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Cities Paying Millions to Get Out of Bad Bank Deals.

When the Great Recession delivered the biggest blow to government budgets this side of World War II, it wasn't just slashing revenue streams — it also made certain financing agreements more costly in the long run.

The agreements are called interest rate swaps, a holdover from the years leading up to 2008 when the booming market made even risky investments seem like a good idea. But in reality, these financing agreements with banks have come back to haunt governments following the financial markets crash and severe drop in interest rates. Last week, Chicago became the latest example when a credit rating downgrade by Moody's Investors Service triggered a potential $58 million penalty for the fiscally beleaguered city.

Penalties related to ratings downgrades are common in swaps, says Municipal Market Analytics Partner Matt Fabian. But typically, the ratings floor is well below the government's rating at the time of the deal.

"Remember, Chicago was super-downgraded back in 2013 — that kind of rating action is almost never expected," Fabian says. "This latest downgrade is a result of the city's huge pension liability, the complete lack of momentum in coming up with any sort of solution and a shifting [emphasis] by Moody's on outstanding liabilities."

Still, Chicago is not alone. Dozens of cities and states across the country still have swaps deals on the books. These deals were meant to save taxpayer money but are in fact doing just the opposite.

In an interest rate swap, a government wants to alter debt it has sold that must be paid back with a varying interest rate that periodically resets, depending on the market. Buying that type of debt is appealing to investors, who believe that interest rates will grow and they will get a higher return on their investment. But governments need to plan out their budgets and it is difficult for budgeters to project debt payments that will vary versus payments that are based on a fixed interest rate. So, the government makes a deal on that debt with a bank: The bank agrees to pay out the investors at the variable interest rate and the government pays the bank a fixed rate that they negotiate. It's a way for the government to hedge against skyrocketing interest rates.

These types of deals were very common in the early to mid-2000s, particularly among larger issuers like major cities, some states and public agencies like housing or airport authorities. Many thought that they were saving taxpayer money: that the interest rate they were paying banks was lower than if they sold that debt and paid out a fixed, market rate of return to investors. But swaps fell largely out of favor after interest rates plummeted — and stayed rock-bottom-low. Governments found themselves stuck paying an interest rate far above the market while the banks pocketed the profits.

Some question the legality of such deals. The Roosevelt Institute's Saqib Bhatti argued some cities could take legal actions against the banks to recoup some of their losses. Bhatti, director of the institute's ReFund America Project that advocates for better Wall Street accountability, noted Chicago Public Schools is potentially leaving millions of dollars on the table with inaction. Last

November the Chicago Tribune published a series that found banks knew the risky auction-rate bond market was in trouble during the summer of 2007, yet they turned around and sold the school district $263 million in auction-rate debt anyway.

“There’s been a number of organizations in the city calling for legal action to recover past payments on these swaps,” says Bhatti. “And thus far, the city has not pursued that option.”

All told, the Tribune estimated that Chicago’s school district issued $1 billion worth of auction-rate securities between 2003 and 2007, nearly all of it paired with interest rate swaps. The city of Chicago holds nearly $3 billion in debt tied up in swaps, an amount nearly equal to its operating budget. The city is likely renegotiating with banks to reset the terms of the four swaps tied to last week’s ratings downgrade instead of paying the $58 million termination fee, although the current administration has unwound some deals by paying tens of millions in fees. If the city wanted to terminate all of its swaps, it would cost north of $300 million, according to its most recent Comprehensive Annual Financial Report. The termination fee represents the amount the debt is underwater, similar to when a homeowner owes more on a house than it’s worth.

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BY LIZ FARMER | MARCH 6, 2015