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## Fears of crushing debt spread to cities, provinces

Such deals were popularized as a way for municipalities to shield themselves from the possibility of higher interest rates. In many cases, analysts say, they have done just that. In the Washington area, for instance, the largest user of interest-rate swaps has traditionally been the District, which now owns \$262.2 million worth of such swaps. City officials say they have no complaints about them.

But a minority of the deals, critics say, were put together by banks in ways that made it almost impossible for local jurisdictions to service their obligations in the long run without suffering losses. The growing number of problematic contracts has ignited a debate in European capitals and Washington, and on Wall Street, over new oversight and curbs on derivative sales, as well as restrictions on municipal borrowing.

Bad deals in Italy are hitting small towns the hardest. Here in Recanati, a town of 22,000, more than a dozen swap contracts were signed between 2001 and 2004. Local officials said they were told they could not lose.

The deal worked this way: To guard against sudden surges in interest rates, Recanati agreed to take out special contracts on the city's \$106 million in debt. It would pay banks a fixed annual interest rate of about 5 percent on the total. In return, the banks would pay the city back an adjustable rate tied to a key European interest rate index, theoretically ensuring that Recanati would not see wild swings in its interest payments.

When European interest rates were high in the mid-2000s, the deal worked out well, allowing Recanati to pocket about \$400,000 between 2001 and 2008. When interest rates fell to record lows in 2009, the tables turned dramatically. The city was forced to keep making fixed-rate interest payments to the banks averaging about 5 percent, while receiving adjustable-rate payments of less than 1 percent in return.

The deals cost the city \$420,000 in just one year and more than wiped its previous gains. With adjustable rates still at rock-bottom levels, Recanati officials calculate that they are set to lose nearly \$700,000 this year. City officials here and in other localities across



Recanati, Italy, faces a financial crisis and is being forced to sell off park land, scale back aid to the elderly and scrap costly repairs on leaking churches and ancient cobblestone streets. (Anthony Faiola - The Washington Post)

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Italy said the possibility of such vast losses was never explained.

On top of that, the swap contracts carried hidden fees of more than \$650,000, according to Marco Fabio Delzio, a Rome-based partner at Martingale Risk, a firm hired to audit the town's contracts. Given those fees, officials say, Recanati would very likely have lost money in the long run even if interest rates had remained high for years.

Yet canceling the swap contracts would cost \$2.2 million more, money this town says it does not have. "We would have to sell our crown jewels, important buildings, more land," said Antonio Bravi, financial adviser for Recanati. "And we would have to cut services."

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Like many municipalities in Italy, Recanati is trying to negotiate a deal to close out the contracts. In the meantime, its fiscal problems are so bad that officials are considering scaling back the city's internationally renowned festival marking the birth of Leopardi, the poet and essayist whose statue looms over the town square. Green spaces on the edge of town are being sold to investors, and Recanati has sought to raise tax revenue by rezoning land for commercial use.

At Recanati's senior-care center, Aliandri Franco, 72, said the city's financial problems have delayed plans to build low-cost housing. Officials are also unable to meet their goal of expanding in-home care to some of Recanati's neediest elderly residents.

"It was a big mistake, getting involved in all this nonsense," Franco grumbled. "I hope they have learned their lesson."

In Italy, the troubles have raised the prospect that bankers may do jail time. Two weeks ago, an Italian court indicted 11 officials at four global banks, including New York-based J.P. Morgan Chase and [Germany's](#) Deutsche Bank, on fraud charges linked to the sale of interest rate swaps to the city of Milan. Those swaps, authorities say, have cost Italy's fashion and financial capital \$140 million since 2003 and were knowingly misrepresented to city officials. All four banks have denied the charges.

"The way these deals were structured, there was just no way any city could win," said Alfredo Robledo, the chief prosecutor in the case. He called it another example of banks "taking advantage" during the 2000s.

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