforcement of existing rules rather than the adoption of a new federal mandate.

Rating Agencies

1. GFOA applauds projects already underway by the national rating agencies such as Fitch Investors Service and Standard and Poor's in establishing volatility ratings for

mutual funds. GFOA urges them to continue to examine instruments and work toward an industry standard in finding ways to provide additional and continuing information to investors regarding new and complex investment instruments.

2. In addition, the rating agencies have heightened their scrutiny of the investment practices of state and local governments, especially those involving pooled investment instruments. This heightened scrutiny will be an ongoing process of credit analysis. GFOA urges rating agencies to closely review investment results, either positive or negative, that may be contrary to general market results and those of similar entities.

GFOA

1. Professional associations such as GFOA must continue to offer training, publications, recommended practices and policies that serve to educate their members. GFOA will continue to work with its membership in assessing their needs for additional training and guidance and will continue to work to this end by developing more recommended practices such as the ones described in the next section and promoting the use of such practices.
2. GFOA believes that by working together with federal, state and local governments, as well as the private sector, confidence in the investment practices and debt administration of state and local governments and in the financial markets in general will be maintained. GFOA looks forward to the opportunity to find new ways of strengthening investment practices and promoting investor protection so that financial emergencies such as Orange County's can be avoided.

III. OVERVIEW OF CASH MANAGEMENT

As a professional association, GFOA's mission is to enhance and promote the professional management of governmental financial resources. For many years, the Association has been the recognized leader in the area of cash management, which encompasses such activities as:

1. the receipt and deposit of cash and negotiable payments,
2. custody of monies and securities of the state or local government entity,
3. reimbursement of funds upon proper authorization,
4. selecting and dealing with financial institutions,

5. investment of cash in instruments that are authorized under applicable statutes, policies and guidelines,
6. cash budgeting and forecasting, and
7. short-term borrowing to meet temporary cash-flow shortfalls.

One of the functions implicitly reserved to the states by the Constitution is that of management of a state's own public finance activities and those of its political subdivisions. No local government may organize, perform any function, tax its citizens, or receive or spend money without the consent of the state. Thus, local governments, as political subdivisions of the states, look to state statutes and regulations for direction regarding permissible investments, debt financing, pension fund management, and other functions. With respect to cash management, state regulation sets the outer limits of local investment policies, authorized investments and concentrations in types of investments, as well as collateralization requirements and other procedures. Within state constraints, local government entities then formulate their own guidelines, many of which restrict authorized investments even further. State laws also govern the creation and management of investment pools.

The role of the federal government has been regulator of those who trade with these entities -- primarily financial institutions and broker/dealers -- or regulator of many of the instruments themselves, but not the regulator of state or local government entities or their financial policies. Such intervention would be a departure from the principles of federalism that reserve certain powers to the states.

GFOA Model Legislation. In 1984, GFOA developed and approved Model Investment Legislation for State and Local Governments that provides a universe of appropriate investment instruments and outlines a series of considerations that should underlie the application of an investment policy at the state or local government level. These guidelines have since been updated as needed and are currently undergoing review.

The GFOA model legislation, in addition to providing a list of appropriate instruments, also includes model legislation for local government investment pools. These pools consist of funds from local governments and are placed in the custody of the state and managed by state officials. While the model legislation refers specifically to state pools, the same operating principles should apply to pools administered locally as well. In the past, local pools have been viewed favorably as they allow small investors to gain the expertise and economies of scale generally available to only larger funds. The model legislation includes provisions relating to:

1. the method of establishing such a pool,
2. creation of a local government investment board, including a member from the state treasurer's office, a representative of county officials, a representative of local

- government finance officers, a representative of school business officials, and a professional in the field of investment and finance who holds no other public office,
3. board functions, including rules for prudent and necessary investment of funds, selection of an investment officer or agent, reporting to pool participants, budgeting and approval of expenditures for the fund's administrative costs, and contracting for legal or other professional assistance,
 4. adoption of rules and regulations necessary to administer the pool, including authorized investments, minimum amounts to be deposited for pool participation, payment of expenses, equitable distribution of earnings or allocation of losses to pool participants, procedures for deposit and withdrawal of funds, and procedures for custody and safekeeping of funds,
 5. authorized investments,
 6. accounting and controls procedures, and
 7. collateral for public deposits.

GFOA Sample Investment Policy. In response to requests from its members for more specific guidance on their investments, the GFOA Committee on Cash Management recently released the GFOA Sample Investment Policy. The purpose of the policy is to aid GFOA members and others in the preparation of their own jurisdiction's policies guiding the investment of short-term operating funds. Entities are encouraged to use this as a model and to customize it to fit their needs and comply with their own state and local laws. It is a complement to the GFOA Model Legislation, and addresses a concern expressed by House Banking Committee Chairman Leach when GFOA testified before the committee last fall.

The GFOA Sample Investment Policy speaks to the following:

1. the objective of investment activities,
2. standards of care,
3. safekeeping and custody,
4. suitable and authorized investments,
5. investment parameters,
6. reporting requirements, and

7. investment pools, adapted from the National Association of State Treasurers' guidelines.

We have incorporated by reference applicable GFOA Recommended Practices in the cash management area, which are discussed in more detail below.

GFOA Recommended Practices and Policies on Cash Management

Another aspect of GFOA's efforts to promote good cash management practices and procedures is the adoption of public-policy positions. In the cash management area, the Association has developed recommended practices for state and local governments and policy statements addressing federal legislative and regulatory activities that affect cash management.

Our recommended practices deal with such issues as:

1. the appropriate use of repurchase agreements as an integral part of an investment program,
2. support for collateralization of public deposits through the pledging of appropriate securities to fully guarantee the safety of funds and support for other risk control procedures,
3. precautions to take when investing public funds in mutual funds,
4. support for competitive bidding in securities purchases and the acquisition of written documentation of price mark-ups from securities dealers prior to the completion of a transaction that is not competitively bid,
5. the selection of investment advisers,
6. recommended investment instruments for public funds,
7. support for the creation of state-administered investment pools and other investment pools created through joint powers statutes and other intergovernmental agreement legislation, and
8. guidance to public entities thinking about using derivatives, which urges finance officers to exercise extreme caution in the use of derivatives instruments, to consider their use only when they have developed a sufficient understanding of the products and the expertise to manage them, and to evaluate the appropriateness of such use for their jurisdictions, including applicable statutes, risk awareness, establishment of internal controls, and relationships with brokers, dealers and investment managers dealing in derivative products.

In June 1995, the Association passed a number of new recommended practices for cash management. These practices include:

1. support for the use of market risk (volatility) ratings in evaluating investment instruments,
2. caution about the use of reverse repurchase agreements, leveraging, and prudent investment practices,
3. endorsement of mark-to-market practices for state and local government investment portfolios and investment pools,
4. development of master trust and custodial bank security lending programs, and
5. support for written investment policies.

Policy statements of the Association address such topics as:

1. support for the Model Investment Legislation for State and Local Governments developed by the GFOA Cash Management Committee,
2. endorsement of the National Association of State Treasurers' Statement in Favor of Full Disclosure for Local Government Investment Pools,
3. support for federal legislation providing for sales practice rules for brokers and dealers of U.S. government securities,
4. support for federal legislation providing for more frequent inspections and more thorough oversight of investment advisers, and
5. support for clarification or issuance of suitability rules for derivatives to assure that the products recommended by a broker or dealer are appropriate for the state or local government entity, an accelerated accounting standard-setting process for derivatives products by the Financial Accounting Standards Board, setting reasonable capital requirements for brokers and dealers, and the closing of regulatory gaps related to securities firms and insurance companies that are dealers of derivatives products.

Suitability

One of GFOA's particular concerns in all financial markets is the issue of suitability. Suitability obligations on the part of brokers and dealers arise in discerning the relationship between a particular instrument and a customer's constraints and affinity for risk. For example, because of

the risk associated with some investment vehicles, a given instrument may not be appropriate for a specific investor. Loss alone, however, does not determine unsuitability. A jurisdiction may invest in an instrument that results in a better-than-expected return, or it may have a mix of investments that include both winners and losers, resulting in no net loss. In either case, some of those investments may have been unsuitable given the characteristics and needs of the jurisdiction.

Similarly, size alone is not determinative of knowledge or sophistication. Proposals are often made to exclude from suitability obligations on the part of a broker or dealer those investors, including governments, whose budget or investment portfolio exceed a given level, based on the assumption that these entities are somehow deemed to be "sophisticated." Recent events confirm that size does not necessarily equal sophistication, and that whether there is a suitability issue depends not only on the level of expertise, knowledge and ability of the investor, but on the facts and circumstances of a given case, including the fact that, as custodians of public funds needed for public purposes, state and local government jurisdictions have a much lower risk tolerance than their private-sector counterparts may.

Finance officers report that derivatives are being aggressively marketed to governments that are assured in many cases by the sales force that the products are safe, government-guaranteed, and will protect principal. Based on these representations, finance officers may determine that an instrument falls within the parameters of a jurisdiction's investment policy, while remaining unaware of the risks associated with the instrument. If the value begins to decline, some finance officers have been assured that it will bounce back. In short, many cautious finance officers believe that they have been misled and that these products have been misrepresented, in part due to a lack of understanding by the broker/dealer trading them. Many of those selling these products played no part in creating them, and may have only limited knowledge themselves regarding the risks. However, these brokers and dealers earn large commissions from the sale of these securities. Unfortunately, there is a decided lack of unbiased information available to investors regarding specific derivatives, even from outside investment advisers or bond counsel, who are often called upon for advice, but who also may not be familiar with these complex instruments.

Federal law now authorizes sales practice rules governing suitability, price mark-ups and churning in the government securities market. It is under this authority that the National Association of Securities Dealers, Inc. (NASD) has issued a rule on suitability obligations of broker/dealers. In addition, GFOA and the Public Securities Association are developing a Broker/Dealer Agreement. These initiatives are discussed in more detail below.

Other GFOA Efforts in the Cash Management Area

GFOA has undertaken several other significant projects to improve state and local government cash management practices.

GFOA-MBIA Survey of Government Investment Practices. GFOA and the MBIA Insurance

Corporation (MBIA) recently conducted a survey of over 1,300 governmental units across the U.S. and Canada to determine the nature of their investment practices. A copy of the results of this survey is attached to this testimony. This survey indicates that many government investment policies restrict investments in derivatives, that most governments follow conservative investment practices and that they do little investing in exotic instruments. The survey also found that a significant proportion of the respondents have reviewed or revised their investment policies since the Orange County bankruptcy filing.

GFOA Cooperation with Other Public Sector Organizations. GFOA is also cooperating with other state and local government organizations in efforts to improve cash management practices. Earlier this year, three seminars were held in conjunction with the National Conference of State Legislatures to address issues relating to state investment statutes and local government investment pools. GFOA is currently working with the National Association of State Treasurers to update its local government investment pool guidelines, which you will hear more about today from NAST.

GFOA Broker/Dealer Agreement. As part of its continuing effort to encourage responsible cash management and appropriate investing, GFOA is working with the Public Securities Association (PSA) to reach consensus on a broker/dealer trading agreement that would provide guidelines for establishing a trading relationship between broker/dealers and governmental units. GFOA does not expect nor advocate that dealers become insurers against losses that may result from market fluctuation or miscalculation by the investor. Instead, this agreement would assist all parties to a transaction in understanding the information to be disclosed by broker/dealers and governmental investors and to recognize the participants' respective responsibilities for dealing with the suitability of investments. Many GFOA members are already using some version of the GFOA Broker/Dealer Agreement successfully in their arrangements with their brokers and dealers.

Federal Legislative and Regulatory Reforms to Improve Cash Management.

GFOA has also been active at the federal level as it assists Congress and the Executive Branch in understanding state and local government cash management practices and in pursuing effective legislative and regulatory reforms that would lead to better management of public funds.

Government Securities Act Amendments of 1993. GFOA has long been in the forefront of federal activities related to state and local public finance issues, particularly with regard to investor protection issues. The Association took the initiative during the reauthorization process of the Government Securities Act in insisting that sales practice rules, which include suitability for brokers and dealers, be included in the reauthorization. GFOA testified several times before both House and Senate committees concerning this legislation. The Government Securities Act Amendments of 1993, as passed, include authority for rulemaking for both bank and non-bank regulators to write sales practice rules dealing with practices such as suitability, mark-ups and churning. It is GFOA's view that the Act already provides for a regulatory structure to be developed that encompasses many of the troublesome derivatives products now being used by investors.

In comments submitted to the NASD regarding its proposed sales practice rules issued under the Act, which focused particularly on the suitability obligation, GFOA urged the NASD to strengthen its draft by requiring certain affirmative duties on the part of broker/dealers in making a suitability determination. The NASD rules have just been issued and are subject to approval by the Securities and Exchange Commission (SEC). Financial institution regulators are currently drafting their versions of sales practice rules. This is a priority issue for state and local government investors, and will continue to receive the attention as well as the active involvement of the GFOA membership.

General Accounting Office. GFOA also cooperated with the General Accounting Office (GAO) in its report on the use of derivatives and actions needed to be taken in this market, which was issued in May 1994 (*Financial Derivatives: Actions Needed to Protect the Financial System*, GAO/GGD-94-133). GFOA assisted in drafting the survey sent to public finance officers and participated in follow-up meetings with the GAO and Congress regarding the results. GFOA also conducted its own survey regarding use of derivatives for debt issuance in conjunction with MBIA, which was released in June 1994.

Congress and the Executive Branch. In addition to presenting testimony before both the House and Senate Banking Committees, GFOA also is monitoring investment-related legislation, such as H.R. 20, introduced by Chairman Leach earlier this year regarding derivatives activities of financial institutions. We note that this legislation contains several provisions specifically related to training and standards in the use of derivatives by state and local governments.

GFOA is particularly committed to the enactment of investment adviser legislation and has undertaken this effort during each of the last several Congresses. This legislation, which would provide a mechanism for funding additional oversight by the SEC of the investment adviser and financial planning industry, is needed to address the explosive growth in this industry. State and local government investors frequently engage such assistance to help them understand some of the more complex transactions they may undertake and to get professional advice that might not be available from their own staff. In addition to the well-documented losses of over \$100 million, which resulted from the advisory practices of Steven Wymer, recent news reports note the role such advisers have played in the current volatile market. Yet, despite passage by both houses in previous Congresses, investment adviser legislation has not been enacted. GFOA has submitted comments to the SEC in support of its initiatives under its current statutory authority in this area.

GFOA has worked closely with a number of federal regulators such as the Federal Reserve Board, the Commodity Futures Trading Commission, the Department of the Treasury, and the Securities and Exchange Commission on issues such as how state and local governments use derivatives, what the purposes of their use are, how derivatives are marketed to finance officers, and what restrictions should or should not be placed on the use of derivative instruments, and by whom. GFOA submitted formal comments to the CFTC regarding proposed exemptions from regulations in the swaps markets and is represented on the newly reinvigorated Advisory Committee on CFTC-State Cooperation.

GFOA has participated in meetings with the President's Working Group on Financial Markets and other state and local government organizations in examining what activities had occurred on behalf of each of these groups. A joint statement was issued by the participants indicating that, in this ongoing effort, we intend to continue to promote the use of sound investment policies by public entities through a number of methods.

Private Sector Initiatives. Two initiatives largely driven by the private sector, but coordinated by federal agencies, are the efforts of the Derivatives Policy Group (DPG), led by the SEC and the CFTC, and the Principles and Practices for Wholesale Financial Markets Transactions group (Principles), headed by the Federal Reserve Bank of New York. The DPG, comprised of six leading industry firms, has formulated a voluntary oversight framework intended to address issues regarding over-the-counter (OTC) derivatives activities, including management controls, enhanced reporting, evaluation of risk in relation to capital and counterparty relationships. The Principles' group, comprised of six organizations representing industry participants in the OTC market, was formed to establish a set of "best practices" for both dealers and end-users in the wholesale market.

While GFOA was not involved in the DPG, we have recently been invited to contribute to the discussions regarding the formulation of the Principles. The Association has submitted several comment letters and has met twice with the Principles' drafting committee in order to inform the drafters about the state and local governments who are end-users of many financial products. These discussions continue.

IV. OVERVIEW OF DEBT ADMINISTRATION

The Orange County, California, bankruptcy and default on outstanding notes have raised questions about the practices and procedures of local governments related to debt planning and issuance as well as the management of outstanding debt. The power to borrow is one of the most tightly regulated and closely scrutinized activities of local governments. State governments have historically placed special legal restraints and controls on their local governments' borrowing behavior and have involved themselves directly in supervising and assisting different aspects of the local borrowing process. Local governments themselves develop debt policies that address various practices and establish guidelines about the use of debt consistent with the state-law framework. Finally, the federal government strongly influences state and local government debt policies and practices through provisions of the federal income tax code, securities laws and the bankruptcy code. The act of borrowing encompasses such activities as:

1. deciding whether to incur debt and determining whether the jurisdiction has the fiscal capacity to repay the debt,
2. selecting consulting specialists such as the financial advisor, bond counsel, and underwriter to assist in the transaction,

3. obtaining public support for general obligation issues through a voter referendum,
4. designing the structure of the debt which includes the maturity schedule, bond denominations, coupon rates, and call provisions,
5. preparing the security agreement for bonds that are not backed by a pledge of the full faith and credit of the issuer detailing how bond proceeds will be disbursed, how facility revenues will be used and what covenants have been made,
6. marketing the bonds, which includes determining the method of sale (competitive or negotiated), preparing sales documents such as the official statement (OS), obtaining a rating, obtaining bond insurance, advertising the sale, reviewing the bids, selecting the underwriter and closing the sale, and
7. managing the outstanding debt which includes maintaining records, investing bond proceeds, complying with federal arbitrage regulations, maintaining relations with rating agencies and investors, providing secondary market disclosure information and monitoring refinancing opportunities to reduce borrowing costs when interest rates fall.

State Regulatory Activities. States are the sovereign and superior governmental entities for the geographic areas they encompass and have constitutional responsibilities over local governments within their boundaries. As such, they may exercise control over all aspects of debt issuance and management. Individual state approaches to the control of long-term and short-term borrowing vary widely. Strong state supervision is often accompanied by the fear that always exists that a local jurisdiction might over-commit itself and default on its repayment of debt, thereby impairing the efforts of other local units in a state, and perhaps the state itself, to obtain capital. Local governments generally operate under several state statutory controls over their borrowing powers. State requirements may differ, however, depending on the type of government issuer (county versus city) and type of debt issued (general obligation versus revenue bond debt). Direct state involvement in local government debt management may take a variety of forms, such as:

1. collection of financial and other information related to local government finances, maintenance of central data files and dissemination of data about local government debt issues,
2. provision of educational materials and programs regarding debt issuance and management,
3. advisory review of legal and fiscal aspects of debt issues and state involvement in the preparation of bond documents, or

4. mandatory approval of debt issues either in particular or as an integral part of broader supervision of local financial decisions and budgets.

The level of an individual state's involvement in local debt management is dependent on many factors. For example, the state may take the view that a strong state role is not necessary because the municipal market serves as a sufficient regulatory force. Rating agencies, bond insurers and underwriters are presumed to have sufficient knowledge and a significant financial stake in transactions to analyze the borrowers themselves and to restrict market access if necessary. Additionally, the state may not aggressively enforce those requirements that are in effect and rely on bond counsel to attest to the legality of the transactions, including compliance with state laws.

The political and public financial history of a state also can influence its involvement in local finance practices. Problems of fiscal integrity and financial solvency dating back to the 1930s prompted some states to become heavily involved in local debt practices. In others, local governments have faced little financial difficulty; hence, there has been little need for a large state role. The size, number and diversity of local governments in a state may have an impact on the design and operation of state programs and the quality of financial management achieved by individual local governments without state involvement may forestall an expansive state role. If home-rule powers are granted to local governments, the state role may be limited as it applies to these jurisdictions.

Most, but not all, state restrictions on local government borrowing have been aimed at tax-exempt general obligation debt and its pledge of taxing power. State involvement in long-term general obligation debt may include some or all of the following:

1. the requirement of a voter referendum to approve the debt,
2. a prescribed maximum maturity on the debt,
3. the requirement for a competitive sale,
4. establishment of a debt limit,
5. state review of proposed debt issues, and
6. state approval of bond issues prior to the sale.

If a state permits the issuance of short-term debt, some key features of state involvement are:

1. restrictions on the uses for short-term borrowing,
2. limits on the maturity of short-term debt,

3. limits on the amount of short-term debt, and
4. state approval of short-term debt prior to the sale.

Other state-law provisions that may influence debt issuance are tax and expenditure limitations and state laws limiting revenue bases that may be taxed by local governments because they affect future revenue-raising powers; state blue-sky laws that impose registration, disclosure and other requirements on issuers in a state; and state laws regarding municipal bankruptcy which cover bankruptcies within the state or require a state agency to assist a local government prior to bankruptcy and perhaps assume control over a financially troubled local government unit.

Local Debt Policies. Local governments control their own debt practices through the adoption of debt policies that are developed within the context of existing state laws. Debt policies typically address types of debt to be issued (tax-exempt versus taxable), acceptable levels of indebtedness, permitted purposes for debt issuance, priorities among types of projects to be financed, policies regarding the use of tax-supported versus self-supporting (revenue) debt, the mix between the use of current revenues and borrowing to finance capital and other needs and the appropriateness of and acceptable levels of short-term indebtedness. Debt policies are submitted to a jurisdiction's elected officials or governing body for consideration and approval. Debt policies establish criteria for the issuance of debt obligations so as not to exceed acceptable levels of indebtedness, they transmit a message to investors and rating agencies who value such evidence of a community's commitment to financial management and provide consistency and continuity to public policy development by providing a set of guidelines to govern local decision making.

Federal Tax Law Restrictions. While the federal government does not directly regulate state and local government borrowing practices, several federal laws significantly affect state and local issuers. The federal income tax code specifies the rules for determining if a state and local government bond may be issued on a tax-exempt basis by differentiating between governmental bonds and private activity bonds. Federal tax law also severely restricts tax-exempt bond issuance procedures and the investment of bond proceeds in higher yielding securities to limit arbitrage earnings, which refers to the interest income attributable to the difference between a government's borrowing rate and the reinvestment rate. Other restrictions on private activity bonds include taxation of interest earned on these bonds under the individual and corporate alternative minimum taxes, prohibitions on advance refundings, which refers to a refunding of an outstanding issue of tax-exempt bonds prior to the date on which the bonds become due or are callable, limitations on the use of proceeds to acquire existing property and land, public approval requirements and restrictions on the use of bond proceeds to pay for bond issuance costs.

Federal Securities Law Restrictions. State and local government securities have been subject to federal securities law regulation since the original adoption of the federal securities laws and the application of the federal antifraud provisions to securities of state and local government in the mid-1930s. The antifraud provisions in the Securities Act of 1933 and the Securities Exchange Act of 1934 generally prohibit fraudulent and deceptive practices in the offer, purchase and sale of

municipal securities. However, the provision of an exemption for these securities from the registration and information reporting requirements that applied to corporate securities was included in this landmark legislation. This exemption was based primarily on the principle of intergovernmental comity. In general, federal regulatory efforts have primarily been focused on brokers and dealers of municipal securities, resulting in the creation of the Municipal Securities Rulemaking Board (MSRB) in the mid-1970s in response to concerns about the sales practices of some municipal securities market brokers and dealers.

In 1990, an important regulatory initiative was undertaken by the SEC that culminated in the adoption of SEC Rule 15c2-12. This rule requires underwriters to obtain and review official statements for municipal issues they are underwriting, to make copies of those offering documents available to potential investors and to file those documents in the Municipal Securities Information Library, a central repository operated by the MSRB. The rule was intended to address important concerns about the availability of information prepared by issuers and the timeliness of the information. Last fall the SEC adopted amendments to Rule 15c2-12 that prohibit dealers from underwriting municipal securities of \$1.0 million or more unless the issuer or an obligated person has undertaken in a written agreement or contract to provide annual financial information, which includes financial and operating data, and material events disclosure on a timely basis.

Federal Bankruptcy Laws. Chapter 9 of the Federal Bankruptcy Laws is designed to provide a mechanism for a governmental entity to work with its creditors to adjust its debts. Causes of municipal bankruptcies include bond defaults, large court judgments, and poor financial planning or management. Since governments cannot liquidate their assets and cease to function, Chapter 9 recognizes the special circumstances of governmental financial emergencies and is primarily for the purpose of debt adjustment. A municipal bankruptcy proceeding does not excuse the debt as it may in the corporate area, and a local government must meet certain eligibility requirements such as being recognized as a debtor by the state to file for bankruptcy. A specific authorization by the state is necessary for a local government to file for bankruptcy. Additionally, the government seeking bankruptcy protection must demonstrate that it is insolvent, meaning that its liabilities exceed its assets.

GFOA Recommended Practices and Policies on Debt Administration

For many years GFOA has provided training and publications related to debt administration to assist its members in understanding the debt planning, issuance and management processes. Additionally it has developed many policy statements to guide its activities to influence federal legislation and regulations affecting debt administration. More recently, the Association has placed significant emphasis on the identification of best practices in this and other areas and the development of official positions recommending the use of these best practices by its members.

Our recommended practices for debt administration deal with such diverse topics as:

1. support for the development of a comprehensive debt policy by all jurisdictions intending to issue debt,
2. the desirability of undertaking a comprehensive analysis of debt capacity on a routine basis to ensure that the amount of debt that is issued is affordable and cost effective,
3. factors to consider when undertaking an advance refunding of outstanding debt,
4. the sale of derivatives products such as floaters, forwards, futures and options by state and local governments,
5. support for a merit-based process for the selection of underwriters and other finance professionals so that there is no linkage between political contributions and the consultant selection process,
6. opposition to the issuance of tax-exempt securities for the sole or primary purpose of investing the proceeds in higher yielding taxable or tax-exempt obligations in order to make a profit from the investment,
7. support for comprehensive and timely disclosure in the primary and secondary markets consistent with guidelines developed by GFOA in the primary and secondary markets, and
8. factors to consider when deciding to sell bonds on a competitive or negotiated basis.

Policy statements of the Association address such topics as:

1. support for commercial bank underwriting of municipal revenue bonds,
2. elimination of the application of the alternative minimum tax on tax-exempt bond interest, and
3. relief from overly burdensome tax code restrictions in the tax-exempt bond area.

Other GFOA Efforts in the Debt Administration Area

GFOA has undertaken or has planned several significant projects to improve state and local debt administration.

Disclosure Guidelines. GFOA has been a leader in the provision of guidance to issuers about

primary and secondary market disclosures in connection with the sale of bonds. Its publication, Disclosure Guidelines for State and Local Government Securities, was first published in 1976 and updated several times, most recently in 1991. Another revision is now underway. These extensive voluntary guidelines have received widespread acceptance and adherence, and are recommended by the SEC. Among other things, the Guidelines call for the preparation of an OS and recommend that there be a discussion in the OS of the principal factors that make an offering speculative or one of high risk and the possible consequences for investment risk. Among the examples of factors that the Guidelines give are fiscal problems of the issuer or other parties that could interrupt or reduce revenues available for payment of debt service, the financial condition of the issuer and the nature of activities or businesses in which the issuer is engaged or proposes to engage.

The Guidelines recommend the provision of annual financial information that indicates important factors related to the financial condition and results of operations of the issuer and the release of information concerning major developments about the issuer as promptly as possible, including information about the likelihood of default in any outstanding indebtedness and relevant changes in assets, revenues, liquidity, and cash flow, among other things.

GFOA Certificate of Achievement in Financial Reporting. GFOA recommends that state and local governments prepare their financial reports in accordance with generally accepted accounting principles (GAAP), which for state and local governments are primarily established by the Governmental Accounting Standards Board (GASB), and have their financial statements audited in accordance with generally accepted auditing standards (GAAS). Governments that meet these standards and prepare a comprehensive annual financial report (CAFR) are eligible to apply for GFOA's highly coveted Certificate of Achievement in Financial Reporting. Under GAAP, the balance sheet of a government presents the investments of the reporting jurisdiction and GAAP require substantial note disclosure about such investments. This note disclosure includes a list of investments by type as well as disclosure of market value for each type of investment. Recently, GASB provided further guidance to preparers of financial statements about the types of disclosures that should be presented for derivatives and similar debt and investment transactions.

Disclosure Videoconference. Next October, GFOA, the National Association of Counties and the Public Securities Association will conduct a national videoconference on the new disclosure responsibilities of municipal issuers to inform elected and appointed officials about the new SEC disclosure rules and explain how to comply with the rules. The videoconference also is intended to make government officials aware of their other disclosure responsibilities under the federal antifraud provisions and relate the disclosure issues presented by the Orange County bankruptcy and default to the new SEC rules and other disclosure responsibilities.

Disclosure Reference Guide. GFOA has compiled a reference guide for its members and other government officials that contains information about the new SEC rules that will facilitate their compliance efforts. The document includes SEC guidance, information about national repositories and sample language concerning the ongoing provision of information.

Federal Legislative and Regulatory Reform to Improve Debt Administration

The GFOA has taken an active role in issues related to debt administration at the federal level for many years in an effort to make the debt issuance and management processes more efficient and to avoid unnecessary federal regulation of state and local government debt administration.

Federal Tax Reform. GFOA strongly supports the exemption for state and local government municipal interest in the federal income tax code and has worked particularly for changes in the federal tax law that would provide relief for state and local government issuers of tax-exempt bonds from the overly harsh and burdensome restrictions that were contained in the Tax Reform Act of 1986. The legislation had major consequences for the purposes for which tax-exempt debt could be issued, the procedures to be followed, the ability to structure public-private partnerships and the ultimate value of such investments to investors. Among the changes GFOA and others have proposed are replacement of the arbitrage rebate requirement with more appropriate restrictions on the investment of bond proceeds. GFOA also supports the restoration of the bank interest deduction for all governmental bonds, which would permit banks to deduct the interest costs they incur to purchase and hold tax-exempt bonds. Loss of this exemption has drastically reduced bank demand for tax-exempt bonds. Repeal of the alternative minimum tax on tax-exempt interest also is endorsed.

Financial Services Reform. GFOA has long-standing policy supporting legislation to permit commercial banks to underwrite revenue bonds issued by state and local governments. The Association believes that increased competition in the underwriting of securities will lead to lower borrowing costs for state and local government bond issuers. The House financial services reform bill (H.R. 1062) would permit commercial bank underwriting of municipal revenue bonds.

SEC Regulation of Municipal Issuers. Legislation has been introduced in the House (H.R. 14) and Senate (S. 114) to eliminate the municipal securities exemption from SEC registration and continuing disclosure requirements and to repeal the so-called Tower Amendment. This amendment was added to the Securities Exchange Act of 1934 during deliberations on the creation of the MSRB and has served to limit the federal regulatory role regarding municipal securities. It prohibits the MSRB and the SEC from requiring municipal issuers to file any document prior to the sale of the securities with the MSRB or the SEC. The MSRB was further prohibited from requiring any information to be furnished by an issuer to prospective purchasers after the securities have been sold. GFOA strongly opposes these bills because they would require mountains of paperwork and a significant outlay by municipal issuers to hire experts and pay new fees and other expenses to comply with myriad SEC rules and regulations that are constantly changing. The SEC could delay the registration of an issue and require issuers to respond to numerous requests for additional information or clarifications. The municipal market is already highly regulated and, by its adoption and modification of Rule 15c2-12 and the promulgation of interpretive guidance, the SEC has demonstrated that it has ample authority to ensure that information about municipal issuers is available to investors in the primary and secondary markets. Furthermore, repeal of the Tower Amendment does not make any sense in light of the purpose and responsibilities of the MSRB. It

is a self-regulatory body responsible for the development of broker/dealer rules. The Tower Amendment clarifies Congress' intent that the MSRB confine itself to broker/dealer concerns. Other self-regulatory bodies do not set disclosure standards and neither should the MSRB. The GFOA believes the Tower Amendment should remain.

SEC Disclosure Rules. GFOA worked extensively with the SEC and other market participants in the development of recent amendments to SEC Rule 15c2-12 affecting secondary market disclosure practices. The Association supports the rule changes approved by the SEC last November. They are responsive to investor needs, but do not impose overly burdensome requirements on municipal issuers. By providing significant latitude in the form and content of disclosure documents, the changes are sensitive to the diversity of the marketplace and respectful of the special status of municipal issuers in our federal system of government. No changes should be made in the current federal regulatory system applying to municipal bonds. The SEC rule changes, which began to take effect on July 3, 1995, are being phased in over a six-month period. The rules, in conjunction with the March 1994 SEC "Interpretive Release on Disclosure Obligations of Municipal Securities Issuers and Others," will effect a sea change in disclosure and should be given a fair chance to be implemented.

Federal Securities Litigation Reform. GFOA supports reforms in the securities litigation process, but does not support legislation passed by the House (H.R. 1058) and Senate (S. 240) that would make it more difficult for investors to bring securities fraud suits, would limit liability in such a way as to immunize from liability certain professional groups, and would impose a short statute of limitations. Since our members are issuers of securities, as well as investors in securities, GFOA supports reforms that will deter frivolous lawsuits and the adoption of appropriately clear standards on aiding and abetting a securities fraud. Those professionals who assist state and local governments in bond issues should not be able to avoid liability when investors in municipal securities file lawsuits. Municipal bond issuers will have greater confidence in the lawyers and other professionals who advise them in municipal market transactions knowing that these advisers will not be immune from liability if they are not sufficiently cautious in serving their state and local government clients. A longer statute of limitations, we believe, is a deterrent to the filing of frivolous lawsuits and is beneficial to state and local governments in their capacity as investors and issuers. Finally, we believe the private securities litigation system is an important complement to the enforcement activities of the SEC and that it is vitally important to maintain investor confidence and provide effective remedies against those persons who violate the antifraud provisions of the federal securities laws.

Municipal Bankruptcy Reform. For many years, GFOA worked with the bankruptcy bar to have revisions to the federal Bankruptcy Code enacted that would recognize fundamental differences between corporate and municipal finance. In 1988, Chapter 9 of the Bankruptcy Code was modified to clarify that a filing under Chapter 9 would not terminate the pledge of special revenues dedicated to the repayment of municipal obligations. Without the changes, liens on revenue sources dedicated to the payment of debt service on municipal obligations could have been invalidated once a local government filed for bankruptcy, regardless of whether the lien was valid under state law. This

change prevented the diversion of revenues dedicated to the payment of debt service to other municipal uses such as the payment of salaries. GFOA supported these efforts to maintain the effectiveness of liens granted on revenues and other monies to secure indebtedness.

MSRB Rules. GFOA frequently submits comments to the MSRB concerning its proposed rules and may subsequently comment on MSRB-approved rules that are before the SEC for final approval. Most recently, GFOA filed comments with the MSRB on proposed Rule G-38 concerning the use of municipal finance consultants by broker/dealers to circumvent political contribution limitations imposed by Rule G-37 on political contributions, which is being challenged in a federal court. Other areas of interest to GFOA have been the MSRB's Municipal Securities Information Library and Continuing Disclosure Information System.

Local Government Credit Problems

The words default and bankruptcy are two of the most awesome words in the entire vocabulary of debt administration. Some would say they are the most gruesome. Fortunately, local government credit problems resulting in bankruptcies and defaults have occurred very infrequently. The relatively low number of local government credit problems can be attributed to the many controls over the debt administration process established by state governments and by local governments themselves who recognize the value of sound financial policies. The private sector also has contributed by serving as a strict gatekeeper to the municipal market.

Historically, the number of defaults in the municipal area has been low. According to a 1993 report to Congress by the SEC, entitled Staff Report on the Municipal Securities Market, it was noted that municipal bonds have had significantly lower rates of default than corporate and foreign government bonds. Moreover, the SEC found that the risk of ultimate non-payment for municipal debt is slight, both when compared to total municipal debt outstanding and total municipal debt in default, because payments may have only been interrupted. It was also noted that municipal default rates vary considerably with the type of bonds issued; general obligation bonds typically experience the lowest incidence of default. The SEC report cited various recent studies that have been undertaken to calculate the municipal bond default rate and to compare municipal defaults to corporate defaults.

Municipal bankruptcy is a mechanism for working out local government financial problems and is one remedy for a default. Primarily, it is a means by which the financial obligations of a local government can be restructured to allow an orderly repayment of debts. The federal Bankruptcy Code has a special section applying to local governments because these governments provide essential services and are not able to cease operations and liquidate their assets as a corporation might. A good source of information on municipal bankruptcies (and defaults) is the ACIR study, Bankruptcies, Defaults and Other Local Government Financial Emergencies (1985). During the period 1960-1971, ten bankruptcy petitions were filed and, from 1972 through mid-year 1984, 21 cases were filed under Chapter 9. Changes in the Code in the mid-1970s may have accounted for

greater reliance on Chapter 9 to solve financial problems in the later period. More recent financial problems have been equally infrequent.

The existing regulatory framework applying to municipal debt has performed admirably in deterring defaults and bankruptcies in view of the large number of issues coming to market each year (approximately 8,000 in a normal year according to the PSA) and the large number of governments of varying size and sophistication that have issued debt (estimated at 50,000 by the MSRB). This is a direct result of state involvement, local governments' commitment to strong financial management, market forces and the stigma attached to bankruptcy and default. One observer has said that the memory of investors, investment analysts, and all others is elephantine when it comes to a default and nothing shakes investor confidence like a default.

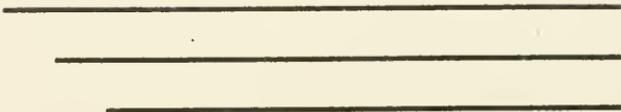
Members of the municipal finance community are all concerned about an individual government's travails in the bond market because of the broad implications for borrowing costs, market access and investor perceptions about the market. At a recent meeting of the GFOA Committee on Governmental Debt and Fiscal Policy, finance officers talked of the seriousness of meeting debt obligations. Some even spoke of the promise to pay as if it were a sacred trust. In a recommended practice adopted that same day by the Committee and subsequently approved by the GFOA Executive Board and membership, GFOA advises local governments that their debt policies should explicitly recognize a long-term commitment to full and timely repayment of all debt as an intrinsic requirement for entry into the capital markets.

Attachment

For additional information about this testimony, please contact Betsy Dotson or Cathy Spain, GFOA Federal Liaison Center, 1750 K Street, NW, Suite 650, Washington, DC 20006. Phone: 202/429-2750, FAX: 202/429-2755.

1995 SURVEY OF GOVERNMENT INVESTMENT PRACTICES

Sponsored by the
Government Finance
Officers Association
and
MBIA



1995 GFOA/MBIA Survey _____ of Investment Practices by _____ State and Local Governments _____

Most governments follow conservative investment practices

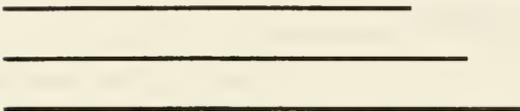
- 57% invest in certificates of deposit
- 49% invest in Treasury bills
- 45% invest in Treasury notes
- 56% invest in state-run investment pools

Many governments participate in investment pools

- 56% place some of their funds in state investment pools
- Of those, 9% have all of their funds in state pools
- 12% place some funds in pools run by other local governments
- 14% place some funds in pools run by private entities

About half of those responding invest only in short-term securities

- Of those governments responding to the question and which combine funds from all sources (except pensions) for investment purposes, maximum investment horizons are:
 - For 22% - 6 months
 - For 23% - 6-12 months
 - For 19% - 1-2 years
 - For 9% - over 5 years



Most governments do not invest in exotic instruments

- Less than 5% have any investments in inverse floaters, reverse repurchase agreements, or flexible repurchase agreements
- Less than 10% have any investments in step-up securities, collateralized mortgage obligations such as mortgage-backed securities, or interest- and principal-only strips

Many government investment policies restrict investments in derivatives

- 43% report investment policies that prohibit any investments in derivatives
- 5% report investment policies permitting limited investments in derivatives
- 1% report policies that do not restrict investments in derivatives
- 39% have policies which are silent on the issue of derivatives

Governmental investors believe derivative investments should be used cautiously, if at all

- 46% of respondents believe that derivatives should never be used
- 24% believe they should be permitted sparingly to hedge against risk
- 9% believe they should be permitted to maximize investment return, where appropriate

The majority of governments do not leverage funds for investment purposes and are opposed to doing so

- 78% do not leverage for investment purposes
- 63% believe funds should never be leveraged
- 10% believe leveraging is appropriate for meeting unexpected cash flow needs
- 3% believe leveraging should be permitted to maximize investment returns

Many governments mark their investments to market regularly

- Of those governments responding to the question and which combine funds from all sources (except pensions) for investment purposes:
 - 10% mark to market daily
 - 28% mark to market monthly
 - 16% mark to market annually

Most governments have investment policies which are reviewed by the jurisdiction's governing body or investment board or committee

- 78% follow a written investment policy
 - Of these, 77% of policies are reviewed by the governing body, and
 - 24% of policies are reviewed by an investment board or committee
-
-
-

In most governments, the investment function is the responsibility of an appointed official, not an elected official

- 81% indicate that ultimate responsibility for investment management lies with an appointed official
- 90% indicate that day-to-day management of investments is handled by internal staff rather than external managers

Most governments have not modified their investment practices since the Orange County bankruptcy

- 25% have reviewed their investment policy since Orange County
 - 7% have modified their policy since Orange County
 - 4% have adopted a written policy since Orange County
 - 4% withdrew funds from external pools
 - 3% have ceased purchasing derivatives
 - 1% have sold their derivative holdings
-
-
-

How do state and local governments invest their funds? And, have their practices changed since the Orange County investment pool filed for bankruptcy?

The Government Finance Officers Association, the professional association for state and local finance officials, and MBIA, a leading insurer of municipal bonds and provider of investment services, discovered the answers to these and other questions about investment practices through their annual jointly-sponsored survey of finance practices.

This survey comes at a critical time. The investment practices of state and local government have been under intense scrutiny following some highly publicized losses incurred in large investment portfolios. Those losses were the result of government managers attempting to achieve higher yields through the use of risky investment practices.

The GFOA/MBIA survey found that most investment officials follow a conservative approach and do not support the use of derivatives or leveraging for the investment of public funds. A significant proportion, though not a majority, of the respondents have reviewed or revised their investment policy since the Orange County bankruptcy filing. While most jurisdictions have adopted a written investment policy, a

significant minority reports that it still does not have such a document.

Responsibility for investment management is generally under the purview of appointed, rather than elected, officials and over half the respondents place some of their funds in state-run investment pools.

Findings are based on responses from over 1,300 governmental units across the United States and Canada. The survey covered investment of all kinds of governmental funds except pension funds. Over half of the respondents manage investment portfolios of less than \$25 million (excluding pension funds) and two thirds of the responses come from municipalities as opposed to other types of governmental units.

We are pleased to provide you with a summary of the survey's findings and thank all those who took the time to answer the survey questions.

Francie Heller
MBIA

Patricia C. Watt
Government Finance
Officers Association

MBIA

MBIA Insurance Corporation



GOVERNMENT FINANCE
OFFICERS ASSOCIATION

TESTIMONY

of the

NATIONAL ASSOCIATION OF STATE TREASURERS

regarding

Investment of State and Local Funds

before the

Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises
U.S. House of Representatives

presented by

Robert Seale

President

National Association of State Treasurers
and State Treasurer of Nevada

July 27, 1995

Mr. Chairman and members of the subcommittee, thank you for extending to me an opportunity to come to Washington to testify on state and local government investment practices.

I am Bob Seale, Treasurer of the State of Nevada and President of the National Association of State Treasurers (NAST). All fifty states, plus the District of Columbia, Puerto Rico, Guam and American Samoa, are represented in NAST. State treasurers are the chief financial officers of their states, responsible for the functions of cash management, debt management, public pension fund investment, and a variety of other functions in their respective states. Treasurers are elected by voters in thirty-eight states, appointed in eight states, and legislatures choose the treasurer in four states. I am joined today on the panel by one of my fellow treasurers, Ken Blackwell of the State of Ohio, representing the National Association of State Auditors, Comptrollers and Treasurers (NASACT). Let me take a minute to explain the difference between our two organizations. Many treasurers, such as myself and Treasurer Blackwell, belong to and participate in both organizations. However NAST represents exclusively state treasurers, while NASACT also represents state auditors and comptrollers.

All of us in state and local government were certainly made aware last year of the unwise practices in which a few local fiscal officers were engaged. I believe that California State Treasurer Matt Fong yesterday addressed the issues in California. I would note that even before Matt Fong was installed as state treasurer, Governor Pete Wilson appointed

him to head up the state's efforts in dealing with the situation in Orange County. I am pleased that both Treasurer Fong, as well as Treasurer Ken Blackwell, are members of NAST's Task Force on Local Government Investment Pools, created earlier this year to review and update our 1989 guidelines for state-managed LGIPs. I am also pleased to say that we continue to maintain and enhance our working relationship with our colleagues in local government, represented by the Government Finance Officers Association (GFOA), which is represented today by Tim Riordan.

I am both a state official charged with managing investment of public funds and operating a state pool, as well as President of NAST. My two-part goal today is to offer NAST's perspective on the questions you have raised for the subject of this hearing, and to share with you NAST's work to put together the recommended best practices for prudent investment management by public entities.

Mr. Chairman, no duty is more important in public finance than the prudent day-to-day management of public monies. This responsibility is more important today than ever in this era of tight budgets and growing demand for services.

NAST has been working since before 1989 in the area of improving the best practices for prudent investment management of public funds. Indeed all of our programs include education directed toward improving the ability of state treasurers and our staff in handling this most important area of cash management, both for our state funds as well as the local

funds entrusted into our care. In fact, NAST has undertaken an ambitious continuing education initiative, known as the National Institute for Public Finance, which is taking place right now at the University of Delaware.

Mr. Chairman, when I appeared before the Senate Banking Committee in January, I indicated at that time that NAST had begun work to review investment guidelines for local government investment pools and to take other steps which would serve to improve investment management. Now it is July, and I want to report that we have completed our review of our 1989 LGIP guidelines. I am pleased to inform you that your committee is the first to see these new, revised guidelines as well as the results of our LGIP survey.

We specifically call your attention to the revised guidelines for LGIP managers and participants, calling for an even greater emphasis on improved and continuing disclosure of pool investment policy and operation to participants including, for example, disclosure of any off-balance sheet obligations. The revised guidelines also recommend independent, third-party oversight and input into the policies and procedures of the LGIP through establishment of an advisory board. Next, the document recommends that the broker/dealer community adhere to the same standards of conduct applying to treasurers, and that the private sector is equally responsible for carrying out disclosure and suitability practices in service to participants. Further, the revised guidelines call for ongoing education of public officials to maintain their expertise amidst changing market conditions, and an ever-increasing array of investment options. The guidelines, however, continue to stress that the

overriding goal of any LGIP investment strategy is and should remain that of assuring safety of principal first, then liquidity, and then yield.

The three most important points made by the NAST guidelines are disclosure, disclosure, and disclosure. Under the disclosure practices recommended by the guidelines, each participating local entity will know the risks and benefits of pool participation. Items for disclosure to participants include the following:

- the legal authority for and investment objectives of the pool, including any potential limits on the ability to access funds;
- the accrual, frequency, and method of distribution for earnings, yield calculation methodology, safekeeping practices, and policy on allocation and amortization of gains and losses;
- administrative costs and procedures for proposed changes to those costs, minimum and maximum account size policies, monthly statements, distribution of quarterly portfolio holdings and market values (with monthly availability), and a copy of the independent accountant's opinion and report.

This communication to participants and disclosure of information will also go to an oversight board contributing to an effective system of checks and balances, something which

was lacking in Orange County and other instances. The residents of Orange County may find little solace right now with this increased emphasis on oversight, but other citizens across the country will be well-served by systems which prevent crises before they reach the taxpayer.

In keeping with the guidelines' recommendation of ongoing education for public officials, NAST, as I have mentioned, is now holding its first annual National Institute for Public Finance. It is a week-long, college-level education program. Indeed I have just come from the campus of the University of Delaware where it is being held and will return there later today. I am joined at the Institute by eight of my fellow state treasurers in this intensive effort to help become better managers regarding the issues of cash and debt management. These topics confront us and our staffs on a daily basis. I am pleased to tell you that the Institute is a great success, and I am even more pleased to tell you that NAST will be continuing the program on an annual basis, which will allow even more state treasurers and treasury staff, and other state and local finance officials, to participate in this invaluable educational opportunity. Among those public finance officials participating at the inaugural Institute are not only the nine state treasurers and investment staff from twenty-one states, but other state and local finance officials, including John Moorlach, the new Orange County Treasurer-Tax Collector.

The Public Finance Institute faculty features experts in the field of public finance, including Paul Maco of the SEC; Robert Dean Pope, a bond lawyer from Hunton and

Williams; Robert McKnew, from the Bank of America and representing the Public Securities Association; and Tom Hayes, the former California state treasurer who was the first expert called in to help resolve the Orange County situation late last year. The Dean of the Institute is Donald Haider, from the Kellogg Graduate School of Management at Northwestern University. You should be commended for your choices of witnesses for this hearing, Mr. Chairman, and since some are among those we have chosen for our faculty, I think it indicates they are the best working in public finance today.

The vigorous curriculum is tailored to the responsibilities carried out by state and local government investment officials. It includes such topics as how we might better finance public investments, the intricacies of municipal bond pricing and negotiation, and the correct usage of credit enhancements. Many of these responsibilities were also addressed by the NAST LGIP Task Force.

The products of our LGIP Task Force effort include the guidelines, as well as the results of a survey of all fifty states concerning the current status of their LGIPS. NAST found that state-operated local government investment pools exist in thirty-two states. The states manage more than \$39 billion in local assets and almost \$30 billion in state assets. Of thirty-three total pools (North Carolina reported having two), twenty are available to both state and local agencies, and thirteen are limited to local assets. Twenty-six states use mark-to-market procedures for valuing assets, and twenty-one states have diversification requirements. More than 15,500 local governments participate in the pools. A copy of the

survey attached to my testimony will allow you to see what treasurers in your states, if applicable, are doing to assist local governments in maximizing investment returns, while at the same time, maintaining the safety of the principal of their investments.

In January I testified that I believe Orange County represented an exception, not the norm. I do not have a crystal ball allowing me to make any guarantees, but I still think the states are the appropriate level of governance in this area, and that there is already enough regulatory authority in place. Federal legislation is not needed at this time. However, in those individual instances where unanticipated losses have occurred, states have advanced remedies that are appropriate to address a situation. Treasurers continue to closely monitor state finances and take steps to make the possibility of losses more remote. I believe that our survey results and the revised NAST guidelines will be a useful tool for federal, state and local policymakers, state and local cash managers, and the public. After all, it is the public - your constituents and mine - who entrust their money to us for prudent, careful safe-keeping.

Thank you, Mr. Chairman.

Guidelines for Local Government Investment Pools

Purpose

The National Association of State Treasurers' Guidelines for Local Government Investment Pools (LGIP) is intended to provide a framework for the formulation of prudent policies and disclosure guidelines for LGIPs. Managed by states for the benefit of their localities, such pools should be administered according to the statutory requirements of each state, prudently placing safety of funds over liquidity and yield.

The National Association of State Treasurers (NAST) recognizes that potential pool participants have numerous alternative investment vehicles from which to choose. The goal of the guidelines is to insure that local government investment officials, when choosing among their available investment options, are fully aware of significant investment and administrative policies, practices and restrictions of the pool and are thereby able to make informed investment decisions on behalf of the local governments.

NAST believes that an overwhelming majority of the participants in public finance, and particularly an overwhelming majority of state and local public officials, operate in an ethical and professional manner and serve the public interest effectively and efficiently. NAST believes, however, that it is imperative that treasurers act to remove all doubts about their commitment to integrity in the public finance market by proactively adopting self-regulation measures which may also serve as models for other public officials. In that regard, NAST recommends treasurers follow the principles as outlined in its Standards of Conduct Resolution, adopted in 1994.

NAST further recommends that the broker/dealer community govern itself to follow the same standards of conduct NAST has recommended for treasurers. The private sector community is equally responsible to disclose all fund management practices to the clients and communities they serve. The investment alternatives offered by brokers/dealers to public finance officials should be suitable for the public entity's objectives. NAST recommends that treasurers obtain a signed agreement of understanding with their brokers/dealers to this effect.

NAST recommends that states operating Local Government Investment Pools adopt appropriate investment guidelines and disclosure policies, as they are consistent with statutory law in each of the states, as soon as practical. Following are items suggested by NAST that should, when applicable, be included in any formulated guidelines and disclosure policies.

I. Statement of LGIP Objectives and Practices

A written statement of objectives should be prepared for each LGIP. The statement should be provided to each pool participant and prospective participants. The statement should contain, at a minimum:

1. Introduction

Legal authority for the LGIP and a definition of pool participant eligibility. Statement regarding the relationship between the Pool Manager and the Pool Participants.

2. Investment Objectives

A statement of pool objectives. The Statement should disclose and describe procedures established by the pool to ensure liquidity. Participants should be informed of any potential limits on their ability to access their funds.

3. Yield Calculation, Earnings and Disclosure

All funds should use a standardized Association for Investment Management and Research (AIMR)/Securities and Exchange Commission (SEC) yield, as appropriate which provides a uniform method of comparing performance. All yields should be quoted net of fees. The statement should disclose the frequency of yield calculation and the methodology utilized (e.g., market value, amortized value, etc.). Relative to earnings, the statement should also disclose the frequency and basis for the accrual, frequency and method of distribution, and the method of the distribution calculation. The statement should include a policy on allocation and amortization of gains and losses.

4. Advisory Board

All LGIP funds should have an independent Advisory Board. It is the responsibility of the Board to monitor the activities of the investment manager and see that they are in compliance with the investment objectives stated in the prospectus. The board should be established with at least some independent participation with a clear definition of its role and responsibilities. Board members should be urged to receive continuing education in public finance matters.

5. Custodian of Securities

Disclosure of safekeeping practices including the safeguards instituted to protect their assets, detailing the minimum safeguards for the pool. All security transactions should be settled on the basis of delivery vs. payment to an independent third party custodian in the name of the pool consistent with industry practices.

6. LGIP Account Administration

Disclosure of the maximum and minimum size of accounts which will be allowed. Disclosure of maximum and minimum transaction sizes that will be allowed for deposits and withdrawals as well as any prior notice that may be required. Also, disclosure of any requirements relating to changes in authorization.

7. LGIP Expenses

Disclosure of administrative costs and all other fees that are or may be imposed. Disclosure of the procedures for changes to fees (e.g., notification requirements, potential input by LGIP participants, etc.).

8. Communication with Pool Participants

LGIP participants should have a regular flow of information from the pool in order to be prudent investors. The type and frequency of communication could include, but not necessarily be limited to, the following:

- Statements of account should be provided monthly and should include, at a minimum, all information necessary for the participants to account for, and assess their activities with, the pool for that period.

- Detailed reports of portfolio holdings should be distributed at least quarterly and available monthly - to include CUSIP numbers, full descriptions of securities, current market values and any off-balance sheet obligations (such as leverage).

- The portfolio's market value should be disclosed at least quarterly, and available monthly on request, to pool participants as well as the advisory or oversight board and to the designated neutral party external to the investment function responsible for assuring compliance with the written investment policy.

- A copy of the independent accountant's opinion and report.

- The actual average maturity for the portfolio.

9. Funds NOT Guaranteed

Most important, there should be complete disclosure to the participant about the risks associated with the LGIP, including a statement that makes it clear the state or government entity does not guarantee invested monies.

10. Compliance

Each LGIP should be audited at least annually by an external auditor independent of the investment function and Treasury. A copy of the opinion and accountant's report should be provided to all pool participants. Disclosure should be made regarding the commingling of state, pension, or other funds in the pool.

LGIP security transactions, fund performance, and fund risk should be monitored on a regular basis by a neutral party external to the investment function to assure compliance with the written investment policy.

11. Arbitrage Disclosure

A statement as to whether the pool is appropriate for the investment of bond proceeds.

12. Other Disclosure

Any other information that the investor might reasonably expect to receive that will enable them to make more informed decisions.

II. Written Investment Policies

Safety is the primary responsibility of every public investment officer/official. Documented investment policies and practices provide a safe environment for the investment of public funds given disclosed levels of risk. A separate written investment policy should be prepared for each pool. Following are items suggested by NAST that should, when applicable, be included in LGIP investment policies:

1. Investment Objectives

A description of investment objectives. This should include disclosure of how the investment policy is designed to meet the pool objectives, as well as a clear and detailed description of the risks associated with these objectives. NAST believes that the primary objectives, in priority, should be safety, liquidity and yield.

2. Authorized Investments

A description of eligible investment instruments including description(s) of any speculative and high-risk strategies and instruments, as well as any restrictions on their use. A description of the credit standard of investments, including both minimum and weighted average credit standards for the pool investments, specifically minimum ratings for investments and policies regarding unrated paper or split-rated paper.

The Policy should disclose:

- the maximum allowable dollar weighted average portfolio maturity; and
- the maximum allowable maturity of individual portfolio securities including disclosure of the maturity used for the calculation, i.e., stated final maturity or effective maturity.

3. Investment Parameters

The Policy should describe the maximum allowable amount or percentage of pool assets to be invested in the securities of all types and maturities of any single issuer. The pool should diversify its investments so that it does not invest more than a stated percentage of its total assets in securities of any one issue.

The weighted average maturity range for the portfolio should also be disclosed.

Floating rate note policies - the maximum maturities of floating rate note instruments, acceptable reference reset rates (recommended limited to money market rates), maximum reset frequencies, and willingness to buy structured notes.

Borrowing may be done for the purposes of short term cash flow enhancements and interest rate arbitrage when appropriate. Borrowing for interest rate arbitrage should only be done on a matched book basis. Borrowing should be limited to stated percentages of the portfolio and these percentages be properly disclosed.

4. Valuation

The Policy should disclose the frequency with which portfolio securities are valued. It is recommended that the portfolio be marked-to-market at least on a monthly basis. It is also recommended that the portfolio value be determined either by an independent pricing service or by obtaining and utilizing multiple assessments to formulate an average valuation.

The method utilized for that valuation (current market value, cost, amortized value, etc.) should be disclosed. Should an LGIP feel that maintaining a constant share value is critical, it may be appropriate to consider Rule 2a-7 of the Securities and Exchange Commission to minimize the likelihood of a divergence between a fund's constant share value and the true market value.

5. Standards of Care

The investment policy should disclose the investment standards, such as the "prudent investor" standard, that apply as well as a statement relating to ethics and prohibitions against conflicts of interest.

A description of procedures regarding changes to the established investment guidelines to include notification of who may change the guidelines, the circumstances under which they may be changed, and the type of notification required to Pool participants.

6. Other

Other policies, procedures and guidelines applicable to the LGIP. The investment policy should demonstrate the exercising of the judgment and care, under the circumstances then prevailing, which individuals of prudence, discretion and intelligence exercise in the management of their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of their capital.



SPECIAL REPORT

A Publication of the National Association of State Treasurers

LOCAL GOVERNMENT INVESTMENT POOLS

Special Report

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LOCAL GOVERNMENT INVESTMENT POOLS

Background

The 1980s and first the half of the 1990s have posed daunting financial challenges to state and local governments. States and localities have been hard-pressed to balance the fiscal needs inherent in trying to provide the maximum in government services at the same time these governments are dealing with reduced public support for financing these services.

State and local government officials have been faced with the difficult and unpopular choice of cutting services or bolstering revenues by raising taxes. As a result and since 1973, one way that states have worked to assist their localities with this problem has been to offer local government investment pools (LGIPs or pools) as a better alternative for managing local funds. LGIPs offer local officials another option for managing their cash reserves, minimizing the risk of principal, while at the same time maintaining liquidity and maximizing yield. Entrusted with the fiduciary responsibility for, in many cases, billions of public dollars, state treasurers have provided their technical expertise, and that of their investment staffs, to assist local governments that want to pool available resources as a cash management tool.

Through participation in LGIPs, local governments can take advantage of investment opportunities formerly available only to larger accounts (i.e. larger governmental units). A pool serves as a voluntary, state-managed investment option for the surplus operating funds within a state. Local governments combine (or pool) their excess operating funds together in an operation much like a money market mutual fund, but with the added benefit of being structured to meet the unique needs of government investors. Although all funds are pooled for investment purposes, each locality's participation in the pool is reported separately. In essence, LGIPs function as financial intermediaries between local governments and financial institutions by using their technical expertise to invest the funds on behalf of those governments who contributed to the pool. These LGIPs have consistently provided investment benefits of particular importance to local governments: safe investments and daily liquidity. With more than 15,000 local governments participating in 32 state-operated pools, LGIPs oversee over \$39 billion in local assets, and almost \$30 billion in state assets, and continue to realize a reputation as a successful tool of investment management.¹

¹From the NAST Survey on Local Government Investment Pools, May 1995.

NAST Special Task Force on Local Government Investment Pools

In 1989, the National Association of State Treasurers (NAST) brought together the senior finance officials of the 50 states to unanimously pass a "Statement in Favor of Full Disclosure for Local Government Investment Pools" (LGIPs). The Statement provided the framework for the formulation of disclosure policies for LGIPs and served as the model to develop the 1995 guidelines which allow the pools to be administered according to the statutory requirements of each state.

In the winter of 1994-95, several local governments and entities independent of state government have recently reported dramatic losses of principal due to hazardous investment practices. Had the NAST "Statement in Favor of Full Disclosure" been followed, as they were by the state pools which experienced no losses, the forfeitures of principal would likely not have occurred. Even before the news broke on the investment losses, NAST recognized the urgent need to either provide written guidance or educational opportunities for inexperienced investors. The earlier planning for a National Institute for Public Finance progressed and in the Summer of 1995, the inaugural Institute was held for both state and local public finance managers.

In addition, the Special Task Force on Local Government Investment Pools was formed to set forth options that would be shared with all types of governments and independent entities allowing for informed investment decisions to be made on behalf of the citizens and institutions they serve. This report is the culmination of the work of the Task Force.

NAST Special Task Forces on Local Government Investment Pools

Hon. Robert L. Seale, Chairman — Nevada State Treasurer

Hon. J. Kenneth Blackwell — Ohio Treasurer of State

Hon. Matthew K. Fong — California State Treasurer

Hon. Jim Hill — Oregon State Treasurer

Hon. Catherine Baker Knoll — Pennsylvania State Treasurer

Hon. Sally Thompson — Kansas State Treasurer

Hon. Ronald L. Tillet — Virginia State Treasurer

Hon. Martha Whitehead — Texas State Treasurer

In 1989, the National Association of State Treasurers (NAST) released its first suggested guidelines for LGIPs, which gained widespread popularity as a resource for state and local cash managers. Now, in response to the growing use and interest in LGIPs, NAST has conducted a study that outlines the key features of state-sponsored LGIPs in 1995. In addition, NAST has developed a revised policy statement which expands upon the principles of full disclosure and updates guidelines for pool operations (see page 7).

Objective of LGIPs

The primary objective of the local government investment pool is the prudent management of public funds on behalf of the local government investor. The strategy for meeting the objective is fundamental and the investment of pool assets is prioritized as follows: safety of principal, then liquidity, and then yield. Because of shared resources and generally lower costs, LGIPs have historically become a more efficient and competitive cash management tool.

Financial Structure of LGIPs

There are similarities between LGIP operations and Securities and Exchange Commission-registered money market mutual funds. Both may use the cash of local governments to invest in a diversified portfolio of money market instruments with earnings paid to participants in proportion to their total investment. When a local government invests in a pool, it essentially buys "shares" of the total pool. Since pools place few limits, if any, on the timing or amount of deposits or redemptions an LGIP participant can make, the funds must remain comfortably liquid. To maintain high liquidity, most pools find it necessary to invest their funds in high-grade marketable securities with relatively short maturities (under one year). Typically, pool portfolios will include certificates of deposit, U.S. Treasury and agency obligations, and other securities rated high in their respective categories. Because of their structure, LGIPs offer small governments the ability to earn interest daily and at the same rate as the large investors in the pool.

Eligibility

Local government units within a state participate in that state's pool on a purely voluntary basis. Participants make deposits and withdrawals as they see fit, and in most cases no commitment is made to the pool by the participant as to the length of its contribution to the pool. Four states have minimum investment times for short-term pools ranging from one to 30 days.

Methods of Deposit and Withdrawal

Since most investment pools require no minimum amount for participation, the deposit and withdrawal requirements are very flexible. Most LGIPs allow participants to select any denomination for investment, but some have set very low minimum requirements: the highest minimum amount is \$5,000; the lowest is \$500. Usually deposits can be made by wire or check, and pool investments generally begin earning income the day of investment.

Participants may typically withdraw funds at any time (or by a designated time) each day and by a variety of means. This serves the local government's imperative for daily liquidity. The most common means of redemption are wire transfers to the participant's bank. Wire transfers enable participants to telephone the pool indicating the amount to be withdrawn and the pool then wires that amount to the participant's bank account, usually on the same day. In some cases, a participant may draw a check on the LGIP account; and those funds continue to draw interest until the check has cleared with the LGIP's custodian.

Investment Management and Supervision

The state treasurer typically manages the actual pool's operations with the assistance of an investment board or management committee composed of pool participants. Although some pools are operated under contract by private investment advisors, the state treasurer is usually responsible for receiving funds, making investments on behalf of participants, and appointing a custodian bank for the funds. The management staff is responsible for handling the portfolio, making investment decisions, maintaining an accounting system to keep track of individual accounts, and calculating and crediting interest payments. Usually the actual custody of the pool's assets is delegated to an in-state bank. Although the state treasurer and management committee have administrative control over the pool, state law and investment policy control the selection of investment instruments for use in the pool's portfolio.

LGIPs usually have both internal and external controls on the selection of investment instruments. Most pools have adopted internal guidelines establishing administrative procedures and investment policy. As LGIPs rapidly grow larger, a written statement of the pool's objectives and the policies designed to meet those objectives becomes imperative. Internal guidelines should identify credit standards, eligible instruments, allowable maturity ranges, and limits of portfolio concentration for each security type. The internal controls should es-

establish and explain the frequency and method used for calculating valuation, yields, and earnings. Further, each internal policy should require monthly statements of accounts, detailed monthly portfolio reports on holdings, and audit opinions on the pool.

Advisory Boards

Advisory or policy boards exist in 23 states to provide oversight and to improve communication between the participant's and the pool's money managers. The Boards are frequently comprised of members of the user group, but also consist of state-wide elected officials. While these Boards are very helpful, written internal safeguards are essential for the protection of the pool's integrity and the ability to properly monitor pool activity.

In addition to internal controls, state laws furnish guidelines in the formulation of an investment policy. In most cases the law permits pool managers to pursue, at a minimum, the same investment options as state governments.

Monitoring Pool Transactions

Of paramount importance in adhering to guidelines set for pool operation is the need to regularly reconcile the investment activity of the pool with state law and policy. Periodic review of pool investment transactions and portfolio holdings will confirm to investment personnel, policy-makers, and participants that the pool operations are maintaining understood policies and guidelines.

This regular review can be accomplished in several ways. First, individual portfolio transactions, as well as aggregate pool composition maturities, can be reviewed on a monthly or more frequent basis to ascertain any discrepancies between policy and actual practice. Both potential and real problems can then be more readily corrected, thus minimizing the negative impact on the LGIP's operation. Second, an outside agency should conduct an audit and report the findings to policy-makers and pool participants on a regular, timely basis. The review process should also contain a mechanism for modifying and enhancing the existing policy. Such a review of operations provides insurance that the LGIP complies with policy and a forum to judge the pool's effectiveness in meeting its goals.

Administrative Costs

Administrative costs usually are deducted from the earnings paid to the participants. Generally no state or local appropriations are required to operate a pool, as many pools utilize existing investment personnel in the

state treasurer's office to provide technical expertise. The administrative costs are further minimized by the economies of scale available by pooling state and local funds, whether they are managed in-house or by outside management. Management fees most often are disclosed in monthly statements or reports.

Advantages of LGIPs

Research has shown that prudently managed pools continue to demonstrate the ability to bear net yields higher than those of comparable alternative investment options. The following benefits can also be attributed to LGIPs:

- By pooling investment funds, local governments can realize higher yields. When local governments combine their excess capital, economies of scale are created that allow pools to obtain the technical expertise and purchasing power needed to create a diverse portfolio that is usually not available to local governments as individual accounts.
- Because local governments are a major source of capital to the money markets, pooling may increase the competitiveness of financial institutions vying for local monies. Therefore, rates on alternative investments may increase.
- LGIPs provide a safe investment for local governments. Although no investment is fully guaranteed, LGIPs emphasize diversifying the investment instruments as a means of protecting against possible losses. In addition to the safe investment instruments utilized in pools, Federal Deposit Insurance Corporation coverage for certificates of deposit generally applies to the proportionate share of each account, thereby reducing the uninsured portion of each deposit. Some states even insure a portion of a local government's contribution to the pool.
- Pools provide an affordable, yet flexible, tool for cash management. Most LGIPs invest in short term instruments. This helps ensure liquidity for participants who need to use their money on short notice. Such investments further assure the safety of the principal by minimizing exposure to interest rate fluctuations over time. Administrative costs are minimized by deducting the expense from the earnings accrual, thus making it unnecessary for cash managers to appropriate additional monies that could be invested. Further, the lack of minimum denominations for investment in many cases, coupled with daily liquidity not only eliminates the need to maintain non-interest bearing demand balances, but also preserves the ability to fine tune the amount invested.

- Pools offer a variable rate of return, usually reported monthly, and many pools provide daily rate quotes along with a moving average of the rate.
- LGIP participation is voluntary. So while investing in a pool may mean that local cash managers have little direct control over the actual investment instruments, the local cash managers are positioned to choose how much to invest and the length of time local funds are invested.
- Many pools have established local advisory councils that provide advice to pool managers and set basic operating policies. Such advisory boards assure that local officials have a voice in the pool's operation.

Limitations of LGIPs

While the benefits available to local governments through LGIPs are considerable, there are limitations that should be considered prior to joining or forming an LGIP.

- Any capital loss, as with any gain, must be borne by all participants. One answer to this concern is to establish a specific investment policy, limit investments to the safest possible instruments, restrict maturities and monitor pool transactions on a regular basis.
- Market losses may result if there is a "run" on the pool. The liquidity offered by pools creates the risk of having a significant number of pool participants make withdrawals from the pool in a short time period. Three states have reported "runs" on their investment pools (Table 14 describes the handling of these situations). In each case, decisive action by the state treasurer resulted in the local government participant being made whole, both as to principal and interest. To counter the risk of loss of principal, many pools institute maturity limits for investment instruments; maintain sufficient liquidity to meet large redemptions; amortize market gains or losses over a specific period of time by raising or lowering monthly interest distributions; and, some include both state and state agency dollars in the pool to increase the monetary resources and thus assure its stability. In general, longer term instruments are avoided unless they are matched to a specific liability and generally be held to maturity.
- LGIPs may remove money from local economies and reduce funds available for local loans. Investing in certificates of deposit of financial institutions that offer competitive rates within the state is one method of dealing with this concern. However, large institutions with state-wide branches will be less affected than re-

gional or local institutions. Because smaller financial institutions cannot competitively bid on large sums of funds, they may be precluded from receiving investments from local governments. However, many local governments already invest substantial amounts of money in federal securities and independent studies conducted by state pools have shown the impact of removal of money from local economies to be minimal.

- Bond proceeds in pools are subject to federal arbitrage regulations. The 1986 Tax Reform Act requires many local governments to rebate investment income in excess of their bond yields. U.S. Treasury regulations governing bond proceeds require that securities be purchased at market prices, and that interest be allocated properly in commingled pools. Indeed, states have modified their pools to reflect the new federal arbitrage rebate regulations and are actively assisting their participants with compliance.

Conclusion

State-sponsored local government investment pools, administered by state treasurers, have established impressive records in terms of pool earnings and increased participation. An LGIP is particularly advantageous to small local governments that may choose to combine their idle cash to make short-term investments equal to those afforded to state government or larger local governments. A carefully designed pool with articulated objectives and policies will consistently maintain the integrity of local funds within a diversified and safe portfolio, provide liquidity nearly equal to a savings account, and offer rates of return on invested monies competitive with comparable alternative investments.

Although LGIPs have operated in both up and down market conditions, and in a changing and challenging economy over the past 22 years, they have proved to be innovative cash management tools for local governments as they seek to serve their taxpayers at minimal risk and utmost efficiency. LGIPs will continue to be a valuable way for state treasurers to assist local governments and all state and local taxpayers as we approach the 21st Century.

**INVESTMENT POLICIES FOR STATE AND LOCAL
GOVERNMENT ENTITIES, PREVENTION AND
MANAGEMENT OF LOCAL GOVERNMENT
FINANCIAL DISTRESS, AND
THE INTEGRITY OF STATE AND LOCAL
GOVERNMENT DEBT ISSUANCE**

**Prepared for the
Subcommittee on Capital Markets, Securities, and Government Sponsored
Enterprises
Committee on Banking and Financial Services
United States House of Representatives**

**J. Kenneth Blackwell
State Treasurer
State of Ohio**

**WRITTEN STATEMENT OF
J. KENNETH BLACKWELL,
STATE TREASURER OF OHIO**

The hearings conducted by the United States House of Representatives Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the Committee on Banking and Financial Services address matters that are of great concern to me as Treasurer of the State of Ohio, as they are to all state financial officers. I am providing this statement in my capacity as State Treasurer of Ohio, a Constitutional officer of the State, as the former Vice Chairman of the Cincinnati Ohio Employees Retirement System, and also as a member of the Executive Committee of the National Association of State Auditors, Comptrollers and Treasurers (NASACT).

NASACT is the professional association of the chief financial officers of the states. NASACT has over 170 members, all of whom perform the functions of Auditor, Comptroller, or Treasurer in their states. NASACT's constitutional purposes include encouraging and providing for the free exchange of information among state financial officials, and between local, state, and federal financial officials, and providing a national forum for the promulgation and dissemination of state positions concerning effective governmental financial administration.

This statement focuses on the establishment of investment policies for state and local government entities, the prevention and management of local government financial distress, and the integrity of state and local government debt issuance. These are only three of the many intricately inter-related financial issues that state and local governments face. It is my belief that state and local governments are creating effective and appropriate legislative and regulatory

responses to deal with these issues, that recent initiatives of the Securities and Exchange Commission may adequately address securities markets information needs, and that further federal government intervention in or regulation of state and local government financial administration is neither warranted nor advisable at this time.

State and Local Government Investment Policies

Generally, state legislation or regulation establishes accounting, reporting, auditing, and standards for state and local government financial administration. These typically prescribe adherence to basic investment policies and often list permissible investments. They also prescribe actions that must be taken to safeguard assets, such as collateralization requirements. Historically these have applied to general purpose units of government such as state agencies, counties, cities, towns, and certain special purpose units of governments such as public colleges and universities, school districts, water districts, and sewer districts.

State governments are currently reassessing the adequacy of those requirements and policies in their content, scope, and as to their applicability to other non-general purpose units of government in light of the recent volatility of interest rates, and concerns about leveraging investment portfolios. I recently proposed a bill to the Ohio Legislature that would limit the maturity of investments held by local governments and local government investment pools, and would prohibit the use of certain derivative instruments and leveraging practices. The bill would also prohibit the creation of local government investment pools outside the State Treasurer's office, and require governments to adopt certain investment policies and file their investment policies with the State Auditor's office.

Local Government Financial Distress

A National Conference of State Legislatures report *State Programs to Assist Distressed Local Governments*, published in March of 1993, indicated that 13 states had statutory provisions to assist distressed local governments and that in 6 other states the legislatures had approved special acts to help specific local governments during the previous 3 years.

Ohio was the first state to enact a comprehensive municipal financial emergency law. From its enactment in 1979 to 1992 fiscal emergencies, under the terms of the law, were declared in only 22 municipalities. Sixteen of these municipalities had the declaration lifted upon successful recovery from financial distress.

The Integrity of State and Local Government Debt Issuance

The United States Securities and Exchange Commission (Commission) noted in their September 1993 *Staff Report on the Municipal Securities Market*, prepared at the request of the Chairman of the United States House of Representatives' Committee on Energy and Commerce and the Chairman of the Subcommittee on Telecommunications and Finance of that Committee, "...municipal securities have had significantly lower rates of default than corporate and foreign government bonds. Moreover, the risk of ultimate non-payment for municipal debt is slight, both when compared to total municipal debt outstanding and total municipal debt in default." The Commission report also cites studies indicating that over the 11 years between 1980 to 1991 no municipal general obligation bond had defaulted, only 1/4% of the dollar volume

of rated bonds, and only 2% of the dollar volume of the non-rated bond issues had defaulted.

Recent Commission initiatives focus on the need for greater transparency in the municipal securities markets, better information flows to the market, and the responsibilities of state and local government issuers in providing information. I shall comment on these last two initiatives.

On March 9, 1994, the Commission published the *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others* (Interpretive Release) which outlined the Commission's views with respect to the disclosure obligations of market participants under the antifraud provisions of the federal securities laws in connection with both primary and secondary market disclosure. This Interpretive Release was effective immediately and is currently considered by issuers, their advisors and counsel in providing information to the public.

On March 9, 1994, the Commission also published Securities Exchange Act Release No. 33742, which requested comment on proposed amendments to Rule 15c2-12. The amendments to Rule 15c2-12 were proposed to enhance the quality, timing, and dissemination of disclosure in the municipal securities market by placing certain requirements on brokers, dealers, and municipal securities dealers. It was the Commission's specifically stated intention that these amendments further deter fraud by restricting securities professionals' activities in securities where little or no current information is available to the market concerning those securities because "... Investors, especially individual investors, place their reliance on these securities professionals for their recommendation of municipal securities."

After an eight month comment period, over which the Commission received over 390 comment letters representing over 475 groups and individuals, the Commission issued Release

No. 34-34961, the final rule adopting amendments to Rule 15c2-12 under the Securities Exchange Act of 1934. Generally, the amendments prohibit the underwriting of municipal securities unless the issuer, and/or other obligated parties, has undertaken in writing to provide notices of certain material events and annual financial information similar to that provided in the official statement accompanying primary market issuance to Nationally Recognized Municipal Information Repositories (NRMSIRs) and to a State Information Depository (SID), if one exists. Furthermore, the amendments require that securities dealers have procedures in place that provide reasonable assurance that they will promptly receive any notices of material events disclosed by issuers. The requirement to undertake to provide information and to provide notices of material events only became effective on July 3 of this year. The requirement to provide annual financial information only becomes effective for fiscal years ending after December 31 of this year. It is apparent that there has not been enough experience with these initiatives to determine whether they will be effective. The Commission states in the release that it considers that the amendments, in concert with past Commission interpretations of the responsibilities of securities dealers and various Municipal Securities Rulemaking Board rules, which require that dealers disclose material facts of a transaction to a customer and that dealers ensure that any transaction recommended to a customer is suitable for that customer, among other requirements, will assist securities dealers in satisfying their obligation to have a reasonable basis to recommend municipal securities to a customer.

NASACT and its members have worked diligently with the Commission, other professional associations, and securities professionals to improve the provision of accurate, relevant, reliable, and timely state and local government financial disclosure in a cost-effective

manner. NASACT research has disclosed the extent to which securities professionals have relied on state-collected information in both primary market issuance and secondary market trading activity. Currently many states are considering the designation of SIDs, as provided for under Rule 15c2-12 amendments and are working with NASACT to ensure national comparability. Commission interpretation of the Rule 15c2-12 amendments within the past month may facilitate increased state involvement in Rule 15c2-12 reporting which could result in improved issuer and obligated party compliance with reporting requirements.

In summary, I believe that the existing regulatory structure and current initiatives at the state and federal levels are adequate to deal with the recent incidents of financial distress and potential defaults on the servicing and repayment of local government debt. I encourage the Subcommittee to monitor and evaluate the enforcement of the existing federal regulations and self-regulatory organization rules cited in this testimony. I believe that in doing so the Subcommittee will find that the great majority of state and local government financial administrators are highly qualified and perform their duties well. I also believe that the Subcommittee will find that state and local government securities are some of the safest investments available to investors anywhere in the world.

I appreciate the opportunity to provide a statement to Congress on this issue of national importance. I hope this statement, and those of my esteemed colleagues, will provide sufficient information for the Subcommittee to reach appropriate conclusions. I welcome the opportunity to answer any questions from the Subcommittee and will endeavor to provide further information to the Subcommittee should they so request.

Testimony of Philip M. Dearborn, Director of Governmental Finance Research
U.S. Advisory Commission on Intergovernmental Relations
on
Municipal Bankruptcy -- Orange County

U.S. House of Representatives
Committee on Banking and Financial Services

Thursday, July 27, 1995

Mr Chairman and members of the Committee, I am Philip M. Dearborn, Director of Government Finance Research of the U.S. Advisory Commission on Intergovernmental Relations (ACIR). My statement today is based on the ACIR reports: City Financial Emergencies, 1973, and Bankruptcies, Defaults, and Other Local Government Financial Emergencies, 1985. In addition to being the director of both studies, I was also an expert witness in both the South Tucson and Bridgeport municipal bankruptcy cases. Also relevant to today's discussion is the ACIR report, Understanding State and Local Cash Management, 1977.

In 1971, ACIR undertook an investigation of the financial condition of major cities to determine what might cause financial emergencies, and to recommend the respective roles that states and the national government should have in the prevention and treatment of financial emergencies in local governments. This study included a review of past municipal defaults, bankruptcies and other financial emergencies. The general conclusions of the report issued in 1973, were that unsound financial management is the most important potential cause of financial emergencies, and that prevention and treatment should be primarily a state responsibility.

ACIR recommended retention of Chapter 9 of the U.S. Bankruptcy Law as a stand-by remedy, but it concluded that, "...the Federal courts are not well equipped to render financial advisory service to a troubled municipal unit. If guidance or supervision is needed to put a municipality on a sound economic basis, the courts should recognize that a State agency or court appointed commission is likely to be better qualified to render financial management assistance."

The 1985 ACIR report updated the review of the occurrences and causes of local financial emergencies that had occurred since the preparation of the earlier report. Based on this review, it found that "there was no evidence that local governments generally are experiencing increased financial emergencies, or that they are likely to do so in the future."

I believe that finding is still valid, despite the Bridgeport and Orange County declarations of bankruptcy. In both these instances, the circumstances were unusual, and there has been no widespread pattern of local financial emergencies reported. Any emergencies that have occurred appear to have been resolved by state or local actions, generally carried out without national publicity, except perhaps for Chelsea, Mass.

The ACIR investigations of financial emergencies have found that historically the causes have been "unsound financial management." Typically, bad budgeting practices, often coupled with unaudited financial reports, resulted in unbalanced budgets, accumulated fund deficits, and

ultimately, losses of liquidity and financial emergencies.

Two additional causes were identified in the 1985 report as "unwise investment policies" and large court judgements against small local governments. Ironically, the finding about the threat from investment policies was based, in part, on the experience of the California city of San Jose that lost \$60 million from bad investments in the early 1980s.

The Orange County financial emergency was a clear result of unwise investment policies. The ACIR recommendation for preventing such emergencies is, "strict [state] laws covering local government investments of inactive cash, and careful adherence to those laws. A local government must time its investments so that funds will be available when needed; it should invest only in U.S. Treasury securities, certificates of deposit with full collateral or insurance protection, and other similar conservative investments."

It is now obvious that the State of California did not have strict laws governing local investments, and as a result, Orange County did not invest conservatively. Preventing similar problems in the future should remain a responsibility of state governments, and any states that have not followed the ACIR recommendations regarding investments, should do so.

In addition to recommending ways to prevent local government financial emergencies, ACIR has also reviewed and made recommendations about what should be done to relieve financial emergencies that do occur. The principal recommendation is that, because local financial emergencies are usually caused by unsound management, it should be the responsibility of states to correct them.

In our federal system states provide the basic constitutional and statutory authority for the operation of local governments. As a result, management of local governments is the legal responsibility of states, not the federal government, except in the narrow circumstances of administration of federal grants. In addition, because the credit and financial reputation of the state and of all of its units of local government are judged by the events that take place within the state, ACIR believes the principal response to local financial emergencies should rest with the state.

The history of financial emergencies shows that ultimately state actions are successful in resolving the problems. For example, the successful experiences in a number of cities in Ohio and in local governments in New York show that states can and do respond to correct problems in their local governments. Although New York City, because of the disproportionate size of its budget, needed some temporary help from the federal government, it was the state that assumed responsibility for finding a permanent solution to the city's problem. In the Bridgeport bankruptcy case, the problem was finally resolved when the federal bankruptcy judge dismissed the case and returned the matter to a state oversight board.

In some instances, such as in several Michigan cities, state courts have successfully overseen corrective actions for cities experiencing financial emergencies. In the South Tucson bankruptcy case, the federal bankruptcy judge sent the case back to the state court where it was successfully resolved.

There have been no instances investigated by ACIR, or me, in which the federal government or federal courts played an important role in resolving a local government financial emergency, except New York City. The few local governments that have used the federal municipal bankruptcy provisions have done so mainly to delay or avoid actions that they would otherwise have been required to take by state orders or rulings of state courts. There is no indication that this pattern has been changing.

One clear possibility that could change this outlook, however, is if Orange County succeeds in avoiding its financial obligations by use of the federal bankruptcy law. Many local governments have been forced by budget problems to make very hard choices involving increased taxes or reductions in vital services. Any evidence that such hard choices can be successfully avoided by use of the bankruptcy law, could trigger other similar efforts.

Nevertheless, ACIR has recommended that the federal bankruptcy law be retained to be used if instances arise in which state remedies are clearly inadequate. However, such use should only come after all available state remedies have been exhausted, specific state permission for the filing has been granted to the local government, and there is clear evidence of insolvency. If a pattern of abuse of the municipal bankruptcy law should develop as a result of Orange County, then the law should be amended to ensure that it is used only in the very limited instances in which it is appropriate.

U.S. HOUSE OF REPRESENTATIVES
Subcommittee on Capital Markets, Securities, and
Government Sponsored Enterprises of the
Committee on Banking and Financial Services

SUMMARY OF TESTIMONY TO BE GIVEN BY
CHARLES W FISH

The Committee has asked if there has been a fundamental shift in the relationship between the issuers and the investors. The answer to that question is "yes." As the market has evolved, growing ever larger and more complex, so too has there been an increase in the investor's needs to maintain confidence in this market's integrity and liquidity. The fundamental shift has been a negative one. The market seems less liquid today with fewer true market-makers and the Orange County debacle has undermined standing precepts with regard to a community's obligation, ability and willingness to live up to the promises made to investors.

As to the question of whether or not Orange County's bankruptcy is an isolated incident, the answer is absolutely not! It may not happen tomorrow - it may not happen next year. But it will happen if fundamental changes are not made in the way many states are failing to provide essential leadership and supervision.

Oversight of a public treasurer conducted by elected officials with no expertise whatsoever amounts to no oversight.

I recommend that the state must provide for the regulation and monitoring of the investment practices of any political subdivision within the state. Any investment practice that is inconsistent with either the spirit or the letter of state investment policy guidelines should require the state's approval in advance. Further, if a public treasurer wishes to accept deposits for investment in a common pool, it should be required by the state to provide such depositors with a prospectus that clearly states the strategic objectives of the pool and the specific investments they will employ in reaching those objectives. The use of any tactic or investment vehicle that is not clearly provided for in the prospectus should be against the law. For obvious reasons, an independent third party custodian should be required to hold all the assets of the pool. The custodian would be required to provide each pool participant with a monthly statement of the market value of the pool's assets.

I recommend that the states take such action as is necessary to ensure that every issue of public debt include the assignment of an independent trustee or fiscal agent. A municipality cannot, under the best of circumstances, honor the obligations it should have towards the bond or noteholder and protect its own interests simultaneously.

I have observed numerous situations where a fiscal agent or trustee, who has been charged with acting as attorney-in-fact for the bondholders, seemed to be taking their direction solely from the issuer. I don't have a specific recommendation to offer. I do feel that there is a considerable need for improvement in this area. The appropriate bank regulatory authorities should pursue remedies vigorously.

States must require that covenants applicable to a new issue be accompanied by an assignment of the responsibility for monitoring and disclosing the issuer's compliance with those covenants.

Any official or governmental body holding the responsibility for overseeing the activities of a public treasurer should be required to demonstrate that they either possess the financial and legal expertise necessary to effectively conduct such oversight or that they have retained that capability through a properly credentialed, independent outside firm.

July 27, 1995

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Dear Honorable Members:

Thank you for the opportunity to provide you with my perspective on the events surrounding Orange County's bankruptcy and its effect on the municipal market as a whole. I have prepared my testimony knowing that which has become common knowledge and anticipating the knowledge that will be imparted to the Committee by fellow panelists. I am, therefore, focusing my comments in hopes of bringing to light the failures of the industry as currently configured to address the welfare of the investor. For those of you that don't know me, let me state for the record that I have spent twenty-five years in the municipal securities industry (all in California), ten years of which was with the investment division of a money center bank and about five years with a major securities firm. I co-founded Fish & Lederer Investment Counsel ten years ago. We are actively engaged in managing both taxable and tax-exempt municipal bonds for high net worth individuals and commercial banks. From 1990 to 1993 I served as a member (and Chairman in my third year) of the Municipal Securities Rulemaking Board. I am a long time resident of Orange County where my business is located. Although this affords me a very broad perspective, my testimony reflects my primary concern, which is the interests of my clients to whom it is vital that the municipal markets remain ethical, fair and liquid.

The Orange County bankruptcy has brought to light a host of shortcomings in the entire arena of public finance in the State of California. I am identifying it as a California problem as I am a strong advocate of the state's responsibility to firmly control all aspects of public finance within its borders. Just as the agencies of the federal government exercise absolute authority over "Wall Street," each state must insure that the highest standards of fiscal management and prudent borrowing are adhered to at all times by their respective political subdivisions. Since recently taking office, State Treasurer Matt Fong has worked tirelessly to bring this about in California. However, much more needs to be accomplished

As to the question of whether or not Orange County's bankruptcy is an isolated incident, the answer is absolutely not! It may not happen tomorrow - it may not happen next year. But it will happen if fundamental changes are not made in the way many states are failing to provide essential leadership and supervision. Before investment policies are changed, codes rewritten, regulatory responsibilities changed, etc., it is imperative that you all view the problems from the vantage point of the investor. I am such an investor and I can tell you without hesitation that the view from these trenches is frightening. The recommendations that I now make are those that I have concluded from personal experience to be absolutely necessary.

Oversight of a public treasurer conducted by elected officials with no expertise whatsoever amounts to no oversight. Only the state has the authority, resources and expertise necessary to provide the oversight that will actually bring about the checks and balances necessary to prevent other "Orange Counties." Additionally, the state is in a far better position to prohibit the intrusion of the agenda of a local politician that may be motivated by self-serving interests and in conflict with the best interests of both the electorate and the investors. You may be thinking this is a bit harsh. Nevertheless, I am telling you, on the record, that I have sold highly rated bonds after discovering that the issuer had consciously failed to honor the rate covenants guaranteed in the bond documents. My inquiry led me to conclude that the only possible explanation was that the rate increases that should automatically have been imposed were blocked by local politicians who feared incurring the displeasure of constituents that would have to pay higher fees. No alarms sounded, no bells rang. Were it not for my own investigation, I would still be in the dark. The trustee knew nothing, the rating agencies didn't have a clue. If any of the government staff to whom the violation must have been obvious were concerned about the rights of the investors, that concern was not sufficient to overcome their fear of losing their jobs. Although covenants are clearly stated and understood by all parties, nowhere is there any assignment of responsibility or procedure for monitoring and disclosing the status of such covenants. We are entirely dependent on the integrity of the issuer, which in this case was sorely lacking. The covenants are put there for a reason and failure to comply with them not only impairs the credit, but in certain cases can put the tax exempt status of the debt in jeopardy.

RECOMMENDATION: All states should insure that the issuance of any debt must be accompanied by the assignment of the responsibility for monitoring and disclosing an issuer's compliance with all applicable covenants. It seems most logical to me that this task fall to the trustee.

Trustees and fiscal agents are not always adhering to the investment policies spelled out in bond documents. Don't get me wrong. I am well aware that the overwhelming majority of the banks engaged in this type of business conduct themselves admirably. However, over the years I've observed numerous situations where a fiscal agent or trustee who has been charged with acting as attorney-in-fact for the bondholders, seemed to be taking their direction solely from the issuer. I have been left with the distinct impression that they felt no obligation whatsoever to me as a bondholder. Perhaps the root of the problem is the inherent conflict of interest when trustees are paid by issuers, not investors, and it is in their interests to respond to the requests of an issuer who is capable of providing them with ongoing business. As a very recent example, in the days following Orange County's declaration of bankruptcy, I discovered much to my chagrin that a bank acting as fiscal agent for a local school district had, at the direction of the issuer, invested the bond reserve funds in Mr. Citron's investment pool. When I confronted him with the language in the governing resolution that did not include Mr. Citron's pool as one of the eligible investments for reserves and further stipulated that all investment securities credited to such fund shall be valued by the fiscal agent at current market value, which was obviously an impossibility in the case of Mr. Citron's pool, his only response was that it was all right in this case because the issuer had ordered it and that he had that in writing

RECOMMENDATION. I don't have a specific recommendation to offer. I do feel that there is a need for improvement in this area and that the appropriate bank regulatory authorities should pursue remedies vigorously.

Even though there are some problems involving independent trustees, they are nothing compared with the problems that may confront an investor in an issue wherein the issuer has chosen to name itself as the trustee, paying agent or fiscal agent. Such was the case with the largest single holding my clients owned in an instrument effected by the county's petition of bankruptcy. In the days following December 6, I met face to face with this city's finance director and chief administrative officer. I explained my background and volunteered some solutions that they may wish to start pursuing as early as possible in case they were unable to repatriate sufficient funds from Mr. Citron's pool in time to meet their debt service on June 30, 1995. I told them that the Depository Trust Company (DTC) would require their authorization to release the names of the other noteholders and that I would like to explain to them all that the meeting had occurred and ask if any of them had any further input. I had no intention of forming a noteholders committee at that time, but told them that I would not be fulfilling my obligation to my clients if I didn't take advantage of the time available to be as organized as possible should worse come to worse and the city default on its debt. I soon found out that DTC, who requires the permission of either the issuer or the trustee before they can release the names of holders, had not even been contacted by the city. I made numerous additional attempts in subsequent weeks to obtain a list of other holders from both the issuer and the underwriter -- to no avail. I was also refused my request to have my name and number distributed to the other holders so that if they wished they could contact me. I reminded the city that in the absence of an outside trustee, they had certain fiduciary responsibilities and that it was certainly conceivable that one or more of their noteholders might not even be aware that there was a problem. I explained to the city's representatives that if we were to gain the cooperation of all the noteholders to any alternative should the city not be able to meet its debt service, surely the sooner we started talking with them the better. I also expressed my desire to investigate a letter of credit or possible insurance arrangement that would only become affordable in the event that all noteholders shared the cost. The city sent a letter to Standard & Poor's (which had originally given the city its highest note rating of "SP-1+") in response to the rating agencies request for an update on the city's plan to honor their obligations in the event funds from the pool were not available in time. Since this was a matter of public record, I requested a copy of the letter. My request was denied two days later with the explanation simply that the letter was in a file marked "confidential" and therefore I could not have a copy. In the end, my staff had to spend countless hours cold calling likely purchasers at random until we had identified enough other holders to persuade the dealer who had marketed the securities (they were not the underwriter) to disclose our name and number to the remaining investors. What should have taken us twenty minutes to obtain from DTC, wound up wasting over two valuable months.

RECOMMENDATION: I recommend that the states take such action as is necessary to ensure that every issue of public debt include the assignment of an independent trustee or fiscal agent. A municipality cannot, under the best of circumstances, honor the obligations it should have towards the bond or noteholder and protect its own interests simultaneously

Early in this testimony I stated that oversight of a public treasurer conducted by elected officials with no expertise whatsoever amounts to no oversight. Surely the most blatant example of this was on June 14, 1994, when the county supervisors approved as a consent agenda item Mr. Citron's request to issue \$600 million in taxable notes. They violated their own county policy in the process, which stipulated that no item of greater than \$50 million would be placed on the consent agenda. In fact, the board had not challenged any of Mr. Citron's requests for years because it was easier to abdicate their responsibility for oversight rather than to seek outside expert help in fulfilling their obligation to properly supervise the treasurer's activities. As the press has been fond of pointing out, it was recently retired Board Chairman Thomas Riley who was quoted as saying that "I don't know how he does it . . . but he makes us look good every year." Keep in mind that the largest single revenue source in the annual budget was "interest income." Yet, they apparently felt no need to know how he did it.

Just as blatant, but overlooked by almost everybody, were Mr Citron's actions in regard to the \$110,200,000 County of Orange Taxable Pension Obligation Bonds, Series 1994B. This issue, with a stated maturity of September 1, 2008, had a bondholders seven day put option that allowed any or all bondholders to tender their bonds at par (100) plus accrued interest with seven days advance notice. A credit arrangement had been recommended through a syndicate headed by CS First Boston, the remarketing agent for the bonds. Apparently without consulting any other pool participants, Mr. Citron, claiming that he could save the county some money, insisted that the county treasurer's investment pool be used to facilitate the purchase of tendered Series B bonds and entered into a standby withdrawal agreement to that effect, dated September 1, 1994. This was just 96 days before the county declared bankruptcy and well beyond the period when Mr. Citron surely knew how precarious the pool's liquidity was.

RECOMMENDATION: The state must provide for the regulation and monitoring of the investment practices of any political subdivision within the state. Any investment practice that is inconsistent with either the spirit or the letter of state investment policy guidelines should require the state's approval in advance. Further, if a public treasurer wishes to accept deposits for investment in a common pool, it should be required by the state to provide such depositors with a prospectus that clearly states the strategic objectives of the pool and the specific investments they will employ in reaching those objectives. The use of any tactic or investment vehicle that is not clearly provided for in the prospectus should be against the law. For obvious reasons, an independent third party custodian should be required to hold all the assets of the pool. The custodian would be required to provide each pool participant with a monthly statement of the market value of the pool's assets.

Any official or governmental body holding the responsibility for overseeing the activities of a public treasurer should be required to demonstrate that they either possess the financial and legal expertise necessary to effectively conduct such oversight or that they have retained that capability through a properly credentialed, independent outside firm.

The Committee has asked if there has been a fundamental shift in the relationship between the issuers and the investors. The answer to that question is "yes." As the market has evolved, growing ever larger and more complex, so too has there been an increase in the investor's needs to maintain confidence in this market's integrity and liquidity. The fundamental shift has been a negative one. The market seems less liquid today with fewer true market-makers and the Orange County debacle has undermined standing precepts with regard to a community's obligation, ability and willingness to live up to the promises made to investors.

The MSRB's Rule G-37 has gone a long way toward addressing investors' concerns with regard to the abuses related to political contributions. The SEC's new rules regarding CDI (continuously disclosed information) are of tremendous importance to the investor. They address what has been the most conspicuous shortcoming of the municipal market, the absence of timely relevant credit information. The confidence that this should bring to the investor is offset in large part by the hue and cry from issuers that seem to feel that they are severely put upon for having to disclose information that every other borrower knows they must provide to the lender. If it truly is too difficult for them, I suspect that they themselves, like the Supervisors of Orange County, are conducting their financial affairs with inadequate knowledge. They need and should receive technical assistance from the state. If they still feel that CDI is too great a burden, it would be better for all concerned if they satisfied their need to borrow by going through a state municipal bond bank or their local commercial bank, rather than trying to borrow from the public

Respectfully submitted,



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***Statement of Robert D. McKnew
Chairman, Public Securities Association***

***before the House Subcommittee
on Capital Markets, Securities and
Government Sponsored Enterprises***

Committee on Banking and Financial Services

July 27, 1995

Summary

Investment Strategy

- All investments involve some form of risk. It is vitally important that investors fully understand the risks to which they are exposed by various financial instruments and how those risks relate to their investment strategies and overall portfolio.
- Investment losses suffered by Orange County are not attributable to particular financial instruments. Rather, they are attributable to an investment strategy that exposed the County to excessive market risk.

Municipal Bankruptcy

- General obligation bonds represent a pledge by a community to exhaust all possible avenues of debt repayment, including tax increases or drastic spending cuts. Default rates among general obligation bonds are close to zero.
- Bankruptcy and default in Orange County is not an indicator of a national trend. Few if any communities engage in the type of investment practices that Orange County did. Moreover, there are huge economic disincentives to default and bankruptcy.

Municipal Investment Practices

- Addressing perceived lapses in state oversight of local investment practices by limiting permissible investments to a narrow list of instruments is short-sighted.
- Responsible rules governing state and local investment practices should encompass sound investment guidelines, mark-to-market requirements, reporting and oversight, and standards of qualification for public investment managers.

Respective Responsibilities of Securities Dealers and Institutional Investors

- Securities dealers have a well-defined and unique role in the market: to provide investors with a means by which to buy and sell securities in the open market. Securities dealers are not investment advisors, which, for a fee, provide buy and sell recommendations.
- A workable contractual agreement between securities dealers and state and local investors should recognize the arm's length nature of the dealer-investor relationship and should acknowledge the responsibility of institutional investors to accept responsibility for investment decisions.

Municipal Disclosure

- New SEC rules related to ongoing municipal disclosure have the potential to drastically improve the availability of financial information regarding municipal securities issuers. These rules should be given the opportunity to take effect before any additional policy actions are undertaken.

Thank you, Chairman Baker, and good morning. I am Robert McKnew, and I appear here this morning as Chairman of the Public Securities Association (PSA). I am also an Executive Vice President of Bank of America, NT & SA.

PSA is the international trade organization of securities firms and banks that participate in the fixed-income markets. Policy issues related to state and local government finance and public investment practices are of profound interest to PSA's members. Recent events in Orange County, California and elsewhere have roiled our markets. Congressional attention to issues related to these events is warranted and welcome, and your leadership in calling this hearing, Chairman Baker, is commendable. We appreciate the opportunity to participate.

The unfortunate events that have transpired in Orange County over the past several months are a watershed in several respects. Losses suffered by the County's investment fund have raised questions related to the prudent use of certain financial instruments such as derivatives and structured securities. The highly leveraged investment strategy employed by the County fund has caused state and local officials around the country to rethink their own investment policies. Orange County's bankruptcy filing and its subsequent attempts to devise work-out strategies have

raised questions regarding the use of repurchase agreements as a financing technique and the status of outstanding general obligation debt securities not just in Orange County or the state of California, but around the country.

The Subcommittee has heard testimony from witnesses who are closer to the evolving Orange County situation than I am and who are better suited to address the specifics of recent events there. My statement this morning will instead focus on more general policy issues related to investment strategy, municipal bankruptcy, state and local investment policies, the responsibilities of securities dealers and institutional investors, and municipal information disclosure.

Investment Strategy

Virtually all investments involve some form of risk. It is vitally important that investors understand fully the risks to which they are exposed by a particular instrument and how those risks relate to their investment strategy, goals and their overall portfolio. Financial market participants in recent years have become quite adept at creating instruments with very specific and focused cash flow characteristics. These instruments can be used efficiently to hedge exposures associated with an investor's portfolio and reduce overall risk. In addition, if an investor seeks to structure a portfolio that performs well under certain specific interest rate environments, financial instruments can be tailored to implement that desired strategy. If interest rates behave the way the investor assumed, those instruments would perform well. However, the investor should understand that if interest rates do not behave as assumed, the instruments may perform quite

poorly. The instruments themselves are not the culprits if the investor loses money.¹ Indeed, the ability of an investor to purchase instruments that isolate risks that he or she wishes to manage — resulting in more efficient hedging opportunities — is a major benefit of today's financial marketplace.

The losses suffered by Orange County's cash management fund are attributable to three principal factors. First, Orange County invested in medium-term notes which, like all fixed income securities, are subject to market risk as interest rates change. Throughout much of 1994, such securities generally fell substantially in price because of interest rate increases. Second, Orange County used short-term borrowing to leverage its investment portfolio to several times its original holdings. By borrowing against its portfolio, the County was able to raise additional funds to buy even more securities. This strategy can amplify the effects of price fluctuations, up or down. Third, the County invested in certain interest-rate-sensitive structured securities, instruments typically created to meet a specific investor need. Often, entire issues of structured securities are purchased by a single investor. Consequently, such securities are hard to value and therefore less liquid, a factor that likely contributed to problems suffered by the County. In short, the County apparently structured a portfolio that would perform very well in an environment of stable or falling interest rates but would be exposed to substantial market risk in an environment of rising

¹ Firms acting as dealers of structured securities generally do not undertake to advise investors on trading strategies. Rarely do firms that sell structured securities to institutional investors ever have full knowledge of the contents of a customer's portfolio or the trading strategy being employed. Indeed, it is often the case that investors view information regarding their portfolios and strategies as proprietary and confidential and take steps to prevent dealers from gaining full knowledge of their situations.

interest rates. It should come as no surprise, therefore, that as a result of the county's one-sided investment strategy, as rates rose throughout much of 1994, the County suffered excessive losses.

Fixed-income investments in general fared poorly throughout most of 1994. For example, the Treasury's 6-1/4 percent 30-year bond due in August 2023 was priced on December 31, 1993 at 98-21² to yield 6.35 percent. By early November 1994, the yield on the same bond had risen to 8.23 percent at a price of 78-09, a drop in price of nearly 21 percent. (By comparison, on the day of the 1987 stock market crash, the Standard & Poors 500 stock index lost just over 20 percent of its value.) The yield on the Treasury's 5-3/4 percent 10-year note due in August 2003 rose from 5.79 percent in December 1993 to 8.00 percent in November 1994 as the price fell nearly 14 percent from 99-20 to 85-31. The yield on the 5-1/8 percent five-year note due in December 1998 rose from 5.19 percent in December 1993 to 7.64 percent in November 1994, with the price falling from 99-23 to 91-05, a nearly nine-percent drop. In the overall Treasury securities market, the Lehman Brothers Treasury Bond Index fell from 5509 in late December 1993 to 4898 in early November 1994, a drop of over 11 percent. Losses in the fixed income markets in 1994 were historic.³ The overall negative 5.01 percent return on the Treasury's five-year note was the worst one-year performance of that security ever. The loss in 1994 on Treasuries with 20 years to maturity was the second worst ever. Although bond prices have risen significantly since late 1994, fixed-income losses last year were substantial.

² Prices of Treasury bonds are quoted here in points and 32nds of a point. A price of 98-21 means 98 and 21/32nds.

³ Thomas T. Vogel, Jr., "After Plunging in 1994, Bond Prices May Take Long Time to Recover," *The Wall Street Journal*, December 30, 1994, page A1.

Orange County's investment losses are not attributable to specific instruments in the County's portfolio. The County's investment losses are the result of a failed strategy which employed leverage to expose the portfolio to excessive, unhedged market risk. When the Federal Reserve began to raise interest rates in early 1994 and bond prices fell precipitously, many fixed-income investors suffered losses. Orange County's losses were magnified as a result of its risky strategy.

The losses suffered by Orange County's cash management fund were excessive, even relative to the overall market. However, it is important to draw a distinction between the investment strategy the County employed and the instruments it used to implement its strategy. Financial instruments such as medium-term Treasury and federal agency notes, structured securities and repurchase agreements are neither good nor bad by themselves. They are simply tools which market participants can use to achieve certain goals. Indeed, with respect to credit risk, such instruments are extremely safe. However, their values are affected by changes in market interest rates. Used properly, these instruments provide a powerful opportunity to manage risk and investments. Used improperly, they can result in excessive risk exposure and poor investment performance.

Municipal Bankruptcy

As you know, general obligation (GO) municipal bonds represent debt backed by the full faith and credit of the issuing community. The nature of a general obligation pledge varies from issuer to issuer due to constitutionally imposed limitations on taxation and spending that exist in some states. In general, however, a general obligation pledge implies that the issuing community will,

in good faith, "use any and all available revenue-producing powers to pay the obligation as it becomes due."⁴ The issuer essentially pledges to exhaust all potential avenues of payment on its debt, including tax increases or drastic spending reductions. A general obligation represents perhaps the most important financial commitment a community can undertake. When I began my career in the public securities markets 25 years ago, I was taught that municipal general obligation bonds were second in credit quality and security only to U.S. government debt.

On December 6, 1994, Orange County, California filed for bankruptcy protection under Chapter Nine of the U.S. Bankruptcy Code. In June of this year, Orange County citizens defeated a referendum to increase the County's sales tax. The tax increase would have generated revenue which could have been used to satisfy debt obligations and permit at least partial payments to local governments who had invested money in the County's fund. In recent weeks, the County defaulted on a large volume of outstanding debt securities. If in the end the County fails to pay its debt obligations, it will be the first major general obligation bond issuer to do so since the Depression.

The importance that municipalities place on the general obligation pledge is reflected in the credit performance of GO bonds. Defaults among all municipal securities, GO and revenue, is extremely low — less than two percent. The default rate among general obligation bonds is close to zero. Among the few GO bond issuers that have defaulted, I know of none in recent memory that has in the end failed to meet its financial obligations, including New York City in the mid-1970s. Given

⁴ Robert S. Amdursky and Clayton P. Gillette, *Municipal Debt Finance Law*, Little, Brown and Company, 1992, p. 26.

the degree of faith that the market places in the general obligation pledge, the reaction of investors and others to recent events in Orange County — first bankruptcy, then several defaults — is no surprise.

Developments in Orange County have affected state and local governments and municipal bond investors who have no direct connection to events there. In the days following the County's defeated referendum to increase the local sales tax, prices of all municipal bonds, especially those issued by California communities, suffered. Fortunately, the effect of the Orange County vote on the overall municipal market was not as severe as many predicted it would be. There is a perception among some market participants that defaults in Orange County — a community that is by all standards affluent and that certainly has the economic means to meet its obligations — call into question general obligation pledges everywhere. However, most investors, issuers and others correctly recognize that the County's bankruptcy and defaults do not forebode a rash of similar occurrences elsewhere. Furthermore, actions taken by county and state officials in the coming weeks and months will indicate whether the failed sales tax vote represents a repudiation by county citizens of their debt obligation or whether it is simply a statement by voters regarding the preferred means of settling the county's bankruptcy. I suspect and hope the latter.

The situation in Orange County is unique. Very few state or local governments knowingly expose themselves to the level of financial risk that the County did through its investment practices. The vast majority of local governments employ prudent financial policies and maintain adequate oversight of their investments. Moreover, there is a strong, market-based disincentive for municipal financial mismanagement.

The biggest deterrent to municipal bankruptcy and default is the cost associated with those actions. If a local government defaulted on its debt, its future access to the capital markets would be extremely limited and would come at an extraordinarily high cost. Moreover, a bankrupt or defaulted issuer is tainted with the stigma of those actions for years, perhaps even decades. Even today, for example, New York City is burdened by the effects of its fiscal crisis in the mid-1970s. In the end, bankruptcies and defaults can hurt citizens and taxpayers as much or more than investors. States and localities recognize the severe consequences of fiscal mismanagement imposed by the market. After all, the relationship between a bond issuer and a bond investor is one of borrower and lender. Few if any investors are willing to lend money to a defaulted borrower, and even then, only at extremely unfavorable costs to the borrower.

For this reason, municipal bankruptcy is relatively rare. Of the nearly 70,000 business bankruptcy proceedings⁵ filed under the Federal Bankruptcy Code in 1993, the last year for which data are available, only nine were municipal bankruptcies filed under Chapter Nine.⁶ In general, PSA does not believe that Chapter Nine creates incentives that adversely affect the municipal market. We also do not believe that wholesale changes to Chapter Nine are warranted. PSA would support certain technical or clarifying changes to Chapter Nine, for example, to clarify that all provisions under the Federal Bankruptcy Code related to repurchase agreements, securities contracts and certain other contracts and instruments apply in Chapter Nine proceedings.

⁵ Business bankruptcies include those filed under chapters seven, nine, 11 and 13.

⁶ Administrative Office of the U.S. Courts, *Annual Report of the Director*.

Municipal Investment Practices

The management of public funds by municipal officials represents a sacred trust. All investments bear risk, and when investing public funds, municipal officials put at risk citizens' money that is intended to educate children and provide for health and safety. It is, therefore, vital that officials charged with the responsibility of investing public funds have the capacity to understand fully the nature of their investments and the risks to which their funds are exposed.

In the wake of recent developments in Orange County, certain public officials have undertaken a hasty response to what is perceived as a lack of state oversight of local government investment practices. Some states have enacted or are considering enacting laws which prohibit or restrict investment in entire categories of instruments. In some cases, these laws would limit public investment to only those instruments that bear the lowest market risk. This approach is shortsighted for several reasons. First, there is no single investment strategy or list of permissible instruments that is appropriate for all local governments in all circumstances.

Second, a local government that invests solely in Treasury bills of the shortest maturity may do a disservice to its citizens by foregoing investment opportunities that are appropriate and consistent with the government's financial goals and risk tolerances and that would earn a higher yield.

Third, by simply shortening the list of permissible investments, this approach avoids the responsibility to manage public funds wisely and to understand the benefits and risks of the instruments in which public funds are invested. As SEC Chairman Arthur Levitt has eloquently stated, "You may as well avoid the dangers of wiring a house by outlawing electricity. One of the

best ways to hedge against risk is to diversify, which is to increase choices. Rather than eliminate investment tools, steps should be taken to assure they are well understood, and wisely employed."⁷

PSA feels that the regulation of municipal investment practices is within the regulatory jurisdiction of state and local, as opposed to federal, regulators. Although PSA opposes public investment policies that too severely restrict permissible investments, we do support guidelines and related measures to help ensure that public funds are managed responsibly, including the following:

- *Investment guidelines.* PSA believes that each local government that invests on its own behalf should develop a well-defined set of investment guidelines. Local officials charged with making investment decisions should bear the responsibility of compliance with the guidelines. Compliance with the guidelines should be demonstrable.
- *Mark to market.* We support proposals to require that the reported value of public investments be adjusted periodically to reflect changes in market prices. Marking to market daily, as required for regulated investment companies, may not be practical for most public investors. However, marking to market monthly or, at the very least quarterly, is vital to monitoring the performance of public investments.

⁷ Arthur Levitt, "Public Funds and Public Trust at the Dawn of the Twenty-first Century," remarks before the Government Finance Officers Association, June 13, 1995.

- *Reporting and oversight.* We also support proposals to require periodic information reporting related to public investments, such as portfolio composition, marked-to-market price data and investment performance analyses. In addition, we support requirements that public officials charged with making investment decisions be subject to ongoing oversight.
- *Standards of qualification.* Finally, we support standards of qualification for public officials with responsibility for investing public funds. Investment and finance professionals employed by broker-dealers are required to pass one or more certification examinations administered by the National Association of Securities Dealers and other self-regulatory organizations. Public investment officials should be required to meet similar professional standards. To that end, we commend efforts such as the National Association of State Treasurers' Public Finance Institute, currently underway, which is designed to educate public officials on the latest developments in debt and cash management.

Public investment policy recommendations of this nature have been recommended by the California Task Force on Local and State Investment Practices, chaired by California State Treasurer Matt Fong, which undertook a comprehensive analysis of local investment practices in California in the wake of the Orange County bankruptcy. We commend the contribution that Treasurer Fong and other members of the task force have made to the debate over local government investment policies.

Respective Responsibilities of Securities Dealers and Institutional Investors

A bank or securities firm that acts as a securities dealer carries out a well defined market function: providing a means by which investors can buy or sell securities in the open market. The role of a securities dealer is to facilitate the purchase and sale of securities among investors. In principal transactions — the type of transaction that is prevalent in the over-the-counter fixed income markets — a securities dealer acts as a market-maker, assuming a counterparty role of buyer or seller.

The role of a securities dealer is sometimes confused with that of an investment advisor. As the name suggests, an investment advisor — for a fee — makes buy and sell recommendations or, in some cases, decisions, for a client. Unlike a securities dealer, an investment advisor has a fiduciary responsibility to his or her client and, also unlike a securities dealer, does not provide the means by which the client buys or sells securities in the open market. The job of an investment advisor is to help ensure that a client's investment choices are wise.

The roles of broker-dealers and investment advisors are often confused, I believe, for two reasons. First, in their role as market facilitators, securities dealers often recommend securities for sale, suggest investment strategies, provide research and analytical services and perform other functions in addition to quoting prices and facilitating transactions. These functions are incidental to a securities dealer's role as a market-access provider. However, similar functions may also be provided by investment advisors. Second, many banks and securities firms also offer investment advisory services, either directly or through affiliated companies, in addition to their roles as securities dealers.

In order to clarify the relationship between broker-dealers and local governments that buy or sell securities, PSA and the Government Finance Officers Association (GFOA) have worked together periodically over the past several years to attempt to develop a sample contractual agreement. The sample agreement would define the roles and responsibilities of a broker-dealer in transactions involving a counterparty local government. It is probably not possible to draft a sample agreement that would be applicable to all — or necessarily even any — dealer-client relationships. Each investor-dealer relationship is unique. However, a sample agreement could be useful in providing a general framework for agreements which could then be tailored to specific situations. PSA, therefore, is committed to continue working with the GFOA on a sample agreement that is agreeable to both parties.

At the very least, a sample agreement should recognize the nature of the relationship between securities dealers and institutional investors. We agree with the characterization of the investor-dealer relationship contained in the voluntary "Principles and Practices for Wholesale Financial Market Transactions," drafted under the coordination of the Federal Reserve Bank of New York, which makes clear that institutional market participants should expect that their counterparties deal with them at arm's length.

In addition, a sample agreement should embody the principle that investors, especially institutional investors, must bear responsibility for their decisions. Efforts to shift investment losses to securities dealers carry ominous implications for our markets. A dealer must know with certainty that as long as a transaction was undertaken lawfully and in good faith, it is binding. There must

be a time certain when the responsibility for the performance of an investment shifts from seller to buyer. A market where investors are permitted to reap the benefits of a rising market but are able to transfer losses incurred in a falling market back to the dealer who sold the securities can not work. If institutional investors, including those who invest public funds, are protected from the consequences of their investment decisions by recourse to the securities dealers with whom they dealt on the basis of an after-the-fact claim that they lacked the knowledge, competence or oversight to make an informed decision, the efficiency of our markets is doomed. We agree with the GFOA that in the case of state and local government investors, "the ultimate responsibility for investment decisions rests with the public finance official."⁸

This is not to imply that securities dealers are without responsibility in dealing with institutional investors. Dealers are appropriately bound to legal and ethical standards in facilitating transactions. These include a clear and complete description of the securities being sold, the price of the instrument, disclosure of any known characteristics of the security that could affect pricing, and efforts to ensure investor understanding of how the instrument could affect his or her financial situation. However, once these responsibilities have been met, a dealer should be able to rely on the certainty that once a security is sold, financial risk shifts to the buyer.

Municipal Disclosure

Events in Orange County have highlighted questions regarding the adequacy of information disclosure by state and local government bond issuers. The issue of information disclosure by

⁸ Corrine M. Larson, "An Introduction to Broker/Dealer Relations for State and Local Governments," Government Finance Officers Association, April 1994.

municipal securities issuers has evolved over the past twenty years since enactment of the Securities Act Amendments of 1975, legislation which eventually led to the SEC's rule requiring the dissemination of official statements in conjunction with the primary offering of municipal securities. PSA has long been a consistent supporter of improved information disclosure in the municipal market. It is our strongly held belief that municipal bond investors deserve access to continuing information concerning the municipal entities in whose securities they have invested. In fact, in 1993 testimony before the House Energy and Commerce Committee, Subcommittee on Telecommunications and Finance, PSA agreed to "support legislative action granting regulatory and enforcement authority to require" greater municipal disclosure.⁹ PSA also helped draft, along with 11 other groups representing municipal securities issuers and analysts, the December 1993 "Joint Statement on Improvements in Municipal Securities Market Disclosure" which recommended some of the provisions adopted by the SEC in later releases.

Most recently, PSA supported the adoption by the SEC in November 1994 of changes to Rule 15c2-12 which generally would require issuers to pledge to release annual financial information and statements of material changes in financial condition before dealers would be permitted to underwrite their bonds. Those rule changes took effect earlier this month. In addition, in March 1994 the SEC issued an interpretive release describing the application of the anti-fraud provisions of federal securities statutes to municipal market participants, including both issuers and dealers. That release, which PSA supports, encompasses certain aspects of information disclosure by

⁹ Statement of Gerald P. McBride, Chairman, Municipal Securities Division, Public Securities Association before the House Committee on Energy and Commerce, Telecommunications and Finance Subcommittee October 7, 1993, page 7.

municipal issuers, including "issues arising from their activities as end users of derivative products."¹⁰ For example, the release states that "disclosure documents need to discuss the market risks to which [municipal bond] issuers are exposed, the strategies used to alter such risks and the exposure to both market risk and credit risk resulting from risk alteration strategies."¹¹

The recently adopted changes to SEC Rule 15c2-12 effectively require municipal issuers to provide annual information of the type and scope included in the final official statement accompanying the primary offering. The change also provides a specific list of material events, disclosure of which would be required. Given the significant progress that has been achieved in improving disclosure by municipal bond issuers and given that new rules governing continuing disclosure took effect just weeks ago, PSA believes that no additional legislative or regulatory changes are warranted at this time. We urge Congress and the SEC to allow the new disclosure regime to take full effect before assessing the need for further action.

Summary

Recent events in Orange County have focused new attention on the unique nature of the trust associated with the investment of public funds. Developments in Orange County have also focused attention on policies and practices necessary to minimize the risk that such an unfortunate series of events could threaten the financial health of other communities.

¹⁰ Securities and Exchange Commission (SEC), "Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others," Release No. 33-7049; 34-33741; FR-42, March 9, 1994, page 20.

¹¹ SEC.

It is my strongly held belief that Orange County represents a unique situation. Most public officials do not undertake the type of risky investment decisions in which Orange County's fund managers engaged. Nor are bankruptcy and default viable financial alternatives for U.S. municipalities. In short, although Orange County appropriately raises concern among market observers, policy makers and others, we should not assume it is an indicator of a trend.

Nevertheless, we should not ignore the opportunity to rethink some of the principles associated with sound state and local financial management and the nature of investor responsibility. It is appropriate, for example, to question the use of imprudent investment strategies, the soundness of municipal investment practices, the adequacy of state and local information disclosure and the extent to which institutional investors are willing and able to bear responsibility for their decisions.

The subcommittee's attention to these and similar issues is commendable. We appreciate the opportunity to participate, and we look forward to working with members and staff in the future.

STATEMENT
OF
THEODORE CRAVER
ON BEHALF OF THE
AMERICAN BANKERS ASSOCIATION
ON
THE MUNICIPAL FINANCE MARKET
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
GOVERNMENT SPONSORED ENTERPRISES
OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES

JULY 27, 1995

SUMMARY

The recent filing for bankruptcy by Orange County and the magnitude of the investment losses suffered by the County has raised many issues with which this Subcommittee, through these hearings, is appropriately addressing. These issues are very important to the investing public; to state and local government issuers that need the financing provided by the municipal market, and to state and local taxpayers who not only enjoy the public works and services funded by municipal bonds but also must stand behind the issuing authorities.

Much has been made in the popular press about the Orange County pools and its investments. It is fair to say that the investments per se were not bad but, rather, the investment strategy itself that was severely flawed. Some have characterized the leveraged borrowing strategy as nothing more than speculating with the taxpayer's money.

While unfortunate, this municipal bankruptcy filing does not warrant enactment of federal legislation aimed at curbing the use of derivative instruments. Any effort to restrict this market, including the ability of certain participants to engage in derivative transactions, would increase costs and burdens, as well as risks, for derivative market participants. Specifically, restrictive legislation could result in banks and other market participants taking on additional interest rate risk, or alternatively making less credit available to local communities. In addition, many banking institutions could be denied the ability to acquire investment securities appropriate to that institution's particular investment philosophy.

Moreover, municipal and county governments are property within the jurisdiction of their states. Consequently, should an examination of all the issues involved reveal that the County's investment policies and/or risk management controls were deficient, the cure, the ABA and ABASA would respectfully submit, is more a matter for state and local, and not federal, lawmakers.

It is, however, imperative that the Orange County bankruptcy have limited effect on municipal securities offerings of other state and local government issues. A spillover effect could have very negative consequences for other municipal offerings, as well as the market as a whole.

It would appear that, to date, the market has largely withstood the Orange County bankruptcy filing. The very act of filing for bankruptcy appears to have given all affected parties breathing room to sort out their financial affairs.

In addition, the numerous investor protection initiatives undertaken to date by both the regulatory authorities and the industry itself have had a calming effect on the municipal securities market. These initiatives have largely centered on getting improved disclosure to investors in both the primary and secondary municipal securities markets.

The ABA and ABASA believe that these initiatives, taken to ensure that the municipal securities markets operate in the sunshine, should be allowed to proceed. Only, if after sufficient time has elapsed and analysis reveals that additional action is needed, should this Subcommittee then consider further initiatives in this regard.

This Congress does, however, have an historic opportunity to improve municipal market liquidity. Tax proposals currently under review by the House Ways and Means Committee will, if enacted, encourage bank investment in municipal securities.

In addition, the full House Banking Committee has put forth legislation that would allow banks to underwrite municipal revenue bonds. If enacted into law, state and local governments will have better access to the capital markets and their securities will achieve increased liquidity which, in turn, results in lower borrowing costs, inuring to the benefit of state and local governments and their taxpayer constituents.

The ABA and ABASA would strongly urge the Subcommittee to continue to support the ability of commercial banks to underwrite municipal revenue bonds and to support ongoing efforts to revise the Internal Revenue Code to allow banks to invest more in municipal securities.

I. Introduction

Mr. Chairman and members of the Subcommittee, I am Theodore Craver, Executive Vice President and Corporate Treasurer of First Interstate Bancorp, located in Los Angeles, California. First Interstate Bancorp is the parent bank holding company of 16 banks located in the 13 western states. The consolidated assets of the Corporation are \$57 billion. As Executive Vice President and Treasurer, I am responsible for managing the Corporation's venture capital, investment, mortgage and consumer asset portfolios, as well as its funding and capital issues. I also am a member of the Asset and Liability Committee which manages the Corporation's interest rate risk and Chairman of the Investment Committee which has fiduciary responsibility for our pension and 401(k) plans. Finally, I have responsibility for the Corporation's broker dealer and bank dealer operations (including municipal bond underwriting), insurance products and mergers and acquisitions. I appear here today on behalf of the American Bankers Association ("ABA") and the ABA's Securities Association ("ABASA"), the latter of which I serve on its Board of Directors. ABASA is an affiliate of the American Bankers Association ("ABA") created to represent the interests of banking organizations in the securities area. The ABA is the national trade and professional association representing the entire banking industry, from the smallest banks to the largest bank holding companies. ABA members represent about 90 percent of the total assets of the banking industry.

Mr. Chairman, I appreciate the opportunity to be here today to discuss the municipal finance market generally and particularly as that market relates to commercial banks and their affiliates. That market now exceeds \$1.2 trillion in outstanding issues.¹

¹ Source: Securities and Exchange Commission ("SEC"); Public Securities Association ("PSA").

Consequently, the issues raised by this panel are very important to the investing public; to state and local government issuers that need the financing provided by the municipal market, and to state and local taxpayers who not only enjoy the public works and services funded by municipal bonds but also must stand behind the issuing authorities.

In general, my testimony will focus on those aspects of municipal finance with which commercial banks are generally involved, namely the underwriting and investment in municipal securities. I will leave to others more experienced than I, the plethora of issues concerning municipal investment standards and municipal bankruptcy filings.

Before discussing these issues, however, I would like to briefly touch on one issue seemingly implicated by the Orange County bankruptcy filing. That issue is derivatives. Both the ABA and ABASA are concerned that much of the discussion concerning Orange County and its investment losses has improperly focused on these instruments, much to their detriment. I share in that concern and wish to state for the record the banking industry's position with respect to these instruments.

II. Derivatives

As the Subcommittee is aware, the term "derivatives" is all encompassing. Derivatives include contracts the value of which depends on, or derives from, the value of an underlying asset, reference rate or index. Examples include forwards, futures, options and swaps. Many of these instruments, such as futures and some options, are traded on

organized exchanges. As such, these instruments are standardized as to maturity, contract size and delivery terms. Others, such as swaps and foreign exchange contracts, are custom tailored contracts traded in the over-the-counter ("OTC") market.

Commercial banks use derivative contracts both as end users and as dealers. Much like other corporations, commercial banks use derivative instruments to manage their own institution's risks and to reduce their funding costs, thereby enabling them to make more credit available in their local communities. For the first quarter of this year, 627 banks used derivative contracts, and that number is expected to grow.²

The term "derivatives" is also used to describe derivative securities, such as structured debt obligations. These instruments are generally securities whose interest rate, redemption amount or stated maturity depend on one or more indices, and/or have embedded forwards or options. Examples of these structured note securities would include step-up bonds, inverse floaters and range bonds. U.S. government sponsored enterprises ("GSEs"), such as the Federal Home Loan Banks, Federal National Mortgage Association, Student Loan Marketing Association, Federal Farm Credit Bank and Federal Home Loan Mortgage Corporation have issued most of these structured notes.

Commercial banks both invest and deal in these securities. As U.S. government-agency securities, these investments are generally perceived to be good credit risks at attractive yields. Over 4,600 commercial banks, or 47% of the industry, held structured notes

² Source: Federal Deposit Insurance Corporation ("FDIC")

valued at \$44 billion in their portfolios at the end of 1994.³ A recent survey of bank portfolio managers revealed, however, that structured notes make up only four percent of the dollar value of securities held in bank investment portfolios.⁴

Much has been made in the popular press about the Orange County investment pools being invested in interest rate sensitive derivative securities, especially inverse floaters. While there are others on this panel as well as those that have preceded more familiar with the details of the situation than I, I think it is fair to say that it was not the investments per se that were bad but, rather, the investment strategy itself that was severely flawed. Indeed, some have characterized the leveraged borrowing strategy as nothing more than speculating with the taxpayer's money.

Specifically, that strategy caused the interest rate sensitivity of the Orange County investment pools to be magnified several times over by the use of reverse repurchase agreements to acquire additional securities paying higher rates. When interest rates rose during 1994, the securities subject to these reverse repurchase agreements declined in market value requiring additional commitments of securities to back the cash exchanged for securities. This call for additional collateral, if you will, combined with requests for withdrawal of funds and reduced interest return on the structured notes purchased generated a cash flow problem that precipitated the filing for bankruptcy.

³ ABA estimates based on data received from its 1995 *Portfolio Managers Survey*.

⁴ American Bankers Association, *Portfolio Managers Survey Report - 1995*.

Mr. Chairman, while unfortunate, this municipal bankruptcy filing does not warrant enactment of federal legislation aimed at curbing the use of derivative instruments. Any effort to restrict this market, including the ability of certain participants to engage in derivative transactions, would increase costs and burdens, as well as risks, for derivative market participants. Specifically, restrictive legislation could result in banks and other financial intermediaries taking on additional interest rate risk, or alternatively, making less credit available to local communities. In addition, many banking institutions could be denied the ability to acquire investment securities appropriate to that institution's particular investment philosophy.

Furthermore, should the efficient execution of these derivative transactions be hampered, risk to capital formation with all of its negative ramifications could result, including the distinct possibility that the derivatives business, or, at least, portions of it, might move off-shore. Derivatives are essential to an efficient market. Our financial services industry needs the ability to move capital around in the most efficient manner possible in order to remain internationally competitive. Any efforts to restrict the derivatives activities of banks and others could severely disable our industry and the markets we serve.

This is not to say that derivatives are without risk. Those risks can be adequately managed, however. With respect to commercial banks and their affiliates, the federal regulators are appropriately supervising bank activity in this area and no need exists for federal legislation. This position is fully supported by the Federal Reserve Board ("FRB"),

the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), and the Securities and Exchange Commission ("SEC"), as well as numerous industry leaders.

Risks associated with state and local government investment policies should also be adequately managed and appropriately supervised. As municipal and county governments are property within the jurisdiction of their states, their risk management and supervision should also be a matter for state and local lawmakers.

Consequently, the ABA and ABASA would urge the Congress to follow the advice of the many regulators and industry experts alike, and not pursue restrictive actions which would have the effect of inhibiting the ability of banks and other market participants to enter into these financial transactions.

III. Investment in Municipal Securities

Commercial banks invest heavily in municipal securities in a variety of capacities. Specifically, commercial banks invest in municipal securities for either their own portfolios or for others through their trust and brokerage departments and affiliates. Commercial bank portfolio holdings of municipal securities equaled \$95 billion for the first quarter of 1995.⁵ These holdings were down only slightly from year-end 1994 totals, but represented a significant decrease from the 1985 peak of \$231.7 billion.⁶

⁵ Federal Reserve Board, *Flow of Funds Accounts, Financial Assets and Liabilities, Q1'95; The Bond Buyer*, June 16, 1995 (hereinafter cited as *Flow of Funds Data and Bond Buyer*).

⁶ *Id.*

In addition, over 2,700 commercial banks and trust companies exercise discretionary and nondiscretionary authority for over 10 million trust accounts with assets in excess of \$9 trillion.⁷ These accounts directly hold over \$156 billion in municipal obligations.⁸

Finally, approximately 120 banks serve as investment advisers to over 1,700 mutual funds, with combined assets of \$521.5 billion⁹. The vast majority of these funds comprise money market and bond funds which are significant investors in the municipal securities markets. Data for first quarter of 1995 reveals that money market and mutual funds hold in excess of \$327 billion in municipal securities.¹⁰

Commercial banks not only invest in municipal securities, but also assist in the issuance of these securities. Specifically, commercial banks also serve as trustee to municipal bondholders. In 1993, over 1,300 banks and trust companies served as bondholder trustee for over 70,621 different municipal issues.¹¹ Total dollar value outstanding of these issues was in excess of \$932 billion.¹²

⁷ Federal Financial Institutions Examination Council, *Trust Assets - 1993*, at 8-9 (hereinafter cited as "FFIEC").

⁸ *Id.* This figure does not include the \$83 billion in money market mutual funds held in bank trust accounts.

⁹ Source: Investment Company Institute.

¹⁰ *Flow of Funds Data; Bond Buyer*

¹¹ FFIEC at 98-99.

¹² *Id.*

Trustees perform a variety of services in connection with their municipal accounts. Prior to a default, the trustee's duties are basically administrative in nature. When, however, an issue goes into default, the nature of the trustee's duties change from being contractual to fiduciary in nature. From that point on, the trustee must ensure that bondholders' claims are treated in bankruptcy proceedings in the best manner possible. To fulfill these fiduciary responsibilities, the trustee may be required to perform any number of functions, including serving on official creditors' committees, preparing proofs of claim and organizing and attending bondholder meetings.

The Orange County bankruptcy presents a host of important issues, many of which this Subcommittee has identified for discussion at these hearings. From both an investor, as well as a fiduciary, perspective, it is imperative that the Orange County bankruptcy have limited effect on municipal securities offerings of other state and local government issues. A spillover effect could have a detrimental effect on other municipal offerings, as well as the market as a whole.

It would appear that, to date the market as a whole has largely withstood the Orange County bankruptcy filing. The very act of filing for bankruptcy is meant to give all affected parties breathing room to sort out their financial affairs and the Orange County bankruptcy filing appears to have done just that.

In addition, the ABA and ABASA believe that the numerous investor protection initiatives undertaken to date by both the regulatory authorities and the industry itself have had a calming effect on the municipal securities market. These initiatives have largely centered

on getting improved disclosure to investors in both the primary and secondary municipal securities markets. For example, the SEC has issued interpretive guidance outlining the primary and secondary market disclosure obligations of all municipal market participants under the antifraud provisions of the federal securities laws.¹³ The SEC has also brought the municipal dealer community into the disclosure process through Rule 15c2-12. Collectively, these disclosure initiatives will become fully effective on January 1, 1996 and should result in significant improvement in the quality and availability of information pertaining to municipal securities.

The concept of requiring disclosure for secondary market trades is not new. From the very earliest stages of this issue, the banking industry has played a leadership role with respect to secondary market disclosure. In early 1990, the ABA's Corporate Trust Committee, representing bondholder trustees, proposed disclosure guidelines for corporate trustees. In issuing this proposal, the Corporate Trust Committee sought not only to assist the efforts of other industry groups to formulate secondary market disclosure guidelines, but also to answer the demands of many municipal market participants, including the dealer community, for increased trustee disclosure. While the 1990 draft guidelines were significantly revised prior to their final adoption in 1991, important elements of the 1990 draft, as well as the final guidelines, were, nevertheless, incorporated into the SEC's recent amendments to Rule 15c2-12.

¹³ Release No. 33-7049, 59 *Federal Register* 12748 (March 9, 1994).

In addition, efforts are currently underway to allow municipal market participants better access to price and volume information concerning municipal securities trades.¹⁴ Efforts, such as these, to improve price transparency enhances market liquidity and depth, and encourages investor confidence in the municipal market.

These efforts are, however, only just now getting underway. Improved disclosure will not happen overnight. It is an evolutionary process and the Congress should allow these very significant initiatives sufficient time in which to develop and operate. Only then will market participants be able to determine whether these initiatives have met their stated goal of improving the quality of information in the municipal market.

This Congress does, however, have an historic opportunity to improve municipal market liquidity. Specifically, I refer to the tax proposals currently being considered by a sister committee of the House of Representatives. One, in particular, will, if enacted, encourage increased bank investment in municipal securities.

As noted above, commercial bank investment in municipal securities has reduced dramatically. That reduction has largely occurred because of changes to the tax code. In 1980, banks held 41% of all tax exempt securities, but by the end of 1994 that figure had dropped to 9.6%. This decline has continued into 1995.

¹⁴ These efforts are being put forth by the Municipal Securities Rulemaking Board ("MSRB") and the PSA.

Tax reform legislation in 1982, 1984 and 1986 each reduced the interest expense banks could claim because of their holdings in municipals, making their after-tax return on these investments less than other investments. The enactment of the alternative minimum tax on corporations further reduced the desirability for banks to hold tax exempts. These provisions affected the cost of and, in some cases, the availability of municipal credit, especially for small communities, school districts and other issues of debt obligations which are often unrated and do not have an established market for their debt.

In 1986, Congress retained a "small issuer" exception to the interest expense disallowance rules, in particular because communities which issued less than \$10 million in debt each year largely relied on the ability to sell their bonds to local bankers. That exception allows banks to deduct 80% of the carrying costs associated with these bonds. We would note that, prior to 1986, this deduction was available for all municipal bonds held in bank portfolios. As the data cited indicates, this tax law change has effectively reduced bank demand for municipal securities. Reduced demand results in higher borrowing costs for the issuing municipality.

Communities that qualify as issuers of so-called "bank qualified" bonds enjoy a yield advantage generally in the range of 20 to 30 basis points, but that yield advantage has been as high as 100 basis points. In short, small communities are able to finance their public need more economically because of the bank qualified provision. While the borrowing needs of small communities have risen, the \$10 million limit has remained at the

level established in 1986. The Anthony Commission Report in October 1989 recommended that it be raised to \$25 million, and the Ways and Means Committee has, in the past, taken action, supported by the ABA, to raise the limit to \$25 million.

Mr. Chairman, many bankers feel a strong commitment to support their local government financing needs. Let me illustrate my point by recalling the testimony of a fellow banker before another House committee. That banker, Chuck Waterman, Chairman and CEO of South Holland Trust and Savings Bank in Illinois, explained that his local public school district issued a \$500,000 anticipation warrant, on which the bank submitted a bid because they felt they had an obligation to support the community. They were the only bidder. In cases, however, where the community issuer has needs over the outdated \$10 million cap, banks are effectively shut out of the market, and the municipal borrowers have more difficulty borrowing funds.

The evidence is clear that banks have little choice but to limit their purchases of state and local obligations to bank qualified small issue bonds. At least 18 different associations representing state and local government officials support raising the \$10 million limit.¹⁵ We join them and again urge the Congress to act to raise the limit and consider indexing the amount for the future.

¹⁵ See letter of May 18, 1995, to Rep. Bill Archer, Chairman, Committee on Ways and Means, from State and Local Government Issuer Trade Associations.

IV. Dealing in Municipal Securities

Commercial banks service their state and local government customers in a number of different ways including offering treasury services to handle accounts receivables and accounts payable, providing cash management accounts, and providing financial advice. In addition, banks underwrite and deal in general obligation bonds while bank securities affiliates, but not banks themselves, can also underwrite and deal in municipal revenue bonds, to a very limited extent.

Banks want to expand the range of services offered to these customers by engaging in municipal revenue bond underwriting. Allowing banks to underwrite municipal revenue bonds in the bank recognizes that securities and banking products targeted to state and local governments have been developed side-by-side and that the most efficient and effective way to serve municipal customers is to offer them a whole array of products to serve their financial needs. Carving out securities products from all other products offered, as some would have, is inefficient and leads to increased costs and burdens.

Moreover, it is an accident of history that banks have been denied the ability to underwrite municipal revenue bonds since Glass-Steagall was enacted in 1933. At that time, Congress made it clear that the continued underwriting and dealing in public securities was a proper role for banks. With rare exception, state and local governments, however, issued, at that time, only general obligation bonds; revenue bonds were virtually unheard

of. Clearly, if state and local governments had then issued revenue bonds with any frequency, banks would have been authorized to underwrite and deal in these securities as well.

The Financial Services Competitiveness Act, H.R. 1062, favorably reported out of the House Banking Committee and recently reported out of the House Commerce Committee would allow banks to underwrite and deal in municipal revenue bonds. This is very important to my bank, as well as to many others. It will allow state and local governments better access to the capital markets and increased liquidity which, in turn, results in lower borrowing costs (yield as well as underwriting costs) inuring to the benefit of state and local governments and their taxpayer constituents. Moreover, many Wall Street and regional brokerage firms have ignored, as less profitable, the underwriting needs of many small communities. Giving banks the ability to underwrite revenue bonds will allow regional and community banks to serve the capital markets needs of these small communities.

Moreover, H.R. 1062 contemplates that the existing regulatory and oversight structure applicable to bank underwriting and dealing in general obligation bonds will continue for any revenue bond underwriting and dealing activities conducted in the bank. That regulatory structure is exactly the same as that applicable to municipal securities dealers generally. Specifically, all municipal securities dealers, whether they are bank dealers or not, operate under the rules of the Municipal Securities Rulemaking Board ("MSRB"). Those rules are and will continue to be enforced by the entity's primary regulator: for

banks, it will be their primary bank regulator, while for municipal securities dealers generally it will be the SEC or the National Association of Securities Dealers who will enforce the MSRB rules.

It should be noted, however, that the SEC is not without authority over bank municipal securities activities. First, the SEC has general antifraud jurisdiction over bank securities activities and, in addition, has oversight responsibility with respect to the MSRB.

Consequently, before any MSRB rule can be amended, modified or adopted, the SEC must first approve it.

Significantly, both the SEC and state and local governments are on record in support of banks underwriting municipal revenue bonds.¹⁶ The banking industry appreciates this support and the work of the full House Banking Committee in putting forth legislation that will allow banks to underwrite municipal revenue bonds and, thereby, further serve their state and local governments.

V. Conclusion

In sum, the ABA and ABASA believe that the current regulatory initiatives and voluntary efforts taken to date to ensure that the municipal securities markets operate in the sunshine should be allowed to proceed. Only, if after sufficient time has elapsed and

¹⁶ See testimony of Arthur Levitt, Chairman of the SEC, before the Subcommittee on Telecommunications and Finance and the Subcommittee on Commerce, Trade and Hazardous Materials of the Committee of Commerce, U.S. House of Representatives, June 6, 1995; See Letters of June 7, 1995 to Rep. Thomas Bliley, Chairman, and Rep. John Dingell, Ranking Minority Member, Committee on Commerce, from State and Local Government Issuer Trade Associations.

analysis reveals that additional action is needed, should this Subcommittee then consider further initiatives. In addition, the ABA and ABASA would strongly urge the Subcommittee to continue to support the ability of commercial banks to underwrite municipal revenue bonds and to support ongoing efforts to revise the Internal Revenue Code to allow banks to invest more of their investment portfolio in municipal securities. Together, these actions will have the beneficial effect of increasing the breadth and depth of the municipal securities markets. Finally, the ABA and ABASA would reiterate their position that derivatives legislation is neither necessary nor appropriate at this time.

**ROBERT J. GENADER,
CHAIR OF
ASSOCIATION OF FINANCIAL GUARANTY INSURORS**

**TESTIMONY
BEFORE
U.S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON
CAPITAL MARKETS,
SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON BANKING AND FINANCIAL SERVICES**

JULY 27, 1995

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ROBERT GENADER, CHAIR OF
ASSOCIATION OF FINANCIAL GUARANTY INSURORS
TESTIMONY
BEFORE U. S. HOUSE OF REPRESENTATIVES SUBCOMMITTEE ON CAPITAL
MARKETS, SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES
OF THE
COMMITTEE ON BANKING AND FINANCIAL SERVICES

I. Executive Summary

Considerable controversy has surrounded the filing by Orange County for protection under Chapter 9 of the United States Bankruptcy Code. As insurers of municipal bonds of all types, we are concerned about the impact this case (and the case law that will result from it) will have on the municipal market. In that regard, I have discussed in detail below the following concepts:

- The municipal bond market functions on trust, honor, and the character of its issuers. Orange County's reservation of rights to recharacterize, invalidate, or challenge security interests in certain of its securities reflects on Orange County's character in the municipal bond market. Furthermore, if the County exercises these rights there will be a fundamental and negative impact on the municipal bond market.
- Changes should be made to Chapter 9, which include stiffening the eligibility requirements for filing under Chapter 9, prohibiting recharacterization of municipal finance transactions, permitting the appointment of a trustee in bankruptcy, restricting the use of funds held by indenture trustees for the repayment of municipal securities, permitting the payment of creditors' bankruptcy professionals, and requiring a showing of best efforts to pay debt in full before a

bankruptcy court can approve a municipal debtor's plan of adjustment which impairs creditors.

- States should enact or revise existing parameters on investment policies and practices, and municipalities should adhere to those parameters. Moreover, a municipal investment manager should be required to report regularly to the local legislative body on the status of that municipality's investment portfolio, and managers should mark to market the securities held by the municipality on a periodic basis.
- Insurance costs will reflect market risk. To the extent Orange County exercises any of its "reserved rights" regarding its outstanding securities, the market will consider all similar instruments to be riskier. However, it is too early to determine the direct impact of Orange County's bankruptcy on municipal bond insurance pricing.

II. Introduction

Chairman Baker and members of the Subcommittee:

My name is Robert Genader. I am the Chair of the Association of Financial Guarantee Insurers ("AFGI") and Executive Vice President of AMBAC Indemnity Corporation ("AMBAC"). It is in my capacity as AFGI chair that I appear before you today. The members of AFGI appreciate the opportunity to share their views with you and stand ready and willing to assist the Subcommittee as it addresses critical issues affecting the municipal securities industry as a result of the Orange County bankruptcy.

A. AFGI

AFGI is comprised of nine triple-A rated U.S.-based companies, seven of which serve as primary insurers of Municipal Bonds:^{1/} AMBAC; Capital Guaranty

Insurance Company ("CGIC"); Capital Markets Assurance Corporation ("CMAC"); College Construction Loan Insurance Association ("Connie Lee"); Financial Guaranty Insurance Company ("FGIC"); Financial Security Assurance Inc. ("FSA"); and MBIA Insurance Corporation ("MBIA"). The two additional AFGI members — Capital Reinsurance Company and Enhance Reinsurance Company — provide reinsurance to the primary issuers. The Municipal Bond insurance industry was founded in 1971 and AFGI was formed in 1986.

The concept of Municipal Bond insurance is simple. A Municipal Bond insurance policy provides an irrevocable and unconditional guaranty that Bondholders will receive timely interest and principal payments. Thus, Municipal Bonds which are insured carry the public credit rating of the insurer, not that of the underlying issuer.^{2/} In the 24 year history of the Municipal Bond Industry, no issue of Bonds insured by an AFGI member has been downgraded, and no investor in an insured Bond issue has failed to receive an insured Bond payment.

Demand for Bond insurance has grown rapidly since 1981 when just five percent of all newly-issued Municipal Bonds were insured. In recent years, more than 38 percent of newly issued Bonds were insured.^{3/} The trend towards more insurance reflects the shift in Municipal Bond ownership from institutions to individual American households. Several factors have contributed to this shift. First, banks and insurance companies have lost some of the tax advantages of holding municipal debt. Second, these companies generally are confident of their own ability to evaluate Bonds, and they have little need for the added security that Bond insurance provides. Rather, Bond insurance appeals most strongly to individual investors, and has brought individual investors to the Municipal Bond market, either through direct ownership of Municipal Bonds or through investment in insured mutual funds or insured unit investment trusts.

Attached hereto as Exhibit I is a brochure describing AFGI and Bond insurance generally. Exhibit II hereto is AFGI's 1994 Annual Report. Exhibit III hereto is a table demonstrating the rapid climb in the use of Bond insurance. Exhibit IV hereto sets forth the ownership structure of certain AFGI member companies.

B. Overview of Municipal Bond Market

Municipal Bonds have become a major component of modern capital markets. Today, the Municipal Bond market is comparable, in overall size, to the U.S. corporate bond market. At the end of 1994, there were \$1.2 trillion in outstanding Municipal Bonds, as contrasted with \$1.3 trillion in corporate bonds.^{4/} Approximately 50,000 different state and local governments are authorized to issue some form of Municipal Security.^{5/} According to the Securities and Exchange Commission ("SEC"), individual investors' holdings in the municipal market (including those investing in mutual and money market funds) grew from 44 percent of the market in 1983 to 76 percent of the market in 1993.^{6/} Exhibit V hereto contains a brief description of certain aspects of the Municipal Bond market.

C. Scope of Comments

The Subcommittee posed a number of provocative questions to the panel members. Many of these issues have been the topic of lively debate from time to time in the Municipal Bond industry. Accordingly, AFGI appreciates the opportunity to publicly address these issues. To the extent certain issues are more relevant to AMBAC and AFGI's industry role, we have focussed our attention on those questions.

III. Has There Been a Fundamental Shift in the Credit Relationship Between the Issuers of State and Local Debt and Investors in the Debt as a Result of the Orange County Bankruptcy?

A. The Municipal Bond Market Functions On Trust, Honor, and the Character of its Issuers.

Because the basic underpinnings of municipal finance are found in the moral and legal obligations of a municipal borrower to pay its debts, the Municipal Bond market functions on the basis of trust and honor. In stark contrast to corporate debt, municipal debt repudiation is almost unheard of in the Municipal Bond industry. Some of the rights reserved by Orange County in its bankruptcy case go to the heart of this matter of trust. In the past, financially-strapped cities such as New York, Philadelphia, Cleveland, and Washington, D.C. have managed to work through fiscal crises to avoid defaulting on their Bond debts,^{7/} and the market sees no reason why Orange County cannot do the same.

According to a municipal bankruptcy expert who also is testifying before this Subcommittee, "[t]he confidence of the Municipal Bond market is essential, and municipalities traditionally have made every effort to honor their public debt obligations."^{8/} Therefore, whenever Municipal Bond defaults have become a possibility, the Municipal Bond market has reacted by demanding corrective action to ensure payment. As a result of this distinction between market cultures, the default rate for Municipal Bonds is lower than the default rate for corporate Bonds.^{9/}

In the wake of the Orange County bankruptcy, commentators are questioning the security of an investment in Municipal Bonds, and the potentially hidden risks inherent in such Bonds. Orange County, unlike other jurisdictions which have faced similar problems, may seek to avoid payment of its debts to Bondholders and has specifically and repeatedly

reserved the right to do so.^{10/} Thus, there is fear in the Municipal Bond market that Orange County could undermine general investor confidence in Municipal Bonds. In a market that relies on confidence, Orange County's willingness to take legal positions against its Bondholders, as I describe below, has cast a shadow over the entire market.^{11/} Moody's Investor's Services ("Moody's") has appropriately summed up the sentiment of participants in the Municipal Bond market: Orange County is violating the trust that underlies the entire Municipal Bond market.^{12/}

Because of the historically low level of default, investors generally consider Municipal Bonds a safer investment than private corporate securities.^{13/} Investors in Municipal Securities are less concerned with the risks of competitive markets than are investors in private corporations, partly because Municipalities usually have access to a more reliable revenue stream from which to pay debt service.^{14/} The Municipal Bondholder views the investment as more secure where there is a broad source of funds the issuer can tap to pay the principal and interest on its obligations. Therefore, credit markets view general obligation Bonds ("G.O. Bonds"), which are backed by the full faith and credit of the issuer as a highly secure form of debt, assuming, of course, sound fiscal management of the issuer. Under G.O. Bonds, the issuer promises to do everything within its power to pay Bondholders, including exercising its power to levy taxes where applicable.^{15/} Because credit markets generally consider G.O. Bonds to be a secure form of debt, these Bonds are typically bought by the most conservative investors. However, because they represent a long-term commitment of tax revenues, G.O. Bonds normally require a popular vote. Thus, as a partial result of public hostility towards tax increases, the trend over the last decade has shifted away from issuing Bonds secured by a pledge of taxing power to issuing Bonds

secured by revenue other than taxes, such as water and sewer charges. These Bonds are known as "Revenue Bonds."¹⁶

In his testimony before the California Debt Advisory Commission ("CDAC") hearings, Stephen Ward, the Chief Investment Officer of Charles Schwab Investment Management, recounted JP Morgan's 1912 testimony before a congressional hearing on the subject of credit. In that testimony JP Morgan is purported to have said that commercial credit was based on character, before anything else, including money and property.¹⁷ As Mr. Ward correctly pointed out "[t]he character of the public finance market in California is being tested by the crisis. If the opportunity for a timely and satisfactory solution is missed, and a wave of defaults results, it could permanently and adversely change the structure of short-term public finance."¹⁸ The State of California apparently shares that view.¹⁹

Although AFGI is cautiously optimistic about Orange County's repeated statements of its intention to pay its Bond obligations, we note that its statements stand in stark contrast to the legal posture it has taken in its bankruptcy proceedings. In particular, AFGI is troubled by the County's reservation of its rights to repudiate its debt in the future, void certain security interests, and "recharacterize" its obligations as something they are not.²⁰ After negotiating the Comprehensive Pools Settlement ("CSA"), the County's primary focus has been on how to timely repay the Holders of the County's Bonds, including its Certificates of Participation ("COPs"). In this regard, Orange County recently sought and obtained much-needed breathing space when it recognized that it could not pay its short-term note debt upon maturity in the summer of 1995. To avoid a default on this short-term Bond debt, Orange County negotiated the highly-publicized (and often criticized) Note Rollover and Debt Extension Agreement (the "Rollover Agreement").²¹ Despite the negative response of the rating agencies and the attack on fundamental elements of the agreement by

the Official Investment Pool Participants Committee, over 99 percent of County Bondholders agreed to extend the maturity of their debt, even though they are no closer to receiving payment than before. However, the Rollover Agreement specifically reserved the County's right to challenge the validity of \$600 million in Taxable Notes, and permitted the County to retain over \$400 million in cash reserves dedicated solely to the repayment of short-term debt.

Notwithstanding progress in paying certain of its obligations, Orange County's repeated insistence (as described below) on reserving certain rights which lie at the core of California's municipal finance scheme has angered the markets and brought Orange County's "character" into serious question. In addition, both AMBAC, in particular, and AFGI, generally, are particularly troubled by the ambiguity of Orange County's recent plan to restructure its COPs and its reservation of rights to challenge the characterization of the leases underlying the COPs transactions.

B. Orange County's Reservations of Rights to Restructure or Challenge the Validity of its Securities

1. Recharacterization of Certificates of Participation

Orange County has reserved its right to challenge the crucial lease-debt distinction which is the foundation of the Certificate of Participation or "COP" structure. A COP is an undivided interest in a stream of lease or installment purchase payments. In other words, Orange County makes lease payments for the use of a public building (i.e. a jail or a parking lot) for which it previously received a lump sum payment. Holders of the "Certificates of Participation" in those lease payments receive a proportional interest in each lease payment.

Under decided case law, a Chapter 11 debtor may seek to recharacterize leases as debt. This tactic is routinely employed by corporate debtors to avoid creditors' efforts to force the debtor to assume its leases, and to forcibly restructure lease obligations. It is unclear whether recharacterization is available to a municipal debtor, but Chapter 9 does not expressly preclude it. Orange County has filed extensive briefs claiming it can use federal bankruptcy case law to alter the characterization of COP issues and their related transactions.

As detailed in Section IV, a state's characterization of the Securities it authorizes its Municipalities to issue should not be questioned in a municipal bankruptcy. In public statements and bankruptcy court documents, Orange County has reserved its right to recharacterize its COPs as either secured or unsecured debt, rather than a lease. A successful recharacterization would dramatically undercut the use of this essential revenue — raising instrument for Municipalities in California and other states.^{22/} As a result of the passage of Proposition 13 in California 17 years ago, the use of COPs has developed into a widespread and well-accepted approach to obtaining much-needed financing without seeking popular approval.^{23/} The COPs structure, and its ability to provide revenue in compliance with California debt restrictions, has been validated by the California courts, provided a transaction adheres to certain structuring principles.^{24/} Orange County repeatedly availed itself of both the validity and the utility of this COP structure. Between 1989 and 1994, Orange County benefitted from approximately \$480 million in COP financings.

A bankruptcy court's intrusion into matters reserved to the states can lead to disastrous consequences for state systems of municipal finance. If successful, creditors could be required to reassess the value of the collateral underlying the COPs (i.e., the assets such as the jail or parking lot in the example above). Given the difficulty of valuing governmental single-purpose assets, such valuation battles are likely to be costly and contentious.

Even worse, it is conceivable that the County might commit the ultimate sin in the municipal marketplace and repudiate its obligation to pay the leases under its existing COPs, on the theory that if COPs are disguised debt, they are void *ab initio* under the California Constitution. Although a recharacterization of a lease as debt does not necessarily mean the County would then try to repudiate its debt, such a strategy is conceivable.²⁵¹

A successful recharacterization of Orange County's COPs transactions would give the Municipal Bond marketplace pause, and likely would change materially the way COPs are structured and priced throughout the country. For example, if a governmental entity has the power to reduce its long-term obligation to the declining value of a single-purpose asset through the use of a Chapter 9 recharacterization, market participants may mandate that assets be reappraised regularly. This added cost would affect all market participants with few benefits to anyone. Alternatively, the market may determine the COPs structure is simply too risky.

As discussed below, the ability of a Municipality to recharacterize publicly-offered municipal debt is inappropriate under concepts of federalism, and is one aspect of Chapter 9 which should be revised. Under well-accepted concepts of federalism, a state authorizes those Securities which it believes are appropriate for its subdivisions to issue. The form of such state municipal finance schemes should not be subject to challenge in bankruptcy court by a cash-strapped municipal debtor, who benefitted from these same finance methods.

2. Statutory Liens Created Pursuant to Tax and Revenue

Anticipation Notes

Orange County challenged a fundamental premise of California municipal finance when it declined to set aside property tax revenues pursuant to a lien created for the

benefit of holders of Tax and Revenue Anticipation Notes ("TRANs"). TRANs are issued by California Municipalities (as well as in other states) to provide an even flow of revenue over the course of a fiscal year.^{26/} To secure payment of the TRANs, an issuer pledges to make set asides of property taxes and certain other revenue during the fiscal year, and creates a lien on such taxes and revenue. After filing its bankruptcy petition, Orange County declined to make such set asides, and challenged the validity of the liens. A group of TRANs holders sought a ruling that its lien was "statutory" rather than "consensual," and thus, would survive Orange County's filing. The bankruptcy court sided with the debtor, however, and as a result, held that the TRANs lien did not survive the County's bankruptcy filing.^{27/} This ruling was viewed as a mortal blow to the TRANs market.

The response to the bankruptcy court's ruling was swift by organizations such as the National Federation of Municipal Analysts ("NFMA").^{28/} NFMA issued a press release on April 18, 1995 to communicate their "concerns regarding the Orange County situation and potentially serious implications for all municipal credits, especially short-term issuers, in California."^{29/} The bankruptcy court decision was recently overturned on appeal by the U.S. District Court for the Central District of California.^{30/} The district court found that the lien was statutory, and thus survived the bankruptcy filing. The County has appealed the district court's ruling to the Ninth Circuit Court of Appeals, and it is unclear what the ultimate outcome will be. Regardless, the damage has been done. In the meantime, California TRANs issuers may now have to seek credit enhancement, something that heretofore had not been necessary.

3. Security Interests in Bond Repayment Accounts

No less ominous is the long-term implication of Orange County's unwillingness to recognize repayment accounts which were funded by the proceeds of various

County note offerings. At the time the County's 1994-1995 short-term debt was issued, the proceeds of the offering were deposited into an account (a "Repayment Account") and invested in the Orange County Investment Pools (the "Pool"). The funds in the Repayment Account were pledged to pay the Bondholders, who had provided the County with its funds by purchasing the Bonds. Like all other investments in the Pool, funds in the Repayment Accounts were depleted by roughly 23 percent as a result of the County's highly-leveraged investment strategy. But the important point is that pursuant to the Comprehensive Settlement Agreement ("CSA") which liquidated the Pool, approximately 77 percent of the original deposits in the Repayment Accounts remain under Orange County's management and control. Nevertheless, the County has refused to return the funds in the Repayment Accounts to the applicable Bondholders. Moreover, the County reserved its right to use those Repayment Accounts (although it has agreed to only use the Repayment Account monies for certain purposes). Finally, the County has reserved the right to challenge Bondholders' security interest in the Repayment Accounts.

In contrast, five school districts also issued taxable notes for arbitrage purposes which they invested in the Pool. They too lost approximately 23 percent of their respective investments (although to date they have recouped approximately 90 percent of their original investment in the Pool). After implementation of the CSA, the significantly depleted Repayment Accounts were returned to the school districts that had issued such arbitrage notes. Unlike Orange County, all five school districts took immediate steps to demonstrate their good character and assure the market of their willingness to repay. At this time, these school districts have paid or have arranged to pay in full their Bondholders, despite the losses they suffered as a result of Orange County's investment strategy. This evidence of their character in handling the repayment of their debts will benefit these entities

in the future when they seek access to municipal debt markets. Meanwhile, Orange County Bondholders have been denied the funds held in their respective Repayment Accounts, and were forced to agree to a County reservation of rights to challenge the validity of their security interest in such accounts.^{21/}

4. Potential Challenge to the Validity of Taxable Notes

Orange County's most shocking act has been to reserve its rights to challenge as void *ab initio* its \$600 million taxable TRANs issue it issued in 1994. If exercised, this reservation, more than any other, will stain the County's character in the view of credit markets.^{22/} The Municipal Bond market has made it clear that such an action would not be lightly tolerated,^{23/} although the recent issuance of Orange County's Recovery Bonds suggests that the County's access to the municipal marketplace has not been completely severed as yet.^{24/}

C. Insurer's Are Investors in the Municipal Market

Concurrent with the significant growth of Municipal Bond insurance as a form of credit enhancement in the Municipal Bond market is the increased presence of insurers as investors in Municipal Bonds. For example, as of December 31, 1994, MBIA, FGIC and AMBAC combined had \$6.3 billion invested in Municipal Bonds out of a combined investment portfolio of \$7.2 billion.

D. Money Market and Bond Funds Are Wary as a Result of the Orange County Filing

Many money market and mutual funds have warned that without credit enhancement, they are no longer willing to purchase Securities from the same Municipalities as they did in the past. Others urged swift California legislative action if local Municipalities were to be assured of a receptive market.^{25/} Whereas investors previously had overlooked

certain balance sheet issues, in response to the same balance sheet issues, investors now require credit enhancement in the form of a letter of credit or Bond insurance. In essence, the credit bar has been raised as a result of Orange County's filing. However, the demand for high quality Municipal Bonds still exceeds supply, in light of the number of Bond and money market funds that need to purchase Municipal Bonds.^{36/}

Theoretically, pricing of municipal debt should reflect ability of Municipalities under state law to raise taxes to pay their debts. States without California's stringent tax constraints (i.e., Illinois) should receive more favorable treatment by the credit markets. Nevertheless, the market has not reflected this difference in the past, and it is too soon to tell whether it will recognize these distinctions in the future.

IV. Should Chapter 9 of the Federal Bankruptcy Code Governing Municipal Bankruptcy be Changed?

A. Background on the Use of Chapter 9 in the Orange County Case

The Orange County bankruptcy has provided a full-scale demonstration of the positive and negative aspects of Chapter 9 of the United States Bankruptcy Code (the "Code"). The County used the protections of Chapter 9 to avoid a run on the rapidly diminishing Investment Pool, stabilized its fiscal condition, and obtained much-needed breathing space for it to formulate a plan for payment of its numerous obligations. These benefits are fundamental to the purpose of Chapter 9.

Unfortunately, the Orange County case has also revealed the dark underside of Chapter 9. Along with its constructive results, Chapter 9 has emboldened the County to use (or threaten to use) aspects of Chapter 9 in highly destructive ways as we described above. Simply put, the County, in its effort to free up assets and find liquidity, has engaged in practices typical of Chapter 11 debtors based on legal and economic premises which have no

place in a Chapter 9 case. As described above, Orange County has reserved the right to recharacterize certain Municipal Securities and their underlying transactions and to repudiate liens that heretofore had been considered "bankruptcy-proof," which, when taken together, threaten the foundation of California's entire system of municipal finance. Unfortunately, because Chapter 9 in its current form does not account for states' needs to regulate their Municipalities' fiscal affairs, the State of California and Orange County creditors are constrained in their ability to prevent Orange County from undermining the municipal finance system in California.

The basic differences between municipal and corporate debtors justify some disparate treatment between creditors of municipal and corporate debtors under the Code. The Code must account for the way issuers and credit markets view municipal debt versus corporate debt. As previously described, the municipal markets have long presumed that Municipalities will do everything in their power to meet their debt obligations. Corporate bondholders make no such assumption — "bankruptcy risks" are well known and factored into the terms of the bargain. The current structure of Chapter 9 does little to prevent Municipalities from impairing their debt and taking positions which potentially undermine the access to credit markets of other municipal borrowers from their own state. A major source of this problem is the degree to which Chapter 9 permits a debtor, via bankruptcy court jurisdiction, to upset firmly entrenched state systems of municipal finance. With revisions to Chapter 9, however, Congress could reaffirm states' roles as the primary overseers of the financial condition of their political subdivisions. In addition, Congress could offset debtors' considerable leverage and create mild disincentives to municipal bankruptcy by vesting certain powers in creditors and providing for the payment of creditors' professionals.

Finally, plan confirmation requirements could be revised to require a showing of best efforts by the municipal debtor to pay its debt in the future.

B. Proposed Changes to the Bankruptcy Code

AFGI posits that basic principles of federalism, in addition to notions of creditors' rights, necessitate a rethinking of the Code's approach to municipal bankruptcy. Accordingly, AFGI suggests a few general changes to Chapter 9 which would help ameliorate the problems discussed in this testimony. AFGI notes, however, that these proposals are in the most general terms and are preliminary at best.

- *Diminish the level of intrusion into areas traditionally reserved to states, by (1) stiffening the eligibility requirements for Chapter 9 protection, and (2) expressly amending Chapter 9 to limit the ability of debtors to seek recharacterization of Municipal Securities and their underlying transactions.*

The current Code hinders states' ability to govern the fiscal affairs of their municipalities. Therefore, AFGI submits that a minor revision to the Code would vindicate fundamental federalism concerns. These policy goals could be achieved merely by amending the Code to require states to decide whether to authorize a particular Municipality to file a Chapter 9 petition at the time the Municipality encounters its fiscal problems, rather than simply classifying types of Municipalities authorized to file.³⁷ Filing-specific authorization could be accomplished directly by a state legislative action or by the action of an authorized state panel or official. Requiring Municipalities to obtain such express state authorization, would push states to accept responsibility for the filing. This requirement would not only recognize states' inherent right to regulate the fiscal practices of their subdivisions, it would give them an opportunity to design alternative financial solutions.

In addition, certain powers of the debtor to seek bankruptcy court recharacterization of Municipal Securities and their underlying transactions as we described above should be curtailed. Although Congress' legislative scheme of municipal bankruptcy takes pains to avoid federal interference with state law affairs, it arguably vests bankruptcy courts with the authority to characterize obligations of municipal debtors in ways that could seriously impact state municipal finance systems. For example, as previously discussed, Orange County has reserved the right to recharacterize the existing COPs as "debt," with potentially disastrous results for California municipal debt issuers.³⁸

Vindicating such federalism concerns in this regard serves two primary purposes. First, virtually all of a Chapter 9 debtor's public functions and duties are derivative of its state's police powers. States have delegated their authority to various political subdivisions to ensure the health, safety, education and welfare of their populace; yet, states ultimately remain obligated to perform these functions if Municipalities are unable to render public services because of budget constraints.³⁹ Accordingly, states should be permitted and encouraged to develop their own methods for dealing with public financial stress. AFGI recognizes that there are undoubtedly situations where resort to bankruptcy court protection is necessary. However, because plans of adjustment have the potential to affect public service functions delegated to Municipalities by the states, states should determine on a case-by-case basis whether to permit the use of Chapter 9.

Second, through the bankruptcy court and the application of the Code, municipal debtors have the ability to sabotage state municipal finance principles. For example, in the Orange County case, the County has challenged the viability of liens created to secure municipal debt issues, which liens had been created under the aegis of state statutes. When Orange County challenged these liens, they challenged a form of financing

which Municipalities in the State of California have employed to raise billions of dollars annually over the past few fiscal years.⁴⁰ California state and local governments have borrowed billions annually each of the last three years.⁴¹ Orange County's threat to recharacterize COPs could undermine a favored method of municipal finance in California as a result of constitutional debt limitations. Every state has an interest in preserving its own access to credit markets as well as access by its subdivisions. Thus, states should be permitted to regulate their subdivisions' access to Chapter 9.

For this reason, AFGI believes that Chapter 9 should be revised to avoid these undesirable results. State law (in conjunction with federal income tax statutes and regulations) dictates the nature of and authority for virtually all Municipal Securities issues. Holders of these Securities bargain for a particular type of instrument, and pay consideration accordingly. Recharacterization by a municipal debtor through the bankruptcy court process can deprive the Holders of the benefit of their bargain in insidious ways. Accordingly, state law characterization of these issues should control, and municipal debtors should not be permitted to undermine state municipal finance schemes in efforts to avoid debt obligations.

- *Permit a trustee to be appointed in a Chapter 9 case; and allow payment of creditors' professional fees.*

Chapter 11 is designed to permit a financially troubled company to reorganize without the appointment of a trustee. However, Congress recognized that certain cases, and certain conduct by debtors in the Chapter 11 context, could necessitate the appointment of a third party to protect the interests of creditors.⁴² Chapter 9 should be revised accordingly. Although the limitations on bankruptcy court jurisdiction are necessary to satisfy supremacy clause requirements, the absence of a trustee in Chapter 9 is particularly troubling. The reasoning for permitting recourse to a trustee is no less compelling in Chapter 9. The

prospect of a trustee acts as an important check on the Chapter 11 debtor. Interested parties in a Chapter 9 case, including the state in which the Municipality is located, should therefore be permitted to seek the appointment of a trustee.

Additionally, because municipal debtors are not required to pay creditors' professional fees, as are corporate debtors, Municipalities do not have this particular financial disincentive to the filing of a Chapter 9 petition.⁴³ The distinctions between municipal and corporate debtors simply do not justify exempting municipal debtors from this payment requirement, thereby jeopardizing the fair representation of creditors. Moreover, to the extent professional fees constitute a cost of bankruptcy protection, municipal debtors require the same disincentives as corporate debtors in this regard, if not more.

- *Require a showing of best efforts to pay debt in full before the bankruptcy court can approve a plan of adjustment which impairs creditors.*

The exit requirements for Chapter 9 should be revised to require a debtor to make a showing of best efforts before the court may confirm a plan which impairs creditors. Unlike corporate debtors, most municipal debtors have the power to levy taxes and raise revenue. Even in California, where taxing powers are severely restricted by constitutional and statutory limitations, Orange County has the ability to raise revenues in ways unavailable to corporate debtors. However, Chapter 9 adopts Chapter 11 standards of plan confirmation which were developed for corporate debtors who have no similar legal power to raise revenues. Chapter 9 therefore may have the unintended consequence of creating an apparent way of circumventing the essential precept of municipal finance — that all resources must be used to meet debt obligations. Imposing a best efforts requirement would help avoid this

perverse incentive, and would accurately reflect the different revenue-raising abilities of municipal debtors and the different cultures of municipal and corporate bond markets.

- *Establish that funds and accounts, especially debt service reserve funds, related to Bond and Certificate of Participation transactions are held in trust for the benefit of the Bondholders and do not constitute property of the debtor.*

Amounts deposited in funds and accounts created by Bond financing documents constitute security for the issuer's obligation to repay its Bonds. In particular, debt service reserve funds funded from Bond proceeds act as a buffer between the Bondholder and an issuer's temporary inability to generate revenues sufficient to pay debt service, and are critical security features upon which substantial reliance is placed by the Municipal Bond market. Although Orange County consented to the use of monies in the Certificate of Participation debt service reserve funds for scheduled principal and interest payments, Bondholders should not be subject to the risk that a particular Chapter 9 debtor may not acquiesce to the use of those funds for their intended purpose. Furthermore, project construction, capitalized interest, or other accounts which were funded from original Bond proceeds should be restricted by bankruptcy law to repayment of the bondholders.

A process has been initiated to consider these issues and to propose concrete solutions to these problems. Recently, a broad-based coalition of municipal finance industry members formed an Ad Hoc Group to propose amendments to Chapter 9.⁴² The Ad Hoc Group is considering many of the problems discussed in these hearings, and is working toward a comprehensive proposal to be issued in 1996 to make Chapter 9 into an effective safe harbor for truly insolvent Municipalities.

**V. Does Chapter 9 Create Incentives That Adversely Affect the Municipal Market?
Are There Increased Incentives for Municipalities to Declare Bankruptcy in the
Future?**

Although Chapter 9 arguably offers Municipalities few incentives (except, perhaps impairing creditors with minimal showings of attempts to raise revenue), it fails to provide offsetting disincentives to its use. Of course, as insurers of municipal debt, we start with the basic premise that no Municipality issues debt with the expectation of availing itself of the protections of Chapter 9. In fact, most states have not authorized their Municipalities to use the breathing space provided by a Chapter 9 filing.⁴⁵ In fact, in many states, financial woes of a far less severe magnitude than those experienced by Orange County have resulted in state intervention in municipal affairs. Such intervention has been well received by the rating agencies and the Municipal Bond markets.⁴⁶ This potential loss of day-to-day management to a state-appointed overseer is a powerful incentive for a Municipality to prudently manage its fiscal affairs.

Although the bankruptcy process entails certain direct and indirect costs,⁴⁷ the ability to repudiate or impair municipal debt may be well worth the cost of professional fees to a cash-strapped Municipality. In addition, as discussed in Section IV, creditors' committee professionals and representatives are not afforded the same right to payment from the debtors' estate as they are in a Chapter 11 proceeding. As insurers, we believe that there should be some "costs" associated in employing bankruptcy as the means of resolving a municipal financial crisis,⁴⁸ and believe that the aforementioned proposals would help create appropriate disincentives.⁴⁹

VI. Should Orange County Have Declared Bankruptcy?

As an association of insurers, we do not believe we are the appropriate parties to comment on the legal or moral propriety of Orange County's bankruptcy filing. We are not privy to the considerations facing the County in the days leading up to the filing. It is too easy to succumb to hindsight, but it does not appear that such an examination will advance this Subcommittee's deliberations. Perhaps the question which this Subcommittee and the market should address is under what conditions a Municipality should be permitted to file for Chapter 9 protection in the future. As discussed in Section IV, states ultimately should be accountable for the decision to allow their subdivisions to file for Chapter 9 protection.

VII. Do the Orange County Losses and Subsequent Bankruptcy Represent a Future Trend in State and Local Finance or Represent an Isolated Incident?

It is difficult, if not impossible, for AFGI or any of the esteemed panelists sitting before you to predict with absolute certainty what long-term effects the Orange County bankruptcy will have with respect to municipal bankruptcies in the future. A bankruptcy filing under Chapter 9 is not unheard of: Between 1980 and 1992, ninety-four entities filed for Chapter 9 protection.⁵⁰ But, it is well known that Orange County is the largest Municipality to file under Chapter 9 in the history of municipal bankruptcies, and therefore, this case will inevitably have an impact upon municipal finance. As John Lonski, chief economist at Moody's Investors Service, has noted, "[f]or municipal finance, Orange County is a seminal event."⁵¹

AFGI believes that to a certain extent, the long-term implications of this bankruptcy depend on how the issues are finally resolved, the extent to which Orange County is able to rehabilitate its financial situation and pay off both its Bondholders and other

creditors, and the new case law which will undoubtedly be written interpreting previously untested sections of California law and Chapter 9.⁵²

While the Orange County case is the biggest municipal bankruptcy, it is certainly not the first, nor will it be the last. Across the nation, an increasing number of cities, counties, and states are all finding themselves facing varying degrees of financial difficulties — partially the result of poor investment choices — which raises the possibility of an increase in the number of municipal bankruptcies in the years to come.⁵³

Further, there is the possibility that Orange County's bankruptcy will make investors more hesitant to purchase Municipal Bonds, forcing Municipalities to provide higher rates of interest in order to attract investors. The fear is that these higher rates could cause a dramatic increase in the borrowing costs for Municipalities nationwide, thus placing an even greater burden on many financially-strapped Municipalities, perhaps precipitating a rash of bankruptcies.⁵⁴ It is important to emphasize that if there is a trend in municipal bankruptcies, it will come as a result of state inaction and a failure of states to adequately regulate and oversee municipal financial activities. Under Chapter 9, only states have the ability to determine which Municipalities may file a petition for bankruptcy, and under which circumstances they may seek protection. Thus, as discussed in Section IV, a Municipality's ability to declare bankruptcy should be contingent upon explicit state approval. So long as states are willing and able to intervene and take an active approach, the Orange County bankruptcy should remain an isolated incident rather than an incipient trend.

VIII. Are States Taking Adequate Steps, Including Reevaluation of Applicable State Statutes, To Improve the Investment Practices of State and Local Governments?

Before we can assess whether the steps being taken by states are adequate, it is important to determine what problem needs to be addressed. Despite the common perception that Orange County's bankruptcy is attributable solely to the County's decision to invest in derivatives, in reality, the reasons underlying the Orange County's Investment Pool's approximately \$2 billion loss are much more complex.²² The genesis of the loss suffered by the Orange County Investment Pool was more a question of unlawful and imprudent leverage than investment in speculative derivatives. While it is true that Orange County's decision to invest in high risk, interest-sensitive securities was in large measure responsible for the debacle, the sheer magnitude of the loss is attributable not to derivatives, but rather to the County's decision to leverage its investments so highly.

Orange County's investment strategy was to use funds currently in its Investment Pool, primarily U.S. Treasury bills, notes and bonds, as collateral to borrow short-term at low interest rates. The proceeds of the borrowings were then invested in mid-term corporate bonds and securities bearing higher interest rates with longer maturities. In times of stable or falling interest rates, these investments are profitable, but when the interest rates rise, longer term bonds suffer a greater decline in value than do short-term bonds. As interest rates rose in 1993 and 1994, such was the case for the Orange County Pool.

These losses, however, were exacerbated by the extent to which Orange County had leveraged the securities used as collateral in order to borrow and invest more money. The leveraging of securities in this case allowed Orange County to use \$7.5 billion in securities as collateral for loans that enabled it to purchase \$20 billion worth of securities.

and it is this leveraging which is the real reason for the magnitude of the County's losses.⁵⁶

The massive loss suffered by the Orange County Pool has resulted in a reassessment by most state legislatures of their municipal investment policies. In fact, according to Standard & Poor's, there has been "a flurry of state and local legislative activity focused on reviewing current guidelines to provide a higher level of safety of invested public monies."⁵⁷ Such activity is taking place on a national level, and at all different levels of government. Instead of merely clarifying or tightening a few questionable provisions, however, certain states may engage in overkill and eliminate effective financing tools.

For example, in California, a number of bills aimed at changing current law with respect to disclosure requirements and investment restrictions have recently passed the California State Senate, and are headed toward the Assembly. The changes under consideration in California include: (i) prohibiting the legislative body of a local agency from investing in derivatives, repurchase agreements and reverse repurchase agreements, (ii) deleting the legislative approval exception to the prohibition against investments that mature in over five years, and prohibiting the use of inverse floaters, 7-day floaters and leveraging in the investment of surplus local funds and local funds generally; (iii) allowing the legislative body of a local agency to delegate its authority to invest local agency funds for no longer than a one-year period; (iv) requiring that any contract awarded by a local agency for the performance of financial services be subject to competitive bidding; and (v) creating a presumption that a local agency is an unsophisticated investor with respect to investment transactions with a broker-dealer and providing the local agency with a right of rescission in such transactions.⁵⁸

Ohio recently adopted legislation which virtually prohibits municipalities from investing in derivatives and/or engaging in leveraging. Legislation passed by the Ohio Senate would prohibit municipalities from investing in mutual funds. Florida is considering a proposal that would require all local governments to file their written investment policies with the state auditor's office. Texas has reduced the maximum maturity on all investments within its TexPool fund to 13 months from three years; brought the average maturity down to 90 days from 270 days; and prohibited the fund from falling below a \$1 ratio of market-to-book value and banned the use of derivatives. Texas is also considering legislation which would restrict mutual fund investments by state agencies, municipalities, and state investment pools. In fact, legislation of this sort is being introduced in state legislatures nationwide.⁵⁹

Perhaps the greatest obstacle to appropriate reform remains the failure to achieve a consensus regarding the definition of derivatives and the extent to which Municipalities should be prohibited from investing in them.⁶⁰ As noted by the Chairman of Public Securities Association,

"I would like to draw an important distinction between investment strategies such as the one employed by Orange County and the financial instruments used to carry out those strategies. Virtually all investments carry some form of risk. It is vitally important that investors understand fully the risks to which they are exposed in particular investments and how those risks relate to their investment strategy, their portfolio, and their overall financial situation."⁶¹

Unfortunately, many involved in this analysis seem to miss the distinction articulated by Mr. McKnew.⁶²

However, it is important to recognize that the system generally has worked. AFGI believes that overreaction is not warranted, and drastic measures should not be taken which would tie the hands of Municipalities and prevent them from managing public funds effectively. Although derivatives have a distinct and particular set of credit considerations,

certain derivatives may have a legitimate place in a well-diversified Municipal Bond investment portfolio.

IX. Should Disclosure or Other Rules Governing Municipal Debt Issuance be Changed to Reflect Municipal Investment Policies?

As the members of this Subcommittee are well aware, the question of whether Municipal Securities should be registered with the SEC is being debated in many quarters. AFGI does not support these well-intentioned efforts which are premised on the notion that registration is tantamount to protection for the Holders of the Securities. While we acknowledge that a few issuers might benefit from such third-party scrutiny, the primary impact of such a requirement would be to further drive up the costs of municipal borrowing, at a time of increasingly tightening budgets and shrinking revenues.

Other regulatory initiatives have been positive. In particular, AFGI applauds the SEC's recent amendments to Rule 15c2-12 which will ensure a regular stream of valuable information to both the primary and secondary markets. As the data become readily available, trends will emerge and all members of the municipal marketplace will be able to more effectively assess the risks of a particular investment. In addition, other SEC regulatory changes during the past 19 months have had a beneficial impact on the market.²³

AFGI does endorse certain rule and guideline changes, however. For example, Municipalities should be required to: (1) adopt written investment policies; (2) report to the applicable legislative body no less than quarterly; and (3) mark to market at least quarterly securities which constitute their investment portfolio or account balances. The appropriate use of derivatives, repurchase agreements and reverse repurchase agreements must be dictated at the state or local level.²⁴ We do not believe it appropriate for the federal government to set those policies. However, such policies must be clearly articulated

in each Municipality's written investment policies, adequately disclosed, and scrupulously followed. To the extent the market believes such decisions are imprudent, rating, pricing and/or access to the market will be affected.

X. How Might the Responsibilities of Regulators (Both Federal and State), Issuers, Rating Agencies, Lawyers, and Market-Makers Be Altered to Minimize the Use of Speculative Investment Policies, Losses and Bankruptcies of Municipalities in the Future?

We agree that the SEC, on behalf of the federal government, has a fundamental responsibility to ensure a Municipal Bond market which provides timely, accurate, and adequate disclosure. We also believe that both the federal and state government have an interest in maintaining a stable market.

Both federal and state regulators play a critical role in the municipal market. A consistent and standard approach to disclosure applicable to the entire Municipal Bond market can only be accomplished at the federal level. A federal regulatory "Working Group" was established by Executive Order in March of 1988, which should help provide such consistency. Acting Treasury Secretary Frank E. Newman described the Group's function as follows: "To promote information sharing among regulators, to discuss various approaches for dealing with serious market issues as they arise, and to encourage consistent and coordinated regulatory actions across markets and market participants."⁶⁵

The recently enhanced SEC disclosure requirements embodied in Rule 15c2-12 were an important step forward in providing market stability. Rule 15c2-12 now ensures a timely and accessible stream of information to the secondary as well as the primary markets. Furthermore, the SEC has taken numerous steps to enhance the integrity of the municipal market.⁶⁶

Although local investment pools are not subject to either the Investment Company Act of 1940 or the Investment Advisors Act of 1940, they are generally subject to the same degree of state regulation. State statutes or regulations typically specify the particular instruments in which an investment pool may invest (and often the percentage of a pool such instruments may comprise). Furthermore, the Government Finance Officers Association ("GFOA"),²² and other industry participants (such as the rating agencies) encourage formulation of and compliance with well-defined guidelines.²³

Consistent with our discussion of federalism concepts, AFGI believes that enhanced state substantive regulation of investment policies by Municipalities should be enacted. Particular emphasis should be placed on appropriateness of certain categories of investments, enhanced disclosure of investment practices and results to municipal governing bodies and state officials, and periodic market validations of investment portfolios.

In addition to the preventive steps outlined above which regulators can take to seek to reduce the risk of significant municipal investment portfolio losses, the Orange County bankruptcy case reveals the need for both state and federal regulators to maintain flexibility with respect to the unique situations which can give rise to such losses. Regulatory enforcement that is driven solely by the letter of the law, and not by its underlying spirit, risks producing outcomes which are inconsistent with the public policies that led to their original adoption. AFGI supports, for example, the SEC's recent and continued careful monitoring of the Orange County case, which led it to work effectively with numerous money market funds during the early days of the Orange County crisis and subsequently during the debt rollover debate. Most recently, the SEC has issued several no action letters which allow certain money market funds to continue to hold their Orange County Bonds (primarily to permit the money market funds to maintain a stable net asset

value). Had the SEC not so clearly understood the ongoing developments in the Orange County case, the municipal marketplace, and the funds' requirements, this outcome could not have been achieved.

Regulators, to the extent authorized by state law, should also be in a position to identify the early warning signs which could help stave off fiscal crisis or massive investment losses. We urge state auditors who have regular responsibilities of investigating municipal holdings and investments to ensure that such funds are held as required by law and subject to legal protections contained in appropriate security documents. To the extent state auditors or state finance officials do not have such responsibilities, appropriate amendments to state law should be considered.

It is important that the new and expanded secondary market disclosure requirements in SEC Rule 15c2-12 be strictly adhered to by the "obligors" subject to that rule. In addition, the need exists for Municipalities to adopt and scrupulously follow investment policies as discussed elsewhere in these remarks.

Other issuer responsibilities have emerged in light of what has been uncovered in the Orange County case. For example, we recommend that all repayment funds, reserve accounts, capitalized accounts, and project funds be held by third party trustees. While such actions do not necessarily help avoid losses or bankruptcies, they do provide some measure of extra security for Bondholders if such events occur. The willingness of Municipalities to insulate in this manner funds expressly pledged to the payment of specific Municipal Securities will give added comfort to those who deal and trade in their respective Securities.

Regardless of whether such funds are held by a third party or in a Municipality's investment pool, Municipalities must take all actions to protect the security interests of Bondholders and the legal requirements regarding such funds must be

scrupulously followed. It is appalling that Orange County did not do what it promised Bondholders it would do with respect to their repayment funds.²⁰ At a minimum, Orange County's actions constitute an impairment of the contracts which the County entered into with its Bondholders when it issued its obligations.

We further suggest that issuers not rely on significant investment earnings as part of their ongoing budgetary balancing process, and that such earnings not be the result of speculative investment decisions. However, effectuating this goal should be a matter left to the states. We realize that the tendency to rely on such earnings may become more prevalent as Municipalities strain in the 1990s to satisfy their obligations to provide essential goods and services. However, such reliance can only lead to the type of leveraging and illegal and unethical activity still being unravelled in the Orange County case.

The rating agencies are also a critical part of the municipal marketplace. Their pronouncements are followed closely by all who participate in the Municipal Securities industry. For example, the S&P Pool Guidelines provide guidance not only to those who manage such pools, but to insurers, other credit enhancers, and purchasers of such Securities.²¹ The Moody's Municipal Credit Report, dated April 12, 1995, which established its rating criteria for local government cash flow notes, is a road map of critical items that should be considered by rating agencies and others who invest in such instruments. But, while the rating agencies can guide Municipalities (as they have) on investment policy, they can (and should) do no more. It is appropriate that their ratings reflect compliance with rating agency investment guidelines, thereby wielding an effective club against nonconforming issuers.

However, the rating agencies, like any other market participant, can only rely on the information provided by the issuer. They are not in a position to, nor should they,

conduct independent audit investigations. If information is falsified, it is unlikely rating agencies will discover it. They can be the victims of fraud as can any other market participant. It is a credit to the character of the participants in the municipal finance industry that there have been so few problems in the past.

The rating agencies can be an effective barometer of the market. For example, Moody's issued a scathing analysis of the recent issue by Orange County of its "Recovery Bonds."²¹ Although Moody's was forced to grit its teeth and rate the Bonds because they were insured by an AFGI participant, MBIA, Moody's was, in fact, rating the claims-paying ability of MBIA and not the creditworthiness of the County. This distinction should not be lost. Moody's was firmly on point in its assessment of the underlying credit risks involved.

The market has not yet adjusted its pricing to reflect that fact that very few states currently authorize their municipalities to file for Chapter 9 protection.²² The market will require new protections in the future or adjust their prices accordingly. In addition, market makers will probably turn to independent bankruptcy counsel to review both the structure of Bond issues and certain items of disclosure in light of what we have learned in the Orange County case. Those issues which are structured to subject their Holders to less risk of impairment through the bankruptcy process might fare better in the marketplace. Similarly, insurers may adjust premium prices in light of the enhanced risk of bankruptcy filings. They too will increasingly turn to independent bankruptcy counsel for advice on structure and security features.

XI. Has the Demand for Bond Insurance Increased and/or the Price of Insurance Increased Since the Orange County Bankruptcy and Have Other Investment Losses Have Taken Place at Municipalities?

The press has indicated that the demand for insurance and other forms of credit enhancement will increase as a result of the Orange County case.²³ This is consistent with statements by the NFMA²⁴ and statements by various municipal and money market funds. Unfortunately, it is too early to tell whether an increased use of credit enhancement, whether by letter of credit or insurance, will be a direct outgrowth of Orange County's Chapter 9 filing or an amalgam of Orange County and other considerations. For example, many California Bond issues this spring have been enhanced, but a careful analysis needs to be conducted to determine why credit enhancement was used in a particular issue.²⁵ Whether the heightened municipal credit concern engendered by the Orange County bankruptcy results in a greater long-term increase in the use of credit enhancement will, in large part, depend on whether the County's short-term and long-term obligations are fully paid.

It also is too early to tell what effect the Orange County situation will have on insurance pricing overall. It has clearly had an effect on recent Orange County financings, however. Insurance pricing is a question of perceived risk which differs by issuer and revenue source, as well as specific security provisions. Clearly, the "character" of the borrower in its past municipal offerings, and its proven willingness to pay, will play a part in the risk analysis. The cost of insurance for Orange County's recent issuance of "Recovery Bonds" in part reflected Orange County's character issue as well as the other risks associated with this unprecedented offering.

Nevertheless, we believe that payment defaults by Orange County on any of its Municipal Securities will have a direct impact on the pricing of similar Securities in the future. Insurers will include the experience of the Orange County payment defaults in their risk analysis when looking at similarly structured instruments.

XII. Do You Think the Criteria and Guidelines on Which Bond Insurance is Based Warrant Revision?

The current criteria for Bond insurance need not necessarily be revised as a result of the Orange County crisis, though certainly the insurance industry will scrutinize the investment practices of Municipalities to a much greater degree. However, the overall guidelines for insurability may change depending on the outcome of the Orange County bankruptcy. Prior to the Orange County filing, at least one AFGI member was uncomfortable with the risks inherent in California lease-backed issues, due primarily to concerns over natural disasters and abatement. If Orange County defaults on its COPs obligations for reasons other than abatement, the perceived risks for all COPs issues increases dramatically. Thus, each individual AFGI member will be forced to rethink the advisability of insuring COP transactions, particularly those in the California market.

XIII. Please Describe Insurance Provided to Orange County Bonds Before and After Bankruptcy, and What Bond Insurers Have Paid and Currently Owe for Orange County Bonds.

Potential exposure as a result of the Orange County case falls into two general categories: First, AFGI exposure due to non-payment of Municipal Securities issued by or for the benefit of Orange County; and second, AFGI exposure due to the non-payment of Municipal Securities issued by or for the benefit of a participant in the Orange County

Pool.⁷⁶ Because of the significant financial loss suffered by Pool participants, AFGI members have been carefully monitoring these governmental entities.

As of July 19, 1995, AFGI members have an aggregate par exposure to Orange County obligations of approximately \$542 million and an aggregate exposure to obligations of Orange County Pool participants of approximately \$3.3 billion.

XIV. What Type of Legal Recourse Do Bond Insurers Have Against Municipalities

Who Lose Money or, as in the Case of Orange County, Refuse to Raise Taxes to Pay Their Obligations?

An insurer's legal recourse varies from transaction to transaction. First, an insurer usually does not have any independent remedies; it stands in the place of the Bondholder once it pays a claim to that Holder. Second, remedies are set forth in the underlying Bond financing documents and are limited both generally and specifically by state constitutions, statutes, and case law. Third, if a Municipality files for protection under Chapter 9, the exercise of insurer's remedies is stayed and its ultimate recovery (assuming, of course, that it has a claim) is determined in the Plan of Adjustment.

State law regarding the exercise of remedies against its subdivisions is a reflection of numerous factors. For example, because a Municipality usually cannot liquidate all of its operations and cease to exist,⁷⁷ most states limit real property foreclosure rights against such entities. A threshold question in most states is whether the municipal property is held in a private or proprietary capacity, as opposed to being held for a public or governmental purpose.⁷⁸ Courts often use open-ended tests, however, so that virtually any activity undertaken by a Municipality is considered a governmental function, and is thus beyond the reach of creditors. However, some courts have been willing to issue writs of execution against property held by the Municipality in a strictly private capacity.⁷⁹

The same public/private analysis applies when an insurer (or the original bondholder) pursues a monetary judgment. For example, a garnishment action to seize a Municipality's financial assets is essentially an action against money instead of real property. Thus, courts often use the same public/private distinction discussed above. Furthermore, state restrictions such as the provisions of Article XVI, Section 18 of the California State Constitution (expenditures from a given fiscal year may not exceed revenues received during that fiscal year), lead to the result that while a Bondholder may have a valid claim, it has no assets on which to execute a judgment after the expiration of the fiscal year.⁸⁰

When an issuer defaults on a G.O. Bond secured by the issuer's taxing power, the Bondholder (or insurer, as the case may be) may seek a writ of mandamus against the tax levying officials of the issuer. Such a writ directs the officials to levy and collect taxes or to pay debt service out of funds in the treasury. Courts, however, are reluctant to issue such a writ if it will result in preventing an issuer from performing its essential municipal functions. Even where courts have been willing to issue a writ, they have structured its terms to protect the issuer's financial viability. Furthermore, courts will generally refuse to grant a writ of mandamus to impose taxes in excess of constitutional tax limitations.⁸¹ In the case of Revenue Bonds, when an issuer fails to satisfy an obligation to maintain rates at an appropriate level to pay debt service, a writ of mandamus may be issued directing the issuer to raise the rates.⁸²

A Bondholder or insurer who can demonstrate that a Municipality has collected revenues intended to pay Bonds and that such payments have not been forthcoming, will usually be entitled to an accounting to ascertain the amount of collections and distributions. This remedy is particularly relevant in the context of Revenue Bonds, which are payable solely from the revenue of a specific project.⁸³

While injunctive relief is a potential remedy for Bondholders and insurers, courts are reluctant to interfere with the governance of a Municipality. Generally, courts will grant injunctions only when the remedy is expressly provided for by statute or when the Bondholder can show that net revenues from a Bond-financed project are being diverted to purposes other than the required payment on the Bonds.

Finally, when a Municipality has defaulted on Bond payments for a publicly financed project, a court may appoint a special receiver who will operate and manage the project. This remedy, however, requires statutory authorization where, as in the case of G.O. Bonds, control over municipal finances is implicated. Courts have been more inclined to grant receiverships where Revenue Bonds are involved. Nevertheless, even when statutory authority to appoint a receiver is provided, courts will exercise great caution in using their discretion to impose a receivership.⁸⁴

Chapter 9 of the Bankruptcy Code, however, establishes its own set of remedies and procedures. While a brief discourse of creditors' rights under a Chapter 9 proceeding is beyond the scope of this testimony, I respectfully refer the Subcommittee to our earlier discussion on possible changes to the Code set forth in Section IV of these remarks.

XV. Do You Rely on Different Criteria, and Do You Receive the Same Information, as do the Rating Agencies?

By and large, the information needed by each of the insurers does not vary greatly from that which is requested by the rating agencies. Such information does vary, however, depending on the type of Bond being issued. For example, unlimited tax G.O. Bonds are routinely less document-intensive, and therefore require much less information

than more complicated transactions, such as student loan bonds or single family housing bonds.

In the typical case, such information includes, on the legal side, copies of the legal documents, including, as appropriate, all bond indentures, resolutions, ordinances or orders, including all pertinent amendments and supplements thereto, which constitute the basic financing documents. If necessary, authorizing legislation, legal opinions, disclosure documents, and any ancillary contracts and agreements may also be requested.

On the underwriting side, a Municipal Bond analyst, in order to make an informed credit judgment, needs to know, at a minimum, the purpose of the issue, the particular characteristics of the issuer or the enterprise, the contents of the financial statements of the issuer or the enterprise, system characteristics (for instance, the number of entities served by a water and sewer project, or demographics for general obligation debt), and the service area background. In addition, a discussion with the issuer's management is usually required.

This does not imply, however, that each of the insurers and each of the rating agencies use this information in the same way or place equal importance on each discrete piece of information. Criteria employed by each company is essentially similar, but is developed independently by each company. Just as each rating agency develops its own criteria for each Bond type, so does each insurer develop its underwriting criteria independently. The rating agencies do, however, review the underwriting criteria of each insurer to satisfy themselves that no insurer is doing business which is considered too risky.

XVI. Conclusion

Mr. Chairman, the Municipal Bond insurers are an integral part of the municipal finance industry, and are committed to preserving the deep level of trust that has been the foundation of this industry. AFGI, representing these insurers, offers these preliminary comments to the Subcommittee in the hopes of contributing to a necessary process of reform. As these comments indicate, AFGI feels that the Orange County bankruptcy has raised issues which require a serious, but measured response on many levels and in many forums. We look forward to being a part of this anticipated process of reform.

ENDNOTES

1. For purposes of this testimony, various types of governmental entities, such as counties, cities, school districts and special districts are generically referred to herein as a "Municipality" unless the context otherwise requires. Furthermore, the term "Bond" or "Security" refers to any one of the types of securities a Municipality might issue, such as bonds, notes, warrants, certificates of participation or other forms of municipal securities sold by a state or its subdivisions. "Municipal Bond" or "Municipal Security" is used to refer to a Bond or Security issued directly by a governmental entity which is a "Municipality" under the Bankruptcy Code, and which is a political subdivision of a state. A "Bondholder" or "Holder" is the beneficial holder of a Bond or Security.
2. The differential between the cost in the market of an "AAA" rated credit-enhanced deal, including the cost of the insurance premium, and the cost in the market of the underlying rating of the issuer usually translates into a lower borrowing cost to the issuer.
3. AFGI Brochure, Exhibit I hereto, at 9.
4. Testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission ("SEC") before the Committee on Commerce of the U.S. House of Representatives, January 12, 1995 (hereinafter the "Levitt Testimony") at paragraph 3 and AFGI 1994 Annual Report, at 1.
5. AFGI Brochure at 5.
6. Levitt Testimony at ¶ 3.
7. Leslie Wayne, "Banging a Tin Cup With a Silver Spoon," N.Y. Times, June 4, 1995, at 5.
8. James E. Spiotto, "Bankruptcy and Workouts," Practising Law Institute No. N4-4567, Dec. 1, 1992.
9. James E. Spiotto, "Municipal Defaults and Bankruptcy: Myth and Reality," Practising Law Institute No. N4-4483, Jan. 11, 1988.
10. See Section III(B) which describes the County's reservation of the right to challenge the validity *ab initio* of its \$600 million taxable notes and the security interests granted to Bondholders in other County obligations, as well as its right to recharacterize Certificates of Participation ("COPs"). Despite these reservations, the County has consistently indicated that it intends to pay its debts. The recent defeat of Measure R (the sales tax measure) suggests that the County may no longer be financially able to honor its commitment in full, regardless of its good intentions.
11. Commentators are not uniform in finding negative reaction in the market. See, Andy Pasztor, "Bankruptcy Aftermath is Modest," Wall St. J., July 11, 1995, at C1.

12. See Leslie Wayne. "Banging a Tin Cup With a Silver Spoon." N.Y. Times, June 4, 1995, at 5.
13. See Testimony of R. Fenn Putman, Managing Director of the Public Securities Association ("PSA") before the Committee on Commerce of the U.S. House of Representatives, January 12, 1995, first paragraph of "Secondary Market Disclosure" section (hereinafter "Putman Testimony").
14. See Robert S. Amdursky and Clayton P. Gillette, Municipal Debt Finance Law: Theory and Practice § 5.1 (1992).
15. In New York, for instance, the state constitution requires G.O. Bond debt to be paid "at all costs." See Flushing Nat'l Bank v. Municipal Assistance Corp., 358 N.E. 2d 848 (1976) (declaring unconstitutional an act placing a moratorium on payment of notes issued by NYC explicitly pledging the City's faith and credit). See also, Amdursky & Gillette § 1.3.1. In contrast, other states, such as Florida, do not find this obligation to be absolute. See e.g., State v. City of Lakeland, 16 So. 2d 924 (1943) (holding that City did not make absolute promise of payment to bondholders; rather, it only constituted a good faith obligation).
16. In 1975, just one third of all newly issued Municipal Bonds were Revenue Bonds. By 1994, 65 percent of all newly issued municipal debt came in the form of Revenue Bonds. For the most part, this shift reflects the growing pressure on state and local governments to finance infrastructure investment without raising taxes. Unlike G.O. Bonds, Revenue Bonds can be issued without voter approval. In addition, some issuers have created Municipal Bonds employing various hybrid structures that combine G.O. and Revenue Bond features. Still other Bonds are backed by pledges of specific tax revenues such as gasoline taxes for a highway bond, or hotel occupancy taxes for a convention center or public improvement bond
17. CDAC Public Hearings Report entitled Credit Implications of the Orange County Crisis (hereafter "CDAC Hearings Report") at 42.
18. Id.
19. Governor Wilson has issued strong warnings on the topic (See e.g., Debora Vrana, "Wilson to G.C.: Help Yourselves Out of the Mess." L.A. Times, Mar. 17, 1995), as has California State Treasurer Matt Fong (See e.g., Eric Bailey, "Fong Revives Talk of State Takeover if County Stumbles." LA Times, June 29, 1995; Michael Utley, "California Legislature Approves Recovery Bills to Allow County Debt." The Bond Buyer, May 15, 1995). On July 17, the Speaker of the California State Assembly, Doris Allen announced the creation of the Assembly Committee on Government Effectiveness and Accountability. Its new chair, Assemblyman Bernie Richter, stated "I would think the committee agrees that Orange County cannot default, and we'll do whatever it takes to prevent that." Mark Lifsher, "Allen Creates Special Panel," Orange County Register, July 18, 1995.
20. The municipal market is watching assiduously to see how the details of the Orange County bankruptcy develop and take shape. Despite the County's repeated statements that it intends to pay its debts, the County's reservation of rights gives the market

cause for concern. We note, with some limited optimism, the Orange County Professionals' recent goal of repaying all of the County's debts set forth in its July 18, 1995 "Financial and Legal Update" presented to the Orange County Board of Supervisors.

21. See Second Amended Stipulation of Settlement and Agreement Respecting Note Debt of the County of Orange (hereinafter the "Extension Stipulation"); Second Amended Note Modification and Extension Agreement (together with the Extension Stipulation the "Rollover Agreement"); Order Approving Second Amended Note Modification Agreement entered June 27, 1995; and Order Approving Compromise of Controversy Respecting Validity of Note Debt entered June 27, 1995.
22. These lease-based municipal finance vehicles are not unique to California. Nationwide, issuance of long-term lease obligations in 1991 totalled over \$12.8 billion, of which less than half were California-based. Morris G. Miller, "Lease-Purchase Financing — Will Political Pressure Kill the Golden Goose." Urban, State and Local Law Newsletter, Vol 15, No. 3, Spring 1992; see also California Debt Advisory Commission, Guidelines for Leases and Certificates of Participation, November, 1993 at 7.
23. According to the California Debt Advisory Commission, over the past 10 years California Municipalities have issued \$37,050,127.080 in COPs. In 1985 there were 193 California COPs issues totaling \$4,185,120,258 (which reflected the impending effectiveness of the Tax Reform Act of 1986), while in 1994 there were 204 issues totalling \$2,945,436,451.
24. See City of Los Angeles v. Offner, 19 Cal.2d 483 (1942) and Dean v. Kuchel, 35 Cal. 2d 444 (1950). Some COPs are structured with "abatement" leases while others carry the risk of non-appropriation. In an abatement lease, the Municipality promises to appropriate funds on an annual basis for the use of the real property involved, so long as it has reasonable right to use of the property. If for any reason the Municipality does not have the right to use the subject property, it is not required to make rental payments. To protect against this risk, the Municipal Bond market usually requires that the Municipality carry some form of rental interruption insurance to cover COPs payments in case the building is damaged or destroyed. On the other hand, some states permit non-appropriation leases. In this type of transaction, the COPs holders are only entitled to payments to the extent that a Municipality appropriates money for the rent. In these circumstances, the Municipality must, of course, surrender possession of the property if it does not appropriate payments.
25. AFGI is encouraged that the County's July 18, 1995 "Financial and Legal Update" relies heavily on the use of COPs. Such reliance, we think, would make recharacterization or repudiation impossible.
26. Because California property taxes are collected semi-annually, Municipalities resort to TRANs to meet liquidity needs throughout the fiscal year.
27. See In re County of Orange, No. SA 94-22272-JR, Findings of Fact and Conclusions of Law In Support of Order Denying Motion For Relief From Stays Under 11 U.S.C.

§§ 362 and 922 To Seek Appropriate Relief In State Court (Bankr. C.D. Cal. March 8, 1995).

28. NFMA represents over 900 Municipal Bond specialists. It correctly noted the ripple effect an Orange County default would have on the borrowing costs of other California governmental entities, such as cities, school districts, and special districts.
29. See Memo to California Bankers, Financial Advisers, Bond Counsels and Note Issuers from National Federation of Municipal Analysts, dated April 18, 1995; see also Thomas T. Vogel, Jr. and Fred Vogelstein, "Bond Funds Protest Orange County Treatment," Wall St. J., May 18, 1995.
30. See In re County of Orange, (C.D. Cal. July 13, 1995) (Ruling on Appeal).
31. See Extension Stipulation at ¶ 9.
32. The County first announced its intention to reserve this challenge in a March 16, 1995 press release. Subsequently, this reservation was formally adopted as part of the Extension Stipulation approved by the Bankruptcy Court on June 27, 1995. Immediately after the County's news release, a press release issued by Moody's Investors Service ("Moody's") stated that if Orange County exercised its reservation it would "totally undermine any hopes the County may entertain to regain credibility in the financial community." Tracy Weber, "County Recovery Plan Hinges On A Word: 'If': Bankruptcy: The Blueprint For Repaying Debt, Released Last Week, Depends On A Number Of Variables," L.A. Times, March 27, 1995 (Orange Co. Ed.).
33. Barbara Flickenger, a Moody's analyst stated that it "would be very, very hard for Orange County to ever recover from [a challenge on the debt]. No investors would believe them." See Debora Vrana, "Default Studied As Last-Ditch Strategic Move," L.A. Times, April 11, 1995, at A1.
34. Moody's addressed the issue of Orange County's character when it reviewed the County's Recovery Bonds offering. In its release dated June 12, 1995, Moody's stated that:

"The county has proposed an extension with holders of other notes due this summer, while retaining its rights to invalidate certain of these obligations. The county also continues to use reserve funds to make payments on its certificates of participation and, again, has retained the right to seek to invalidate of these obligations. The sales tax that could make the county's recovery plan achievable may lack the support needed for a successful vote. Without an intensive effort by the county to address its revenue requirements and honor all of its debt obligations, the credit quality on the Refunding Recovery Bonds, absent credit enhancement, is consistent with the county's other obligations, which are well below investment grade."

Similarly, Daniel Heimowitz, executive vice president of Moody's stated in response to the Measure R defeat, that what Orange County is saying is tantamount to "[w]e took your money, and now we don't owe you money." "Critics calling Orange

County Names After Unthinkable Rejection of Tax." Orange County Register, July 2, 1995.

35. See letter dated May 15, 1995 to Governor Pete Wilson, et al. from Alliance Corporate Financial Group Inc., The Benham Group, Franklin Resources, Inc., PNC Institutional Management Corporation, Sanford C. Bernstein & Co., Inc., Charles Schwab & Co., Inc., and Vanguard Group of Investment Companies.
36. We note, however, Standard & Poor's recent rating downgrade of Benham's California Municipal Money Market Fund and Benham's California Tax-Free Money Market Fund to Single 'A'-plus from triple 'A', as a result of the rating agency's view that Orange County had defaulted in its \$169 Million Tax and Revenue Anticipation Notes Series A. See "S&P Lowers Rating on two Benham Money Funds," Standard & Poor's Ratings Group, July 19, 1995. According to the S&P Release dated July 19, 1995, these downgrades came "as a result of positions both funds hold in Orange County Notes." See Peter Heap, "Two California Funds Downgraded By S&P Following County Defaults," The Bond Buyer, July 20, 1995, at 5.
37. As discussed later, the Ad Hoc Committee (described at endnote 44 and accompanying text) is considering similar questions regarding what action a state should be required to take to authorize its Municipalities to file. One suggestion under discussion is to permit states to continue to adopt blanket authorization legislation, but to require that such legislation be enacted after Congress has considered and adopted revisions to Chapter 9 which reflect Congressional concerns about use of the Code in the Orange County bankruptcy.
38. See Section III(B)(1).
39. For example, in Butt v. State of California, 4 Cal. 4th 668 (1992), the California Supreme Court held that the State of California has a duty, based on the state constitution, to intervene when the budgetary problems of a school district would otherwise deprive its students of basic educational equality.
40. CDAC reports that Municipalities (which it designates "Local Issues") issued approximately \$9.8 billion in TRANS in the fiscal year ended December 31, 1993 and approximately \$7.5 billion in the fiscal year ended December 31, 1994. See "California Public Debt Issuance by Type and Refunding for the Period January 1, 1993 to December 31, 1993" and "California Public Debt Issuance by Type and Refunding for the Period January 1, 1994 to December 31, 1994" published by CDAC. In his testimony before CDAC at the hearings on the Credit Implications of the Orange County Crisis, Tom Kenny, Senior Vice President and Director of the Municipal Department for Franklin Advisors, stated that, assuming \$19 billion in TRANS issues, a "50 basis points in yield penalty would total approximately \$95 million a year; 100 basis points would total \$190 million." CDAC Report of Hearings at 38.
41. Id.; see also endnote 40 and Comments of the Honorable Matt K. Fong, California

State Treasurer and Chairman of CDAC at the February 22, 1995 CDAC Public Hearings titled "Credit Implications of the Orange County Crisis."

42. See 11 U.S.C. § 1104.
43. For a further discussion of Chapter 9 incentives and disincentives, see Section V. supra.
44. Members include: A.G. Edwards, AMBAC, Chapman & Cutler, Fidelity Investments, Katten Muchin & Zavis, Latham & Watkins and NatWest Markets.
45. As of 1993, there were 15 states which specifically authorized their Municipalities and political subdivisions to file for bankruptcy protection (Alabama, Arizona, Alaska, California, Florida, Idaho, Kentucky, Louisiana, Montana, New Jersey, North Carolina, Ohio, Oklahoma, Pennsylvania, and South Carolina). See Jonathan J. Spitz, "Federalism, States, and the Power to Regulate Municipal Bankruptcies: Who May Be a Debtor Under Section 109(c)?" 9 Bank. Dev. J. 621, 632 and n.86 (1993).
46. For example, when Troy, N.Y. faced a recent fiscal crisis, the State of New York established a Municipal Assistance Corporation ("MAC") and legislatively prohibited Troy from filing for bankruptcy as long as the MAC's bonds remained outstanding. Christina Pretto, "Troy, N.Y., Could Enter Debt Market Under New Agency, Board Aegis." The Bond Buyer, July 3, 1995, at 1.
47. Direct costs include payment of debtor professionals hired to provide bankruptcy related services (i.e., lawyers, accountants and underwriters) and the cost of such professionals for creditors to the extent the debtor agrees. The Orange County Register has reported that attorneys and professionals in the Pool case submitted over \$2,847,271 in fees and expenses from December through March 31, 1995, alone. Ronald Campbell, "Suddenly Meek Attorneys Answer Questions on Billing." Orange County Register, June 23, 1995. This number does not include County attorneys and professionals or Creditors' committee and subcommittee attorneys and professionals. Indirect costs include the increase in vendor and other charges for goods and services in the future which cannot be quantified accurately at this time.
48. Orange County officials argue that the County has suffered — it has been forced to downsize. However, too many see that as a benefit to the populace, not a penalty.
49. We do not discount the tremendous potential disincentives imposed by the municipal market in the form of increased borrowing costs and limited market access. However, we believe it is too early to quantify such impacts.
50. James E. Spiotto, "Municipal Insolvency: Bankruptcy, Receivership, Workouts and Alternative Remedies." State & Local Government Debt Financing (M. David Gelfand, ed.). 1991 at Appendix 13F.
51. Bernice Napach, "Orange County: Lesson in Risk Management." Investor's Business Daily, December 30, 1994, at A1.

52. As noted above, while it is still too early to fully discern even the short-term implications of the bankruptcy, the empirical evidence we have so far is mixed. According to the Bond Investors Association ("BIA"), the frequency of Municipal Bond defaults has risen sharply in 1995, in stark contrast to the declining trend over the past four years. The BIA reported that during the first half of 1995 there have been 26 disclosed defaults in the municipal market totaling \$745 million, which is a 65 percent increase over the \$451 million in defaults recorded by the association during the first two quarters of 1994. Donald Yacoe, "Research Shows Alarming Rise in Defaults," The Bond Buyer, July 11, 1995, at 7. BIA's Richard Lehman, stated that "nearly all of the increase this year comes from Orange County," indicating that excluding the Orange County bankruptcy there has been only a marginal increase in the volume of Municipal Bond default. Id. Again, it is difficult to determine whether this constitutes a trend, and if so, for how long this trend will continue.
53. In the wake of the Orange County bankruptcy, Moody's identified a number of California municipal investment pools for further review, including those operated by the Counties of San Bernardino, San Diego, Monterey, Placer, Solano and Sonoma. See Bernice Napach, "Orange County: Lesson in Risk Management," Investor's Business Daily, December 30, 1994, at A1. Moody's also placed its Aa rating for Walworth County, Wisc. under review for a possible downgrade after learning of investment losses due to collateralized mortgage obligations. Id. Standard & Poor's announced that after examining 25 California county investment pools (as a result of the Orange County bankruptcy), it found that 13 of them did not meet Standard & Poor's guidelines. "Standard & Poor's Creditweek Municipal," January 26, 1995. While investment pool losses or investment practices in and of themselves may not portend an imminent onslaught of municipal bankruptcies, they do indicate that there have been a number of municipal investment pools which have invested public monies in excessively risky investments, thus exposing them to excessive risk.
54. In examining the impact that the Orange County bankruptcy will have on future bankruptcies, we think perhaps the best place to start is an examination of the circumstances and events which caused the bankruptcy. There can be little doubt that part of the blame for the bankruptcy is attributable to California's Proposition 13, which in 1978 cut property taxes and the revenues associated with them. This watershed event led to tremendous pressures on those municipal officials entrusted with the investment of public funds to obtain above-average returns on investments to replace revenues lost due to Proposition 13. This trend towards using investment revenue as a means of paying for vital public services was precipitated by Proposition 13's undesirable effect of limiting tax revenues available to fund such services. Compounding this problem, post-Proposition 13 revenue-raising limits have hamstrung the County in its efforts to deal with its fiscal emergency.
55. As stated by Alan Greenspan, Chairman, Federal Reserve Board, in response to a question from Senator Dodd during the January 5, 1995 Hearings of the Senate Committee on Banking, Housing and Urban Affairs:

"The use of derivatives in that particular set [Orange County] of strategies is probably not all that relevant, because what derivatives do is make an arcane investment strategy which can be implemented without derivatives less costly. And so that if he had no derivatives but insisted upon the same strategy that he was involved with, he would have come up with the same problem, it just would have cost him a little more. And I think the difficulty is that it's the investment strategy, the portfolio strategy which the treasurer of Orange County embarked upon, which is the problem. That derivatives were involved is really a passing issue."

56. For a more detailed explanation of leverage, see Testimony of Robert D. McKnew, Chairman, Public Securities Association, before the United States Senate Committee on Banking, Finance and Urban Affairs on January 6, 1995 (hereinafter the "McKnew Testimony").
57. Standard & Poor's, "Local Government Investment Pool," June 1995 (hereinafter "S&P Pool Guidelines").
58. See e.g., California State Senate 1995-96 Second Extraordinary Session, Senate Bills, 13, 20 and 27.
59. See S&P Pool Guidelines for a discussion of these legislative responses.
60. See Valerie C. Carlson, "Derivatives Slow GFOA Panel's Investment Policy Vote." The Bond Buyer, February 13, 1995 at 7. Kieran Beer, *et al.*, "Treasurers Say Pools Need More Disclosure, Not Federal Regulation." The Bond Buyer, February 13, 1995, at 1.
61. See McKnew Testimony.
62. However, action is being taken by public finance organizations, such as the Government Finance Officers Association (GFOA), National Association of State Treasurers (NAST), and the Municipal Treasurers Association (MTA), who have all recommended changes in existing law. See David Kaplan, "Committee to Discuss Model Investment Rule." The Bond Buyer, June 9, 1995, GFOA Annual Supplement, at 4A. NAST met in mid-February to formulate a policy on investment pools. While there was disagreement as to whether greater disclosure and better accounting standards would be sufficient to protect the public, or whether intervention by the SEC was necessary, there was a virtual consensus that something needed to be done. See Kieran Beer, "Treasurers Say Pools Need More Disclosure, Not Federal Regulation." The Bond Buyer, February 13, 1995, at 1. The GFOA previously adopted a model investment policy, and is urging Municipalities to adopt written investment policies. The three organizations have even begun considering formulating an industry standard for municipal investment policies. We urge states to consider these studied measures before adopting new legislation.

63. Chairman Levitt summarized the SEC's proactive measures in the municipal market during 1993 and 1994 in his testimony before the House Committee on Commerce on January 12, 1995 as having:

- issued in March 1994 an interpretive release addressing the application of the antifraud prohibitions of existing securities laws to the municipal securities markets. The release noted, among other issues, the Commission's views about municipal issuers' disclosure practices with respect to their derivatives activities, both as issuers and end-users; and reminded municipal issuers that the antifraud provisions apply to their statements that can be reasonably foreseen to affect the secondary market for their securities;
- adopted extensive revisions to existing rules applicable to municipal securities brokers and dealers that will facilitate better annual disclosure of financial information and timely disclosure by municipal securities issuers of material events that affect the value of municipal securities;
- taken steps to improve price transparency for the municipal securities and other debt markets; and
- encouraged industry initiatives and approved MSRB rule G-37 eliminating "pay-to-play" practices from the municipal bond market.

AFGI acknowledges the benefit of these measures, but believes that the SEC should abandon any discussions to require registration.

64. See McKnew Testimony.

65. The Working Group was reactivated in 1994 by Secretary Bentsen. Its members are the Secretary of the Treasury and the chairs of the SEC, CFTC and the Federal Reserve. See Testimony of Acting Treasury Secretary Frank N. Newman before the Senate Committee on Banking, Housing, and Urban Affairs on January 6, 1995.

66. See Levitt Testimony.

67. In 1984, GFOA developed and approved "Model Investment Legislation for State and Local Governments." This model suggests a list of appropriate investments and provides a form of model legislation.

68. See endnote 62 and accompanying text.

69. See Section III, supra, which discusses Orange County's reservation to challenge the validity of the security interest Bondholders have in their repayment funds.

70. S&P Pool Guidelines, endnote 57 supra.

71. See Moody's Investors Service Rating News, "Moody's Addresses Credit Quality of Orange County CA Refunding Recovery Bonds," June 12, 1995.

72. See endnote 45 and accompanying text.

73. See e.g., Bernice Napach, "Investors Demanding Insured Muni Bonds," Investor's Business Daily, Jan. 24, 1995, at A1; Michael Utley, "California Notes Find Fans Scarce as Orange County Skips Set-Asides," The Bond Buyer, May 18, 1995, at 1.
74. See endnote 29 and accompanying text.
75. For example, the County of Los Angeles obtained a Letter of Credit by a consortium of banks to support its \$1,300,000,000 TRANs series issued on June 21, 1995. It would be simplistic to suggest that any one factor led to Los Angeles County's reliance on credit support to market note debt which it had issued without credit support in previous years. The Orange County bankruptcy, the question of the survivability of the TRANs lien (see Section III), and Los Angeles County's worsening financial crisis most certainly each played a factor in Los Angeles' decision to obtain credit enhancement. See Michael Utley, "Market: California Short-Term Debt Issues Key Paying Orange County Realty," The Bond Buyer, July 7, 1995, at 20; Jeffrey L. Rabin, "Banks Warily Grant Loan to L.A. County; Credit: Mindful of Orange County's Deadbeat Status, They Attach Stock Letter of Credit to L.A.'s \$1.3-Billion Package," L.A. Times, July 4, 1995, at B1.
76. Political sub-division participants in the Orange County Pool included cities, school districts, redevelopment agencies and special purpose districts such as transportation, water and sanitary districts.
77. We say "usually," because in limited circumstances certain special districts could cede their obligations to another political subdivision. For example, a local sanitation district's obligations might be transferred to a local water district. Even under this scenario, however, certain assets essential to the sanitation district's activities might need to be transferred, along with its obligations, to the water district.
78. Amdursky & Gillette § 5.4.3 n.37.
79. For instance, the Supreme Court of Alabama held that a lot of land located outside city limits and not used for any governmental purpose was subject to levy and sale under execution. Murphree v. City of Mobile, 18 So. 385 (1932). Likewise, the Supreme Court of Ohio found that an automobile owned and used by the city waterworks division was subject to sale under a writ of execution. State ex rel. Baldine v. Davis, 204 N.E. 2d 91 (1964). On the other hand, some jurisdictions, such as Illinois and Maryland, refuse to make the ambiguous public/private distinction and simply deny execution against any municipally-owned property. Amdursky & Gillette § 5.4.3 n.51-52.
80. See Weaver v. San Francisco, 43 P. 972 (1896); accord, W.W. Montague & Co. v. English, 119 Cal. 225 (1897).
81. Amdursky & Gillette § 5.4.1.
82. See e.g., State ex rel. Allstate Insurance Co. v. Union Public Service District, 151 W. Va. 207, 151 S.E.2d 102 (1966) (holding that once some service is provided, charges to users must be raised to an amount sufficient to pay bondholders); Amdursky & Gillette § 5.4.2.

83. See Willard v. City and County of Honolulu, 323 F. Supp. 666 (D. Haw. 1971):
Amdursky & Gillette § 5.4.5.
84. Amdursky & Gillette § 5.4.7.

EXHIBIT I

AFGI Brochure

MUNICIPAL BOND INSURANCE

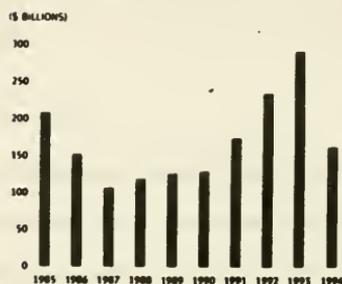
HELPING TO BUILD AMERICA

EXECUTIVE SUMMARY

Good schools, hospitals, highways, airports, environmental systems and transit networks are critical for a prosperous America. With federal support for such projects in decline since the 1980s, state and local governments have assumed primary responsibility for replenishing the nation's infrastructure. The municipal bond is their most effective financing tool. Outstanding new municipal bonds issued by state and local governments and their agencies are currently estimated at \$1.2 trillion.

At the time of issuance, all insured municipal bonds receive the highest possible rating, triple-A, from at least one of the major credit rating agencies such as Moody's Investors Service, Inc., Standard & Poor's Corporation, and Fitch Investors Service, Inc. Insurance enables states and municipalities to save on their borrowing costs. Over the life of a typical bond financing, these savings can be substantial. American citizens benefit directly from these savings, which reduce the taxes or fees they must pay. American communities benefit by being better able to afford necessary projects. And American investors benefit by gaining access to securities that are safer and more stable than uninsured bonds.

The Association of Financial Guaranty Insurers (AFGI) is comprised of nine triple-A rated U.S.-based companies. All follow conservative policies in selecting issues for insurance, in setting aside capital reserves, and in managing their own investment portfolios. Since the founding of the bond insurance industry in 1971, no monoline financial guaranty insurance company has been downgraded, no issue insured by an AFGI member company has been downgraded, and no investor in an insured bond has failed to receive a bond payment.

1994 MUNICIPAL BOND ISSUANCE
BY SECTORANNUAL MUNICIPAL ISSUANCE
BY YEAR

A MUNICIPAL BOND: FLEXIBLE, POWERFUL FINANCIAL TOOL

THE WORK BONDS DO

A municipal bond is a debt instrument that enables a state or local government to borrow money in the capital markets. From its origins in 1812, the municipal bond has played a vital part in building America — from the canals and railroads of the nineteenth century to the airports and container ports of the twentieth. In the years of the post-World War II economic boom, the municipal bond market grew at an accelerated pace. From just \$4.4 billion in 1952, annual issuance of long-term municipal debt climbed to \$77.2 billion in 1982. Thereafter, it more than tripled to a peak of \$290 billion in 1993.

In overall size, the municipal bond market (estimated at \$1.2 trillion in bonds outstanding at the close of 1994) is comparable to the U.S. corporate bond market (estimated at \$1.3 trillion in bonds outstanding at the end of 1994).

Municipal bonds are used to finance virtually every kind of public capital project, from bridges to mass transit systems to sewage treatment plants to court houses to electric generating plants. They also finance certain types of private projects that serve important public purposes such as low- and moderate-income housing, private hospitals and colleges, and industrial facilities. In 1994, general purpose/public improvement bonds represented the largest sector of municipal issuance.

From the Dallas-Fort Worth Airport Authority to New Hampshire's Merrimack Village School District, and from the Seacoast Utility Authority of Palm Beach County, Florida to the San Diego County Regional Transportation Commission in California, municipalities and agencies, both large and small, strive to upgrade their existing facilities, meet new environmental standards, respond to population growth, and capitalize on opportunities for economic development. By issuing bonds, they can undertake important projects without imposing undue financial burdens on their taxpayers or ratepayers.

While "new money" bonds serve to finance new capital projects, "refunding" bonds are used to refinance an issuer's existing debt. When interest rates fell to historically low levels in 1993, many issuers took advantage of the opportunity to refinance. As interest rates rose in 1994, the number of refundings declined sharply.

TAX-EXEMPT STATUS

Since the introduction of the federal income tax in 1913, interest income from most municipal bonds has been exempt from this tax. Tax exemption is very advantageous to state and local governments because it allows them to borrow money at below-market interest rates.

Investors are willing to accept a slightly lower rate of interest on a bond if they do not have to pay tax on the income. Precisely how much lower the investor will accept depends on the marginal federal income tax rates in effect at any given time. The higher the tax rate, the more valuable the exemption to investors — and, therefore, to issuers. In the current environment, tax exemption saves municipalities substantial dollars in interest costs. Nationwide, tax exemption means billions of dollars in savings every year for state and local governments.

STRUCTURES TO MATCH NEEDS

Most municipal securities are either general obligation bonds (G.O.s) or revenue bonds. G.O.s are backed by the full faith and credit of the issuing government — ultimately, by its power to levy taxes and to take any other steps necessary to repay bondholders. Since G.O.s are a long-term commitment of tax revenues, they normally require voter approval. General obligation bonds have often financed roads, schools, prisons, and other public buildings.

Revenue bonds, by contrast, are backed by a specific source of revenue related to a given project — tolls, for example, in the case of a highway project, landing fees for an airport addition, or water charges for a

water system upgrade. These revenues are legally pledged to pay principal and interest, on schedule, to bondholders. The issuer of a revenue bond is generally an independent agency of a state or local government, such as a turnpike authority or an electric power authority, that has a monopoly over an essential service. Its revenues are, therefore, reasonably secure.

In 1975, just one-third of all newly issued municipal bonds were revenue bonds. By 1994, 65% of all newly issued municipal bonds were revenue bonds. For the most part, this shift reflects the growing pressure on state and local governments to finance infrastructure investments without raising taxes. Unlike G.O.s, revenue bonds can be issued without voter approval.

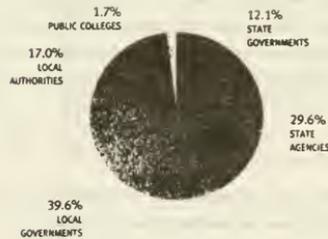
Some municipal bonds have a hybrid structure that combines G.O. and revenue bond features. Other bonds are backed by specific tax revenues such as gasoline taxes for a highway bond or hotel occupancy taxes for a convention center bond.

Long-term financings of 30 years are common in the municipal bond market. Issuers often try to match the term of a bond issue to the useful life of the project it finances. In this way, future taxpayers and ratepayers join with present ones in paying for facilities from which they benefit.

1994 INSURED MUNICIPAL BONDS
BY SECTOR
SOURCE: THE BOND BUYER



1994 ISSUERS OF MUNICIPAL BONDS
SOURCE: THE BOND BUYER



A MULTITUDE OF ISSUERS

Approximately 50,000 different state and local governments and agencies of government are authorized to issue bonds. They are located in all 50 states, as well as in the District of Columbia, Puerto Rico and several American possessions overseas. Local governments typically account for the largest share of issuance (39.6%) in 1994, followed by state agencies (29.6%) and local authorities (17.0%). State governments (12.1%) and public colleges (1.7%) are also substantial issuers.

A VEHICLE FOR HOUSEHOLD SAVINGS

Either directly or through mutual funds, American households own the overwhelming majority of municipal bonds. At the end of 1993, the most recent figures available, individual households held \$584.6 billion (48.0%) of all municipal debt directly, and an additional \$321.3 billion (26.4%) in the form of mutual and money-market funds. For many individual investors, municipal bonds are an attractive vehicle for long-term savings. Retirees, as well as younger people saving for their retirement, are large owners of municipal bonds.

By eliminating most other types of tax-advantaged investments, tax reforms of the 1980s increased investor demand for municipal bonds. At the same time, the creation of municipal bond mutual funds widened the circle of potential investors. The minimum investment in some mutual funds is just \$100, compared with the \$5,000 typically needed to buy a municipal bond in the new issue market.

Changes in the tax law during the 1980s also reduced the appeal of municipal securities to institutional investors. Through the third quarter of 1994, property/casualty insurance companies (12.5% of the market) and commercial banks (8.1%) still hold municipal bonds, but to a lesser degree than in the past.

BOND RATINGS

Currently there are approximately 1.5 million different municipal issues outstanding in the marketplace. Because of differences in structure, even bonds from a

single issuer may differ substantially from one another in credit quality. For the investor, selecting the right municipal bond can be a daunting task.

Bond ratings from independent agencies — Moody's Investors Service, Inc., Standard & Poor's Corporation, Fitch Investors Service, Inc., and Duff & Phelps among others — provide objective guidance to investors as they sort through their alternatives. After analyzing an issuer's ability to pay interest and repay principal as scheduled, these agencies assign a credit rating between triple-A (for the very best securities) and D (for securities already in default). Securities rated triple-B and above are generally considered "investment grade."

The rating agencies periodically review their bond ratings. If significant changes have occurred in a local economy, in an issuer's financial condition or in the level of demand for a particular facility, the agencies may upgrade or downgrade the issuer. When this happens, existing bonds from that issuer typically rise or fall in market value, and investors holding these bonds experience a capital gain or loss — at least on paper.

In the municipal bond market, as in other investment markets, reward is directly related with risk. Bonds offering the greatest safety and security (and carrying the highest credit ratings) pay the least interest. Conversely, riskier, lower-rated bonds must pay interest at substantially higher rates if they are to attract investors.

Municipal bond insurance is an ironclad guaranty from an insurer that it will make timely interest and principal payments to bondholders if the issuer defaults on its obligation. Bond insurance enhances the credit quality of an issue. The claims-paying ability of all the leading municipal bond insurers has been rated triple-A. As a result, every issue they insure is automatically rated triple-A by the rating agencies. In a sense, by paying a premium, the issuer is able to "rent" the insurer's triple-A rating and, thereby, save on borrowing costs.

Bond insurance is a win/win proposition that benefits issuers and investors alike.

HOW BOND INSURANCE ADDS VALUE

INTEREST COST SAVINGS

By boosting the rating on a security to triple-A, bond insurance enables the issuer to save on interest costs. Suppose, for example, that the G.O.s of the City of Metropolis are rated A. If they were issued without insurance, Metropolis might have to pay 6.1% in annual interest. With insurance, the bonds would be rated triple-A, and the interest rate might fall to 5.9%. On a \$100 million issue, Metropolis could save as much as \$1 million in interest costs over the life of the bond. These savings could then be passed along to residents of Metropolis, most likely in the form of lower property taxes.

Bond insurance is cost effective for an issuer as long as the interest cost savings exceeds the premium paid to the insurer. The riskier the transaction, the higher the premium.

Outside the municipal market, bond insurance has also been applied to several types of securities, including highly structured transactions backed by revenues from mortgages or home equity loans. These transactions help financial institutions replenish their capital for further lending. American consumers benefit from this use of financial guaranty insurance because it helps to make first and second mortgages and home equity loans more available and more affordable.

OTHER BENEFITS TO ISSUERS

For a smaller municipal issuer, buying insurance may be simpler and less expensive than applying for a credit rating. Insurance can also increase the marketability of an issue. When interest rates are in flux, this can be very important to the issuer.

1994 MUNICIPAL FINANCE BY STATE
\$ 162,981 MILLION

LEADING BOND RATING SERVICES
EXPLANATION OF CORPORATE/MUNICIPAL BOND RATINGS

	MOODY'S	STANDARD & POOR'S	FITCH
HIGHEST QUALITY, "GILT EDGED"	Aaa	AAA	AAA
HIGH QUALITY	Aa	AA	AA
UPPER MEDIUM GRADE	A	A	A
MEDIUM GRADE SPECULATIVE	Baa	BBB	BBB
PREDOMINANTLY SPECULATIVE	Ba	BB	BB
SPECULATIVE, LOW GRADE	B	B	B
POOR TO DEFAULT	Caa	CCC	CCC
HIGHEST SPECULATION	Ca	CC	CC
LOWEST QUALITY, NO INTEREST	C	C	C
IN DEFAULT, IN ARREARS, OR QUESTIONABLE VALUE	—	DDD	DDD
	—	DD	DD
	—	D	D

Small or infrequent issuers are unknown to most municipal investors, and bond insurance may improve the market's acceptance of their securities. Some mutual funds, as well as individual investors, buy only insured bonds. Insurance may, therefore, widen the circle of potential buyers for a bond offering.

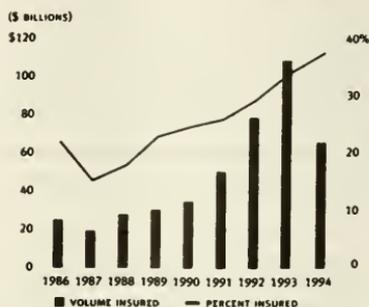
Furthermore, municipal issuers have, in recent years, taken advantage of innovative bond structures that help them further reduce their interest costs. Some recent bond issues are backed by several different sources of revenue. Others are variable-rate demand bonds or securities with swap provisions. These complex structures may be unfamiliar to investors and difficult for them to evaluate on their own. Here, too, bond insurance is often the best way for an issuer to gain a favorable and timely response from the investment markets.

GREATER SECURITY FOR INVESTORS

For investors, the key benefit of bond insurance is that it increases the safety and security of their investments. The owner of an *uninsured* bond can look to just one source for interest and principal payments: the issuer of

the bond. The owner of an insured bond can look to two sources: the issuer and the insurer. Naturally, when their long-term savings are at stake, investors are highly conscious of security. They want to be as certain as possible that they will receive interest and principal payments, in full and on time. Many are willing to pass up the slightly greater yield of an uninsured bond for the increased safety of an insured one.

Investors are also reassured by the fact that insured bonds generally retain their value in the secondary market better than uninsured bonds. This is an important consideration for any investor who may need to sell a bond before it reaches its maturity. When a municipal issuer is downgraded by the rating agencies, its outstanding bonds are downgraded too, and they decline in value. However, the outstanding insured bonds retain their triple-A ratings. Although insurers do not guaranty trading value, insured bonds tend to retain a major share of their value. When, for example, the City of Philadelphia faced the threat of default during a 1990 financial crisis, one uninsured Philadelphia bond lost 12% in value, but a comparable insured bond from the same issuer lost just 2%.

INSURED MUNICIPAL BONDS
SOURCE: SECURITY DATA COMPANY

THE GROWING DEMAND FOR BOND INSURANCE

Demand for bond insurance has grown rapidly since 1981 when just 5% of all newly issued municipal bonds were insured. In recent years, more than 38% of newly issued bonds were insured. In part, this trend reflects the shift in municipal bond ownership from institutions to individual American households. Banks and insurance companies are generally confident of their own ability to evaluate bonds, and they have little need for the added security that bond insurance provides. Bond insurance appeals most strongly to individual investors.

As a class, municipal bonds are a very secure form of investment — second only to U.S. Treasuries. Issue by issue, however, municipal bonds do represent a broad spectrum of risk. Municipal defaults have been relatively rare since the Great Depression, but they have, from time to time, occurred. As a result, some investors have suffered serious losses and a far greater number have become aware of the potential for losses.

New York City's financial crisis of the 1970s was an important turning point for the municipal bond market. During this crisis, the city imposed a moratorium on payments to holders of its short-term notes. In the same period, New York State's Urban Development Corporation also defaulted. In time, both the city and the state agency met their obligations in full, but pay-

ments did lag. These bonds and notes lost market value and investors were appropriately upset. None of these securities were insured.

In 1983, the \$2.25 billion default of the Washington Public Power Supply System (WPPSS — appropriately nicknamed "Whoops") had an even more dramatic impact on the market. The utility had issued bonds to finance the construction of nuclear plants. Most of the bonds were uninsured, but some carried financial guaranty insurance. When the bonds defaulted, holders of the insured bonds received their interest payments in full, on schedule. Investors holding uninsured WPPSS bonds experienced significant delays and reductions in their payments. This well-publicized default heightened investor concern about the risks of municipal bonds.

INSURING A BOND

Bonds are typically insured at the time they are issued. Most often, the issuer invites competing bids from several insurers. Competition among municipal bond insurers helps control the overall cost to governments of issuing insured bonds. The insurance premium is generally paid in full by the issuer at the time the bonds come to market.

In a relatively small number of cases, existing bonds are insured in the secondary market. This occurs when a broker or dealer holding a large quantity of bonds that were issued without insurance decides that it would be advantageous to have them insured.

Financial guaranty insurers thoroughly analyze a bond offering before deciding whether it is insurable. They evaluate the financial strength of the issuer, its total level of indebtedness, and the state of the local economy. They determine whether the revenues dedicated to servicing the debt are likely to prove adequate over time. Municipal bond insurers focus primarily on bonds that are, on their own merits, of investment-grade quality. If an issue does not meet its standards, an insurer will often suggest changes in the credit structure that would make the transaction insurable — a valuable service to state and local officials.

AFTER A BOND IS INSURED

Most municipal bonds are long-term obligations. Bond insurance policies are of equally long duration. After an insurer has promised to pay principal and interest throughout the life of a bond, it continues to monitor the issuer's financial health and its compliance with the bond's covenants. Surveillance of insured transactions gives the insurer early warning of any problems that could lead to default. In some cases, the insurer can then intervene to avert or minimize the damage.

In those rare instances when a default does occur, the insurer steps in to pay interest and principal to investors. These payments are made as originally scheduled under the terms of the bond and payment is not necessarily on an accelerated basis. During this period, the bondholders' rights are transferred to the insurer, which works with the issuer to remedy the default in order to contain its own losses. Since 1989, municipal bond insurers have experienced an annual loss rate of just .01%. Over time, the insurers were able to recover a substantial share of this total from the issuers.

Seven AFGI member companies serve as primary insurers of municipal bonds: AMBAC Indemnity Corporation, Capital Guaranty Insurance Company, Capital Markets Assurance Corporation, College Construction Loan Insurance Association, Financial Guaranty Insurance Company, Financial Security Assurance Inc. and Municipal Bond Investors Assurance Corporation.

Two additional AFGI companies — Capital Reinsurance Company and Enhance Reinsurance Company — provide reinsurance capacity to the primary insurers. Reinsurance allows the primary companies to cede some of the risk that they incur, of particular importance for very large bond issues. Reinsurance also helps primaries shape their books of business and provides a cost-effective source of capital.

These seven primary companies and two reinsurers — the members of the Association of Financial Guaranty Insurers (AFGI) — are all monoline companies active solely in writing financial guaranties. For this reason,

they are not vulnerable to the types of losses experienced by many multiline property/casualty insurers in recent years. Whereas a number of multiline companies have suffered downgrades in their claims-paying ability, no monoline company has been downgraded.

In terms of ownership, the members of AFGI occupy a broad spectrum. AMBAC is owned entirely by holders of its publicly traded stock. FGIC is 99% owned by GE Capital Corporation. The other companies have a mix of public and corporate ownership or are jointly owned by several financial institutions. Among AFGI members, Connie Lee alone is partly government owned.

A CONSERVATIVE APPROACH

A triple-A claims-paying ability rating is a financial guaranty insurance company's franchise. To safeguard their ratings and protect the interest of insured bond investors, these companies have adopted conservative business practices. To begin with, bond insurers focus on insuring types of securities that, historically, have had a very low risk of default. In addition, all issues they select for insurance are already of investment-grade quality. As a result, the loss ratio of the financial guaranty insurance industry is well below the insurance industry average.

The industry's accounting principles are also inherently conservative. Although premiums for municipal bond insurance are normally paid in full in advance, this money is not immediately booked as income. Instead, it is held in reserve and recognized as income over time, as the insured obligations it represents expire. Spreading income recognition over a long period of time promotes predictable returns and safety for investors.

In managing their investment portfolios, financial guaranty insurance companies also adhere to conservative standards. The securities in their investment portfolios are high in quality with more than 98% rated single-A or above.

Adequate capital reserves are critical to keeping an insurance company's claims-paying ability at the triple-A level. From the end of 1989 to the end of 1993, the latest available period, the qualified capital of the AFGI member companies grew 81% to \$5.2 billion. During this period, the industry's "risk to capital ratio" remained constant at 136:1. In other words, the capital the industry generated from its highly predictable earnings base kept pace with the insurance that it wrote.

CLOSE REGULATORY ATTENTION

Financial guaranty insurance companies must meet the requirements of insurance regulators in every state where they do business. They are also subject to intense scrutiny from the rating agencies which evaluate and assign a rating to every transaction they insure. To test the adequacy of the companies' capital resources, the rating agencies apply a computer-simu-

lated stress test which measures their ability to pay claims at a level comparable to those experienced during the Great Depression. No member of AFGI has ever been downgraded.

A RESOURCE FOR THE FUTURE

Through conservative business practices, the financial guaranty insurance industry has established a record of exceptional safety and stability. The dependable triple-A rated claims-paying strength of the bond insurers and reinsurers means that they will continue to be a valuable resource to America's states, cities and towns. As the nation's stock of schools, hospitals, highways, houses, water treatment plants, municipal utilities and colleges is renewed in the years ahead, bond insurers will help states and localities raise the necessary funds at a more affordable cost.

FINANCIAL GUARANTY INSURERS COMPARED TO PROPERTY/CASUALTY AND LIFE/HEALTH INSURERS

	Financial Guaranty	Property/Casualty	Life/Health
RISK PROFILES			
Risk Characteristics of Insured Portfolio	Municipal and structured asset-backed corporate credits which historically have a very low default rate. More than 95% of securities insured by the industry were rated investment grade before insurance was provided.	Actuarial, jurisdictional, unpredictable, and catastrophic risks. (May include automobile, home, and liability insurance, as well as coverage of natural disasters such as fire, floods, and earthquakes.)	Actuarial, predictable risks. (May include health insurance and financial products such as annuities.)
Loss Management	Paid over time (up to 30 years); high recovery of claims paid.	Immediate payout; no salvage or recovery claims paid.	Immediate payout; no salvage or recovery of claims paid.
Quality of Investment Portfolio	Very high quality. More than 98% of investments are rated single-A or higher.	Investment portfolio may include investment grade and junk bonds, equities, private placements, and commercial real estate.	Investment portfolio may include investment grade and junk bonds, equities, private placements, and commercial real estate.
High-Risk Exposure in Investment Portfolio	None.	Commercial real estate and some junk bonds.	Commercial real estate.
BUSINESS CHARACTERISTICS			
Volatility of Earnings	Stable and predictable earnings. Little volatility.	Cyclical.	Low.
Business Focus	Sharp focus on only one line of business; write to a zero-loss strategy.	Pricing to cover expected and catastrophic losses.	Pricing to cover expected losses and asset/liability management.
Capital Base	Dedicated exclusively to financial guaranty business.	Supports multiple lines of business.	Supports multiple lines of business.
Ratings/Trends	Triple-A. Stable. Each company is rated triple-A by at least one major rating agency. In the 24-year history of the industry, no insurer has ever been downgraded.	Below investment grade to triple-A. Down.	Double-B to double-A. Stable.

EXHIBIT II
AFGI 1994 Annual Report

AFGI

ASSOCIATION OF FINANCIAL GUARANTY INSURORS
ANNUAL REPORT 1994

ASSOCIATION OF FINANCIAL GUARANTY INSURORS

The Association of Financial Guaranty Insurers (AFGI) is comprised of nine triple-A rated U.S.-based companies that insure or reinsure the debt service of municipal bonds and asset-backed securities. Financial guaranty insurance, commonly called "bond insurance," provides that, in the event of a default by an issuer of an insured bond, principal and interest will be paid to the bondholder as originally scheduled. Generally, the contract does not provide for the acceleration of payment. In the event of a default, the full amount of debt service payments is made

on schedule by the insurer as if there had been no default.

Each of the nine bond insurance companies carries a triple-A claims-paying ability rating from one or more of the major credit rating agencies: Moody's Investors Service, Inc., Standard & Poor's Corporation, Fitch Investors Service, Inc. and Duff & Phelps Credit Rating Company. Insured bonds receive the triple-A rating of the insurance company instead of the underlying rating of the issuer of the bonds.

Triple-A rated bond insurance benefits issuers by lowering the cost of

financing and increasing market acceptance.

Lower costs for municipalities create savings which can be passed on to taxpayers. For investors, bond insurance offers the highest possible ratings as well as safety and liquidity.

In the 24-year history of the bond insurance industry, no monoline financial guaranty insurance company has been downgraded, no issue insured by an AFGI member company has been downgraded, and no investor in an insured bond has failed to receive an insured bond payment.

Member Companies

AMBAC Indemnity Corporation
Capital Guaranty Insurance Company
Capital Markets Assurance Corporation
Capital Reinsurance Company
Connie Lee Insurance Company
Enhance Reinsurance Company
Financial Guaranty Insurance Company
Financial Security Assurance Inc.
MBIA Insurance Corporation

Glossary of Insurance Terms

CAPITAL RATIO

Net insurance in force divided by qualified statutory capital.

COMBINED RATIO

The total of the expense ratio and the loss ratio.

CONTINGENCY RESERVES

A reserve used in statutory accounting (SAP) designed to protect policyholders against the effect of excessive losses occurring during adverse economic cycles.

DIRECT PAR AMOUNT

The principal amount of obligations insured directly by a primary insurance company.

DIRECT PREMIUMS WRITTEN

All premiums arising from policies issued directly by the primary insurance company to its policyholders.

EXPENSE RATIO

Underwriting and operating expenses divided by net premiums written.

LOSS RATIO

Losses and loss adjustment expenses incurred divided by net premiums earned.

NET INSURED PRINCIPAL AND INTEREST (P&I)

The sum of all obligations (net of reinsurance) covered under insurance and reinsurance policies in force. Insurance in force in the case of a financial guaranty insurance policy is the sum of all unpaid principal and interest, in respect of the obligations insured, assuming payment at maturity in accordance with the terms of such obligations, net of refunded bonds.

NET PAR AMOUNT OUTSTANDING

Direct par amount outstanding plus assumed reinsurance, less ceded reinsurance.

NET PREMIUMS EARNED

The portion of net premiums that is recognized as income during a given period.

POLICYHOLDERS' RESERVES

The aggregate of qualified statutory capital and unearned premiums and loss reserves.

QUALIFIED STATUTORY CAPITAL

The aggregate of policyholders' surplus and contingency reserves, calculated in accordance with statutory accounting practices.

REINSURANCE

A procedure whereby an insurer transfers ("cedes") to another insurer a portion of the risk insured and a portion of the related premiums.

STATUTORY ACCOUNTING PRACTICES (SAP)

Recording transactions and preparing financial statements in accordance with the rules and procedures prescribed or permitted by state regulatory authorities and generally reflect a liquidating rather than a going concern concept of accounting.

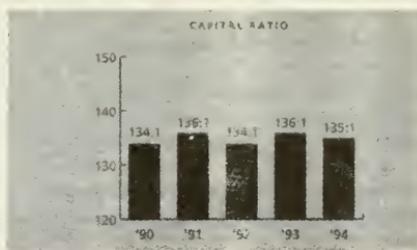
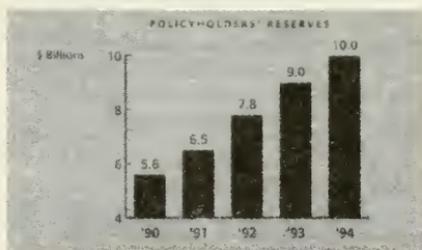
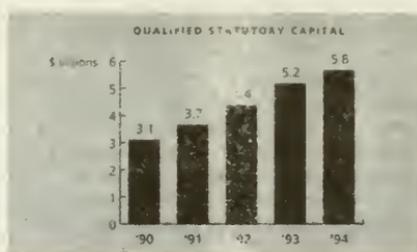
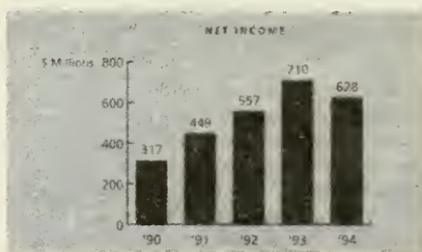
UNEARNED PREMIUM RESERVE

A reserve account that contains the portion of premiums attributable to the unexpired period of policies that has been collected by an insurer but has not yet been recognized as net earned premiums and accounted for as revenues.

Insurance Outstanding

(Amounts in \$ millions)	Net Par Outstanding 12/31/94
Municipal	
General obligation	\$121,759
Tax-backed revenue	45,017
Utility revenue	82,397
Health care revenue	51,168
Transportation revenue	25,771
University revenue	14,948
Housing revenue	12,556
Student loan	3,286
International	1,492
Other	12,840
Total Municipal	\$371,234
Non-Municipal	
Mortgage-backed securities	\$ 22,809
Asset-backed securities	23,927
Investor-owned utility obligations	5,437
Other	6,160
Total Non-Municipal/Structured Finance	58,333
TOTAL	\$429,567

Combined Financial Highlights



TO OUR READERS

During 1994, the financial guaranty insurance industry faced new opportunities and challenges. The unprecedented bankruptcy filing of Orange County, California at year-end focused attention on the value of bond insurance and provided a dramatic argument in favor of insured municipal bonds. Media coverage helped concerned investors and others gain a greater understanding of the benefits of bond insurance.

While bond insurance does not guaranty market risk, insured bonds consistently outperformed their uninsured counterparts during the height of the Orange County crisis. Insured bonds held their value better and maintained their marketability while uninsured bonds became highly illiquid. The hard-learned lessons of Orange County will long stand as a reminder of the comfort and safety that bond insurance provides.

MARKET CONDITIONS AND PERFORMANCE

Rising interest rates throughout 1994 saw municipal bond issuance decline to \$164 billion from \$292 billion in 1993. The overall decline was attributable to a 75% decrease in refundings from the prior year. However, in 1994 new money issuance increased nearly 20% to \$117 billion from \$97 billion in 1993. The level of insured penetration increased to 38% from 37% in the prior year, but the smaller market contributed to a 42% decrease in the dollar volume of insurance written.

A number of AFGI member companies provide financial guaranty insurance for corporate securities, including asset-backed and other structured finance transactions. The rapidly expanding asset-backed market is younger than the municipal market and represents a growing portion of the industry's total business. In 1994, the industry insured \$25 billion in structured and asset-backed securities, a 16% increase over 1993.

CONTINUED FINANCIAL STRENGTH

The financial results of AFGI members reflect some of the most conservative accounting practices in the insurance industry. Policyholders' reserves, which are invested primarily in marketable, high-quality fixed income securities, nearly equal the industry's assets. Premiums, generally collected upfront and in full, are held in reserve and recognized as income over time as the insured obligations they represent expire. The industry's annuity-like method of earning premiums promotes predictable returns and creates financial stability.

SAFETY OF BOND INSURANCE

Largely as a result of stringent underwriting standards and the inherently low risk profile of the credits we insure,

the financial guaranty insurance industry has a loss ratio substantially lower than the insurance industry average. In addition, capital resources have grown dramatically. Since the end of 1990, qualified capital has grown 86% to \$5.8 billion. During the same period, the industry's capital ratio was 135:1, relatively unchanged from previous years. This means that the industry's capital, created from its highly predictable earnings base, has kept pace with the amount of insurance it has written.

WORKING TO IMPROVE COMMUNICATIONS

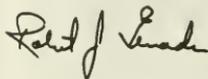
AFGI took steps during 1994 to improve communications with its many constituencies, including investors, legislators, issuers and investment bankers. During the Orange County situation, for example, AFGI acted swiftly to inform investors about the status of their insured debt. With full page ads in *The Wall Street Journal* and *The New York Times* just two business days after the bankruptcy filing announcement, AFGI member firms reiterated their unconditional guaranty of payment to holders of insured bonds.

Further, to speak with a single voice for the bond insurance industry when working with issuers, rating agencies, bankers, and legislators, AFGI created a committee during the height of the Orange County crisis. The group played such a valuable role that it has become a permanent part of AFGI and is now known as the Risk Management Committee.

1995 AND BEYOND

While 1995 municipal volume is likely to be lower than 1994, there are strong indications that new issuance will increase in the years ahead. Many municipalities have delayed financings and our nation's infrastructure needs eventually must be addressed. Additional growth in our business should also come from the increasing volume of asset-backed and structured transactions that we insure.

The value of bond insurance is more fully recognized now than ever before. As the bond insurance industry enters its twenty-fifth year, we welcome this renewed confidence in our business and look forward to a long and successful future serving the needs of issuers and investors.



Robert J. Genader
Chairman

May 26, 1995

Combined Financial Highlights⁽¹⁾

(Amounts in \$ millions)	Summary for the Years Ended December 31,				
	1994	1993	1992	1991	1990
Insurance Written & Outstanding					
Direct municipal par insured	\$ 78,917	\$ 114,437	\$ 83,941	\$ 58,125	\$ 37,798
Direct non-municipal par insured	24,718	21,390	11,783	10,568	10,628
Total direct par insured	<u>\$103,635</u>	<u>\$135,827</u>	<u>\$ 95,724</u>	<u>\$ 68,693</u>	<u>\$ 48,426</u>
Total outstanding net insured P&I	<u>\$785,126</u>	<u>\$704,569</u>	<u>\$586,579</u>	<u>\$500,204</u>	<u>\$419,320</u>
Financial Results					
Income Statement					
Direct premiums written	\$ 872	\$ 1,277	\$ 1,028	\$ 769	\$ 655
Net premiums earned	595	674	461	382	266
Net investment gain	564	631	563	479	403
Other income	6	7	6	5	5
Losses & loss expenses incurred, net of salvage received	67	5	64	43	44
Other underwriting expenses	310	304	255	242	227
Restructuring charges	0	85	0	0	0
Net income before taxes	788	918	711	581	403
Income taxes	160	207	154	132	86
Net income	<u>\$ 628</u>	<u>\$ 710</u>	<u>\$ 557</u>	<u>\$ 449</u>	<u>\$ 317</u>
Balance Sheet					
Cash and invested assets	10,065	9,179	7,618	6,405	5,495
Other assets	277	238	319	296	209
Total assets	<u>\$ 10,342</u>	<u>\$ 9,417</u>	<u>\$ 7,937</u>	<u>\$ 6,701</u>	<u>\$ 5,704</u>
Losses and loss expense reserves	128	71	129	80	50
Unearned premium reserve					
(deferred premium revenue)	4,038	3,778	3,219	2,704	2,382
Contingency reserves	1,720	1,439	1,127	881	698
Other liabilities	369	373	197	246	149
Surplus	4,087	3,756	3,265	2,790	2,425
Total liabilities and surplus	<u>\$ 10,342</u>	<u>\$ 9,417</u>	<u>\$ 7,937</u>	<u>\$ 6,701</u>	<u>\$ 5,704</u>
Qualified statutory capital	<u>\$ 5,807</u>	<u>\$ 5,195</u>	<u>\$ 4,392</u>	<u>\$ 3,671</u>	<u>\$ 3,123</u>
Key Statistics					
Capital ratio	135:1	136:1	134:1	136:1	134:1
Return on average surplus	16.0%	20.2%	18.4%	17.2%	13.4%
Loss ratio	11.3%	0.7%	13.8%	11.2%	16.6%
Expense ratio	36.3%	23.8%	24.8%	31.5%	34.6%
Combined ratio	47.6%	24.5%	38.6%	42.7%	51.2%

(1) This report was prepared by AFGI and refers to the financial guaranty industry as a whole. The combined results are based on information provided by the member companies and are unaudited. All disclosures are on a statutory accounting basis in accordance with rules and procedures prescribed or permitted by state regulatory authorities.

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Treasurer

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Financial Services Company

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Senior Vice President
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Senior Vice President
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EXHIBIT III

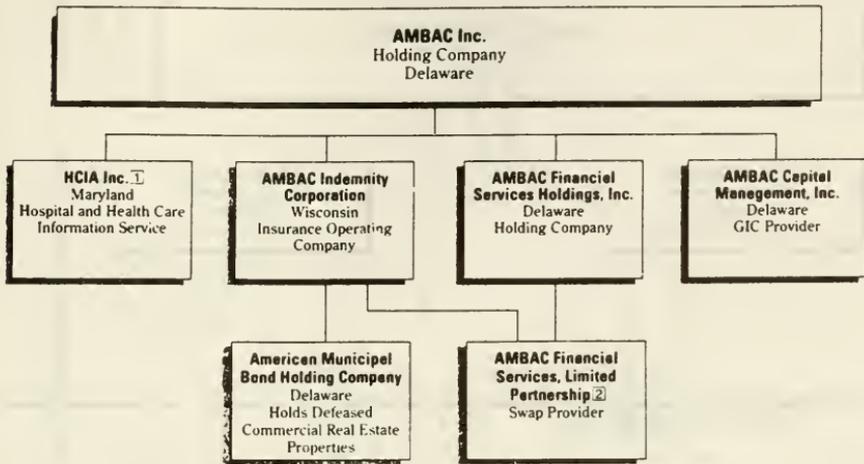
New Issues of Long-Term Municipal Bonds

	<u>Total Volume</u>	<u>Insured Volume</u>	<u>Insured Bonds as Percentage of Total Volume</u>
	<u>(\$ in billions)</u>		
1984	\$101.9	\$16.7	16.4%
1985	207.0	46.7	22.6
1986	151.2	23.6	15.6
1987	105.4	18.7	17.7
1988	117.8	30.5	25.9
1989	125.0	30.6	24.4
1990	128.1	33.5	26.1
1991	174.1	51.9	29.8
1992	235.0	80.9	34.4
1993	292.0	108.3	37.1
1994	163.0	62.2	38.2

Source: Statistics (other than those relating to 1993 and 1994) are based upon estimated data reported by The Bond Buyer, 1994 Yearbook. The 1993 and 1994 statistics are AMBAC Indemnity estimates, compiled from industry sources including Securities Data Company, Inc. and The Bond Buyer. Statistics in the Insured Volume column include only the insured portion of an issue. Amounts in the total Volume and Insured Volume columns represent gross par amounts issued or insured, respectively, during such year.

EXHIBIT IV

Ownership Structure of AFGI Member Companies

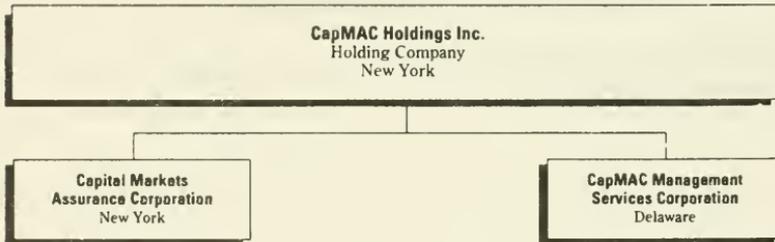
AMBAC—Ownership Structure


¹ AMBAC Inc. sold 27% of HCIA Inc. through an initial public offering on February 28, 1995.

² AMBAC Financial Services Holdings, Inc. is the sole general partner with a 10% partnership interest. AMBAC Indemnity Corporation is the sole limited partner and holds a 90% partnership interest.

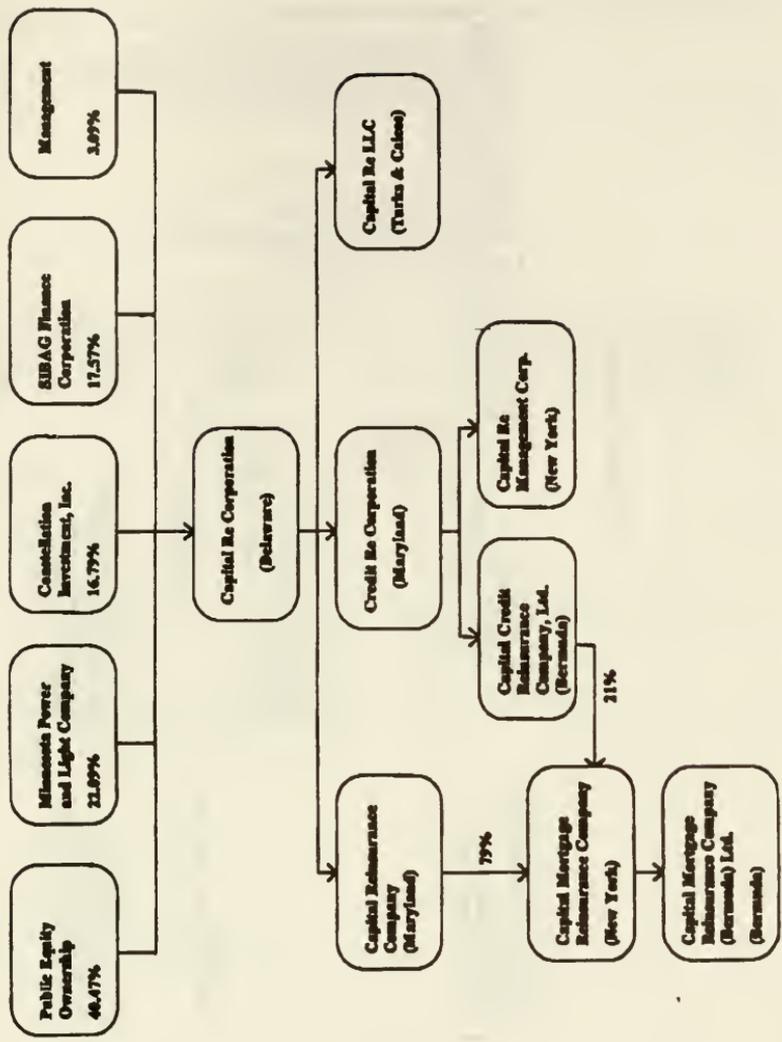
Moody's Investors Service, "Perspective on Bond Insurance; Bond Insurers 1994 Annual Report Industry Overview," 1995

Capital Guaranty—Ownership Structure

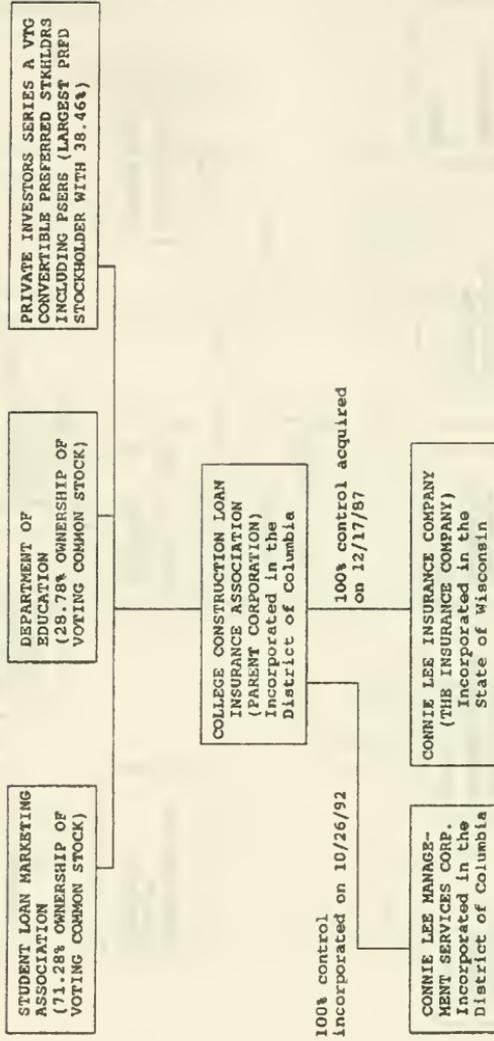
CapMAC—Ownership Structure

Moody's Investors Service, "Perspective on Bond Insurance; Bond Insurers 1994 Annual Report Industry Overview," 1995

CAPITAL RE CORPORATION CORPORATE ORGANIZATION CHART As of 5/30/95



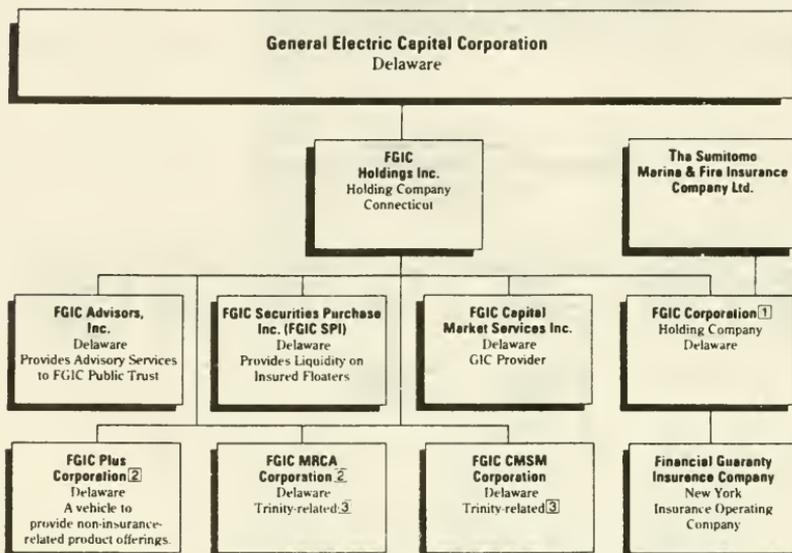
STOCKHOLDER DIAGRAM



ANNUAL STATEMENT FOR THE YEAR 1994 OF THE ENHANCE REINSURANCE COMPANY
**SCHEDULE Y - INFORMATION CONCERNING ACTIVITIES
 OF INSURER MEMBERS OF A HOLDING COMPANY GROUP**
PART I - ORGANIZATIONAL CHART



FGIC—Ownership Structure

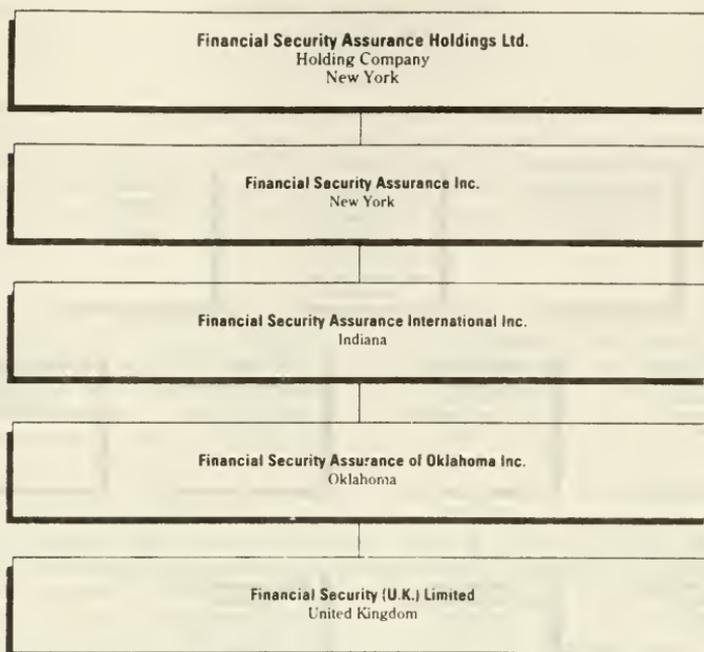


¹ Owned by FGIC Holdings Inc. (99%) and The Sumitomo Marine & Fire Insurance Company Ltd. (1%)

² Formed in 1995.

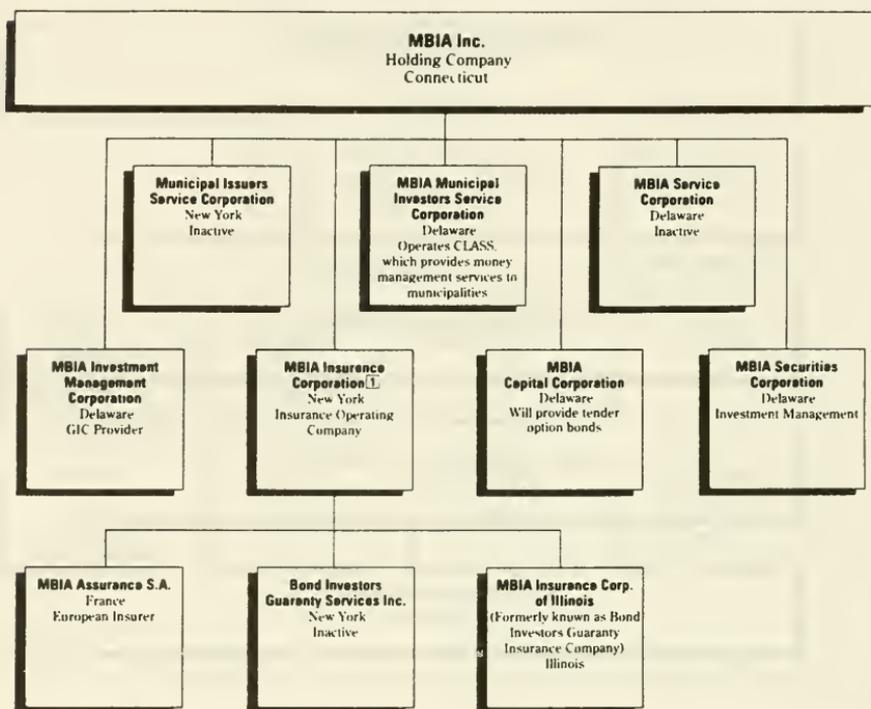
³ Trinity is a Aaa-rated entity. Its principal activities will be the issuance of up to \$2 billion of investment contracts.

Moody's Investors Service, "Perspective on Bond Insurance; Bond Insurers 1994 Annual Report Industry Overview," 1995

FSA—Ownership Structure

Moody's Investors Service, "Perspective on Bond Insurance; Bond Insurers 1994 Annual Report Industry Overview," 1995

MBIA—Ownership Structure



¹ Formerly Municipal Bond Investors Assurance Corporation.

Moody's Investors Service, "Perspective on Bond Insurance; Bond Insurers 1994 Annual Report Industry Overview," 1995

EXHIBIT V

MUNICIPAL BOND INDUSTRY:
A BRIEF OVERVIEW

As a class, Municipal Bonds^{1/} are considered a highly secure form of investment, second only to U.S. Treasury Bonds.^{2/} Issue by issue, however, Municipal Bonds represent a broad spectrum of risk. Although Municipal Bond defaults have been relatively rare since the Great Depression, they have occurred with some regularity at various levels and in all economic environments.^{3/} As a result, some investors have suffered serious losses and a far greater number have become aware of the potential for losses.

New York City's financial crisis of the 1970s was an important turning point for the Municipal Bond market. During this crisis, the city imposed a moratorium on payments to holders of its short-term notes. In the same time period, New York State's Urban Development Corporation defaulted on certain of its obligations. Ultimately, both the City and the state agency met their obligations in full (facilitated by the activist role played by the State of New York), although timely payments were not made in accordance with original debt service schedules. As a result, Bonds lost market value, and investors were appropriately upset. None of these securities were insured. In 1983, the \$2.25 billion default of the Washington Public Power Supply System ("WPPSS" — appropriately nicknamed "Whoops") had an even more dramatic impact on the Municipal Bond market. WPPSS had issued Bonds to finance the construction of nuclear power plants. Most of the Bonds were uninsured, but some carried financial guaranty insurance. When the Bonds went into default, holders of insured Bonds received their interest payments in full and on schedule. Investors holding uninsured WPPSS Bonds experienced significant delays and reductions in their payments. This well-publicized default heightened investor concern about the risks of Municipal Bonds, and demonstrated the benefit of Municipal Bond insurance.

Municipal Bonds are used to finance virtually every kind of public capital project, including roads and bridges, mass transit systems, sewage treatment plants, courthouses, schools and colleges, and electric generating plants. They also finance certain types of private projects that serve important public purposes such as low and moderate-income housing, private hospitals and colleges, and industrial facilities. From the Dallas-Fort Worth Airport Authority to New Hampshire's Merrimack Village School District, and from the Seacoast Utility Authority of Palm Beach County, Florida to the San Diego County Regional Transportation Commission in California, municipalities and agencies, both large and small, strive to upgrade their existing facilities, meet new environmental standards, respond to population growth, capitalize on opportunities for economic development, and address cash flow shortages. By issuing Municipal Bonds, Municipalities can finance

important projects without imposing undue financial burdens on their taxpayers or rate payers.

Local governments typically account for the largest share of issuance of Municipal Bonds (39.6%) in 1994, followed by state agencies (29.6%) and local authorities (17.0%). State governments (12.1%) and public colleges (1.7%) are also substantial issuers of Municipal Bonds.^{4/}

Despite the general view of Municipal Bonds as a secure investment, political forces may present risks to the municipal market investor that are not present in the corporate context. For example, the electorate may want to allocate scarce dollars to fund municipal services, rather than to pay off debt.^{2/} Thus, the interests of Bondholders may be subordinated to the interests of the issuer's citizens in maintaining essential municipal functions such as schools and police departments.^{6/} Similarly, voters may adopt tax limitation measures (such as California's Proposition 13 or Massachusetts' Proposition 2½) which could constrain an issuer's ability to meet its budgetary requirements in either the short or long-term.^{2/} Also, unlike the corporate context, Municipal Bondholders generally do not have a right to foreclose on municipal property in order to satisfy the debt.^{8/}

Endnotes

1. Terms used herein are defined in Mr. Genader's Testimony.
2. See Testimony of R. Fenn Putman, Managing Director of the Public Securities Associations ("PSA") before the Committee on Commerce of the U.S. House of Representatives, January 12, 1995, first paragraph of "Secondary Market Disclosure" section.
3. Robert W. Collin, "Creditors' Rights and Remedies," State & Local Government Debt Financing, (M. David Gelford, ed.), 1991. According to S.G. Feldstein, over 6,000 defaults of Municipal Bonds occurred between 1839 and 1969. "Municipal Bond Defaults and Remedies: An Historical Overview," Vol. 4, No. 1 Municipal Finance at 8, 9 (Winter, 1983).
4. AFGI Brochure, Exhibit 1 to Testimony, at 5.
5. Robert S. Amdursky & Clayton P. Gillette, Municipal Debt Finance Law: Theory and Practice § 5.1 (1992).
6. See, e.g., Defoe v. Town of Rutherfordton, 122 F. 2d 342 (4th Cir. 1941) (suggesting that if payment of a debt would prevent an issuer from performing essential government functions, a writ of mandamus to pay creditors will not issue).

7. Market perception is that both the Orange and Los Angeles County crises are the inevitable response, albeit delayed, to Proposition 13. Such an analysis is beyond the scope of this brief overview. But an understanding of the interrelationship between state and local constraints on revenue sources may be critical to this Subcommittee's work. In addition, courts have generally suggested that the right of Bondholders to receive payment is subordinate to the right of the issuing Municipality's constituents not to be taxed beyond a certain point. Amdursky & Gillette § 5.4.1.

8. See Section XIV of Mr. Genader's Testimony for a brief discussion on foreclosure actions. Note, however, that Bondholders may also find comfort in the Contracts Clause (Art. 1, § 10, Cl. 1) of the U.S. Constitution. Pursuant to this clause, a law passed by a legislature subsequent to the issuance of debt, solely for the purpose of repudiating such debt to Bondholders, is likely to be considered an invalid impairment of a contractual obligation. Thus, Bondholders expect that a specific revenue-producing law in effect at the time a Bond was issued will remain in effect. Failing that, at a minimum, Bondholders do have a reasonable expectation that sufficient funds from *some* source will be available to pay the debt.

STATEMENT OF MATTHEW P. FINK

PRESIDENT

INVESTMENT COMPANY INSTITUTE

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES AND GSEs
OF THE COMMITTEE ON BANKING AND FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

ON

MUNICIPAL BANKRUPTCY

JULY 27, 1995

TABLE OF CONTENTS

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I. INTRODUCTION

My name is Matthew P. Fink. I am President of the Investment Company Institute, the national association of the American mutual fund industry. The Institute's membership includes 5,632 open-end investment companies (mutual funds), 470 closed-end investment companies, and 11 sponsors of unit investment trusts. The Institute's mutual fund members have assets of nearly \$2.4 trillion, accounting for approximately 95 percent of total industry assets, and serve over 38 million individual shareholders.

I am pleased to be here today to discuss the Institute's views on municipal bankruptcy, and in particular, the recent bankruptcy filing by Orange County, California.

II. BACKGROUND

Municipal securities are of vital importance to American investors, to state and local governments that need access to capital in order to provide financing for public works and services, and to state and local taxpayers who stand behind municipal issuers. In recent years, mutual funds have been the largest purchasers of municipal securities.

There are two types of mutual funds that invest primarily in municipal securities – municipal bond funds and tax-exempt money market funds.¹ These funds have been an

¹ *Municipal bond funds* invest primarily in bonds issued by states and municipalities. In most cases, income earned on these securities is not taxed by the federal government, and may not be taxed by state and local governments. *Tax-exempt money market funds* seek the highest level of federally tax-free income consistent with the preservation of investment principal. These funds invest in short-term municipal securities issued by states and municipalities to finance state and local projects. See *Mutual Fund Fact Book*, Investment Company Institute 1995.

investment choice for millions of middle-class Americans as well as institutions.² Mutual funds provide millions of individual investors with the ability to invest in a broad array of municipal securities, and thus to obtain the significant tax advantages offered by these securities.

Investors own *shares* of the mutual fund, each of which is a security representing a proportionate ownership in all of its underlying securities. Dividends, interest and capital gains produced by these securities are paid out to investors in proportion to the number of shares owned. Thus, investors who invest a few hundred dollars get the same investment return per dollar as those who invest hundreds of thousands.

As of December 31, 1994, there were approximately 1,012 municipal bond funds with approximately 5.4 million individual investor accounts and approximately 1.1 million institutional accounts. These funds held approximately \$227 billion in municipal securities (both long-term and short-term obligations), representing approximately 18% of the total municipal securities outstanding.

As of the same date, there were approximately 319 tax-exempt money market mutual funds with approximately 1.8 million individual investor accounts and approximately 283,000 institutional accounts. These funds held approximately \$111 billion in short-term tax-exempt municipal securities, representing approximately 9% of the total municipal securities outstanding. It is our understanding that tax-exempt money market funds held an

² In addition to mutual funds, there are two other types of investment companies that invest in municipal securities: *unit investment trusts* and *closed-end investment companies*. Unit investment trusts own a fixed portfolio of securities until the maturity of the trust, at which time the trust is dissolved and the proceeds are distributed to unit holders. Closed-end funds, like mutual funds, are managed on an on-going basis, but their shares are not redeemable, and instead they are traded on one of the major stock exchanges or in the over-the-counter market. As of December 31, 1994, unit investment trusts held approximately \$57 billion in municipal securities and closed-end funds held approximately \$49 billion in such securities.

overwhelming majority of the outstanding short-term tax-exempt debt issued by Orange County prior to the bankruptcy filing.³

Through their active participation in the municipal securities market, mutual funds provide substantial financial support to a wide variety of state and local government projects, including schools, highways, hospitals, airports, bridges, water and sewer works, and other public projects. The following table provides an example of the broad types of investments in municipal securities made by municipal bond funds.

TABLE
Distribution of Investments of Municipal Bond Funds
By Purpose as of June 30, 1993⁴
(\$ million)

<u>Category</u>	<u>Total Investment</u>
Health Care	\$35,068
Environmental Facilities	32,797
Energy	29,515
Transportation	27,559
Housing & Urban Development	20,935
Education	18,251
Public Facilities	11,705
Industrial Development	9,274
Others	28,565
Total:	\$213,669

³ See, e.g., Wayne, *Orange County Gets a Reprieve On Paying Debt*, N.Y. Times (July 8, 1995); Stirland, *S&P Tracks Money Market Funds With New Set of Weekly Indexes*, The Bond Buyer (July 12, 1995).

⁴ Individual fund data may vary by reporting period. Source: Morningstar, Inc. (calculations by the Investment Company Institute).

III. OBSERVATIONS REGARDING THE ORANGE COUNTY BANKRUPTCY

Over seven months ago, on December 6, 1994, Orange County, California and the Orange County investment pool first sought protection under Chapter 9 of the federal Bankruptcy Code.⁵ Participants in the municipal securities market were taken by surprise because the filing involved one of the largest and wealthiest counties in the nation that had previously issued highly-rated debt.⁶

The Orange County bankruptcy and its impact on the municipal securities market are, of course, still unfolding. New developments occur on an almost daily basis. At this time, we can therefore offer only our preliminary views of the impact of this bankruptcy filing on the municipal securities market and the issues that it raises.

As Arthur Levitt, Chairman of the Securities and Exchange Commission, has so cogently pointed out in testimony and in speeches on the subject, municipal bonds represent a "contract" between the municipality and the public investor that is bound by trust and confidence. Public investors trust municipal bonds, in part, because they are generally based on an implicit agreement by the issuer that "investors will be repaid before anyone else."⁷

Orange County's bankruptcy has the potential of affecting investor confidence in the market. An erosion of confidence in the marketplace, even if subtle, may result in higher costs

⁵ The bankruptcy filing by the pool was subsequently dismissed.

⁶ Before the bankruptcy filing, Orange County's debt had received among the highest ratings by the national rating agencies. See Vogel, *Orange County Fund Had Green Ratings Light*, Wall St. J. (Dec. 6, 1994).

⁷ Levitt, *The (Municipal) Bonds of Trust*, Wall St. J. (Mar. 10, 1995). As Chairman Levitt also states, "Americans trust municipal bonds as they do few other instruments." *Id.*; see also Testimony of Arthur Levitt, Chairman, U.S. Securities and Exchange Commission Concerning Municipal Bond and Government Securities Markets Before the Committee on Banking, Housing and Urban Affairs, United States Senate (Jan. 5, 1995) ["Levitt Testimony"].

of borrowing for state and local governments.⁸ For example, in the wake of the bankruptcy filing some California issuers report that it has been necessary for them to obtain credit enhancements or pay a slightly higher yield when issuing securities.⁹ This would appear to indicate that there may be an increased cost of borrowing for some municipal issuers, particularly those in California. Moreover, if Orange County repudiates its obligations to certain of its bondholders this trust could be severely undermined.¹⁰

IV. MAINTAINING INVESTOR CONFIDENCE IN THE MUNICIPAL SECURITIES MARKET

The events in Orange County have put to the test the relationship between a municipality and the purchasers of its debt instruments. The final outcome of the bankruptcy may not occur for some time, and therefore at this point in time, it may be premature to offer specific suggestions for possible changes to federal laws or regulations.¹¹

⁸ In a recent speech before state and local finance officers, Chairman Levitt stated, "In the fraternity of municipal issuers, the actions of one affect the reputation of all. . . . The consequences of such a default would clearly be heavy for the issuer - and this would be even more true of non-general obligation debt, which carries only the moral obligation of the issuer to repay." *Levitt-Orange County Default Will Impact Nationwide*, Reuters (June 13, 1995).

⁹ *Grant's Municipal Bond Observer*, vol. 2 (June 30, 1995) ("On Tuesday, [June 27, 1995] it was estimated that [Orange County] paid a penalty of 150 basis points on the borrowing it did in order to repay its so-called Teeter bonds."); Pasztor, *Bankruptcy Aftermath is Modest - Orange County Woes Having Little Impact on Municipal Bonds*, Wall St. J. (July 11, 1995) (reporting that both San Bernardino County and Alameda County in California recently had to obtain a letters of credit in order as a condition of selling bonds); McEntee, *Orange County Losses Cast Shadow Over Darkened Southeast Market*, The Bond Buyer (July 6, 1995). However, some commentators have asserted that the Orange County bankruptcy has had no significant affect on the municipal securities market. See, e.g., Burns, *Orange County Didn't Sour Market*, Business Week 89 (July 17, 1995). In fact, it may have had some effect, as discussed herein. Moreover, as stated above, it is simply too early to assess fully its impact.

¹⁰ See, e.g., Vogelstein, *Voter Revolt Shakes Faith in Muni Sector*, Wall St. J. (June 29, 1995) (discussing the rejection by Orange County taxpayers of a county-wide ballot on June 27, 1995 to raise sales taxes in order to provide funds for repayment of bonds); Utley, *Note Default Sends Tremors Through Municipal Market*, The Bond Buyer (July 10, 1995).

¹¹ Of course, the bankruptcy may make a reexamination of Chapter 9 and other provisions of the Bankruptcy Code advisable, since there has not been a filing under Chapter 9 of the federal Bankruptcy Code of this magnitude or complexity. See Wayne, *Banging a Tin Cup with a Silver Spoon - Orange County's Tough Approach Tests Municipal Finance System*, N.Y. Times (June 4, 1995) ("Municipal bankruptcies and defaults are extremely rare. . . . There have been about 120 municipal bankruptcies since 1979, but most were special tax districts or tiny local governments."). In addition, the events may lead to further examination by the SEC of its disclosure regulations with respect to the (Continued....)

The Institute fully supports, however, Chairman Levitt's recent statement that state and local officials "entrusted with public funds would be remiss not to take this opportunity to examine how well their funds are managed; to ensure that they understand all the investments made with the money; to determine that they are appropriate and prudent and place safety and liquidity above risk and return; and to make absolutely certain that effective internal accounting systems are in place to sound the alarm if the slightest problem or discrepancy is found."¹² In this regard, we have two recommendations that states and municipalities should consider to enhance the protection of these investments and to help maintain investor confidence in the municipal securities market.

First, state and local governments should consider imposing substantive requirements on the operations and structure of local government investment funds and governmental pools. In doing so, they should look to the precedent of the Investment Company Act of 1940, which imposes detailed, substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. The Institute believes that, had the California investment pool been subject to the type of strict requirements set forth in the Investment Company Act, it is unlikely that the Orange County bankruptcy would have occurred.

The Investment Company Act requires, for example, that mutual funds sell and redeem their shares at their current net asset value, which must be determined daily. The daily market-to-market requirement imposes a discipline upon mutual funds to which other financial institutions, including state investment pools, are not subject. In addition, the Act, among

primary and secondary markets for municipal securities. The Institute applauds the recent efforts in improving disclosure in this area made to date by the SEC. See Exchange Act Release No. 34961 (Nov. 10, 1994), 59 FR 59590 (Rule 15c2-12 amendments); Exchange Act Release No. 34-33741 (Mar. 9, 1994), 59 FR 12748 (Interpretive Release on disclosure obligations of participants in the municipal securities markets).

¹² Levitt, *The (Municipal) Bonds of Trust*, Wall St. J. (Mar. 10, 1995).

other things, requires that mutual fund officers and employees with access to fund assets be bonded against larceny and embezzlement and specifies stringent restrictions on leverage.¹³

Many state officials and other commentators have urged that the principles of the Investment Company Act be applied to municipal investment pools. For example, a preliminary report issued by an advisory board to a special California Senate Committee on Local Government investments recently concluded that, "[c]onsideration should be given to enactment of legislation parallel to provisions contained in the Investment Company Act of 1940 and ERISA legislation."¹⁴ A committee of the Government Finance Officers Association reportedly has agreed that state legislators should require mark-to-market accounting for local government investment funds and municipal investment pools.¹⁵ The California Treasurer reportedly expressed strong support for requiring that local governmental pools mark their portfolio securities to market, reasoning, "By marking to market, I think those in the Orange County pool would have known much sooner . . . that they were in deep trouble."¹⁶

Second, we believe that it is ironic that, in response to the losses suffered by the Orange County investment pool – which was subject to none of the Investment Company Act's protections discussed above – several states have considered and enacted legislation to limit

¹³ See Sections 2(a)(41) and 22 (mark-to-market); Section 18 (leverage restrictions); 17(g) (fidelity bonding) of the Investment Company of 1940.

¹⁴ Preliminary Report from the Board of Advisors to the Senate Special Committee on Local Government Investments 6 (Feb. 16, 1996).

¹⁵ See *GFOA Committee Adopts Policy Statement on Mark-to-Market Accounting for Funds*, BNA Daily Report for Executives (Feb. 3, 1995).

¹⁶ *California Treasurer Urges Regular Pool Fund Reporting to Flag Portfolio Risk*, The Bond Buyer (Jan. 17, 1995) (comments of Matt Fong, Treasurer). The Texas legislature recently approved legislation that requires any local government investment pool functioning as a money market fund to mark its portfolio to market daily. See Texas House Bill 2459. Other commentators also agree that, similar to those requirements imposed on mutual funds, mark-to-market accounting and regular periodic reporting by unregulated local government investment funds could provide earlier recognition of portfolio risks. See, e.g., Testimony of Marc E. Lackritz, President, Securities Industry Association, Before the Senate Committee on Banking, Housing and Urban Affairs 3 (Jan. 6, 1995).

state and local investments in mutual funds that are regulated under the Investment Company Act.¹⁷ State and local governments should recognize, in light of the Orange County bankruptcy and other recent problems involving unregulated investment pools, that mutual funds, because they are fully regulated by the Investment Company Act, offer superior diversification, professional management and liquidity under a strict and comprehensive regulatory regime. In this regard, the Institute believes states should encourage, rather than discourage, their investment pools to invest in mutual funds.

* * *

We commend this Subcommittee for exploring the complex, yet important, issues surrounding municipal bankruptcy. We thank you for the opportunity to present our views and would be happy to answer any questions.

¹⁷ For example, bills that limit (or further limit) the type of mutual funds that state and local governments may invest in have recently been introduced in California and enacted in Colorado, Maine, and Maryland.

TESTIMONY OF

MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION

HEARING BEFORE THE
HOUSE SUBCOMMITTEE ON CAPITAL MARKETS,
SECURITIES AND GOVERNMENT SPONSORED ENTERPRISES
COMMITTEE ON BANKING AND FINANCIAL SERVICES

JULY 27, 1995

SECURITIES INDUSTRY ASSOCIATION

120 BROADWAY
NEW YORK, NY 10271

1401 EYE STREET, NW
WASHINGTON, DC 20005

**TESTIMONY OF
MARC E. LACKRITZ
PRESIDENT
SECURITIES INDUSTRY ASSOCIATION**

**HEARING BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS,
SECURITIES, AND GOVERNMENT SPONSORED ENTERPRISES
HOUSE BANKING & FINANCIAL SERVICES COMMITTEE**

JULY 27, 1995

Chairman Baker, Representative Kanjorski, Members of the Subcommittee:

I am Marc Lackritz, President of the Securities Industry Association ("SIA")¹ I appreciate the opportunity to participate in this hearing on issues concerning state and local debt issuance and investment practices. SIA member firms are active in all phases of corporate and public finance, serving individual and institutional investors, corporations, and government entities.

INTRODUCTION

With respect to the current status of state and municipal finance, we would like to stress the following three points:

- First, efforts to improve public disclosure concerning municipal securities (and municipal investment pools) should continue;
- Second, state responses to losses suffered by municipalities should be mindful of the need for flexibility in managing an investment portfolio to get the best return for taxpayers, and should reflect the reality of the institutional markets; and
- Third, state and municipal investment managers should be better trained and qualified to invest funds in a prudent and professional manner.

¹ The Securities Industry Association is the securities industry's trade association representing the business interests of more than 700 securities firms in North America, which collectively account for approximately 90% of the securities industry revenue in the United States.

NEED FOR ENHANCED DISCLOSURE

Municipal securities investors historically have received less disclosure than if they had invested in corporate securities, particularly with respect to developments in the secondary market. When the federal securities laws were enacted in the 1930s, Congress exempted municipal issuers from the reporting requirements because the municipal markets were relatively free of the abuses found in the equity markets at that time, and most investors were large institutions.² Over the years, however, the percentage of municipal securities held by individual investors has greatly increased.³ As a result of the shift to a more retail-oriented market, it is important that investors in municipal securities receive more comprehensive disclosure of the risks associated with these investments.⁴

In addition to individual investors, SIA believes the entities that invest in local government investment pools also need more meaningful disclosure to understand investment risks and to make informed investment decisions.⁵ For example, the periodic disclosure of information regarding the value and overall performance history of an investment pool would enable investors and taxpayers to evaluate the performance of the pool's management -- both in relation to other investment pools and in relation to the pool's own investment objectives and parameters. The use of mark-to-market accounting would

² In 1975, Congress amended the Securities Act to require municipal bond dealers to register with the SEC, and created the Municipal Securities Rulemaking Board ("MSRB") to oversee municipal broker/dealers. The Tower Amendment to the 1975 amendments (Section 15B(d)(2) of the Securities Act), however, specifically precludes the SEC or the MSRB from requiring issuers to file or distribute disclosure documents.

³ The most recent data show the "household sector" holding \$370.3 billion of municipal securities, with open and closed-end mutual funds holding \$256.2 billion, money market funds holding \$116.5 billion, and bank personal trusts holding \$114.4 billion. This amounts to 73.7% of the total amount of outstanding municipal securities. *Flow of Funds Accounts*, Federal Reserve Board, First Quarter 1995.

⁴ SIA is hopeful that the amendments to Rule 15c2-12, which generally became effective July 3, 1995, may prove helpful in ensuring better and more timely information to municipal investors. We have concerns about the effectiveness of the rule, however, because it places the burdens of disclosure on dealers, rather than issuers. See 17 CFR 240.15c2-12.

⁵ "Investment pools" are funds managed by a state or local government and consisting of funds from local governments and agencies. Generally, they allow small government investors to gain the expertise and economies of scale typically available only to larger entities. They are roughly analogous to mutual funds for local governments.

also be in an important step in improving disclosure, because it would bring to light unrealized losses in a portfolio much earlier.⁶

Development of a standard method of disclosing investment risk will undoubtedly take time, as better methods of measuring and reporting risk continue to evolve.⁷ We anticipate that over the next few years, policymakers and the industry will work toward consistent disclosure practices for the presentation of the risks -- such as market, credit, and liquidity -- that are material to investors. We do not believe, however, that additional federal legislative action is currently necessary to accomplish these objectives, but encourage all efforts to improve the transparency of municipal investment fund disclosure.

STATE INITIATIVES IN MUNICIPAL FINANCE

During the past year, SIA has been very active in presenting the securities industry's views on a number of investment guidelines bills introduced in state legislatures in the wake of the losses experienced in several jurisdictions. While the specifics of each bill varies, SIA generally endorses efforts by states:

- To require municipalities to establish clear, flexible written investment policies; and
- To require state and local investment officers to receive some minimum training in the principles of finance.

These steps would help ensure that investment managers understand the risks of the markets without unnecessarily restricting investment choices.

We are concerned, however, with provisions in state investment guideline bills that would:

⁶ SIA is pleased to note that the Government Finance Officers Association ("GFOA") has recommended that investment pools be marked to market monthly, with quarterly valuation of individual investments. *The Bond Buyer*, June 9, 1995. The Government Accounting Standards Board ("GASB") is also working on new standards to improve disclosure. *The Bond Buyer*, July 24, 1995, p. 29.

⁷ See the discussion of this point in the recent SEC concept release on improving descriptions of risk by mutual funds. Rel. No. 33-7153; 34-35546; IC-20974 (April 4, 1995) 60 FR 17172.

- Impose stringent investment restrictions on the use of "derivatives."⁸ As explained in more detail below, such provisions will limit the ability of state and local entities to manage their assets to maximum advantage.
- Legislate the relationship between municipalities and securities firms in a manner which does not reflect the realities of the institutional market. These provisions may have the effect of persuading many reputable securities firms to limit their business dealings with municipalities in jurisdictions enacting such bills, thereby denying taxpayers the benefits of the most sophisticated investment techniques.

Taken as a whole, these responses are likely to drive up costs for taxpayers while decreasing investment returns, and limit the ability of state and local entities to choose the financial firms with whom they wish to do business. The ultimate result of these policies could be higher state and local taxes, increased fees for licenses, permits, and other municipal services, or decreased services to make up for revenue shortfalls.

A. Investment Restrictions

One of the most fundamental building blocks of modern finance is "portfolio theory," whereby investors seek to maximize the return on their investment given the level of risk they are prepared to accept. A key component of the theory is "diversification," which is an economist's version of the old adage, "don't put all your eggs in one basket." According to portfolio theory, prudent investors will create a portfolio composed of a variety of financial instruments that, when taken as a whole, give them the best expected return for a given level of risk. When analyzing an investment portfolio, therefore, it is essential that the focus be on the portfolio *as a whole*, and not the individual components. Limiting the ability of an investment officer to choose certain classes of instruments could

⁸ These bills often define "derivative" very broadly so as to include a variety of instruments such as collateralized mortgage obligations ("CMOs"), interest only certificates ("IOs"), and principle only certificates ("POs"). CMOs are securities backed by real estate mortgages. The cash flows of those securities can be divided into various segments, such as IOs, where the owner receives only the interest or some part of the interest paid on the mortgages in the underlying pool, and POs, where the owner receives a share of principal payments on the mortgages. These instruments are viewed by the securities industry as a variety of cash instrument. By not defining the term "derivative" with care, restrictions on the use of such instruments could result in unintended restrictions on portfolio managers.

result in a portfolio that fails to maximize investment return or that is more susceptible to unexpected market developments, and is harmful to the interests of taxpayers and investors.⁹ Rather than ban investment in a particular type of financial instrument, the real question should be whether the instrument assists the investor in constructing a portfolio that maximizes return for a given level of risk.

SEC Chairman Arthur Levitt recently articulated this point by means of a telling metaphor:

[C]are must be taken not to be seduced by easy cures, such as narrowing lists of permitted investments to only the safest. You may as well avoid the dangers of wiring a house by outlawing electricity. One of the best ways to hedge against risk is to diversify, which is to *increase* choices. Rather than eliminate investment tools, steps should be taken to assure they are well understood, and wisely employed.¹⁰

Municipalities should not be prohibited from using "derivatives" or any other investment product. The use of *financial strategies* whose risks were not fully understood by the financial manager and/or by affected investors were at the root of the losses in Orange County and other jurisdictions. Such a faulty investment strategy would have caused losses regardless of whether it was implemented solely in cash instruments or with derivatives. For the most part, municipalities have used derivatives to manage interest rate risks in ways that have saved taxpayers significant amounts of money, and limiting their access to such strategies will only impede the ability of municipalities to manage financial risk.

B. Reflecting the Reality of the Institutional Market

Some of the state investment guideline bills we have been monitoring and lobbying attempt to legislate a new relationship between municipalities and securities firms that does

⁹ While some "derivative" instruments have greater volatility than a "typical" fixed income security, many such products respond to changes in interest rates in a manner opposite to that of ordinary debt instruments. Thus, used as a hedging mechanism, such instruments can often reduce risk for a fixed income portfolio taken as a whole.

¹⁰ "*Public Funds and Public Trust at the Dawn of the Twenty-First Century*" remarks by Arthur Levitt, Chairman U.S. Securities and Exchange Commission, Government Finance Officers Association, Baltimore, Maryland, June 13, 1995 (emphasis in original).

not reflect market realities. For instance, some bills create a presumption that any securities firm executing a transaction with a municipality is implicitly representing that the transaction is appropriate for that municipality and in accord with its investment guidelines.¹¹ Compliance with such a provision would be very difficult, if not impossible, because most state or municipal entities manage their own investments and use a number of securities firms to execute portfolio transactions. Municipal investors typically will not disclose to a broker-dealer any information regarding its portfolio that is not directly related to a particular transaction. Portfolio theory would indicate that a given transaction cannot be judged appropriate for an investor without access to the full range of information concerning that investor's portfolio. As a result, unless a securities firm had access to all relevant information about a municipality's portfolio (i.e., was acting as investment adviser), it would never truly be in a position to verify that a particular transaction is appropriate in all respects.

SIA fears these provisions will cause some of the most responsible and careful securities firms -- realizing that they are not in a position to make the required representations -- to refrain from conducting business with entities covered by such provisions, which can only hurt state and local taxpayers and/or bondholders who ultimately pay for investment mistakes. They would also effectively prohibit a municipality from purchasing "execution-only" services from a securities firm, by requiring the broker to shoulder the additional risk of an "appropriateness" determination just to sell a particular instrument from a municipal portfolio. As a result, firms may increase transaction charges to those entities to cover the costs of potential litigation, again hurting taxpayers and investors.

In addition, requiring dealers to make "appropriateness" determinations runs contrary to a fundamental premise of financial markets that counterparties are ultimately responsible for their investment decisions. Legislatively altering the relationship between municipalities and securities firms will almost certainly lead to more litigation to shift financial responsibility for unsuccessful investment strategies to broker-dealers. This would destabilize the markets and give rise to the kinds of systemic risk that Congress and

¹¹ The problem is exacerbated by the fact that municipal investment guidelines are often inconsistent or very vague. It is essential not only that municipalities establish guidelines but that they provide meaningful guidance to investment managers and advisers. As noted above, SIA supports state efforts to establish clear, flexible, written investment guidelines.

regulators have sought to avert. In our view, Federal Reserve Board Chairman Alan Greenspan put it well when he testified last year that:

. . . derivatives increase economic efficiency by allowing the transfer of risk to those most willing to bear it. For the transfer of risk to be effective and the efficiency to be realized, end-users must retain ultimate responsibility for the transactions they choose to make.¹²

SIA notes that there are a number of initiatives underway designed to articulate guidelines for market participants operating in the institutional markets.¹³ We hope these efforts will ultimately strike the appropriate balance between the respective duties of dealers and their customers.

BETTER FINANCIAL MANAGEMENT

SIA believes all participants in the financial markets should be responsible for evaluating and ensuring that they understand how an instrument or strategy will affect their overall financial position. Regulatory and legislative actions that create disincentives for participants to meet this responsibility will interfere with this objective and prove counterproductive.

Investment officers who commit a municipality to a financial obligation that they do not understand merit neither sympathy nor a remedy when losses result. Municipalities can retain professional financial advisors to assist investment officers in evaluating transactions and strategies they do not fully understand. On the other hand, dealers who have not been engaged as financial advisors and who do not have access to the type of information

¹² Testimony by Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, at p. 16 (May 25, 1994).

¹³ Last year, a group of representatives from investment and commercial banks began meeting under the auspices of the New York Federal Reserve Bank to draft a set of "Principles and Practices" for the OTC institutional or "wholesale" financial markets. Several representatives of SIA member firms have been involved in the project from the outset. The hope is that SIA and the other trade associations will ultimately endorse the final product and recommend that their members consider adopting the "Principles." In addition, the National Association of Securities Dealers ("NASD") is working on an amendment to its suitability interpretation to provide further guidance to NASD members on their suitability obligations under the NASD's Rules of Fair Practice when making recommendations in equity or debt securities to institutional clients.

necessary to evaluate the appropriateness of a transaction should not be held responsible for such a determination.

Municipal investors and taxpayers who, directly or indirectly, entrust their financial assets to the management of others should ensure that the persons discharging that management function are well qualified and are subject to sensible and prudent investment parameters. Investors and taxpayers are entitled to meaningful and understandable disclosure regarding applicable investment strategies and parameters, portfolio assets and liabilities, and past performance.

CONCLUSION

Mr. Chairman, the issues identified by the Committee in connection with this hearing are important. Although improvements can be made in state and local government investment practices, we would caution against legislative or regulatory actions that could lead to higher costs, increased risks, and harm to taxpayers.

The quality of municipal disclosure should be improved to shed more light on relevant investment risks. More transparent disclosure is essential for taxpayers and investors to understand the risks to which their funds are exposed. Municipal fund investments should be subject to clear written investment guidelines that are flexible, yet incorporate appropriate risk parameters.

In addition, rather than outlaw the use of certain categories of financial instruments, states should ensure that the individuals who invest public funds have the flexibility necessary to prudently manage their portfolios. Investment officers should be selected based on their judgment and ability to manage the various risks present in the marketplace, but must ultimately be held accountable for their actions.

SIA does not believe that federal legislation is necessary at this time to accomplish these objectives. We appreciate the interest that this Committee has shown in these issues, and thank you for hearing our testimony on these matters.

MUNICIPAL LOSSES RELATED TO DERIVATIVES

(Through December 1994)

DATE ORGANIZATION

1992	Public Service Co. of New Hampshire Pension Plan	This pension plan lost \$25 million on derivatives investments and placed the blame on a plan official. An affiliate of Prudential Insurance Co. and State Street Bank.
1994	Auburn, Maine	Lost \$6 million out of \$16 million invested in mortgage-backed derivatives. Firms which sold the derivatives are Liberty Capital, Irvine Calif. MGSJ, Houston Texas. Interstate Johnson, Charlotte, NC and Paine Webber, Houston Texas.
SPRING 1994	Escambia County, Fla	\$6.25 million derivatives portfolio plunges 70% in value, leading to a \$4,375,000 loss.
JUNE 1994	Virginia Retirement System	Revealed that a recently dismantled derivatives program had cost their fund about \$66 million.
JUNE 1994	Florida Treasurer's Office	Announced that investments plunged by about \$175 million due in part to mortgage derivatives.
JULY 1994	Mound, Minnesota	City government's portfolio lost \$500,000 due to investments in derivatives made for the city by Piper Jaffray Co.
JULY 1994	Moorhead, Minnesota	Their portfolio started with \$6,250,000 and is now worth \$5,284,000 for a loss of \$966,000. The derivative investments were made for the municipality by Piper Jaffray Co.
JULY 1994	Maple Grove, Minnesota	Portfolio fell from \$5 to \$3.8 million due to derivatives investments by Piper Jaffray Co.
JULY 1994	Andover, Minnesota	Portfolio fell from \$2 to \$1.6 million due to derivatives investments by Piper Jaffray Co.
AUGUST 12, 1994	Charles County, Maryland	Reports of a \$1.3 million loss in county funds due to derivatives investments, later estimated at \$8.3 million. The brokers involved were Liberty Capital, Ca. and NY; Smith Barney, NY; Signet Bank, Va.; Trading Desk, Inc., UK; and Murchinson, Houston, Texas.

Source: Beau Dietl & Associates

SEPTEMBER 1, 1994	Wyoming Retirement System	Board reports paper losses of \$15 million from their derivative portfolio with Piper Jaffray Co.
SEPTEMBER 2, 1994	City of Jackson, Ohio	Lost 82½ of \$416,852 invested in a type of mortgage derivative, leading to a loss of \$343,458 through Hart Brokerage, Houston, Texas.
SEPTEMBER 9, 1994	State of Florida	State lost \$90 million through derivatives investments made through Piper Jaffray Co.
DECEMBER 1994	TexPool	This Texas state investment fund invests for 1300 school districts, utility districts, counties and cities. It lost an estimated \$70 million when interest rate soared. A fund representative stated the instruments were sold to the Texas State Treasury and therefore no losses were realized to date by the fund. The fund dealt directly with the Federal Reserve Account.
DECEMBER 1994	Cuyahoga County, Ohio	This municipality reported a loss of \$137 million. Local prosecutors are investigating
DECEMBER 1994	Orange County, California	Announced that its \$20 billion leveraged portfolio had lost \$2.02 billion in value. The portfolio held \$8.6 billion in Fannie Mae debt and \$1.7 billion in other federal agency debt. The County filed for Chapter 9 Bankruptcy Code protection on December 6, 1994. The investment banks included were Merrill Lynch & Co., Smith Barney, CS First Boston, Morgan Stanley and Nomura. The money was entrusted by the County and 180 other agencies.
UNDATED	Sandusky County, Ohio	Mortgage derivatives investments in the early 1990's cost the county over \$5 million according to Virgil Swartzlander, the county treasurer. The county's broker, Government Securities Corporation, Houston, Texas has agreed to reimburse the county \$5.5 million.
UNDATED	Portage County, Ohio	Mortgage derivatives investments in the early 1990's cost the county about \$5 million according to Maurice Kline, the county treasurer, the county treasurer. The county is suing its broker, GSC, Government Securities Corporation

UNDATED	Fresno County Employees Retirement Association	Invested \$850 million with Mellon Trust. Losses were incurred but Mellon Trust subsequently shored up the accounts.
UNDATED	Massachusetts Bay Transportation Authority Retirement Fund	Invested \$1 billion with Mellon Trust. Losses were incurred but Mellon Trust subsequently shored up the accounts.
UNDATED	Washington State Investment Fund	Invested \$26 billion with Mellon Trust. Losses were incurred but Mellon Trust subsequently shored up the accounts.
UNDATED	Connecticut Trust Fund, Hartford	Invested \$11 billion with Mellon Trust. Losses were incurred but Mellon Trust subsequently shored up the accounts.
UNDATED	City of River Rouge Employee Retirement Fund	This city retirement fund lost over \$1.1 million.
1986&1987	West Virginia	The state had a \$279 million loss on treasuries, reverse repos, and options. The fund recovered about \$28 million in settlements from Salomon Brothers, Goldman Sachs, Natwest Government Securities Inc., Greenwich Capital Markets and several other firms. Morgan Stanley is still fighting a \$48 million court order stemming from the loss. The Public Securities Association has filed a brief with the state appeals court charging that the decision improperly shifts the responsibility for losses to dealers and makes them "insurers" of profit for clients.
DECEMBER 1994	Cuyahoga County, Ohio	This municipality reported a loss of \$137 million. Local prosecutors are investigating 8 securities firms and 2 banks.
DECEMBER 1994	Placer County, California	This county's 4370 million portfolio had 42% invested in derivatives that have now lost half of their value, for a loss of \$77.7 million.
DECEMBER 1994	San Bernardino, California	This county's \$2.5 billion fund had \$750 million in reverse repurchase agreements that subsequently had major losses.

UNDATED	Vermillion, Ohio	A 1992 investment of \$200,000 in mortgage derivatives from Hart Securities of Houston plummeted in value to \$16,000 according to Rosalie Townsend, the town's treasurer.
UNDATED	Louisiana State Pension Fund	Suffered estimated losses of \$50 million, much of it through derivatives, through the brokerage firm of MMAR, Houston, Texas now out of business.
UNDATED	San Diego County	The county has suffered \$357 million in paper losses so far. Lost 10.7% of its \$3.3 billion fund. The county's brokers included Kidder Peabody, Swiss Bank, Smith Barney, Bank of America, Morgan Stanley, Prudential Securities, Bear Stearns, and Merrill Lynch.
UNDATED	City of San Diego	Lost \$12 million.
UNDATED	Town of Chardon, Ohio	The town lost \$250,000 on derivatives investments through Hart Brokerage, Houston, Texas.
UNDATED	Danbury Schools, Ohio	Lost \$215,000 with Hart Brokerage, Houston, Texas.
UNDATED	Bryan, Texas	Lost \$1.5 million with Government Securities Corp.
UNDATED	Strongsville Schools, Ohio	Lost \$640,000 with Hart Brokerage, Houston, Texas.
UNDATED	Painesville, Ohio	Lost \$5 million with Hart Brokerage, Houston, Texas
UNDATED	Putnam Country, Ohio	Lost \$400,000 with Government Securities Corp., Houston, Texas.
UNDATED	Wyoming State Auditor	Lost \$15 million
UNDATED	Massachusetts State Teacher's Employee Retirement Fund	When the fund manager discovered the fund was losing money, they withdrew their account. The Mellon Trust invested its own funds to shore up the account.
UNDATED	State of Wisconsin Investment Board, Madison	Invested \$22 billion with Mellon trust.

DECEMBER 1994	Monterey, California	This county's \$338 million portfolio has had paper losses of over \$16 million.
DECEMBER 1994	Solano, California	This county's \$427 million fund has had paper losses of over 5% due to significant use of derivatives.
DECEMBER 1994	Sonoma, California	This county's \$735 million fund has over \$322 million in derivatives investments which have lost over 6% of their value.
DECEMBER 1994	Pensacola, Florida	This county has lost \$22.2 million on its \$45 million derivatives investments, which translates to nearly 22% of its total \$103 million portfolio.
UNDATED	City of River Rouge Employee Retirement Fund	This city retirement fund lost over \$1.1 million.
UNDATED	Walworth County, Wisconsin	This county lost on derivatives called CMO's.
UNDATED	Madera County, California	This county has had undisclosed losses on derivatives investments.
DECEMBER 1994	Texas State Treasury	Reported losses of \$1,334,633 after investing 4.9% of ota portfolio in derivatives.



State of Connecticut
OFFICE OF THE TREASURER

CHRISTOPHER B. BURNHAM
TREASURER

55 ELM STREET
HARTFORD, CT 06106-1773

August 3, 1995

The Honorable Richard Baker, Chairman
Subcommittee on Capital Markets, Securities, and
Government Sponsored Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives
2129 Rayburn HOB
Washington, D.C. 20515

Dear Chairman Baker:

I would like to submit this letter for inclusion in the records of your hearings on state and local government investment policies. My interest in this subject comes from my duty as the sole trustee of a \$2 billion short-term investment fund for state funds and 150 local government entities.

Your efforts in this area are quite timely given the recent instances of governments imprudently and over-aggressively pursuing investment income at the expense of safety and, ultimately, taxpayer funds. Making some of the recent losses even more difficult is the fact that they have occurred in pools run by a state or county government for the benefit of constituent government units. Those of us who manage investments for the benefit of other jurisdictions have doubly-high responsibilities - to our own taxpayers and to the taxpayers of jurisdictions that have entrusted us with their funds. It is vital that our standards are high and our practices are sound.

We must start with strong, clear and effective investment policies. Our short-term policies must call for achieving strong returns only after consideration of principal and liquidity. Safety of principal must always be our first goal, followed by the provision of liquidity to fully meet the daily cash needs of all of our customers. While many state and local governments are facing tighter and tighter fiscal conditions, resulting in greater pressure to raise revenue through more aggressive investment programs, we must resist such temptations.

55 Elm Street Hartford, Connecticut 06106-1773
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The Honorable Richard Baker
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As recent difficulties in some pools illustrate, effective guidelines must address our goals, safekeeping and management controls, and reporting and disclosure practices. They must also, at a minimum, address the quality and volatility of securities, the maturities of securities, and the use of borrowing to leverage portfolios.

In my view a pool of operating cash is no place to make speculative investments, to make anything but short-term investments, or to chase additional returns through leveraging.

Connecticut's enclosed short-term investment policy, for example, generally allows the investment in only first-tier securities, requires a weighted average maturity of under one-year (we generally are under 90 days, and currently are at 30 days), and limits borrowing through reverse repurchase agreements to just five percent of the portfolio and only to provide temporary liquidity. We have adopted the "prudent expert" standard, a notch above the "prudent person" standard of care, and we run our pool with a reserve to cover market losses or security defaults (which we have never had to tap in the fund's 23-year history). Finally, we "mark-to market" our security values monthly.

In terms of derivatives, we prohibit investment in speculative securities, such as strips, inverse floaters, CMT floaters, leveraged floaters, dual index floaters, COFI floaters, and range floaters, which can experience high price volatility with changing market conditions, and whose market values may not return to par even at the time of an interest rate adjustment.

On the other hand, adjustable rate securities whose interest rates are positively (rather than inversely) tied to standard money market interest rate benchmarks, are allowed, given other maturity and credit quality standards. The values of these securities tend to return to par upon the scheduled adjustment of interest rates. Indeed, such securities with frequent interest rate resets experience less price volatility than many fixed-rate securities.

Of course, policies are only as good as the level of compliance with them. To that end, our investment program is overseen by an independent advisory council, our transactions are monitored by a performance analysis unit within a separate Treasury division, and compliance will be monitored annually by both state auditors and a public accounting firm. We also are significantly stepping up our level of reporting and disclosure to our investors.

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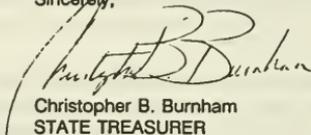
While all jurisdictions differ in their cash flow patterns, available funds, and their tolerance for risk, and while treasurers and other finance officials can reasonably differ on some of the subjects discussed above, I believe these practices are prudent and appropriate and serve as a good model for others.

I commend the work of the Government Finance Officers Association in developing its sample investment policy, and its recommended practices regarding, among other issues, leveraging, derivatives, securities lending, and portfolio "mark-to-market" activities.

I also commend the National Association of State Treasurers in expanding its guidelines for local government investment pools. The latter guidelines are particularly important, because I think it is paramount that we at the state level police ourselves and responsibly carry out our duties. I do not believe that federal regulation is appropriate given the Tenth Amendment to the Constitution.

I appreciate the opportunity to share my thoughts with the subcommittee on this important issue.

Sincerely,



Christopher B. Burnham
STATE TREASURER

CBB\LAW:ss

Enclosure

**Investment Policy
Connecticut State Treasurer's
Short-Term Investment Fund**

A. Background

The Treasurer's Short-Term Investment Fund (STIF) is an investment pool of high-quality, short-term money market instruments for state and local governments. Operating since 1972 in a manner similar to a money market mutual fund, STIF has provided a very safe, liquid and effective investment vehicle for the operating cash of the State Treasury, state agencies and authorities, municipalities, and other political subdivisions of the state.

All State, local and political subdivisions of the state are authorized to invest in STIF by CGS 3-27a and 3-27b.

B. Purpose

The purpose of this document is to specify the policies and guidelines that provide for the systematic management of STIF and the prudent and productive investment of funds.

**C. Investment
Objectives**

STIF seeks as high a level of current income as is consistent with, first, the safety of principal invested by the State, municipalities and others, and, second, the provision of liquidity to meet participants' daily cash flow requirements.

**D. Safety of
Principal**

Safety of principal, STIF's primary objective, shall be pursued in a number of ways.

1. Investments shall be undertaken in a manner that seeks to ensure the preservation of capital in the overall portfolio by

protecting against credit risks (from security defaults) and the erosion of market prices (from rising interest rates)

2. The Fund's investments shall be made in conformance with prudent guidelines for allowable instruments, credit quality and maturities. See Section H.
3. STIF shall maintain adequate diversification of instruments, issuers, industries and maturities to protect against significant losses from credit risks and market changes. See Section H.
4. All securities shall be held by a third-party custodian.
5. All transactions shall be handled on the basis of delivery vs. payment to the custodian bank.
6. STIF shall maintain a reserve for losses -- which has never been needed in STIF's 22-year history -- should an unforeseen problem develop. Annual allocations to the reserve are paid from investment returns and equal one-tenth of one percent of the fund's total investments until the reserve equals one percent of investments.
7. All repurchase agreements shall be fully collateralized, with the custodian bank receiving delivery of the collateral.
8. Reverse repurchase agreements may be used only to meet temporary liquidity requirements of the fund and may not exceed five percent of total fund assets. See Section H.

While STIF is managed diligently to protect against losses from credit and market changes, and though deposits are backed by high-quality and highly-liquid short-term securities, the Fund is not insured or guaranteed by any government and the maintenance of capital cannot be fully assured.

However, STIF -- which consists predominantly of funds for which the Treasurer is sole trustee -- is managed in a prudent manner consistent with the preservation of principal, the provision of liquidity, and the earning of competitive yields, as demonstrated by the Fund's 22-year history of safety and success.

E. Liquidity

The portfolio shall be structured through sufficient investments in overnight and highly-marketable securities to allow complete liquidity for participants. In addition, reverse repurchase agreements totalling up to five percent of fund assets may be used to meet temporary liquidity requirements.

Participants have full and quick access to all of their funds. Participants may make same-day (up to 10:00 a.m.) deposits and withdrawals of any size. Withdrawals are sent via Fed wire, thus funds are available for use on the day of withdrawal. No transaction fees are charged on deposits or withdrawals.

F. Yield

STIF's investment portfolio shall be designed to attain a market-average rate of return throughout budgetary and economic cycles, taking into account investment risk constraints and the liquidity requirements of the fund.

The portfolio shall be managed with the objective of exceeding the average of three-month U.S. Treasury Bill rates for the equivalent period. This index is considered a benchmark for near-riskless investment transactions and, therefore, comprises a minimum standard for the portfolio's rate of return. The investment program shall seek to augment returns above this threshold, consistent with stated risk limitations and prudent investment principles.

While STIF shall not make investments for the purpose of trading or speculating as the dominant criterion, STIF shall seek to enhance total portfolio return through active portfolio management. The prohibition on speculative investments precludes pursuit of gain or profit through unusual risk. Trading in response to changes in market value or market direction, however, is warranted under active portfolio management.

G. Prudence

Investments shall be made with the care, skill, prudence, and diligence -- under circumstances then prevailing -- that prudent persons acting in like capacities and familiar with such matters

would use in the conduct of an enterprise of a like character and with like aims, not for speculation, but for investment, considering the probable safety of their capital as well as the probable income to be derived.

The standard of prudence to be used by STIF's investment officials shall be the "prudent expert" standard and shall be applied in the context of managing an overall portfolio. Investment officers acting in accordance with written procedures and the investment policy and exercising due diligence shall be relieved of personal responsibility for an individual security's credit risk or market price changes, provided deviations from expectations are reported in a timely fashion in writing and appropriate action is taken to control adverse developments.

H. Investment Guidelines

All investments must be made in instruments authorized by CGS 3-27c - 3-27e. In addition, the Treasurer has adopted the following investment guidelines:

1. STIF may invest in the following securities:
 - a. U.S. Government & Federal Agency securities.
 - b. Certificates of deposit of the 50 largest commercial banks in the United States in order of deposits and whose long-term debt is rated at least C by Thomson Bank Watch and whose short-term debt is rated TBW-1.
 - c. Certificates of deposit of U.S. branches of foreign banks with long-term debt ratings of at least B/C by Thomson Bank Watch and with short-term debt ratings of TBW-1.
 - d. Certificates of deposit of commercial banks and thrift institutions in the State of Connecticut whose long-term debt is rated at least C by Thomson Bank Watch and whose short-term debt is rated TBW-1 or whose total risk-based capital ratios exceed 10 percent.

- e. Bankers' acceptances of those banks meeting the criteria in b., c. and d. above.
- f. Fully-collateralized repurchase agreements with primary dealers of the Federal Reserve or qualified commercial banks, with possession of collateral by the State's custodian bank.
- g. Commercial paper of companies that meet at least one of the following criteria:
 - i. Short-term debt rated either:
Moody's P-1
S & P A-1
 - ii. Long-term debt rated at least:
Moody's Aa3
S & P AA -
 - iii. Domestic branches of qualified foreign financial institutions (see c. above).
- h. Corporate or asset-backed securities rated not less than:
 - Moody Aa3
 - S&P AA -
 - D&P AA -
- i. Asset-backed securities with maturities of under one year rated A-1, P-1 or D-1.
- j. A line of credit of up to \$100 million with the Connecticut Student Loan Foundation. Any resulting loans shall be fully collateralized by student loans with interest and principal 98 percent federally guaranteed.
- k. The portfolio currently includes securities issued by the State of Israel, which mature in less than six years, and which, in aggregate, total less than .5 percent of the portfolio value. These notes' interest rates are reset semi-annually at the prime rate minus 50 basis points. The Treasurer's Investment Committee is reviewing the appropriateness of these

securities in terms of credit quality, liquidity, and yield.

2. Reverse repurchase agreements, in aggregate, may not exceed five percent of net assets at the time of execution. While any reverse repurchase agreement is outstanding, new investments must match the maturity of the shortest-term outstanding reverse repurchase agreement. Reverse repurchase agreements are to be used only to meet temporary liquidity requirements of the fund.
3. No investments may be made in "derivative" securities, such as futures, swaps, options, interest-only strips, principal-only strips, inverse floaters, CMT floaters, leveraged floaters, dual index floaters, COFI floaters, and range floaters. These types of securities can experience high price volatility with changing market conditions, and their market values may not return to par even at the time of an interest rate adjustment.

Investments may be made in adjustable rate securities whose interest rates move in the same direction as standard short-term money market interest rate benchmarks, such as LIBOR, Treasury bills, one-month commercial paper and the prime rate, and conform with STIF's other credit and maturity standards. The values of these securities tend to return to par upon the scheduled adjustment of interest rates. Some parties in the financial services industry consider these types of adjustable rate securities to be derivatives, others do not.

4. All investments must be made in U.S. dollar-denominated securities.
5. The dollar-weighted average portfolio maturity (including interest rate reset periods) may not exceed one year; individual maturities may not exceed five years.
6. STIF shall diversify its investments to avoid incurring unreasonable risks inherent in overinvesting in specific instruments, industry segments, individual issuers or maturities. Diversification strategies shall include:
 - a. At the time of purchase, no more than ten percent of

the overall portfolio may be invested in securities of a single bank or corporation, unless insured or collateralized.

- b. There is no limitation on the percentage of assets that may be invested in securities of the United States government, its agencies or instrumentalities, or in overnight repurchase agreements.
- c. No more than 25 percent of the net assets of the fund may be invested in any industry other than the financial services industry at the time of purchase.
- d. No more than 50 percent of the net assets of the fund may be invested in the combined total of commercial paper and non-asset-backed corporate notes at the time of purchase.
- f. Investments in securities that are not readily marketable, other than securities that mature within seven days, may not exceed 10 percent of the fund's net assets at the time of purchase.

Investment decisions shall be based on the relative and varying yields and risks of individual securities and the fund's liquidity requirements.

I. Interest Payments

STIF pays interest quarterly based on monthly guaranteed rates that are set on or before the first day of each month by the Treasury based on STIF's portfolio and market conditions. In addition, participants are paid a bonus distribution -- based on actual earnings less guaranteed interest payments, expenses and the payment to the reserve for losses -- after the end of each STIF fiscal year (May 31). The bonus distributions, while not guaranteed, have ranged from five to 22 percent of previously-paid interest over the past five years.

All rates are calculated and quoted on the basis of the actual number of days in a year (an "actual-over-actual" basis).

J. Administrative Costs

STIF is provided to participants without sales or management fees. Administrative costs are paid from investment earnings, and all STIF participants (including the state and local entities) share in covering the Fund's expenses in proportion to the size of their investments. Costs have run at between two and three basis points (or \$2-3 per \$10,000 invested).

K. Delegation of Authority

The Short-Term Investment Unit within the Treasury's Cash Management Division manages STIF's investments. Deposits, withdrawals, participant record-keeping and the distribution of interest are handled by the STIF Administration Unit within the Treasury's Cash Management Division.

L. Daily Confirmations

Confirmations of daily deposits and withdrawals are sent the day after the transaction.

M. Monthly Statements

Monthly statements of balances, account activity, and accrued and paid interest are mailed to participants by the 10th day of each month.

N. Reports

Quarterly and annual reports describing STIF's monthly guaranteed and actual yields, performance relative to standard benchmarks (90-day Treasury bills, 90-day Certificates of Deposit and the IBC/Donoghue First Tier Institutions-Only Money Fund Index), and investments shall be provided to all participants. A detailed portfolio listing and commentary on economic conditions shall be provided with each report.

**O. Participant
Manual**

A manual describing STIF's operating procedures, past performance, instructions for opening and closing accounts and making deposits and withdrawals, and methods of distributing interest, is provided to all participants. There currently are no restrictions on the size or number of accounts or transactions.

P. Audit

The Auditors of Public Accounts audit STIF's financial statements and operating procedures annually. Copies of audit opinions will be provided to all participants.

**Q. Portfolio
Valuation**

STIF's values and yields are accounted for on an amortized-cost basis. All securities, except for those securities listed in Sections H.1.j and H.1.k, above, are also marked-to-market on a monthly basis. Significant deviations of market values to amortized costs shall be reported to Assistant Treasurer for Cash Management, the Assistant Treasurer for Pension Funds Management, and the Treasurer's Investment Committee at the first weekly meeting following such determination.

**R. Internal
Controls**

The Treasury shall establish and maintain a system of internal controls, which shall be documented in writing. The internal controls shall be reviewed by the Auditors of Public Accounts. The controls shall be designed to prevent and control losses of public funds arising from fraud, employee error, misrepresentation by third parties, or imprudent actions by employees and officers.

**S. Investment
Advisory Council**

STIF's investment practices and performance, including the documentation discussed in Section N shall be reviewed on a quarterly basis by the Investment Advisory Council established pursuant to CGS 3-13b.

**T. Financial
Dealers and
Institutions**

The STIF investment officer shall develop criteria for selecting brokers and dealers. All repurchase agreement transactions will be conducted through primary dealers of the Federal Reserve Bank of New York and qualified banks (as defined in Sections H.1.b., H.1.c, and H.1.d.) which have executed master repurchase agreements with the Treasury.

U. Ethics

Officers and employees involved in the investment process shall refrain from personal business activity that could conflict with proper execution of the investment program, or which could impair their ability to make impartial investment decisions. Employees and investment officials shall disclose in writing to the Treasurer, or the Treasurer's compliance officer, any material financial interests in financial institutions that conduct business with STIF, and they shall further disclose any large personal financial/investment positions that could be related to the performance of STIF's portfolio, particularly with regard to the time of purchase and sales.

V. Bond Proceeds

Bond proceeds may be deposited in STIF. Accounting and arbitrage rebate calculations are the responsibility of participants. STIF's investment program is not designed to restrict yield in order to avoid arbitrage rebates.

W. Conformance with Guidelines

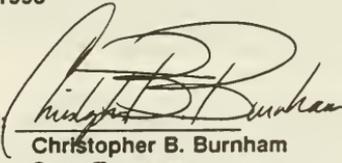
The Performance Analysis Unit of the Pensions Funds Management Division shall monitor the STIF portfolio on a quarterly basis to determine compliance with this policy. The Auditors of Public Accounts will review compliance annually.

X. Conformance with National Standards

These guidelines, together with the participant manual, were designed to meet the December 4, 1989 disclosure guidelines of the National Association of State Treasurers for local government investment pools.

June 27, 1995

Approved:

A large, stylized handwritten signature in black ink, appearing to read "Christopher B. Burnham". The signature is written over a horizontal line that serves as a separator between the signature and the printed name below.

Christopher B. Burnham
State Treasurer



INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC.

1270 Avenue of the Americas
Suite 2118
Rockefeller Center
New York, New York 10020-1702
(212) 332-1200
FAX: (212) 332-1212

July 27, 1995

**Statement of
International Swaps and
Derivatives Association, Inc. to the
Subcommittee on Capital Markets, Securities,
and Government Sponsored Enterprises of the
Committee on Banking and Financial Services
of the U.S. House of Representatives**

The International Swaps and Derivatives Association, Inc. ("ISDA") appreciates the opportunity to present this written statement to the Subcommittee on Capital Markets, Securities, and Government Sponsored Enterprises of the Committee on Banking and Financial Services of the U.S. House of Representatives in connection with the Subcommittee's hearings to be held on July 26 and 27, 1995 relating to state and local government debt issuance and investment practices.

ISDA is an international organization whose primary membership comprises 163 of the world's largest commercial, merchant and investment banks and other institutions that conduct significant activities in swaps and other privately negotiated transactions. Many of the issues scheduled to be addressed in the Subcommittee's hearings are of great importance to ISDA and its membership.

ISDA supports the efforts of the Subcommittee to ensure that adequate steps are being taken to improve the investment practices of state and local governments. Recent well-publicized losses by some local government funds have reaffirmed the necessity of appropriate management controls and sound risk management strategies.

The legitimate interest in requiring appropriate management controls and sound risk management strategies might lead to unnecessary restrictions on the use of risk management products that are necessary for state and local governments to appropriately manage their risks. Limits on investment authority at the state and local government level should be focused on (i) ensuring governments have in place appropriate investment and risk management policies and procedures, including appropriately structured limits on risk taking and (ii) ensuring continued compliance with such investment policies and procedures.

ISDA

Unfortunately, ISDA has observed several recent legislative initiatives at the state level that focus on limiting the use of specific types of investments, rather than on investment policies and limits on risk taking. ISDA believes that these proposals are at odds with the stated goal of ensuring sound investment and risk management practices. Limits on certain types of investments will not prevent losses from unsound investment policies, and in fact may exacerbate such losses.

Limits on types of allowed investment products and transactions may impose unnecessary costs on state and local governments that attempt to implement sound investment and risk management policies in the least expensive manner, or may preclude them from implementing such policies at all. State and local governments should be encouraged to effectuate their investment policies in the most efficient and cost-effective way possible. Therefore, state and local governments should be afforded every opportunity to use a variety of products and transactions to establish their investment portfolio and to manage the risks associated with their financial activities.

For both of these reasons, ISDA has opposed legislative initiatives at the state level that have focused on types of allowed investments rather than on appropriate investment and risk management policies. ISDA believes that this distinction is crucial, and should be kept in mind by the Subcommittee during its deliberations on these issues.

The experiences of Orange County bear out the important difference between appropriate investment policies and appropriate types of investment products and transactions. Based on public reports, losses experienced by the Orange County fund were due to the use of a financial and investment strategy that exposed the fund to significant risk in adverse market conditions. This financial strategy utilized a high degree of leverage in order to obtain above market investment yields. This leverage exposed the fund to significant risk in market conditions that differed from the fund manager's expectations about the movement of interest rates. The unsound investment strategy of the Orange County fund could have been implemented through any number of investment products or transactions, and therefore the types of products or transactions held by Orange County should not be the target of prohibitive legislation.

Having said that, the focus of ISDA's efforts as a financial trade association, swaps and other privately negotiated transactions, were not involved in the losses experienced by the Orange County fund. Nevertheless, swaps



and other privately negotiated transactions have received increased scrutiny due to the Orange County situation and other well-publicized events, even though they are widely regarded as efficient and safe risk management tools. Again, the focus must be placed on investment policies and good risk management, and not on the products or transactions used to implement such policies.

For many years, ISDA has made efforts to educate municipalities regarding the necessity of implementing sound risk management policies. Clarifying that state and local governments have the capacity to engage in the transactions necessary to effectuate such sound risk management policies has been a focus of ISDA's efforts. More recently, ISDA has been involved in several industry initiatives targeted at improving risk management practices for all entities that regularly engage in financial transactions. ISDA believes that many of these initiatives express practices that are equally applicable to state and local governments with respect to their investment policies and procedures. It is only through the informed development of sound investment and risk management policies that losses like those experienced by the Orange County fund can be avoided in the future.

- - -

ISDA is committed to its continuing effort to educate and inform the public regarding the beneficial risk management uses of swaps and other privately negotiated transactions, and therefore appreciates this opportunity to express its view to the Subcommittee in connection with its inquiry into the investment policies of state and local governments.



GOVERNMENT FINANCE
OFFICERS ASSOCIATION

1750 K Street, N.W., Suite 650, Washington, DC 20006
202/429-2750 • Fax: 202/429-2755

August 25, 1995

Honorable Richard H. Baker, Chairman
Subcommittee on Capital Markets, Securities and
Government Sponsored Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, DC 20515

Attn: Ted Beason

Dear Chairman Baker:

The Government Finance Officers Association (GFOA) is pleased to respond to the questions you posed in your letter of August 4, 1995, concerning the regulation of derivatives, municipal bond disclosure, and municipal bankruptcy. Enclosed you will find our views on these subjects. I would note that in some instances we do not have official Association positions, but have provided technical comments about the subject where we have no policy.

I want to take this opportunity to thank you for including GFOA as a participant in the hearing on municipal finance. The hearing provided an excellent overview of state and local government cash management and debt administration activities, clarified the purposes of the bankruptcy code and brought to light the many factors contributing to the Orange County, California, bankruptcy and default. I also want to thank your staff for the assistance they provided GFOA in advance of the hearing.

The municipal market is indeed an important sector of the national capital markets. GFOA is pleased to provide additional assistance to you, other members of the committee and the staff as you proceed with your work in the municipal area. Please feel free to call Cathy Spain or Betsy Dotson in the GFOA Federal Liaison Center at (202) 429-2750.

Sincerely,

Timothy H. Riordan, President
Government Finance Officers Association
and
Director of Finance, City of Dayton, Ohio

Enclosures

HEADQUARTERS OFFICE

180 North Michigan Avenue, Suite 800, Chicago, Illinois 60601
312/977-9700 • Fax: 312/977-4806

Responses to Questions
posed by the
Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises
of the
U.S. House of Representatives Committee on Banking and Financial Services
to the
Government Finance Officers Association

The Government Finance Officers Association (GFOA) has prepared the following responses to written questions addressed to Timothy H. Riordan, President of the Government Finance Officers Association, following his testimony before the Subcommittee on July 27, 1995.

Question 1

You include in your list of suggestions to Congress that regulatory gaps related to securities firms and their affiliates regarding derivatives activities should be closed in order to control the activities of such affiliates to be subject to scrutiny as are the parent firms. Could you please elaborate?

Response 1

In June 1994, the Government Finance Officers Association adopted a policy statement regarding the regulation of derivative products. Included in this policy was support for federal action to close the regulatory gaps related to securities firms and their affiliates that are dealers of derivative products. This recommendation is derived from findings in the U.S. General Accounting Office report, *Financial Derivatives: Actions Needed to Protect the Financial System* (GAO/GGD-94-133). That report found that, while financial institutions are subject to periodic regulatory examinations regarding their use of derivatives, there are no federal regulations regarding derivatives activities by securities firm affiliates.

The SEC is authorized to regulate activities involving securities firms that buy and sell for their own accounts and as agents for their customers. These firms must register with the SEC and comply with its requirements for regulatory reporting, minimum capital, and examinations. They must also comply with the requirements of the various exchanges and industry associations. The SEC monitors broker-dealer capital levels through periodic reporting requirements and regular examinations. Securities laws, however, do not apply to a securities firm's entire organization, which may include holding companies or other affiliates. Because the SEC's jurisdiction pertains only to securities, it does regulate affiliates of broker-dealers whose activities involve products that are not securities. Because some of these products are also outside the regulatory jurisdiction of the Commodity Futures Trading Commission, the affiliates trading them remain essentially unregulated.

The Market Reform Act of 1990 authorized the SEC to collect information from registered broker-dealers about the activities and financial condition of their holding companies and “material associated persons.” This information includes the total derivatives notional/contract amounts, aggregate credit risk of firms’ derivative dealer affiliates and certain concentrated exposures to individual counterparties. The SEC does not receive information showing gains and losses on derivatives separate from securities firms’ other trading activities, which could be used to assess risks taken through speculation.

In addition, the SEC has capital standards that address derivatives, but these standards apply only to regulated broker-dealers and not to over-the-counter (OTC) derivatives dealers that are affiliates of securities firms. The SEC has no authority to examine the activities of these affiliates. It is reportedly for this reason that firms have chosen to conduct OTC activities in affiliates.

Closing these gaps to make regulation of securities firms’ affiliates like that of the firms themselves and financial institutions will result in greater assurance that potential problems will be identified and addressed on a timely basis.

Question 2

You include in your list of suggestions to State Governments that states review their regulation of insurance company affiliates that are dealers of derivatives products to ensure that state insurance regulations are adequate with regard to these activities. Could you please elaborate?

Response 2

The GFOA policy statement on derivatives also called for closing the gaps related to regulation of insurance company affiliates. State insurance agencies are responsible for regulating insurance companies headquartered and licensed in their respective states. This is not a federal function. There is little or no state oversight of derivatives activities of insurance company affiliates by state insurance regulators. Derivatives dealer affiliates of insurance companies are subject to minimal reporting requirements and no capital requirements and are not examined. Therefore, no information is available on these derivative dealers’ counterparty credit exposure, or the sources and types of income earned from derivatives.

As is the case with affiliates of securities firms, regulation of the derivatives activities of insurance company affiliates will allow potential problems to be recognized earlier and hopefully be avoided.

Question 3

What would be the benefits of standardized reporting requirements across the country? What would be the drawbacks?

Response 3

There is already some measure of uniformity and standardization in municipal disclosure as described below:

- The GFOA Disclosure Guidelines for State and Local Government Securities provide extensive recommendations regarding the form and content of primary and secondary disclosure documents.
- The Governmental Accounting Standards Board sets generally accepted accounting principles (GAAP) for state and local governments. GAAP sets forth the minimum requirements for a fair presentation of financial data in external financial reports and assures a degree of comparability in financial reporting among different governments.
- The National Federation of Municipal Analysts has published a Disclosure Handbook for Municipal Securities that identifies the type of information needed by analysts to make informed investment decisions. The Handbook is prepared on sector-by-sector basis to highlight the important information needed to evaluate specific credit risk in the primary and secondary markets.
- The National Council of State Housing Agencies and the Association of Local Housing Finance Agencies have developed reporting formats for housing issuers which have been in use for several years.
- The Public Securities Association has developed recommendations for a consistent presentation of basic bond provisions in official statements that is based in part on the GFOA Disclosure Guidelines.

GFOA strongly supports the existing regulatory framework for municipal disclosure. It believes that the changes in SEC Rule 15c2-12 will improve disclosure and the Association is working with its members and other organizations representing municipal market participants to facilitate implementation. One concern the Association has about rigid, standardized reporting in the municipal market is that the result of such a requirement would be the provision of less information to investors.

The amendments to SEC Rule 15c2-12 are now being implemented by state and local government issuers and we anticipate that there will be more uniformity in municipal disclosure as a result of these efforts. Issuers are reviewing the information provided in their official statements to determine the best format and to facilitate the provision of annual information that “mirrors” the information provided in their official statements. Moreover, many issuers are considering using their comprehensive annual financial reports (CAFR) as the vehicle for providing their annual financial information. The statistical section of the CAFR provides mostly trend data and nonfinancial information useful in assessing a government’s financial

condition. This section is of greatest interest to investors and creditors because the trends it delineates and the nonfinancial factors it identifies can provide crucial insights to those assessing a government's future creditworthiness. GASB identifies 15 standard statistical tables that should be presented in the CAFR if they are relevant. Governments are encouraged to supplement these basic tables with other data they believe would be helpful to readers in assessing the government's financial condition.

The corporate system of standardized reporting requirements in the disclosure area, which specifies the form and content of disclosure, presumably makes it easier for investors and others to use information submitted to the Securities and Exchange Commission (SEC). However, this formal, highly regulated system imposes significant costs on the providers of such information and is geared to a market that is significantly different from the municipal securities market. Furthermore, the form and content of disclosure information provided in the municipal market has not been the subject of criticism. The concerns cited most have been the availability and timeliness of information. These concerns have been addressed by recent SEC actions.

GFOA is strongly opposed to a new federal regulatory structure that forces issuers to disclose information in the primary and secondary markets on standardized forms for several reasons. The municipal market is very diverse in terms of types of issues and issuers and it would be very difficult to design standardized forms that would suffice for the wide variety of financings. Several years ago, the National Federation of Municipal Analysts developed 16 separate suggested (not mandatory) secondary market disclosure forms for municipal bond issues because of the great variety in bond financings. Members of the GFOA Committee on Governmental Debt and Fiscal Policy reviewed these forms and proposed changes in the forms to the analysts. However, in many instances, the finance officers noted that the forms were a good model or approach, but would need modification if applied to a specific financing in their jurisdiction. Copies of two of the forms are attached to illustrate how different the information needs are for different types of financings. One form is for a general obligation and the other is for a water and sewer system bond.

Question 4

At present, the Bankruptcy Code leaves to the States whether its municipal entities can avail themselves of the Federal Bankruptcy process. Should the law require a municipality to confer with the State government before commencing bankruptcy?

Response 4

GFOA does not have a policy position in this area. Given that local governments are creatures of the state, this appears to be a matter of state law and one to be determined on a state-by-state basis.

Question 5

What do you think of Mr. Spiotto's suggestion that a uniform statute be adopted by all states which governs municipal financial distress?

Response 5

GFOA does not have a policy position on this subject. However, GFOA and other organizations have on occasion developed model statutes to assist state legislatures and executive branch staff. We believe that these types of efforts are worthy and provide technical assistance that is important in the consideration of legislation. While uniform legislation may be desirable, it is not likely to occur once the individual state legislatures take up consideration of the legislation.

In 1979, GFOA published a study entitled State Roles in Local Government Financial Management: A Comparative Analysis. A major finding of this study was the great diversity that exists among states in the degree of state involvement in local financial management and even the diversity that exists within a single state depending on the type of government considered. Therefore, what might be acceptable and even welcome in one state in terms of state involvement in a bankruptcy filing might be vehemently resisted in another state. The development of model legislation and the endorsement of such legislation by key organizations is one way to bring focus to the issues.

Question 6

Should the law require the State, not the municipality, to assert that bankruptcy is a last resort after all rational and feasible alternatives have been fully explored?

Response 6

GFOA does not have a policy position on this issue, but given the states' constitutional responsibilities for local governments, it appears this should be a matter of state law and not federal law.

August 25, 1995

**General Obligation
Bonds****Secondary Market Disclosure**

Issuer _____ CUSIP Base# _____

Key Financial Contact/Position _____

Telephone Number _____

Reporting Period - Fiscal Year Ended _____

Please check box if audit or CAFR is requested

Secondary Market Disclosure Forms have been designed by the National Federation of Municipal Analysts (NFMA) to expedite the process of ongoing disclosure. They are intended to cover information deemed necessary to facilitate continuing credit analysis on a sector-by-sector basis. This information is intended to supplement the annual audit or CAFR. Additional space for responses has been provided on page four of this form. Copies of this form may also be sent to the Municipal Securities Rulemaking Board (MSRB). For information on the MSRB's Municipal Securities Information Library System, please call Thomas A. Hutton, MSRB, (202)223-9503.

Outstanding Debt Service (as of ___/___/___)

Please provide information for all tax-supported debt including BANs, COPs/lease rental bonds and special tax bonds, e.g., sales tax/motor fuel - principal only

Total G.O. debt outstanding	\$ _____
BANs	\$ _____
Lease-rental obligations/COPs	\$ _____
Other tax-supported debt	\$ _____
Total	\$ _____
Total overlapping debt, if available	\$ _____
Next year's estimated debt service - FY___ (principal & interest)	\$ _____

Describe use of derivative products (e.g., interest rate swaps) including counterparty risk

PAGE TWO OF FOUR • SECONDARY MARKET DISCLOSURE

Financial Data (Specify Budgetary or GAAP basis)

Budget Summary - General Fund: For periods covering final adopted budget for last fiscal year and current fiscal year

Revenues: (3 largest)

	FY _____ (000)	FY _____
_____	\$ _____	\$ _____
_____	_____	_____
_____	_____	_____
Interfund Transfers _____	_____	_____
Other _____	_____	_____
Total _____	\$ _____	\$ _____

Expenditures: (3 largest)

_____	\$ _____	\$ _____
_____	_____	_____
_____	_____	_____
Interfund Transfers _____	_____	_____
Other _____	_____	_____
Total _____	\$ _____	\$ _____
Ending Balance	\$ _____	\$ _____

Please discuss recent revenue trends, including changes in rates for major sources

Please provide for last three fiscal years:

	FY _____	FY _____	FY _____
Assessed value (\$000)	_____	_____	_____
Full value (\$000)	_____	_____	_____
Tax rate	_____	_____	_____
Net levy (\$000)	_____	_____	_____
Current collections (\$000)	_____	_____	_____
Total collections (\$000)	_____	_____	_____

Please list five largest taxpayers and respective assessed values

	Taxpayer	A. V. (\$000)	% of total A. V. of issuer
1.	_____	_____	_____
2.	_____	_____	_____
3.	_____	_____	_____
4.	_____	_____	_____
5.	_____	_____	_____

***PAGE THREE OF FOUR * SECONDARY MARKET DISCLOSURE**

Discuss major revaluations, assessment appeals and results thereof for largest taxpayers

Capital Improvements

Tax-supported borrowing plans

	FY_____	FY_____	FY_____
	(000)		
G.O. bonds	\$ _____	\$ _____	\$ _____
COPs/leases	_____	_____	_____
Other tax-supported bonds	_____	_____	_____

Description of Issuer/Obligor

5 largest employers and number of employees

	Employer	# of employees
1.	_____	_____
2.	_____	_____
3.	_____	_____
4.	_____	_____
5.	_____	_____

Discuss announced major expansion, layoff/closure plans, bankruptcies or significant tax delinquencies for largest employers or taxpayers, if available

School enrollment trend, for school district bond issuers, for the last three years

	FY_____	FY_____	FY_____
Total Enrollment (K-12)	_____	_____	_____

Extraordinary Debt Service Payment Events

Notification of delinquent debt service payments, and/or unscheduled draws on letters or lines of credit

Supplemental Information

Please discuss significant litigation, environmental regulations, proposed or enacted legislation or taxpayer initiatives which would materially affect the issuer/obligor, its revenue base or expenditure requirements

Status of current labor contracts/labor relations environment

Additional space for responses (please site specific areas)

Signature

Prepared by _____

Title _____

Address _____

Phone _____

Signature _____ Date _____

The NFMA does not warrant the completeness of this form or the accuracy or completeness of any information provided by any issuer hereunder. The information required in this form is intended to produce a document appropriate for informing investors. It is not intended, however, to create disclosure requirements or a legal obligation to provide any or all items of information, although careful adherence to this form is recommended.

FOR ADDITIONAL FORMS OR INFORMATION, PLEASE CONTACT LISA GOOD, NFMA EXECUTIVE DIRECTOR
OF BUSINESS AFFAIRS,

P.O. BOX 14893, PITTSBURGH, PA 15234
PHONE: (412) 341-4898 • FAX: (412) 341-4894

**Retail Water and
Sewer System Bonds**

Secondary Market Disclosure

 Issuer _____ CUSIP Base# _____

 Key Financial Contact/Position _____

 Telephone Number _____

 Reporting Period - Fiscal Year Ended _____

 Please check box if audit or CAFR is requested

Secondary Market Disclosure Forms have been designed by the National Federation of Municipal Analysts (NFMA) to expedite the process of ongoing disclosure. They are intended to cover information deemed necessary to facilitate continuing credit analysis on a sector-by-sector basis. This information is intended to supplement the annual audit or CAFR. Additional space for responses has been provided on page four of this form. Copies of this form may also be sent to the Municipal Securities Rulemaking Board (MSRB). For information on the MSRB's Municipal Securities Information Library System, please call Thomas A. Hutton, MSRB, (202)223-9503.

Outstanding Debt Information (as of ___/___/___)

Please provide information for each separately secured issue or project (parity issues may be consolidated as one)

 Name of issue or project _____

Outstanding principal balance \$ _____

Authorized but unissued debt \$ _____

Next year's estimated debt service - FY _____ (principal & interest) \$ _____

Maximum annual debt service/year _____ \$ _____

 Debt service coverage ratio for last fiscal year
(as calculated under indenture) _____

 Debt service reserve fund balance(s) as of _____ \$ _____
 Fully funded On build-up schedule

PAGE TWO OF FOUR • SECONDARY MARKET DISCLOSURE

Describe exposure to derivatives, (e.g., interest rate swaps) including counterparty risk

Financial Data**Water System**

Please provide for last three fiscal years:	FY_____	FY_____	FY_____
Number of customers	_____	_____	_____
Water sales (gal. 000)	_____	_____	_____
Average daily demand (MGD)	_____	_____	_____
Peak demand(MGD)	_____	_____	_____
Maximum treatment capacity (MGD)	_____	_____	_____
Unaccounted for	_____	_____	_____
New water connections	_____	_____	_____
Water rate increases	_____	_____	_____
Residential charge - 7,500 gal/mo	_____	_____	_____
Residential connection charge	_____	_____	_____

Please list five largest customers:	Revenues (\$000)	Volume (MGD)	Customer type*
1. _____	_____	_____	_____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
4. _____	_____	_____	_____
5. _____	_____	_____	_____

* commercial, industrial, wholesale, utility or other

Sewer System

Please provide for last three fiscal years:	FY_____	FY_____	FY_____
Number of customers	_____	_____	_____
Sewage treatment	_____	_____	_____
Average daily flow (MGD)	_____	_____	_____
Peak daily flow (MGD)	_____	_____	_____
Maximum treatment capacity (MGD)	_____	_____	_____
Unaccounted for	_____	_____	_____
New sewer connections	_____	_____	_____
Sewer rate increases	_____	_____	_____
Residential charge - 7,500 gal/mo	_____	_____	_____
Residential connection charge	_____	_____	_____

Please list five largest customers:	Revenues (\$000)	Volume (MGD)	Customer type*
1. _____	_____	_____	_____
2. _____	_____	_____	_____
3. _____	_____	_____	_____
4. _____	_____	_____	_____
5. _____	_____	_____	_____

* commercial, industrial, wholesale, utility or other

Discuss major expansion or layoff/closure plans for largest customers

Capital Improvements

Describe recently completed major capital projects and current status of major ongoing projects (cost and schedule vs. projections)

Describe future capital plans and financing, including federal and state grants

Extraordinary Debt Service Payment Events

Notification of delinquent debt service payments, draws from debt service reserve funds and/or letters/lines of credit and/or technical violations of bond indenture

Supplemental information

Trustee contact/firm _____

Phone number _____

Please discuss significant litigation, environmental regulations, proposed legislation or compliance with environmental regulations which would materially affect the issuer or the operation of its facilities



INVESTMENT COMPANY INSTITUTE

MATTHEW P. FINK
PRESIDENT

August 25, 1995

The Honorable Richard H. Baker
Chairman, Subcommittee on Capital Markets,
Securities and GSEs
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Congressman Baker:

I am pleased to submit the Institute's responses to questions from the Capital Markets Subcommittee concerning the recent hearing on municipalities. The hearing has helped to define the many issues surrounding the recent events in Orange County and municipal bankruptcies in general. The Institute appreciates the opportunity to express its views on such an important matter.

We would be pleased to provide any additional information requested.

Sincerely,

A handwritten signature in cursive script, appearing to read "Matthew P. Fink".

INVESTMENT COMPANY INSTITUTE

RESPONSES TO QUESTIONS FROM CAPITAL MARKETS SUBCOMMITTEE
CONCERNING HEARING ON MUNICIPALITIES

August 25, 1995

Question 1: A significant portion of the Orange County Investment Pool was invested in Government Sponsored Enterprise structured notes. Such notes carry low credit risk but high market risk. Such notes, therefore, carry a triple-A rating, which can be misleading to investors. Could you please comment? Should such notes also carry some sort of market-risk rating?

Response: Based on the foregoing, the Institute does not believe that such notes also should carry some sort of market-risk rating. Mutual funds, and particularly money market funds, are significant purchasers of structured notes. As the question points out, the triple-A rating of these notes represents a rating of their credit quality and not an assessment of their market risk. Portfolio managers and credit analysts for these mutual funds fully understand the nature and scope of the ratings assigned to these notes.

Moreover, mutual fund managers possess the expertise to evaluate independently the investment risks (including credit¹ and market risks) associated with the notes. Indeed, such evaluation is an integral part of the services provided by fund advisers. Finally, the Institute is not aware of any complaints by its members that the ratings assigned to these notes have been misleading.

Question 2: The GFOA stated in their testimony that many cautious finance officers believe that they have been misled by broker-dealers regarding the purchase of derivatives, and that these products have been misrepresented, in part due to a lack of understanding by the broker-dealer trading the derivatives. Could you please comment?

Response: The Institute cannot respond to the issue of whether finance officers have been misled by broker-dealers, since the Institute was not privy to those transactions. With respect to mutual fund purchases of derivative instruments, an Institute survey of its members showed that the overall level of investment in derivatives by mutual funds is quite modest. When mutual funds purchase derivatives, most of these investments either are designed to hedge against portfolio risks or else do not involve risks substantially different from other investments.²

¹ Specifically, Rule 2a-7 under the Investment Company Act of 1940, which governs the regulation of money market funds, requires that the board of directors (or its designate) of a money market fund independently analyze the creditworthiness of any portfolio security and any entity providing a credit enhancement for a portfolio security.

² See Statement of Matthew P. Fink, President, Investment Company Institute, Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, on

The Institute believes that it is important for all mutual funds that invest in derivatives to ensure that their internal controls and procedures are sufficient to reasonably ensure that these investments are consistent with their stated objectives and policies and otherwise in compliance with applicable law.³ We have not received any complaints from our members that these products have been misrepresented to them by broker-dealers.

Question 3: Mr. Fish stated in his testimony that trustees and fiscal agents for bondholders are not always adhering to the investment policies spelled out in bond documents, and instead take direction solely from the issuer. Could you please comment?

Response: It is the Institute's understanding that the underlying documentation for a municipal bond issue usually specifies a list of permitted investments that can be made by the trustee or fiscal agent who has been charged with acting as attorney-in-fact for the bondholders. We also understand that the trustee may look to the issuer of the bonds for investment direction, because the issuer is often in a better position to evaluate the cash needs of the particular municipality or governmental entity that issued the bonds.

If a trustee were to make investments at the direction of the issuer that are in contravention of the investment policies stated in the underlying bond documents, then it would appear that investment guidelines specified in the bond documents would have been breached. We have not heard from our members of any specific situations where this has occurred.

Question 4: The extension, or roll-over, of \$800 million of Orange County notes has been characterized as a forced rollover because the noteholders had no other choice. Do you agree?

Response: Investors in the Orange County notes appear to have been confronted with a difficult choice whether or not to participate in the roll-over plan as proposed by the County. We are not, however, in a position to agree or disagree with the characterization. The Institute did not participate in the decision-making process of its members who were faced with the rollover decision. Each mutual fund that held these notes made its own determination as to what would be in the best interests of its shareholders.

Investments in Derivatives and Other Mutual Fund Issues 5-10 (Sept. 27, 1994) (reporting the results of an Institute survey of members' use of derivative instruments and discussing mutual funds' use of derivatives).

³ In this regard, the Institute has developed a detailed memorandum for its members on the subject of mutual fund investments in derivatives. See *Investments in Derivatives by Registered Investment Companies*, Investment Company Institute (Aug. 1994).

Question 5: Mutual funds and other investors rely heavily on Rating Agency ratings when making an evaluation of the safety and soundness of an investment. Do you feel you were well-served by the Rating Agencies' high ratings of Orange County securities? Do you think that the rating agencies should refine their evaluation of municipal investment practices going forward?

Response: The management of a mutual fund has the ultimate responsibility to make investment decisions for the fund. Although mutual funds may consider the rating of a particular security when making an investment decision, the rating is often not the determining factor. In the case of a money market fund, for example, Rule 2a-7 requires the mutual fund's board of directors (or its delegate) to make an independent determination of the creditworthiness of all securities in the portfolio of the fund.⁴

It remains true, however, that the rating agencies had given the notes high ratings on the day before the County filed for bankruptcy protection.⁵ The fact that ratings are not fool-proof provides further illustration of the dangers in relying upon rating agencies as a substitute for regulation by the SEC.⁶

⁴ See note 1, *supra*.

⁵ See, e.g., Vogel, *Orange County Fund Had Green Ratings Light*, Wall St. J. (Dec. 6, 1994).

⁶ The Institute recently filed a comment letter with the SEC on this issue. Letter to Jonathan G. Katz, Secretary, Securities and Exchange Commission, from Paul Schott Stevens, General Counsel, Investment Company Institute, *Concept Release Concerning Nationally Recognized Statistical Rating Organizations* (Release No. IC-20508; File No. S7-23-94) (Dec. 6, 1994).

**Securities Industry Association**

1401 Eye Street, NW • Washington, DC 20005-2225 • (202) 296-9410 • Fax (202) 296-9775

Marc E. Lachwitz
President

September 14, 1995

The Honorable Richard Baker
Chairman
Subcommittee on Capital Markets,
Securities and Government Sponsored Enterprises
Committee on Banking and Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Follow-up to July 27 Testimony

Dear Mr. Chairman:

I am pleased to have the opportunity to respond to the questions contained in your August 4 letter. Please find these responses attached.

We hope that you find the responses to these questions helpful. If you have further questions or would like us to clarify or amplify our responses, please feel free to contact me or Steve Judge, Senior Vice President, Government Affairs. With best wishes, I am

Sincerely yours,

A handwritten signature in black ink that reads "Marc E. Lachwitz". The signature is written in a cursive, flowing style.

RESPONSES TO QUESTIONS WITH REGARD TO JULY 27
HEARING BEFORE THE SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES
AND GOVERNMENT SPONSORED ENTERPRISES
HOUSE BANKING AND FINANCIAL SERVICES COMMITTEE

Question 1

A significant portion of the Orange County Investment Pool was invested in Government Sponsored Enterprise structured notes. Such notes carry low credit risk but high market risk. Such notes, therefore, carry a triple-A rating, which can be misleading to investors. Could you please comment? Should such notes also carry some sort of market-risk rating?

Response

Credit risk is only one type of risk inherent in investing in financial instruments, and it is important that investors understand the difference between credit risk and market risk. For example, because of the Government guarantee, the 30 year Treasury bond is regarded as having no credit risk, but is subject to a substantial degree of market risk. As a result, a 30 year T bond purchased at the height of the bond rally in October 1993 would have lost more than 20 percent of its value if sold at the low of that interest rate cycle in November 1994. The change in price was due solely to the market risk of long term fixed income securities.

Traditionally the rating agencies have focused solely upon rating instruments with respect to credit risk. However, we understand that the agencies are now beginning to rate instruments on other criteria, including market risk. This development should prove useful to investors.

Question 2

The GFOA stated in their testimony that many cautious finance officers believe that they have been misled by broker-dealers regarding the purchase of derivatives, and that these products have been misrepresented, in part due to a lack of understanding by the broker-dealers trading the derivatives. Could you please comment?

Response

Obviously, since we are not privy to the facts that formed the basis of the GFOA's testimony, we can't comment upon those specific cases. Of course, broker-dealers are required to deal equitably with their clients, and if misrepresentations are proved, the plaintiffs will be free to pursue remedies already provided under existing law.

With respect to the suggestion that broker-dealers trading derivatives don't understand them, we would first note that many of the instruments lumped under the heading of "derivatives" are actively traded and are not complex financial instruments. Thus, neither pricing the instruments nor estimating their cash flows are particularly difficult. Those firms that are active dealers in such instruments are and have been for some time devoting considerable resources to creating and explaining these instruments to their customers. Over the past decade, many Wall Street firms have recruited academics from various backgrounds from the leading universities and research centers in the U.S. and abroad as part of that effort.

Having said that, we must point out that the difficulty in "understanding" derivatives can be grossly exaggerated. For example, while calculating the precise change in the value of a security under various scenarios can involve some complex mathematics, understanding how that instrument will react to a change in interest rates is a relatively straightforward matter. If Robert Citron understood that the strategy he adopted for the Orange County portfolio was heavily dependent upon stable or declining interest rates, and very vulnerable to rising interest rates, he didn't need a doctorate in finance to understand the risks he was running.

We suspect many if not most of the situations referred to by the GFOA involve the prepayment risk entailed by investments in mortgage-backed securities, highlighted by the very large interest rate spike of 1994. The impact of interest rate changes on the value of these securities was not fully anticipated by the market as a whole, including some dealers, due to a variety of special factors. This demonstrates the dangers in generalizing about "derivatives."

We can not overemphasize that it is essential that those charged with the responsibility of investing taxpayer funds should ensure that either they understand the instruments they purchase, or that they retain investment advisers to perform that function for them. This will ensure that disclosure concerning derivatives transactions will be understood by the municipality's finance officers. After the fact complaints by those who have made imprudent and/or unprofitable investment decisions should not be used as a pretext to impose additional responsibilities upon broker-dealers.

Question 3

Can brokerage firms do anything through enhanced research or other means to get more information to the market about the nature of different municipal issuers' willingness and legal obligations to repay?

Response

This question concerns credit risk, since it addresses the ability/willingness of the issuer to meet its obligations as they mature. As stated in our response to question one, the rating agencies have always rated municipal securities on credit risk, and have been the primary mechanism in informing the markets as a whole about the credit worthiness of municipal issuers. In the wake of the Orange County default, the agencies are reviewing their procedures in an attempt to ensure that they are accurately reflecting the credit risk of municipal issuers. We believe that additional disclosure by municipal issuers of their investment portfolios would be helpful in this effort.

Many broker-dealers also research the municipal market, including the credit risk inherent in particular municipal securities. However, the rating agencies have traditionally been viewed as the primary source of information on credit risk, which we expect will continue to be the case.

More generally, the municipal market has a generally excellent record of issuers meeting their obligations in a timely fashion. It would be most unfortunate if recent developments in the municipal market, or shortsighted attempts to blame dealers for failed investment strategies, led some issuers to adopt a casual attitude to meeting their obligations. We suspect that issuers who evidence such an attitude will find raising additional funds in the capital markets much more difficult.

~~RICHARD H. BAKER~~, LOUISIANA, CHAIRMAN
 T.G. MAYNORTH, ARIZONA, VICE CHAIRMAN
 FRANK CRENSHAW, OHIO
 JON FOX, PENNSYLVANIA
 STEVE STOCKMAN, TEXAS
 FRANK LOBIONDO, NEW JERSEY
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 RICE LADD, NEW YORK
 SPENCER BACHUS, ALABAMA

PAUL E. SANJOSE, PENNSYLVANIA
 MAURICE HENDEY, NEW YORK
 GARY ACEVEDO, NEW YORK
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 JOHN J. LAFARGE, NEW YORK
 CHARLES E. SCHUMER, NEW YORK
 FLOYD H. FLAKE, NEW YORK
 MAXINE WATERS, CALIFORNIA
 BILL CRITON, UTAH
 CRD 776-048

U.S. HOUSE OF REPRESENTATIVES
 SUBCOMMITTEE ON CAPITAL MARKETS, SECURITIES, AND
 GOVERNMENT SPONSORED ENTERPRISES

OF THE
 COMMITTEE ON BANKING AND FINANCIAL SERVICES

ONE HUNDRED FOURTH CONGRESS
 2129 RAYBURN HOUSE OFFICE BUILDING
 WASHINGTON, DC 20515

August 4, 1995

Mr. Robert McKNew
 Executive Vice President
 Bank of America NT & SA
 555 California Street
 San Francisco, CA 94104

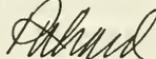
Dear Mr. McKNew:

On behalf of the Members of the Subcommittee for Capital Markets, Securities, and Government Sponsored Enterprises, I want to thank you for appearing as a witness at the July 27th hearing and for your thoughtful testimony and comments.

Through your participation, we were able to focus national attention on a sector of the capital markets that is important to every American.

It is our intention to give further consideration to Chapter 9 of the Federal bankruptcy code, the adequacy and timeliness of municipal disclosure, and state oversight of governmental investment practices. I have enclosed some additional questions to which we would like to receive written responses in order to complete the hearing record. Please send your written responses to Ted Beason at 2129 Rayburn House Office Building, Washington, D.C. 20515.

Sincerely,



RICHARD H. BAKER
 Chairman, Subcommittee on Capital
 Markets, Securities & GSEs

RHB:tb

**Response of the Public Securities Association
to Questions Posed by the
Subcommittee on Capital Markets, Securities
and Government Sponsored Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives**

The Public Securities Association (PSA) appreciates the opportunity to address questions raised by the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises in conjunction with our testimony before the Subcommittee on July 27, 1995. We commend the Subcommittee's continued attention to issues dealing with the federal bankruptcy code, the adequacy and timeliness of municipal disclosure and state oversight of government investment practices. We are pleased to submit these additional comments on specific questions raised by the Subcommittee in Chairman Baker's letter of August 4, 1995.

Q: The GFOA stated in their testimony that many cautious finance officers believe that they have been misled by broker-dealers regarding the purchase of derivatives, and that these products have been misrepresented, in part due to a lack of understanding by the broker-dealer trading the derivatives. Could you please comment?

A: In general, PSA believes that professional, institutional investors, including state and local governments, should assume the full responsibility for their investment decisions. Institutional investors, including state and local governments, are, by definition, fiduciaries charged with the responsibility of investing other people's money. They bear the burden of ensuring that their investment decisions are wise and in the best interests of the beneficiaries of the funds in their charge. If professional, institutional investors are able to assign blame for poor investment decisions after the fact to broker-dealers who sold them the instruments, dealers then become de facto investment guarantors. This would carry with it serious and onerous implications for the efficiency of our capital markets. Ultimately, it would lead to higher costs for all capital markets participants — issuers, investors and dealers — through less liquidity, greater price volatility, higher transaction costs and higher costs of capital. SEC Chairman Arthur Levitt has enunciated the fundamental principle that "all customers — whether it's your neighbor down the street, your local municipality, or a large, international corporation — must take responsibility for understanding what they are buying and how it fits their investment objectives."¹

Moreover, broker-dealers are virtually never given the full details of a customer's investment strategy or the contents of his or her portfolio. Hence, broker-dealers almost never possess all the knowledge necessary to make informed judgments as to the appropriateness of an investment for an institutional customer.

¹ Arthur Levitt, Chairman, Securities and Exchange Commission, "Public Trust and Public Funds," remarks before the National Association of State Treasurers, October 16, 1995, page four.

This is not to imply that securities dealers are without responsibility in dealing with institutional investors. Dealers are appropriately bound to legal and ethical standards in facilitating transactions. They must be honest and deal in good faith. They must not mislead. Their calculations must be accurate. They must employ good-faith assumptions. Perhaps most importantly, they are liable for fraud. If a broker-dealer knowingly makes false or misleading statements in recommending a security for sale, that dealer is fully — and appropriately — subject to criminal and civil action. However, once these responsibilities have been met, a dealer should be able to rely on the certainty that once a security is sold, financial risk shifts to the buyer. As Federal Reserve Board Chairman Alan Greenspan has said, “markets function most efficiently when both parties to a financial transaction are free to enter into transactions at their own discretion, unhampered by any perceived need to serve the interests of their counterparties.... If discipline from incurring losses from mistakes were mitigated, vigilance would be relaxed.... I believe that we should start with the principle that parties to financial transactions are responsible for their own decisions and only use regulation to adjust the balance of responsibilities between the parties cautiously after the benefit has been clearly established.”²

PSA supports legislation to codify the notion that professional, institutional investors should bear responsibility for their investment decisions. We fully support, for example, the investor responsibility provision in H.R. 2131, the Capital Markets Deregulation and Liberalization Act of 1995, currently pending before the House Commerce Committee. This bill would establish a rebuttable statutory presumption against dealer liability regarding investment decisions made by institutional investors with portfolios of \$10 million or more. The bill would not affect dealer suitability obligations to retail investors or to institutional investors with portfolios smaller than \$10 million. It is also not designed to affect dealer obligations under the securities fraud statutes. This proposal represents a sensible and thoughtful way to ensure that large, professional, institutional investors bear responsibility for their investment decisions.

Q: Mr. Fish stated in his testimony that trustees and fiscal agents for bondholders are not always adhering to the investment policies spelled out in bond documents, and instead take direction solely from the issuer. Could you please comment?

A: Bond trustees play a vital role in the municipal securities market. In representing the interests of bondholders, trustees help ensure that issuers meet their obligations to investors as spelled out in bond indenture documents. However, we do not feel that trustees should be expected or required to regulate the activities of bond issuers. We believe that issuers themselves should bear a significant level of responsibility for ensuring that they adhere to their obligations under a bond indenture as well as statutory, regulatory or self-imposed requirements such as investment and disclosure policies. As we stated in our testimony, for example, we support changes to SEC rule 15c2-12, which took full effect at the end of 1995 and which we believe will result in significantly more and better information on the financial condition of municipal bond

² Statement of Alan Greenspan, Chairman, Board of Governors of the Federal Reserve System, before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, January 5, 1995, page three.

issues being made available to market participants. In general, we do not believe that significant problems exist with regard to the responsibilities and actions of bond trustees.

Q: Under what circumstances would you put 40 percent of your portfolio in derivative securities on an unhedged basis?

A: This question can only be answered on a case by case basis. PSA believes that every institutional investor, and especially those in the public sector, should establish and adhere to a written set of investment policies and guidelines. These policies should reflect an investor's goals and strategies as well their risk tolerances, including the extent to which an investor is willing to risk the loss of principal in an investment. Such a policy should also address the extent to which a manager should be able to commit an investor to instruments which are subject to market risk, including "derivative securities." The policy should be fully reviewed and approved by the investor's governing body, in consultation with outside experts, if necessary. An investment manager's adherence to an investor's policies and guidelines should be monitored on a regular basis and audited periodically. This is the best way to ensure that an investment manager does not assume undue risks with the capital under his or her control. We feel very strongly that blindly restricting the use of any investment vehicles by any or all classes of investors through statute or regulation is unwise policy. Indeed, the best way to mitigate market risk is through diversification, which implies more, not fewer, investment choices.

Q: Do you believe that counties should be allowed to leverage up by the use of reverse repurchase agreements? How much leverage is appropriate?

A: Again, this questions can only be answered on a case by case basis. One important element of an investor's written investment policies and guidelines, discussed above, should be the extent to which a manager should be permitted to leverage an investor's risk exposure through the use of repurchase agreements and through other means. One thing is certain: repurchase agreements and reverse repurchase agreements, when used responsibly, can be powerful and efficient tools for investors and other market participants, including state and local governments. The same principle applies to repurchase agreements as applies to "derivative securities." Any attempt to restrict their use on a broad basis would create more problems than it solved.

Q: What should be the duration of pooled municipal funds invested by a county like Orange? How do you make that determination?

A: PSA believes that, in general, the best way for a state or local government investor to reduce exposure to market risk is to match the maturities of their investments with the time of their liabilities. Long-term liabilities, such as pension fund payments, should be associated with long-term investments. Short-term liabilities should be funded with short-term investments.



SARAH A. MILLER
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TRUST AND SECURITIES

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January 5, 1996

Mr. Ted Beason
Senior Professional Staff Member
Subcommittee on Capital Markets,
Securities and Government sponsored
Enterprises
Committee on Banking and Financial Services
U.S. House of Representatives
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Questions submitted to Theodore Craver relating to Orange County Hearings

Dear Mr. Beason:

Enclosed please find responses to the questions posed to Mr. Theodore Craver by letter of August 4, 1995 from Chairman Richard H. Baker. I apologize for the lengthy delay in responding to these questions.

On behalf of the American Bankers Association and the ABA Securities Association, I wish to thank you for meeting with myself and Mr. Jeffrey Powell, Chairman of the ABA's Corporate Trust Committee, to discuss some of these issues. I hope that that discussion, along with the responses enclosed herein, will help further the debate.

Please do not hesitate to contact me if either the ABA or ABASA can be of any assistance in this matter.

I look forward to working with you in the very near future.

Sincerely yours,

Sarah A. Miller

Enclosure

cc: T. Craver
D. Shannon

CAPITAL MARKETS SUBCOMMITTEE HEARING ON MUNICIPALITIES

- Q. The GFOA stated in their testimony that many cautious finance officers believe that they have been misled by broker-dealers regarding the purchase of derivatives, and that these products have been misrepresented, in part due to a lack of understanding by the broker-dealer trading the derivatives. Could you please comment?
- A. As a general matter, the ABA and ABASA believe that broker-dealers do understand the derivative products that they are offering to prospective purchasers. Moreover, any deficiencies in that knowledge have largely disappeared, we believe, as broker-dealers, as well as investors, have improved immeasurably their collective understanding of derivative instruments and how they function under various market conditions. That knowledge has improved largely due to several important hearings on the issue of derivatives held over the last year or so in both the House of Representatives and the Senate. In addition, federal bank and securities regulators have added to the industry's collective knowledge by issuing numerous pronouncements on derivatives and the appropriate use and management of these products. Finally, the industry itself has issued policies and procedures relating to wholesale derivative transactions. Together, these government and industry efforts have assisted broker-dealers, government finance officers and other market participants in understanding derivative instruments and the important uses they serve.
- Q. Mr. Fish stated in his testimony that trustees and fiscal agents for bondholders are not always adhering to the investment policies spelled out in bond documents, and instead take direction solely from the issuer. Could you please comment?
- A. Bondholder trustees and fiscal agents seldom have investment discretion. Instead, the trust indenture or fiscal agent agreement will set forth a detailed list of "Permitted Investments," and grant or reserve to the municipality or other issuer the sole power to direct the investments.

As a directed trustee or agent, the bank's sole responsibility is simply to verify and confirm:

- (1) the authenticity of the investment instructions; and
- (2) that the investments fall within the definition of "Permitted Investments" set forth in the governing instrument, and any special requirements applicable thereto (e.g., prior consent of rating agencies or insurer).

There is a default provision in the investment powers found in most government documents, which grants limited investment discretion to the trustee or fiscal agent. These clauses typically provide that, failing timely investment directions from the municipality or other issuer, the trustee or agent is authorized or instructed to invest in certain financial instruments. However, this is usually limited to money-market sweep accounts, or direct U.S. Treasury obligations (but not investment contracts or other types of derivatives).

When acting as a corporate trustee or fiscal agent, banks generally insist that the investment powers and duties in the governing document be clear and unambiguous. If a trustee or agent were in a situation where, after closing, there is any uncertainty or ambiguity in the investment language, a trustee or agent would not seek direction from the issuer, but, rather, would seek either a formal legal opinion from bond counsel to clarify the ambiguity, or failing that, would probably insist on a formal amendment to the governing document. This latter option would typically require bondholder consent.

- Q. Under what circumstances would you put 40% of your portfolio in derivative securities on an unhedged basis?
- A. There is no right or wrong answer to this question for the answer depends on a facts and circumstances type of analysis. For example, it may be appropriate to invest 40% of one's portfolio in derivatives if the investment strategy for that portfolio is to seek a high return from high risk securities. On the other hand, if the investment strategy for that portfolio is a conservative one, i.e., preservation of principal invested is paramount, it would not be appropriate to have a high concentration of any securities, derivative or otherwise.

It should be noted that high concentrations of securities in bank investment portfolios would generally pose safety and soundness concerns for bank examiners. Consequently, it is highly unlikely that a bank would have a 40% concentration of any type of securities in their investment portfolio.

- Q. If a small number of commercial banks held \$500-600 million of defaulted Orange County notes for their own investment accounts and their regulators were requiring bank[s] to write the assets down, would the ABA's [and ABASA's] testimony have come out stronger against the Orange County bankruptcy?
- A. This is a difficult question to answer for the simple fact that the regulators would not allow a commercial bank to hold a high concentration of any security. For example, the Comptroller of the Currency limits national bank investment in municipal revenue bonds to 10% of capital and surplus for each obligor. If a bank went over that amount, the regulators would have required the bank to divest itself of some of the offending securities.

If, hypothetically, 100 banks each held \$5 million in Orange County notes and because of or in spite of the bankruptcy the notes were trading at 75-80% of their value, the regulators, we believe, would be more concerned about the downturn in bank investment earnings, not the insolvency of the municipal issuer.

- Q. Do you believe that counties should be allowed to leverage up by the use of reverse repurchase agreements? How much leverage is appropriate?
- A. Again, this is a facts and circumstances issue that will depend on the particular needs of that county or municipality and whether state or local law allow such financing techniques.
- Q. What should be the duration of pooled municipal funds invested by a county like Orange? How do you make that determination?
- A. There is no steadfast rule regarding duration. Nor should there be. The appropriate duration for pooled municipal funds depends on the various needs of the respective tax bases. Is there a near or long term need for the invested funds? Does the municipality have a cash surplus beyond that needed to fund current government operations?
- Q. Under what circumstances would your bank invest in an inverse floater of a GSE? Would you employ a hedging strategy with the asset?
- A. These securities would be deemed high-risk under banking regulatory guidance and, therefore, neither my bank nor any other bank, for that matter, could acquire these securities for investment purposes. Banks can, however, acquire these securities in order to reduce interest rate risk in accordance with safe and sound practices. In addition, institutions with strong capital and earnings and adequate liquidity may acquire these securities for trading purposes. The trading department must, however, have well-developed policies and procedures for handling these high risk securities.
- Q. Since banks invest and deal in municipal securities, risky investment practices of municipalities may ultimately cause losses to banks. Shouldn't banks advocate prudent investment practices of municipalities?
- A. Of course, banks should advocate prudent investment practices for municipalities. However, what is prudent for one municipality, may not be prudent for another. Consequently, we believe that prudence should be defined in terms of investment under the terms set out by state and local legislatures with a view to the needs of the underlying tax base.

- Q. In your testimony, you noted that 4,600 commercial banks owned \$44 billion of structured notes at year-end 1994. These structured notes made up only 4% of the banks' total investment portfolio of \$1.1 trillion. Do you think it strange that it escaped public attention that the Orange County Investment Pool owned \$8 billion of structured notes in a \$20 billion portfolio or 40% as of the end of November?
- A. It is our understanding that the Investment Pool's high concentration of structured notes did not go without notice, at least insofar as the local community was concerned. An election campaign was ongoing and it is our understanding that this issue was raised by the candidate running against the incumbent county treasurer. We would also note that conventional wisdom has it that the investments themselves were not problematic but, rather, the investment strategy. Hopefully, with the advent of the SEC's secondary market disclosure rules, high concentrations of securities and the investment strategies served by these securities will be disclosed to a wider market. Wider and deeper market disclosure should add needed discipline to the process.
- Q. Would you explain the "at this time" qualifier at the end of your testimony on the need for derivatives legislation?
- A. That "at the time" qualifier was used to state that the ABA and ABASA do not currently see the need for federal derivatives legislation. We believe the regulators and the industry itself have behaved quite responsibly in issuing numerous guidelines, standards, principles and practices pertaining to derivative investments and trading. In addition, the SEC has issued secondary market disclosure guidelines. The ABA and ABASA believe that these many significant actions should be allowed time in which to work. Only if these efforts prove insufficient, should the Congress even consider taking further action. The ABA and ABASA's worst fear is that onerous and burdensome legislation will drive this very profitable business offshore.

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