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Rising Rates on Wall Street Loans Push States to End Swap Deals.

- **Tax cut triggered clauses letting banks boost rates on loans**
- **Market shift lets them come out ahead despite big bank fees**

U.S. state and local governments are paying Wall Street firms millions of dollars to terminate interest-rate swap trades, spurred by rising costs on bank loans and bond-market swings that are allowing them to save money by refinancing derivative-laden deals.

Some of the nation's biggest debt issuers, including Illinois, New Mexico, and Massachusetts, have all sold fixed-rate bonds in the last six months and used some of the proceeds to pay banks to back out of the swap agreements. The low yields on new fixed-rate bonds have allowed some of them to come out ahead despite the termination payments.

In June, the New Mexico Finance Authority issued $420 million of fixed-rate debt, spending $64 million of the proceeds to terminate five swaps on floating-rate bonds and loans. That came after its costs on about $285 million of the notes owned by Bank of America Corp. had increased by about $1 million annually after the corporate tax cut allowed the bank to raise the interest rate to make up for its smaller profits on the tax-exempt loans.

"If you have debt out there that's costing you over 5 percent and you can refinance it for less than 3 percent, the savings can be used to absorb the cost of the termination," said Michael Zavelle, chief financial strategist at the New Mexico Finance Authority.

The derivative trades are the legacy of a popular financial tactic used more than a decade ago, when states and cities sought to save money by borrowing with floating-rate bonds paired with interest-rate swaps instead of selling traditional fixed-rate debt. The deals unraveled during the financial crisis when the housing bust hammered insurers that guaranteed the bonds, causing the interest rates to soar.

While many governments paid billions to back of out the deals, others opted to convert their floating-rate bonds into direct loans with banks. But many loans included clauses giving banks the right to raise the interest rate if legal changes lowered the return on their investment. The 2017 tax cut that slashed the corporate rate made the tax-exempt loans less valuable than before compared with other assets, once federal taxes are taken into account. So banks demanded more interest to make them whole.

"That changed the whole economics of this transaction," said Zavelle. "It made sense only because costs increased because of the tax law change."

Last month, Illinois issued $965 million of fixed-rate debt at an overall rate of 4.2 percent, using $75 million of the proceeds to terminate five swaps. A portion of the new bonds retired $600 million in floating rate-debt sold to four banks under direct purchase agreements that were set to expire in November. The borrowing costs on the new debt was about half of the old bonds, according to the state.

“Although a swap termination payment was due in order to fix out the bonds, the savings associated with the new lower interest cost fixed-rate refunding bonds far exceeded those costs,” Elizabeth Tomev, a spokeswoman for Governor Bruce Rauner, said in an email.

Swap terminations have also been driven by the drop in short-term municipal bond yields compared with those in the swaps market. That has made it more advantageous for governments to issue debt to unwind swap agreements that are set to expire within the next ten years, according to Nat Singer, senior managing director at Swap Financial Group, an interest-rate swap adviser to states, hospitals and universities.

In February, the Palm Beach County school district in Florida issued $339.5 million of bonds to refinance three series of floating-rate notes, using $50.4 million of the proceeds to end related swap trades. The rates on the new fixed-rate debt of 4.6 percent to 5.3 percent was about the same as the combined rate on the old debt and swaps, according to an April presentation to the school board.

“We actually had permission from our school board to terminate them for a couple of years now, we were just waiting for the right market conditions,” said Leanne Evans, the school district’s treasurer.

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