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Derivative Deals Making Comeback for Municipalities.

Local governments in Pennsylvania are turning again to the kinds of derivative deals that backfired during the credit crunch, as the lure of up-front cash and the potential to cut costs prove hard to resist.

Dauphin County, for example, has cleared the way to enter an interest-rate swap on a deal that helped settle the debt of the once-insolvent state capital, Harrisburg. Berks County, which in 2009 spent roughly its parks and library budgets to end swaps, agreed to a new contract in March.

The governments are tapping swaps even as municipal borrowers, from Philadelphia's school district to California's water-resources department, have paid to end money-losing derivatives banks pitched as tools to lower borrowing expenses.

In 2009, Pennsylvania had the most local governments using swaps on variable-rate debt, Moody's Investors Service says.

"You've got to think long and hard before you take a risk that you have no control over," said Steven Goldfield of New York-based Public Resources Advisory Group, who helped develop Harrisburg's recovery plan. "As a governmental official with public funds, you want to preserve the funds."

Even after federal regulators pushed through rules sparked by the swaps fallout, public money remains at risk, say Pennsylvania state senators backing stronger restrictions. The measures, up for a vote as soon as September, would have barred the latest deals.

The swaps are contracts, typically between a bank and a borrower, to exchange interest payments. The agreements were intended to shield issuers from the risk of rising interest rates.

Yet market convulsions during the financial crisis often spurred expenses in excess of payments. Localities nationwide have paid more than $4 billion to Wall Street to terminate the derivatives, data compiled by Bloomberg show.

Swaps figured in the fiscal woes of Harrisburg, forced into the state's first receivership in 2011 after skipping debt payments on an incinerator project. A 2012 audit said derivatives tied to the deal boosted fees and risk.

Dauphin County backed the incinerator debt and made payments the city skipped. As part of the settlement that allowed Harrisburg to exit receivership in March, the county contributes a portion of the interest rate on $24 million in fixed-rate bonds that financed the incinerator's December sale, said Jay Wenger of Susquehanna Group Advisors, the county's financial adviser.

Last month, county commissioners approved an ordinance authorizing a deal called a swaption involving an up-front payment to the county Wenger says would go toward debt service. Royal Bank of Canada would have the right at a future date to compel the county to pay a floating rate in exchange for fixed payments until 2033.

Transactions involving immediate cash have “been the cause of 99 percent of the abuse in the market,” said Lucien Calhoun of Flourtown-based Calhoun Baker, administrator of the Delaware Valley Regional Finance Authority, which provides municipal loans.

Dauphin has not entered into the contract. In 2011, it agreed to two swaps with RBC, effective in 2015 and 2016, that would cost about $626,000 combined to terminate, according to Susquehanna. Wenger said commissioners would do the third swap to manage their interest-rate risk, the same reason for the 2011 deals.

Berks County returned to the swaps market after losing money on earlier deals. In 2009, it paid termination fees totaling $13.8 million, filings show.

The March structure is a basis swap – the county pays a variable rate based on tax-exempt municipal bonds and receives from PNC an amount based on a taxable variable rate, documents show.

The March swap would save at least $2.6 million over its 23-year term, and reserves would cover exit payments, Finance Director Robert Patrizio said.

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