# Big Banks Squeeze Billions in Profits from Public Budgets

***An estimated $28 billion already taken out of public budgets to pay banks on swap deals, big banks seek to collect billions more.***

**B**ig banks are profiting at state and local governments' expense using the same toxic financial instruments that helped crash the economy. These derivatives known as interest rate swaps, were sold to governments with a promise that they would lower their borrowing costs but have now become a huge liability. The banks have already taken as much as $28 billion from state and local governments. Now, during the worst public budget crisis in memory, the big banks seek to collect billions more from toxic deals that local and state governments are trapped into and are forcing layoffs and cuts to services to cover payments to banks.

**Big banks must renegotiate or cancel the derivatives, which could prevent the transfer of billions of dollars from public budgets to big banks.**

**Bank Deals Turn Toxic: Increased Costs for Governments, Windfall for Banks**

Banks like JPMorgan Chase, Bank of America, and Goldman Sachs initially marketed derivative deals with the promise that they would help state and local governments reduce their cost of borrowing for public improvement projects.[1] In a typical deal, a state or local government agreed to "swap" interest rates on variable-rate bonds, with the government paying the bank a fixed rate in exchange for a variable payment that would track the interest due on the bonds. If interest rates were projected accurately, the payments would more or less balance out over the life of the contract and the public entity would end up with something similar to a fixed-rate bond.

Derivatives, however, have turned into a windfall for banks and a nightmare for taxpayers. In the wake of the financial collapse, the federal government aggressively drove down interest rates to save the big banks and spur economic recovery. The unintended consequence was the creation of an opportunity for banks – whose variable payments were tied to prevailing interest rates – to reap a tremendous profit from the deals. While banks are still collecting fixed rates of 3 to 6 percent, they are now regularly paying public entities as a little as a tenth of one percent on the outstanding bonds, with rates expected to remain low in the future. Over the life of the deals, banks are now projected to collect billions more than they pay state and local governments – an outcome which amounts to a second bailout for banks, this one paid directly out of state and local budgets.

While banks have benefitted, state and local governments have been trapped in expensive and risky debt. They are paying above-market rates and are exposed to even higher penalty rates if banks and other financial institutions withdraw support for their complicated variable-rate debt. Yet the banks have made it prohibitively expensive for state and local governments to refinance by demanding tens or hundreds of millions of dollars in fees to terminate derivatives. In some cases, public entities have gone ahead and made the payments out of desperation; in others, the banks have actually forced termination of the deals just to collect the huge termination fees. The overall effect is staggering. Banks are estimated to have collected as much as $28 billion in termination fees alone from state and local governments over the past two years. This does not even begin to account for the outsized net payments that state and local governments are now making to the banks.

Finally, there is also mounting evidence that it is no accident that these deals have gone so badly, so quickly for state and local governments. Ongoing investigations by the U.S. Department of Justice and the California, Florida, and Connecticut Attorneys General implicate nearly every major bank in a nationwide conspiracy to rig bids and drive up the fixed rates state and local governments pay on their derivative contracts. [2] If the allegations are true, the banks' illegal practices have directly contributed the outsized costs and risks now faced by state and local governments.

**Local Governments All over the Country Are Caught up in the Swaps Net**
Back in November *BusinessWeek* told the story of Detroit, a city whose swaps had gone bad. Detroit struck a derivatives deal with UBS (UBS). However the deal came with problematic strings attached. If the city's credit rating dropped, the banks could opt out of the deal and demand a sizable breakup fee. That's precisely what happened last year when Detroit saw its credit rating slashed. The banks executed the swap termination clause and the city of Detroit, already struggling was on the hook for $400 million.[3]

While the press have reported numerous stories of cities like Detroit, caught with high termination payments, the reality is there are hundreds (maybe even thousands) more cities, counties, utility districts, school districts and state governments with swap agreements. These agreements could be ticking time bombs. In any case, in the current interest rate environment they are causing cash strapped local and city governments to pay millions of dollars in unneeded fees directly to Wall Street. In location after location governments are caught between the high fees to the banks and the extraordinary termination fees they would need to get out of the deal.

In Pennsylvania for instance, the banks pitched at least 500 deals involving interest rate swaps, totaling $12 billion. "Most of the transactions - which occurred outside the state's largest cities of Philadelphia and Pittsburgh - have been made without public bidding, which means that banks and advisers privately arranged the deals with small school districts." [4] One in five school districts and 86 other local governments in Pennslyvania have swap agreements according to a report issued by the Auditor General's office. The Department of Community and Economic Development's records indicate that 626 swap filings were made in Pennsylvania between October 2003 and June 2009, which related to $14.9 billion in debt.[5]

No one has yet completely categorized all the outstanding swap deals entered into by local and state governments but a cursory search of a small sample Comprehensive Annual Financial Reports (CAFRs) revealed multiple swaps issued in at least 32 jurisdictions in 12 states.[6] Table 1 below includes some examples of these swaps within the State of California. Table 2 looks at locations outside of California.

**Banks Must Renegotiate Derivatives to Prevent State and Local Government Budget Cuts**

The banks that created the economic crisis and received trillions of dollars in bailouts should not be allowed to profiteer from the crash while state and local governments suffer. Banks have renegotiated derivative contracts in the past, and they must commit to modifying the contracts on a much wider scale in order to do their part to support economic recovery. Sen. Robert Menendez and Rep. John Lewis have introduced legislation which would impose a 100 percent tax on derivative termination fees to keep banks from seeking to collect on these deals, but banks cannot wait to act.

Banks must commit to reform their derivative businesses now in order to stave off catastrophic cuts to state and local government services:

- Renegotiate or cancel deals at no cost to taxpayers to stop the massive transfer of wealth from the public sector to banks;
- Disclose bank derivative holdings before state and local governments plan budgets; and
- Sign a code of ethics which will govern their future marketing and pricing of municipal derivatives.

## Sampling of Interest Rate Swap Deals Across the Country

### *Deals Below to Cost Taxpayers More Than $1.25 Billion in 2010*

| State | Public Entity | Annual Swap Payments ($ million) | Termination Fee† ($ million) | Bank Counterparties | Local Budget Situation |
|---|---|---|---|---|---|
| CA | See California table below | 364.7 | 1,004.1 | BofA, Citi, Goldman, JPMChase, Others | See California table below |
| CO | City & County of Denver | 33.9** | 289.5 | Goldman, BofA, JPMChase, RBC, Others | Cut $200M from its budget in FY 2010 |
| CO | Denver Public Schools | 34.7 | 81.3 | JPMorgan Chase, Bank of America, RBC | Dealing with $120M deficit in FY 2010 |
| CO | City of Aurora | 2.6 | 9.6 | JPMorgan Chase, Morgan Stanley | N/A |
| CT | State of Connecticut* | 9.8 | 16.7 | Unknown | Dealt with a $515 M deficit in FY 2010 |
| IL | State of Illinois | 57.7** | 88.8 | Unknown | Dealt with a $13.2B deficit in FY 2010 |
| IL | City of Chicago | 66.9** | 442.2 | Unknown | Dealt with a $520M deficit in FY 2010 |
| IL | Chicago Public Schools | 35.7 | 164.2 | RBC, Loop Financial, BofA, Goldman, Other | Facing up to $1B deficit in FY 2011 |
| LA | City of New Orleans | 9.0 | 52.8 | UBS | Dealt with a $68 M deficit in FY 2010 |
| MA | State of Massachusetts* | 18.5 | 325.7 | Barclays, Morgan Stanley, Citigroup, BofA, BofNY, DeutscheBank, JPMorganChase, Goldman Sachs, Ambac | Dealt with a $3B deficit in FY 2010 |
| MD | City of Baltimore | 18.5** | 63.2 | Unknown | Facing a $121M deficit in FY 2011 |
| MI | City of Detroit | 107.1** | 303.8 | Unknown | Dealing with $300M deficit in FY 2010 |
| MO | City of Kansas City | 7.8 | 35.1 | Citigroup, UBS, Barclays | Dealt with $65M deficit in FY 2010 |
| NC | City of Charlotte | 22.7 | 45.0 | Unknown | Facing a $9M deficit in FY 2011 |
| NC | City of Winston-Salem* | 3.1 | 14.0 | Unknown | Cut $25M from its budget in FY 2010 |
| NJ | State of New Jersey | 118.4 | 535.6 | Unknown | Facing an $11B deficit in FY 2011 |
| NY | State of New York* | 102.0 | 534.0 | Unknown | Dealt with a $3.2B deficit in FY 2010 |
| NY | Metro Transportation Authority | 103.7** | 579.5 | Citi, JPMChase, UBS, Morgan Stanley, Others | Dealing with $783M deficit in FY 2010 |
| OR | State of Oregon | 13.5 | 34.5 | Bank of America, Morgan Stanley, JPMChase | Dealt with $4.2B deficit for 2010-11 |
| PA | City of Philadelphia | 94.4** | 332.0 | JPMC, Citi, RBC, Goldman, MorgStan, Others | Dealt with $2.4B deficit in FY 2010 |
| PA | Pennsylvania Turnpike | 26.4 | 145.5 | Goldman Sachs, Deutsche Bank | N/A |
| | **TOTAL** | **$1,251.1** | **$5,097.1** | | |

*Annual payments based on interest rates as of February 2010*

# Sampling of California Interest Rate Swap Deals

| Public Entity | Annual Swap Payments ($ million) | Termination Fee[†] ($ million) | Bank Counterparties | Local Budget Situation |
|---|---|---|---|---|
| State of California[*] | 135.2 | 269.2 | Unknown | Dealing with a $52.1B total deficit in FY 2010 |
| City & County of San Francisco | 19.2 | N/A[‡] | JPMChase, Goldman Sachs, BofA, Depfa | Facing a $522M deficit in FY 2011 |
| City of Corcoran | 0.7 | 2.2 | Piper Jaffray | N/A |
| City of Los Angeles | 19.0 | 29.0 | Bank of New York Mellon, Dexia | Dealt with a $212M mid-year deficit in FY 2010 |
| City of Menlo Park | 2.4 | 8.5 | Piper Jaffray | Dealt with a $550K mid-year deficit in FY 2010 |
| City of Oakland | 5.2 | 19.0 | Goldman Sachs | Still facing a $4M deficit in FY 2010 |
| City of Oxnard[*] | 1.9 | 7.7 | Royal Bank of Canada, Others | N/A |
| City of Pittsburg | 4.8 | 13.3 | Piper Jaffray | Facing a $2M deficit in FY 2011 |
| City of Richmond | 6.0 | 21.1 | Royal Bank of Canada | Still facing a $10M deficit in FY 2010 |
| City of Riverside[*] | 11.6 | 29.9 | Unknown | Dealing with $4M deficit in FY 2010 |
| East Bay Municipal Utility District | 34.4 | 29.1 | Citi, SBS Financial, JPMChase, BofA, Other | N/A |
| Metro Transportation Commission[*] | 62.8 | 411.1 | Ambac, Citi, JPMChase, BNY, BofA, Goldman Sachs, Morgan Stanley | N/A |
| Peralta Community College District | 19.0 | N/A[‡] | Morgan Stanley | Cut $13M from budget in FY 2010 |
| Riverside County[*] | 3.9 | 24.1 | Citigroup | Dealing with $71M deficit in FY 2010 |
| Sacramento County[*] | 25.4 | 88.9 | Bank of America, JPMorgan Chase | Cut $195M from budget in FY 2010 |
| Valley Transportation Authority | 13.2 | 51.0 | Unknown | Dealt with $98M deficit in FY 2010 |
| **TOTAL** | **$364.7** | **$1,004.1** | | |

*Annual payments based on interest rates as of February 2010*

[*] The swap payments for these entities are not calculated based on current interest rates, but taken from their most recently available Comprehensive Annual Financial Reports (CAFR).
[†]Termination fees are based on the figures reported in the entities' most recently available CAFRs, either from FY 2008 or FY 2009.
[**]The actual number is likely higher. In each of these entities, we found a few swaps for which we were unable to calculate the current payments, so those swaps were left out of this calculation.
[‡]We were unable to determine the proper termination fee for these entities.

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[1] http://www.auditorgen.state.pa.us/Department/Press/WagnerCallsOnBanRiskySwapContracts.html
[2] http://www.bloomberg.com/apps/news?pid=20601015&sid=a852NJ_VtI1U&refer=munibonds
[3] http://www.businessweek.com/magazine/content/09_48/b4157034230199.htm
[4] http://www.bloomberg.com/news/marketsmag/mm_0308_story2.html
[5] http://www.auditorgen.state.pa.us/Department/Press/WagnerCallsOnBanRiskySwapContracts.html
[6] See swap table