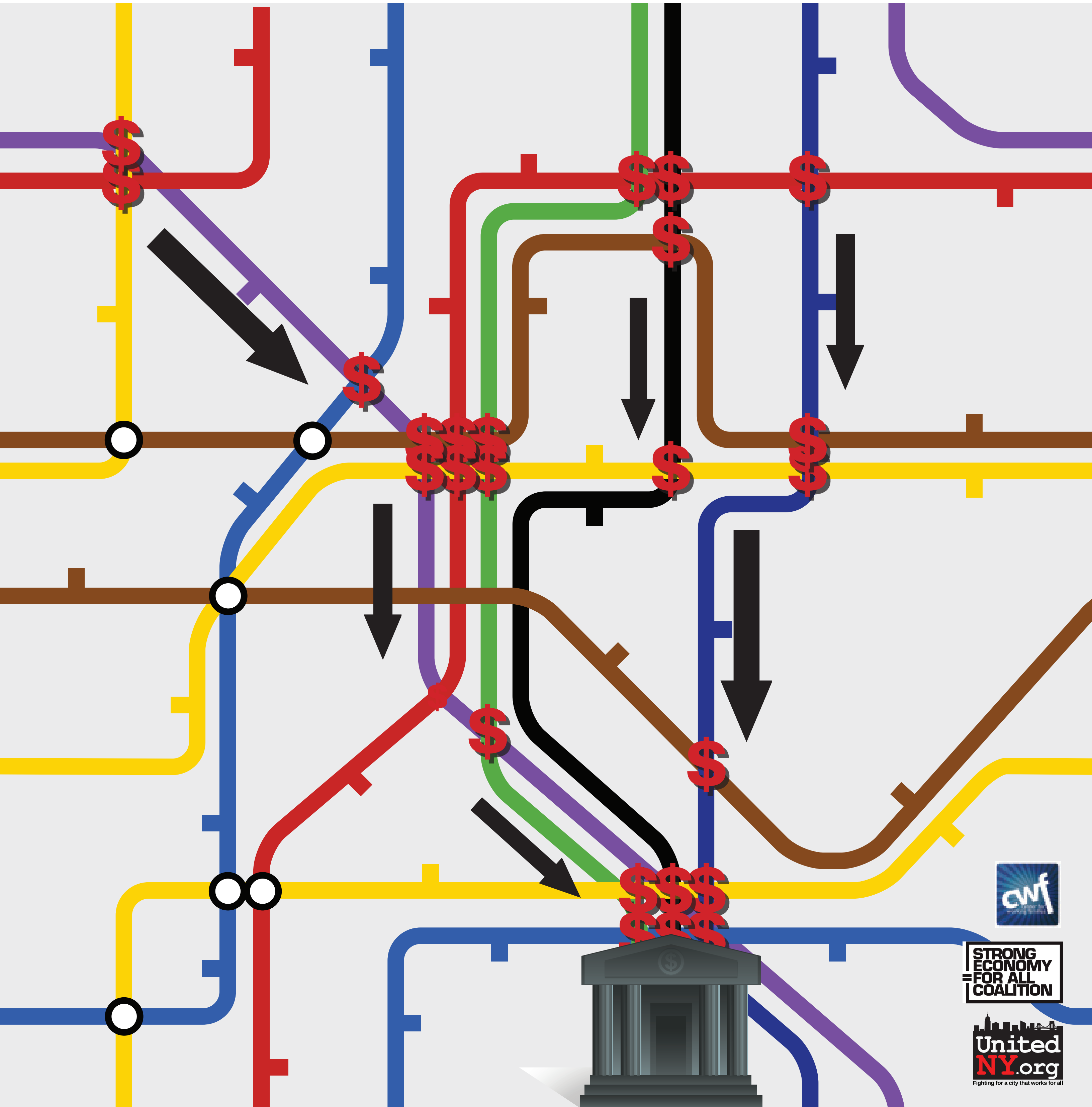
MONEY FOR NOTHING

How interest rate swaps have become golden handcuffs for New Yorkers



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EXECUTIVE SUMMARY

Interest rate swaps — complex financial products engineered by Wall Street that most people likely have never heard of — have turned into a major stream of cash moving directly out of public budgets and into the pockets of the biggest banks. Swaps were sold to public officials as a way to lower the costs of borrowing by, in essence, converting variable interest rates on municipal bonds into fixed interest rates. However, these swap deals have instead grown into a huge liability, draining away money that could otherwise be used to maintain essential services, close budget gaps, retain good jobs, and shore up our crumbling infrastructure.

Thanks to historically low interest rates — brought about by federal action on behalf of the banks as part of the bailout that started in October 2008 — New York State, New York City, and other New York public entities are today paying over **$236 million per year** to the big banks on just a few of these swap deals.[1]

That's money for nothing going from taxpayers to the big banks. Right now, government officials seem to have no way out of the golden handcuffs, unless they make the agonizing choice to pay nearly **$1.4 billion** to terminate these harmful contracts. What's worse, future payments on these swap agreements — some of which last up to thirty years — promise to leech away at public services and funds for decades to come.

The Metropolitan Transportation Authority (MTA) provides a striking example:

- Since January 2000, the MTA has already paid out a net **$658 million** to banks under these swap agreements, experiencing losses that spiked after interest rates were slashed as part of the federal bank bailout strategy.
- The MTA's net swap payments in 2010 alone, if spent on transit instead of payments to banks, **could have spared the riding public from deep subway and bus service cuts and cleaning reductions, as well as 1,012 MTA workers at New York City Transit from layoffs and the elimination of 749 positions[2] associated with these cuts** — with over $40 million to spare. (See Table 4.)
- The MTA is projected to pay banks in 2011 nearly **$118 million** in net swap payments. This is money the MTA could instead use towards restoring its 2010 service cuts.
- The MTA remains on the hook for nearly **$1.3 billion** in payments to banks before its current swap agreements terminate — nearly half of which will not terminate until after 2030.
- As of the end of September 2011, the MTA would have to pay **$714 million** in termination fees if it were to end its swap arrangements today — up from $408 million in June 2011, a mere three-month period — and refinance the associated bonds at the current lower fixed rates.

The economic collapse and federal bailout changed the "rules of the game" with respect to interest rates. Now taxpayers are suffering and governments are stuck with the old rules while banks are allowed to play by the new ones. We need one set of rules for everyone.

Banks should be held accountable for their part in crashing the economy, not rewarded with a second bailout under lucrative swap agreements.

Banks should:

1. Renegotiate or cancel these deals at no cost to taxpayers.
2. Be transparent about the deals that currently exist.

Government officials should:

1. Insist that big banks come to the table and renegotiate or cancel these deals, at no cost to taxpayers.
2. Require a full accounting of swaps deals, affording the public with much needed transparency about bank dealings.
3. Conduct business with those banks that agree to work cooperatively in cleaning up these deals that currently transfer tax dollars to a small portion of the private sector.

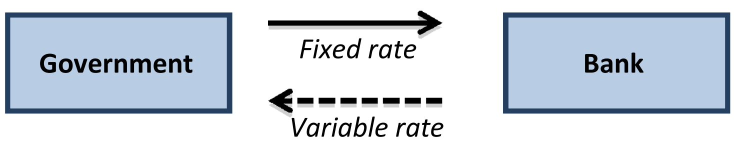
WHAT ARE INTEREST RATE SWAPS & HOW DO THEY WORK?

Bonds Are Issued to Raise Money

State and local governments borrow money for various reasons, but often it is to build and maintain a costly infrastructure of roads, tunnels, bridges, schools, and other public buildings. Governments usually borrow money by issuing bonds. Investors who buy the bonds are, in effect, making a loan to the government, which the government pays back to the bondholder with interest. Since infrastructure improvements are usually long term, high cost projects, the duration of government bonds is usually twenty or thirty years. Governments can issue fixed-rate or variable-rate bonds. Fixed-rate bonds offer governments predictability in costs since the interest rate remains constant over the bond's duration. Variable-rate bonds, on the other hand, tend to carry slightly lower interest rates and thus, on the surface, lower the cost to the government of borrowing. Yet, interest rates on variable-rate bonds fluctuate based on market conditions and, as with an adjustable-rate mortgage, there is always the risk that the rate can spike up, causing the government's interest payments to skyrocket.

Banks Marketed Swap Deals as Protection Against Higher Interest Rates

Banks marketed interest rate swaps to state and local governments, arguing that swaps would guard against the risk of higher interest rates on the variable-rate bonds that governments issued. Essentially, interest rate swaps are secondary deals between governments and the banks. In a typical swap deal, the government pays a fixed interest rate to the bank on the value of an underlying bond that the government issued, and in turn the bank pays a variable interest rate on the bond to the government.[3]

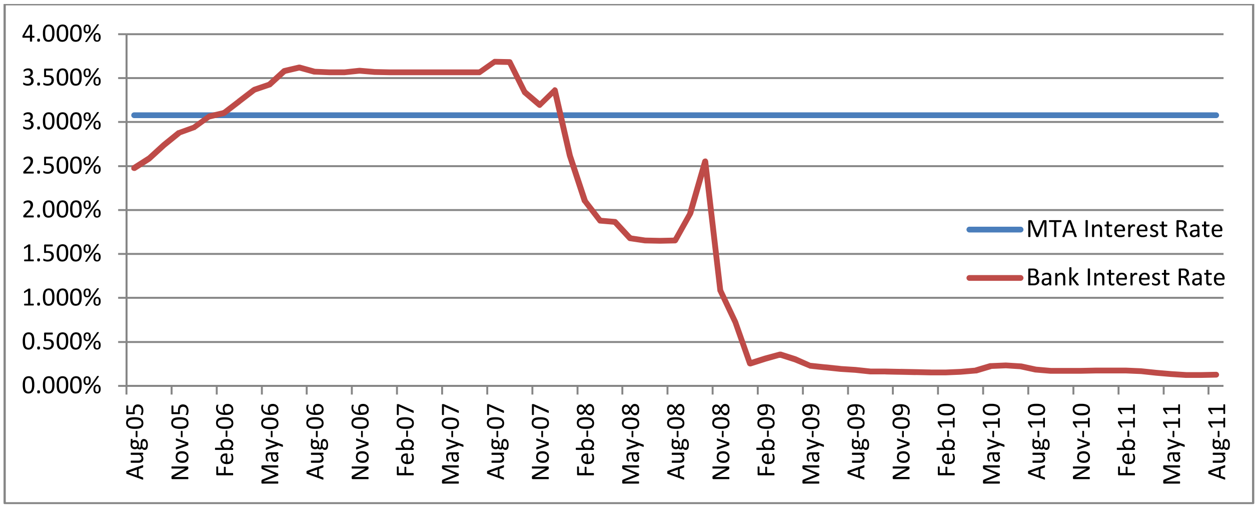


Another Bailout for Banks

Swap deals, however, have turned into a windfall for banks and a nightmare for taxpayers. In the wake of the financial collapse in 2008 largely caused by the banks, the federal government aggressively drove down interest rates to spur economic recovery.[4] The consequence of low interest rates has been to create another opportunity for big banks to reap a tremendous profit from swap deals. While banks typically charge fixed rates of 3% to 6% to public entities under swap agreements, banks are now — thanks to swap-related variable payments being tied to low prevailing interest rates — paying public entities as little as 0.10% on the outstanding bonds underlying the swap agreements.[5] Moreover, interest rates are expected to remain low for the foreseeable future.[6]

Looking at Figure 1 below one can see the extent to which fixed and variable interest rates have diverged over time in relation to one of the sixteen active swaps between the MTA and its big bank counterparties in the deals.[7] While the interest rate paid by the MTA remained constant throughout the period, the bank's variable rate began to drop in 2007. After a brief spike, the bank's rate dropped precipitously at the end of 2008, and has remained low since then.

Figure 1: Interest Rates on a Swap Tied to MTA 2005B Bond



Over the life of a single deal like the one charted above, the banks are projected to collect hundreds of millions of dollars more in interest paid to them than they pay to the public bodies.[8] Since lowering variable interest rates was a federal policy designed to resolve a crisis in large part created by the banks themselves,[9] these hundreds of millions in swap profits are, in effect, a second bailout for banks, this one paid directly out of state and local budgets, and ultimately by taxpayers. And while the federal bailout was a loan to be repaid, swap profits is money permanently transferred from the public coffer to the banks.

No Easy Way Out for Governments

While banks have benefitted from swap agreements, state and local governments have been trapped in expensive, long-term, risky debt. Governments are paying interest rates that are vastly above market and are exposed to additional financial risks, like being required to post tens of millions in collateral if ratings institutions like Moody's or S&P downgrade the government's credit rating.[10] At the same time, banks have made it prohibitively expensive for state and local governments to terminate the swap deals, demanding tens or hundreds of millions of dollars in fees to do so.[11]

These termination fees are equal to the "fair value" of the swaps — the value to the bank of the stream of future net payments. The higher the value to the bank, the greater the termination cost to the public entity. This fair value rises as long-term interest rates fall. Due to the heightened global economic turmoil in recent months and the faltering of the U.S. recovery, long-term interest rates have declined and potential termination fees have increased.

As Steven I. Turner, a partner in the law firm of Hawkins Delafield & Wood LLP (a firm that has represented various public entities and served as bond counsel in numerous deals including interest rate swaps), stated in remarks to the Securities and Exchange Commission: "However, no one foresaw the dramatic impact of the mortgage credit crisis and associated financial market turmoil on these swap instruments. … [B]ecause of the dramatic drop in interest rates, the fixed interest rate stream being received by the swap counterparty was very valuable and therefore it was very expensive to terminate and at the same time it was difficult to post collateral.

In addition to the termination risks associated with insurer downgrades, issuers found that they had bargained away their right to most economically take advantage of declining long-term fixed interest rates to refund variable rate debt because the benefits of the refunding were outweighed by the termination costs of the swap contract."[12]

In some cases, public entities have gone ahead, terminated the deals, and paid the termination fees. According to Bloomberg LP, taxpayers forked over $4 billion to big banks between January 2008 and November 2010 to get out of swap agreements that went sour.[13]

Even if governments choose not to terminate a swap, they could be forced to do so through no fault of their own, such as when the insurance company that guarantees the government's swap payments has its credit downgraded. This could cause the swap to terminate and the government to owe termination fees to the bank. For example, according to Bloomberg LP, when Lehman Brothers declared bankruptcy in 2008, the MTA was required to pay $9.4 million to terminate two swaps and an investment agreement with the bank.[14]

The Philadelphia School District exemplifies the predicament that these swaps present to government agencies, resulting in a huge cost to taxpayers, and reductions in essential government services. According to Bloomberg LP, the Philadelphia School District was slated to incur a $63 million termination fee in 2011 to cancel five swaps, and, according to bond documents, previously paid $26.6 million in termination fees to get out of other swap deals. The $89.6 million total in termination fees to big banks is about six times the amount the district spent on books and supplies for Philadelphia's school children in 2009, according to Bloomberg LP.[15]

However, paying exorbitant termination fees is not an inevitable outcome. As with any contract, banks could renegotiate the swap deals or waive the termination fees — and governments should insist that the banks do so in the interest of citizens and taxpayers. The Asian Art Museum in San Francisco is a good example. The Museum was in the middle of a financial crisis that included a technical default on its bond covenants. In January 2011, JPMorgan Chase agreed to restructure the Foundation's bonds — by replacing the variable rate ones with fixed rate ones — and to cancel a swap deal and refund $13 million that the museum had posted in collateral on the swap. According to the City's attorney these concession solved the immediate financial crisis and helped guard against similar crises in the future.[16]

For their part, banks have not shied away from walking away from deals that have become costly to them. For example, in 2009 the Wall Street Journal reported that Morgan Stanley (counterparty to several swaps involving New York public entities) was able to obtain a release from substantial debt when it "hand[ed] the keys" to Crescent Real Estate Equities Co. over to another lender Barclays Capital.[17]

NEW YORK'S INTEREST RATE SWAPS

New York State, New York City (and related entities), the Port Authority of New York and New Jersey, and the MTA collectively are party to at least 86 active interest rate swap deals. These swaps have a value of $10.6 billion — a figure that, with some exceptions, represents the approximate value of the bonds with which they are associated. This count is not exhaustive, as there is no central record of all interest rate swap agreements entered into by government entities.

As Table 1 below illustrates, New York public entities currently are paying over $236 million per year to banks as part of these deals. However, if these entities were able to cancel all their swap agreements, they would be hit with over $981 million in termination fees.

Table 1: Cost of Swaps to Public Entities[18]

Entity	Value of Swaps	Government Net Annual Payment to Banks	Potential Termination Fee
State of New York	$2,299.0	$70.6	$231.0
MTA	$4,169.1	$117.6	$714.3
Port Authority of NY/NJ	$647.2	$27.7	$148.0
New York City	$2,616.2	$10.9	$180.8
New York City IDA	$198.1	$0.2	$19.8
NYC Public Library	$92.3	$3.2	$13.5
NYC Water Authority*	$601.0	$6.2	$54.4
TOTALS	$10,622.9	$236.4	$1,361.8

In millions of dollars. MTA and Port Authority net payment figures are annualized.

Through these swap deals, the banks are forcing these entities to choose between exorbitant interest payments or turning over huge sums to the banks in termination fees to get out of the deals. It's a classic "heads I win, tails you lose" message from the banks. While New York is fighting to recover from a recession, public money — that should be used to fill budget gaps, retain teachers, invest in infrastructure improvements, and ensure that other critical services are maintained — is instead being paid to the banks.

Many of the banks associated with these swaps were bailed out with taxpayer money and federal guarantees since the 2008 financial crisis – JPMorgan Chase ($100.8 billion), Wells Fargo ($43.7 billion), Morgan Stanley ($36.2 billion), Citigroup ($414.9 billion), and Goldman Sachs ($53.4 billion).[19] Now the big banks together are siphoning off hundreds of millions of dollars more each year out of public budgets.

In defending these deals, some might argue that the government's investment managers simply lost the bets they made on these swaps given the economic situation and interest rates at the time. Others might argue that it was a prudent strategy to hedge the risk that the prospect of higher rates posed to the government's debt costs. However, whether or not these swap deals were unwise or seemed sensible at the time is not the point.

* Water Authority calculations exclude one swap because the bank's swap payment is based on the bond rate, which was not immediately available.

Banks are profiting from the economic downturn that they caused, to the detriment of state and local governments, public bodies, and taxpayers. ***This must stop.***

In 2009, JPMorgan Chase paid $722 million in a settlement with federal regulators over accusations, neither admitted nor denied by JPMorgan Chase, of alleged irregularities in connection with municipal bond offerings in Jefferson County, Alabama. According to Bloomberg LP, the swap deals drove the County to file the largest municipal bankruptcy in US history after talks to reorganize its debt broke down.[20] JPMorgan Chase is the counterparty to most of New York City's swap deals.

In its 2010 annual report, UBS disclosed that it had been subpoenaed concerning ongoing investigations into whether banks may have manipulated the LIBOR rate on which many of their variable rate swap contracts were based, artificially depressing their costs. In doing so, banks increase the disparity between the fixed rates paid to them and the variable rates they pay to public entities in these swap deals. Some of the banks holding swap agreements with New York government entities — including Citigroup and UBS — have been the subject of these investigations.[21]

New York City

New York City is a party to twelve active swap deals. In addition, a number of other City-related entities have swap agreements, including the Public Library (two swaps), the Water Authority (four swaps), and the Industrial Development Agency (twelve swaps).[22] Overall, the deals average 17 years in duration from origination to termination. Some of these swaps have been in place since 2002 and some are not scheduled to terminate until as late as 2036. Thus, public entities are locked into some swap deals for 29 years.

As Table 2 below illustrates, as of June 30, 2010, the City and its related entities paid an average interest rate of 2.003% to the banks as part of their swap agreements, compared with the banks paying an average interest rate of only 1.419%. This means that the public entities earned a net negative interest rate of0.584% on the swaps, which when multiplied by the value of the swap deals ($3.5 billion) translates into an annual payment of $20.5 million to the banks.

Table 2: Swap Rates and Payments Related to NYC-Related Entities

	Swap Values	Avg Gov't Rate	Avg Bank Rate	Avg Net Rate	Gov't Payment
New York City	$2,616.2	1.693%	1.277%	-0.415%	$10.9
NYC IDA	$198.1	4.089%	3.978%	-0.111%	$0.2
Public Library	$92.3	3.902%	0.452%	-3.451%	$3.2
Water Authority	$601.0	2.378%	1.343%	-1.035%	$6.2
TOTALS	$3,507.6	2.003%	1.419%	-0.584%	$20.5

In millions of dollars.

The State of New York

The State of New York had 37 swap agreements as of March 31, 2011. The swap agreements correspond with bonds worth $2.3 billion that were issued by four State entities — the Dormitory Authority (including bonds and a loan issued by the Dormitory Authority on behalf of the City University of New

York), the Urban Development Corporation, the Housing Finance Agency, and the Local Government Assistance Corporation.

These swap deals are costing the State $70.6 million per year in payments to the banks, with the State paying an average interest rate of 3.296% on the value of the swaps, compared to an average interest rate of 0.223% being paid by the banks to the State. To terminate all of its existing swap deals, the State would be forced to pay $231 million in fees — the estimated market value of the swaps.

In September 2010, the State terminated all of its "atypical" swap deals, i.e. where the State swapped paying a fixed rate for paying a variable rate. The State explained that it had entered into these atypical deals because these swap deals can "provide variable rate debt at a lower cost than traditional (or natural) variable rate debt, since it does not require additional support costs (liquidity agreements, insurance, brokerage dealer fees, and remarketing fees)."[23]

The irony is that the cancelled swap agreements had been earning net income for the State, and therefore, upon termination, the State was able to collect $43 million in termination fees from the banks. This apparent benefit was more than offset, however, by the $48 million in termination fees that the State had to pay to the banks to cancel other swap deals.

The Port Authority

The experience of the Port Authority of New York and New Jersey is another unfortunate example of what can go wrong with interest rate swap deals. Currently, the Authority is party to three swap agreements which together are projected to cost the Authority $27.7 million in 2011.[24]

The fact that the Authority has been paying an average of $2.3 million per month to banks since November 2010 because of these three swap deals is made more troubling by the fact that the deals are all "unhedged." That is, unlike most swap deals entered into by public entities, the Authority's swaps do not correspond to any underlying bonds. The Authority is paying the banks millions per month for an arrangement that will never serve its intended purpose — to balance out the variable-rate interest the Authority is paying its bondholders.

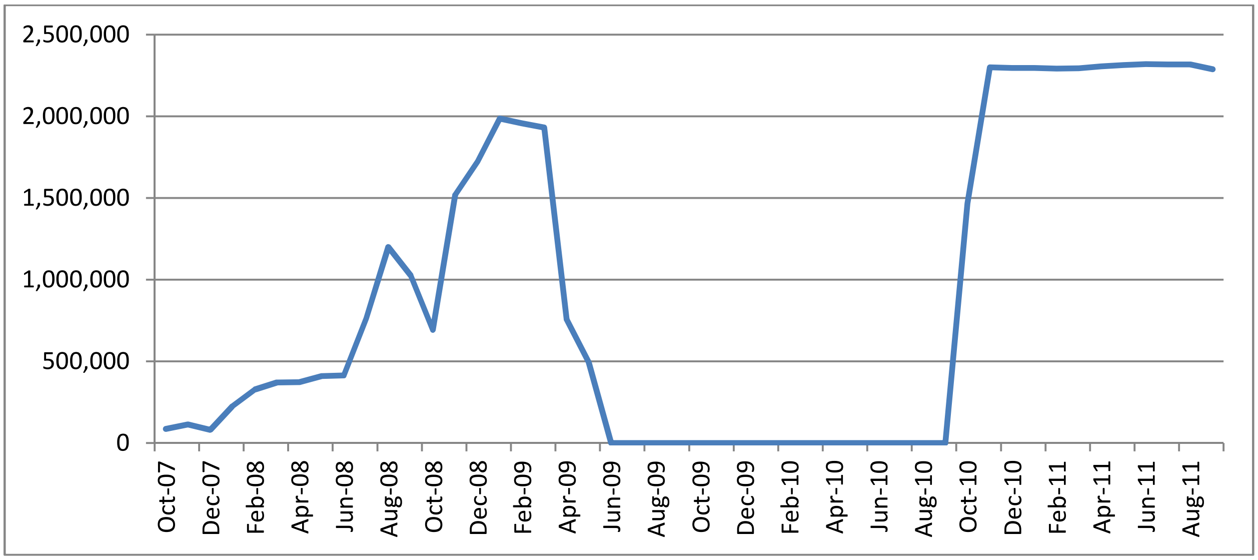
In June 2006, the Authority entered into these three swap agreements, expecting to hedge against the variable rate interest on new bonds that the Authority anticipated it would issue in October 2007, July 2008, and August 2008.[25] Once these swap contracts were signed, the Authority was bound to the contracts' terms despite that two of the anticipated bonds were never issued. The principal on the third bond was refunded (paid back to bondholders) only six months after the bond was issued. As a result, the Authority is party to three standalone swap contracts on which it is obligated to make net payments — or achieve net gains, if interest rates rise dramatically — for the next 28 to 30 years.

In essence, the Authority is paying "money for nothing," with the banks likely to turn a tidy profit on these swap deals until far into the future. The $43.2 million in swap payments that the Authority has paid on these swap deals since October 2007 is projected to balloon to over $746 million between October 2011 and their eventual terminations between 2035 and 2038.[26]

According to the Authority's 2009 financial statements, the Authority sought to "mitigate the impacts of unfavorable market conditions" by coming to an agreement with the banks to amend the three swap agreements. These amended agreements allowed the Authority to defer their swap payments until October and November 2010 — saving, in the short term, over $35.9 million during the deferral period. However, the price for this new arrangement was to pay an even higher interest rate to the banks at the point when the payments resumed. So, instead of paying an already unbalanced average of 3.95% interest to the banks as compared to the 1.83% the banks were paying to the Authority, the Authority is now on the hook for an average interest rate of 4.46% compared to the banks' average rate of 0.19%. Ultimately, instead of saving the Authority money over the life of the swap agreements, the amended agreements are projected to cost the Authority an additional $50.6 million by the time they finally terminate.[27]

Figure 2 below illustrates the trajectory of the Authority's monthly net interest payments to the banks related to their existing swap deals.

Figure 2: Port Authority's Monthly Net Swap Payments (3 Swaps)[28]



THE MTA: A CASE STUDY

The New York Metropolitan Transportation Authority is one of the largest public transit systems in the world. It has an annual operating budget of nearly $12 billion,[29] and serves a 5,000 square mile jurisdiction in New York and Connecticut. On an average weekday, it carries 8.5 million passengers system-wide and over 800,000 vehicles on its toll bridges and tunnels.[30] It serves as a backbone for a region with the largest concentration of jobs in the country and the source of $1.2 trillion of economic activity.[31]

Between 1982 and 2008, the MTA invested more than $78 billion in the maintenance and expansion of its regional transit network.[32] Capital investments included the purchase of new trains and buses, routine system maintenance to keep the system safe and reliable, and expansion projects such as the Second Avenue Subway and East Side Access. However, as federal and state financial support for public transportation has declined, the MTA debt service has been growing faster than any other expense.[33]

Today, the MTA owes $30 billion in outstanding debt[34] used to fund its system improvement projects. Its complex debt portfolio includes bonds secured at both fixed and variable interest rates. Historically, the MTA has relied on fixed rate bonds for long-term debt[35] to limit its exposure to variable interest rates. However, 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 provide stability to its operating budget,[36] all the while providing the necessary financing to maintain and upgrade New York's transit system.

The package the MTA *really* received turned out to be quite different.

The MTA's Swap Agreements with Major Banks

The MTA currently has sixteen active swap agreements with major banks (and another one scheduled to become active in 2012) to protect against potential losses due to rising interest rates in the marketplace. These agreements are with JPMorgan Chase, Citigroup and Citibank, UBS, AIG, Morgan Stanley and Ambac.

The swap agreements are associated with $3.4 billion in outstanding bonds. The oldest agreement was entered into in 2000 and the most recent will become active in 2012. Nearly half of these agreements expire after 2030.

With few exceptions, the banks have profited each year from their swap deals with the MTA. However, in the wake of the 2008 financial meltdown, the banks' earnings have increased substantially and the MTA has found itself caught in a web of toxic swaps. In the wake of the October 2008 crisis, as part of a larger bailout strategy to save the banks, the federal government pushed interest rates down to nearly zero.[37] The result is a 1.62% average variable interest rate paid by the banks over the life through August 2011 of the existing swap agreements compared to a 4.5% average fixed interest rate paid by the MTA – little more than one third the MTA's interest rate.

Low variable interest rates have resulted in the MTA's average swap payments to the banks increasing three-fold. Net swap payments to banks have increased the MTA's annual costs from $35 million in the 35 months prior to October 2008 to $111 million in the 35 months starting October 2008. During the life of the existing swap agreements, the MTA has made $658 million[†] in net swap payments to the banks. 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.

Table 3 below shows the projected earnings in 2011for each bank from the MTA swap agreements, the estimated future bank earnings for the remaining life of the swaps, and the banks' potential termination fees.

[†] $658 million is the difference between the MTA's swap payments at a fixed interest rate ($1,176 million) and the banks' swap payments at a variable interest rate ($518 million) through August 2011.

Table 3: Bank Earnings from MTA Swap Agreements

Bank[38]	Projected 2011 MTA Net Swap Payments‡	MTA's Net Future Swap Payments[39]	Termination Fees as of September 2011
AIG	$3.41	$55.60	$26.24
Ambac	$2.12	$1.8	$1.40
BNP Paribas	$3.35	$51.26	$40.57
Citigroup	$32.45	$302.93	$172.79
JPMorgan Chase	$20.48	$260.3	$251.39
Morgan Stanley	$16.99	$52.64	$31.80
UBS	$38.80	$549.69	$190.08
Totals	**$117.61**	**$1,274.22**	**$714.27**

In millions of dollars.

The nearly $118 million in annual payments and the nearly $1.3 billion in projected future swap payments going to the banks means that banks have a strong incentive to keep the MTA in these deals. As of September 30, 2011, the MTA faces a price tag of $714 million[40] in termination fees to end these arrangements — up from $408 million in June 2011, a mere three-month period.

With only three of the MTA's swap agreements set to expire by 2013, five expiring in 2019, and the remaining nine not scheduled to expire until after 2030, the chokehold by the banks remains firm.

Moreover, these swap payments are in addition to a host of other fees the MTA already pays to bankers who package and sell the bonds, amounting to between $2.50 and $5 on every $1,000 worth of debt, according to the MTA. Over the last two years, underwriters of MTA's debt such as Goldman Sachs, JPMorgan, Bank of America, Merrill Lynch, Wells Fargo and Barclays earned $39.7 million in fees just for issuing bonds. Between 2000 and 2008, the MTA paid Goldman Sachs alone $28.8 million in fees.[41]

MTA's Solution to the Budget Gap: Layoffs, Service Cuts & Fare Increases

The MTA's financial woes stem from multiple sources, including the financial meltdown and dwindling city and state support for its operations and capital investments.[42] However, the crushing weight of debt financing and its related payments are a critically important factor. From 2003 through 2011, the MTA's debt service has ballooned 130%, from $868 million to $2 billion a year, with its debt payments currently accounting for 16% of the MTA's total revenue.[43]

With little prospect for additional public support from the city or the state, the Authority is proposing the largest borrowing program in its history, over $12 billion to fund its current capital needs. New borrowing could further increase debt service as a share of the MTA's total revenue.[44]

The flip side of increasing debt pressures is the repeated austerity measures the MTA has implemented to address chronic budget deficits. The Authority has slashed service, hiked fares, and laid off employees. The 2010 service cuts were part of the largest service reduction package in decades. With no budget relief

‡ Annualized based on LIBOR and SIFMA rates as of August 2011.

in sight, two additional 7.5% increases are expected in 2013 and 2015, on top of the three increases since 2007 — meaning fares and tolls will have increased 66% since 2002, or at twice the rate of inflation.[45]

Swap payments that the MTA has dished out to the banks could have been used to mitigate the service cuts and fare and toll increases that New Yorkers have suffered. Examination of these costs in relation to swap payments gives an idea of just how much the banks are profiting off the backs of New York City transit riders and workers.

Table 4: The MTA's Cuts to Riders & Workers vs. The Banks

The MTA's Cuts to Riders & Workers		
Savings/Revenues From….	2010	2011
462 Station Layoffs, 346 Positions Eliminated (NYCT)[46]	$30.8	$52.5
Subway Service Cuts & 149 Positions Eliminated (NYCT)[47]	$7.6	$17.7
Bus Service Cuts & 550 Layoffs (NYCT)[48]	$24.5	$54.1
Cleaning Reductions & 254 Positions Eliminated (NYCT)[49]	$15.6	$21.3
7.5% Toll and Fare Hike[50]		$424.0
Zero "Labor" Wage Initiative[51]		$33.0

In millions of dollars.

The MTA's "Cut" to the Banks	
Year	Swap Payments To Banks
2007	$19.6
2008	$59.3
2009	$114.4
2010	$119.6
2011[§]	$117.6

Already on the brink of a crisis, the MTA cannot afford nearly $118 million per year in swap payments (Table 4), let alone $714 million (Table 3) to terminate the swap agreements. The MTA must push the banks to renegotiate or cancel these swap deals without penalty instead of transferring their budget woes to its riders and workers.

RECOMMENDATIONS

The banks that created the economic crisis and received trillions of dollars in bailouts should not be allowed to profit from the crash they created while state and local governments suffer. Banks have renegotiated derivative contracts in the past, and they must commit to modifying the swap contracts on a much wider scale and do their part to support economic recovery.

One rule making body recently advocated for stricter regulations and disclosure related to swaps. According to Bloomberg, the Municipal Securities Rulemaking Board, which "writes regulations for banks that work in the tax-exempt market, said [on August 3, 2011] that it asked the U.S. Securities and Exchange Commission to approve … proposed rules … [that] would require banks to disclose all 'material risks' of bond financings, including the floating-rate securities coupled with interest-rate swaps that once flourished. Banks also would have to disclose potential conflicts of interest, including incentives they have to recommend such transactions, payments they may get from other parties in the deal and whether banks are betting on derivative contracts that only pay off if the borrower defaults."[52]

§ Annualized based on figures through August 2011.

These regulations would be helpful, however banks must act immediately, committing to reform their derivative businesses in order to stave off catastrophic cuts to state and local government services:

- Renegotiate or cancel deals at no cost to taxpayers to stop the massive transfer of wealth from the public sector to banks; and
- Create a central listing of all swap deals so the public is afforded greater transparency about bank dealings and swap agreements.

Public entities should also take steps to rid themselves of toxic swap deals and make it easier for citizens to learn about risky swaps and other derivatives in which their tax dollars are invested. Public entities should:

- Demand that bank counterparties cancel swaps at no cost or renegotiate terms more in line with today's interest rates for their swaps; and
- Conduct business with those banks that work cooperatively on cleaning up these deals that are depleting public coffers.

CONCLUSION

In the best of times, interest rate swap agreements are a risky proposition for public entities seeking to lower the cost of their debt. During or following a recession in which interest rates are depressed, the potential consequences of risky derivatives become very real. When swap deals turn against the public, it is a recipe for pain both from a budget perspective and in the lives of residents who may suffer from higher transit fares, crumbling infrastructure, worker layoffs, and cutbacks on services.

Because of these deals, banks are making a profit off taxpayers due to an economic downturn caused by these same banks. After having received billions in taxpayer bailout money, banks have a public responsibility to work with governments and other public entities to find ways to lessen budgetary pressures and retain jobs. With governments and residents fighting to recover from a recession and stave off another one, the last thing we need is banks taking hundreds of millions of dollars annually out of public coffers. Unless some of the current deals can be terminated they will continue drawing off taxpayer money until 2036.

That interest rate swaps are contractual agreements does not mean that public entities cannot act. They can push banks to renegotiate these deals or to cancel them without imposing termination penalties. If a bank does not cooperate, public entities should conduct business with banks that do. New York City, the largest city in the United States and home of many of the financial firms that are leeching money from its budget, should set a powerful example that could resonate nationwide. Residents, too, should speak out, demonstrate, and demand that public entities fight back and hold the banks directly accountable. We cannot permit the banks that crashed the economy to continue to profit from the financial crisis they caused.

APPENDIX A: How Banks Profited at Public Expense After the Bailout

The 2000 swap agreement that the MTA entered into with Citigroup Financial Products (associated with MTA Bridges & Tunnels Subordinate Revenue Bonds Series 2000CD) illustrates how bad these deals have become for the MTA since the economic collapse. In December 2007, Citigroup's variable interest was 3.36%, and the MTA's fixed rate was 6.07%. Translated into dollars, the MTA paid Citigroup $1.02 million that month, while receiving $0.56 million from Citigroup. The net monthly cost to the MTA was $0.45 million.[**] In December 2008, Citigroup's variable interest rate sharply dipped to 0.70% and, a year later, in December 2009, was a mere 0.09%. While the MTA's monthly obligation in December 2009 was $633,809, it only received $9,398 from Citibank that month, resulting in a net monthly cost of $624,411 to the MTA.

Table 5: Interest Rates & Net Monthly Costs on MTA's 2000CD Swap Deal

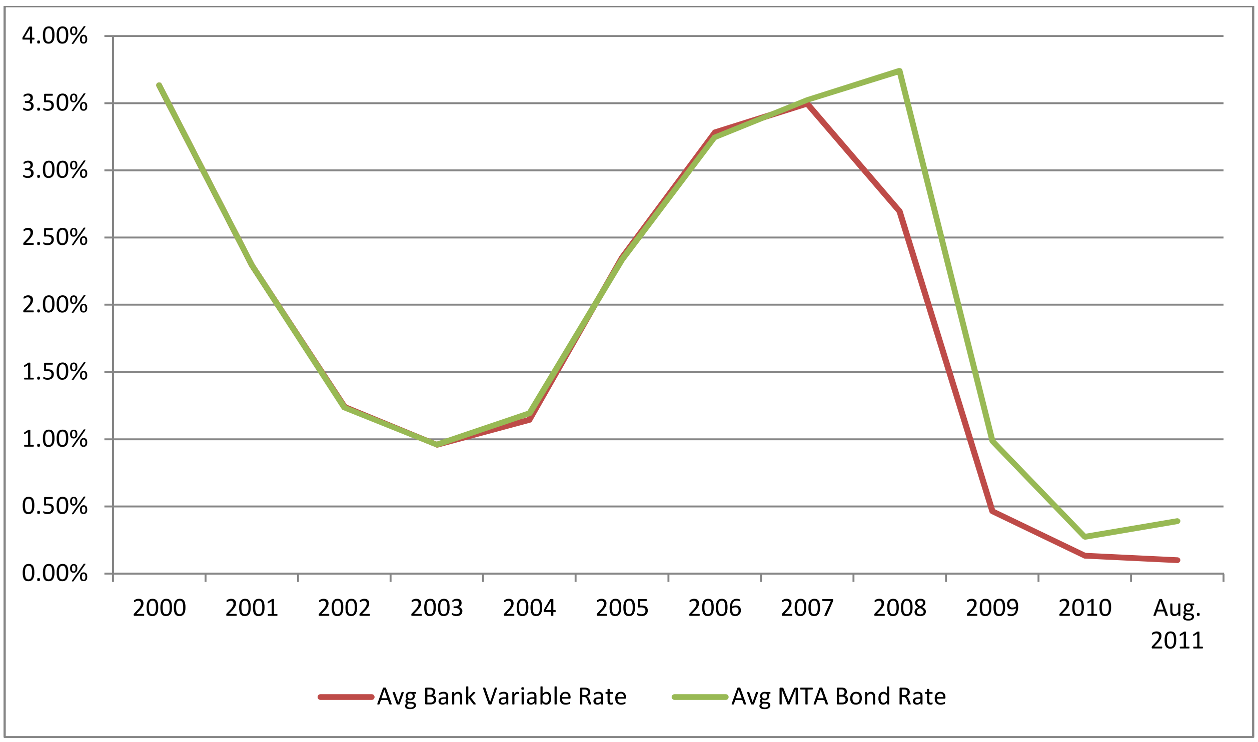
Date	MTA's Fixed Rate	Bank's Variable Rate	MTA Payments to Bank	Bank Payments to MTA	Net Monthly Cost to MTA
Dec. 2007	6.070%	3.36%	$1,017,130	$563,024	**$454,106**
Dec. 2008	6.070%	0.70%	$954,002	$110,017	**$843,985**
Dec. 2009	6.070%	0.09%	$633,809	$9,398	**$624,411**

[**] Numbers have been rounded to nearest hundredth.

APPENDIX B: Interest Paid by Banks to the MTA Compared to Interest Paid by the MTA to Bondholders

The variable rate that banks are paying to the MTA on swaps is supposed to track the market-based variable rate that the MTA has to pay bondholders. Where that is true, the income received by the MTA from the banks essentially equals the MTA's obligation to its bondholders, and the MTA's only cost on the bond should be the fixed rate it has to pay the banks for the swap. The extent to which this "balancing" actually occurs varies between bonds and over time. What is clear from the MTA bonds with swaps that we have examined is that, since the economic crisis, the average variable bond rate paid by the MTA to its bondholders and the average variable swap rate paid by banks to the MTA have diverged. The figure below illustrates this divergence.

Figure 3: Average Variable Interest Rate from Banks to the MTA Compared to Average MTA Interest Rates to Bondholders



As can be seen, between 2000 and 2007, the variable rate on the swaps tracked the bond rate relatively closely. However, whereas the average interest rate paid by the MTA to its bondholders was 0.39% in August 2011, the banks' average swap interest rate paid to the MTA was 0.10%. In addition to the hundreds of millions paid thus far by the MTA to banks as part of these swap deals, the gap created by this divergence — as much as $32.4 million in 2008 alone, and over $7.1 million in just the first eight months of 2011 — is another unanticipated negative aspect of the deal.

APPENDIX C: Current MTA Swaps and Associated Bond Issues

Table 6: Current MTA Swaps

Swaps & Associated Bond Issue	Bank Counterparties	Projected 2011 Net Annual Swap Payments (in millions)[††]	Swap Termination Date	Future MTA Payments at August 2011 Interest Rates (in millions)
2000AB	JPMorgan Chase Bank, NA	$8.54	1/1/19	$33.21
2000CD	Citigroup Financial Products	$6.07	1/1/19	$23.53
Series 2001B	Citigroup Financial Products	$4.99	1/1/19	$33.53
Series 2001C	Citigroup Financial Products	$5.08	1/1/19	$34.23
Series 2002F	Ambac Financial Services, L.P.	$2.12	1/1/13	$1.80
Series 2002D-2	JPMorgan Chase Bank, NA	$8.60	11/1/32	$175.83
Series 2002B	Morgan Stanley Capital Services	$16.98	9/1/13	$52.64
Series 2003B	Citigroup Financial Products	$2.73	1/1/19	$10.58
2004A	UBS AG	$11.81	1/1/30	$126.59
Series 2002F (Old Citi 2005B)*	Citibank, N.A.	$3.11	1/1/32	$47.55
Series 2003B Old 2005B)*	Citibank, N.A.	$0.24	1/1/32	$3.71
2005B*	JPMorgan Chase Bank; BNP Paribas, Inc.; and UBS AG	$10.05	1/1/32	$153.78
2005B*	UBS AG	$10.05	1/1/12	$153.78
2005B*	UBS AG	$3.35	1/1/12	$51.26
Series 2005D and Series 2005E	75% UBS AG, 25% AIG Financial	$13.65	11/1/35	$222.40
2008A	Citigroup Financial Products	$10.24	11/1/31	$149.80
Series 2012B	JPMorgan Chase Bank, NA		11/1/32	
TOTAL		**$117.61**		**$1,274.22**

*Annual payments for the swaps associated originally with Bond Series 2005B are calculated together.
Information compiled from MTA Consolidated Financial Statements, June 30, 2011.

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[1] All figures concerning the value of; interest rates of; past, current, and future payments on; and termination fees concerning interest rate swaps applicable to the entities covered in this report are from or calculated based on financial statements or Comprehensive Annual Financial Reports (CAFRs) issued by the respective entities. The endnotes reference the specific financial statement or report.
[2] Positions eliminated include those eliminated through attrition and the elimination of additional budgeted positions.
[3] These variable rates are usually tied to an index such as the London Interbank Offering Rate (LIBOR) or the Securities Industry and Financial Markets Association (SIFMA) index. The variable rate of the swap is supposed to track, if not cancel out, the underlying interest rate on the bond. After the economic crisis of 2008, this no longer appears to be true, at least with respect to the MTA. See Appendix B.
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