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Economy & Efficiency Commission
Presentation

Editorial Note: Although every effort has been made to insure the accuracy of the material in this presentation, the scope of the material covered and the discussions undertaken lends itself to the possibility of minor transcription misinterpretations.

PRESENTATIONS BY
Mark Saladino
Treasurer and Tax Collector
Los Angeles County

January 8, 2009

Chairman Ikejiri greeted Mr. Saladino, Treasurer and Tax Collector and welcomed him while turning it over for Mr. Saladino to speak to the Economy and Efficiency Commission (EEC). Mr. Saladino expressed that he was honored to be there and thanked Executive Director Edward Eng for inviting him to speak to the EEC.

Background

Mr. Saladino stated that the Treasurer and Tax Collector (TTC) is the primary agency to bill, collect, disburse, invest, borrow, and safeguard monies and properties on behalf of the County, other governmental agencies and entities, and private individuals as specified by law. TTC provides cash management services to 17 cities/agencies, 120 school districts/organizations and administers approximately 300 bank accounts for County departments, school districts and special districts. It also provides enforcement, auditing, consulting, education, estate administration, trust accounting, property management and public information services. The department issues and collects fees for approximately 10,000 business licenses, and collects transient occupancy, utility and business taxes in the unincorporated area. It also collects money from parking meters.

Mr. Saladino reported that as the nation's largest county, Los Angeles County has broad exposure to the financial markets through its Treasury Pool, borrowing program, and banking relationships. As of September 2008, the County had total outstanding debts in excess of $1.8 billion, and Treasury Pool investments of more than $18 billion, representing funds of more than 135 public agencies. He explained that his analysis of the County's exposure to those financial institutions most affected by the current economic crisis indicates that the total amount of at-risk investments is less than $30 million. Mr. Saladino stated the current financial crisis first gained prominence in August 2007 as a worldwide "credit crunch" exposed vast amounts of subprime mortgage –backed securities in the portfolios of the world's largest financial institutions. He also stated that the Federal Reserve Bank responded to lack of liquidity in the credit markets by increasing the money supply for banks and by initiating a series of aggressive interest rate cuts. The problems affecting the financial markets proved more severe than anticipated; and in March 2008, Wall Street saw its first casualty as Bear Stearns was recapitalized by the Federal Reserve and sold at a deep discount to JP Morgan. He explained that this action was followed by even more dramatic events, including the failure of IndyMac

Bank, the Federal takeover of Fannie Mae, and Freddie Mac, the bankruptcy of Lehman Brothers, the sale of Merrill Lynch to Bank of America, the near insolvency of American International Group (AIG), the FDIC's seizure and sale of Washington Mutual's banking operations to JP Morgan, and the government-facilitated purchase of Wachovia by Citigroup.

County Investment Policy

Mr. Saladino reported that all investment decisions of the County are governed by the California Government Code. The investment policy of the County expands upon the limitations set forth in the Government Code and establishes specific ratings criteria and investments limits for each type of security available for purchase in the Treasury Pool. Mr. Saladino shared that the investment policy most recently adopted by the Board of Supervisors on March 11, 2008 reaffirms the commitment to conservative investment practices and establishes the following priority for selecting investments: (1). Safety of Principal (2). Liquidity (3). Return on Principal. He explained that as a result of the conservative practices of the Investment Office, the Treasury Pool has not experienced any investment loss despite the recent market turbulence and restructuring of the nation's financial system. Furthermore, his emphasis on liquidity has resulted in an investment portfolio that maintains more than 60% of its value in securities that mature in less than thirty days.

County Exposure to Firms Headline In The Financial Crisis

Fannie Mae and Freddie Mac

Mr. Saladino explained that in September 2008 the U.S. Treasury placed Fannie Mae and Freddie Mac into conservatorship and made explicit the Federal Government's guarantee of all debt securities issued by these two entities. He stated that as a result, Fannie Mae and Freddie Mac debt securities are considered equally secure to other forms of indebtedness issued by U.S. government agencies.

Merrill Lynch, Bear Stearns and Lehman Brothers

Mr. Saladino stated that on September 30, 2008, the County owned $182 million of commercial paper notes issued by Merrill Lynch & Co. These investments are considered highly secure given that Merrill Lynch was recently acquired by Bank of America (the largest U.S. bank holding company) and that the final maturity of these notes is October 14, 2008. He stated that the Treasury Pool does not currently own any Bear Stearns or Lehman Brothers debt securities. The agreement provides the County with a guarantee rate of return an original investment amount of $28.2 million and is collateralized by securities that he does not believe to be at risk of default. He also explained that because of the uncertainty surrounding all Lehman Brothers entities, his office is exploring termination of the agreement in order to cash out the investment and prevent any possible loss.

American International Group Inc.

Mr. Saladino reported that on September 17, 2008, the Federal Reserve and the U.S. Treasury agreed to loan AIG $85 billion in exchange for warrants equivalent to 80% ownership of the firm. He stated that the unprecedented move by the Federal Government provides an implicit guarantee that greatly enhances the credit-worthiness of all AIG debt securities. He also reported that in September 2008, the Treasury Pool owned $200 million in commercial paper notes issued by American General Finance Corporation and AIG Funding Inc. These two entities operate as financial divisions of the larger AIG holding company and its insurance businesses. In addition to the commercial paper investments, the County was a party to one guaranteed investment contract (GIC) with AIG, which had an initial investment amount of $27.6 million. The agreement was terminated on September 29, 2008 and the County received a full cash settlement for the outstanding balance in GIC. AIG has now been removed from the County's list of permitted investments.

Banking Relationships

Mr. Saladino stated that the County's commercial banking operations are managed by the Cash Management

Division of his Department. This division has direct oversight responsibility for the County's principal commercial banking accounts with Bank of America, Bank of the West, Citibank, Union Bank of California, and Wells Fargo Bank. The County also has limited relationship with Antelope Valley Bank and U.S. Bank. Mr. Saladino also shared that the most significant banking relationship is with Bank of America, which currently holds more than $46 million of the County's assets in depository accounts. None of the commercial banks doing business with the County is currently considered to be at risk of failure. The County does not have any ongoing banking relationships with IndyMac, Washington Mutual or Wachovia.

Deferred Compensation Plans

Mr. Saladino stated that one of the investment options in the County's Deferred Compensation and Thrift Plan (Horizons) is the Washington Mutual Bank fund. He stated that on August 29, 2008 he made a recommendation to the Horizons Plan Administrative Committee (PAC) to limit investment in the Washington Mutual Bank fund to $250,000, the maximum amount insured by the FDIC. Participant balances in excess of $250,000 were immediately transferred to the County's Stable Income Fund to prevent losses in the event of Washington Mutual failure. He also reported that on September 25, 2008, the FDIC seized and sold Washington Mutual Inc. in the largest failure ever of a U.S. bank. In order to further protect participants in Horizons and the 401K Savings Plan, the PAC directed that letters be sent to remind the participants of the applicable FDIC insurance limit in the plan's bank fund and to advise them that excess balances could be subject to loss in the event of a bank failure.

Conclusion

Mr. Saladino stated that the crisis of 2008 has ushered in a period of unparalleled change and uncertainty for the financial community. He shared that his department has relied upon an established system of internal controls, policies, procedures, and security selection practices to avoid any serious disruption to the County's investment, borrowing and commercial banking programs. As of October 2008 the Treasury Pool has no investment exposure to any of the troubled banks or insurance companies. With continued vigilance, he believes the County Treasury will remain well-positioned to withstand the ongoing financial crisis.

Questions

Commissioner Soteras asked about the Status of LACERA. Mr. Saladino replied that at the peek the LACERA investment fund was worth $41 billion dollars and now the fund is down to about $35 billion. It is a big lost which may get worse but, interestingly, the effect of the huge losses will not be felt at the County level for some time. LACERA does not recognize gains and losses immediately. In order to provide more budget certainty and to protect the County budget from spikes in its contribution rate, whenever the department has gains or losses, the department recognize it over a three year period. He also stated that the County's contributions to LACERA for the 2009/2010 fiscal year are actually going down by $19 million.

Commissioner Mindlin asked whether Mr. Saladino's department is involved in any of the Hedge funds that are throwing up their gates. Mr. Saladino replied no and that he is not involved with any of those funds; the Board of Investments with LACERA is an extremely conservative group. Mr. Saladino shared that he is an investor similar to Warren Buffett. Warren Buffett always says "unless I understand how an investment works and where the money comes from I will not invest in something I do not understand." Mr. Saladino added that Hedge Funds present a black box because they are unregulated. The County has no Hedge Fund exposure at all.

Commissioner Mindlin asked if Mr. Saladino's investment portfolio is suffering from the "denominator effect" (where falling stock prices are leaving institutional investors over exposed to real estate, which could trigger further declines in property values). Mr. Saladino replied that yes he is impacted by the denominator effect. The real estate is now over allocated because of the denominator effect. The department has a target allocation, and when the total fund size reduces suddenly, one may have had 10% of his investments in real estate yesterday but today he is suddenly up to 12% or 15% because the total funds have shrunk because the real estate is only appraised on an annual basis.

Commissioner Mindlin asked what Mr. Saladino is doing with the Fund managers in real estate or else where, where one has committed a lot of money and the pension plans are saying “don’t make a capital call on us” right now. Mr. Saladino replied that his department has reallocated some money out of equities as needed to maintain the department’s balance. Mr. Saladino stated that real estate will correct itself. The department’s real estate investments are reappraised every year so although there is a denominator effect right now, but when the department does the next round of evaluations or appraisals, it will come back into balance.

Commissioner Mindlin asked what Mr. Saladino will do if he has committed to $100 million to any associate but they have only called $50 million. Mr. Saladino replied that most of the department’s real estate currently is properties that the County owns outright.

Vice-Chair Barcelona stated that there is a lot of talk about having a moratorium on foreclosures; in the big picture on a County level-is that a good thing or bad? Mr. Saladino replied that foreclosures are obviously disruptive because it depresses the price of properties. The median in home price in Los Angeles has declined anywhere from 25% to 30%. A lot of people assumed that this immediately translated into property tax rolls and its not. The reason it’s not is because in some other counties like Riverside and San Bernardino-those counties had a lot of new construction in recent years. Los Angeles County is well developed and there has been relatively little new construction in Los Angeles County within the last five years. The vast majority of properties in Los Angeles are still assessed below market value because of proposition 13.

Commissioner Fuhrman stated that one of the impacts of AIG running into trouble was their guarantee of RTD lease-back arrangement which put RTD in the hole $200 million dollars. Mr. Fuhrman asked whether if Mr. Saladino has thought about the County taking on that guarantee using some of those resources to provide assistance. Mr. Saladino replied that he is unsure if the County can guarantee MTA debt. He explained that he is not familiar with all the technical aspects of leverage lease transactions. LACERA could do it, but he doesn’t think LACERA is in the market for providing credit support. Mr. Saladino stated that he talked with the Chief Investment Officer of LACERA about it and because other pension funds have provided liquidity and credit support, its real easy money if you are providing credit support for an agency that really doesn’t need it.

Commissioner Cole asked if a property is worth $1 million dollars and then it drop in market value, can one go back and do reevaluation of the equation? Mr. Saladino replied that property reevaluation is not based on market value but rather the assessed value. It is called Proposition 8, which was passed several years ago to amend Proposition 13 to allow people to request a decline in value if their market value of the property falls below their current assessed value. Mr. Saladino explained that the assessed value generally is set when you buy your property, the amount you paid for you’re your property it will be your assessed value. If you bought a house at $1 million dollars that would be your assessed value but if that house is now worth $800,000 dollars which is clearly below your assessed value then there is a form you can download from the Assessor website and along with the form you need to have two comparable properties which you can also get from the Assessor’s website. Mr. Saladino also explained it has to be a recent sell within a certain time period, then you file the application with the Assessor what you think the value of the property is, and the Assessor will review it which may take up to six months.

Chairman Ikejiri expressed his appreciation to Mr. Saladino for coming to speak to the EEC and the Commissioners applauded.

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