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A Wall Street Gimmick That Soaks Taxpayers

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The subprime mortgage crisis isn't the only Wall Street-created calamity upending the finances of U.S. states and cities. For more than a decade, banks and insurance companies convinced governments and nonprofits that using swaps contracts would lower interest rates on bonds sold for public projects such as roads, bridges, and schools.

It didn't work out that way. Since the credit crisis began in 2008, failed swaps deals have cost more than $4 billion as hundreds of borrowers, from the Bay Area Toll Authority in California to Harvard University, quietly pay Wall Street firms to end interest-rate swap agreements. The termination payments to Wall Street firms come at the worst possible time. States will face budget gaps of $72 billion next fiscal year, according to the National Conference of State Legislatures.

Borrowers terminate swaps—the cost is determined by current interest rates and other factors—because doing so may be cheaper than continuing to make payments. The California Water Resources Dept. this year spent $305 million unwinding interest-rate bets that backfired,

paying banks led by New York-based Morgan Stanley (MS). North Carolina paid $59.8 million in August, enough to cover the annual salaries of 1,400 full-time workers. Reading, Pa., got caught on the wrong end of a deal, costing it $21 million, equal to more than a year's worth of real estate taxes. "It was brilliant, and it all blew up on me," says Brian Mayhew, chief financial officer of the Bay Area Toll Authority. In July 2009 the state agency paid $105 million to Ambac Financial Group (ABK), the bond insurer that filed for bankruptcy on Nov. 9, to dissolve $1.1 billion of interest-rate agreements.

In all, borrowers have made more than $4 billion of termination payments to companies including Citigroup (C), JPMorgan Chase (JPM), and Bank of America (BAC) since the beginning of 2008, according to a review of hundreds of bond documents and credit-rating reports by Bloomberg. Alexander Samuelson, a Citigroup spokesman, declined to comment, as did Mary Claire Delaney of Morgan Stanley, Justin Perras of JPMorgan Chase, and Danielle Robinson of Bank of America. In September 2008, JPMorgan said it would stop selling interest-rate swaps to government borrowers.

Few taxpayers are aware of the cost of untangling municipal swaps. The only disclosure of the payments to Wall Street often is buried in documents the borrowers have to give investors when they sell bonds. In many cases, the firms getting the payments aren't explicitly identified, and government officials often don't call attention to the payments made to cancel contracts. Many telephone calls and e-mails from Bloomberg News to dozens of government and nonprofit officials over the last eight months seeking comment on derivatives transactions went unanswered.

Wall Street banks and insurers peddled $500 billion of interest-rate swaps to governments and nonprofits before the credit crisis, says a report published by the International Monetary Fund in June. In a typical transaction, a borrower would sell bonds with a variable interest rate. At the same time, it would enter into a swap that required it to pay a fixed interest rate to a bank or insurance company, which would pay the borrower a variable rate. The net result was that the bond issuer paid a lower interest rate than it would have if it had simply issued conventional fixed-rate bonds. That's how it was supposed to work. When interest rates plunged during the credit crisis, the banks and insurance companies started paying much less to the governments and non-profits on the other end of the swaps, turning the deals into money losers for the borrowers.

While banks got paid to underwrite municipal bonds for public projects, they were able to generate additional fees if the borrower used a swap with the transactions. Because the contracts were unregulated and privately negotiated, the profits that Wall Street booked were not disclosed. "The basic idea from the bank's perspective is just to do a swap because that's where the money is," says Andrew Kalotay, head of the debt management advisory firm Andrew Kalotay Associates in New York. "Look at all the fees they get."

In addition to getting termination payments, Wall Street is finding another way to profit–underwriting bonds that borrowers are selling to raise money for the termination fees and to refinance their variable rate debt. Morgan Stanley, JPMorgan Chase, and Bank of America were among the firms that got termination payments from California's Water Resources Dept. this year at the same time they were paid to help the state agency sell its bonds, according to offering documents.

"There's just no reason these entities should be playing with this stuff," says Christopher Whalen, managing director at Torrance (Calif.)-based research firm Institutional Risk Analytics. "They don't have the capacity to evaluate these instruments. They are totally lost."

The bottom line: *Borrowers are paying billions of dollars to get out of swaps deals, which backfired when interest rates plunged.*

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