INTEREST-RATE DEALS STING CITIES, STATES

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Buyer's remorse has hit some cities and states that did deals with Wall Street in different times.

Hundreds of U.S. municipalities are losing money on interest-rate bets they made during the bull market in hopes of protecting themselves from higher rates. The deals backfired when rates fell, shriveling the sums paid to municipalities. Now some are criticizing Wall Street and trying to exit the contracts.

The Los Angeles city council approved a measure this month instructing city officials to try to renegotiate an interest-rate deal with Bank of New York Mellon Corp. BK -0.84% and Belgian-French bank DexiaDEXB.BT 0.00% SA. The pact, reached in 2006 to help fund the city's wastewater system, currently is costing the city about $20 million a year. The banks declined to say how they would respond to a request to renegotiate.

In Pennsylvania, 107 school districts entered into interest-rate swap agreements from October 2003 to last June. At least three have terminated them. Under one deal, the Bethlehem, Pa., school district had to pay $12.3 million to terminate a swap with J.P Morgan Chase & Co., according to state auditor general Jack Wagner. J.P. Morgan declined to comment.

State lawmakers have proposed restrictions on municipalities' ability to use swaps. "It's gambling with the public's money," Mr. Wagner said. "Elected officials are simply no match for the investment banker that's selling the deal."

Examples of Interest-Rate Swaps

This study by the Service Employees International Union, which represents municipal employees, is based on government filings and payment estimates using current interest rates. It compares the interest-rate swap payments of cities with their budget outlooks. The payments don't reflect corresponding moves in municipal bonds. Included with some examples are securities firms that entered into the transactions with the municipalities.

The Service Employees International Union said Chicago, Denver, Kansas City, Mo., Philadelphia, Massachusetts, New Jersey, New York and Oregon all are in the hole on swaps agreements they made with financial firms. The required payments range from a few million dollars to more than $100 million a year, the union said.

Such deals are deepening the misery faced by state and local governments throughout the U.S., already facing their worst financial squeeze in decades because of shrinking tax revenue and stubbornly high pensions and other costs.

Are Municipal Bonds the Next Bubble to Pop?

America's states and cities may be going bankrupt, but investors shouldn't worry. Dow Jones Adviser columnist James Altucher explains.

Government agencies that saw the transactions as a cushion against fiscal surprises now are being squeezed by the arrangements. The supply of municipal derivatives swelled to more than $500 billion before falling in the past two years, estimates Matt Fabian, managing director at research firm Municipal Market Advisors. Moody's Investors Service says the surge was fueled by Wall Street marketing efforts, demand from state and local governments and "relatively permissive" statutes on the use of swaps in Pennsylvania and Tennessee, both of which are taking steps to tighten rules.

Many of the deals generated higher fees for securities firms than traditional fixed-rate debt. Government officials, for their part, entered the deals in hopes of reducing borrowing costs.

The swaps were introduced in many cases along with floating-rate debt that municipalities issued because it was cheaper than traditional fixed-rate debt. Lower interest rates have served them well on this; their borrowing got cheaper.

But municipalities also added swaps to the mix, promising to pay a fixed rate to banks, often 3% or more, while receiving payments from banks that vary with interest rates. On the swaps, the municipalities generally have been losers, as the interest that banks have to pay them have often fallen below 0.5%.

Government budgets are stretched thin, prompting officials to look for dollars wherever they can. The clashes over the swaps come amid growing scrutiny of the municipal-bond market, where the U.S. government is investigating whether there was bid rigging in certain cases.

Wall Street firms say no one was complaining when the deals were helping municipalities save. Defenders of swaps say they still can help cities if paired with the right borrowing strategy.

Some securities-industry officials say they are open to renegotiating with municipalities so long as doing do doesn't cause a tidal wave of demands.

"If they can't come to an agreement on how to modify, the contract should stand," said Michael Decker, a managing director at the Securities Industry and Financial Markets Association, a trade group.

Escaping isn't cheap or easy. Under a transaction between Oakland, Calif., and a Goldman Sachs GroupGS +0.87% -backed venture, Goldman paid the city $15 million in 1997 and $6 million in 2003, according to Oakland financial reports. But now, the city stands to lose about $5 million this year.

That money "is coming out of taxpayers' pockets and could be used for other things," said Rebecca Kaplan, a city council member. She wants the city to renegotiate. But the city faces a $19 million termination payment. Oakland officials didn't respond to requests for comment.

Some deals have led to court. Last August, a unit of bond insurer Ambac Financial Group sued the Bay Area Toll Authority for payments it said it was owed under various swap agreements. The authority paid Ambac $104.6 million to terminate the swaps after the insurer's credit ratings were downgraded and bonds associated with the swaps were retired. Ambac claims it is owed $156.6 million under the agreements.

The toll authority, which is fighting the claim, said it made the payment, and Ambac sued for the other part of what it says it is owed. An Ambac lawyer couldn't be reached for comment.

How a Deal Went Bad

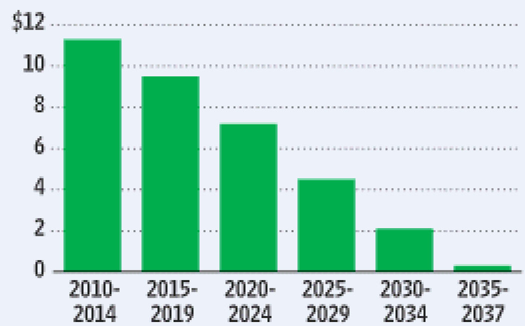
In 2007, Richmond, Calif., agreed to an interest-rate swap that promised Royal Bank of Canada payments based on a fixed rate of 3.99%; the city got payments that varied with Libor.

Reuters

Richmond, Calif., 16 miles northeast of San Francisco, has a population of 103,000 and includes industrial areas including this Chevron oil refinery.

Falling interest rates shrank the amount of cash Richmond got, while variable-rate debt it was paying out to investors stayed relatively expensive. The swap, which may be restructured, could leave the city owing $34.8 million in payments to RBC during the life of the swap, at current interest rates

Net interest-rate swap payments, in millions



Sources: Richmond, Calif. Finance Department

Next month, Richmond, Calif., is expected to restructure a $65 million agreement with Royal Bank of CanadaRY -0.70% that could cost the struggling city an estimated $3.5 million a year, based on current interest rates. Under the revised deal, Richmond would make smaller, more regular payments to the bank over time.

In November, RBC and city officials rejiggered a separate transaction that would have cost Richmond about $2.5 million. An RBC spokesman said bank officials are working with the city to "restructure the underlying bonds in a way that best serves the city's interests and those of its residents."

The "goal of the original transaction was to lower borrowing costs for the city," the bank spokesman said, adding that the bonds didn't perform as anticipated because of downgrades at bond insurers that backed them.

Richmond's vice mayor, Jeff Ritterman, said he still is reviewing next month's proposed restructuring. Financial woes have forced Richmond to cut its budget and lay off employees.

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