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COUNTY OF SAN MATEO, CALIFORNIA

HEARING OF THE HOUSE COMMITTEE ON FINANCIAL SERVICES
ON THE EFFECT OF THE LEHMAN BROTHERS BANKRUPTCY ON STATE AND LOCAL GOVERNMENTS"
MAY 5, 2009

Chairman Frank, Ranking Member Bachus, and Members of the Committee:

Thank you for inviting me to testify on the effect of the Lehman Brothers Bankruptcy on state and local governments. My name is Richard Gordon and I am a member of the Board of Supervisors of the County of San Mateo. San Mateo County is a county of approximately 735,000 located in the San Francisco Bay Area. Together with my fellow Board member Mark Church, who has submitted written testimony to the Committee, I serve on our Board's Finance and Operations Committee.

I also would like to specially thank our representatives in Congress, Jackie Speier and Anna Eshoo as well as Senator Diane Feinstein, who -- together with Chairman Frank -- have highlighted the national implications of the Lehman bankruptcy on local governments and communities across this country. With their encouragement, our county staff has connected with a national network of public instrumentalities that has collectively lost 1.7 billion dollars of investments in commercial bonds and similar conservative debt instruments as a result of the Lehman collapse. So, clearly the issues being discussed today are of great importance to local governments and communities.

General Description of Impact:
As a direct result of the Lehman bankruptcy, public instrumentalities across the United States suffered an immediate loss of monies that were invested in Lehman bonds and other securities. As I mentioned earlier, these losses, which have impacted hundreds of public instrumentalities across the United States, are presently estimated to total $1.7 billion.

The Unique Position of Public Instrumentalities:
Public instrumentalities at the state and local level are unique in that, as a rule, we are fully funded by the taxpayers. Although the exact restrictions will vary from state to state, as a general matter, state constitutional and statutory constraints require local governments to operate on a "pay as you go" basis, with strict limitations on the revenue that can be generated on a yearly basis.

The revenues raised by public instrumentalities are for the direct benefit of constituents, in the form of services (*e.g.*, teachers, police services, public works services) or capital improvements (*e.g.*, classrooms, roads, sewer facilities).

Typically, this revenue is not collected on a steady ongoing basis. In many states, for example, property taxes are collected twice a year. As a result, the ongoing operations of our schools, counties, and other local public entities require careful management of cash flow (*e.g.*, to pay salaries) and state laws generally place strict limitations on the ways that public funds may be invested. Unlike the private sector, the overriding investment objective for public funds is the preservation of capital rather than gain.

In California, for example, treasury pool investments are restricted to high quality debt instruments, including federal agency instruments, high-grade commercial paper, corporate bonds and similar investments. Returns are relatively low, consistent with the conservative nature of the investment allowed, and are largely intended to keep pace with inflation. Treasury pool portfolios are managed to hold investments to maturity so that return of principal is assured.

By way of example, as of September 15, 2008, our County's Pool held conservative financial instruments bought through Lehman representing about 5.9 percent of the par value of all pooled assets. These investments included safe "floating rate" securities and one corporate bond. The floating rate securities, as required by law and County investment policy, were rated "A-1" at purchase, and the corporate bond was rated "A" at purchase.

In my county, the Treasury Pool's investment history reflects the conservative nature of the Pool's investment strategy. The Pool's average gross return on investment for the last 5 years, for example, was 3.68 percent. Because of the conservative investment strategies required by state law, and our County's Investment Policy, investments only make a return sufficient to keep up with inflation, so that these public funds will not "lose ground" against the general economy. In other words, the Pool is not run for the purpose of turning a profit.

When asked the question: "Why would a municipality invest in Lehman Brothers in the first place?" therefore, it is important to recognize some key principles: First, in light of the constraints placed on local treasury pool investments regarding the rating of the issuing entity, limits on the percentage of the pool that could be invested in any one entity, limits on the types of investments that could be purchased -- as well as the liquidity needs of pool participants -- Lehman corporate bonds were one of the few investments that the public instrumentalities could make. Second, it should be recognized that local governments as a general matter are prohibited from purchasing equities. In other words, the Lehman securities purchased were conservative investments in bonds and corporate notes, not speculative purchases of Lehman stock. Finally, as evidenced by the hundreds of billion dollars of other investments in Lehman that are being sorted out through the bankruptcy process, it is clear that, up until the date that Lehman filed for bankruptcy, public entities were not alone in the conclusion that Lehman investments, if not sound, were certainly not a clear liability.

As a result of the Lehman bankruptcy, 15 cities, numerous special districts, and 24 school districts -- all of whom had placed taxpayer funds into the Treasury Pool -- suffered an unexpected and devastating financial hit. These losses have been substantial and have resulted in the direct loss of services and the delay or cancellation of needed capital improvements. The losses include the loss of many jobs, including teachers, police officers, fire fighters, health care workers and construction workers.

Losses in our county alone, for example, include:

- $25 million in San Mateo County Transit Authority funds that will stall planned electrification of the Caltrain Peninsula Commuter Rail Service;

- $40 million in K-12 school operating funds, that includes teacher salaries, educational materials, books and facility construction and maintenance;

- $36.7 million of the County of San Mateo operating funds that support such activities as San Mateo Medical Center (public hospital), affordable housing development, parks, childcare, In-Home Support Services for the elderly and disabled, law enforcement, and construction of sorely-needed correctional facilities; and

- $12.3 million in special district operating funds including the Bay Area Air Quality District, and numerous sanitation and flood control districts.

Statewide and nationwide, the impact described above is not unique:

- Cities, counties, and local agencies in Arizona have sustained losses exceeding $40 million;

- Cities, counties, and local agencies in Florida have sustained losses exceeding $400 million;

- The State of Oregon's investment pool sustained losses of approximately $170 million; and

- In addition, schools, special districts, local agencies, and state governments in Alaska, Massachusetts, Michigan, Minnesota, New Jersey, New Mexico, Pennsylvania, and Washington have also lost hundreds of millions of taxpayer dollars as a result of the decision to allow Lehman to collapse.

The Direct Benefit of Assisting Lehman-Impacted Public Instrumentalities

Some may wonder: "If TARP funds are used to assist public instrumentalities who suffered Lehman losses, won't this open the floodgates to scores of requests from other public and private investors who have suffered losses as a result of the downturn in the economy?"

On behalf of the affected public instrumentalities, I respectfully submit that the answer is "No."

As set forth in the Emergency Economic Stabilization Act of 2008 itself, and as clarified in the colloquy between Chairman Frank and Representative Eshoo in January, one of the purposes of TARP is to assist local governments, especially those that were impacted by the decision to allow Lehman to collapse. While the use of TARP to capitalize banks, financial institutions, and other industries is undoubtedly important and necessary to bring our national economy back to health, by providing TARP funds to make local governments whole for Lehman losses will yield a direct and immediate benefit to local economies.

Because the TARP monies would be directed towards local public entities, the use of such funds will be transparent and the benefits will be quantifiable. Such funds will directly support our local schools, police, fire districts, libraries, hospitals and job training efforts. Taxpayers will be able to clearly identify the number of jobs created, the number of buildings constructed, and the number of constituents directly served as a result of the use of TARP funds in this manner.