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Citigroup Leads Wall Street Drive to Hurt Taxpayers (Update2)

By Michael McDonald

May 9 (Bloomberg) -- Taxpayers from Massachusetts to California are paying Wall Street banks to end derivative contracts gone bad as they exit the collapsing auction-rate bond market, with penalties in some cases topping \$10 million and compounding the pain of rising borrowing costs.

Sacramento County, California, paid Morgan Stanley \$5 million to cancel an interest-rate swap agreement when it refinanced \$79.5 million in auction-rate securities last month. The fee added to the cost of the bonds after the rate on the securities more than doubled to 9.8 percent in March as dealers stopped supporting the market.

"It's kind of like damage control," said Chris Marx, the county's debt officer. "It didn't make a lot of sense to us to leave the swap in place."

The breakdown of the \$166 billion market where municipal rates are typically set through bidding run by a dealer is squeezing borrowers already hurt by the first decline in state sales-tax revenue in six years, according to the Nelson A. Rockefeller Institute of Government in Albany, New York.

States, cities, hospitals and colleges face penalties exceeding \$10 million to terminate swaps that failed to protect them against higher rates, according to interviews with borrowers and advisers. That's on top of the \$1 billion in fees they're paying to dealers to help sell bonds that would replace auction-rate securities they sold, based on industry averages.

'Tough Lesson'

"Some of the termination fees are ugly," said Christopher "Kit" Taylor, former executive director of the Municipal Securities Rulemaking Board, the market's regulator. "It's going to be a tough lesson for a lot of issuers."

Though no data exists on how many municipalities entered into swaps, it was "the trade du jour," said Robert Fuller, a financial adviser who runs Capital Markets Management LLC in Hopewell, New Jersey. Many issuers sold auction-rate securities and then agreed to swaps with their bank, leaving them with a fixed rate derived from the taxable bond market that was often lower than conventional tax-exempt rates, he said.

Citigroup, based in New York, was the top underwriter of auction-rate securities in the municipal market, arranging \$55 billion in sales between 2000 and the end of last year, according to data compiled by Thomson Reuters. Zurich-based UBS AG, which said on May 6 it will close or sell its municipal bond department, underwrote \$42 billion, followed by Morgan Stanley of New York at \$22 billion and 19 others.

"Most swaps are negotiated with the investment bank that does the underwriting," Fuller said. "It's unusual that an issuer would use a counterparty other than the underwriting investment bank."

Dealers Flee

For almost two decades, auction-rate bonds allowed local governments, hospitals, and closed-end mutual funds to issue debt maturing in as long as 40 years at short-term rates that reset every 7, 28 or 35 days through bidding.

Investors and dealers began to abandon the market in February on concern that the creditworthiness of companies insuring the bonds was deteriorat-

ing because of their losses from guaranteeing debt backed by subprime mortgages.

More than two-thirds of auctions failed, data compiled by Bloomberg show, and the average rate on seven-day securities rose to 6.89 percent on Feb. 20 from 3.63 percent a month earlier, according to the Securities Industry and Financial Markets Association. When an auction fails because sellers' orders overwhelm demand from bidders, rates are set at a predetermined "penalty" level.

Municipal issuers have replaced or announced plans to refinance more than \$63 billion of auction-rate debt, according to Bloomberg data.

New Problem

Because most borrowers entered into swaps where they agreed to make a fixed payment in exchange for variable payments from the banks arranging the transaction, they now have to fix the contracts, said Jeff Pearsall, a managing director at Philadelphia-based Public Financial Management, the largest adviser to U.S. municipalities.

"We're spending the bulk of our time fixing broken, insured auction-rate bonds, many of which have swaps attached," Pearsall said. "It tends to raise their cost of capital."

A swap is a type of derivative, or financial instrument derived from stocks, bonds, loans, currencies or commodities, or linked to specific events like changes in interest rates or the weather. In a swap, parties exchange payments based on a specified amount of debt.

Interest-Rate Swaps

For issuers of auction-rate bonds, the variable rates they received, based on the London interbank offered rate, roughly matched the cost of auction-rate bonds for more than five years. The relationship broke down this year as rates on auction-rate bonds soared and Libor fell.

"In many cases they've had years of savings that are now being taken back in part or in whole," said Peter Shapiro, managing director of Swap Financial Group, a South Orange, New Jersey-based financial adviser to state and local governments.

Redding, California, expects to pay Citigroup \$6.7 million to close out a swap on \$67.3 million of auction-rate bonds it sold, said Tom Graves, finan-

cial manager of the city's electric system, the recipient of the proceeds.

It refinanced the bonds on April 28, selling fixed-rate debt because it was concerned variable rates in the municipal market might shoot up again, he said. Danielle Romero-Apsilos, a spokeswoman for Citigroup, declined to comment.

'Very Good Alternative'

"It was a very good alternative while it worked," Graves said in reference to the use of auction bonds combined with fixed-rate swaps. "Our feeling was that there was still uncertainty in the marketplace that hadn't been resolved."

Sacramento County did a swap with Morgan Stanley in conjunction with a sale of \$79.5 million in auction-rate securities for its airport in May 2006. The contract was to last until the bonds, which were insured by New York-based XL Capital Assurance Inc., matured in 2024.

The county agreed to pay the bank a fixed rate of 3.785 percent in return for a variable payment that was supposed to cover the cost of the bonds. The rate it received from Morgan Stanley was capped at 65 percent of the one-month Libor, which averaged 5.08 percent that month.

Sacramento County paid an annualized rate that reached 9.8 percent at a monthly auction of \$39.7 million of its bonds on March 11. The county received a variable rate of about 2 percent from Morgan Stanley, according to the bond documents. Jennifer Sala, a Morgan Stanley spokeswoman, declined to comment.

Wisconsin Public Power

Wisconsin Public Power Inc. in Sun Prairie spent about \$11 million to terminate swaps on \$192 million of tax-exempt auction-rate bonds it refinanced on April 21, according to a Standard & Poor's report. Marty Dreischmeier, the company's chief financial officer, didn't return calls for comment. The swaps were done with Bear Stearns Cos. and JPMorgan Chase & Co., both based in New York, S&P said.

CareGroup Inc., a hospital system based in Boston, plans to borrow \$371.1 million to refinance auction bonds and terminate interest rate swaps with Citigroup and Bank of America Corp. of Charlotte, North Carolina, at an estimated cost of \$12 million,

according to reports from Standard & Poor's. CareGroup's spokesman Jerry Berger confirmed the information from the reports and declined to elaborate.

Bentley College in Waltham, Massachusetts is preparing to terminate swaps on \$56 million in auction-rate bonds that it's refinancing, said Paul Clemente, the CFO. The penalty changes daily de-

pending on interest rates, and Clemente declined to speculate on the final cost. The swap was arranged by Lehman Brothers Holdings Inc. in New York and Bank of America.

"It's probably going to cost us something," Clemente said. "These are the risks of getting into interest-rate swaps."