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Saint-Etienne Swaps Explode as Financial Weapons Ambush Europe

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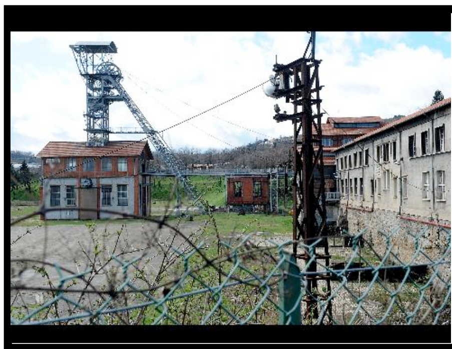
By Alan Katz



April 15 (Bloomberg) -- The worst global financial crisis in 70 years arrived in Saint-Etienne this month, as embedded financial obligations began to blow up.

A bill came due for 1.18 million euros ($1.61 million) owed to **Deutsche Bank AG** under a contract that initially saved the French city money. The 800-year-old town refused to pay, dodging for now one of 10 derivatives so speculative no bank will buy them back, said Cedric Grail, the municipal finance director. They would cost about 100 million euros to cancel today, he said.

"It's a joke that we're in markets like this," said Grail, 38, from the 19th-century city hall fronted by an arched facade and the words Liberte, Egalite, Fraternite. "We're playing the dollar against the Swiss franc until 2042."

Saint-Etienne is one of thousands of public authorities across Europe that tried to shave borrowing expenses by accepting derivatives deals whose risks they couldn't measure. They may be liable for billions of euros, according to the Bank of Italy and consulting and law firms in France and Germany. As global economies climb out of recession, the crisis is hitting Saint-Etienne in central France, Pforzheim in western Germany and Apulia, an Italian regional government on the Adriatic. They may pay for their bets into the next generation.

Alabama's Jefferson County

From the Mediterranean Sea to the Pacific coast of the U.S., governments, public agencies and nonprofit institutions have lost billions of dollars because of transactions officials didn't grasp. Harvard University in Cambridge, Massachusetts, agreed last year to pay more than $900 million to terminate swaps that assumed interest rates would rise.

For Jefferson County, Alabama, the day of reckoning came earlier than in Saint-Etienne, but the common denominator was the use of complex, unregulated financial instruments known as derivatives that are typically linked to changes in market interest rates, currencies, stocks or bonds. Billionaire investor Warren Buffett, chairman of Berkshire Hathaway Inc., in 2003 called derivatives "financial **weapons** of mass destruction."

They pushed Jefferson County close to bankruptcy two years ago. It had refinanced $3 billion of debt with variable-rate bonds and purchased interest-rate swaps to guard against borrowing costs rising. Its interest rates soared when insurers guaranteeing the bonds lost their top credit grades, and the rate the county received under the swap deals fell.

Under the interest-rate swap deals popular with European municipalities, a bank would agree to cover a locality's fixed debt payment and the government or agency would pay a variable rate gambling its costs would be lower -- and taking on the risk that they could be many times higher.

'Hopes of Gain'

The deals were often based on differences between short- and long-term rates or currency movements.

"This is speculating in the hopes of gain," said **Peter Shapiro**, managing director at Swap Financial Group LLC, in South Orange, New Jersey, an adviser to companies and governments. "The investor is taking a chance in hopes of a high return. It has nothing to do with hedging."

Use of swaps in Europe soared in the late 1990s and early 2000s because banks pitched them as the easiest way to reduce costs on fixed-rate loans, according to **Patrice Chatard**, general manager of Finance Active, which helps more than 1,000 localities across Western Europe manage their debt.

The financial institutions that sold the derivatives were many of the same ones that received government bailouts to weather the worst global credit crisis since the 1930s.

1.21 Trillion Euros

They include the **Royal Bank of Scotland Group Plc** and Dexia SA, based in Brussels and Paris. Frankfurt-based Deutsche Bank, which packaged and resold **subprime** U.S. mortgage loans and sold swaps in Europe, didn't take government funds.

City and regional governments in Europe mainly get their financing from banks, while in the U.S. they primarily raise funds by selling bonds to investors. Municipalities and other local authorities in the European Union's 27 member states had a combined debt of 1.21 trillion euros in 2008, according to **Eurostat**, the EU's statistics agency.

Government officials used up-front cash payments from guaranteed rates at the beginning of swap contracts to artificially lower their short-term financing costs and live beyond their means, said Emmanuel Fruchard, who is a city council member in Saint-Germain-en-Laye, near Paris.

"These municipal swaps are the same thing as Greece," said Fruchard, a former banker at Credit Lyonnais, now a unit of Credit Agricole SA, who designed swaps in the early 1990s. "It's all trying to dress up your accounts."

Greek Rescue

Greece, plagued by tax evasion and soaring pension costs, made a series of agreements with banks to help defer interest payments, helping to understate its budget deficit for years, the finance ministry reported in February. The country's credit ratings were cut in December after estimates for the 2009 deficit doubled. Greece imposed new levies on large companies, raised the value-added tax, increased tariffs on fuel, alcohol and tobacco and cut public-employee wages to shrink the shortfall and restore **investor confidence** in its debt.

Those measures didn't work. The yield demanded by investors on 10-year Greek bonds soared to 7.36 percent by April 8, from 4.42 percent six months earlier, while the euro fell by 9.7 percent against the dollar over the same period. European governments on April 11 offered Greece a rescue package worth as much as 45 billion euros at below-market interest rates in a bid to stem its fiscal crisis and restore confidence in the euro.

12 Percent Cut

Germany, Italy, Poland and Belgium also used derivatives to manage fiscal deficits, Walter Radermacher, the head of Eurostat told EU lawmakers in Brussels yesterday without being specific.

Municipalities are having to rewrite their budgets. Saint- Etienne raised taxes twice, slashed by three-fourths a plan to renovate a museum commemorating the region's extinct coal mining industry and

sparked the cancellation of a tram line. Pforzheim, on the edge of the Black Forest in Germany, is scrimping on roads, schools and **building** renovations.

Known as Gold City for its historic jewelry and watch- making industry, Pforzheim was ordered by the Baden-Wuerttemberg **regional government office** in Karlsruhe to cut its budget by 240 million euros, or about 12 percent annually, over the next four years because of a 55 million-euro loss on derivatives and a projected 50 million-euro annual shortfall from a decline in tax revenue and rising social costs.

The town followed the advice of Deutsche Bank in taking out bets on interest rates in 2004 and 2005, according to **Susanne Weishaar**, Pforzheim's budget director until March.

'Painted Hand Grenade'

The bank gave her a 10-year chart showing long-term rates were consistently higher than short-term, she said. During an initial phase of guaranteed rates, the town paid 1.5 percent to the bank on 60 million euros of debt while receiving 3 percent to 3.75 percent.

In 2005 and 2006, the difference between long- and short- term rates collapsed. As potential losses soared in 2006, Weishaar bought more swaps from **JPMorgan Chase & Co.** in a vain attempt to protect the town budget. Today Pforzheim owes 55 million euros to New York-based JPMorgan, she said. That's 11 percent of this year's spending.

The Deutsche Bank swaps have a positive value for the city of about 9 million euros, Weishaar said, offset by the negative value of JPMorgan swaps set up to protect the city.

"It's like Easter eggs," said Weishaar, 45, who holds a degree in math and economics from the **University of Ulm**. "You want to buy one and somebody sells you a painted hand grenade instead."

If the grenades explode -- or when local officials decide to cut their losses and get out of long-term contracts when the market is against them -- taxpayers foot the bill.

Risks Versus Savings

More than 1,000 municipalities in France had 11 billion euros in "risky" contracts at the end of 2009, according to Paris-based **Finance Active**. In Italy, about 467 public borrowers faced losses of 2.5 billion euros on derivatives as of the end of September, according to the **Bank of Italy**.

In Germany, Deutsche Bank sold contracts based on the difference between long- and short-term rates to about 50 municipal governments and utilities. Local authorities also bought swaps from regional banks and Commerzbank AG. No national consolidated figures exist, according to Roland Simon of Simon & Partner, a law firm in Duesseldorf.

For cities like Saint-Etienne, the risks from buying swaps were out of proportion to the potential savings.

Saving 126,377 Euros

The town borrowed 22 million euros in 2001 from Dexia at 4.9 percent to consolidate borrowings for civic projects. The rate would rise if the benchmark three-month London interbank offered rate, or **Libor**, exceeded 7 percent.

Under Mayor **Michel Thiolliere**, Saint-Etienne signed six swap contracts on that loan between 2005 and 2008, the last three with Deutsche Bank. That lowered the city's effective costs to 4.35 percent in 2006, to 4.07 percent in 2007 and 4.3 percent in 2008 and 2009. The difference in 2009 was a saving of 126,377 euros.

The risks in the equation hit the town this month. The contract obligated Saint-Etienne to pony up on April 1 a quarterly payment of 1.18 million euros -- equivalent to an annual 24 percent on the debt -- while Deutsche Bank would pay 241,886 euros. The swap is based on the strength of the British pound against the Swiss franc. The U.K. currency has slumped by 21 percent in the two years since the deal was signed.

"This isn't traditional asset management," Fruchard said in reference to swaps based on currency moves in general. "It's speculative, like a hedge fund. And it's done in bad faith. An elected official who takes the benefit from the guaranteed low rates without understanding what happens after his mandate ends is acting in bad faith."

Fighting Deutsche Bank

Saint-Etienne sued Deutsche Bank in November, alleging the bank had failed to warn officials with sufficient detail of the risks in the contract, and claiming the city didn't have the right to sign the agreement because it was "speculative."

The city hasn't paid what it owes the bank, and returned Deutsche Bank's January net payment of 30,735 euros, according to Chantal Bayet, who is in charge of debt service and financial analysis. Saint-Etienne has increased the amount it has set aside for financial risks to 6.5 million euros, from less than 400,000 euros in 2008.

Deutsche Bank disputed the claims. "Deutsche Bank, as in any transaction of this kind, worked closely with the client to ensure that risks and opportunities of the transaction were well understood by all parties," the bank said in a statement in November. The bank has no further comment, spokesman **Christian Streckert** said in an e-mail.

'Daily Risks'

For his part, Thiolliere had little choice for reducing Saint-Etienne's interest costs, he said. After the area's last deep coal mine closed in 1983, the city faced terminal decline, he said. The local team in France's top professional soccer league holds the record for championships with 10 but hasn't won since 1981.

"Managing a town is like running a company: It's taking risks daily," said Thiolliere, mayor for 14 years before being voted out of office in 2008. He still represents the Loire region in the French **Senate**.

Accounting rules in Europe help keep derivatives deals hidden. Most local governments have no obligation to set aside cash against potential losses, and reflect only current-year cash flows in balance sheets.

"It's only transparency that will make elected officials scared to invest in dangerous products," said Jean-Christophe Boyer, deputy mayor of Laval, in western France, which has swaps covering about 25 percent of its total debt of 86 million euros. "Even if we banned them today, the impact is coming now, tomorrow and 10 years from now," he said, because of the number of derivatives contracts still in force.

Ban on Swaps

European towns desperate for cash jumped into the global derivatives experiment that loaded the financial system with leverage and led to the credit crisis in late 2008. Epitomized by Lehman Brothers Holdings Inc.'s collapse, the fallout cost banks and brokerages alone $1.28 trillion in writedowns and credit losses, according to data compiled by Bloomberg, and required at least **$15 trillion** in support from central banks and governments in the U.S., the U.K. and the euro zone, based on Bank of England data.

Efforts to regulate derivatives sales to local governments are patchy. The European Commission isn't working on EU-wide rules. In France, the central government oversaw a voluntary good-conduct charter, inked in December, that wasn't signed by all banks operating there nor by all local government associations. In Italy, a Senate committee in March proposed a ban on swaps for smaller towns except for provincial capitals.

Generational Impact

A judge charged Deutsche Bank, JPMorgan, Zurich-based **UBS AG** and Depfa Bank Plc with fraud linked to the sale of derivatives to the City of Milan, Italy's financial and fashion capital. The trial is scheduled

to start May 6.

Deutsche Bank spokesman Streckert referred to the firm's March statement that said, "We continue to believe that our case is compelling and that we will be cleared." JPMorgan spokesman David Wells declined to comment.

"We are convinced that neither Depfa nor the accused employees have violated any law or regulation," Depfa's parent, Hypo Real Estate Holding AG, said in an e-mailed statement last month. Spokeswoman Nina Lux said the company stands by that. UBS reiterates its March statement that "no fraud was committed by UBS nor by any of its exponents," spokesman Richard Morton said in an e-mail.

'Shouldn't Buy It'

The use of derivative contracts by some Italian municipalities will weigh on their debt for "generations," said Tullio Lazzaro, chairman of the state audit court, on Feb. 17 in Rome.

Under the French **voluntary agreement,** banks pledge not to sell local authorities interest-rate contracts based on debt principal, commodities or foreign currencies. The accord also excludes so-called snowball swaps, which move in steps where each payment is based on the previous payment. This works to magnify any trend. Calculations in swaps also may contain multipliers that exaggerate any change.

"I'm not against all structured products, but if you can't explain the real utility to a mayor in under a minute, you shouldn't buy it," said Sandra de Pinho, finance director for the city of Lille in northern France.

Understanding agreements like these requires complex software, mathematical and financial expertise that local governments often don't have, said Fruchard, the former banker.

Snowball Swaps

Take Saint-Etienne's two snowball swaps with Royal Bank of Scotland. In one of the contracts, the town pays a fixed rate of 3.92 percent until May 2011 on an underlying debt of 7.2 million euros while RBS pays 9.69 percent, less 10 times the difference between 10-year and 2-year interest rates, capped at 12 percent and with a floor at zero.

The contract with RBS was a counter-agreement for a swap that Saint-Etienne had signed with Paris-based **Natixis SA**. The swaps are based on an underlying loan by Dexia at 4.94 percent that runs until 2026.

Under the other contract, Saint-Etienne is paying 3.77 percent until June 2011 on 8.3 million euros while RBS picks up the payment of 9.71 percent less the same formula in the previous swap. The underlying loan from Dexia is also at 4.94 percent and lasts until 2026.

Permanent Rate Increase

After the dates specified in both contracts, the city each quarter must pay the previous rate if the difference between the 20-year constant maturity swap rate less the three-month **Euribor** rate, another interest-rate benchmark, is greater than or equal to negative 0.3 percentage point. If that rate is less than negative 0.3 percentage point, Saint-Etienne must pay the previous rate plus three times the difference between 0.1 percentage point and the 20-year versus 3-month spread. Any increase is permanent until the contracts end in 2020 and 2021.

Saint-Etienne would need to pay RBS 3.18 million euros to cancel the first snowball swap and 4.05 million euros to cancel the second, according to a Jan. 29 presentation by the mayor's office.

Claire Gorman, a spokeswoman for RBS, declined to comment on the contracts, discussions with Saint-Etienne or on the bank's policies on sales of derivatives to local governments.

Saint-Etienne asked **Eric Gissler**, a French finance ministry official named last year to mediate disputes

over swaps, to help negotiate a settlement with Natixis, according to Jean-Claude Bertrand, the deputy mayor in charge of finances since 2008. The town has been unsuccessful in discussions to alter its contracts with RBS, he said.

Looking for Deals

Saint-Etienne has derivative contracts with at least six banks, according to a chart of the city's finances. "They put people into competition with each other in some ways and searched for products with different characteristics," said **Christian Le Hir**, chief legal officer for Natixis.

Natixis is ready to negotiate with Saint-Etienne under the aegis of the mediation system set up by the French government, he said. The voluntary charter creates a level playing field for banks and will prevent local governments from signing inappropriate contracts, he said.

Speaking generally about what happened in municipal finance and not specifically about Saint-Etienne, Le Hir said banks and local governments were both looking for deals.

"Banks were looking to sell products," Le Hir said. "Local governments were looking to buy them because it suited them, at least in the short term, with accounting rules that weren't suitable and a government that didn't look into these transactions because local authorities needed to refinance themselves with better conditions. It was a whole context."

Renegotiation Pattern

Saint-Etienne and other towns renegotiated their finances repeatedly. After Thiolliere lost local elections in 2008, the new administration discovered Saint-Etienne had at least 26 swaps, many of them renegotiated several times, according to the complaint the city filed against Deutsche Bank.

"The number of people who believed, in good faith, even in big cities, that when you renegotiate your debt you win, is crazy," said **Michel Klopfer**, the author of "Financial Management for Local Governments," a how-to handbook used throughout France. Klopfer has consulted for 31 out of the 37 French cities with more than 100,000 residents. "Banks accelerated their renegotiation proposals while making clients believe, incredibly, that renegotiating means winning."

For **Dexia**, the largest lender to local governments in France and Belgium, "restructuring debt was an important factor in the profitability of this business in the past," said **Pierre Mariani**, the bank's chief executive officer, on a Feb. 24 conference call. "It will continue, but in safe conditions for the bank and for our clients."

Pforzheim Deals Probed

It would cost Saint-Etienne 20 million euros today to cancel the Deutsche Bank swap, Grail said, while still leaving the town to pay off the 19 million euros left in the underlying loan from Dexia.

"Our goal isn't to go to war with the banks," Grail said. "Our goal is to protect Saint-Etienne citizens from the aberrant decisions made by the prior team."

Pforzheim, a town of 117,000 that traces its history back 1,900 years to Roman times, hasn't sued Deutsche Bank over its swap deals. The Mannheim prosecutors' office is investigating Weishaar, the former budget chief, and former Mayor **Christel Augenstein** over the decision to buy the swaps, according to Peter Lintz, a spokesman.

'They Cheated Me'

Augenstein denied any wrongdoing, saying she relied on the advice of Deutsche Bank. Weishaar said she did nothing wrong, and that she thought Deutsche Bank's 10-year chart on interest rates was misleading. Her resignation in November took effect at the end of March.

"I think they cheated me, and I want my money back, my city's money back," she said.

Deutsche Bank declined to comment through spokesman **Streckert**.

In December 2004 and August 2005, Deutsche Bank sold Pforzheim three contracts known as spread-ladder interest-rate swaps, Weishaar said. The transactions functioned in part like the snowball swaps that Saint-Etienne bought because each period's rate was based on the previous rate, plus a formula.

Weishaar was trying to reduce the town's costs on 60 million euros of debt so it could spend more on education, she said. The contracts hinged on the difference between short-and long-term interest rates.

What went wrong was that short-term rates rose faster than long-term rates. The European Central Bank doubled short-term rates to 4 percent from 2 percent between December 2005 and June 2007. This caused the spread compared with long-term costs to narrow to 0.07 point by October 2006 from 0.63 point on Dec. 1, 2005, faster than Weishaar says she expected.

Counter-Swaps

The amount that Pforzheim potentially owed surged to 20 million euros in October 2006 from 644,000 euros a year earlier, Weishaar said, scanning spreadsheets on the computer screen in her home office. After that, she decided to try to protect Pforzheim from any further losses, she said.

Johannes Banner, a banker at JPMorgan in London, had given a presentation on swaps at a conference in Potsdam, Germany, attended by one of Weishaar's colleagues. Weishaar called Banner, explained the contracts she held, and asked him to come up with a way to limit the town's exposure, she said. The bank set up a series of contracts capping Pforzheim's loss at 77.5 million euros.

"We didn't have the money to buy out the Deutsche Bank contracts, but we had to limit the danger," Weishaar said. "Even if the cap was very high, at least it was a cap."

JPMorgan's Wells declined to comment.

Three-Decade Payback

JPMorgan set up swaps as the exact reverse of the Deutsche Bank contracts. Pforzheim agreed to pay 77.5 million euros to JPMorgan beginning in 2014, less the value of three options.

In February, the city council voted to cancel that contract and pay off the net 54.96 million euros it owed to JPMorgan at the time, said Bernhard Enderes, head of human resources, who led internal investigations by the city into the way the debt was handled. It decided to borrow the funds at a fixed rate over 30 years to cover the cost, Enderes said.

That would cost about 3 million euros a year for the next three decades, or the same as the combined annual operating budgets of the city library and jewelry museum. Enderes hasn't yet secured the loan or paid JPMorgan, according to Michael Strohmayer, a spokesman for the town.

Deutsche Bank wouldn't discuss its dealings with Pforzheim. Standard warnings in the bank's spread-ladder swap contracts with local governments included: "A worst-case scenario cannot be quantified" and said there was a "theoretical risk of unlimited losses." It's written in bold face on the fourth page of six in a typical term sheet obtained by Bloomberg News.

Likely to Lose

Clients were aware of the potential benefits and risks, said **Christian Duve**, a lawyer representing Deutsche Bank in German cases over spread-related swaps.

"Six separate appellate courts in Germany have ruled that the bank provided all necessary information to the municipalities and companies and have dismissed their claims," Duve said in an e-mailed statement.

A German appeals court said in a Feb. 26 **ruling** that Deutsche Bank didn't provide enough information to a corporate customer, who wasn't identified. The bank constructed the swap so that the customer was likely to lose money, the court found. The appeals court, the Stuttgart Higher Regional Court, ordered Deutsche Bank to pay 1.5 million euros. The bank appealed.

Pforzheim, bombed by the British Royal Air Force in the final months of World War II, will cut investment spending by about 80 million euros between 2010 and 2013 to compensate for losses on swaps and slumping revenue from changes to local tax law, the **city** said in March.

'Real Pain'

It has postponed until at least 2014 the construction of a sports complex for the Hilda-Gymnasium school, scrapped 11 million euros of planned refurbishments for Nordstadtschule, a vocational school, and canceled plans to turn a century-old building into a design and business center.

"We trusted Deutsche Bank that the transactions complied with all applicable laws and weren't speculative," Augenstein, the former mayor, said. "Otherwise, I would never have agreed to them."

In **Saint-Etienne**, the consequences of losing gambles on rates include tax increases of 7.5 percent in 2009 and 2 percent this year. The government slashed 19 percent, or 50 million euros, from its 2008-2014 investment plan. The city reduced by three-quarters an 80 million-euro project to update the museum commemorating the coal-mining industry, Bertrand said. Its woes forced the cancellation of a 120 million-euro plan for a new tram line, he said.

"The real pain for us is just starting now and is coming over the next several years," said Grail, the finance director.

Saint-Etienne's guaranteed rates under eight remaining swaps or structured loans end between this month and September 2012, while one allows the city to pay nothing until 2020.

"The problem is no bank today will take on a swap where you're betting on 10 times the yield curve, or on foreign currencies," Grail said. "So we're stuck, and the explosions are starting to go off."

To contact the reporter on this story: **Alan Katz** in Paris at **akatz5@bloomberg.net**.

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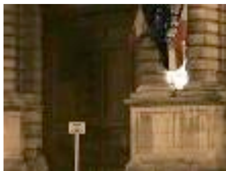

Watch

Rival Toxic Views
April 15 (Bloomberg) -- The 800-year-old French town of Saint-Etienne could end up owing as much as 100 million euros ($136 million) as a result of bets on derivatives that have turned toxic in the wake of the global financial crisis. This report includes comments from Jean-Claude Bertrand, deputy mayor in charge of finances for Saint-Etienne, Cedric Grail, the city's finance director, and Michel Thiolliere, who was mayor from 1994 to 2008. They spoke with Bloomberg's Alan Katz.

Watch

St Etienne Swaps
April 15 (Bloomberg) -- Bloomberg's Eric Coleman reports on the debt problems faced by the French town of Saint-Etienne after derivatives contracts it initially signed to save money began to blow up. Saint-Etienne is one of thousands of public authorities across Europe that tried to shave borrowing expenses by accepting derivatives deals whose risks they couldn't measure. They may be liable for billions of euros, according to the Bank of Italy and consulting and law firms in France and Germany.

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