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Detroit Emergency Manager Calls Swaps "Ticking Time Bomb."

Bankers who sold Detroit interest rate swaps placed “a ticking time bomb” in their structure, the city’s emergency manager said in court as a trial resumed over a proposal for ending the swaps.

Although the city collected $40 million over eight months from the swaps deal, falling interest rates helped the banks behind the deals turn a profit, Orr testified today before U.S. Bankruptcy Judge Steven Rhodes in Detroit. Since 2009, the city has paid more than $200 million to the banks behind the swaps, according to public records.

The city has proposed paying UBS AG (UBSN) and Bank of America Corp. a $165 million termination fee to get out of the swaps contract.

Days before Detroit filed the biggest ever U.S. municipal bankruptcy in July, Orr negotiated an agreement to end the swaps at a discount. After that deal was attacked by creditors and questioned by Rhodes, the city on Dec. 24 announced a renegotiated termination payment about $65 million less than the original.

The swaps are tied to pension obligation bonds issued in 2005 and 2006. They were designed to protect against rising interest rates by requiring the banks to pay the city if rates rose above a certain level. When rates instead went down, the city was required to make monthly payments.

SEC Consulted

Orr testified that after he became emergency manager last year he had “plenty” of concern over whether the swaps were fraudulently put together. He said he asked the U.S. Securities and Exchange Commission if it would be willing to investigate the deal.

Megan Stinson, a spokeswoman for Zurich-based UBS, said the bank couldn’t immediately respond to Orr’s comments.

Eventually, Orr testified, he decided to settle with the banks instead of suing them in order to avoid a risky trial and prevent any threat to casino taxes used to guarantee payment of the swaps.

Creditors led by bond insurer Syncora Guarantee Inc. oppose the settlement, saying it’s too costly. The city didn’t prove it would lose if it sued to cancel the contracts instead of settling with the banks, Syncora said.

Syncora said in court papers that the deal could cost it money as the insurer of some of the bonds and swaps. Under the settlement, Syncora would be released from any obligations related to the swaps, according to the city.

Bond insurer Ambac Assurance Corp. claimed Detroit could win any lawsuit against UBS and Charlotte, North Carolina-based Bank of America over the swaps.

A mediator who helped craft the latest deal recommended the $165 million settlement, saying it was in the best interest of all parties involved.

The case is In re City of Detroit, 13-bk-53846, U.S. Bankruptcy Court, Eastern District of Michigan (Detroit).

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