SECURITIES

Swap deals unnerve California

Some say credit default swaps may influence the market for muni bonds.

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REPORTING FROM NEW YORK

Is Wall Street profiting from California's misery?

That's been a concern of state Treasurer Bill Lockyer, who takes a dim view of financial instruments — known as credit default swaps — that enable speculators to bet against California's ability to pay its debts.

Like other giant Wall Street firms, JPMorgan Chase & Co. helps investors place such bets against California but also earns hefty fees from the state for helping it get the best prices on the bonds it sells to finance capital improvements and other expenses.

So it was no small annoyance, Lockyer said, when JPMorgan Chief Executive Jamie Dimon publicly suggested in February that he was more concerned about California's budget problems than about Greece's.

Dimon called Lockyer the next day to smooth things over, the treasurer said.

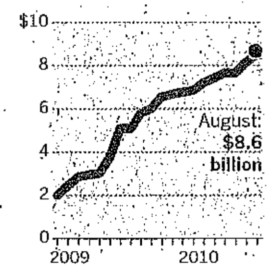
The CEO's remarks came after a number of Wall Street firms issued research reports recommending going "short" on California using

[See Swaps, B6]

Eyes on California

Total volume of credit default swaps outstanding on California bonds, monthly data and latest

(Scale in billions)



Source: Depository Trust & Clearing Corp.

Los Angeles Times

Bets against state on repaying debt stir concern

[Swaps, from B1]

swaps.

Such downbeat analysis "just makes you worry that taxpayers are going to wind up paying more [in interest costs] because of the negative noise," the state treasurer said in an interview.

The market for gambling on whether California will go broke — or will at least be hard-pressed to make good on all its debt — is big and growing fast.

The total volume of swaps outstanding on California's debt surged to a record $8.6 billion last week, up from $5.1 billion a year ago and equal to more than one-tenth the size of California's outstanding general-obligation debt.

In late June, investors were so eager to go buy protection on California bonds that at one point they paid prices that implied a 62% chance of the state's defaulting on its bonds, despite the fact that it has never defaulted and is practically prohibited by the state constitution from doing so.

Although they've been around for more than a decade, credit default swaps — essentially insurance contracts that pay off when bond payments aren't made on time — have a recent notorious history. They were blamed for the 2008 collapse of American International Group Inc., which sold billions of dollars of swaps on mortgage-backed bonds before the securities plunged in value in the housing meltdown.

They also played a key role in a controversial mortgage-linked product at the heart of a government fraud lawsuit against Goldman Sachs Group Inc., which the company recently settled for $550 million.

The market for swaps on state and municipal bonds has developed in just the last few years, and California — with its huge debt and low credit rating — has quickly become the biggest focus for investors, with New Jersey and New York coming in a distant second and third.

As the market grows, Lockyer and others are raising the possibility that it could influence the market for the state's actual bonds. That's a concern in part because the municipal swaps market is much more volatile. For example, the annual cost of insuring five-year California bonds using swaps surged to 3.5% in late June from 1.8% in April, only to fall back to 2.8% on Wednesday.

The buyers of protection at or near the June peak were "radically overestimating the probability of default," a Deutsche Bank analyst wrote in early July.

Lockyer agreed.

"It tells you that there are still many foolish investors out there," he said. Still, he added, "it worries me that that it might cause others to worry about the security of their investment in California."

The volatility is already making some investors nervous about buying California debt, said Matt Fabian, senior analyst at Municipal Market Advisors.

"They are backing away from credits like California, not because they don't think they are safe, but because they are tired of having to justify those purchases to risk managers," Fabian said. "That kind of stuff hurts pricing."

Lower bond prices mean higher interest costs for the state.

Some experts attribute the volatility to the swaps market's hot-house nature. A Citigroup analyst wrote in 2008 that municipal swaps were being wrongly interpreted as "being based on sophisticated analysis of default risk, rather than what it is: a new, thinly traded market where prices can be pushed to extremes by a handful of players."

Early this year, Lockyer opened an investigation into the market for California credit default swaps, asking for data from the big Wall Street dealers, led by Goldman Sachs and Morgan Stanley. In June, he reported finding no evidence that the swaps market has made the state's borrowing more costly.

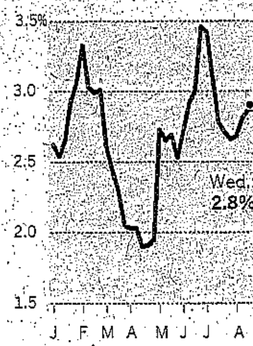
In fact, even as California's budget trouble has attracted attention in recent months, the market interest rates on the state's bonds have generally been sliding along with yields on all kinds of bonds.

Lockyer said he would keep collecting data on the market.

The banks have argued that credit default swaps, by enabling holders of California bonds to hedge their risk, make more investors willing to buy the state's debt.

Bond volatility

Annual cost of insuring California five-year bonds with credit default swaps, as a percentage of the amount of debt covered



Source: Bloomberg

Los Angeles Times

The swaps market "plays an important role in creating liquidity by promoting confidence among investors that they have alternatives in transferring or mitigating risk," Goldman CEO Lloyd Blankfein wrote to Lockyer.

But it isn't necessary to own California bonds to buy the related swaps. Industry insiders say the market volatility points to a heavy presence of speculators.

"There is a new toy out there," said John Mousseau, a municipal finance expert at Cumberland Advisors. "These are people who are just using it as a tool to make money."

At times the banks themselves have promoted speculation in their research.

"Stay short California [general obligation] debt in the near term," JPMorgan analysts wrote in June 2009.

A few months earlier, researchers at Bank America Merrill Lynch told investors that California's "chronic exercises in fiscal brinksmanship have raised legitimate concerns over the state's ability to service its debt."

Such reports are particularly grating to Lockyer because some come from the banks his office employs. The companies, however, say the reports show their research arms are acting independently, as they are supposed to, free of undue influence from other bank operations such as underwriting.

Some banking analysts and Lockyer say the constitutional requirement that Sacramento make its debt payments before paying almost anything else makes default an impossibility — and makes the whole market in swaps a futile exercise.

"There are always sufficient revenues there," he said of the state's coffers, "absent a thermonuclear war or total collapse of the market system."

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