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Deals Gone Bad Push Muni Borrowers to Dump Interest-Rate Hedges.

With borrowing costs about to rise, why are U.S. municipal-bond issuers paying to dump interest-rate hedges?
Because they're hoping to avoid the fate of Chicago, by simplifying their finances and controlling the timing of when they unwind floating-rate bond deals. Last month, the city tried to refinance debt tied to derivatives that went awry while it still had investment grades from the three biggest rating companies. Moody's Investors Service cut Chicago to junk before it could sell the securities, driving up borrowing costs.

Issuers in the $3.6 trillion municipal market are finding that exiting the hedges now, even with the Federal Reserve poised to raise rates, beats having to pay them off in an unknown future. The money to end the interest-rate swaps is going to banks including Goldman Sachs Group Inc. and Morgan Stanley — many of the same Wall Street firms that got the governments into the deals in the first place.

"This is the worst possible time to voluntarily pay to terminate swaps," said Saqib Bhatti, a fellow with the New York-based Roosevelt Institute, which advocates for municipal-finance reforms. "You're subjecting taxpayers to additional fees and payments."

Happy Banks

Even so, the authority that financed the stadium for the National Football League's Indianapolis Colts paid Goldman Sachs $71 million last month to get out of a swap. Agencies in Pittsburgh and Denver are also exiting swaps on their own timetables. A Denver-area highway authority is bringing a deal next month that will allow it to partially end swaps with Morgan Stanley.

Michael DuVally, a spokesman for Goldman Sachs in New York, and Lauren Bellmare at New York-based Morgan Stanley declined to comment.

The swaps are wagers on the direction of borrowing costs. Banks sold them as a way to save on bond sales, but the bets went wrong for many issuers when the Fed cut rates starting in 2007. With the Fed's benchmark near zero since 2008, the rates that municipalities typically receive on the swaps have been close to that level.

Cities, states and localities have spent at least $5 billion to end interest-rate swaps since 2008, according to data compiled by Bloomberg.

"I'm sure the banks are happy," said Andrew Kalotay, chief executive officer of a New York-based advisory firm to municipal and corporate borrowers.

Chicago Surprise

Governments with swaps want to avoid the fate of Chicago, which refinanced after getting cut to junk, said Matt Fabian, partner at Concord, Massachusetts-based Municipal Market Analytics Inc.

Swaps contracts usually stipulate that banks can demand termination payments if issuers' ratings fall below specified levels. Chicago's downgrade put it in a position where banks could've forced it to make payments. It wound up paying $200 million to end swaps as part of the refinancings.

The case of Chicago "doesn't exactly encourage issuers to keep large swap portfolios," Fabian said.

Deutsche Bank and Wells Fargo & Co. are among counterparties with which Chicago terminated swaps, according to city documents. Gabriel Boehmer, a spokesman for San Francisco-based Wells Fargo, didn't have an immediate comment. Amanda Williams at Deutsche in New York declined to comment.

Mayor Rahm Emanuel has focused on "ending the unsustainable financial practices of the past," Carole Brown, Chicago's chief financial officer, said in a statement. His plan "would continue putting Chicago's fiscal house in order -- including addressing the city's highly leveraged legacy debt portfolio."

Swaps inflate the expense of exiting variable-rate debt, so issuers have to calculate the total cost of refinancing, Kalotay said.

"You pay a substantial penalty, but going forward you're going to pay a lower interest rate," he said. "Or if you wait for rates to go high enough, you could get paid on the swap, but then the cost of refinancing the bonds is higher."

Same Debt

The Indiana agency that financed Lucas Oil Stadium paid Goldman Sachs in May as part of a bond offering to end a swap. The sale by the Indiana Finance Authority saved money by refinancing floating-rate-bond and derivative deals put in place in 2005 and 2007, according to CFO Dan Huge.

The authority is paying the same in debt service but eliminated the risk it would have to unexpectedly cancel the swap because of an event such as the downgrade of a party in the deal, Huge said.
"We used the interest-rate savings to terminate the swap," he said. "It was a wash."

Next month, the E-470 Public Highway Authority, which runs a toll road outside Denver, plans to pay $4 million to partially terminate a swap with Morgan Stanley as part of canceling and converting variable-rate debt sold in 2007, said CFO Stan Koniz.

"The thinking was, 'We got the money, let's get rid of it,'" Koniz said. "Is there ever really a good time to terminate a swap?"

Tangled Mess

Pittsburgh's Water and Sewer Authority has "done some unwinding where it is in our best financial interest," said Paul Leger, the city's debt director, who also sits on the utility's board. The city itself has no swaps.

"But in general, because of the cost-of-buyout provision, we're not looking to unwind them," Leger said. "Our water and sewer system has the most tangled mess of swaps and debt that I've ever seen. It's a no-way-out swap."

Issuers should negotiate lower termination costs, said Bhatti at the Roosevelt Institute. He cited the example of Detroit, where a judge forced the bankrupt city and banks to negotiate smaller payments.

"It's good that issuers are finally admitting these deals are bad," Bhatti said.

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