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FAIR GAME

The Swaps That Swallowed Your Town

By GRETCHEN MORGENSON
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AS more details surface about how derivatives helped Greece and perhaps other countries mask their debt loads, let's not forget that the wonders of these complex products aren't on display only overseas. Across our very own country, municipalities, school districts, sewer systems and other tax-exempt debt issuers are ensnared in the derivatives mess.

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Like the credit default swaps that hid Greece's obligations, the instruments weighing on our municipalities were brought to us by the creative minds of Wall Street. The rocket scientists crafting the products got backup from swap advisers, a group of conflicted promoters who consulted municipalities and other issuers. Both of these camps peddled swaps as a way for tax-exempt debt issuers to reduce their financing costs.

Now, however, the promised benefits of these swaps have mutated into enormous, and sometimes smothering, expenses. Making matters worse, issuers who want out of the arrangements — swap contracts typically run for 30 years — must pay up in order to escape.

That's right. Issuers are essentially paying twice for flawed deals that bestowed great riches on the bankers and advisers who sold them. Taxpayers should be outraged, but to be angry you have to be informed — and few taxpayers may even know that the complicated arrangements exist.

Here's how municipal swaps worked (in theory): Say an issuer needed to raise money and prevailing rates for fixed-rate debt were 5 percent. A swap allowed issuers to reduce the interest rate they paid

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on their debt to, say, 4.5 percent, while still paying what was effectively a fixed rate.

Nothing wrong with that, right?

Sales presentations for these instruments, no surprise, accentuated the positives in them. “Derivative products are unique in the history of financial innovation,” gushed a pitch from Citigroup in November 2007 about a deal entered into by the Florida Keys Aqueduct Authority. Another selling point: “Swaps have become widely accepted by the rating agencies as an appropriate financial tool.” And, the presentation said, they can be easily unwound (for a fee, of course).

But these arrangements were riddled with risks, as issuers are finding out. The swaps were structured to generate a stream of income to the issuer — like your hometown — that was tethered to a variable interest rate. Variable rates can rise or fall wildly if economic circumstances change. Banks that executed the swaps received fixed payments from the issuers.

The contracts, however, assumed that economic and financial circumstances would be relatively stable and that interest rates used in the deals would stay in a narrow range. The exact opposite occurred: the financial system went into a tailspin two years ago, and rates plummeted. The auction-rate securities market, used by issuers to set their interest payments to bondholders, froze up. As a result, these rates rose.

For municipalities, that meant they were stuck with contracts that forced them to pay out a much higher interest rate than they were receiving in return. Sure, the rate plunge was unforeseen, but it was not an impossibility. And the impact of such a possible decline was rarely highlighted in sales presentations, municipal experts say.

Another aspect to these swaps’ designs made them especially ill-suited for municipal issuers. Almost all tax-exempt debt is structured so that after 10 years, it can be called or retired by the city, school district or highway authority that floated it. But by locking in the swap for 30 years, the municipality or school district is essentially giving up the option to call its debt and issue lower-cost bonds, without penalty, if interest rates have declined.

Imagine a homeowner who has a mortgage allowing her to refinance without a penalty if interest rates drop, as many do. Then she inexplicably agrees to give up that opportunity and not be compensated for doing so. Well, some towns did exactly that when they signed derivatives contracts that locked them in for 30 years.

Then there are the counterparty risks associated with municipal swaps. If the banks in the midst of these deals falter, the municipality is at peril, because getting out of a contract with a failed bank is also costly. For example, closing out swaps in which Lehman Brothers was the counterparty cost various New York State debt issuers $12 million, according to state filings.

Termination fees also kick in when a municipal issuer wants out of its swap agreement. They can be significant.

1 | 2 NEXT PAGE »

A version of this article appeared in print on March 7, 2010, on page BU1 of the New York edition.

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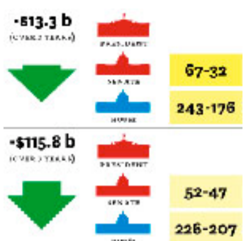

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