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New Jersey Turnpike's Swaps Mean a Windfall, Sort of.

• Swaps pay more, but underlying floating-rate debt costs more
• Agency has almost $800 million of swaps, had been $1.8 billion

Motoring through some old bond-offering documents the other night, I was struck by something unexpected and shocking and I couldn't look away: Interest-rate swaps!

And not one or two, but 16 of them totaling $795 million, all legacies from bond deals from 2015 to 2020. There they were, laid out for all to see starting on page 16 of the prospectus for a bond offering from the New Jersey Turnpike Authority in January 2021.

It occurred to me that they might be proving a boon, with London interbank offered rates, a key component of the swaps, having generally drifted higher in recent weeks ahead of next month's widely expected Federal Reserve rate hike.

Swaps swept through the municipal market in the 1990s. They went from being something that sophisticated issuers used to hedge floating-rate debt to something that no issuer of any size could possibly do without.

They blew up in the Jefferson County, Alabama, bankruptcy in 2011, and rueful local governments and school districts spent years getting out of the contracts with sometimes hefty termination payments, totaling billions of dollars nationwide, after the financial crisis. They were intended to protect against the risk of rising rates, but rates fell, leaving municipalities paying more, not less.

But they never really went away. They remained a legitimate financing tool for big bond issuers like the New Jersey Turnpike, which in January was upgraded by Moody's Investors Service to A1. The authority has $10 billion in fixed-rate and $800 million of variable-rate bonds outstanding, so the swaps amount to less than 10% of that.

The authority "used to have something like $1.8 billion in swap notional amount back in 2004," or 40% of total debt, wrote John Medina, a senior credit officer at Moody's, in an email about the swaps portfolio.

No Windfall

As it turns out, the swaps aren't turning into a windfall for the authority even as short-end rates are rising, but they do appear to be working as intended.

The swaps essentially represent a side bet on a related series of bonds. An issuer offers to pay a bank a fixed rate in exchange for a floating one. That floating rate, as the authority says in its offering docs, "is meant to closely approximate the method of determining the floating interest rate payable" on the underlying variable-rate bonds. But if short-term rates rise, so will the floating rate the counterparty pays.

So let's assume an issuer pays a fixed rate, and accepts a percentage of an index as its floating rate, say 67% of Libor, a level used in some of the turnpike swaps. As the index climbs, the issuer gets 67% of a larger and larger number. Hence my question about a windfall.

And the answer was: Yes. And no.

"The mark-to-market value as of a couple of weeks ago was only negative $46 million" on the agency's floating- to fixed-rate swaps, on what is now a notional amount of about $774 million, Medina wrote.

In each swap, NJTA is receiving a percentage of Libor and paying a fixed percentage, he explained. As that underlying index for the receiving side rises, NJTA will get more funds on a monthly cash-flow basis for each swap. However, the interest costs are also rising on the underlying floating-rate obligations.

"So NJTA is paying more on a monthly cash-flow basis for each of those floating-rate notes," he said.

Which means that the increased amount the Turnpike gets on the swaps is canceled out by the larger sum it's paying out. And this is exactly how swaps should work in a large, sophisticated issuer's stack of debt.

'Prudent Approach'

The swaps portfolio has shrunk along with the agency's use of variable-rate debt, Medina said.

"This has allowed NJTA to take advantage of the declining and low interest-rate environment for the last decade or so while keeping a portion of its large debt portfolio at the shorter end of the curve," he said. "A prudent approach to debt management over time."

The Turnpike didn't respond to a request for comment on the swaps portfolio.

There's one other thing that struck me about this financing. Instead of issuing typical variable-rate bonds, the authority chose direct-purchase transactions, or private placements with single investors, for its floating-rate exposure, bypassing the whole underwriting process and market risks of variable-rate demand obligations. So maybe that's what's hot in Muniland now.

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By Joseph Mysak Jr

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— With assistance by Danielle Moran

(Joe Mysak is a municipal market columnist who writes for Bloomberg. His opinions do not necessarily reflect those of Bloomberg LP and its owner, and his observations are not intended as investment advice.)