

April 13, 2010

The Honorable Bill Lockyer  
Treasurer  
State of California  
915 Capitol Mall  
Room 110  
Sacramento, CA 95814

State of California CDS

Dear Treasurer Lockyer:

Citigroup Inc. and Citigroup Global Markets Inc. (together, "Citi") hereby responds to your March 29, 2010 letter to Vikram Pandit, seeking certain information relating to trading activity concerning State of California credit default swaps ("CDS"). Citi reserves the right to supplement or amend this response in the event additional relevant information is discovered.

**Citi Support for the State of California**

Citi's Municipal Securities Division ("MSD") is one of the largest municipal securities market makers, and has the largest portfolio of municipal securities, of any commercial or investment banking firm. Over the years, Citi has maintained an outsized exposure to general municipal credit and, specifically, to the State of California.

We believe that there is no larger supporter of the State of California credit than Citi. Citi maintains a \$14 billion tax-exempt municipal bond portfolio, \$2 billion of which is attributable to state of California issuers. In addition, as set forth in the Offering Memorandum for the State's most recent general-obligation bond sale, dated March 25, 2010, Citi currently has \$700 million in outstanding letters of credit in support of the State's general obligation debt (all of which were provided to the State in 2009), more than any other U.S. commercial or investment banking firm. Citi was one of the few financial institutions that continued to accept, honor and cash IOUs issued by the State throughout the challenging events of this past summer. Citi also has worked closely with your Office to develop and execute the Housing Bond Private Placement Option Program, which is intended to restart lending for low- and moderate-income housing development in California, as mandated by the State's voters under Propositions 1C and 46. Finally, as Joint Bookrunner for the State's recent \$3.4 billion Federally Taxable General Obligation and Build America Bond ("BABs") offering, Citi marketed California's general obligation bond credit in 29 countries and helped generate over \$6 billion of new interest in the State's offering.

**State of California Question #1**

*Describe your firm's trading activity in municipal and State of California credit default swaps ("CDS"). In your answer, please provide detailed information about all of the following:*

- *Your firm's activity in making markets (i.e., providing, on a regular basis, firm one-way or two-way quotes to clients) in municipal and State of California CDS.*

- *Your firm's role as a broker, arranger or facilitator of State of California CDS trades.*
- *The categories of clients for whom you provide market-making services, or for whom you broker, arrange or facilitate trades, in municipal and State of California CDS. Examples of such clients include, but are not limited to, hedge funds, insurance companies, monoline insurers, banks and dealers.*
- *Your firm's volume of State of California CDS trades from Jan. 1, 2007 through the present. Please provide the total volume and the volume for each category of client.*
- *Your firm's current outstanding gross and net notional amount of State of California CDS.*

### **Citi Response**

Citi currently makes two-sided markets in State of California CDS, which helps provide clients with liquidity. Since the inception of its State of California CDS market-making activities, Citi's MSD has traded State of California CDS with approximately 30 different counterparties, including insurance companies, monoline insurers, commercial banks, broker-dealers and hedge funds.

From January 1, 2007 through March 31, 2010, Citi had \$3,314,800,000 in gross-notional State of California CDS trading volume. Of this amount, approximately \$2,514,800,000 represents newly entered buy/sell positions and approximately \$800,000,000 reflects the closing out of original trades, leaving a current gross outstanding notional volume of \$1,714,800,000. Citi's current net-notional amount of State of California CDS is \$49,400,000, which means Citi is exposed to a decline in the State of California's credit (*i.e.* Citi is long the State of California via CDS).

On an aggregate basis (*i.e.*, bond positions, extension of bank facilities and CDS positions), Citi has never taken a net-short position with respect to the State of California and has extensive exposure to the State of California. In addition, during the relevant period, Citi has not taken a proprietary negative position, on an aggregate basis, on the State of California.

### **State of California Question #2**

*Describe any credit analysis/marketing information you distribute to clients that contains information regarding municipal CDS in general, and California CDS specifically, from Jan. 1, 2007 through the present.*

### **Citi Response**

Citi's MSD has published three articles concerning California CDS. The first publication, dated January 18, 2008, discusses the spread between bonds and CDS in California. The article does not make predictions or advocate trading strategies. The second research piece, dated December 12, 2008, discusses yields and prices in the municipal bond market, and notes

that prices for State of California CDS “ha[ve] gone haywire” and “bear no relationship to real risks whatsoever.” The third publication, dated December 16, 2008, observes that the cost of insuring California’s debt had become more expensive than insuring against Mexico’s debt. The author notes that this development is “overdone,” focusing on California’s GDP (which six times higher than Mexico’s), public-sector debt burden (which is one fifth of Mexico’s), and the forthcoming Obama Administration stimulus package (for which Mexico would not be eligible).

**State of California Question #3**

*Describe, in your view, how State of California CDS trading, in recent years, has affected the State, its bond sales and the borrowing costs paid by taxpayers.*

**Citi Response**

Citi does not believe that there is any discernible relationship between Citi’s State of California CDS trading activity, on the one hand, and the State’s bond sales and borrowing costs paid by taxpayers, on the other hand. Citi is not able to comment on other market participants’ trading activities or strategies.

**State of California Question #4**

*Provide your outlook for the municipal CDS market and, more specifically, the State of California CDS market, over the next two years. In your response, please include a discussion of your firm’s views on: whether (and how) continued growth of the taxable Build America Bond market could increase the use of municipal CDS; and the circumstances under which growth in CDS trading could adversely affect the State and its debt issuance?*

**Citi Response**

With the advent and potential extension of taxable BABs, it is possible that the trading volume of State of California CDS will increase substantially because a large array of taxable bond investors often are inclined to raise or lower the credit exposure of their underlying portfolio through the use of CDS. Because municipal bond insurance remains limited and/or cost prohibitive, taxable bond investors also may have fewer alternative means to manage their portfolio risk. Moreover, further development and liquidity in the municipal CDS market could result in greater liquidity for the State’s taxable bonds by providing taxable bond investors with greater comfort that they could use CDS if necessary to help manage their portfolio risk.

\* \* \* \*

Citi is providing the information contained in this letter and the enclosed documents in response to, and in cooperation with your request. Accordingly, Citi respectfully requests that the materials produced herein, together with this letter (the “Confidential Materials”), be accorded confidential treatment under any and all applicable rules and statutory provisions,

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REQUESTED BY CITI**

including Cal. Gov't Code §§ 6254, 11180.5 and 11183, as well as any and all common-law rules, regulations, practices, procedures, privileges and protections.

If any other person (including any government employee) requests an opportunity to inspect or copy the Confidential Materials, or if the State Treasurer's Office contemplates the disclosure of the Confidential Materials to any other person, pursuant to California Public Records Act, Cal. Gov't Code §§ 6250 *et seq.* or otherwise, we respectfully request that the undersigned receive immediate notification of such request and that all written materials pertaining to such request be forwarded to our attention so that Citi may have an opportunity to object to any such disclosure.

The requests set forth above also apply to any memoranda, notes, transcripts or other writings of any sort that are created by, or at the request of, an employee of the State Treasurer's Office and that (i) incorporate, include, or relate to any of the Confidential Materials, or (ii) refer to any conference, meeting or telephone conversation between employees of the State Treasurer's Office and Citi, its employees, counsel or other representatives, relating to the Confidential Materials.

The Confidential Materials remain the property of Citi. We therefore request that, upon the conclusion of the inquiry by the State Treasurer's Office, the enclosed documents, and any copies made thereof, promptly be returned to the undersigned.

\* \* \* \*

If you have any questions or require any additional information, please contact me at (212) 723-5373.

Respectfully,



Howard Marsh  
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Head, Municipal Securities Division  
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