



COUNTY OF SAN MATEO
Inter-Departmental Correspondence

Treasurer Tax Collector

DATE: November 3, 2008

BOARD MEETING DATE: November 4, 2008

SPECIAL NOTICE/HEARING: None

VOTE REQUIRED: None

TO: Honorable Board of Supervisors

FROM: Lee Buffington, Treasurer Tax Collector

SUBJECT: Information regarding the Investment Pool and the Lehman Brothers Investment and Bankruptcy.

At its October 21, 2008 meeting, the Board requested me to attend today's meeting and present information and answer questions regarding the Investment Pool and the recent loss suffered by the Investment Pool as the result of the Lehman Brothers bankruptcy. The Board directed the County Counsel's office to develop questions and submit them to me in advance.

The following are my responses to County Counsel's questions. I submitted this document on November 3, to members of your Board, the Treasury Oversight Committee, and agencies participating in the Investment Pool. I have worked with staff to respond to the questions in as thorough a manner as possible. I will give a short presentation and welcome the opportunity to respond to follow up questions.

I. Investment Pool and the Pooled Fund Investment Policy.

A. Background Information on the Investment Pool and Its Participants.

- 1. Describe the Investment Pool, the three parts of the pool, and the differences between each of the three parts of the pool.*

As set forth in the Investment Policy, the pool is divided into three parts based on the nature of the use of a participant's funds and the

resulting amount of banking activity generated by such funds. Funds deposited for payroll purposes, for example, are placed in "Pool 1" and subject to certain fixed and variable banking costs in addition to the Pool's standard administration fees. Funds which do not generate excessive banking activity are only charged fixed banking costs and administrative fees and are placed in "Pool 2." Finally, funds that only require incidental use of the County banking system are placed in "Pool 3" and are only charged administrative fees.

All funds in the Investment Pool hold the same investments and are therefore subject to the same gains and losses with the exception of the banking and administrative fees and costs that are charged. At present, approximately 9% of total funds reside in "Pool 1," 20% in "Pool 2," and 71% in "Pool 3."

2. *In addition to the County, how many and what type of local agencies participate in the Investment Pool?*

In addition to the County, numerous local agencies participate in the Investment Pool, including 25 school districts and 15 cities, as well as special districts.

3. *Do all of these agencies participate in all three parts of the Investment Pool? If not, why not.*

Not all of the local agencies have funds in each of the three parts of the Investment Pool. The Treasurer determines which "part" of the Pool a fund is placed into and this determination depends on the purpose of such fund and the local agency's banking needs. Some local agencies, such as school districts, have funds from which regular payment obligations such as payroll are made, and, therefore, those funds are placed in "Pool 1." Other local agencies have funds which do not require regular banking services and such funds are therefore placed in "Pool 3."

4. *Does the Treasurer maintain any separate accounts for outside local agencies in addition to the Investment Pool? If so, please explain.*

The Treasurer does not generally maintain accounts for local agencies outside of the Investment Pool. Currently, the Treasurer only has one such account which has been maintained at the request of the Brisbane School District. The Brisbane account has been maintained for approximately 10 years and contains instruments with longer maturity terms than would have otherwise been allowed in the Investment Pool pursuant to state law and the Investment Policy.

B. State Law Authority and Requirements.

1. What is the statutory authority to establish an investment pool?

Each California county maintains a pooled treasury, comprised of funds belonging to the county as well as to school districts, special districts, and other local agencies within the county. Cal. Gov't Code § 27000. Government Code § 27130 further recognizes that "by pooling deposits from local agencies and other participants, county treasuries operate in the public interest when they consolidate banking and investment activities, reduce duplication, achieve economies of scale, and carry out coherent and consolidated investment strategies."

2. What are the primary objectives of investments of the pool as set forth in state law?

Pursuant to state law, the primary objectives in managing public funds, in order of priority, are to: 1) safeguard the principal of the funds; 2) satisfy the liquidity needs of depositors; and 3) achieve a return on the funds. Cal Gov't Code § 27000.5.

3. Does state law limit the types of investments that can be made with funds maintained in the pool? If so, describe the types of allowable investments.

Yes, there are limits. Please see my response to the following question for a description of the allowable instruments.

4. Does state law allow the pool to invest in equities? Are there any other common types of investments that state law does not allow the pool to invest in?

State law places strict limitations on the instruments in which local agencies may invest as well as the concentration of such investments. Cal. Gov't Code §§ 53601, 53601.6, 53601.7, 53601.8, 53635, 53635.2, 53638, and 53684. By way of general description, treasury pool investments are limited, by statute, to conservative instruments such as U.S. Treasury obligations, highly-rated commercial paper, certificates of deposit, and the like. Treasury investment pools are prohibited, by statute, from investing in equities and are not allowed to purchase other instruments, such as "inverse floaters," "range notes," "interest only strips," and any other securities which could result in zero interest accrual if held to maturity.

5. *Does state law limit the percentage of pool funds that can be invested in each type of investment? If so, what are those limits?*

Yes, there are limits. Please see my response to the following question for a description of the limits.

6. *Does state law limit the percentage of pool funds that can be invested with one issuer? If so, what are those limits?*

State law also places restrictions upon a treasury pool's concentration of investments. Such restrictions depend upon the instruments at issue as well as the type of local entity making the purchase. For example, Cal. Gov't Code § 53635, which applies specifically to County pooled funds (as opposed to non-pooled funds held by other local agencies), authorizes county treasury pools to invest up to 10% of fund proceeds into the commercial paper of a single issuer so long as such issuer has a rating of A-1/P-1/F-1. Section 53635 also allows up to 30% of a pool's funds to be invested in "medium term notes," but only 20% of the pool's funds to be invested in mutual funds and money market mutual funds.

C. *The Treasury Oversight Committee and the Pooled Fund Investment Policy.*

1. *Explain the Pooled Fund Investment Policy currently in effect and its components.*

The Pooled Fund Investment Policy sets forth the philosophy of the investing for the fund, the objectives of the fund, the allowable investment instruments, the maturity and average life of pool investments, and specific qualifications of the investments. The Policy sets forth controls relating to investment authority, reporting, auditing, accounting methods, withdrawal requests and other related control matters. Finally, the Policy sets forth the procedures to be followed in executing investment transactions.

2. *What is the membership of the Treasury Oversight Committee? What are the statutory duties and responsibilities of the Treasury Oversight Committee?*

Government Code § 27131(a) provides that the Board of Supervisors, in consultation with the Treasurer, determines the size of the committee, which shall consist of 3 to 11 members selected from the list of categories set forth in the statute. Within these parameters, our Treasury Oversight Committee has eight members, with such members selected from the following allowable categories: the

Treasurer, a representative appointed by the Board of Supervisors, the County Superintendent of schools or her designee, four members nominated by the Treasurer and confirmed by the Board of Supervisors, and one member selected by the Presidents of the various school boards.

Government Code §§ 27130 and 27131 provide for the formation of a Treasury Oversight Committee in order to: 1) insure participation by local agencies in the review of investment policies; 2) involve participating local agencies in the management of their funds; and 3) enhance the security and investment return on their funds by establishing criteria for the withdrawal of funds. The Treasury Oversight Committee reviews and monitors the investment policy. The Committee also causes an annual audit to be conducted to determine the Treasury's compliance with certain statutes. This audit may include issues relating to the structure of the investment portfolio and risk. Pursuant to statute, the Treasury Oversight Committee does not direct individual investment decisions, select individual investment advisors, brokers, or dealers, or impinge on the day-to-day operations of the treasury.

3. *Explain the role of the Treasury Oversight Committee with regard to the management and oversight of the Investment Pool and monitoring of investment decisions.*

Pursuant to the Investment Policy, the responsibility for making investments resides with the Treasurer who supervises the investment program within the guidelines of the Policy and state law. The Treasury Oversight Committee meets quarterly to evaluate general strategies and to monitor results and discuss the economic outlook, portfolio diversification, maturity structure and potential risks to the funds.

The Treasury Oversight Committee causes an annual audit to be conducted of the portfolios, procedures, reports and operations related to the Investment Pool.

4. *Under what statutory authority is the Investment Policy developed and adopted? Describe the process used, including the roles of the Treasurer, Treasury Oversight Committee and Board of Supervisors, in developing the Investment Policy.*

The Investment Policy is developed and adopted pursuant to Government Code Section 27133. In accordance with Section 27133, the Treasurer annually prepares the policy which is reviewed by the Treasury Oversight Committee. The annual Investment Policy is then

approved by Board of Supervisors. All amendments to the Policy must be approved by the Board of Supervisors.

5. *List the investment objectives set forth in the policy. Are these investment objectives consistent with state law?*

The investment objectives in the Policy are consistent with state law and can be summarized as follows:

Safety

Preservation of principal is of primary importance. The objective is to minimize credit risk while recognizing and controlling market risk.

Liquidity

The pool attempts to match maturities with capital expenditures and other planned outlays.

Yield

The County pool is designed as an income fund to maximize the return on investible funds over various market cycles, consistent with limiting risk and prudent investment principles. Yield will be considered only after the basic requirements of safety and credit quality have been met.

In addition to these investment objectives, the policy set forth the following two general objectives:

Leverage

The Treasurer shall not leverage the County pool through any borrowing collateralized or otherwise secured by cash or securities held unless authorized by this investment policy.

Public Trust

In managing the investment portfolio, the Treasurer shall exercise a degree of professionalism that will sustain public confidence in the County and pool participants, remembering that both investment instruments and the method of transacting investment business are subject to public scrutiny. The perception of safety and professionalism is as important as the reality of these concepts. To further public trust, the investment officer is prohibited from doing personal business with brokers that do business with the County.

6. *What types of investment instruments are allowed under the policy? Are these consistent with state law? Are they consistent with the investment objectives of the pool?*

Subject to the limitations set forth in Government Code §§ 53600 *et seq.*, the Treasurer may invest in the instruments listed in the chart below, subject to the limits of flexibility described in the Policy.

INSTRUMENT	RATING	LIMITATIONS		
		% of Fund	% of Fund per Issuer	Maturity
U.S. Treasury Obligations		100	100	15 years
Obligations of U.S. Agencies or government sponsored enterprises		100	100	15 years
Bankers Acceptances *Domestic: (\$500 million minimum assets) *Foreign: (\$500 million minimum assets)	A1 / P1/ F1	15 15	10 10	180 days 180 days
Collateralized time deposits within the state of CALIFORNIA		30	10	1 year
Negotiable certificates of deposit		30	10	5 years
*Commercial paper/Floating rate notes	A1 / P1/ F1	40	10	270 days or less
Repurchase agreements secured by U.S. Treasury or agency obligation (102% collateral)		100	50	1 year
Reverse Repurchase agreements		20	20	92 days
Corporate bonds and medium term notes including asset-backed bonds (two agencies)	A	30	10	5 years
Local Agency Investment Fund (LAIF)			Up to the current state limit	
Shares of beneficial interest issued by diversified management companies as defined in Government Code section 53601		10	5	
Mortgage Backed Securities/CMO's: No Inverse Floaters No Range Notes No Interest only strips derived from a pool of Mortgages	A	20	5	5 years

7. Does the policy limit the pool's purchase of any particular types of investments? If so, are these limits consistent with state law?

As reflected in the chart above, the Policy limits the percentage of the fund that can be invested in all of the above listed investment instruments except for U.S. Treasury Obligations, obligations of U.S. Agencies or government sponsored enterprises, and the repurchase agreements secured by the United States for which there is no stated limit. The percentage allocations set forth in the Investment Policy are consistent with state law.

8. *Does the policy limit investments with a single issuer, and are these limits consistent with state law?*

As reflected in the chart above, the Policy limits the percentage of funds per issuer for each of the above listed investment instruments. These limits range from 5% to 50% depending upon the issuer and type of investment and, in some instances, such as with U.S. Treasury Obligations, state law does not impose a limit. The percentage limits set forth in the above chart are consistent with state law.

9. *Does the policy include any provisions for the removal of funds from the pool by a participating agency? If so, please describe the provisions, and the reasons for the provisions.*

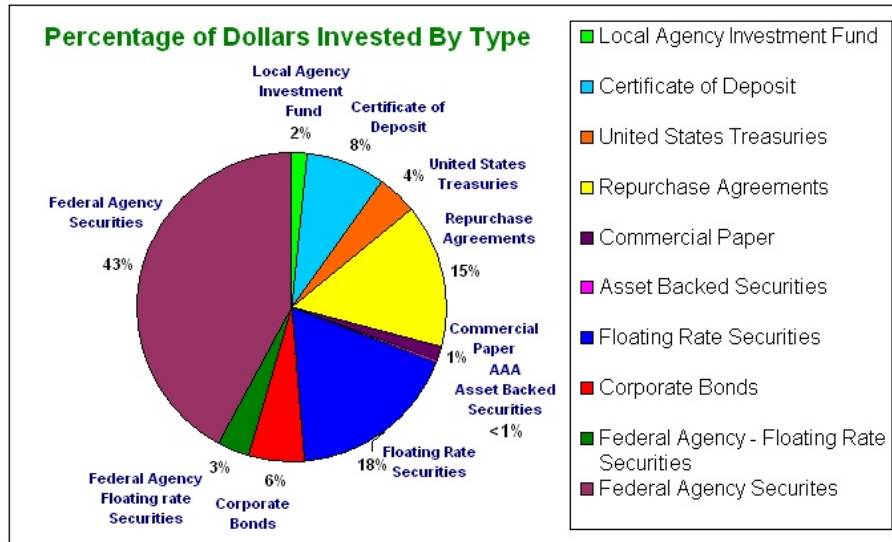
Government Code sections 27133(h) and 27136 require that each local agency seeking to withdraw funds from a county treasury pool first submit such request in writing to the county treasurer. The statutes further require that each county's investment policy set forth criteria for participant withdrawals and that the treasury evaluate any such request in accordance with the policy. Our Investment Policy provides that funds deposited in the Pool may be withdrawn at the maximum rate of 20% of the principal balance per month, exclusive of apportionment, payroll and day-to-day operations, unless specifically authorized by the Treasurer. The rationale for the 20% cap on withdrawals is to avoid the need to prematurely liquidate assets to fund unanticipated large withdrawals, thus protecting the remaining Pool participants.

The policy further provides that the Treasurer will honor all requests to withdraw funds for normal cash flow purposes. Any request to withdraw funds for purposes other than cash flow such as for external investing shall be subject to the consent of the Treasurer. These requests are subject to the Treasurer's consideration of the stability, liquidity and predictability of the pooled investment fund, or the adverse effect on the interests of the other depositors in the pooled investment fund.

D. *Investment Decisions.*

1. *Describe the current allocation of the pool investments by type of investment instrument and by issuer.*

The Investment Pool's current allocation of assets is set forth below:



Information concerning pool investment allocation by issuer is reflected in the Pool's standard monthly report. The Pool's September 2008 Monthly Report is attached as **Attachment 1**. It should be noted that state law does not limit the amount of pool assets which may be invested in federal agency securities and the Investment Policy allows up to 100% of the Pool's assets to be invested in these instruments. The Pool's current investment in federal agency securities reflects the conservative nature of such investments.

2. *How does your office insure that investments are made in accordance with the investment policy and state law?*

Our office determines if the security is one of the instruments listed in the Investment Policy. We also check the ratings of the institutions offering the instruments from ratings agencies such as Standard & Poor's, Moody's, and Fitch. We then determine whether adding this type of investment to the portfolio furthers our investment objectives as set forth in the Policy.

3. *Is the preservation of principal the primary basis for investment decisions?*

Yes, preservation of principal is the primary basis for investment decisions. One of the chief ways of protecting principal is adhering to the statutory limitations relating to the types of investment instruments that may be purchased. These instruments are historically safer investments for the purposes of preserving principal than unauthorized investments, such as equities. It is important to note that the fiscal objectives of the Investment Pool also include the maintenance of a

margin of liquidity in order to meet anticipated as well as unanticipated expenses.

4. *Does your office take into consideration the cash needs of the pool participants? How does the pool participants' long term and short term need for funds affect investment decisions?*

Satisfaction of the Pool's on-going objectives is affected by the fact that, notwithstanding the need to provide for payments to participants throughout the year, there are only three time periods during the year when the Pool receives more tax money than it pays out. These operational concerns, as well as the requirements set forth in state law and the Investment Policy, impact the type and amount of investments that my office purchases for the Pool. For example, in light of the above, the Pool purchases instruments with the intent of holding such investments until their scheduled maturity dates or to benefit from the income of the instruments, as opposed to timing such purchases and sales for maximum profit.

5. *Describe the process used to make investment decisions and who makes the decisions. What information is considered before an investment decision is made? Is there anyone outside of the Treasurer's Office with whom your office discusses its investment decisions?*

Our office insures that the investment meets the Government Code, the Investment Policy and rating requirements. Then we evaluate our liquidity needs, the market overview, and examine whether the security is competitive with other like securities and whether it fits our portfolio.

E. *Monitoring of Investments.*

1. *Describe the process for monitoring pool investments. What are the steps? Who monitors them? What is the process for determining whether to sell or retain investments?*

Our monitoring process has several aspects: All securities are automatically brought to current market prices daily and significant price swings are identified. We monitor the ratings from Standard & Poor's, Moody's, and Fitch as well as our financial information reporting services, such as Bloomberg's and TradeWeb, for new information. We consult with economists Keitaro Matsuda, Michael Bazdarich, and Peter Struck twice a year, and we watch the price comparison between like securities. Although we purchase securities with the intent and capacity to hold them to maturity, we continuously monitor our portfolio for subsequent changes in percentages resulting

from non-purchase activity or changes in credit rating of our existing securities.

2. *What factors are considered before deciding to sell an investment prior to its maturity date? Do these factors differ from the factors considered for the initial purchase of an investment? If so, why do they differ and how do they differ?*

There are two main reasons why we would sell an instrument before its maturity date: either the fund needs to liquidate an asset to meet the cash needs of the participants or there is an instrument that we have determined is better than the instrument presently in the portfolio. I am assuming that your question is directed to the latter of these two reasons. If we are selling one asset to purchase another, we analyze the "opportunity cost" of such a transaction. In other words, we determine what it will cost the portfolio to sell prior to maturity date and what will be gained by purchasing the new asset at that time, rather than waiting until the existing investment matures. If we feel as though the potential new asset would be a better asset due to its features such as yield, then we would sell the existing asset prior to maturity to make the purchase.

F. *Returns on Pool Investments.*

1. *For each of the three parts of the Investment Pool, list the average gross returns, over the last 10 years, 5 years, 3 years and 1 year.*

The Pool's average gross return for the last 10 years is 4.36%. The average gross return on investment for the last 5 years is 3.68%. The average gross return on investment for the last 3 years is 4.14%, and the average gross return on investment for the last year is 4.31%. Annual gross returns for the last 10 years are set forth on the chart attached as **Attachment 2**.

2. *What is the Local Agency Investment Fund? How do the returns of the Investment Pool compare with Local Agency Investment Fund?*

The Local Agency Investment Fund is a voluntary program created by statute in 1977 as an investment alternative for California's local governments and special districts. The Fund is administered by the State Treasurer. Agencies such as the County are limited in the amount that they can invest in the Fund.

Attachment 2 also sets forth annual gross returns of the Investment Pool as compared to the Local Agency Investment Fund for the last 10 years.

II. Purchase of Lehman Brothers Instruments Held at the time Bankruptcy.

A. Detailed Description of the Lehman Brothers Investment Instruments.

1. *How many specific Lehman investment instruments were held in the Investment Pool at the time that Lehman declared bankruptcy?*

The Lehman Brothers investments held by the Investment Pool at the time of the bankruptcy are set forth in **Attachment 3**.

2. *For each of the Lehman instruments:*
 - *List the date of purchase.*
 - *The amount of the investment.*
 - *The maturity date.*
 - *Describe the type of investment instrument and which category it fell under pursuant to the Investment Policy.*
 - *Describe how each investment instrument worked, i.e., at what intervals interest was earned, and how it was calculated?*

As set forth on **Attachment 3**, at the time of the bankruptcy filing, the Pool held seven “floating rate” securities and one corporate bond. The chart also sets forth the amount of each investment and each instrument’s maturity date, as well as other relevant information. The chart also sets forth the floating rate notes’ reset dates in light of the Investment Policy which provides that corporate floating rate notes are analyzed/run to their reset date rather than final maturity date. The floating rate securities pay out each quarter and are based on the London Interbank Offered Rate (LIBOR) which made them attractive investments because the U.S. dollar was dropping in value against all other currencies. The corporate note paid out semi-annually.

B. Decision to make the purchase.

1. *What was the process for determining to buy each of these Lehman investment instruments?*

Please see my response to Question B.2.

2. *Describe the process used to verify that each purchase would be in conformance with the criteria set forth in the Investment Policy.*

Our office first determines whether it is authorized to purchase the security pursuant to the Government Code and the Investment Policy based on the type of investment at issue, its maturity date, and its rating. If it is determined that state law and the Policy allow the Pool to purchase the instrument, we then evaluate the strength of the instrument and our portfolio needs as well as general market conditions based on our market research.

- 3. Was the process used to determine to purchase the Lehman instruments the same as the process used in determining to purchase other investments? If not, in what way did the process differ?*

The process was the same as other securities except that with respect to our purchase of Lehman securities, our analysis took into account the London Interbank Offered Rate (LIBOR) in comparison to U.S. rates.

- 4. What was your specific role in the decision to purchase the Lehman instruments?*

I was involved in the decision to purchase each of the Lehman Brothers instruments.

- 5. What factors were considered in deciding to purchase the Lehman instruments?*

Although the Lehman instruments were purchased over several years, in each case the process was the same. For each instrument, the following factors were considered: the purchase of the instrument satisfied state law requirements; the purchase of the instrument satisfied the requirements of the Investment Policy; verification that the rating of the financial institution met statutory and Investment Policy requirements; and the terms of the instrument satisfied the liquidity and allocation needs of the Pool. With respect to the Lehman investments specifically, we compared available like instruments and the LIBOR vs. U.S. rates were compared. Finally, we reviewed the general market conditions and economic forecasts.

- 6. What analysis was done in regards to the amount of each Lehman investment to be purchased?*

In addition to the foregoing, we also evaluated the size of each investment, the Investment Policy requirements, the needs of the pool, pricing, and yield.

7. *What information was used in making such decisions?*

We utilize a real time Bloomberg terminal which provides us with access to the Bloomberg Professional service through which our office can monitor and analyze real-time financial market data movements and monitor news and price quotes. We also review other financial and news publications such as the Wall Street Journal, Barons, and the New York Times, as well as financial news broadcasts. Since we purchase investments directly from primary dealers, including Lehman Brothers, we also have access to the primary dealers' bond traders and economists.

8. *What was the role of the rating agencies in your review of the soundness of each of the Lehman instruments?*

As with our other investments, the ratings issued by various ratings agencies provide a starting point for determining whether the Pool is authorized by statute and the Investment Policy to purchase the instrument. Following an instrument's purchase, we continue to follow financial institution ratings in order to take into account any ratings changes. Because such ratings changes often lag behind market conditions, however, we place primary importance on current market research.

C. *Diversification and the Lehman Brothers Purchase.*

1. *When making investment decisions, is diversification by sector (i.e., financial, transportation, energy, manufacturing, etc.) a consideration?*

We always consider sector diversification in the decision to purchase instruments that we are authorized to invest in. However, we are faced with certain market constraints that limit our ability to achieve broad diversification. Unlike banks, brokerages and finance companies, other sector companies do not go to market with offerings as frequently, thus making the timing of these purchases difficult. It is also difficult to find and procure non finance investment instruments that meet statutory and Policy requirements, have the appropriate term and pay well.

2. *Was there a review of the impact of the Lehman investment on the Pool's diversification by sector?*

We reviewed the impact of the Lehman investments on the Pool's diversification by sector at the time of each Lehman purchase.

3. *Have there been other instances when there has been a similarly significant investment with one investment bank?*

The Pool currently holds Morgan Stanley investments which comprise approximately 4.3% of the Pool. There have been other instances during the last 23 years where the Pool has made other significant investments in a single issuer in accordance with state law, the Investment Policy, and the Pool's portfolio needs. There were no negative impacts on the Pool as a result of such investments.

4. *At the time each of the subject Lehman investments was purchased, did the total of all similar investments fall within the parameters set forth in the investment policy for that type of investment and did it fall within the policy parameters at all times thereafter?*

As set forth earlier, at the time of purchase our practice is to make sure any new purchase meets state law and the Investment Policy requirements regarding the allocation of the Pool by instrument category and issuer. Subsequent changes in percentages resulting from non-purchase activity, such as the influx of tax moneys, are taken into account when making future investment decisions.

5. *At the time each of the subject Lehman investments was purchased, did the total of all similar investments fall within the per-issuer limits set forth in the investment policy and did it fall within per-issuer limits at all times thereafter?*

Yes, we verified that each of the subject Lehman instruments were in compliance at the time of each purchase and thereafter.

III. Monitoring the Lehman Brothers Instruments After Purchase.

1. *After each Lehman investment vehicle was purchased, what was the process for reviewing the investment to ensure it remained a sound investment and who was responsible for conducting that review?*

Please see my response to Question III.3 below.

2. *Describe what your office did in regards to monitoring the Lehman Brothers investment from the date of purchase to the date Lehman Brothers declared bankruptcy.*

Please see my response to Question III.3 below.

3. *Was the process used in reviewing the Lehman investments the same as the process used in reviewing other investments?*

Our monitoring process has several aspects. All securities are automatically marked to market daily as opposed to the price at purchase. We identify significant daily price swings and monitor the price comparison between like securities. We monitor the rating agencies and subscribe to reporting services. We also confer with economists Keitaro Matsuda, Michael Bazdarich, and Peter Struck twice a year.

The Lehman purchases were made over a four year time period. At the time of initial purchase of each of the investments, Lehman Brothers instruments were considered conservative and secure investments.

Our attention and monitoring were heightened by a series of significant events in the months leading up to Lehman's declaration of bankruptcy. For example, in January 2008, Bank of America announced its takeover of Countrywide. This was followed by the bailout and takeover of Bear Stearns by J.P. Morgan in March 2008. We, like other observers of the market, were of the opinion that such takeovers and other consolidation in the financial industry would likely continue. We further noted that the events related to Countrywide and Bear Stearns, in which noteholders were made whole, led many observers to conclude that Lehman was unlikely to declare bankruptcy.

Immediately prior to the bankruptcy, we followed Lehman's negotiations with the Korean Development Bank regarding a possible takeover. We were aware that the Korean Development Bank, Bank of America and Barclays Bank were identified as potential suitors for Lehman. Additionally, many observers also thought that Federal assistance for Lehman would be forthcoming. All of above factors led us to believe that Lehman note holders would be made whole.

As the Board is aware, Lehman's declaration that it would file for bankruptcy on Sunday, September 14, 2008, and subsequent filing, was unprecedented and sudden. Up until 10:00 p.m. on Friday, September 12, 2008, we, like other investors, thought that Bank of America was intending to purchase Lehman Brothers. However, there was a sudden turn of events due to Merrill Lynch's last minute offer to Bank of America. On Sunday, after Barclays announced that they had stepped away from the acquisition and the Lehman sale to Bank of America failed to materialize, Treasury Secretary Paulson refused to offer Lehman Brothers the same guarantees that had been provided to Countrywide and Bear Stearns. During this entire time period, my staff was conferring with the representatives from various brokerage houses such as Morgan Stanley and Merrill Lynch, as well as Lehman Brothers.

4. *What was your role in reviewing the on-going soundness of the Lehman investments?*

I was involved in all of the monitoring activities described above.

5. *What was the role of the rating agencies in the review of the soundness of each of the Lehman investments? How often were rating agency ratings reviewed?*

Historically, in monitoring the ongoing soundness of our investments, we receive continuous updated information regarding ratings changes. While ratings were one of the factors used in our on-going evaluation of Lehman Brothers, we placed greater weight on our market research due to the fact that ratings changes can often lag behind current market conditions.

6. *How did the sale of Bear Stearns in March 2008 factor into your office's evaluation of the soundness of the Lehman investments and/or the retention of the investments, if at all?*

Please see my response to Question III.3 above.

7. *At any time before the Lehman bankruptcy, was consideration given to selling any of the Lehman investment instruments? If so, describe the circumstances behind that consideration, including when such consideration was given, the circumstances that led to the consideration, who was involved in that consideration, and why a decision was made not to sell.*

Selling any or all of the Lehman instruments was one of the options that we continually considered. Up to and including Friday September 12th, our evaluation of the situation, which included the factors detailed in my answer to Question III.3 above, led me and my staff to conclude that it would be more beneficial for the Pool to hold the securities as opposed to selling at a definite loss.

8. *For each of the types of Lehman instruments, describe the effect of selling the instruments before their maturity date.*

Selling any instruments, including the Lehman instruments, prior to their maturity dates would have a direct, negative impact on Pool earnings which would affect all Pool participants. The magnitude of any such earnings losses would depend on both market conditions as well as the time remaining until the instruments' maturity.

9. *Was the Treasury Oversight Committee advised of concerns with the Lehman investments at its meeting prior to the bankruptcy? If so, what were they told?*

Our office's evaluation of the Lehman investments was discussed at the Treasury Oversight Committee's July 2008 meeting at which time the Assistant Treasurer advised that Lehman Brothers' rating had been downgraded from "A1" to "A2" but remained at investment grade. The Assistant Treasurer informed the committee that our office remained confident in Lehman Brothers. He also informed the committee that the Pool continued to purchase Lehman Brothers' overnight commercial paper as well as entered into repurchase agreements with Lehman. The committee was informed that the Pool owned numerous financial securities from Morgan Stanley, Lehman Brothers, Union Bank, and Wells Fargo, and that our office remained confident in these investments but would closely monitor Lehman Brothers. The Assistant Treasurer further noted that there was a high probability that Lehman Brothers would be purchased by an investment bank such as Barclay's. Following the July 21, 2008, meeting, the Treasury Oversight Committee also received monthly portfolio reports for July 2008 and August 2008 which set forth the cost basis for the Lehman investments as well as their then-current market price.

10. *What other public entities are you aware of that had investments in Lehman Brothers at the time of the bankruptcy?*

Monterey was the first other county that I was aware of to announce that it had Lehman exposure. Since that announcement, a number of other counties have joined the group including: Sacramento, Alameda, Madera, Tuolumne, San Diego and others. Approximately twenty California cities have also indicated that they had Lehman exposure.

IV. Calculation of and Accounting for the Lehman Brothers Investment Loss.

1. *Describe how gains and losses have been historically distributed among participants in the Pool.*

For at least the past twenty years, gains and losses have been attributed to each depositor based on their average daily pool balance as reported by the County's Controller and are attributed to the fund balance of each depositor on a quarterly basis.

2. *Is this consistent with the Investment Policy?*

Yes. The policy mandates that losses "shall be allocated as otherwise described in this investment policy." The policy provides that gains or losses

from investment sales be credited or charged to investment income at the time of sale. The policy further provides that gains and losses are to be proportionately allocated to each depositor and each depositor is given credit for accrued interest earnings and capital gains each quarter based on their average daily pool balance as reported by the County Controller. Finally, the Policy provides that gains or losses will be attributed to the fund balance of each depositor quarterly.

3. *Describe how the loss was calculated as a result of the Lehman bankruptcy. Who was involved in decisions regarding how to calculate such loss, what other alternatives were considered, and why a decision was made to write down the loss as a total loss.*

The Lehman loss occurred in the quarter ending September 30, 2008. During this quarter the Pool also made some earnings. My office distributed the gross earnings proportionately to each participant and then deducted the proportionate rata share of the loss to each participant. The net effect of these transactions was a loss of 4.7% against each participant based on their average daily balance for the quarter.

I considered several factors before making my decision to write down the loss as a total loss. First, if the Treasurer's office continued to recognize a value in the Lehman investment, we would have to continue to include it in the portfolio. If we continued to include it in the portfolio, it would have diluted all future earnings because it would have been a non-performing asset, *i.e.* earning zero. Another factor was the potential negative effect that continuing to recognize a value in the Lehman investment would have upon Pool participant's ratings for future bond sales. Finally, a failure to write down the loss during the quarter would expose Pool participants to the risk that other participants would withdraw significant funds from the Pool prior to the complete recognition of the loss.

V. Actions Taken by the Treasurer's Office Following The Lehman Brothers Bankruptcy.

1. *Describe the steps that your office has taken in regards to reevaluating the pool's investments in investment banks in light of the Lehman bankruptcy and other market and financial events.*

Consistent with our past practice, we are continuing to evaluate each of the Pool's investments on a daily basis in light of current market conditions. The only other significant exposure the pool has to investment banks is the investment in Morgan Stanley, which, in September, we reduced from \$160 million to \$105 million. The Morgan Stanley investment is approximately 4.3% of the Pool's portfolio. On September 21, 2008, the federal government

allowed Morgan Stanley to become a bank, allowing it to take in deposits thus building capital. This action dramatically changed the basic structure of the company. On October 14, Mitsubishi purchased a 20% interest in Morgan Stanley and the U.S. Treasury Department purchased \$10 billion in Morgan Stanley preferred stock. Morgan Stanley's present long term ratings continue to be "Investment grade" ratings in accordance with the Government Code and its short term ratings remain investment grade as well.

With respect to the Pool's bank holdings, the Pool currently holds investments in strong A rated California Bank (owned by Mitsubishi Bank), Union Bank of California, Sun Trust and PNC all of which are large AA rated financial institutions. We are not adding any financial sector investments to the fund with the exception of the highest rated commercial paper and Certificates of Deposits. This office will continue to evaluate each of its investments in light of any developments which may occur.

- 2. Describe the steps that your office has taken to address any potential problems in the portfolio which might present a risk of additional losses.*

Since the Lehman bankruptcy, our office has taken a number of steps to reduce our risk consistent with the Policy's guidelines and state law. First, we have instituted an internal operational investment limit of 5% per issuer pending consideration of changes to the County Investment Policy. This percentage decrease will ensure a broader diversification than the 10% set forth in the Policy. Finally, as an on-going process, I continue to work with my staff to determine additional steps that can be taken to address any potential problems in the portfolio.

- 3. What factors should be considered in determining whether to establish lower limits on the amount of total pool funds that can be invested in a particular investment vehicle as well as the amount of pool funds that can be invested with a particular issuer?*

In the current financial market, the number of firms that meet the investment policy criteria is greatly reduced and getting smaller every day. Consequently, there are fewer firms with which we can choose to invest. Lowering the limits on investment vehicles and issuers means that we would need more vehicles and more vendors to meet our portfolio requirements. While there is implied safety in greater diversity there is also the added risk of having to relax our standards to include more issuers and a greater variety of instruments to remain fully invested and profitable.

- 4. Describe the efforts that are being undertaken in regards to recovering of pool assets from the bankruptcy, through the federal rescue legislation or other avenues?*

Within days of the Lehman bankruptcy, we were in contact with officials from Monterey County because its treasury pool also held Lehman Instruments. Like our Board, the Monterey County Board of Supervisors determined to hire the Nixon Peabody law firm in New York to handle the bankruptcy claims.

In addition to the officials from Monterey County, I had discussions with the finance director from the City of Costa Mesa. We discussed the Lehman loss and began to contact other local agencies that suffered similar losses as a result of Lehman's collapse. We contacted Congresswoman Anna Eshoo advising her of our situation and asking for assistance. The County Counsel's office is overseeing the legal aspects of the Lehman loss. The Congressional efforts have been very capably taken over by Deputy County Manager Mary McMillan, who also coordinates the weekly telephone conference between California public agencies that suffered a Lehman investment loss. Finally, this Board, on behalf of the Pool participants, has determined to commence litigation against the officers and directors of Lehman brothers.

VI. Treasurer's Office's On-Going Reporting and Providing Of Information to Pool Participants.

1. *Describe the nature and frequency of your office's reports to the pool participants relating to the investment policy and the returns from the investments.*

The Policy provides that the Treasurer will prepare a monthly report for the County pool participants and members of the County Treasury Oversight Committee stating the type of investment, name of the issuer, maturity date, par and dollar amount of the investment. For the total pooled investment fund, the report will list average maturity and the market value. In addition, the Treasurer shall prepare a quarterly cash flow report which sets forth projections for revenue inflows, and interest earnings as compared to the projections for the operating and capital outflows of depositors. This projection shall be for at least the succeeding 12 months.

The Treasurer's office has a permanent mailing list of 76 individual pool participants to whom we e-mail monthly reports which consist of the earnings report, year end GASB information, fixed income distribution, the portfolio, gains and losses analysis, the transaction summary, a comparison of our projected expenditures for the month vs. the actual expenditures, a twelve month cash flow forecast, a comparison of our results vs. LAIF, and a copy of the current yield curve. In addition, there are ten other pool participants who get hard copies of the reports. If we receive any inquiries from the public or other pool participants, they also receive e-mail copies of the reports. By tradition all copies of materials to the schools are sent to the County

Superintendent of Schools for them to distribute. All of this information is also now available on our web site.

Finally, as set forth above, the Treasury Oversight Committee, which reviews and advises the Treasurer on performance and investment decisions meets quarterly. The appointees to this Committee are representatives of the major participants in the Pool, including representatives of School Boards and the County Office of Education. Minutes of these are available to pool participants and the public generally.

2. *Can more or different types of information be made available in such reports?*

Given the large number of Pool participants, it would be problematic to try to meet differing expectations with regard to provisions of information. In addition, it would be difficult to make any changes in our current reporting software. We are, however, always open to suggestions. If our office currently can not give the requested information, we will keep the request in mind while we work on the next version of our software.

3. *Can the reports be made available online?*

Commencing last month, our office now posts all Pool reports on our website.

cc: John L. Maltbie, County Manager
David Boesch, Assistant County Manager