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WALL STREET CONFIDENCE TRICK: How "Interest Rate Swaps" Are Bankrupting Local Governments

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Far from reducing risk, derivatives increase risk, often with catastrophic results. — Derivatives expert Satyajit Das, Extreme Money (2011)

The "toxic culture of greed" on Wall Street was highlighted again last week, when Greg Smith went public with his resignation from Goldman Sachs in a scathing oped published in the New York Times. In other recent eyebrow-raisers, LIBOR rates—the benchmark interest rates involved in interest rate swaps—were shown to be manipulated by the banks that would have to pay up; and the objectivity of the ISDA (International Swaps and Derivatives Association) was called into question, when a 50% haircut for creditors was not declared a "default" requiring counterparties to pay on credit default swaps on Greek sovereign debt.

Interest rate swaps are less often in the news than credit default swaps, but they are far more important in terms of revenue, composing fully 82% of the derivatives trade. In February, JP Morgan Chase revealed that it had cleared $1.4 billion in revenue on trading interest rate swaps in 2011, making them one of the bank's biggest sources of profit. According to the Bank for International Settlements:

[I]nterest rate swaps are the largest component of the global OTC derivative market. The notional amount outstanding as of June 2009 in OTC interest rate swaps was $342 trillion, up from $310 trillion in Dec 2007. The gross market value was $13.9 trillion in June 2009, up from $6.2 trillion in Dec 2007.

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.

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.

. . . [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.

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. . . .

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." But even sophisticated players could have found themselves on the wrong side of this sort of manipulated bet. Satyajit Das gives the example of Harvard University's bad swap deals under the presidency of Larry Summers, who had fought against derivatives regulation as Treasury Secretary in 1999. There could hardly be more sophisticated players than Summers and Harvard University. But then who could have anticipated, when the Fed funds rate was at 5%, that the Fed would push it nearly to zero? When the game is rigged, even the most experienced gamblers can lose their shirts.

Courts have dismissed complaints from aggrieved borrowers alleging securities fraud, ruling that interest-rate swaps are privately negotiated contracts, not securities; and "a deal is a deal." So says contract law, strictly construed; but municipal governments and the taxpayers supporting them clearly have a claim in equity. 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.

Why are these swaps so popular, if they can be such a bad deal for borrowers? Bond-Graham maintains that capitalism as it functions today is completely dependent upon derivatives. We live in a global sea of variable interest rates, exchange rates, and default rates. There is no stable ground on which to anchor the economic ship, so financial products for “hedging against risk” have been sold to governments and corporations as essentials of business and trade. But this “financial engineering” is sold, not by disinterested third parties, but by the very sharks who stand to profit from their counterparties’ loss. Fairness is thrown out in favor of gaming the system. Deals tend to be rigged and contracts to be misleading.

How could local governments reduce their borrowing costs and insure against interest rate volatility without putting themselves at the mercy of this Wall Street culture of greed? One possibility is for them to own some banks. State and municipal governments could put their revenues in their own publicly-owned banks; leverage this money into credit as all banks are entitled to do; and use that credit either to fund their own projects or to buy municipal bonds at the market rate, hedging the interest rates on their own bonds.

The creation of credit has too long been delegated to a cadre of private middlemen who have flagrantly abused the privilege. We can avoid the derivatives trap by cutting out the middlemen and creating our own credit, following the precedent of the Bank of North Dakota and many other public banks abroad.

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