Bond Case Briefs

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How Philadelphia Says It Got Ripped Off by Bank Bond 'Robots'

When numbers are big, little things can add up. That's why Philadelphia says that price-fixing by seven Wall Street banks has cost states and municipalities billions of dollars — and why the city says it was unaware of the scam until whistle-blower Johan Rosenberg came forward. Philadelphia's charges are echoed in suits filed by the whistle-blower on behalf of California, Illinois, Massachusetts and New York. The banks are contesting the whistle-blower's charges. The suits, over what are known as variable-rate demand obligations, or VRDOs, represent the biggest legal challenge to the generally staid municipal bond market in over a decade.

1. What are VRDOs?

Long-term bonds issued by states and municipalities whose interest rate resets on a monthly, weekly or sometimes even daily basis.

2. What's their appeal?

For borrowers like Philadelphia, VRDOs combine long-term maturities of as much as 30 years with short-term interest rates, which are generally lower. For the investors who buy them, VRDOs have a selling point that sets them aside from other kinds of municipal bonds: they come with a "put,'' that is, a promise by the issuers who sell them that they'll buy them back if an investor wants out. That limits their risk if, for instance, yields fall when a VRDO rate is rest.

3. Then who bears the risk?

Ultimately, the issuers. VRDOs carry bank liquidity facilities, such as letters of credit or a standby purchase agreement, although remarketing agents usually take bonds that are put back into inventory for resale. VRDOs that are put back to the issuer are presented to the bank providing the liquidity, and become so-called bank bonds, their payment accelerated so that those bonds maturing in 30 years become due in four or five years, with the municipality making quarterly payments.

4. What do the lawsuits say?

That to avoid having investors put the bonds back, the banks set their interest rates a little bit higher than market conditions would have otherwise justified. And that to avoid having borrowers switch to a bank offering a lower rate, they conspired to keep rates in line with each other. According to one of the suits filed by the whistle-blower, the banks "engaged in a coordinated 'Robo-Resetting' scheme where they mechanically set the rates en masse without any consideration of the individual characteristics of the bonds, the associated market conditions or investor demand."

5. How does the whistle-blower know about this?

According to the suits, Rosenberg became suspicious that the remarketing agents were "working in coordinated fashion" and resetting VRDO interest rates "on an algorithmic or some other mechanical basis." He confirmed these suspicions by performing a forensic analysis of interest rates and other market data.

6. Is there other evidence to back up these claims?

Philadelphia's lawsuit says there is. It says that emails and other communications exist showing bank officials sharing information about VRDO rate-setting. And it cites an analysis of the VRDO market by Rosenberg showing banks may have set interest rates higher than was warranted.

7. How much would that add up to?

The total size of the outstanding VRDO market has been estimated at $150 billion. An additional 25 basis points on that much debt could have cost borrowers billions of dollars, although the Philadelphia lawsuit doesn't specify how much and merely asks that the amount be determined at trial. The series of whistle-blower qui tam suits seeks at least $3.6 billion in damages.

8. What do the banks say?

Philadelphia is suing seven banks who acted as remarketing agents for $1.6 billion in VRDOs. They are JPMorgan Chase & Co., Bank of America Corp., Citigroup Inc., Goldman Sachs Group Inc., Wells Fargo & Co., RBC Capital Markets LLC and Barclays Plc. Philadelphia is also seeking class status for other states and municipalities that sold VRDOs. So far, the banks have declined to comment on the Philadelphia suit and have asked that the qui tam whistleblower lawsuits be dismissed, although in Illinois, a judge decided that the matter must proceed to trial. The other lawsuits are making their way through the system.

9. What else might happen?

The Philadelphia lawsuit says that both the Securities and Exchange Commission and the Department of Justice are conducting investigations into the whistle-blower's allegations.

The Reference Shelf

- A primer on VRDOs by Morgan Stanley.
- The case filings in Philadelphia's lawsuit. is City of Philadelphia v. Bank of America Corp., 1:19-c--01608, U.S. District Court, Southern District of New York (Manhattan).
- The Encyclopedia of Municipal Bonds, by Joe Mysak (Bloomberg Press/Wiley) 2012.

Bloomberg Quicktake

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