COUNTY OF LOS ANGELES
TREASURER AND TAX COLLECTOR

MARK J. SALADINO
TREASURER AND TAX COLLECTOR

September 30, 2008

TO: Supervisor Yvonne B. Burke, Chair
Supervisor Gloria Molina
Supervisor Zev Yaroslavsky
Supervisor Don Knabe
Supervisor Michael D. Antonovich

FROM: Mark J. Saladino
Treasurer and Tax Collector

SUBJECT: **IMPACT OF FINANCIAL CRISIS**

On September 23, 2008, your Board requested that I prepare a report on the impact of the current financial crisis on the County Treasury. The situation on Wall Street has dramatic implications for our nation's economy and has given rise to an unprecedented level of government intervention into the financial markets. Municipal governments are not immune to these events and some have suffered investment losses.

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. This memorandum will address each area of exposure, after a brief description of the controls, policies and procedures we have in place to minimize risk and maintain stability during this period of market turbulence.

As of September 30, 2008, the County had total outstanding debt in excess of $1.8 billion, and Treasury Pool investments of more than $18 billion, representing funds of more than 135 public agencies. Our 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, as detailed below.

Background

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. The Federal Reserve Bank responded to a lack of liquidity in the credit markets by increasing the money supply for banks and by initiating a series of aggressive interest rate cuts. Yet 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. 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.

On September 29, 2008, the United States House of Representatives rejected a proposal by Treasury Secretary Henry Paulson to allow the Treasury to purchase up to $700 billion in distressed securities in order to restore confidence and liquidity to the banking system. At this writing, discussions are ongoing among the Congressional leadership, the President, the Treasury Department, the Federal Reserve, the FDIC, and the Securities and Exchange Commission (SEC).

County Investment Policy

All investment decisions of the County are governed by the California Government Code (commencing with Section 53600), which provides strict guidelines for investments made by public agencies in the State of California. The Investment Policy of the County expands upon the limitations set forth in the Government Code and establishes specific ratings criteria and investment limits for each type of security available for purchase in the Treasury Pool. The Investment Policy most recently adopted by your Board on March 11, 2008 reaffirms this commitment to conservative investment practices and establishes the following priority for selecting investments:

1. Safety of Principal
2. Liquidity
3. Return on Principal

To demonstrate strict compliance with the Investment Policy, a monthly Report of Investments is submitted to your Board which provides detailed information on every security held in the Treasury Pool. This report is prepared by my Department's Compliance Auditor, who operates independently of the Investment Office and monitors cash accounting and investment practices on a daily basis. The Compliance Auditor's staff reviews each investment trade within hours of its execution and confirms that every investment is in conformance with the Investment Policy. The County Auditor-Controller performs a similar series of risk controls on a quarterly basis and routinely reviews investment transactions for compliance with approved policies. Finally, the County's outside auditor independently validates Treasury Pool operations and annually accounts for all County investments.

County Investment Management

The Investment Office of my Department is an active participant in the securities markets, and staff monitors financial news and market conditions on a continuous basis. Because of the large number of public agencies that rely on the Treasury to meet their banking needs, I have instructed staff to maintain a high degree of daily liquidity. This enables us to meet cash requirements even if anticipated receipts are delayed, such as recently occurred before adoption of the State budget. On a daily basis, a minimum of $400 million in cash typically passes through the Treasury for disbursement or investment.

In order to minimize the risk associated with the purchase of any security not guaranteed by the U.S. Government, the Investment Office continuously monitors issuers' credit through subscriptions to several rating agencies and financial news services. Any material development with respect to an issuer or a particular security is transmitted immediately to the Investment Office through ratings notices, Bloomberg alerts, and communications from the County's authorized broker-dealers. This constant flow of information allows the Investment Office to respond quickly to ratings downgrades or other information that could affect the creditworthiness of a particular proposed investment.

As a result of the conservative practices of the Investment Office, the Treasury Pool has not experienced an investment loss despite the recent market turbulence and restructuring of the nation's financial system. Furthermore, my 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 (30) days.

The overall risk profile of Treasury Pool investments also provides a high degree of protection, because the vast majority of securities are rated "AA" or "AAA" by two or more of the credit rating agencies. However, the Investment Office does not rely on credit ratings alone; we also consider the structure and any collateral of a proposed investment and often reject certain "AAA" securities that do not meet our standards. For example, the Investment Office staff did not purchase any sub-prime mortgage securities or structured investment vehicles (SIVs), despite their high ratings and relative popularity in recent years. It is this type of investment that has caused the greatest damage to government investment pools in California and other states. In contrast, our investment selection process and due diligence efforts have allowed the Treasury Pool to avoid the riskiest form of exposure to the sub-prime mortgage crisis.

Because it remains impossible to predict the final outcome of the ongoing market turmoil, the Investment Office will continue to maintain maximum liquidity in the Treasury Pool and pursue only the most secure investment options.

County Exposure to Firms Headlined in the Financial Crisis

Fannie Mae and Freddie Mac

On September 7, 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. 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.

Current Treasury Pool holdings include $3.2 billion in Freddie Mac, $2.3 billion in Federal Home Loan Bank, and $1.2 billion in Federal Farm Credit Bureau debt securities. In total, U.S. government agency securities account for more than 35% of the Treasury Pool's holdings.

Merrill Lynch, Bear Stearns and Lehman Brothers

As of 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.

The Treasury Pool does not currently own any Bear Stearns or Lehman Brothers debt securities. The only County investment that involves Lehman Brothers is a forward purchase agreement related to the County's 2006 Tobacco Bonds. This agreement was entered into with Lehman Brothers Special Financing Inc. on February 8, 2006 and is neither part of the Barclays acquisition of Lehman Brothers Inc. nor is it subject to the recent bankruptcy filing by Lehman Brothers Holdings. The agreement provides the County with a guaranteed rate of return on an original investment amount of $28.2 million and is collateralized by securities that we do not believe to be at risk of default. Because of the uncertainty surrounding all Lehman Brothers entities, my office is exploring termination of the agreement in order to cash out the investment and prevent any possible loss.

American International Group Inc. (AIG)

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. This unprecedented move by the Federal Government provides an implicit guarantee that greatly enhances the creditworthiness of all AIG debt securities. As of September 30, 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, as referenced in the CEO's memorandum dated October 2, 2008

concerning the effect of AIG's condition on the County's commercial insurance program. The final maturity of these notes is October 9, 2008.

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. This investment agreement was terminated on September 29, 2008 and the County received a full cash settlement for the outstanding balance in the GIC. AIG has now been removed from the County's list of Permitted Investments.

County Debt

The County's outstanding debt is managed on an ongoing basis by the Public Finance Office of my Department. As of September 30, 2008, the County had approximately $725 million in outstanding short-term debt and $1.1 billion in long-term debt. The County's only variable rate exposure is through its tax-exempt commercial paper (TECP) program, which currently has $205 million of notes outstanding. The TECP program is secured by a letter of credit issued jointly by two German state banks and by JP Morgan Chase Bank. The letter of credit retains the highest possible ratings from both Moody's and Standard & Poor's. However, in the past two weeks the credit contraction has begun to spread to the commercial paper market as several municipal issuers have faced spiking interest rates on new note issuances.

The two broker-dealers that currently market the County's commercial paper to investors are Morgan Stanley and Lehman Brothers. All investment banking and brokerage units of Lehman Brothers were acquired by Barclays Capital and have continued operating without interruption. My office anticipates continuing the commercial paper broker-dealer relationship with Barclays Capital, and we will seek to further diversify the commercial paper program by adding one or two new broker-dealers to market the notes, subject to the successful negotiation of favorable terms.

Outside of the commercial paper program, the County does not have any outstanding letters of credit or variable rate exposure. The County has never issued auction-rate securities or any form of the variable rate demand obligations that have recently experienced wide swings in both marketability and interest rates.

Banking Relationships

The County's commercial banking operations are managed by the Cash Management Division of my 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 relationships with Antelope Valley Bank and U.S. Bank.

By far 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

One of the investment options in the County's Deferred Compensation and Thrift Plan (Horizons) is the Washington Mutual Bank fund. On August 29, 2008, on my recommendation the Horizons Plan Administrative Committee limited 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 Stable Income Fund to prevent losses in the event of Washington Mutual's failure. 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, each 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. In addition to the letters, personal contact was made or attempted with each participant having a bank fund balance in excess of the FDIC insurance limit.

LACERA

LACERA is a large, well-diversified pension fund, approximately 20% of which consists of investments that are not publicly traded. Although the remainder of the fund's assets is publicly traded, those investments are selected by external managers and are not valued on a daily basis.

The impact of the current financial crisis on LACERA is difficult to separate from the effect of general market fluctuations and the results of active management. However, on September 19, 2008, LACERA's Chief Investment Officer issued a report summarizing the pension fund's exposure to Lehman Brothers, AIG and Merrill Lynch. A copy of that memorandum is attached for your reference.

Summary

The crisis of 2008 has ushered in a period of unparalleled change and uncertainty for the financial community. My 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 14, 2008, the Treasury Pool will have no investment exposure to any of the troubled investment banks or insurance companies. The only outstanding

investment that may remain at risk is one forward purchase agreement with an initial par value of $28.2 million (described above under "Merrill Lynch, Bear Stearns and Lehman Brothers").

The absence of any long-term variable rate debt, auction-rate securities or swap agreements has maintained the integrity of the County's debt issuance program and kept borrowing costs to a minimum. As a result of these conservative practices, management and staff in my Department have helped ensure that the County Treasury is well-positioned to withstand the current crisis and disruptions to the financial markets.

We will continue to closely monitor developments in the current financial crisis, and will promptly advise your Board and the CEO if any event occurs which we believe could have a material adverse effect on the County.

Attachment

c: Executive Officer of the Board of Supervisors
Chief Executive Officer
Auditor-Controller
LACERA

ATTACHMENT

September 19, 2008

TO: Each Member
Board of Investments

FROM: Lisa Mazzocco
Chief Investment Officer

SUBJECT: RECENT CAPITAL MARKET TURMOIL

The purpose of this memorandum is provide your Board with an update regarding LACERA's exposure to Lehman Brothers Holdings Inc. (Lehman), American International Group Inc. (AIG) and Merrill Lynch Co. Inc..

Staff divided the information for each firm into three categories. The first category, *Investment Portfolio Exposure,* identifies LACERA's security exposure to these organizations (See Attachment). The second category, *Counterparty Exposures,* addresses the three firms' business activities with LACERA's service providers[1]. The third category, *Investment Management Exposure,* identifies whether LACERA uses this firm for any money management services.

LEHMAN BROTHERS HOLDINGS INC.

I) Investment Portfolio Exposure

Lehman Brothers Holdings Inc. (Lehman), founded in 1850, filed for bankruptcy protection earlier this week after several failed attempts at finding a buyer. While the entire organization was not included in the bankruptcy proceedings, Staff attempted to identify all of LACERA's potential exposure to Lehman.

LACERA had 543,300 shares of Lehman stock worth approximately $2 million on Friday, September 12th, and the shares are virtually worthless as of this writing.

LACERA's has four potential sources for exposure to Lehman bonds: 1) all of LACERA's fixed income managers, 2) Western Asset Management's cash account and enhanced S&P 500 account, 3) the commodity portfolio managers (PIMCO and Lehman-Gresham), and 4) the re-investment of the cash collateral for the securities lending program.

[1] Counterparty exposure (or risk) is incurred when two organizations enter into a contractual agreement and one party cannot honor its obligation.

As of September 12, 2008, LACERA's aggregate exposure to Lehman bonds totaled $56.7 million. This exposure breaks out as follows: the fixed income managers' $44.7 million, Western's cash account $10.5 million and the Enhanced S&P 500 account $0.6 million and PIMCO's cash account (for commodities) $0.9 million. Fortunately, the securities lending cash collateral pool had no exposure to Lehman bonds.

At this juncture, it is too early to assess LACERA's total loss from the fixed income exposure. Theoretically, however, it could be the entire $56.7 million (but that is unlikely). The actual loss will become more clear as Lehman works through the bankruptcy proceedings.

II) Counterparty Exposures

The following categories address the exposures that LACERA's investment managers have to Lehman. These exposures fall into three categories: securities lending, derivatives, and unsettled trades.

1) ***Securities Lending*** - LACERA's securities lending guidelines require lenders to maintain 102% cash collateral for domestic securities loaned and 105% for international securities. As of September 12, 2008, Lehman had borrowed $8 million in securities from LACERA. Collateral for this loan totaled 107% of the market value of the securities borrowed. The lender, BNY Mellon, has requested the securities be returned.

2) ***Derivatives*** - Counterparty risk is incurred when two organizations enter into a derivatives agreement, such as a swap[2]. A bankrupt counterparty may be unable to honor its contractual commitment. As a result, the other counterparty may be forced to absorb a loss (or lose a gain).

   To mitigate counterparty risk, LACERA's Derivatives Policy requires managers to monitor a counterparty's creditworthiness and only use counterparities that have an investment grade rating of A3 (Moody's Investor Service) or A- (Standard & Poor's).

   At the beginning of the week, LACERA's managers had some counterparty exposure to Lehman. However, as of this writing, all of the counterparty exposure to Lehman has been closed and therefore eliminated.

[2] A "swap is an agreement between two parties to exchange a sequence of cash flows over a certain period of time." Source: Kolb, Robert, Futures, Options & Swaps, (Massachusetts: Blackwell Publishers, Inc. 1997), 613.

3) ***Unsettled Trades*** - On Monday, BNY Mellon required all trades with Lehman be settled on a cash-only basis. One trading nuance relates to the use of Mortgage Backed securities known as "to be announced" (TBAs). These securities have delayed settlements of usually one month. This delayed settlement introduces some risk, so any gains generated from the trade may be lost because of Lehman's inability to deliver the trade.

   Currently, LACERA has a total of $2 million in gains on TBAs with Lehman as the broker. At this juncture, the managers have indicated to staff they believe these gains, if sustained, will be honored.

III) Investment Management Exposure

Lehman/Gresham manages a $230 million commodity mandate for LACERA. The commodities exposure is managed by Gresham, which is completely independent of Lehman. BNY Mellon maintains custody for all of the securities except for the futures contract margin collateral which is maintained by J.P. Morgan.

Currently, Lehman is trying to sell its asset management group. However, if Lehman should be unsuccessful in selling this group, it could become part of bankruptcy proceedings. In such a scenario, LACERA would be unable to terminate the relationship without the prior approval of the bankruptcy judge. A related bankruptcy concern is the departure of key asset management personnel.

Lehman/Gresham has done an excellent job managing LACERA's commodity mandate, outperforming their benchmark by 200 basis points (bps) for the year ending August. As such, staff is not recommending any action at this time and will continue to carefully monitor the situation.

AMERICAN INTERNATIONAL GROUP INC.

I) Investment Portfolio Exposure

In an unprecedented move, The Federal Reserve and the US Treasury agreed to loan American International Group Inc. (AIG) $85 billion in exchange for warrants equivalent to 80% ownership in the firm. According to press reports this action will require shareholder approval.

AIG was a large counterparty in the credit default swap market, and it was apparent that if they defaulted on their obligations it could potentially wreak havoc on the global financial system. Surprisingly only one week ago, Treasury Secretary Paulson was adamant that no additional taxpayer money be used for bailouts.

As the world's largest insurer, AIG had a 30 bps weighting (.30%) in the S&P 500 on September 12, 2008. As such, LACERA had exposure to this security in the Russell 1000

and the S&P 500 Index Funds. In addition, many of LACERA's active managers owned the security. LACERA's aggregate AIG share exposure totaled 1,900,000. On Friday, September 12, 2008, the shares were worth $23 million. The market value of these shares declined sharply and were worth less than $4 million on Wednesday, September 17, 2008.

As of September 12, 2008, LACERA's fixed income exposure to AIG totaled $23.6 million: $23.2 million in the fixed income portfolio and $0.4 million in the securities lending cash collateral pool. Although the government's ownership is viewed as a positive development, the fact that the government loan takes priority over outstanding bonds, makes the eventual outcome unclear.

II) Counterparty Exposures
Derivative contracts which had AIG as a counterparty have been closed as of this writing. Otherwise, there were no other outstanding exposures identified with this organization.

III) Investment Management Exposure
In July 2007, your Board committed $25 million to an Asian commingled real estate fund managed by AIG. At this juncture, it is too early to comment on any potential ramifications, if any, to this investment. Staff's primary concern is the potential departure of key personnel. Staff will monitor this situation and keep your Board apprised of any notable events.

MERRILL LYNCH CO. INC.

I) Investment Portfolio Exposure
After taking $45 billion in write downs and raising $15 billion in new capital, Merrill Lynch Co. Inc. decided it could no longer remain an independent firm. On Sunday, September 14, 2008, Bank of America agreed to purchase Merrill Lynch Co. Inc. for $29 a share. Merrill's stock is currently trading in the $18-22 range. LACERA has approximately $22 million worth or Merrill stock (one million shares) and $56.9 of Merrill's bonds (of which $5 million is in a securities lending collateral pool).

II) Counterparty Exposures

1. ***Securities Lending***
   Counterparty exposure within LACERA's Securities Lending Program amounts to $8 million. The lender, BNY Mellon has received collateral equivalent to 111% of this value. Therefore, they feel comfortable maintaining this position.

2. ***Derivatives***
   LACERA has no derivatives exposure to Merrill.

3. ***Unsettled Trades***
   LACERA has a total of $1.2 million in potential gains on TBAs with Merrill as the broker.

III) Investment Management Exposure

Merrill Lynch Co. Inc. has a 49% ownership interest in BlackRock Financial Management Inc. (BlackRock), a LACERA fixed income manager[3]. While this is a considerable ownership position, BlackRock maintains a majority of independent directors. At this juncture, Staff has no concerns about this change in ownership negatively effecting BlackRock.

FINAL COMMENTS

Please note that working with my staff, we strived to accurately identify all of LACERA's exposures to these organizations. I earnestly believe we have identified all of the key issues. However, because of the intricate nature of these exposures, and the extremely fluid nature of the week's events, some details may have not been included in this summary.

LACERA has not yet funded the 130/30 mandate approved by your Board in June. If the program had been funded during this tumultuous time, determining the fund's exposure would have added another level of complexity given the prime brokerage aspect of the strategy.

The magnitude of this week's events is incomprehensible. In a matter of ten short days, the country's financial system has been dramatically altered. With the U.S. government announcement of the mortgage bailout, (estimated at $1 trillion) a temporary guarantee of $50 billion to ensure money market fund solvency, and a curb on short selling of financial stocks, the market is now rebounding tremendously. Clearly, these are bold, decisive moves. Now, however, the question remains about how the carnage on Wall Street will affect Main Street.

Attachment

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lehmanupdate1.doc

CC: Board of Retirement
Gregg Rademacher
Janice Golden
Robert Hill
David Muir

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[3] The market value of the BlackRock portfolio as of September 15, 2008 was approximately $1.4 billion.

ATTACHMENT

INVESTMENT PORTFOLIO EXPOSURE SUMMARY
(Market Values as of September 12, 2008)

	AIG	Lehman Brothers	Merrill Lynch	Sum
EQUITY HOLDINGS	$23,175,722	$1,984,133	$18,771,672	*$43,931,527*
FIXED INCOME HOLDINGS	$23,261,328	$55,770,354	$56,863,618	*$135,895,300*
COMMODITIES HOLDINGS	$769,421	$864,927	$4,689,917	*$6,324,265*
TOTAL HOLDINGS EXPOSURE	*$47,206,471*	*$58,619,413*	*$80,325,207*	*$186,151,091*
AS PERCENT OF TOTAL FUND	*0.13%*	*0.16%*	*0.22%*	*0.51%*