Crimes of Wall Street

Pennsylvania Senate Debates Ban on 'Swaps'

by Nancy Spannaus

Sept. 14—The Local Government Committee of the Pennsylvania State Senate held a five-hour public hearing in the state capital of Harrisburg Sept. 9, debating whether to ban local governments and municipal authorities from gambling with taxpayers' money through interest-rate swaps. The practice has become widespread during recent years, leading to the ripoff of hundreds of localities across the United States and Europe, to the tune of billions of dollars. One of the most prominent examples recently is the City of Detroit, which is in hock for hundreds of millions on a swap contract which "went bad," resulting in the city owing huge payments to mega-banks.

Two bills are before the Pennsylvania Senate that would ban the swaps, S. 903 and S. 904. They were introduced on June 7, 2013, by Sen. Mike Folmer (R) and Sen. Rob Teplitz (D). Folmer's legislation would ban interest-rate swaps for all local governments, school districts, and taxing authorities, as part of a municipal finance-reform package, while Teplitz's bill would ban Philadelphia and its school district from using swaps. As *EIR* has pointed out (see " 'Swaps'/Gambling Slams School Districts" in the Sept. 6 issue), Pennsylvania localities, including school districts, were particularly hard hit by interest-swap scams since they were legalized in the state in 2003.

The Pennsylvania Department of Community and Economic Development has calculated that, all told, the Commonwealth is on the hook for more than $17 billion due to these financial practices.

None of these ripoffs would have been possible, if Wall Street had not succeeded in repealing FDR's Glass-Steagall bill in 1999, thus removing prohibitions against such gambling by commercial banks. Senator Folmer, realizing this, has also declared his support for the reinstatement of Glass-Steagall by Congress. His full statement can be found in *EIR*'s Aug. 2 edition. There is currently a Pennsylvania State Assembly resolution calling for Glass-Stegall, H.R. 73, with 42 co-sponsors.

Former Auditor-General Speaks Out

Among the speakers at the hearing was one of the most informed individuals on the subject in the state, Jack Wagner, who served as the state's Auditor General from 2005 to 2013. He conducted numerous investigations into the swaps ripoffs, and made referrals to law enforcement and regulatory authorities for the unscrupulous actions of financial institutions that were involved in the transactions, including Wells Fargo, JPMorgan Chase, Deutsche Bank, and the Royal Bank of Canada.

Jack Wagner
Pennsylvania Auditor General, 2005- 2013

Wagner had repeatedly exposed the dangers of these financial instruments during his tenure, and called for banning them in the public sector. He spoke in favor of the bills, which would prohibit local governments and municipal authorities from using swaps.

Here are excerpts from his Sept. 9 testimony.

"Let me begin with a simple explanation. A swap is a contract between a bond issuer, such as a school district or other public entity, and an investment bank, in which the parties bet on which way interest rates will move. In Pennslvania, Act 23 of 2003 authorized local government to enter into 'qualified interest-rate management agreements,' or swaps. In theory, swaps allow government entities to enter into variable-rate debt financing in order to take advantage of low interest rates and, at the same time, hedge against the possibility of those same interest rates going up. In many instances, the public entity is given an up-front financial incentive to enter into the agreement.

"As I said, that's the theory. In reality, swaps are nothing more than a form of gambling with public funds. The party that guesses right wins and get paid; the party that guesses wrong loses and must pay the other party. How much is won or lost is determined by the size of the underlying debt, how much interest rates fluctuate, and other factors.

"How risky are swaps? Just ask Larry Summers, a former U.S. Treasury Secretary and top White House economic advisor, who is reportedly under consideration to be the next chairman of the Federal Reserve Bank. This is a man who should understand complex financial instruments. Yet as President of Harvard University from 2001 to 2006, Mr. Summers approved swaps so toxic that the school paid banks a total of almost $1 billion to terminate them.

"Hardly a day goes by without a news report of someone else getting burned by a swaps deal gone sour. Organizations of every stripe—public and private; for-profit and not-for-profit; universities; hospitals; state, local, and even foreign governments; school districts; and public authorities—have been hurt and non e are immune to the toxic effects of these transactions. Any benefits that these deals may confer—even to the fortunate few who do not lose money—pale in comparison with the enormous risks involved, risks that may lurk for literally years in the future. Is it any wonder that many commentators are now recognizing that the only reason that swaps continue to be sold so aggressively is the enomous fees and profits that they generate for the investment banks and financial services firms that seek them? Wall Street is vehemently opposed to the elimination of swaps with public entities, for obvious profit reasons.

"It is my understanding that the bills under consideration were prompted by the city of Harrisburg's experience with swaps, which were a contributing factor to our capital city's debt crisis. My own involvement with this issue began with a special investigation conducted by the Department of the Auditor General and released in November 2009. We found that the Bethlehem Area School District in Lehigh and Northampton counties had entered into the most swaps of any school district in Pennsylvania during a three-year period, 13 swaps in total. We reviewed just two of the district's swaps, because those were the only two that had concluded by the time of our investigation.

"We found that the district was the victim of a variety of deceptive marketing tactics and that it lost at least $410.2 million on those two swaps, largely due to excessive fees and other charges and a termination payment. The taxpayers of the district were then hit with property tax increases to pay for the losses incurred. Since the issuance of our report, the district heeded our advice and terminated many of its active swaps, some with positive results and some with negative results, but it still has a long road ahead.

"Unfortunately, when it comes to gambling taxpayer money in swaps, Pennsylvania school districts and municipalities are No. 1 in the nation, according to Moody's Investors Service. On a statewide basis, according to the Department of Community and Economic Development (DCED), 108 of 500 school districts—a shocking 21 percent—and 105 local governments in the Commonwealth had $417.25 billion in public debt tied to swaps between October 2003 and September 2012. The precise number of different swaps and the precise amount of debt could not be determined because DCED data may include some double-counting and some of the swap agreements filed may not have been fully acted on.

"It is important to note that this data does not include [other] public authorities, because their use of swaps is not currently tracked or overseen by state government. According to the U.S. Census Bureau's 2012 Census of Governments, there are over 1,700 municipal authorities in Pennsylvania. Therefore, the total number of local governments using swaps could be even higher than we think."

No Win

Wagner went on to give other examples of the losses suffered by local authorities, including the Delaware River Port Authority, the School District of Philadelphia, the Southeastern Pennsylvania Transportation Authority, and the Pennsylvania Turnpike Commission. He concluded as follows:

"The fundamental guiding principle in handling public funds is that they should never be exposed to the risk of financial loss. Swaps may be perfectly acceptable in the private sector, where private citizens are free to decide how much risk they can tolerate when their own money is at stake. But they should have no role in government, where it is the taxpayers' money that is at stake. Public debt should be financed with fixed interest rates that are transparent, reliable, and easily understood by decision-makers and the public.

"I also reject the counter-argument that we have heard over and over again—that not all swaps deals turn sour, and that many swaps deals have saved a great deal of money. That position brings no comfort to the many public entities that have been badly served by swaps deals that backfired. Any financial vehicles that produces winners and losers is, by definition, unsuitable for the public sector. Accordingly, I urge the committee to pass Senate Bills 903 and 904 at your earliest opportunity."