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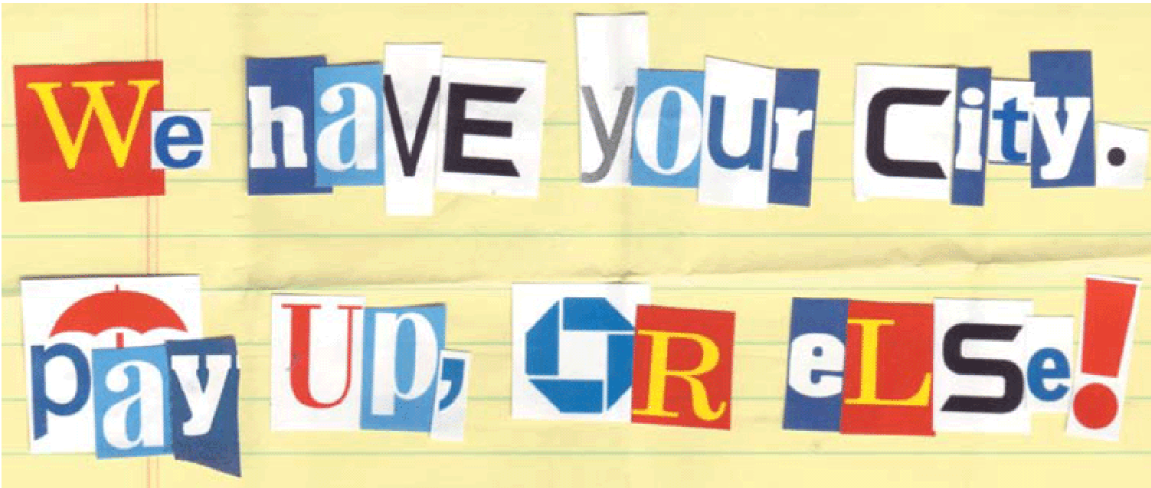
Feature

The Swap Crisis



Interest rate swap deals have allowed the big banks to hold local governments and agencies hostage for tens of millions of dollars.

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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 a type of financial derivative called 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 timeframe. 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.

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.

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.

Some signs of resistance are appearing, however. Slowly, but surely, nascent coalitions of civic activists are exposing these swap deals and demanding that banks refund the cities. In doing so they are challenging more than just unfair financial deals. By contesting injustices caused by financial derivatives embedded in the budgets of local governments, activists are in fact criticizing a core instrument of globalizing capital.

Swaps: Scams, or the New Capitalism?

Contrary to popular opinion, financial derivatives are not simply esoteric instruments designed for gambling in the new so-called "casino capitalism." Nor are they simply manipulative scams used by cynical traders to skim cream from the "real economy." This isn't to say that derivatives contracts and trading are "good," or "fair," but simply that they are not just tricks used by Wall Street to "game the system." Certainly fraud and predation takes place, made possible by the asymmetrical information advantages of elite banks, and also by lax regulations and an opaque market dominated by a handful of firms. Even so, the bulk of derivatives contracts and trading represents a legal activity that is integral to the operation of the contemporary capitalist economy.

Derivatives are the new real global economy in all its frightening scope and purpose. As Dick Bryan and Michael Rafferty explain in their important study *Capitalism with Derivatives: A Political Economy of Financial Derivatives, Capital, and Class*, the most central function of derivatives is "the commensuration of values across time and space." The most important value Bryan and Rafferty are referring to is the value of money itself.

After the abandonment of the Gold Standard in 1971, there was no anchor for the values of different currencies. There was no easy way, therefore, to price money (across currencies and over time) except in relational terms, and doing so was full of risk. By extension there was no neat way to price all other commodities with any certainty, because currency exchange rates and interest rates were constantly in flux. Initially this was only a problem for a few nations, and only for a handful of American, European, and Japanese corporations that operated on a truly global level and therefore had to worry about how revenues or debts generated or owed in one market would translate into another. Then came stagflation, the oil price shocks of the early 1970s, and other periods of instability.

By the 1980s, capital was demanding a solution. The project of globalization hinged upon transcending these barriers. Derivatives, especially interest rate and currency swaps, were the answer. Swaps create a mechanism by which global corporations can protect themselves from, or take advantage of, the flux that threatens to undermine the value of their capital—changes in interest rates and currency prices. They allow firms and even governments to choose which currencies and interest rates they expose themselves to, and under what terms. On the level of individual firms, it's this hedging function that is most responsible for the enormous growth in swaps transactions, as companies attempt to fix and reduce the value of their debts, while protecting and even increasing the value of their income streams from devaluations caused by inflation, changes in exchange rates, or changes in benchmark and central bank interest rates.

Interest rate swaps are today the single largest type of derivative in existence, making up more than 80% of the value of all derivative contracts signed by U.S. commercial banks. Measured by their notional amounts (the "notional" of a swap is a fictive sum of money corresponding to an actual principle on real debt), U.S. banks have an outstanding $202 trillion in interest rate derivative contracts. In other words, U.S. banks are using swaps to transform interest rate payments on $202 trillion in debt, owed by corporations, governments, and other banks, so that these entities can switch from variable rates to fixed, or vice versa, and so that they can peg their debt payments to any number of global rates.

On a global level the total notional amount of interest rate swaps was most recently estimated at $441 trillion by the International Swaps and Derivatives Association. These trillions of dollars represent the debts of virtually all major corporations and governments. More than any other development in the last thirty years, this new derivatives regime creates the globalized economy.

Magical Solutions for Municipal Finance

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 also been characterized by volatile interest rates. Many local governments have been stung by wild swings in variable

The IBM-World Bank Interest Rate and Currency Swap of 1981

One of the first swap deals was the famous IBM-World Bank currency and interest rate swap of 1981. The World Bank wanted to borrow funds in German deutsche marks and Swiss francs to finance its operations, but had borrowed its limit in these two countries and was blocked by authorities. At the same time, IBM had already borrowed large sums of Swiss and German currencies, and also sought to borrow dollars in the United States, but was hesitating because lending rates were very high for companies there. The solution, invented by bankers at Solomon Brothers, was to have the World Bank and IBM swap their debts. IBM deposited its borrowed deutsche marks and francs with the World Bank, and the World Bank borrowed U.S. dollars and then deposited them with IBM. This example shows what swaps and other derivatives could accomplish for global corporations: the deal circumvented national capital controls and shielded IBM from changes in the value of the franc and deutsche mark, while allowing the World Bank to borrow Swiss and German currency, as it sought. This specific derivative contract transcended national regulatory barriers, creating a cohesive global market mechanism where before nothing had existed. It was the globalization of capital in one dramatic, if mind-numbingly complex, swoop. Similar "over the counter" (OTC) derivative deals between parties have proliferated since, 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.

boosting trillions in capital to a truly transnational level.

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. The same in reverse would be true for the bank counterparty, but with a variable rate. This transaction, according to neoclassical economic theory, capitalizes on the "comparative advantages" of each party in different debt markets. At least in theory, everyone was supposed to gain access to cheaper money through markets that had been made more efficient by Wall Street's wizards.

Swaps Conquer America

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.

Like California's MTC, managers of New York's Metropolitan Transit Authority got into the swap market to free up money and expand, but now New York bus and train riders are among the biggest victims of the rate swap crisis. As described in United NY's report:

> ...like other public entities, the MTA issues variable-rate bonds in search of lower interest rates to reduce the cost of borrowing; and like other public entities, the MTA believed swap agreements would protect it against interest rate market volatility and

Case Study:
Oakland's "Plain Vanilla" Rate Swap

"Plain vanilla" swap agreements proliferated in the late 1990s and mid-2000s as the U.S. economy heated up and interest rates climbed. Many local officials believed that locking themselves into long-term fixed interest rates as high as 6% would be wise to hedge against being stuck in variable rates that could climb further. Perhaps it would have been, had the global economy not staggered after 9-11, and then come to a screeching halt in 2008, causing central bankers to slash interest rates to virtually zero. It was this historic near-collapse of the capitalist system that turned most floating-to-fixed swap deals into toxic junk. Unfortunately, these are exactly the type of swaps local governments signed up for to hedge billions of dollars. In 2008 the variable rates that the banks use to calculate their payments to the cities, such as the London Interbank Offered Rate (LIBOR), followed the Federal Funds rate to virtually zero, while the fixed rates local governments were obliged to calculate their payments with stayed the same. The net difference means local governments pay the banks.

In the case of Oakland, California, in 1997 the city agreed to pay Goldman Sachs a fixed 5.6% rate in exchange for a payment equivalent to 65% of LIBOR until 2021 on a notional amount beginning at $170 million, and reducing over time as the principle on bond debt it mirrors is paid off. As the chart below shows, it was never a good deal for the city over the long-run since the net balance of payments, the difference between Oakland's constant 5.6% obligation and whatever LIBOR happened to be on any provide stability to its operating budget, all the while providing the necessary financing to maintain and upgrade New York's transit system.

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. "These expenditures feed bank profits and ransack the MTA's ability to provide safe and reliable service and make needed improvements to the transit system," United NY concludes.

payment date, was always in the bank's favor. When LIBOR dropped to less than 1% in 2008 Oakland, however, was stuck with a toxic swap contract requiring millions in payments to Goldman Sachs each year, with no meaningful hedging function against climbing variable rates.

In Pennsylvania the situation is arguably worse given that the state's largest city, Philadelphia, is in a much weaker fiscal position than New York City. According to a study prepared by the Pennsylvania Budget and Policy Center in January 2012, Philadelphia and its schools have lost $331 million in swap payments made to Wells Fargo, Morgan Stanley, Goldman Sachs, and other banks. Among the most damaging agreements were nine separate swaps between the Philadelphia School District and Morgan Stanley, Goldman Sachs, and Wells Fargo that were terminated in 2010 and 2011 for a combined penalty of $89.6 million. Like many of the public entities hit hard by rate swap payments, Philadelphia's public schools serve a student body that is primarily Black and Latino, making up 56% and 18% of the district's students respectively. In April, the "chief recovery officer" of the district announced that the school system would essentially be dissolved and dozens of schools closed.

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. Oakland, a city of roughly 400,000 with a Black, Latino, and Asian majority, faced a $58 million budget deficit last year, forcing layoffs and cuts to many departments and services. At the same time Oakland has been paying millions yearly to Goldman Sachs under the terms of a swap signed in 1997. The local community college system in Oakland had to pay Morgan Stanley approximately $1.6 million last year, even while the board of trustees discusses the need to make an additional $11.7 million in budget cuts.

Because swaps have counterparties, that is, parties that take opposing positions in the stream of interest rate payments, it's only logical to assume that if one of the parties is drowning, the other must be high above the waves. Unfortunately there isn't much data available to gauge just how much the handful of banks that dominate the rate swaps market have benefited from the artificial conditions that have caused the municipal rate swap crisis.

To be sure, Wall Street's biggest banks are reaping huge returns on municipal interest rate swaps. The U.S. Office of the Comptroller of the Currency has explained that "derivatives activity in the U.S. banking system is dominated by a small group of large financial institutions. Five large commercial banks represent 96% of the total industry notional amount." Within this monopolized finance sector, derivatives "are dominated by swaps contracts, which represent 66% of total notionals." Five banks make the market: JPMorgan Chase, Citibank, Bank of America, Goldman Sachs, and HSBC. Together they control $150 trillion of the $154 trillion notional amounts of interest rate swaps sold by U.S. banks. A large chunk of this business is made up of "over the counter" (OTC) swap contracts with local governments.

Drop the Swaps

On an unseasonably warm February day this year, several dozen activists including members of the Association of Californians for Community Empowerment, Riders for Transit Justice, union members of SEIU 1021 and Transit Workers Union 250A, along with community college students, gathered in front of San Francisco's old Bank of America Building. Locals have long derided the edifice as a "Darth Vader hat" because of its shape, but the ominous nickname also hints at the tenants inside, mostly elite investment banks and private equity firms. Goldman Sachs has offices perched high above the ground floor.

The activists were roaming the financial district, entering bank branches and attempting to penetrate security cordons to enter express elevators, thereby gaining access to the offices of senior bank executives. Once inside they would demand an audience with management, explain the problem of how rate swaps are putting enormous financial burdens on already-

Interest Rate Scams

Even though the swap crisis is largely a structural injustice that hasn't required any legal wrongdoing to harm local communities, it has been punctuated by several high-profile criminal cases in which the banks and corrupt municipal leaders purposefully defrauded the public:

- In the most infamous swap fiasco of all, upwards of 20 officials in Jefferson County, Alabama, including a County Commissioner, were bribed by JPMorgan Chase bankers to refinance a troubled $3.2 billion sewer project. JPMorgan replaced the county's fixed-rate bonds with variable-rate bonds hedged with swaps. When the market crashed in 2008, the swaps became onerous debts in and of themselves. By late 2011, Jefferson County filed for the largest municipal bankruptcy in U.S. history. JPMorgan was ordered to drop $647 million in expected payments from the county while refunding $50 million, in addition to a $25 million SEC fine.
- Depfa, UBS, Deutsche Bank, and JPMorgan were sued by Milan, Italy, in 2010 for their roles in a $2 billion dollar swap fraud harming the city. Once on the brink of financial ruin, today the litigiously proactive Milan is in settlement talks with the banks, which will reportedly

strapped public schools, transit authorities, and cities, and then demand the branch fax a letter to headquarters. Activists responded to uncooperative bank staff with chants of "drop the swaps," and "make banks pay!" The letter's message: cancel the swaps. Refund public goods.

While resistance against the rate swap crisis has developed slowly and unevenly, it may now be gaining steam in some important places. 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.

pay $526 million to the city.

- Also in Italy, the town of Cassino agreed to a rate swap in 2003 with Bear Stearns. The investment bank (later acquired by JPMorgan Chase) convinced Cassino's officials to swap a relatively modest fixed-rate debt on 22 million euros for the variable LIBOR rate. LIBOR at the time was hovering at 1%. By 2007 LIBOR peaked at 5.7%. According to a Bloomberg report, "Cassino started losing money on the swap with the third half-yearly payment, paying about 2 million euros after LIBOR soared."

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.

Back in California, it's been harder to convince officials to take action. Oakland's City Council has told activists that they would like to drop the swap, but that termination by the city would result in a roughly $16 million fee. Nevertheless City Council members say they're negotiating with Goldman Sachs to end the deal. California's Metropolitan Transportation Commission has rebuffed the entreaties of transit advocates to seek renegotiation of their astronomically expensive swap liabilities. The Peralta Community College system has reportedly been discussing renegotiation of its rate swap with Morgan Stanley since at least last December, to no avail. But even with these detours and roadblocks, community activists keep pressing the issue.

Confronting Swaps, Confronting Capital

One of the traps that activists who are beginning to address the rate swap crisis can fall into is framing the problem solely as one of "greedy banks" that used "esoteric" derivatives to "hoodwink" public officials. In some cases this does seem to be what happened. In Milan, Italy, for example, JPMorgan Chase, Depfa, UBS, and Deutsche Bank were brought to trial in 2010. Bank and city employees have been accused of fraud in connection with rate swaps that were attached to over $2 billion in municipal debt. Today Milan is reportedly in talks with the banks to settle the case, with the banks set to pay $526 million to the city.

The vast majority of swap agreements, however, are not the product of fraud. Framing the issue as one of greedy banks that conned the public has led so far to reformist proposals that will neither create pressure to systematically repair the financial injustice of the rate swap crisis, nor address the deeper structural problems associated with the rise of derivatives.

Rather than defining derivatives as scams, or as esoteric instruments used in a make believe world of finance capital, we should recognize them as central instruments of contemporary capitalism. Doing so leads to a more comprehensive explanation of why the rate swap crisis happened, and what should be done about it. It also connects the problem to wider struggles against capitalist globalization and avoids diverting energy into shallow reformist laws and regulations that will only be circumvented.

As instruments designed to allow local governments to reduce their risks in a world of global capital flows and floating interest rates, swaps seemed to work perfectly fine for over a decade. During this "normal" run of the economy, individual governments were able to reduce their exposure to interest-rate volatility, and even save money. What this obscured, however, was the systemic risk that was building up through the entire financial sector. By pursuing their own individual security as agents in the neoliberal global marketplace, organizations of all kinds, including business firms and governments, actually created mass insecurity. Along with systemic risk, the new globalizing economy powered by derivatives was characterized by more intense and widespread forms of corporate predation across the globe, from the U.S. housing market, to the currencies of

Thailand and Indonesia.

When the system's own contradictions finally became too much, the vast global web of derivatives that spread risk to every corner of the earth became the toxic germ that threatened to wipe out capital. In response, the architects of this system bailed out the largest banks directly with public funds. No similar bailout was offered to local governments, however. The public has been left holding derivative contracts that are currently not much more than agreements to subsidize banks further with taxpayer dollars. Meanwhile the global financial system made possible through swaps and other derivatives is being tweaked, slightly, so that it can proceed to expand if and when a new cycle of global investment kicks off.

This blatantly unjust, but perfectly legal, outcome reveals several things about the rate swap crisis. First, the crisis is caused by an inherent contradiction in the project of capitalist globalization. The management of inter-market risks at the individual firm or consumer level causes a heightened level of social risk at the global level. Second, in response to this crisis, the architects of this system have revealed that the true goal of globalization through derivatives is to expand and protect private capital, not public wealth and local communities. By bailing out banks and protecting the debt held by hedge funds and private equity, while offering no similar assistance to local governments, the elites who occupy positions of power in the central banks and global financial corporations displayed the logic of the system for all to see. Finally, derivatives are not being dropped, but instead subjected to regulations that will attempt to prevent the buildup of systemic risks. These regulations, however, will do nothing to check the global predation of corporations, empowered as they are with derivative instruments.

In confronting derivatives by demanding a just solution to the rate swap crisis, we are doing more than just contesting one aspect of the larger economic crisis that began in 2008. We are in fact confronting the dangerous instruments that have facilitated globalization of capital over the past three decades by socializing risks and privatizing profits. In this respect the rate swap crisis, and community responses to it, can be contextualized in capital's push toward globalization, and the ongoing resistance of communities to this project.

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SOURCES: Dick Bryan and Michael Rafferty, *Capitalism with Derivatives: A Political Economy of Financial Derivatives, Capital, and Class*, Palgrave MacMillan, 2006; SEIU, "Big Banks Squeeze Billions in Profits from Public Budgets," March, 2010; Michael Steward, "Money for Nothing: How Interest Rate Swaps Have Become Golden Handcuffs for New Yorkers," United NY, Center for Working Families, and Strong Economy for All Coalition, Dec., 2011; Sharon Ward, "Too Big To Trust?: Banks, Schools, and the Ongoing Problem of Interest Rate Swaps," Pennsylvania Budget and Policy Center, Jan., 2012; *Bloomberg Businessweek*, "JPMorgan Says Credit, Swaps Among Trading-Revenue Leaders," Feb. 28, 2012; U.S. Office of the Comptroller of the Currency, "OCC's Quarterly Report on Bank Trading and Derivatives Activities," Third Quarter 2011; "Philadelphia School District announces its dissolution," *Philadelphia City Paper*, April 24, 2012.