

April 14, 2010

Mr. Bill Lockyer  
Treasurer  
State of California  
915 Capitol Mall, Room 110  
Sacramento, CA 95814

Dear Mr. Lockyer:

I am responding to your March 29, 2010 letter to Jamie Dimon requesting information about the credit default swap ("CDS") market in municipal bonds and, in particular, State of California bonds. As a follow up to our response, I would be happy to discuss any concerns you have in regard to J.P. Morgan's ability to be an effective partner in meeting the ongoing financing needs of the State.

### **A Brief History of Municipal Credit Default Swaps and J.P. Morgan's Role**

The market for corporate CDS began in the mid 1990's and became a regularly quoted market throughout the 2000's. J.P. Morgan has played a role in the CDS market since inception, primarily as a market maker. The CDS market on municipal entities began around 2004-2007. This market is substantially smaller than the market in corporate CDS and only involves a few key names, including the State of California. J.P. Morgan participates in the Municipal Credit Default Swap ("MCDS") market, primarily as a market-maker. As a result of our market-making activity, we maintain some positions in MCDS. In May 2008, the market developed the MCDX index, which is a basket index of 50 different single name MCDS contracts. J.P. Morgan also acts as market-maker for this index. J.P. Morgan participates in the MCDS market to meet the needs of investors and to facilitate liquidity in the market.

### **State of California Credit Default Swap Questions**

*1) Describe your firm's trading activity in municipal and State of California credit default swaps ("CDS"), including the following:*

*a.) 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.*

J.P. Morgan acts as a market maker in MCDS, including the State of California. Trading and firm two-way quotes to clients are generally done “by appointment” at the request of clients, though firm two-way MCDS quotes are provided periodically.

*b.) Your firm’s role as a broker, arranger or facilitator of State of California CDS trades.*

J.P. Morgan has acted as broker for MCDS, including the State of California, for different investor/institutional clients.

*c.) 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.*

J.P. Morgan has provided market making services in MCDS to hedge funds, asset managers, banks, and other dealers. To the best of our knowledge, we have not dealt with monoline insurance companies in the MCDS market.

*d.) Your firm’s volume of State of California CDS trades from January 1, 2007 through the present. Please provide the total volume and the volume for each category of client.*

<u>Trade Year</u>	<u>Notional Amount of Short Protection</u>	<u>Notional Amount of Long Protection</u>	<u>Number of Trades</u>
2007	275,000,000	310,800,000	32
2008	321,400,000	290,000,000	64
2009	95,000,000	55,000,000	16
2010	-	35,000,000	3
<b>Total</b>	<b>\$691,400,000</b>	<b>\$690,800,000</b>	<b>115</b>

<u>Counterparty Type</u>	<u>Notional Amount of Short Protection</u>	<u>Notional Amount of Long Protection</u>	
Dealer	564,400,000	558,100,000	76
Bank	67,000,000	107,700,000	33
Asset Mgmt	50,000,000	25,000,000	4
Hedge Fund	10,000,000	-	2
<b>Total</b>	<b>\$691,400,000</b>	<b>\$690,800,000</b>	<b>115</b>

*e.) Your firm’s current outstanding gross and net notional amount of State of California CDS.*

For State of California MCDS, J.P. Morgan currently has long protection notional of \$790.8 million and short protection notional of \$693.4 million, for a net long protection notional of \$97.4 million. However, we would highlight that notional is not always an appropriate benchmark of exposure within a trading book, since various trades have different maturities and duration.

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

J.P. Morgan's Fixed Income Strategy group has commented from time to time on the State of California, MCDS and MCDX in its publications. The following issues of "US Fixed Income Markets Weekly – Municipals" contain references to MCDS or MCDX: April 9, 2010, March 14, 2010, February 19, 2010, January 24, 2010, November 13, 2009, June 19, 2009, June 5, 2009, February 27, 2009, February 20, 2009, February 6, 2009, January 23, 2009, December 12, 2008, October 24, 2008, October 17, 2008, July 25, 2008, June 20, 2008, June 6, 2008, June 2, 2008, May 16, 2008, May 9, 2008, and May 2, 2008.

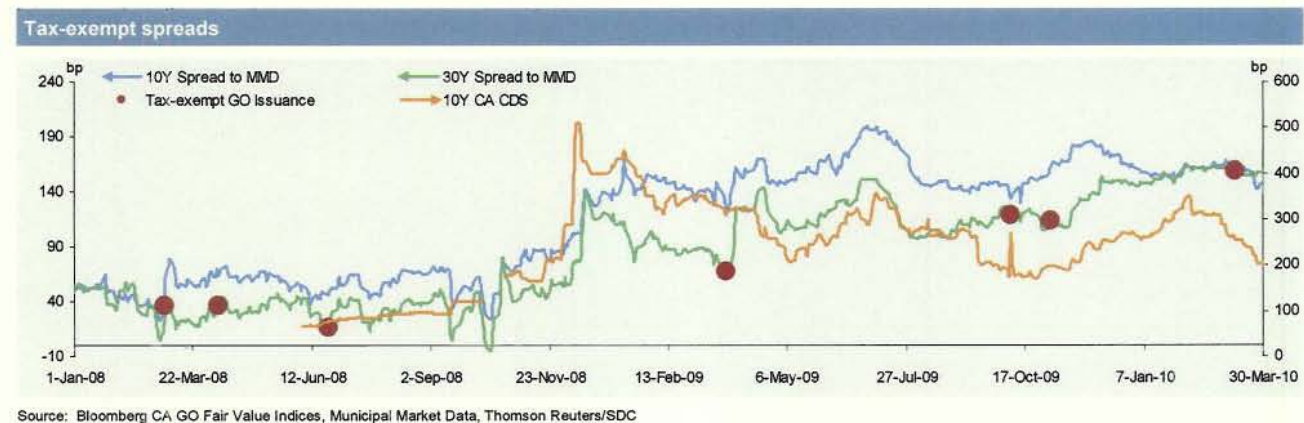
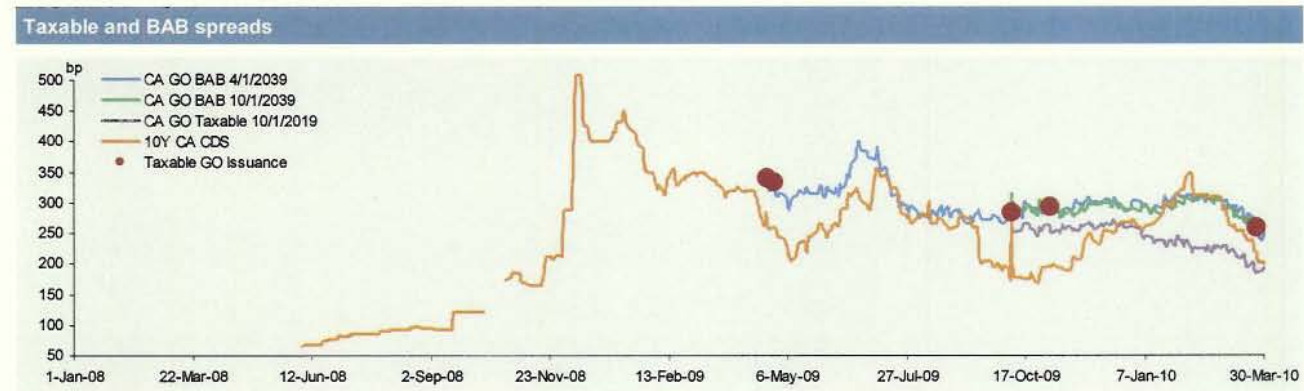
While these reports span a wide array of topics and market environments, there is discussion of the launch of MCDX, relative value comparisons between MCDX and single name MCDS and between MCDS and cash bonds (including those of the State), analysis of the State's budget and fiscal environment, and certain trade recommendations.

Separately, our Public Finance Investor Derivatives group provides marketing material to investor clients that from time to time discuss MCDX and MCDS as a potential product alternative for their portfolio management needs. To the best of our knowledge, no marketing materials have included any trade recommendations in regards to buying protection on the State of California through an MCDS contract.

*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.*

To the best of our knowledge, trading in State of California CDS has had no observable impact on the borrowing cost of the State. We do think that the use of CDS products may have expanded the potential buyer base for the State's debt, as they provide investors with an effective hedging tool for managing credit risk.

The following graphs outline the State's tax-exempt and taxable credit spreads since 2008, along with 10Y CDS trading levels.



We observe that while the general direction of CDS spreads tracks the direction of tax-exempt spreads, we note that at times there can be a significant differential in levels due to the structural dynamics of both markets. Since bond trading spreads represent a combination of interest rate risk, funding risk (CDS is generally an unfunded position), and credit risk, it is difficult to arrive at a true neutral comparison between the markets. In addition, there is little evidence that an increase in MCDS spreads causes a direct increase in bond spreads.

*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 view 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?*

The future use of CDS products in the municipal market is somewhat unknown, and will be driven by prevailing market forces. To the extent there is continued use of MCDS, we expect the MCDX basket will continue to dominate trading, since it is a more liquid instrument that can help participants hedge the general credit environment for municipals. In our view, the CDS market does not contribute to an increase in the borrowing cost of the State. The deepening market for taxable municipal bonds through the BAB program could potentially increase market participation in CDS to the benefit of the State, since it might expand investor capacity for the State's debt.

## **J.P. Morgan's Commitment to the State of California**

J.P. Morgan's commitment to California dates back to the early 1980s, when our firm provided a bridge loan to the State in anticipation of the passage of legislation authorizing the sale of Revenue Anticipation Notes. Over the past ten years, J.P. Morgan has underwritten over \$150 billion in financings for the State of California and its various departments and authorities, \$41.4 billion of which we served as senior manager. In addition to our role as underwriter, we currently remarket approximately \$1.9 billion in short-term paper, and provide significant credit enhancement and liquidity support, with our exposure to the State of California and its departments totaling over \$1 billion.

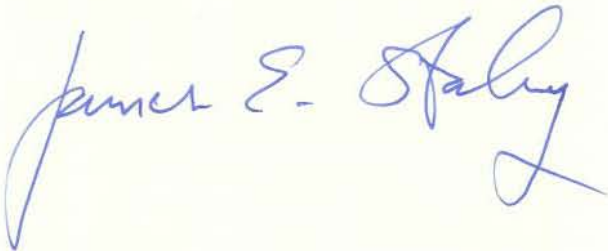
During the power crisis of 2000 and 2001, JPMorgan served as lead agent bank for a \$4.3 billion bridge loan to the Department of Water Resources that enabled the State to cease using the State's general fund for the purpose of purchasing power in 2001. JPMorgan itself lent \$2.5 billion, the largest loan ever made by the firm to any client.

In April 2009, J.P. Morgan served as joint book runner and senior manager for a \$6.85 billion general obligation bond issue, including \$5.23 billion of Build America Bonds ("BABs"), the largest California general obligation bond sale in history. With the issuance of BABs, the State was able to quickly access new markets to meet critical funding needs and save taxpayers an estimated \$1.1 billion over the life of the transaction.

In 2009, J.P. Morgan offered to lend the State up to \$4 billion. Ultimately, the State's cash flow needs required only \$1.5 billion of interim assistance, which J.P. Morgan provided by purchasing an Interim Revenue Anticipation Note. The proceeds of the Interim Note allowed California to fully redeem all the state IOUs early and meet its financial obligations until a publicly offered cash-flow borrowing could be executed. On September 23, 2009, J.P. Morgan led California's \$8.8 billion Revenue Anticipation Notes public offering, designed to address timing differences between State revenue receipts and expenditures over the course of the fiscal year and used to repay the \$1.5 billion 2009 Interim RAN. Our firm's public support to the State helped reassure the market and ultimately helped lower the financing cost of the RAN transaction. In addition, J.P. Morgan has offered to finance the State's cash flow needs in 2010.

Our firm is committed to deliver results to our clients through strong partnership. Our business model continues to be driven by our ability to extend credit and create a broad effective distribution of the State's debt, ultimately to the benefit of the taxpayer. We look forward to our continued relationship with the State, and we welcome any additional comments or questions you might have on this topic.

Sincerely,

A handwritten signature in blue ink, reading "James E. Spaly". The signature is written in a cursive style with a large, sweeping initial "J" and a long, trailing flourish at the end.