CALIFORNIA STATE TREASURER BILL LOCKYER

NEWS RELEASE

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Treasurer Lockyer Urges Tougher Federal, International Leverage Limits to Curb Speculative Trading of Credit Default Swaps Linked to Municipal Bonds

SACRAMENTO – State Treasurer Bill Lockyer today urged adoption of federal and international rules to limit leverage in the trading of municipal credit default swaps (CDS) to help prevent speculative, or "naked," trading of the derivatives.

Lockyer made the proposal as he released responses from six major Wall Street investment banks to his May 5 follow-up questions about their trading of California CDS. The six investment banks include: Bank of America Merrill Lynch, Barclays, Citigroup, Goldman Sachs, J.P. Morgan and Morgan Stanley. Since 2007, California taxpayers have paid these six banks $215 million to market the State's bonds.

"The municipal CDS market, when used by bondholders to hedge risk, can benefit issuers by increasing demand for bonds," said Lockyer. "But naked trading of CDS by investors who don't own California bonds poses a potential danger to taxpayers. Unchecked speculation opens the door to market manipulation that could artificially inflate perceived credit risk and increase taxpayers' borrowing costs on bonds. Reducing leverage opportunities will make it harder for speculators to game the system and hurt taxpayers."

Lockyer has called on Congress to include in financial regulatory reform legislation a ban on naked trading of municipal CDS. Absent such a ban, he said today, reducing leverage through effective and enforceable capital requirements would be a significant step toward preventing abuse. The federal regulatory proposals now before a Senate-House conference committee include provisions that appear to impose tougher capital and margin requirements on major swap market participants. Depending on how those provisions are ultimately crafted, and the extent to which they are applied to municipal CDS, they could be useful in providing taxpayers the protection sought by Lockyer.

The following summarizes the banks' responses in major areas addressed by Lockyer's May 5 information request, specifically with respect to California CDS. The request covered the period January 1, 2007 through May 5, 2010.

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- Speculative bets against California credit for firm's own account (proprietary trading): Bank of America Merrill Lynch, none; Barclays, none; Citigroup, two trades with $10 million face value; Goldman Sachs, four trades in 2008 with $35 million face value, three open positions, eliminated proprietary trading desk January 2009; J.P. Morgan, none; Morgan Stanley, none.

- Facilitating naked bets against California credit (through market-making): All six banks said they had no knowledge about their California CDS clients' motivations. As a result, they said, they were unable to provide any information about the extent to which their market-making activities facilitated naked trading of California CDS. In explanation, the banks said clients do not disclose why they want to buy CDS, do not want to provide such disclosure, and that such confidentiality helps the market function efficiently.

- Income from market-making in California CDS: Four of the banks – Bank of America Merrill Lynch, Citigroup, Goldman Sachs and Morgan Stanley provided no information. They said providing such information either was impossible because trading income is aggregated, or that they only provide financial information in regulatory financial reports (Morgan Stanley). Barclays reported it lost $2.7 million. J.P. Morgan said it earned $4 million.

Lockyer said the responses to his follow-up questions confirmed two preliminary findings he made following the banks responses to his initial letter of inquiry, dated March 29, 2010. One, the effect of CDS trading on California bond prices is not significant enough to cause concern at this time. And two, the banks themselves have not bet against the credit quality of California GO bonds to any meaningful extent. Meanwhile, there remains a lack of information about the extent to which the banks facilitate clients' naked trading of California CDS.

To protect California taxpayers, Lockyer said his office will continue to closely monitor the municipal CDS market, with a focus on the trading activities of its bank partners. Starting in 2011, Lockyer said his office will require all 86 firms in the State's bond underwriter pool to file quarterly reports on their municipal CDS market activity.

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