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Wisconsin Bet That Interest Rates Wouldn't Go Down and It Lost Big.

- **Derivative deal left state paying above-market rates for years**
- **It’s now planning to call off deal with Citi, UBS, JPMorgan**

In 2003, as the Federal Reserve was easing monetary policy to stave off a recession, Wisconsin placed a nearly three-decade long bet with some of Wall Street’s biggest banks that interest rates wouldn’t go any lower.

Yet they continued to fall — and the state has been tied to those money-losing derivative trades ever since, paying as much as 5.5% interest on some of the $475 million it borrowed to shore up its employee pension system. It couldn’t refinance without paying Citigroup Inc., UBS Group AG and JPMorgan Chase & Co. steep fees to call off the contracts, which became increasingly valuable to the banks as interest rates declined.

Now, with state and local bond yields holding near more than half-century lows, Wisconsin may finally end its ill-fated experiment with high finance. It’s waiting for the chance to refinance the debt, cut its exposure to swings in interest rates and produce savings big enough to cover the $157 million of termination fees it owes the banks.

“There’s a market where we can do that and still maintain or achieve some overall savings, and that’s what we’re waiting for,” said David Erdman, who has been Wisconsin’s capital finance director since 2015. “It is market sensitive, and it just hasn’t reached our bogeys yet to move forward and complete.”

Wisconsin may be among the last wave of states and cities seeking to sever their ties to a financial tactic that has virtually disappeared since it backfired during the chaos of the credit crisis more than a decade ago, when it foisted unexpected costs on governments around the county. It helped push Alabama’s biggest county into bankruptcy and drove Detroit deeper into the hole in the run-up to that city’s record-setting collapse. As recently as 2016, Chicago spent heavily to back out of derivative trades after its credit rating was cut to junk.

A key measure of yields is about half what it was in 2003
The strategy involved governments borrowing through the sale of floating-rate bonds. They then entered into interest-rate swaps under which they agreed to make fixed-rate payments to banks in exchange for those pegged to an index. Those variable-rate payments were supposed to cover what was owed on the bonds, leaving the governments effectively paying only the fixed rate. It was supposed to be cheaper than selling traditional fixed-rate debt.

But, other risks aside, the steep cancellation fees kept governments on the sidelines during the refinancing booms that erupted when interest rates fell, keeping them locked into above-market costs. In 2003, for example, 20-year municipal-bond yields exceeded 5%. They’re about half that now.

Wisconsin is currently planning to sell $622 million of new bonds. That would raise cash to pay off $475 million of variable-rate debt and cover the termination costs owed to the banks for interest-rate swaps tied to the one-month London interbank offered rate.

Wisconsin is looking to squeeze every penny it can from the deal, postponing it until factors like credit spreads and the relationship between Libor and Treasuries are favorable enough to make canceling the swap worth it, Erdman added.

Wisconsin would join a broader push by issuers to seize on low interest rates to exit such derivative-laden bond deals, Moody's Investors Service managing director Timothy Blake said. The Illinois State Toll Highway Authority was among them, issuing nearly $700 million in fixed-rate debt last year to refinance and cover a $143 million swap-termination payment. The deal will end up costing the toll authority an additional $21 million over the 11-year life of the bonds, said chief financial officer Michael Colsch.

"The last five years, maybe even since Lehman, we don't see a lot of governments entering into new swaps," Blake said, referring to the 2008 bankruptcy of the investment bank. "The appetite for these more complex synthetic fixed-rate deals has gone away."

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