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Wall Street's Taxpayer Scam: How Local Governments Get Fleeced — and So Do You.

A trick Wall Street uses with municipal finance is to make it seem complex. It isn't — here's what you should know

The news was buried somewhat by all the hubbub over President Obama's executive orders and the (manufactured) scandal over Jonathan Gruber (aka, History's Greatest Monster) but earlier this week, a movement to rein in Wall Street took a step activists hope is just the first of many. Galvanized in part by a recent blockbuster investigation on the damage done by a series of loans taken from Wall Street by Chicago Public Schools — which have not panned out and which Mayor Rahm Emanuel is trying to disown — opponents of Wall Street's "predatory loans" demanded action, using a new report from the Roosevelt Institute as a guide.

Titled "Dirty Deals: How Wall Street's Predatory Deals Hurt Taxpayers and What We Can Do About It," the report is an in-depth look at one of Wall Street's most insidious but overlooked practices that also tackles how government officials can fight back — assuming, of course, that they're interested. Earlier this week, Salon called Roosevelt Institute fellow Saqib Bhatti to discuss his findings and recommendations for what those concerned about Wall Street malfeasance can do next. Our conversation is below and has been lightly edited for clarity and length.

Could you explain to me what the relationship is like between Wall Street and municipal governments? Or is it too varied to say there's any single dynamic?

There are, of course, some nuances from place to place, but in general there are some broad trends. The relationship between municipalities and Wall Street is largely broken because there's a very strong imbalance of power that exists or, at least, is perceived to exist. Banks typically set the rules of the game. They make recommendations for different types of deals municipalities should be doing, they pitch deals to them. Typically, municipalities may bargain around the margins but largely accept the rules as they're set by Wall Street.

When I say there's a perception of imbalance of power I use that word because, in reality, municipalities could have a lot more power if they chose to wield it. If they actually chose to play hardball or question some of the underlying assumptions that Wall Street brings into various municipal finance deals, they could potentially fight to get a better deal or to question the entire framework around how some fees are structured and so forth.

And why is it that municipal governments even go down this road, dealing with banks? What makes this so irresistible?

The reality is that there really is a revenue crisis in our country that's really affecting city and local governments. Over the course of the last 35 years it's been very hard to raise revenue, and so there are real budget problems that exist. Typically, what this means is that cities and states regularly have to borrow money and often the pitch from banks is, "Here's a way you can borrow for less!" or "Here's a way you can save some money!" That's typically how it's framed, as an exciting new

product that can save you money. But what often isn't factored in there is that new product could have a lot of risks built-in, and those risks actually have a dollar value and a real cost.

And those would be the "predatory deals" you refer to in the report's title. How are you defining a "predatory" deal?

I think a predatory deal is one that really takes advantage of the vulnerabilities in the customer. I'd say they are typically characterized by high costs, high risks, high levels of complexity, and they're often designed to fail or designed in a way where the bank is not concerned if they do fail.

Do officials tend to know that these deals are structured in such a disadvantageous way? Do they think that for whatever reason they'll make it work or outsmart the banks? Or do they often not know what they're getting into?

One of the big problems is that often the banks really downplay the risks or misrepresent the likelihood of the risks occurring. Often, government officials are really not aware that the risks could actually materialize. One of the things that's featured prominently in the report is interest rate swaps. With interest rate swaps, in particular, one of the big problems was that there's all sorts of risks that were embedded in the deals, and in the paperwork there's all these disclosures that say these risks exist, but when the banks actually pitched the deals the pitch said not to worry about those risks. Or they would make projections of all the money the city could save but those projections were all based on none of those risks materializing.

Especially with products that are relatively new, that are not widely understood and where, frankly, in many cases they haven't been around long enough to really understand what all the risks are, there is this huge problem that exists. The risks just are not disclosed on a level that they should be and in reality, that's not just unethical, it's also illegal and violates the Fair Dealing Standards of the Municipal Securities Ruling Board.

So to take this more into the here-and-now, can you tell me a bit about a recent news story or event that involves this issue?

There was a great Chicago Tribune investigation last week that looked at financial schemes that Chicago public schools (CPS) got into. CPS took out a series of auction rate securities, which they then linked together with interest rate swaps, and the idea was, it was pitched to CPS as a way to get a cheaper interest rate than taking out a traditional fixed-rate bond. A hypothetical example would be that if you were to take out a fixed-rate bond it might cost you 8 percent and the banks were basically saying that if you do this complicated scheme that involves all these auction rate securities and interest rate swaps and a few other things, you can essentially lock in a synthetic fixed rate of 6 percent, which is cheaper than 8 percent, and so you can save some money.

The problem was that there were a lot of risks associated with this. For instance, the 6 percent was not really a 6 percent. The synthetic fixed was actually not fixed because there were other variables in there that made it so that you weren't really getting a fixed rate. There are traditional costs that were not properly represented to CPS. One of the other problems that existed in particular was that when the banks projected cost savings, they compared the deal to a more expensive one that CPS wouldn't have gotten, so in this case it's as though they made a cost-saving projection that was predicated on the idea that CPS would pay 9 percent otherwise, when, in reality, CPS would have paid 8 percent. They inflated the cost of the alternative to make it seem like a better deal.

There are a number of similar things that went on. One of the problems that eventually surfaced in those deals was that the auction rate securities market completely froze up. When that happened,

the variable interest rate on the underlying bonds actually skyrocketed. At the moment at which Bank of America in 2007 underwrote some of these auction rate securities deals, Bank of America officials were already aware of the fact that the market was headed for a meltdown — that's an exact quote from the Tribune, "headed for a market meltdown" — and did actually still underwrite the deal for CPS to get these auction rate securities and didn't warn CPS of this fact. That risk was not actually disclosed to CPS.

In reality, the bigger thing is that — and this is the part that's often lost on public officials, unfortunately — when Wall Street banks are pitching deals their No. 1 goal is not to save money for taxpayers. Their No. 1 goal is to maximize profits for themselves. In this hypothetical situation where a bank says, "You can get a fixed rate for 8 percent or a synthetic fixed for 6 percent," the reason they're steering you towards the 6 percent deal is that they get to charge more fees because that deal is more complex. In a traditional fixed-rate bond, if the interest rate is 8 percent the banks get to charge some fees upfront for underwriting the bond but that interest, over time, is going to the bondholders and not back to the banks. In a synthetic fixed-rate structure, the interest that's going to go to bondholders is much, much lower and the rest of the money is actually going to the banks.

The reason why they push you into these structures that have more complex transactions and more individual deals built into them is that with each of these deals, banks get to charge fees and collect more of that money for themselves instead of it going to bondholders or anywhere else. That's the piece that's often lost on public officials, is that no, the bank is not looking to do you a favor. They're looking to maximize their own profits and, ultimately, those profits are coming at the expense of taxpayers.

OK, so how do people end up experiencing this in their everyday lives? Obviously no one wants to see their tax dollars wasted, but that's a somewhat abstract transaction — a few numbers on your monthly check or what have you. How does it become more tangible, the downside?

I think it has a huge impact. For example, the Detroit Water Department in 2012 had to pay $547 million in penalties to terminate interest rate swaps. Now more than 40 percent of the water bill that people pay in Detroit actually goes towards paying off that termination fee, and it's hit the Water Department hard so now the Water Department is actually shutting off the water of Detroiters who have missed just a couple of payments on their bill. In the meantime, they're actually paying out $547 million in fees to banks on these deals.

There is strong reason to believe that if the Detroit Water Department pursued legal claims against the deals that they could have recovered some of that money, but instead of trying to recover the $547 million they're turning off the water on low-income, working-class people of color who are already struggling to get by.

In Chicago we've seen the impact of these finance deals in school closings. in Chicago we had the largest school closing in the history of the country when 50 schools were closed last year, presumably to save money. Based on CPS' own estimates, each school closing would have saved up to about $800,000, and in the meantime the school system is paying out $36 million a year on its interest rate swaps. The Tribune estimated that this complex financing structure with auction rate securities is going to end up costing the school system $100 million more than if it had chosen a fixed-rate traditional bond, and that's actually a conservative estimate because it only looks at a small number of the deals that CPS has.

You mentioned before that municipal officials have more control over this situation than they either think or want us to believe. What are some of the tools they could be using?

There's a couple. There are some legal angles here, which is that for many of the deals that have taken place there have been a clear law-breaking risk. That's a case with things like the illegal manipulation of the LIBOR interest rates, that's happened with the way a lot of these auction rate securities and interest rate swaps were pitched and the risks misrepresented. There are some clear legal angles there, you can file for an arbitration with the Financial Industry Regulatory Authority under the Fair Dealing Standards of the Municipal Securities Ruling Board. You can also sue for state-based claims for breach of contract and fraud, where applicable.

Beyond that, there's some bigger stuff overall, which is just not done very often. Cities and states could actually play hardball with Wall Street. In reality, there are a lot of different fee structures, deal structures, that exist only because they're not really pushed back on, ever. For example, bond underwriting fees are typically a percentage of the total amount that's being issued, but in reality it's not any more work for a bank to underwrite a $200 million bond than it is to underwrite a $100 million bond and they get to make twice as much money. There's no reason why that's the case; there's no reason why it's a percentage, but if any one city were to try to buck that trend, they would say, "That's just not how it works."

The reality is that the market is not preordained. Right now, Wall Street sets the terms of the market and cities and states negotiate around the margins. What we need is to turn that on its head. If we actually had cities and states saying, "Here are the rules that we're going to operate by because this is what works for taxpayers," and Wall Street can take it or leave it, if they actually stand by that they can move the market. American taxpayer dollars are still one of the largest pools of capital that exist in the country, in the world.

The city of Los Angeles currently has a campaign where they're trying to reduce their fees. The city of Los Angeles is the second-largest city in the country. It also has a huge pension fund and many different agencies that it controls. If you actually have the city of Los Angeles take a hard line that says, "We won't do business with any banks that don't abide by this set of rules or that don't put the interests of taxpayers first," then they can actually change the way Wall Street deals with them. If you have enough cities getting together and saying they'll do that, that can have an impact.

In 2012 the Oakland city council managed to pass a resolution to boycott Goldman Sachs because they wouldn't renegotiate an interest rate swap. The city of Oakland by itself is relatively small, but if you had Oakland, Los Angeles, Chicago, Chicago Public Schools, New York, the New York Metropolitan Transportation Authority, all of these different bodies with interest swaps, if they were to pass similar resolutions they could renegotiate these interest rate swaps in a heartbeat. There's this power of numbers and we need cities and states to more effectively use their leverage as customers of Wall Street to renegotiate our relationship.

The report has a few recommendations for how government officials and citizens can address this problem. What are they?

One is that we need greater transparency around the financial health of our cities; we need to know how much money we're paying out every year on financial years, and we need greater transparency in terms of the deals that we've entered into and the risks that are contained within them.

Secondly, we need accountability … [if] we learn that the banks have broken the law, we need to actually litigate against them and get back the money they've taken from us. We need to hold them accountable, and then even where there is not illegal behavior, but there is unethical behavior, we need to use our leverage as customers of Wall Street to hold them accountable and try to get a better deal.

Thirdly, we need to try to reduce fees, again using our leverage as customers of Wall Street.

The fourth recommendation is something I call “collective bargaining with Wall Street,” which is the idea of having cities and states across the country band together and try to change the conditions and terms that Wall Street operates under to better reflect the interests of taxpayers.

Fifth is creating more public options for financial services. There are many types of financial services like investment management or debt management that cities and states could do themselves for cheaper and they need to start thinking about developing those capacities.

Finally, the last recommendation of the report is to create publicly owned banks. We currently have one of these in the U.S., which is the Bank of North Dakota, and we need to look at the option of creating more publicly owned banks either at the city, state or county levels.

Say you’re a voter who cares about this issue but isn’t really so wonky and numerically inclined. What are some red flags or good signs, in terms of rhetoric, that people should be paying attention to when they’re deciding whom to support in local government?

Any politician who says, “All of our deals are fine” — that should be a red flag. Anyone who says, “We’re sophisticated and we know what we’re doing” — that should be a red flag. Anyone who tries to obscure what’s going on by muddling it in complexity, to make it hard to understand — that should be a red flag. What we should be looking for is people who can actually talk about this in a way that makes sense.

One of the tricks Wall Street has when it comes to municipal finance and when it comes to finance more generally is to make things seem overly complex, so complex that people stop caring and believe they can’t possibly understand it. That’s not actually the case. In reality, most of these things can be understood and can be talked about in plain English, and what we really need is more elected leaders who are willing to break these things down and talk to voters about them in a way that they can understand and that can offer real, common-sense solutions that don’t take a finance degree to understand. At the end of the day, this stuff does not need to be so complicated. Anyone who’s promising another complicated financing scheme as a solution is probably not actually going to be able to deliver on that because the more complex you get, the more heavily weighted things are in the banks’ favor.

The key words we should be looking for from politicians is that we shouldn’t need key words. They should just be able to talk about solutions that actually make sense to the average person and make it clear that they’re actually going to hold banks accountable for these deals they’ve already gotten into and make sure we’re having good, plain, vanilla banking going forward that will make sure we get the best deals.

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