Calif. Bonds Totter as State Issues IOUs

On February 3, California's bond credit rating was downgraded below that of every other state by Standard & Poors, one of the Big 3 Wall Street rating agencies. The agency reduced its rating on $46 billion of California's general obligation bonds from "A+" to "A." While an "A" rating may not sound so bad, it's at the lower end of investment grade bonds; most states have "AA" or "AAA" ratings.

Following the failure of the state to meet its budget deadline of June 30, Governor Arnold Schwarzenegger declared a fiscal state of emergency, and state Controller John Chiang began issuing $3.3 billion in IOUs, instead of checks. Those being hit first and hardest are counties and local governments that rely on millions of dollars from the state each month, taxpayers expecting state income tax refunds, and businesses and contractors who do business with state agencies.

Every day the state prolongs its budget standoff puts the state's bonds at greater risk. Of course, if the final "solution" arrived at by the governor and the legislature fails to address the big-spending, big-taxing, big-regulating policies that put California into its present crisis, the situation is sure to deteriorate, with even more dire consequences. The nation's most populous state, with the world's eighth largest economy, is tottering on the brink.

Although S&P has continued to keep California's general obligation bonds rated as "A," it has dropped the state's appropriation-backed debt to "A-". One of the other major rating companies, Fitch Ratings, dropped California's $59 billion in general obligation bonds to "A-" on June 25. Also in June, Moody's Investor Service put California general obligation bonds on watch for a possible downgrade to "A3," it's equivalent of an "A-" rating.

However, Wall Street investors are already trading California bonds as if they have a "BBB" credit rating, which is below average quality. Investors seem to be saying they don't trust the ratings system, and with good reason. The corrupt rating practices of the Big 3 – S&P, Fitch, and Moody's – are at the heart of the current global economic meltdown. For years they profited handsomely, raking in billions of dollars in fees from the issuers of bad "securitized" debt. Using fraudulent accounting and "modeling" practices, the ratings agencies were critical players in the Big Con that allowed the "creative restructuring" of trillions of dollars of "BBB" (or lower) bonds into debt that was resold with a "AAA" rating.

If the great credit rating scandal had gotten the attention it deserved (and still deserves, with appropriate investigation and prosecution), executives of the Big 3 ratings agencies would be cell mates with Bernie Madoff. As would be top officials of the Federal Reserve and the Securities and Exchange Commission, who looked the other way and pretended that the debt securitization legerdemain was all on the up-and-up, as long as it carried the imprimatur of the ratings agencies.

The inherent conflict of interest in having the ratings agencies paid by the issuers of the bonds remains in place, and investors are saying that they don't trust the inflated ratings given to California bonds. Governor Schwarzenegger has called upon banks to accept the state's IOUs, but the banks have been reluctant. Bank of America and Wells Fargo have agreed to accept the IOUs from their customers, but only until July 10.

Photo of Gov. Arnold Schwarzenegger: AP Images

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