BILL LOCKYER
TREASURER
STATE OF CALIFORNIA

May 13, 2009

The Honorable Timothy Geithner
U.S. Secretary of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Secretary,

I am writing today to ask that you authorize extending TARP assistance to the State of California and other financially strapped states and local governments which face a severe cash flow crunch in the near term due to eroding tax revenues resulting from the current economic downturn. If we cannot obtain our usual short-term cash flow borrowings there could be devastating impacts on the ability of the State or other governments to provide essential services to their citizens, such as fire and police protection, education and social services. Such a scenario could also cause major disruption to financial markets. An inability to access the short-term market, resulting in drastic cash-flow management measures would likely limit the State's ability to access the long-term bond market as well. This, in turn, would slow and could eventually even halt our infrastructure construction programs.

We have developed a structure, described below, to help the State and other governments obtain the short-term funding they need, but cooperation from the banking community and back-up TARP support from the Treasury will be critical to making the proposed transactions successful.

Current Environment

This year, the State of California and many other States and localities, are suffering from a dramatic drop in tax revenues, which not only is creating substantial budget shortfalls but is also exacerbating their cash-flow needs. Governments normally issue short-term notes secured by future tax revenues (usually called Tax and Revenue Anticipation Notes or "TRANs") to bridge timing imbalances between revenues and expenditures during a fiscal

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year. Even with a balanced budget, California believes its cash flow shortfall in fiscal 2009-10 will be in excess of $13 billion. The enormous size of the required funding together with the State's current credit condition and the continued weakness of the municipal finance market as compared to prior years make it highly unlikely that the State can access the short-term market for its TRAN borrowing based on its own credit.

Over 75% of California's General Fund budget supports local school districts, provides funds to counties for social services and funds other local governments. We project that the State will be almost out of cash in July. If a viable TRAN borrowing program cannot be implemented in early July and completed by September, the State will have to take drastic steps to manage its dwindling cash resources, which will result in delays of payments owed to school districts, counties, social service providers, vendors and others who count on State payments for their own livelihoods. In particular, delaying payments to already cash-strapped school districts might even push some of them into bankruptcy.

Proposed Funding Transaction and TARP Support

Given California's weakened financial condition, the State will need to structure a significant portion of its TRANs with credit enhancement provided by letters of credit or standby purchase agreements from banks and other financial institutions in order to gain access to the capital markets. In the event of a default by the State and a draw on a bank's credit instrument, the bank would make the required payments to investors in exchange for the notes. Although the State will be legally obligated to repay the banks over time through its notes, the current credit crisis makes it highly unlikely that the State can induce the banks to provide the required credit support, even at exorbitant rates, without further protection for the banks. To induce banks to make credit available, we propose that the Treasury establish a program under TARP by which the Treasury would be obligated to purchase defaulted State or local government TRAN notes from the banks only in the event of default, if banks acquire notes in these transactions. We are highly confident that such a program would be greeted with enthusiasm by the banking community, which would make available substantial amounts of credit for TRAN borrowings.

The Emergency Economic Stabilization Act of 2008 permits the purchase of financial instruments, such as the notes, originated or issued after March 14, 2008, upon a determination by the Secretary of the Treasury, after consultation with the Chairman of the Board of Governors of the Federal Reserve, that the purchase of such notes by the Treasury is necessary to promote financial market stability. A fiscal meltdown by California or any other large State or municipality would surely destabilize the U.S., if not worldwide, financial markets.

Additional detail is provided in the attachment to this letter. Thank you for your consideration. If you require any additional information, please feel free to contact me or a member of my staff at (916) 653-2995.

Sincerely,

Bill Lockyer

BILL LOCKYER
California State Treasurer

cc: Governor Arnold Schwarzenegger
California State Controller John Chiang
California State Assembly Member Karen Bass
California State Senator Darrell Steinberg
U.S. Senator Barbara Boxer
U.S. Senator Dianne Feinstein
U.S. Representative Nancy Pelosi
U.S. Representative Barney Frank
U.S. Representative Brad Sherman
Gene Sperling, Counselor to Secretary Geithner

PROPOSED TARP PROGRAM FOR STATE AND LOCAL GOVERNMENT TRANS

- **Elements of the Proposed Program**

  - **Best solution is one that doesn't require new legislation –** Due to the urgent time constraints facing California and other government entities, we believe the best approach would be to implement a program under existing law and with existing congressional approval.

  - **Establish Program** - Under Sections 101(a)(1) and 3(9) of the Emergency Economic Stabilization Act of 2008 ("EESA"), the Secretary of the Treasury, following consultation with the Chairman of the Board of Governors of the Federal Reserve, and upon transmittal of such determination to the appropriate committees of Congress, would determine that it is necessary in order to promote financial market stability to establish a program to purchase from participating financial institutions certain designated assets, consisting of defaulted State or local government TRANs.

  - **Program Mechanics** - The following mechanics will be needed to establish an effective federal credit support program:

    - **Commitment to Purchase -** The Treasury would provide written guidance to all domestic banks and foreign banks with U.S. agencies that the federal government will use TARP as necessary to purchase certain State and local TRANs from banks which provide credit enhancement to support such notes. Treasury may include parameters and qualifications for participating banks and/or government agencies and their TRANs. Upon submitting a simple application, Treasury would commit to purchasing up to a specified amount of defaulted TRANs issued by the government agency. It will be important that once made, the Treasury commitment is irrevocable so that there can be no grounds under which the participating banks can remove their credit enhancement for the State or local TRANs.

    - **Fees to Treasury** - Treasury would charge State and local issuers who use the federal backstop an upfront fee (e.g., 1.00% of the face value of the cash flow notes being issued). The fee would be payable (most likely through the banks) from the proceeds of the cash flow borrowing.

    - **Notice of bank draw** - If the State or locality projects that it cannot repay its TRAN obligation at maturity, it would provide a specified advance notice to the bank of its intention to draw on the credit enhancement supporting the borrowing to repay investors. The Government should be able to project by 30-45 days before maturity if it might default. The bank would immediately notify Treasury of a potential draw on the TARP facility. (The draw could be cancelled if the

Government is ultimately able to pay its TRANs without drawing on the bank credit.)

- **Simultaneous bank and Treasury purchase** - On the day that the bank credit is drawn upon, the Treasury would purchase the non-performing assets from the bank under TARP. The simultaneous execution will be important to the banks to allow them to minimize their capital charges for this program.

- **Repayment of Federal obligation** - With the purchase of the non-performing assets by the Treasury, the defaulting State or local government would then be obligated to repay the Treasury based on the repayment terms under its reimbursement agreement with the bank. These terms may depend on state law, and can range from use of first available cash to an amortization over three to five years.

- **Warrants or Debt Instruments Required to be Delivered to Treasury** – We are aware that Section 113 of EESA provides that the Secretary may not purchase any troubled asset unless the Secretary receives from the financial institution from which the asset is purchased either equity warrants or voting stock or senior debt instruments. Although the notes in the proposed program will be purchased from banks which provide credit support for State or local government TRANS, in the event of default on such TRANs, the objective of this program is to assist the States and local governments that are in need of funding, and not to assist the banks as such. Accordingly, it is very important that any requirement for the banks to deliver warrants, securities or debt instruments to the Treasury be crafted in a manner that does not discourage bank participation in the proposed program, or it will not achieve its ultimate purpose.

Additional Considerations

- **Consistent with EESA** - Section 103(7) of EESA expressly includes the need to ensure stability for State and local governments as a consideration in making TARP assistance available.

- **Consistent with Tax-exempt Status of TRANs** – Although there has been discussion about creating some program with a direct federal guaranty of State or local TRANs, such a program does not appear to be authorized under any current laws. Moreover, such a program could require the TRANs to bear taxable interest, because direct federal guaranty of municipal instruments is generally prohibited by Section 149(b) of the Internal Revenue Code. By contrast, the TARP-based program described above, where the federal guaranty is in the form of a back-up obligation to purchase TRAN notes from banks, should allow the TRANs to be issued with tax-exempt interest, saving substantial costs to the States and local agencies. It will be important for the Treasury or Internal Revenue Service to confirm that the proposed program will not violate Section 149(b).

- **This Is a New Problem** – This operating cash crisis is not related to the market dysfunction that arose in early-mid 2008 with the auction rate bond and bond-insured and bank-enhanced long-term bond markets, nor is it related to the more extensive contraction of the municipal bond market starting in September 2008. The cash flow issue has only been identified and highlighted in the last several months.

  This operating cash crisis has not been relieved by the State's recent successful long-term general obligation bond sales which have totaled more than $13 billion, including more than $5.2 billion of Build America Bonds. These long-term financings have provided funding for many voter-approved capital construction projects and will have a significant stimulus effect to the California economy. But none of the proceeds of these bond issues can be legally used to meet operating cash flow needs. Only Revenue Anticipation Notes ("RANs") and Revenue Anticipation Warrants ("RAWs") can be used by the State to borrow for operating cash flow purposes. The fact that the State has recently been able to issue long-term bonds does not mean it can presently access the short-term market, as investors in the two markets look at different financial metrics.

- **Key to Stimulus Efforts** - By employing great numbers and providing critical safety net support to millions of disadvantaged Americans, the proper functioning of State and local government is essential to attaining the federal government's overall stimulus objectives. If States and localities are unable to meet their short-term cash flow borrowing needs, the effect will be immediate, chilling and a significant setback to the country's economic stimulus efforts that are just now beginning to produce results.

- **Not a Giveaway** - Because the State and local borrowers who draw on their bank letters of credit are obligated to repay the banks or their successors, the federal government should be fully repaid for any purchases it makes. In addition, because the State and local government issuers utilizing the federal support will have to pay fees to both the Treasury and their letter of credit bank, they will not utilize the guarantee if they have a less costly alternative.

- **Very Low Likelihood of Loss of Federal Funds**– Historically, there has been nearly a zero default rate on municipal TRAN borrowings. There is only a small chance that the Treasury will ever be called upon to purchase defaulted municipal TRANs and even if it does, its risk of eventual nonpayment is virtually nil because municipalities must repay their debts eventually. These are ultimately much better assets than many of the "toxic" assets TARP was originally created to remove from the financial system.

- **Short-Term Not Long-Term Federal Obligation** – Unlike the problems which are facing the auction rate bond and variable rate bond markets, which could require long-term commitments (as long as 30 years) from the federal government, the federal credit support that is needed for the cash flow borrowings of troubled States and localities will only require a short-term commitment by the federal government. At most, the credit backstop should only be required for the next three or four years.

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