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New Mexico's Effort to Hedge Against Higher Rates Backfires.

As borrowing costs have fallen, public agencies from school districts to county and state governments have saved millions of dollars by refinancing debt that carries higher interest rates.

For the state of New Mexico, that has meant savings of more than $300 million for the Department of Transportation alone, which has refinanced or closed out a dozen lines of credit and outstanding bonds since 2010.

But lower interest rates have not been good news in every case for the Department of Transportation. Taxpayers also have lost millions of dollars by not being able to restructure some debt approved in 2004 under then-Gov. Bill Richardson to pay for highways, bridges and the New Mexico Rail Runner Express.

Despite interest costs being half of what they were a decade ago, refinancing some $400 million in outstanding bonds at substantially lower rates would involve paying a a huge penalty — $80 million to $100 million — because of a complicated hedging strategy between the state and Wall Street banks.

Of the $1.58 billion authorized under Richardson's programs, which included the train, $440 million were part of these interest-rate swap agreements. The average fixed-rate bonds at the time were paying 4.3 percent, but the state decided to sell bonds with a floating interest rate that could have cost more if rates rose. To protect against that risk, the bonds were swapped and taxpayers ended up paying between 3 percent and 5.072 percent on the amount borrowed.

Now the state pays 2.4 percent to borrow money. At times last year that cost was under 2 percent, a rate the Department of Transportation said it would have jumped at had it been able to refinance.

So, while the swaps protected taxpayers against rate increases, the deals backfired because they made it impossible to refinance the debt or obtain a lower floating rate.

"These swaps were intended to protect the state against higher interest rates, but they actually hurt the state because interest rates went down," said Marc Joffe, a policy analyst with the Reason Foundation and a former director at Moody's Analytics.

Any termination costs on bonds that have swap agreements would be paid to Goldman Sachs, Deutsche Bank, JP Morgan Chase, and UBS AG, according to state financial records.

"If they get out of the swaps today, they would have to pay $87 million," said Michael Zavelle, chief financial strategist for the New Mexico Finance Authority. "And you'd have to refinance $420 million, plus the termination cost."

Zavelle said the bond deal that included swaps shifted the risk for the borrowing from the lender to taxpayers, and it came at a time when those in public financing were doing more deals with these sorts of hedges.

Interest-rate swaps or hedges are not part of state debt packages today, though they are still prominent in the portfolio of The University of New Mexico.

“Our philosophy is, if the only way you can do that project is by taking on extra risk, that’s probably something you shouldn’t be doing,” Zavelle said.

Those in state government now see the issue the same way.

“If we were to issue more debt today, we wouldn’t do it that way,” said Marcos Trujillo, the bond-financing director with the Department of Transportation.

Tom Church, Cabinet secretary of the department, said Gov. Susana Martinez’s administration inherited the swaps from a time when concerns about rising rates made them more common. The other advantage is the swaps brought more predictability to costs and allowed more borrowing up front.

“At the time this was a tool being used around the country,” Church said. They provided “a comfort level that you’d never had to pay a lot more in interest.”

Zavelle and others tried to calculate what it would cost to refinance the bonds and determined the termination costs would be higher than any interest rate savings, even though borrowing costs are significantly lower.

Church said interest rates have to rise more than 3 percentage points from today’s level for refinancing to make sense with the high termination fees.

Most of the initial transportation bonds had an initial interest rate below 4 percent but could have been adjusted. With the swap agreement, the rate the state pays today is more than 5 percent.

Termination costs exist because the banks and lenders that receive interest from the state road fund promise regular money to their investors, often retirees or insurance companies. When rates are low, those banks would not be able to find another borrower to pay them the same amount, upward of 5 percent under the agreement with New Mexico, or they would have to make up the difference.

So the termination fees are built into the swap contract to cover the promised payments until the bonds mature.

At the end of 2016, the interest rate swaps were $119 million underwater, meaning that would have been the loss that would result from terminating the agreements, according to state financial reports.

If interest rates go up, then the termination fees actually go down because it becomes easier for lenders to replace the revenue. At some point when the bulk of interest is paid on the bonds, there will be no termination cost. That is expected to happen in 2024.

“Every year that goes by, the termination value goes down, so there is a benefit in waiting to redo the swaps,” Zavelle said.

Joffe said many entities, including the Chicago Public Schools, counties in California and parishes in Louisiana were burned badly by swap deals.

“When it comes to municipal finance, simple is better than complicated. It turns out these things often backfire, and that’s what happened here,” Joffe said after looking at documents about New Mexico at The New Mexican’s request.

Zavelle added: “If they had financed at a fixed rate and paid a bit more, they would have refinanced. Probably overall, they would have been better off with a fixed rate and it would have eliminated all the risks..”

By Bruce Krasnow | The New Mexican

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