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States Bristle as Investors Make Wagers on Defaults

By IANTHE JEANNE DUGAN

As U.S. cities and towns wrestle with financial problems, investors are finding a new way to profit on their misery: by buying derivatives that essentially bet municipalities will default.

These so-called credit default swaps are basically insurance contracts that have long been available to protect holders of corporate bonds against default. They became available a few years ago for municipal debt, allowing investors to short sell—or bet against—countless cities, towns and bridges, and more than a dozen states, including California, Michigan and New York.

The derivatives are still thinly traded, but their existence has the potential to make investors skittish about the issuers of the bonds that underlie them. That has been the case for issuers ranging from Greece to Bear Stearns and Lehman Brothers during the financial crisis. When the price of this insurance goes up, nervous investors have sold off securities issued by these entities.

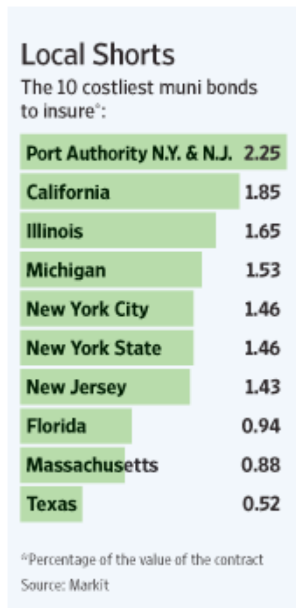
The proliferation of the derivatives is angering treasurers around the country, who say the derivatives are sending a negative message and possibly driving up their costs of borrowing at a time when they need all the help they can get. California planned to send out letters as soon as this week to big Wall Street firms that sell its bonds, seeking in-depth information about their roles in selling derivatives.

"Firms that are underwriting our bond sales are then telling the purchasers maybe they need to buy a CDS reflecting some risk," California Treasurer Bill Lockyer said in an interview. "They are speaking with two tongues, and we want to find out whether that impacts us in an adverse way."

In recent weeks, the treasurer received initial information in letters from the banks, but he is probing further to find out who is buying the products and whether the bank is trading in-house for its own profit. The underwriters who have been questioned are J.P. Morgan Chase & Co.; Merrill Lynch and its parent, Bank of America Corp.; Citigroup Inc.; and Barclays PLC. All the banks told California their activity is making it easier for the derivatives to trade without large prices moves and that they aren't driving up the issuers' borrowing costs.

J.P. Morgan, Bank of America and Citigroup declined to comment beyond the letters they sent. Barclays couldn't be reached for comment.

Credit default swaps are the investment products that play a starring role in the federal case against Goldman Sachs Group Inc. and have served as a tool for investors to make money on other investors' misfortunes, such as the collapse of the housing market.



Betting on a default creates a perception of risk and could ultimately affect credit ratings, which determine how much it costs debtors to borrow money. Banks that deal in derivatives don't have to disclose who is trading or the prices they are paying. Much like corporate CDS, information isn't available beyond the name of the issuer and the spread—the amount the buyer must pay the seller for protection every year over the life of the contract. Critics say dealers can earn higher profits through this lack of transparency, because buyers and sellers don't have real-time data about prices.

The financial-overhaul bill working its way through Congress aims to change the dynamics. Some lawmakers are proposing dealers publicize the buyers of CDS, similar to the way such information is available for stocks.

"Like other states, the Ohio Treasury is concerned about the increase in CDS's and other shorting instruments," Simone Wilkinson, the state's press secretary, said in an email. In Connecticut, Treasurer Denise Nappier has been monitoring whether CDS are affecting the price of the state's bonds.

Some observers say the swaps don't have an impact. Brian Yelvington, a trader at Knight Securities, is among experts who have offered advice to state officials seeking information about whether the instruments are being used for manipulation, which he says isn't happening. "It takes a 10-minute tutorial for them to understand," he says, that the bets aren't nefarious and that they are traded too thinly to affect the market for bonds or a state's bond rating.

The rise in municipal credit-default swaps comes amid growing pessimism about the financial condition of the nation's cities and states. During the recession, local government revenue has declined as people spend and earn less, and raising taxes is becoming harder to do. So bonds, long considered a safe bet, are increasingly regarded as risky.

Municipal CDS are documented by the Depository Trust and Clearing Corp., which settles derivatives trades. The contracts are currently trading on California, Illinois, Michigan, Nevada, Florida, New Jersey, Ohio, Massachusetts, Connecticut, Wisconsin, Maryland and Texas. Credit default swaps also are traded for New York City, the Port Authority of New York and New Jersey, and many other taxing districts.

The derivatives also can be traded through an index called the Markit MCDX set up in 2008 by data provider Markit. The index tracks CDS for an underlying basket of 50 issuers of municipal bonds. It is now trading at a spread of about 1.3% of the value of the bonds being insured, but has been as low as 0.40% and as high as 3.5%. The spread is what the buyer must pay to the seller of the protection every year over the life of the contract. This is calculated as a percentage of the value of the contract. California, for example—the state with the widest spread—is now trading at just under 1.9%. That means if a buyer wanted to protect $1 million worth of five-year bonds, it would cost about $19,000 a year for five years.

"The CDS market is allowing people to take a view on the way municipalities will go," says John Jay, an analyst at AITE Group, a market research and advisory firm in Boston. "You can't short California stock, so this is a way to make a bet." Dealers say many of the contracts are being bought by bondholders looking to hedge their investments. Investors, however, don't have to own bonds in order to buy the contracts, and traders say much of the activity is coming from hedge funds speculating that municipalities will default.

"California has never defaulted," says Mr. Lockyer, the treasurer, "and the likelihood is as close to zero as any calculation can be, absent a major thermonuclear war."

Ms. Nappier, the Connecticut state treasurer, said in an email that the state launched an initial inquiry after it learned about "potential speculative abuse of CDS in the muni market." She says Connecticut hasn't found evidence that the CDS adversely affected the cost of its debt. But, she says, "there certainly is room for ensuring

greater disclosure and stronger collateral requirements."

Write to Ianthe Jeanne Dugan at ianthe.dugan@wsj.com

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