CS FIRST BOSTON

Memorandum

To: Interested Parties

From: CS First Boston

Date: February 1, 1995

Subject: State Response to the Orange County Financial Crisis

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On December 6, 1994, the County of Orange filed a petition for Chapter 9 bankruptcy to protect itself from creditors. The filing was prompted by investment losses in the County Treasurer's Pool, which at the time were estimated at $2 billion.

On December 7, CS First Boston representatives met with representatives of the State Treasurer's Office, the Department of Finance and the California Senate. Our message was that, without State action, the bankruptcy filing would have widespread and negative implications far beyond Orange County. The loss of investor confidence in the County would translate into a loss of confidence in nearly all municipal credits in the State and would also affect the State's ability to borrow. The State's response -- or lack of response -- to the bankruptcy would send a message to other local governments and the investment community about whether the fiscal irresponsibility that got Orange County into trouble would be permitted to continue as the County attempts to solve its problems.

The County has professed a desire to avoid a State "bailout". Likewise, the State has expressed a preference not to intercede to help the County with its losses. In overview, a bailout would not be the appropriate remedy. Nonetheless, as we have watched the County's response to its investment losses, we believe ever more strongly that prompt action by the State is needed.

We are not alone in that belief. The *Los Angeles Times* has supported the concept of State intervention in its editorials. There is growing realization of the need in Sacramento. And even Orange County has not approached the State requesting relief from mandates and other State assistance.

The Orange County bankruptcy cannot be allowed to undermine California's own fiscal well being. Businesses locate and expand here because government has played a strong role in providing public infrastructure and an educated workforce. Residents enjoy a high quality of life combined with a low tax environment. Local government has learned fiscal discipline without compromising the services it provides to constituents. And investors -- both in public companies as well as municipal bonds -- rely on the State to continue to maintain a well-run system of government that meets the needs of its citizens and its financial obligations. With the need for State intervention becoming clearer every day, the State must develop a plan that holds Orange County accountable for its problems, enables it to work its way out of its crisis, and minimizes the negative impact of the bankruptcy on others in the State.

Orange County's Ability to Solve Its Own Problems

The Magnitude of the Problem

A fundamental question yet to be resolved is how the Pool's losses will be allocated. While the County maintains that the losses should be shared on a *pro rata* basis by all pool participants, Pool participants contend that the County should make all other investors whole on their investments. The bankruptcy work-out plan being prepared by the County, which is expected to be presented in early to mid-February, will most likely lean toward the County's position of a shared loss.

Even assuming this best case from the County's perspective, the County will still be required to make draconian changes to its budget by cutting services or raising revenues. Furthermore, the County may need to restructure its outstanding debt, extend its outstanding short-term notes, or issue new debt to bond its way out of its problem by spreading the budgetary pain over a number of years.

The County's ability to institute cuts which alone are deep enough to solve its current and future year budgetary short-falls is debatable. Progress has been slow. Layoffs already made by the County are currently being reviewed by the bankruptcy court in response to union complaints concerning the selection of employees to be terminated. And the County has been adamant in rejecting tax increases to solve the problem.

So what are the alternatives? County representatives have intimated that one possible solution is to forego or delay payment on its debt. For a number of reasons, the State should not allow this to happen. As described in more detail below, the State and its local governments have borrowed billions of dollars. If the State stands by and lets the County avoid responsibility for its mistakes by not paying investors, the future costs to all Californians will be enormous.

County representatives have also asked for relief from State mandates. The implications of granting relief to Orange County will go beyond the County's present situation and may serve as precedents for future local government crises. The State must weigh these factors in its decision concerning mandate relief as part of the County's solution.

A Capital Market Solution

Thus, a solution provided by the capital markets is the only responsible way for the County to address its problems and for the State to assist the County while isolating the rest of the State from any negative fallout. Short and long-term borrowing to spread the loss over multiple years is essential to any recovery.

The County's ability to access the market is therefore an essential cornerstone of the recovery plan. Yet the County's inability to respond quickly with a reorganization plan has seriously eroded investor confidence in the County's ability to manage itself through the crisis. Recently, the County compounded the problem with statements to the municipal market intimating a restructuring or possible repudiation of debt. Those statements sent shock waves through the California short-term municipal market. Last week alone, while interest rates generally were dropping, California tax-exempt short-term rates increased .75 to 1.00 percentage point. At this point, the County's ability to access the capital markets is severely curtailed or non-existent.

Before describing how the State could assist the County in accessing the capital markets, it is important to understand the damage its bankruptcy has done to the cost of borrowing for California governments and the asset value of California investors.

Increased Cost of Borrowing

Since December 6, the customary trading advantage which California issuers have enjoyed relative to the national municipal market has eroded and actually crossed over such that California issuers now borrow at rates *higher* than the general market. This is the case in both short and long-term markets.

The flight from the California short term market resulted in an 18 basis point deterioration in the relationship between California variable rate securities and the benchmark Public Securities Association ("PSA") variable rate index. This results in additional borrowing cost on an annualized basis of **$28 million** on approximately $15.5 billion of currently outstanding California floating rate debt.

In addition, the 18 basis point yield penalty may result in an additional **$3.3 million** in debt service costs on floating rate securities to be issued in 1995, assuming issuance remains constant at 1994's level of $1.825 billion.

Assuming a general market increase in yield of 20 basis points, California issuers may be required to pay approximately $79 million of additional debt service per year on fixed-rate notes and bonds to be issued in 1995, assuming that issuance remains constant at 1994's level of $39.23 billion. Assuming a 10 year average life for California fixed-rate debt, the present value of this additional debt service is over **$582 million**.

This increased cost translates directly into higher costs for taxpayers and the need to raise revenues or eliminate services to meet the higher debt service costs. With respect to new long-term bonds, these higher costs will be locked in and payable for many years to come.

Because of the publicity surrounding the short-term notes issued by the County and several school districts, the borrowing costs for such transactions are under particular pressure. This will prove especially troublesome for the State and other entities which must access the short-term note market in the next several months to meet on-going cash flow requirements.

As indicated earlier, the intimations from the County that debt may be repudiated or repayment deferred have had a tremendous negative impact on the short-term note market. Even outstanding variable rate issues supported by liquidity lines from commercial banks are increasingly difficult to remarket. Investors in California paper are no longer satisfied to have issues backed by liquidity lines of credit which leave banks with potential ways to break the agreement should the issuer's credit deteriorate. Investors are now demanding more costly *letters* of credit which provide the *unqualified* support of the bank.

Evaporation of Investors' Asset Value

Most bonds issued by California or its municipalities are owned either by individuals or by institutions (such as mutual funds) that pass on the benefits of tax-exemption to individuals. Because California residents who own California tax-exempt bonds are able to exclude interest income both from their federal and state income taxes, most California municipal bonds are owned, directly or indirectly, by California residents. In the wake of the Orange County bankruptcy, the value of California bonds declined relative to municipal bonds from other states.

California Tax-Exempt Funds - Nearly $710 million has been redeemed from California money market funds, or 4.6% of net asset value. At the same time, national money market funds received *inflows* of 3.5%.

$1.1 billion has been redeemed from California long term funds, or 3.2% of net asset value. This rate of redemptions is 80% higher than redemptions from national long term bond funds. Approximately **$514 million** of California bond fund redemptions are attributable to the Orange County filing.

Since December 6, California bond funds have appreciated in value by approximately $640 million, or 1.83%. At the same time, however, national long-term bond funds have appreciated in value by nearly 3.00%. Over **$400 million** of potential market appreciation, representing 1.15% of the outstanding par amount of bonds, may have been lost as the California bond funds under performed the general market.

Tax-Exempt Secondary Market - Less liquid securities in the secondary market suffered an even greater decline in value. Assuming a general market increase in yield of 20 basis points and a 10 year average life for California fixed-rate debt, nearly 1.5%, or **$2.57 billion**, in value may have been lost on the approximately $168.6 billion of outstanding California notes and bonds.

Total Cost

Market value penalty in the bond market	$2,570,000,000
Additional variable rate borrowing cost on existing debt	28,000,000
Additional short term borrowing cost on 1995 note issues	3,300,000
PV of additional fixed rate debt service on 1995 long term issues	582,000,000
Total	**$3,183,300,000**

The risk of a deepening crisis in the County will only serve to amplify the current negative effects of the County's bankruptcy on the market. Should additional governmental entities that participated in the Pool be forced to file for bankruptcy or to delay or repudiate debt service payments, the market penalty for all California issuers will increase in direct proportion.

In summary, the Orange County bankruptcy has had a significant negative impact on the value of the investment portfolios of numerous California residents. Going forward, the State can take action to bring the value of California bonds back in line with those of other states; or it can exacerbate and prolong the problem by signaling to the markets that the State is not willing to enforce on Orange County its obligation to be fiscally responsible and make good on its debts.

Alternatives for Remedial Action

State Intercept of Existing County Revenues

At no cost to the State, the State could intercept funds it currently collects for distribution to the County and use those funds to pay debt service on outstanding or new bonds. Orange County's 1994-95 discretionary general fund budget of $462 million included $16.8 million in sales taxes and $96.6 million in vehicle license fees which could be captured by such an intercept. The intercept would provide investors with the assurance that debt service will be paid to the extent that revenues are collected by the State.

The removal of the County political process as a bondholder risk factor will broaden the County's and other related parties access to the debt market and lower overall borrowing costs. The intercept will assure that debt service is an obligation of the County that is not discretionary, even in difficult times.

The intercept will allow the County to restructure its outstanding debt (particularly its notes), if need be. It will also allow the County to issue new debt to ease its way out of its crisis. Without such an intercept, we doubt that investors will lend money to the County.

The way this would work is simple. For example, if the County is projecting that the bankruptcy will have a one-time impact on its general fund budget of $500 million. Rather than absorbing the full $500 million in one year, the County could make a cut of $100 million in the first year and borrow $400 million to make up the difference. Over five years, the $400 million could be paid back (with interest) at a cost of about $94 million each year. Thus, the County would convert a cut of $500 million in one year into a much more manageable cut of roughly $94 million in each of six years.

The concept of the intercept could also be used to assist other Pool participants, assuming the bankruptcy court assigns some of the loss to them.

State Intercept of New County Revenues

Given the growing view that the County is unlikely to be able cut its expenses enough to make up its operating shortfall, it may be necessary to institute a temporary increase in the sales tax, hotel occupancy tax or other taxes available to the County. While the County Board of Supervisors has unwaveringly denied that a tax increase is an option, local business leaders and key private sector figures are increasingly vocal in stating that no alternatives can be eliminated from consideration in this situation. This additional source of revenue would also be a candidate for the State intercept program.

Municipal Assistance Corporation

On December 7, we predicted the need for the formation of a new entity which would function to assist the County in its recovery by monitoring its overall management, including its cost reduction efforts, existing debt management and issuance of new debt. This entity might have many of the characteristics of the Municipal Assistance Corporation ("MAC") which was formed in New York in 1974 to issue debt to aid the recovery of New York City from its fiscal crisis.

MAC was successful in New York because of the cooperation between the State, the City and the business community. It sent a clear signal to the investment community that all members of government were willing to work together to achieve a balanced budget. MAC was the financing tool for the City and the Financial Control Board was given the responsibility for eliminating the structural deficit facing the City. MAC and the Financial Control Board included as members the Mayor and Comptroller of the City, the Governor and Comptroller of the State and several key members of the business community. We recommend a similar structure including County supervisors because they bring with them important knowledge about the workings of the County and will ultimately reassume full financial control of the County once the crisis has passed, again following the New York City model. It is important to note that the first placement of debt by MAC was a private placement to the pension funds. We believe that this approach should be explored in California as well.

Creation of an independent authority is not designed to remove local control over day-to-day management of the County. Instead, it is to supplement local leadership with outside assistance and oversight. The authority gives strength and credibility to the actions of County leaders, shields some tough decisions from political influence and signals that a solution to the bankruptcy is an issue of State concern.

Because it involves one-time investment losses rather than a fundamentally anemic economy like New York City in 1974, many believe that the Orange County situation is less severe and more easily resolved by the County itself. While that facet of the situation may be true, it should be noted that the Orange County situation has the same pressing need New York City had for immediate resources to meet debt service and other obligations and has the additional complication of the involvement of the 186 Pool participants. It is not merely Orange County's problem which must be solved.

The Bankruptcy Petition

CS First Boston believes that the bankruptcy process has hindered and will continue to hinder the resolution of the fiscal crisis. The County's intention in filing for bankruptcy was to protect assets while it assessed the true impact of the Pool's losses and evaluated its options concerning settlement with Pool participants. Now that the Pool has been restructured and the losses calculated, the bankruptcy can only hinder the County's return to fiscal health.

Going forward under Chapter 9 will put into the hands of the bankruptcy judge decisions concerning the County's future course and the future of all 187 Pool participants that should be left to elected officials. It is also predicated upon an assumption that the County is either unable or unwilling to meet its financial obligations. The Orange County economy is strong and the County has a history of balanced budgets (albeit based, in part, on extraordinary investment income). These factors point to the fundamental strength of Orange County that should be the foundation of its recovery. Bankruptcy is the solution of the weak. For an entity as strong as the County, fiscal discipline with State assistance can solve the problem.

Action by the County and the State can elevate the County from the status of bankrupt debtor and eliminate the need for the bankruptcy process. With State assistance, a negotiated resolution to the crisis outside the bankruptcy filing is possible. It is also the approach that -- from the perspective of the County, other Pool participants and the State -- resolves the crisis with the least impact on the independence and reputations of all involved.

Recommendations

In summary, CS First Boston believes the State should:

- Urge Orange County to abandon the Chapter 9 process;

- Establish an independent state authority to assist the County in managing through its crisis;

- Create an intercept program to guarantee the outstanding and future debt of the County and other Pool participants;

- Urge the County to develop a realistic plan based on its continuing obligation to provide County services and to meet financial obligations. Any County plan must include consideration of new revenues, if necessary;

- Prior to July 1, 1995, assist the state authority to issue debt backed by intercepted funds, to moderate the budgetary impact of the crisis.

If you have any questions, please feel free to contact one of the following CS First Boston representatives.

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