CALIFORNIA STATE TREASURER BILL LOCKYER

NEWS RELEASE

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Treasurer Lockyer Releases Data on Major Banks' Trading of Derivatives Linked to California Bonds

Will Require Quarterly Reports on Underwriters' Default Swap Trading

SACRAMENTO – State Treasurer Bill Lockyer today released data that show the top six fee earners among investment banks that sell California bonds have, since 2007, completed more than $27.5 billion of trades in a market where investors can profit by taking a dim view of the State's credit risk.

The volume of the firms' trades of credit default swaps (CDS) on State general obligation (GO) bonds equals 63.2 percent of the $43.5 billion of GO bonds issued by California since 2007. The $27.5 billion CDS trading figure includes buys and sells the banks completed for themselves or their clients. Those clients include hedge funds, broker-dealers, insurance companies and banks, according to information provided by the six underwriters.

The banks provided the data in response to Lockyer's March 29, 2010 letter seeking information about the firms' trading activity in the municipal CDS market. In the letter, he voiced concern about banks selling the State's bonds on one hand, and on the other hand betting against, or facilitating bets against, those bonds. The letter also expressed Lockyer's worry that CDS prices, if they reflected a negative, baseless view of California's creditworthiness, could harm the State's bond sales and burden taxpayers with higher interest costs. Lockyer said taxpayers have a right to know about the firms' CDS trading activities.

The six investment banks include: Bank of America Merrill Lynch, Barclays, Citigroup, Goldman Sachs, J.P. Morgan and Morgan Stanley. Since 2007, the State has paid the firms a combined $215 million in bond underwriter fees and commissions.

Following are specific CDS figures provided by the banks. The net face value (notional value) represents the difference between the value of CDS bought and sold:

- Bank of America Merrill Lynch: volume since 2007 – $2.1 billion (obtained after letter response); gross face value as of March 31, 2010 – $1.7 billion; net face value as of March 31, 2010 – $39 million

- Barclays: volume since 2007 – $2.5 billion; gross face value as of March 31, 2010 – $2.5 billion; net face value as of March 31, 2010 – $1 million

- Citigroup: volume since 2007 – $3.3 billion; gross face value as of March 31, 2010 – $1.7 billion; net face value as of March 31, 2010 – $49 million

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- Goldman Sachs: volume since 2007 – $8.8 billion; gross face value as of April 14, 2010 – $3.9 billion; net face value as of April 14, 2010 – $17 million

- J.P. Morgan: volume since 2007 – $1.4 billion; gross face value as of April 14, 2010 – $1.5 billion; net face value as of April 14, 2010 – $97.4 million

- Morgan Stanley: volume since 2007 – $9.4 billion; gross face value as of April 14, 2010 – $1.9 billion; net face value as of April 14, 2010 – $38 million

Purportedly, as the name implies, CDS are a kind of insurance against default. Generally, under a municipal bond CDS contract, the buyer gets paid if the issuer fails to make bond payments, or delays or reduces payments. GO bonds almost never default. California never has defaulted in its history.

In reality, as information provided by the banks confirms, expectations of actual default play little or no role in most municipal CDS trades. Instead, investors buy or sell them to bet on how perceived credit risk will be reflected in market prices. Or they use them as a hedge against bond holdings, letters of credit or other credit exposures. Buyers can bet that an issuer's perceived credit risk will increase and that the prices, or spreads, on the issuer's CDS also will rise. If that happens, the buyer profits. Buyers doesn't even have to own the bonds to place a bet and win. Conversely, sellers of CDS can profit if the perceived credit risk lessens.

The information provided by the banks was analyzed by experts in Lockyer's office and outside financial advisers. Based on that analysis, Lockyer has reached some <u>preliminary</u> conclusions about the banks' trading of CDS on California GO bonds, and the effect of that activity on taxpayers' borrowing costs on the bonds:

- The CDS trading's effect on bond prices is not significant enough to cause concern <u>at this time</u>.

- The data suggest the banks themselves, during the period covered, did not bet against the credit quality of California GO bonds. The low net face value of the banks CDS positions, on the surface, indicates the absence of any conscious decision to "short" California GOs via the CDS market. Lockyer will seek more information to further clarify the banks' "proprietary" trading of California CDS.

- More information is needed to determine the extent to which the banks' clients who have no California credit exposure have placed speculative bets with California CDS, and the extent to which the banks have facilitated those bets. Lockyer will ask the banks for that information.

Additionally, Lockyer announced his office will require all 86 firms in the State's bond underwriter pool to file quarterly reports that provide detailed information on each firm's CDS market activity.

And he urged Congress to pass strong legislation to regulate the market for derivatives, including municipal CDS. He said legislation should make the market fully transparent. To protect against speculative trading, Lockyer said legislation also should require CDS buyers to own the underlying securities, such as bonds.

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Ongoing monitoring of California CDS trading is important, said Lockyer, especially if Build America Bonds (BABs) become a permanent part of the municipal bond landscape. BABs are taxable, and they are more akin to corporate bonds than traditional tax-exempt municipal bonds. CDS play a much more prominent role in the corporate bond market. The six banks agreed CDS likely will gain significance in the municipal bond market if the BABs program lives beyond its current 2010 sunset date.

"We're not going away," said Lockyer. "We will remain vigilant in protecting taxpayers' interests. The potential for harm exists, and the danger will only grow in the evolving municipal bond market. These banks told us the CDS market can bring some benefit to California because it increases liquidity and makes our bonds more attractive to investors. That may, or may not, be true. What we know is Wall Street has a bad habit of turning even good things into catastrophe. And taxpayers' primary operating principle should be this: Look out when Wall Street says it's looking out for you."

The banks' responses to Lockyer's request for information are available at www.treasurer.ca.gov.

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