

Lloyd C. Blankfein  
Chairman  
Chief Executive Officer

Goldman  
Sachs

April 14, 2010

The Honorable William Lockyer  
California State Treasurer  
915 Capitol Mall, Room 110  
Sacramento, California 95814

Dear Treasurer Lockyer:

I am responding to your letter of March 29, 2010 regarding the municipal finance markets. Before answering your specific questions, I think it would be helpful to underscore a few key points.

Goldman Sachs maintains a continuing commitment to California as a bond underwriter and to the municipal finance markets generally. California is a very important client of the firm, and we have been privileged to work with the State to finance critical infrastructure and other needs. Furthermore, Goldman Sachs has a long tradition in the municipal marketplace where we have helped states and municipalities access the capital markets for over 50 years.

In addition to being an underwriter, Goldman Sachs acts as market-maker for an array of municipal products, including securities issued by states and municipalities, as well as for instruments based on those securities. The role of market-maker is essential to maintaining the efficiency, liquidity and integrity of any market. In the ebb and flow of the market, buyers and sellers cannot always be immediately matched. As a market-maker, we step in with our own capital to execute a trade for that client—hence, the name "market maker." By consistently providing prices at which we are willing to both buy and sell, we promote confidence in a market's liquidity and make investing clients more willing to participate. The more liquid the market is for a particular security, the more likely investors are to participate in that market. The resulting broader base of potential investors ultimately lowers the cost of borrowing for issuers like the State of California.

Since they were developed in the late 1990s, credit default swaps ("CDS") have become a means of managing credit risk similar to the buying and selling of cash securities. Our experience is that CDS are used in practice primarily to manage changes in value due to changes in credit risk, and not as a bet that a particular issuer will or will not default. In this context, CDS permit Goldman Sachs and other broker-dealers to better manage their inventory of California GO bonds, and thereby provide greater market liquidity for those instruments.

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As you will see from the answers below, in addition to our roles as a leading underwriter of and market-maker for California bonds, we are an active market-maker for California CDS, and the CDS market is small relative to debt outstanding. You will also find that Goldman Sachs' largest counterparties in California CDS are other banks and broker-dealers. That activity largely reflects market-making and hedging activity by ourselves and others. By making markets in municipal CDS, Goldman Sachs is not expressing a view that California or any other state or municipal issuer will default.

Below please find the answers to your specific questions:

***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.***

Goldman Sachs is an active market-maker for California tax-exempt bonds, Build America Bonds ("BABs") and CDS, as well as for other municipal products, providing regular two-way quotes to buy or sell such products. Our investing clients include money managers, banks, insurance companies, hedge funds and other market participants.

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The chart below breaks down Goldman Sachs' California CDS volume by client type since January 1, 2007.

Client Type	Volume Since 2007 (Gross Notional Volume)	% of Total
Banks or Broker-Dealers	5,518,400,000	63%
Hedge Funds	2,733,600,000	31%
Money Managers	321,000,000	4%
Insurance Companies	110,000,000	1%
Other	46,000,000	1%
<b>Total</b>	<b>8,729,000,000</b>	<b>100%</b>

Goldman Sachs' current net notional position in California CDS is very small, \$17 million, and our current gross notional position in California CDS is approximately \$3.9 billion. The difference between the gross and net notional amounts reflects the fact that as a market-maker, we enter into many offsetting trades across our client base.

**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.**

Groups within Goldman Sachs' Securities Division routinely prepare sales and marketing materials. These materials are distributed to the firm's institutional sales force, who can, if they so chose, share them with the firm's investing clients. The groups that prepare such sales and marketing materials are located in the Securities Division on the public side of the firm's "Chinese Wall." They prepare the materials without any input from Goldman Sachs' Investment Banking Division, including the group that provides underwriting services to the State of California, which is on the private side of the firm's "Chinese Wall."

The sales and marketing materials that have contained information about municipal CDS typically address the general credit profile of municipal issuers, using public, third-party data. Specific issuers such as the State of California are not singled out in these materials. Any decision by an investor to buy or sell municipal CDS is an expression of that investor's view or its need to manage its own risks.

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**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.**

The market for California CDS is small relative to the State's outstanding debt. According to DTCC, the net notional amount of outstanding California CDS in the entire market was \$877 million as of March 19, 2010. By comparison the State's outstanding GO debt is almost \$76 billion, and its most recent bond sales were \$5.9 billion. The small size of the municipal CDS market limits its ability to have any material effect on bond sales and borrowing costs.

We believe that CDS trading has had little or no effect on California's borrowing costs. The State's credit, budget and debt management (and not CDS prices) are the primary drivers of the State's borrowing costs. Other drivers of market perception that ultimately affect borrowing costs for issuers generally and the State specifically include: the actions of the credit rating agencies, debt burden, pension concerns, volume and frequency of debt issuance, underlying economic conditions, and ongoing negative headline risks associated with states and municipalities. These factors also affect the price of municipal CDS.

The State has done an effective job of, among other things, managing its issuance calendar and reaching out to new investors to explain the strength of its GO credit, its low GO debt burden and its use of GO bonds to only invest in infrastructure. These efforts have helped to improve investors' view of the State's credit.

**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?**

Going forward, we believe that the BAB market will and should grow in size as a cost effective source of capital for municipalities. As the market for California BABs and tax-

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exempt bonds grows, California CDS volume might increase given that CDS are used by both taxable and tax-exempt investors in California GO bonds. We believe, however, that the California CDS market will remain relatively small in size compared to the bond market, and thus, will not be a driver of California's borrowing costs. As noted above, the primary drivers of California's borrowing costs will be the State's management of its credit, budget and debt.

We also want to note that Goldman Sachs supports various efforts and initiatives to enhance the transparency and efficiency of CDS markets, such as the broad move to a central clearing house for and exchange trading of standardized derivatives. The establishment of a central clearing house would be most effective at enhancing price discovery and reducing systemic risk.

Goldman Sachs has been privileged to serve in its role as one of California's underwriters and to support California through its activities as a market-maker. I appreciate your interest in this matter and would be happy to answer any further questions.

Sincerely,

A handwritten signature in blue ink, appearing to read "Lloyd C. Blankfein", followed by a long horizontal line extending to the right.

Lloyd C. Blankfein  
Chairman & CEO  
The Goldman Sachs Group, Inc.