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Markets

Bankers Who Broke Big Dig With Swaps Gone Awry Get Paid for Fix

Michael McDonald
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The same bankers who sold Massachusetts interest-rate swaps that blew up the debt financing for the so-called Big Dig road and tunnel project in Boston -- costing taxpayers $100 million -- are getting even more money to fix what they broke.

UBS AG bankers showed up at the Massachusetts Turnpike Authority in 2001 with a solution to a growing deficit at the state agency overseeing the $15 billion project. The bank gave the authority $29.1 million for an interest-rate swap linked to $800 million of Big Dig bonds, an agreement meant to cut the cost of paying back the debt and cover part of the budget shortfall. JPMorgan Chase & Co. and Lehman Brothers Holdings Inc. made similar deals.

The deal with UBS backfired as credit markets faltered two years ago, costing toll payers $36.3 million in extra interest and leading the Zurich-based bank to demand as much as $400 million to end the arrangement when the Big Dig bonds' insurer lost its top credit ratings.

"There was really no mention of any downside of these swaps," said Christy Mihos, a turnpike board member from 1999 to 2004 who voted for the UBS agreement. "It was portrayed as a no-brainer that we could not lose."

The same Wall Street banks that triggered the worst financial collapse since the Great Depression also helped government borrowers from Greece to California paper over deficits with derivative deals promising savings on borrowings. Many of the agreements failed when credit markets seized up in 2008 and swap payments from banks no longer covered rising debt costs.

Swap Betting

States, cities and nonprofits have spent about $5 billion unwinding the transactions since then, said Peter Shapiro, managing director of Swap Financial Group in South Orange, New Jersey, an adviser to state and local governments.

"Use of these types of derivatives is making a bet," said Joseph Giglio, a business professor at Northeastern University in Boston and former head of municipal securities at Chase Manhattan Bank. "If it seems too good to be true, it is."

The fallout from the Big Dig swaps didn't stop Massachusetts from giving new business to many of the same banks and officials who arranged them.

Governor Deval Patrick, 53, hired UBS in September 2007 to advise him on overhauling the state's transportation finances. The agreement came about nine months after he named former UBS banker Henry Dormitzer undersecretary for administration and finance. The former UBS banker was a member of a team that sold the firm's swap to the turnpike, according to Mihos.

Buried Bodies

"If you want to find out where the bodies are buried, you've got to go talk to the gravedigger," Patrick, who's seeking re-election this year, said in an Oct. 29 interview in Boston regarding his use of UBS as an adviser.

Dormitzer, who left the Patrick administration in 2008, declined to comment when reached by telephone.

Massachusetts also hired Paul Ladd, a former turnpike official who authorized the UBS swap in 2001, as part of an investment-banking team that refinanced about $2 billion of Big Dig debt this year.

The state signed up underwriters that would get Massachusetts the best price on its bonds, said Jay Gonzalez, the governor's secretary of administration and finance.

"Whether or not a particular individual happened to work at the firm that has some history or another was not an overriding concern," Gonzalez said in an interview. "We wanted to make sure we got the breadth in the underwriting team with the banks that were capable of selling hundreds of millions of dollars worth of bonds that have a real story behind them."

Downtown Transformation

The Massachusetts Turnpike Authority was created in 1952 to oversee a 138-mile (229-kilometer) section of what is now part of Interstate 90. In 1997, the Boston-based agency was put in charge of the Big Dig, the most expensive public works project in U.S. history, which transformed the city's downtown by replacing an aging elevated highway with tunnels.

While the project's cost was estimated at about $5 billion when work began in 1991, expenses soared, sparking federal and state probes and criminal charges against contractors. No charges were brought related to the bond sales and derivatives.

To help cover budget shortfalls, the authority took the projected savings from swaps as upfront payments instead of waiting for them to accrue over time, according to Fitch Ratings. It collected $5.3 million from JPMorgan in 1999, $29.1 million from UBS in 2001 and $35 million from Lehman in 2002, according to its annual report.

'Humongous Deficit'

"It's easy to sit back now and say it was a terrible decision," said Jordan Levy, a board member from 1997 to 2004 who voted for the swaps. "We were sitting there with this humongous deficit and they presented us a way out."

In a swap transaction, two parties exchange payments, typically a floating one for a fixed. State and local governments usually sold variable-rate bonds and negotiated with banks to leave them paying fixed interest that was lower than prevailing municipal rates.

In addition to the expenses of the UBS swap, the authority paid $408,000 of extra interest since 2002 on a JPMorgan derivative linked to $100 million of Big Dig bonds, said Cyndi Roy, a spokeswoman for the state's administration and finance office. The contract is set to last until 2029, according to a copy of the agreement.

The turnpike also had to set aside as much as $19.6 million of cash as collateral against the JPMorgan contract as central banks slashed benchmark rates amid the credit crisis, according to bond documents.

Justin Perras, a JPMorgan spokesman in New York, declined comment.

Lehman Payment

The authority paid $3.2 million to end the Lehman Brothers swap after the New York-based bank declared bankruptcy. Lawyers for what remains of the firm are disputing the amount paid, according to bond documents. The turnpike was told by bankers in 2007 that terminating the derivative contract could cost as much as $43 million.

The UBS swap backfired in January 2008 when the exchange of payments began. The agency, rated close to below-investment grade at Baa2 and Baa3 by Moody's Investors Service, was unable to refinance $800 million of its bonds into floating rates to match the agreement. It paid an extra $49.9 million in interest through the end of March this year and received $13.6 million from the bank, Roy said.

The UBS burden worsened last year when a unit of Ambac Financial Group Inc. that insured both the Big Dig bonds and the swap lost its top credit ratings. UBS sought a payment to end the swap, which the state said would cost as much as $400 million.

$100 Million

The demand forced Governor Patrick to step in. The Democratic-controlled Legislature dissolved the turnpike authority and pledged $100 million a year from a sales-tax increase to a new transportation agency so it could refinance the bonds. UBS dropped its payment claim and Patrick refinanced all of the highway's Big Dig debt, including a sale of $800 million of floating-rate bonds to match the bank's swap.

Doug Morris, a spokesman for UBS in New York, declined to comment.

"I'm glad the governor is cleaning up these messes," Mark Montigny, a Democratic state senator from New Bedford who last year sought a formal probe of the turnpike swaps, said in an interview. "However, until we investigate and assign blame and find out if in fact there is criminal behavior or at a minimum serious civil recovery, then we learn nothing."

The governor's new transportation department in November hired Bank of America Corp., JPMorgan Chase, Barclays Plc and Citigroup Inc. to refinance the turnpike's Big Dig bonds, paying the underwriters $7.7 million for securities sold in March and May this year, according to sale documents.

Working With Massachusetts

Ladd, the turnpike's former chief financial officer who authorized the UBS swap, according to a copy of the contracts, represented Charlotte, North Carolina-based Bank of America working with the state to sell the bonds, said Jonathan Davis, the official who oversaw the offering.

Ladd left the turnpike in 2002 and is based in Boston. He declined to comment in a telephone call.

Paul Haley represented Barclays in a role similar to Ladd's, Davis said. Haley was the Lehman Brothers banker who sold the turnpike a swap in 2002, according to Mihos, and a former chairman of the Massachusetts House Ways and Means Committee. He joined Barclays when the London-based bank bought Lehman's investment banking and trading operations after its bankruptcy. He declined to comment.

'Brink of Ruin'

The state used Mintz, Levin, Cohn, Ferris, Glovsky & Popeo PC, the turnpike's bond counsel on the derivative, according to Mihos and Levy, as its disclosure counsel. John Regier, a lawyer at the Boston-based firm, said it verified the accuracy of information on the state's finances given to investors for the bond sale and had nothing else to do with the transaction.

"The turnpike authority was on the brink of ruin because of the financial decisions made earlier this decade," said Mary Connaughton, who served on the turnpike's board from 2005 to 2009 and is running for state auditor this year as a Republican. "It doesn't make sense to bring back the same old players."