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How Banks Could Return the Favor

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LIKE millions of homeowners, shrewd state and local governments are looking to refinance. Interest rates have hit rock bottom. So why not save some public money by replacing old debts with new ones at lower rates?

The bad news for taxpayers is that such easy refis are out of the question for many governments and agencies short on cash. And that's because these borrowers have been trapped by Wall Street.

Behind all of this is — you guessed it — derivatives. Bankers have embedded interest-rate swaps in many long-term municipal bonds. Back when, they persuaded states and others to issue bonds and simultaneously enter into swaps. In these arrangements, the banks agreed to make variable-rate payments to the issuers — and the issuers, in turn, agreed to make fixed-rate payments to the banks involved.

These swaps were supposed to save the public some money. And, for a while, they did. Then the financial crisis hit — and rates went south and stayed there. Now issuers are paying bond holders above-market rates as high as 6 percent. In return, they are collecting a pittance from banks — typically 0.5 percent to 1 percent.

Why not just refinance the old bonds? Well, if you think it's costly to refinance a home mortgage, try refinancing a derivatives-laced muni. The price, in the form of a termination fee, can be enormous. New York State, for one, has paid $243 million in recent years to extricate itself from swaps-related debt. That money went straight from taxpayers' pockets to Wall Street.

Corporations rarely do deals like these, because they generally avoid making long-term bets on interest rates. But bankers sold the idea to public borrowers. The total bill to terminate all of these swaps-related deals would run into many billions.

Officials who have done such financing typically defend it. They say these deals were struck at lower rates than those associated with fixed-rate debt at the time. Therefore, the defenders say, the deals have saved money for issuers and taxpayers.

But if states, cities and others had issued plain vanilla fixed-rate debt to begin with, they could have refinanced much of it by now at little or no cost. They would be paying significantly lower financing costs and would not be facing huge penalties to get out of the deals.

LAST week, a study was published by the Refund Transit Coalition, a group that supports public transit, detailing some of these harmful deals. Entitled "Riding the Gravy Train," it said it had found 1,100 swaps deals at more than 100 government agencies that are costing taxpayers $2.5 billion a year.

The report delves into the high costs of swaps-related debt at 12 transit agencies nationwide, including authorities in Boston, Chicago, Detroit, New York, San Francisco and Baton Rouge, La. In these 12 systems alone, swaps deals are costing riders $529 million a year, the study says. That's the difference between the fixed rate paid by the issuers and the floating rates they receive.

This difference certainly adds to the burden that cash-starved transit agencies already shoulder. A 2011 study by the American Public Transportation Association found that of 117 transit agencies surveyed, half had cut service or raised fares. Money that might go toward services is going to swaps instead. So think of these swaps as a kind of Wall Street-driven austerity measure. Everybody else — workers, riders, taxpayers — makes concessions. Banks give up nothing.

When issuers do decide to escape these snares, the hefty termination fees are typically paid for with new debt deals. For example, of the $243 million that New York State paid to terminate its swaps deals recently, $191 million was financed by new debt issuance. This may dull the immediate pain, but it only adds to taxpayers' burden by piling an interest rate onto the termination cost.

The trillion-dollar question is why debt issuers don't push the banks to cut or reduce these exit fees. Yes, swaps are contractual arrangements that were agreed to in better days. But issuers that raise a lot of money in the debt markets have considerable leverage, given how much they pay Wall Street banks to underwrite their debt.

In New York, for example, the Metropolitan Transportation Authority plans to issue $2.2 billion in new debt this year and may refinance an additional $6 billion.

Why doesn't the M.T.A. use that leverage to prod banks to lower exit fees on some of the $3.3 billion in debt issued with swaps? Patrick McCoy, the M.T.A. finance director, was asked precisely that when testifying in a recent arbitration case between the Amalgamated Transit Union and New York City Transit.

First, Mr. McCoy expressed surprise at the idea. Then he said he had no plans to use any leverage the M.T.A. might have, like suggesting that the agency wouldn't place new bonds with a bank unless it agreed to renegotiate on the swaps.

That led the arbitration panel's chairman to say, "Such renegotiations may not be successful, but it is more than difficult to understand why the authority is of the opinion that it should not even try."

In an interview on Friday, I asked Mr. McCoy why he wouldn't ask the banks that underwrite

M.T.A. bonds for concessions on the swaps debt.

“It’s working,” he said. “Why would I want to incur the costs, aggravation and bad faith that goes with it to suggest that we want out?”

The fight has been taken up by Rebecca Kaplan, a councilwoman in Oakland, Calif. Trying to negotiate an escape from a swap that is costing her city $4 million a year, she wrote a letter in 2011 to Goldman Sachs, the banker on the deal, asking it to reduce the exit fees, which stand at $15.5 million.

“When taxpayers bailed out these big banks there was a social contract made,” said Jason Overman, Ms. Kaplan’s spokesman. “We did them a favor, but then when they’re back on their feet they’re not extending us that same courtesy.”

A few weeks ago at Goldman’s annual meeting, Lloyd C. Blankfein, its C.E.O., was asked about tearing up the Oakland swap. He said: “I don’t think we’re in a position to do that,” adding that it would not be fair to shareholders.

James A. Parrott, deputy director and chief economist at the Fiscal Policy Institute in New York, criticizes these deals along with officials who don’t try to get out of them.

“Government officials need to acknowledge that they made a mistake when they signed up for these ill-conceived, high-risk financial bets,” Mr. Parrott said. “But that mistake is woefully compounded when they then impose austerity rather than stand up to the banks.”

You know the score. Once again, it’s Wall Street 1, Main Street 0.

This article has been revised to reflect the following correction:

Correction: June 17, 2012

The Fair Game column last Sunday, about state and local governments that are aiming to refinance bonds containing interest rate swaps, misidentified the recipients of fixed rates of interest in these instruments. The issuer pays a fixed rate to banks involved in the transaction, not to bond holders.