BANK FRAUD: The Big Losers in the Libor Rate Manipulation

Local Governments Which Entered Into Interest Rate Swaps Got Scalped

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Local Governments Which Entered Into Interest Rate Swaps Got Scalped

We know that the big banks conspired to manipulate Libor rates, with the approval of government authorities.

We know that the Libor manipulation effected the world's largest market – interest rate derivatives.

But who are the biggest victims?

Sometimes the big banks manipulated the Libor rates up, and sometimes down. Different groups of people got hurt depending which way the rates were gamed.

Bloomberg's Darrell Preston explained last year how cities and other local governments got scalped when rates were manipulated downward:

> **In the U.S., municipal borrowers used swaps to guard against the risk of higher interest costs** on variable-rate debt by exchanging payments with another entity and tying how much they pay to an underlying value such as an index. **The agreements can backfire if rates move in unexpected directions, resulting in issuers making larger payments**.The derivatives were often designed to **offset the risks of increases in the short-term rates** tied to auction-rate securities, fixing borrowers' costs by trading their debt- service payments with another party. **Instead, rates dropped**.
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> The yield on two-year Treasury notes fell from about 5.1 percent in June 2007 to a record 0.14 percent on Sept. 20. On Oct. 6, the U.S. Treasury sold $10 billion of five-day cash- management bills at 0 percent.

Ellen Brown adds:

> For more than a decade, banks and insurance companies convinced local governments, hospitals, universities and other non-profits that interest rate swaps would lower interest rates on bonds sold for public projects such as roads, bridges and schools. The swaps were entered into to insure against a rise in interest rates; but instead, interest rates fell to historically low levels. This was not a flood, earthquake, or other insurable risk due to environmental unknowns or "acts of God." It was a deliberate, manipulated move by the Fed, acting to save the banks from their own folly in precipitating the credit crisis of

2008. The banks got in trouble, and the Federal Reserve and federal government rushed in to bail them out, rewarding them for their misdeeds at the expense of the taxpayers. [The same thing happened in England.]

How the swaps were supposed to work was explained by Michael McDonald in a November 2010 Bloomberg article titled "Wall Street Collects $4 Billion From Taxpayers as Swaps Backfire":

> In an interest-rate swap, two parties exchange payments on an agreed-upon amount of principal. Most of the swaps Wall Street sold in the municipal market required borrowers to issue long-term securities with interest rates that changed every week or month. The borrowers would then exchange payments, leaving them paying a fixed-rate to a bank or insurance company and receiving a variable rate in return. Sometimes borrowers got lump sums for entering agreements.

Banks and borrowers were supposed to be paying equal rates: the fat years would balance out the lean. But the Fed artificially manipulated the rates to the save the banks. After the credit crisis broke out, borrowers had to continue selling adjustable-rate securities at auction under the deals. Auction interest rates soared when bond insurers' ratings were downgraded because of subprime mortgage losses; but the periodic payments that banks made to borrowers as part of the swaps plunged, because they were linked to benchmarks such as Federal Reserve lending rates, which were slashed to almost zero.

In a February 2010 article titled "How Big Banks' Interest-Rate Schemes Bankrupt States," Mike Elk compared the swaps to payday loans. They were bad deals, but municipal council members had no other way of getting the money. He quoted economist Susan Ozawa of the New School:

> The markets were pricing in serious falls in the prime interest rate. . . . So it would have been clear that this was not going to be a good deal over the life of the contracts. So the states and municipalities were entering into these long maturity swaps out of necessity. They were desperate, if not naive, and couldn't look to the Federal Government or Congress and had to turn themselves over to the banks.

Elk wrote:

> As almost all reasoned economists had predicted in the wake of a deepening recession, the federal government aggressively drove down interest rates to save the big banks. This created opportunity for banks – whose variable payments on the derivative deals were tied to interest rates set largely by the Federal Reserve and Government – to profit excessively at the expense of state and local governments. While banks are still collecting fixed rates of from 4 percent to 6 percent, they are now regularly paying state and local governments as little as a tenth of one percent on the outstanding bonds – with no end to the low rates in sight.
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> . . . [W]ith the fed lowering interest rates, which was anticipated, now states and local governments are paying about 50 times

> what the banks are paying. Talk about a windfall profit the banks are making off of the suffering of local economies.
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> To make matters worse, these state and local governments have no way of getting out of these deals. Banks are demanding that state and local governments pay tens or hundreds of millions of dollars in fees to exit these deals. In some cases, banks are forcing termination of the deals against the will of state and local governments, using obscure contract provisions written in the fine print.

By the end of 2010, according to Michael McDonald, borrowers had paid over $4 billion just to get out of the swap deals. Among other disasters, he lists these:

> California's water resources department . . . spent $305 million unwinding interest-rate bets that backfired, handing over the money to banks led by New York-based Morgan Stanley. North Carolina paid $59.8 million in August, enough to cover the annual salaries of about 1,400 full-time state employees. Reading, Pennsylvania, which sought protection in the state's fiscally distressed communities program, got caught on the wrong end of the deals, costing it $21 million, equal to more than a year's worth of real-estate taxes.

In a March 15th article on Counterpunch titled "An Inside Glimpse Into the Nefarious Operations of Goldman Sachs: A Toxic System," Darwin Bond-Graham adds these cases from California:

> The most obvious example is the city of Oakland where a chronic budget crisis has led to the shuttering of schools and cuts to elder services, housing, and public safety. Oakland signed an interest rate swap with Goldman in 1997. . . .
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> Across the Bay, Goldman Sachs signed an interest rate swap agreement with the San Francisco International Airport in 2007 to hedge $143 million in debt. Today this agreement has a negative value to the Airport of about $22 million, even though its terms were much better than those Oakland agreed to.

Greg Smith wrote that at Goldman Sachs, the gullible bureaucrats on the other side of these deals were called "muppets."

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Who could have anticipated, when the Fed funds rate was at 5%, that the Fed would push it nearly to zero?

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The banks have made outrageous profits by capitalizing on their own misdeeds. They have already been paid several times over: first with taxpayer bailout money; then with nearly free loans from the Fed; then with fees, penalties and exaggerated losses imposed on municipalities and other counterparties under the interest rate swaps themselves.

Bond-Graham writes:

> The windfall of revenue accruing to JP Morgan, Goldman Sachs, and their peers from interest rate swap derivatives is due to nothing other than political decisions that have been made at the federal level to allow these deals to run their course, even while benchmark interest rates, influenced by the Federal Reserve's rate setting, and determined by many of these same banks (the London Interbank Offered Rate, LIBOR) linger close to zero. These political decisions have determined that virtually all interest rate swaps between local and state governments and the largest banks have turned into perverse contracts whereby cities, counties, school districts, water agencies, airports, transit authorities, and hospitals pay millions yearly to the few elite banks that run the global financial system, for nothing meaningful in return.

Bloomberg's Darrell Preston writes:

> Ask a Nobel Prize-winning economist what's the difference between the mayor of Baltimore losing taxpayer money with derivatives sold by Wall Street and millions of Americans defaulting on subprime loans and he'll say there isn't any: State and local governments are victims of opaque financing they don't understand, the same way individuals go broke on borrowing at rates too good to be true.
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> **"These financially unsophisticated local officials were being exploited by big banks,"** said Columbia University Professor Joseph Stiglitz, who won the Nobel Prize in 2001 with George Akerlof of the University of California, Berkeley and Michael Spence, now at New York University, for their analysis of markets with asymmetric information.
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> "The outrage was not just that there were high transaction costs, but that **the risk wasn't understood by those who used them**," Stiglitz said.
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> **Jefferson County**, home to Birmingham, the state's biggest city, became the **biggest municipal bankruptcy on record after costs spiraled out of control on its auction-rate debt and related derivatives used to finance a sewer project**. The county defaulted on the securities, issued in 2002 and 2003 to refinance fixed-rate sewer bonds, as short-term yields fell.
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> Bill Slaughter, **the lawyer who advised Jefferson's County Commission on bond sales at the time of the refinancing, said later that he couldn't figure out the math on the swaps**.
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> Alabama's Jefferson County wound up in bankruptcy after it defaulted on about $3.1 billion of debt backed by sewer revenue in 2008. The financial crisis had pushed up the cost of its bonds, including the auction-rate debt, and required early repayments that the county couldn't afford. The swaps tied to the securities also didn't shield it from rising expenses.

> **Some overseas government borrowers have been banned from using swaps in their finances**.
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> In January 1991, the U.K. House of Lords ruled that local authorities weren't permitted to use swaps and derivatives. Parliament's upper chamber said such agreements had "the stigma of being unlawful." Municipal authorities, including the London borough of Hammersmith & Fulham, had speculated on the direction of borrowing costs in the late 1980s using interest-rate swaps. Auditors challenged the transactions, resulting in a series of court rulings that said such activities were outside of the council's jurisdiction and thus unenforceable by banks involved.
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> In 1997, the U.K. barred local governments from investing in derivatives.
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> **Greece used currency swaps, the biggest of which were with Goldman Sachs Group Inc., to hide 5.3 billion euros ($7.7 billion) of debt** from 2001 to 2007, Eurostat, the European Union's statistics office, said in a May report. **When the arrangements were added to the nation's accounts, it spurred a surge in borrowing costs and triggered Europe's debt crisis**.
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> "The banks make so much money off of the swaps, they don't care about the underwriting fee or other fees" collected from municipal issuers, Kalotay said. In testimony at a July 29 SEC hearing held in Birmingham, he estimated that municipal **taxpayers have paid $20 billion in fees on swaps valued at $1 trillion in the past five years**, noting that banks usually get about 2 percent on such transactions.

And Darwin BondGraham notes:

> In 2002 a little-known but powerful state agency in California and Wall Street titans Morgan Stanley, Citigroup, and Ambac consummated one of the biggest deals to date involving … an "interest rate swap." A year later the executive director of the Bay Area's Metropolitan Transportation Commission, Steve Heminger, proudly described these historic deals to a visiting contingent of Atlanta policymakers as a model to be emulated. Swaps were opening up a brave new world in public finance by extending the MTC's purchasing power by $200 million, making a previously impossible bridge construction schedule achievable in a shorter timeframes. The deal would also protect the MTC from future volatile swings in variable interest rates. To top it off, the banks would make a neat little profit too. Everybody was winning.
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> Then in 2008 it all came crashing down. The financial system's near collapse, the federal government's unprecedented bailouts, and global economic stagnation mean that the derivative products once touted as prudent hedges against uncertainty have instead become toxic assets, draining billions from the public sector.
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> The MTC was forced to pay $104 million to cancel its interest rate swap with Ambac when the company went bankrupt in 2010. Whereas once the Commission's swaps portfolio was saving it money, now it must pay millions yearly to a wolf pack of banks including Wells Fargo, JPMorgan Chase, Morgan Stanley, Citibank, Goldman Sachs, and the Bank of New York. The MTC's own analysts now estimate that the Commission's swaps have a net negative value of $235 million. This money all ultimately comes from tolls paid by drivers crossing the San Francisco Bay Area's bridges, toll money that not too long ago

was supposed to purchase bridge upgrades. Now it's just a free lunch for the banks.

The MTC is only one example. Local governments and agencies across the United States have been caught in a perfect storm that has turned their "brilliant" hedging instruments into golden handcuffs. The result is something of a second bailout for the Wall Street banks on the other sides of these deals.

Perhaps worst of all has been the double standard set by the federal government. In 2008 when the world's biggest banks stumbled toward insolvency, the U.S. Treasury stepped in to inject capital through the Troubled Asset Relief Program (TARP). TARP allowed the banks to offload or restructure their most toxic holdings, including many derivatives like interest rate swaps.

Four years later no such relief has been mobilized for cities, counties, and public agencies suffering from the toxic interest rate swaps they have been forced to hold. In its size and severity, the rate swap crisis rivals other discrete financial injustices related to the global economic meltdown of 2008. Unlike these other crises that have received enormous attention from the media and reform-minded officials, the foreclosure crisis for example, the rate swap crisis has remained hidden from public scrutiny, left to fester.

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So why did local governments in the United States jump on the swap-wagon? The big-picture transformation of global capitalism engendered by derivatives was the last thing on the minds of local leaders as they signed rate swap agreements over the last two decades. They were feeling globalization's local effects, however.

The post-Gold Standard era for local and state governments has … been characterized by volatile interest rates. Many local governments have been stung by wild swings in variable interest rates on bond debt. Conversely, many public entities found themselves locked into high long-term rates, unable to refinance during periodic dips. In other words, they incorrectly guessed what the price of borrowing money would be over a given time frame, and they were forced to pay the difference. In an age of chronic municipal budget shortfalls produced by tax rebellions and capital flight, a few million burned on rising interest rates, or the inability to refund debt at lower levels, is a big political deal.

Seeking to hedge against this risk, and still deliver the goods voters want, local governments eagerly signed contracts for a particular variety of swap, the floating-to-fixed contract in which cities would issue long-term debt pegged to variable rates, and then swap payments with a bank counterparty that offered the surety of a low "synthetic" fixed rate.

There was another reason for the rise in popularity of municipal swaps though. As illustrated in the case of California's Metropolitan Transportation Commission, the promise of extending a government's purchasing power by reducing its overall debt payments enticed many CFOs to ink swap deals. The means by which swaps could lower the cost of borrowing money for public entities hinges on the way that derivatives, as they have for global corporations, promised to create larger integrated debt markets where before there were barriers.

What swaps allowed many governments to do was to replace a floating rate with a synthetic fixed rate that was often significantly lower than would otherwise be possible if the local government itself directly issued a fixed-rate debt. Local governments tend to be able to issue slightly lower initial variable-rate debt than other sorts of borrowers (mostly large business corporations) can in other debt markets. Conversely, many banks and corporations can issue fixed rate debt at significantly lower rates than local governments have been able to. Big banks figured out how to profit from these differences with rate swaps. By issuing debt in the most favorable terms and then swapping interest-rate payments, a local government could transform its relatively low but risky variable-rate debt payment into a higher fixed-rate obligation that is lower than it would have otherwise been had the government gone straight to the market to sell fixed-rate bonds.

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In March, 2010, the Service Employees International Union released one of the most comprehensive studies to date calculating how much toxic interest rate swaps have cost communities during the Great Recession. Combing through the financial reports of major cities, states, and public agencies from New York to California, **SEIU researchers estimated that $28 billion had already been paid by governments to the banks, and that for 2010 alone, public entities would have to pay at least another $1.25 billion**.

More recently, researchers in New York and Pennsylvania have dissected specific swap deals that have drained millions from local school systems, transit agencies, and the budgets of cities and counties. New York state and its local governments were forced to pay $236 million last year to fulfill the terms of swap agreements signed with Wall Street, according to a December, 2011 report prepared by United NY, a union-supported advocacy group. These swap payments are ultimately drawn from taxes, fees, and other sources of public revenues, diverted away from crucial services that have been cut back during the Great Recession.

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Because of the economic collapse, and the decline of interest rates in 2008 to virtually zero, **the MTA has been forced to pay the amazing sum of $658 million in net swap payments so far**.

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Philadelphia and its schools have lost $331 million in swap payments made to Wells Fargo, Morgan Stanley, Goldman Sachs, and other banks.

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Other enormous transfers of public revenues to the banks include a loss of $10 million by the Bethlehem Area School District after the system was forced to cancel one particularly toxic swap. Then there’s a case that is similar to California’s MTC boondoggle. The Delaware River Port Authority, the public entity that operates and maintains toll bridges linking Philadelphia with New Jersey, lost $65 million on swap deals. As of 2010 these swaps have a negative value of $199 million for the Port Authority.

Back in California, **virtually every other government and public agency has been hit by costly rate swap payments or termination fees**.

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In Pennsylvania the problem was identified early on by officials like the state’s auditor general Jack Wagner. Since 2009 Wagner has been imploring local and state leaders to ban their agencies from entering into interest rate swaps.

Wagner's office conducted one of the earliest (and maybe the only) official audits of swaps in the United States after the financial crisis, finding that Pennsylvania governments had entered into 626 individual interest rate swap agreements with a mere thirteen banks, linked to $14.9 billion in public debt.

Wagner concluded:

> the use of swaps amounts to gambling with public money. The fundamental guiding principle in handling public funds is that they should never be exposed to the risk of financial loss. Swaps have no place in public financing and should be banned immediately.

His office has so far succeeded in convincing the Delaware River Port Authority to ban itself from using rate swaps in the future, while also introducing a bill in the state legislature to ban future swap agreements by Pennsylvania governments.

Wagner's efforts have been bolstered by the Pennsylvania Budget and Policy Center's statewide study of swaps, referenced above. Most recently the Philadelphia City Council has convened hearings to investigate how interest rate swaps affecting the city's agencies and school system were created. The resolution calls for the city to assess "whether corrective actions, including legal remedies, should be pursued." Philadelphia is considering litigation to determine if banks, government employees, or advisers misrepresented or otherwise fraudulently put taxpayers on the hook for millions by obscuring the risks involved, or purposefully structuring them to implode to the banks' benefit.

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