Dear Ms. Pulst,

I am writing on behalf of the Fix LA Coalition, attaching written statements prepared for the City Council Budget and Finance Committee for its June 30, 2014 hearing on Item 14-0566, Councilman Koretz's motion, which was listed as Agenda Item 3.

Attached are written statements by Wallace C. Turbeville and R. Bradley Miller, who appeared in person, and a letter written to the committee by another expert, Thomas Adams, who was unable to attend in person. I've attached bios of all three.

I also intend to submit the written statement of Lisa Cody, a research and policy analyst at SEIU Local 721, which is also a member of the Fix LA Coalition, as soon as I can obtain a copy. Ms. Cody also appeared in person. I do, however, have ready access to a Power Point she used during her presentation, so I am attaching that.

Finally, I am attaching a document entitled Renegotiating Interest Rate Swaps which was prepared by SEIU research staff.

In a separate email that will follow shortly, I will attach the "No Small Fees" report by the Fix LA Coalition, which was referenced during the hearing, and an update of that report presented earlier to the Budget and Finance Committee by the Coalition of LA City Unions, which is also a part of the Fix LA Coalition, during budget deliberations.

Thank you for your assistance.

Sincerely,

Ted Rohrlich
Director of Research and Policy
Service Employees International Union Local 721
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Los Angeles, Ca. 90017
(o) 213-251-3704
(c) 213-839-0789

Written Statement of R. Bradley Miller, attorney and former Congressman

Thank you for the opportunity to be here today.

Just a little more than a decade ago, borrowing by public entities was fairly standard and well understood. This quiet corner of finance was obviously ripe for Wall Street "innovation."

The complex transactions that Wallace Turbeville just described were not designed to improve municipal finance for issuers or investors, but to make more money for underwriters.

Without addressing the specific circumstances of the Los Angeles financings, the financings created significant risk that was lopsidedly if not entirely borne by issuers. The Municipal Securities Rulemaking Board's fair dealing rule requires an understandable disclosure of known material risks.

The rule recognizes that there is a disparity between underwriters and even the most sophisticated issuers, which would almost certainly include the City of Los Angeles, in understanding the mind-numbingly complex financings designed by underwriters.

The MSRB issued an Interpretative Notice and Guidance on Implementation of that notice in 2012 specifically on duties of underwriters to issuers in complex financings. The MSRB said that the substance of the required disclosures "arise from the same fundamental duty of fairness to the issuer that the MSRB has already required under Rule G-17 for some time."

The MSRB said that an underwriter could not treat a presentation "as merely a sales pitch without regulatory consequence," but as something issuers can rely upon to be "true and accurate."

The Guidance requires underwriters to "disclose the material financial characteristics of the complex municipal securities financing, as well as the material financial risks of the financing that are known to the underwriter and reasonably foreseeable at the time of the disclosure," including risks associated with a recommended swap. The disclosure "should be sufficient to allow the issuer to assess the magnitude of its potential exposure as a result of the complex municipal securities financings." The "disclosures must be made in a fair and balanced way based on principles of fair dealing and good faith."

The Guidance said that "[p]age after page of complex jargon in small print would not satisfy the requirements."

Major banks now argue that the financial crisis was an unforeseeable “perfect storm,” a “black swan.” Others, including the majority of the Financial Crisis Inquiry Commission, disagree. Every major underwriting bank employed teams of highly credentialed economists who could hold tenured faculty positions at any university in the world. Underwriters undoubtedly knew the risks of complex municipal financings. If the banks did not know precisely what would go wrong, they knew that something might go wrong, certainly over the term of the swaps.

The written presentations by underwriters that we have seen were merely a sales pitch. The presentations minimized risks to issuers if the presentations mentioned the risks at all.

A handful of cases in lower federal courts have held that violation of MSRB rules does not create a private right of action. If those cases are correct, Los Angeles cannot sue in court for violation of the MSRB fair dealing rule. But under the federal securities laws, the MSRB can “provide for the arbitration of claims, disputes and controversies relating to transactions in municipal securities.” The MSRB allows arbitration of claims under their rules by the Financial Industry Regulatory Authority, or FINRA.

Any remedy that arbitrators might award would like result in very significant recoveries for many public entities.

It is possible, maybe likely, that the boilerplate in the financing documents said that the exclusive forum for any dispute is litigation in court. The courts have reached different conclusions on whether such provisions are effective, but the federal appeals court for California recently decided that they were. The law in that area is new and still developing.

In any case, any public issuer considering arbitration should act quickly. The FINRA rules require claims to be brought within six years of the events that give rise to the claim, but are reasonably flexible about when that period begins. Since the most acute phase of the financial crisis was six years ago this fall, any public issuer that wants to protect their legal rights should analyze potential claims and act quickly.

I welcome any questions.

R. Bradley Miller | Of Counsel to the law firm Grais & Ellsworth, LLP

R. Bradley Miller became Of Counsel to the firm in 2013 after serving for a decade in the United States House of Representatives.

As a member of the House Financial Services Committee, Mr. Miller led efforts to enact financial reform legislation, including legislation to prohibit predatory mortgage lending and create the Consumer Financial Protection Bureau, or CFPB. He also led efforts to address the foreclosure crisis and reform the private mortgage securitization market.

"Depending upon your perspective," *New York Times* columnist Gretchen Morgenson wrote, "Mr. Miller is either the right man in the right place on Capitol Hill—if you're a consumer—or a threat to the status quo."

As chairman of the Investigations and Oversight Subcommittee of the House Science Committee, Mr. Miller led investigations into contamination by formaldehyde fumes of trailers that the Federal Emergency Management Agency provided families displaced by Hurricane Katrina; contamination of drinking water at Camp Lejeune, North Carolina, by various chemicals over a 30-year period; and delay and obstruction of assessments of public health effects of chemical exposure under the Environmental Protection Agency's Integrated Risk Information System, or IRIS. He worked with the House Democratic leadership to develop the legal strategy to enforce congressional subpoenas issued to the Bush Administration concerning the firing of U.S. Attorneys.

Mr. Miller has been interviewed on almost every cable news channel, including MSNBC, CNN, Fox News, Fox Business, CNBC, Bloomberg, Current TV, and Al Jazeera America, and has frequently been quoted in national publications on a variety of issues, especially financial reform and housing. He has published opinion articles in national publications, including *Politico, Rollcall*, *The Hill*, *The Wall Street Journal*, *American Banker*, *Bloomberg View*, *The New Republic*, *Huffington Post*, and *Salon*.

Before election to Congress in 2012, Mr. Miller practiced law for more than 20 years in North Carolina. He argued issues to North Carolina appellate courts as diverse as liability for environmental cleanup costs under general liability insurance policies, will interpretation, the priority of security interests, the rights of public employees, and the rights of developmentally disabled adults. He served for two years in the North Carolina House of Representatives and six years in the North Carolina Senate.

Since joining the firm, Mr. Miller has testified before Congress on the effect of the Dodd-Frank Act on community banks; wrote the chapter on regulatory enforcement in *An Unfinished Mission: Making Wall Street Work for Us*, published by Americans for Financial Reform and the Roosevelt Institute; and was principal author of an *amicus curiae* brief for 19 current and former members of Congress on the "cross-border" enforcement of the Commodity Futures Trading Commission's swaps rules under the Dodd-Frank Act.

Mr. Miller is also a Senior Fellow at the Center for American Progress.

Education

- Columbia University, JD 1979
- London School of Economics, MS 1978
- The University of North Carolina at Chapel Hill, BA 1975

Other Employment

- Senior Fellow, Center for American Progress, 2013-present

Previous Employment

- United States House of Representatives, Member 2003-2013
- North Carolina Senate, Member 1997-2002
- North Carolina House of Representatives, Member 1993-1994
- Private law practice with various firms, 1980-2002

Judicial Clerkship

- The Honorable J. Dickson Phillips, Jr., U.S. Court of Appeals for the Fourth Circuit, 1979-1980

Bar Admissions

- North Carolina, 1979
- EDNC, MDNC, Court of Appeals for the Fourth Circuit

Written Statement of Wallace Turbeville, Senior Fellow, Demos

Time for a Careful Look at Los Angeles' Financing Cost

Before 2008, municipalities were prime targets for banks and insurance companies that were intent on taking advantage of customers in the evermore complex financial markets. This has changed little. However, the wreckage from the financial crisis and the Great Recession has cast a spotlight on these practices, even more intense for cities with budget challenges.[1] For Los Angeles, as in many municipalities, a focused analysis of the cost of financing operations is clearly in order.

Municipalities, large and small, throughout the nation routinely enter into financial transactions with banks and insurance companies that are unfavorable in terms of pricing or risk, or often both. Typically, excessive costs go unnoticed. After the deals close, questions are rarely raised. Tragically, excessive risk is more likely to become a headline after the fact when deals go bad. The consequences can be catastrophic.

Why do municipalities so often enter into bad deals?

More often than not, local governments do not know they are getting a bad deal.[2] This is not a question of their professional competence or honesty of municipal administrators or elected officials. Rather, mispricing and excessive risk are far more often either intentionally hidden or involve such complex financial structures that no one but large sophisticated banks could comprehend them, at least prior to the lessons learned from the crisis. In finance, risk and price are closely related. The price of a bond or a derivative is a mathematical function of risk. If the issuer takes on more risk, the investor will pay a higher price. Both ends of this spectrum can be exploited. Below are some examples of how this works:

Obscure Pricing. There are over 44,000 individual municipal issuers with no central exchange, preventing any semblance of transparency within the municipal bond market. Pricing in this market has been made even more complex by the types of products sold to unsuspecting cities throughout the land. Central to this is that the interest paid on almost all municipal debt is exempt from income taxes in the hands of the holders. This means that the investor base for municipal debt is narrower than for conventional debt and has very specific needs. That means fair pricing can be difficult to ascertain.

It also means that local governments are often sold financial structures and products that private companies would be highly unlikely to entertain. The 2006 Los Angeles Wastewater financing is a perfect example of that, with long-term insured floating rate debt tied to a long term LIBOR swap. (See Appendix)

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[1] The Dodd-Frank financial reform act recognizes the special susceptibility of local governments to unfair pricing and risk. The act requires outside financial advisors to municipalities, who typically negotiate alongside the local governments with the banks and insurance companies, to register with the SEC and meet minimum standards and imposes a fiduciary duty on them. It also charges banks marketing derivatives to local governments (and to pension funds) with higher duties than when they deal with private customers. Unfortunately, the financial sector was able to push for important loopholes when the implementing regulation for both of these provisions that were adopted. For example, methods for indirectly influencing financial advisors were exempted and ways for banks to both sell products and advise on their sale were allowed.

[2] There is little doubt that influence is sometimes paid for by the banks and insurance companies. Over the last thirty years there have been numerous prosecutions and settlements that have been based on such bad behavior. But clearly graft is nowhere near the primary problem, though often receiving most of the headlines.

Excessive Complexity. Banks routinely use this complexity to their advantage. The cost paid for simple debt can be elusive. But banks are constantly pushing even more complex deals. A great example is the 2006 Los Angeles Wastewater deal. (See Appendix) When the transactions reach such a level of complexity, assessing the fairness of costs is extraordinarily difficult. Therefore, even if the complex structures are a good idea – and most often they are not because of the extraordinary risks embedded in them – the fairness of the pricing is murky at best.

Misrepresentation of Risk. Banks and financial advisors often market derivatives as insurance or hedges against interest rate risk embedded in complex financing schemes that they urge on local governments representing that the schemes are better than simpler alternatives. However, these derivatives incorporate multiple severe risks that they often either downplay or do not fully disclose. Moreover, the pricing of the derivatives, both the fair market price and the risk adjusted price, is typically obscure. The clearest examples of this are interest rate swaps, often in large amounts and for decades long duration that are rarely used in the corporate world. Kalotay and Associates has estimated that cities and other public entities have incurred billions of dollars in unnecessary fees on swaps. Even worse is the embedded risk. These derivatives devastated the finances of school districts like Denver, Philadelphia, and Wisconsin and wreaked havoc on cities like Harrisburg and Detroit. The example of Detroit is telling. Detroit's derivatives were part of a complex financial deal that Wall Street banks urged on the city and which received accolades and awards at inception. This same deal was the biggest contributing factor to the City's legitimate debt and its liquidity problems. The Pennsylvania state auditor wrote a scathing analysis of swaps, leading to their prohibition in the state.

Churning. Municipalities do not pay income taxes on revenues or on earnings from the investments that they hold. Coupling this with the tax exemption on municipal bond interest means that it can be very advantageous for municipalities to refinance debt. [3] Banks will often take advantage of this situation, by promoting debt refinancing often by providing questionable analysis of savings; and some debt issues have been refinanced time and again. Long term, fixed interest rate municipal bonds almost always include special provisions allowing municipalities to retire the bonds early to take advantage of low interest. The valuation of this right is actually an embedded derivative and is extremely complex, providing financial institutions with the opportunity to profit from unnecessary deals and obscure pricing of the debt. Therefore, even the simplest debt is very complex, making its cost very difficult to understand.

Bid-rigging. There are numerous examples of where banks have colluded to fix prices outside of competition. A wide spread scheme relating to bid-rigging in the investment of bond proceeds (known as "yield burning") was prosecuted after a whistle blower disclosed the practice. Just this month, the SEC brought charges on a pay-to-play arrangement relating to Philadelphia and Pennsylvania. Another example are the Guaranteed Investment Contracts (GICs) where federal investigations found that banks colluded to allow a designated winner to see competing bids and thus offer a lower interest rate on government investments, cheating taxpayers out of hundreds of millions of dollars.

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[3] Because of the tax exemption, interest rates on municipal debt are routinely below the interest rate on treasury securities. Municipalities can borrow in a financing and collateralize old, higher interest rate debt with treasuries until the special call date on the old debt rolls around. Because the old debt is collateralized with treasuries, the municipality's obligations under the old debt cease and the new, lower interest debt replaces it, even though both the old and new debt are still held by investors. These "advance refundings" are often opportunities for overcharging by banks and insurance companies.

Wallace C. Turbeville

Senior Fellow, Demos

Wallace Turbeville practiced law for seven years before joining Goldman, Sachs & Co. in 1985 as an investment banker. In his twelve years at Goldman, he specialized in infrastructure finance and public/private partnerships. From 1990 through 1996, he was posted to the London office where he was co-head of a group tasked to pursue financing of transportation, energy and environmental projects, particularly in the newly opened eastern European nations. While in London, Mr. Turbeville served on the consultative Committee for Public/Private Partnership Finance of Transportation Infrastructure of HM Treasury.

In 1997, Mr. Turbeville founded, and became Managing Partner of, the Kensington Group. The firm focused on financial advisory services in domestic and international energy, environmental, transportation and telecommunications sectors. In late 2000, the firm was engaged to advise public and private clients relating to the California energy crisis. In the process of these assignments, Mr. Turbeville observed credit management weaknesses in the derivatives markets. He led the development of an innovative business model for the post-trade management of credit exposures in over-the-counter derivatives transactions, adapting many of the characteristics of traditional clearing for initial application in the OTC energy markets. This business was spun off as VMAC LLC in late 2002, and Mr. Turbeville became its Chief Executive Officer.

Mr. Turbeville left VMAC in late 2009 to devote his efforts to financial reform, energy and environmental policy issues. He served as Visiting Scholar at the Roosevelt Institute and authored nearly 30 articles concerning financial reform, energy, the environment and political opinion.

In October 2010, Mr. Turbeville joined Better Markets, Inc. He was the primary author of dozens of comment letters relating to proposed rules and studies implementing the Dodd-Frank Act of the Commodity Futures Trading Commission, Securities and Exchange Commission, Financial Stability Oversight Counsel and the Federal prudential banking regulators. He resigned from Better Markets in late 2011 to devote time to interests in New York City while continuing to assist Americans for Financial Reform in its efforts relating to the Volcker Rule and derivatives regulation. He has testified on financial reform issues before the Permanent Subcommittee on Investigations of the US Senate Committee on Homeland Security and Governmental Affairs and the House Financial Services Committee.

Thomas J. Adams
99 Hudson Street
New York, NY 10013

City of Los Angeles June 27, 2014

Ladies and Gentlemen:

I have been asked to provide a brief statement on the Los Angeles City Administrative Office's (CAO) May 30, 2014 report and summary on the City's bond issuance and fees and its response to Fix LA Coalition's "No Small Fees" report. I am a twenty-five year veteran of the finance industry, with a background as an attorney, credit analyst, senior executive at a municipal bond insurance company and a financial consultant to investors, regulators, law makers and other interested parties.

The CAO's report provides an excellent description of the various bonds and programs, as well as the rationale behind these programs and issuances. Clearly, the CAO and the people responsible for the programs are highly skilled and attentive to the needs of the City.

As a financial professional who worked at municipal bond insurance companies Ambac Assurance Corporation and Financial Guaranty Insurance Company for over 11 years, my observation is not that the CAO was negligent in the issuance of debt but rather that the CAO's report highlights how Wall Street works as it relates to municipalities.

Because large municipalities, as a part of their structure and organization, have regular on-going funding needs, they are desirable clients for Wall Street banks. In other areas of business, such clients might be wooed or enticed with special service or volume discounts. Sadly, the prevailing view is that if a client needs to issue debt, particularly on a recurring basis, then they have a weak hand for negotiation. Wall Street banks see the recurring debts as an opportunity for additional fee extraction.

While cities are managing issues relating to the many economic complexities of a modern municipality, in the same transactions Wall Street banks are primarily concerned with how much they will be paid for the issuance. The city takes real economic risks (which it works diligently to minimize) when it issues debt programs based on future revenue collections, payment obligations and interest rate movements. Wall Street banks, however, effectively take virtually no risk for their roles in the transactions and are focused, instead, on fee maximization. This is prevailing truth, ultimately is the crux of the argument being made in the Coalition to Fix LA's report: municipalities such as Los Angeles need to take an approach to its debt programs that matches the approach that Wall Street banks take to them.

Wall Street is looking to maximize the fees it can charge on the transactions, consequently, municipalities need to be looking to minimize such fees to the maximum extent possible and level the playing field.

The 2006 Wastewater System revenue bonds, discussed in the CAO's report, serve as an excellent example. As noted, the city faces risk in transactions such as this, including risks related to future interest rate movements. Because the city faces such risk, Wall Street sees an opportunity for additional fees. No one can accurately forecast long range interest rates, of course, and few people could have anticipated the catastrophic macroeconomic events that would lead to a massive drop in future interest rates. However, while the city worked to structure a transaction that would incur low current debt payments and be protected from future interest rate movements, the banks managed to structure a transaction that would maximize fees under a variety of potential outcomes. While the drop in rates was not easily anticipated, when it happened, Wall Street was set up to be paid multiple times over.

First, increasing the complexity of the deal,is an important mechanism for maximizing bank fees. They are paid more for such transactions and they provide an opportunity for banks to build in more advantageous features for themselves than would exist under simple debt terms. While the city no doubt diligently negotiates terms to protect itself from the additional complexity, simply by entering into the more detailed agreements, the city has created an opportunity for the banks to extract more fees, such as when an interest rate swap is terminated.

Second, because of the deal structure, the City hired monoline municipal insurers to insure a portion of the bonds. As an employee at such a firm at the time of this issuance, I am certain we were happy with that decision. Unfortunately, while it was, again, not easily anticipated at the time, the municipal bond insurers were devastated by the financial crisis and their credit ratings were substantially downgraded shortly after Wastewater Systems transaction closed. This had the unfortunate effect of adding challenges and costs for the city when considering a refunding of the bonds.

At the risk of upsetting some of my former co-workers, I note that it is additionally unfortunate that the City was persuaded to add the expense and complexity of bond insurance to the transaction. The City has never defaulted on its debt; yet it effectively, took on the risks embedded elsewhere in the portfolio of the bond insurers by including them in the transaction. Like Wall Street banks, bond insurers are focused on the fees they will be able to extract from the transactions on which they might participate rather than the risks and expenses a municipality might face when entering a transaction with them.

It is not my intention to suggest that the City should be able to anticipate unlikely or extreme events better. Rather, because such events create challenges and complexities which will be used as opportunities for additional fee extraction, the City should be vigilant in maximizing its negotiating leverage, simplifying its structures, and maintaining awareness of how Wall Street maximizes its own benefits from the municipal debt transactions.

I would be pleased to discuss these issues in further detail, should the City Council, CAO or other recipients of this letter so desire.

Best regards,

Thomas Adams

Thomas J. Adams Partner, Paykin Krieg & Adams LLP

Mr. Adams is a twenty-five year veteran of the financial services industry. He draws on his experience as both a lawyer and credit analyst to provide clear, understandable explanations and advice for the complex issues underlying financial markets and securities, structured finance, municipal securities and the credit markets. Mr. Adams advises financial institutions, investors, hedge funds and other parties on issues relating to the mortgage market, asset-backed securities, credit derivatives, financial guarantors, mortgage insurance companies, municipal securities and industry customs, practices and trends. In addition, he has worked extensively on consumer finance issues relating to residential mortgage foreclosures and bankruptcies.

Mr. Adams is frequently cited as an expert on securitization and financial industry matters and has been quoted in major publications, such as Time Magazine, BusinessWeek and Bloomberg News. He has discussed similar issues on television programs such as Bloomberg TV and the Business News Network (Canada). Mr. Adams has spoken at numerous industry conference panels and investor and research company presentations. Mr. Adams has acted as an advisor and contributor to influential financial website Naked Capitalism with featured analysis on AIG, the Federal Reserve's Maiden Lane transactions, collateralized debt obligations, and mortgage loan foreclosure issues. Mr. Adams was previously a principal in the distressed securities investment firm of FairHope Capital, LLC and a principal in Trade Metrics Corporation. Over the course of his career he has had extensive interaction with the lenders, servicers, rating agencies, bank analysts, traders, regulators, accountants, attorneys and other parties to the structured finance, credit and debt capital markets. Mr. Adams has a JD from Fordham University School of Law and a BA from Colgate University.

Renegotiating Interest Rate Swaps

By SEIU Research Staff

Wall Street banks sold risky interest rate swap agreements to thousands of public entities by telling them it would save them money on borrowing costs, but the opposite happened. Banks are now making millions in profits from these toxic deals, even as our governments are cutting services to our communities. These swaps are costing our communities hundreds of millions in fees each year. The banks argue that these contracts cannot be broken, and demand tens and even hundreds of millions in termination fees to unwind the swaps.

Across the country and overseas, however, there are a growing number of cases where public entities have successfully renegotiated swap agreements without penalties. Questionable practices and/or legal pressure have often facilitated these negotiations. There are, however, also cases where municipalities have renegotiated swaps successfully without these independent supports. Moreover, there is also evidence suggesting that the banks did not fully and accurately disclose the risk involved in these transactions and that this practice was widespread. As a result there are potential legal remedies through arbitration and in the courts. Even without a legal angle, the City of Los Angeles should use their ability to deny business contracts as a way to exert pressure on the Bank of New York Mellon and Dexia to renegotiate the swaps without penalties.

Richmond negotiates better terms for its swap:
In 2007, the Richmond Community Redevelopment Agency entered into a swap agreement with the Royal Bank of Canada that was connected to a $65 million variable rate Tax Allocation bond.[1] With the financial crash, the city's bond interest payments and swap payments drastically increased. As a result in 2010, the city decided to refinance the remainder of the 2007 bond and in the process also successfully renegotiated its swap agreement. Whereas in the original swap, the city paid a fixed rate of 3.99%, in the new swap the city's swap payments were based on 100% of SIFMA plus a fixed 0.83%.[2] As a result the city was able to reduce its annual swap payments by nearly $2 million.[3]

City of San Francisco Steps in to Save Asian Art Museum:
In 2005, JP Morgan Chase advised the Asian Art Museum of San Francisco to refinance bonds from a fixed to a variable rate. As part of the transaction JP Morgan sold the Museum a swap to hedge the interest rate risk and advised them to purchase insurance from MBIA to lower the Museum's risk to investors.[4] In 2008, when MBIA was downgraded, the museum's interest rate skyrocketed.[5] In 2009, JP Morgan Chase required the Museum to purchase a letter of credit to stabilize the interest rate. When the letter of credit was due to expire, JPMorgan refused to renew, which would require the Museum to pay the bonds in full and trigger a swap penalty payment to JPMorgan Chase. In early 2011, San Francisco city officials stepped in to save the museum, negotiating an agreement with JPMorgan to restructure the debt into fixed rate bonds and cancelling the swap agreement the Museum had with JPMorgan Chase without penalties.[6]

Jefferson County, Alabama receives relief:
In 2002, JPMorgan Chase advised Jefferson County officials to refinance their sewer bonds from a fixed rate to variable rated bonds with $2.7 billion in swaps attached. Over the next two years the county acquired an additional $3.1 billion in swaps with various banks for a total of $5.8 billion. When the financial crisis hit, the deals became toxic. The variable interest on the bonds skyrocketed and the variable rate paid by the banks on the swaps plummeted.[7] In 2009, the Securities and Exchange

Commission filed charges against JPMorgan Securities Inc. and two of its directors that it illegally paid off officials in Jefferson County, Alabama to secure interest rate swap deals. As part of the settlement, JP Morgan Securities agreed to forfeit payment on more than $647 million in swap termination fees.[8]

Detroit saves $260 million in swap termination fees:
When Detroit's emergency manager filed for bankruptcy, the City of Detroit estimated that it owed Bank of America and UBS $345 million in swap termination fees.[9] The two banks attempted to extract payment outside of the bankruptcy proceedings by negotiating with the city just days before the filing, thus jumping to the front of the line of creditors including Detroit's pensioners who'd given their working lives to the city.[10] In the end, judicial pressure and political resolve from elected officials enabled the City to negotiate the swap payments down to $85 million.[11] The bankruptcy judge refused to accept initial terms of payment, arguing they were too generous.[12] The Detroit City Council voted unanimously to reject a proposal from the emergency manager to obtain a loan from Barclay's to fund the swap payments.[13] And Detroit's emergency manager filed suit against the banks alleging that the initial bond offering they had structured on which the swaps were based was illegal and thus the swaps were invalid as well.[14] Together these proactive steps allowed the city to renegotiate the swaps and save the City $260 million.

Alabama Utility Wins $7.5 million Arbitration Award:
Between 2002 and 2007, under the advice of AmSouth Bank, the Baldwin County Sewer Service LLC, sold $42 million in variable rate debt that included four swap agreements. When the financial crisis hit, they were locked into the fixed rate of the swap, while the payments received from the bank plummeted. In a recent arbitration hearing, the arbitrators found that the bank failed to communicate the true risks of the swap and actively misrepresented the utility's potential financial obligations. As a result the utility won a $7.4 million refund in swap payments made since 2008 and cancellation of an $8 million termination fee.[15] The misrepresentation and lack of disclosure on the part of the bank have clear parallels in financial institutions' dealings with municipalities.

European officials take on banks' derivatives dealings:
The British Financial Conduct Authority (FCA) found that nine banks had inappropriately sold interest rate swaps to small businesses since 2001, costing them millions in losses. In May 2013 the FCA ordered the banks to pay compensation plus interest, and the banks have allot nearly £4 billion ($6.8 billion U.S.) for payments. These small businesses were sold the swaps based on the understanding that it would save them money, without the understanding of the risks involved.[16] Similary, in 2011, the German's Highest Court of Appeals ruled against Deutsche Bank for failure to disclose risks involved in its swap agreements and the profits to be had, and ordered the bank to pay compensation.[17]

Ethically, legally, morally and financially, it's our responsibility to act: As our elected representatives, the Mayor and City Council are entrusted with protecting the City's resources. Like other public entities both in the U.S. and abroad, ***we should make every effort to recoup the losses and terminate the swaps without further cost to our communities.***

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[1] City of Richmond Comprehensive Annual Financial Report for the Year ending June 30, 2009, pp. 81 & 85, http://www.ci.richmond.ca.us/DocumentCenter/View/5386.

[2] City of Richmond Comprehensive Annual Financial Report for the Year ending June 30, 2009, pp. 81 & 85, http://www.ci.richmond.ca.us/DocumentCenter/View/5386; City of Richmond Comprehensive Annual Financial Report for the Year ending June 30, 201-, p. 79, http://www.ci.richmond.ca.us/DocumentCenter/View/6622.

[3] Based on LIBOR and SIFMA interest rates prevailing in March 2010.

[4] San Francisco Asian Art Museum Financial Crisis Facts (Factsheet previously legalized by SEIU legal dept).

[5] http://artsbeat.blogs.nytimes.com/2011/01/11/deal-could-help-asian-art-museum-in-san-francisco-fend-off-bankruptcy/

[6]http://sfmayor.org/ftp/archive/mayornewsom/press-release-mayor-newsom-city-attorney-herrera-city-controller-ben-rosenfield-president-chiu-and-asian-art-museum-foundation-announce-proposal-to-restructure-foundation%27s-debt/index.html

[7] http://www.bloomberg.com/apps/news?pid=nw&pname=mm_0708_story2.html

[8] http://www.sec.gov/news/press/2009/2009-232.htm; http://www.washingtonpost.com/wp-dyn/content/article/2009/11/04/AR2009110404582.html.

[9] http://dealbook.nytimes.com/2014/01/16/judge-rejects-detroits-deal-to-exit-swap-contracts

[10] http://www.nytimes.com/2013/08/16/opinion/no-banker-left-behind.html

[11] http://www.freep.com/article/20140303/NEWS01/303030133/Kevyn-Orr-bankruptcy-city-of-Detroit-Bank-of-America

[12] http://www.freep.com/article/20131218/NEWS01/312180095/Bankruptcy-judge-Detroit-swaps

[13] http://www.freep.com/article/20131021/NEWS01/310210121/Detroit-City-Council-Kevyn-Orr-Barclay-loan

[14] http://dealbook.nytimes.com/2014/01/31/detroit-sues-to-cancel-some-costly-contracts

[15]

http://www.google.com/url?sa=t&rct=j&q=&esrc=s&source=web&cd=1&ved=0CB8QFjAA&url=http%3A%2F%2Fwww.bloomberg.com%2Fnews%2F2014-06-09%2Falabama-utility-shows-how-to-win-back-bank-swap-fee-muni-credit.html&ei=DWmsU8jqHZGeugSj6oKoCA&usg=AFQjCNE-868o29OANAfbs_K3AX8dMPfKtw

[16] http://uk.reuters.com/article/2014/03/05/britain-banks-misselling-idUKL6N0M21PR20140305; http://www.fca.org.uk/consumers/financial-services-products/banking/interest-rate-hedging-products

[17] http://dealbook.nytimes.com/2011/03/22/german-court-rules-against-deutsche-bank-in-swaps-case/?_php=true&_type=blogs&nl=business&emc=dlbkpma21&_r=0; http://online.wsj.com/news/articles/SB10001424052748704355304576214900864332050

Why the City Said It Bought Swaps

"For the cost of the swaps, the program is getting a hedge against rising interest rates. The City was able to lock in a fixed swap rate during a period of historically low interest rates. <u>As rates increase</u>, the City will receive higher amounts of money from the counterparties as those payments are based on a variable index that <u>increases</u> as the rates paid on the bonds <u>increase</u> (although not always proportionally)."

How Swaps Really Work

The swaps gave the City a hedge against rising interest rates.

But the City agreed to lock itself into making fixed rate payments to its bank swaps partners for 22 years whether interest rates increased <u>or decreased</u>.

In return, the banks agreed to pay the City a variable rate linked to LIBOR that would likely increase or decrease together, although not necessarily proportionately, with the variable rate the City was obligated to pay its bondholders.

True Costs of Swap Deal—
A City Trapped

- **Gretchen Morgenson of the New York Times:**

  "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."

CAO Report Doesn't Tell This Full Story

Actual Cost of Bonds with Swap to date:

$316.8 mn (bonds) x .0334 (synthetic fixed) x 9 (years) = $95.2 mn

+ issuance costs + liquidity costs = **$104.1 mn**.

CAO's alternative scenario of non-refunded fixed rate bond:

$316.8 mn (bonds) x .043 (fixed rate 2006) x 9 (ears) = $122.6 mn

+ issuance costs = **$125.8 mn.**

The CAO's scenario is unrealistic:

- ***CAO assumes that City would not refund that debt at historically low interest rates***

What is Missing from CAO's Report?

Fixed rate bond without swap:

- City could have refinanced at any time.
- The City certainly would have refinanced after Wall Street crashed the economy and the Federal Government cut interest rates at new record lows.

VS.

Variable rate bond with swap:

- The City ***gave up*** option to refund the debt for the entire 22 years of the bond deal
- The City ***was unable*** to take full advantage of rock bottom interest rates
- **<u>Giving up the option to refinance</u> will cost the City tens of millions of dollars over the life of the bonds**

Why Are We Certain the City Would Have Refinanced?

- The City has refinanced when it wasn’t locked into an interest rate swap.
- The City’s Debt Management Policy has the CAO regularly monitor potential savings available by refunding
- The City has saved hundreds of millions of dollars in the last 5 years through the refunding of bonds.
- The City paid tens of millions in termination fees to its swap partners just for the right to refinance part of its debt.

The Total Costs of Swaps Deal to the City (over life of bonds)

- **$104.1 mn** = cost of swap through May 2014
- **$34.2 mn** = fixed interest on 2012 refunded bonds
- **$26.1 mn** = repayment bond issued for swap termination
- **$5.4 mn** = interest on additional $26.1 m in new bonds
- **$68.4 mn** = Principal interest + swap payments on swapped bonds
- **$9.1 mn** = letters of credit required for swaps deal

- **$247.3 mn** = **TOTAL COST** over the life of the swapped deal

Fixed Rate Debt Cost
(in accordance with Debt policy)

- **$81.7 mn** = fixed interest 4.3% for first 6 years
- **$104.5 mn** = interest on refunded remaining bonds 11 years
- **$8.3 million** = call premium on remaining principal

- **$194.5 million** = **TOTAL COST** fixed interest rate with 2012 refunding

"The Full Monty" on Wastewater Debt

Costs over life of bonds

Variable Rate Swaps Deal:	$247.3 million
Fixed Rate (no swap):	– $194.5 million
Swaps Deal Costs City	**$52.8 million**

The Swap Trap

- The City ***gave up*** its option to refinance when interest rates hit historic lows.
- The City was ***locked into*** swap deal for 22 years
- Financial institutions sold these deals to municipalities ***to extract profits***
- In the ***private sector***, there is ***no such thing*** as a swaps deal for 22 years
- In the private sector swaps deals range from ***1 to 7 years***

Chairman Krekorian and Members of the Committee, I appreciate and thank you for the opportunity to testify today.

I believe it is safe to say that no matter what side of the aisle you are on, no one disputes:

That Wall Street's reckless, unethical, and sometimes illegal actions caused the greatest financial crisis since the Great Depression

That Wall Street made huge profits from its own reckless behavior before, during, and after the crisis, and today continues to do so.

That the "Too Big to Fail" and "Too Big to Jail" mentalities in this country have allowed financial institutions to run wild.

We believe that LA should lead the way and set its own precedent—hold Wall Street accountable where others have not and let Wall Street know we are "Too Big to Be Ignored."

From the day the Fix LA Coalition was born, our goal has been to partner with the City—its Council members, the CAO, the Mayor, and others—to spur initiatives aimed at reducing the fees that Wall Street takes from the City and redirecting those savings into the vital services that Angelenos desperately need. We reject the notion that the practices and assumptions of the finance industry are fixed and unchangeable and so should the City of LA.

We must shine a light on the nature and extent of the City's transactions with Wall Street—creating a level of transparency that has no parallel and will facilitate a greater understanding of the potential savings that can be achieved. We applaud and appreciate that the CAO has already committed to implementing a debt management data base to better track all costs associated with debt.

In our report, “No Small Fees” the Coalition does not question or criticize the City’s need to issue debt to pay for infrastructure and public services nor do we suggest that the City does not vigorously negotiate to get market rates. We do question, however, whether the “market rates” Wall Street is offering municipalities are reasonable and fair.

In fact, there is a growing chorus of academic and industry experts—some of whom will testify today—that report a troubling, nationwide trend of municipalities getting ripped off—“that municipalities pay significantly more than other market participants for essentially the same product.”

Nobel prize winning economist Paul Krugman had this to say about financial innovations such as interest rate swaps. “They were promoted as ways to spread risk, making investment safer.

"What they did instead—aside from making their creators a lot of money, which they didn't have to repay when it all went bust—was to spread confusion, luring investors into taking on more risk than they realized."

We believe that government officials must take bold action to do whatever it takes to prevent the fleecing of taxpayers going forward and to recoup losses that have occurred as a result of the deceptive marketing of derivatives such as interest rate swaps by Wall Street firms.

We ask that the City pursue every possible avenue whether legislative, regulatory, legal, or otherwise to reduce the fees that the City pays to Wall Street, to renegotiate bad deals, and to invest those savings in order to better serve the people of Los Angeles.

We have suggested the following to that end:

1. Reduce fees through the in-sourcing of financial advisors;

2. Explore legislative or administrative remedies that would permit the City to negotiate debt as a single entity with one credit rating or develop methods which more effectively force banks to compete against one another;

3. Explore alternative sources of credit enhancement for the City's debt;

4. Pursue all legal actions against banks related to the manipulation of interest rate indexes;

5. Exercise its fiduciary responsibility to taxpayers by exploring all options to renegotiate the swaps deal that over the life of the bonds will cost this City over $50 million in losses; and finally,

6. When and if negotiation fails, refuse to do business with banks that are happy to profit off the very products they created to deceive the public.

It is within the context of the Coalition's collaborative approach to helping the City save money, that we find the nature and tone of the CAO's May 30th and June 27th reports both troubling and problematic.

(1) Although we appreciate the CAO's discussion of why the City issues debt and how its interest rates compare with other municipalities, we fail to see how the report addresses the Coalition's concerns about the fees that the City of LA is paying for its financial transactions.

Furthermore, making these comparisons misses the point, which is that municipal governments in general are likely paying far too much—and much more than players in the private sector.

To be blunt, the idea of comparing Los Angeles' record in this area with that of other municipalities would be like comparing two ships and finding that one is doing better because it is sinking more slowly than the other.

(2) However, the most troubling aspect of the CAO's report is the position that was taken with regard to the City's swap deals with Mellon and Dexia.

The CAO has asserted, even with the benefit of hindsight, "[t]he bottom line is we still ended up ahead. The swaps are saving us money."

According to a newspaper article, the CAO asserted that from "2014 through 2028, the swaps will save an additional $22.9 million over fixed rate debt."

We assert that these statements are incorrect and are based on a false premise.

Go to Power point presentation

This is why the City said it bought swaps:

"For the cost of the swaps, the program is getting a hedge against rising interest rates." The City locked itself into a fixed swap rate in 2006 at a time when interest rates were very low.

The City expected interest rates to increase meaning that the City would receive higher payments from its counterparties—meaning Bank of NY Mellon and Dexia—because those payments are based on a variable index that increases as the rates paid on the bonds increase (although not always proportionally).

However, this is how swaps have trapped the city:

The city got its hedge against rising interest rates, and in doing so, locked itself into making fixed rate payments on its bonds for 22 years whether interest rates went up or down

- The City of Los Angeles, strapped for cash during the Great Recession, was stuck, locked into its 3.34% synthetic fixed rate that had become a bad deal.
- Gretchen Morgenson of the New York Times described the plight of cities like Los Angeles that had entered into swaps:

  "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."

The CAO Report does not tell the true costs of the swaps deal over the life of the bonds.

- **Start with the actual costs of the deal through May 2014—We agree with the CAO's calculation of that cost at $104.1 million.**

The CAO then compares this with a scenario of non-refunded fixed rate bonds.

The CAO calculates the cost of this fixed rate alternative by taking the entire debt times the interest

rate available in 2006 for 9 years. And that total is $122 million plus issuance costs, which raise the total to $125.8 million.

<u>What's wrong with this scenario? It relies on an unrealistic assumption: that the City</u> would not refund this debt when interest rates hit historic lows.

What is missing from the CAO's report is that the City could refinance its fixed rate debt at any time and certainly would have after the crash when the Fed cut interest rates to new record lows.

What did we give up with the swaps deal?

We gave up the option to refund that debt for the entire 22 years of the bond deal without paying an enormous termination fee.

We were not able to take full advantage of rock bottom interest rates.

Giving up that option to refinance will cost the City tens of millions of dollars over the life of the bonds.

NEXT slide

You might ask why we are so sure that the City would have refinanced.

Because when not trapped by swaps, the City always refunds.

Because the City's Debt Policy requires that the CAO monitor potential savings available by refunding.

Because the City saved hundreds of millions of dollars by refunding other deals.

And because the City paid tens of millions in termination fees to its swaps partners just for the right to refinance part of this debt.

NEXT SLIDE

Let's walk through the total costs of this swap deal.

Costs of the swap deal up until May 2014 were $104.1 million.

- Then add the costs of the swaps deal going forward.

- In 2012, City refunded the first 12 years of its swapped variable rate bonds (164.7 million) with fixed rate bonds at 1.887%

- That means that the City will now pay 1.887% in interest on the $164.8 million for the next 11 years = **$34.2 million**

- In order to terminate portions of the swaps, the City had to pay $26.1 million in termination fees to Mellon and Dexia

- To pay the termination fees, the City issued additional debt in the amount of $26.1 in 2012

- City will owe that **$26.1 million** to repay the principal on the additional debt issued in 2012 to pay the termination fee

- Interest cost on the additional debt is $26.1 million x 11 years x 1.887% = **$5.4 million**

- The City still has $151.1 million of swapped bonds remaining

- According to the City's CAFR, the interest costs on the $151.1 million through 2028 will be **$68.4 million**

- Because the swaps deal requires letters of credit, at an assumed cost of 55 basis points (.55% per year) that will result in an additional cost ($151.1 m x 11 x .0055) of **$9.1 million**

That means a total cost of $247.3 million over the life of the swapped deal

NEXT SLIDE

What would be the costs in the real alternative fixed rate scenario?

- Assume, as the CAO says, that the City had entered into swaps, but had issued $316.8 million in 2006 at the then-available 4.3% fixed interest rate

- From 2006-2012, City would have paid **$81.7 million in** interest = $316.8 million x 4.3% x 6 years

- Then assume that, in 2012,when fixed interest rates hit rock bottom, the City would have refunded the remaining principal on the debt at historically low interest rates

- City pays 3% interest on average on remaining bonds—rate is blended fixed interest rate given that some bonds have shorter maturities and lower interest rates (1.887%) and most of the remaining bonds have longer term maturities averaging 11 years with interest rates around 3.7% = 11 x $316.8 m x 3% = **$104.3 million**

- Since the bonds are being refunded before 10 years, pay a call premium of 3% x principal remaining = **$8.3 million**

$194.5 million over the life of the fixed interest rate with 2012 refunding

NEXT SLIDE

What is the difference in cost between the swapped deal and the fixed rate with no swap:

Swaps Deal:	**$247.3 million**
Fixed Rate (no swap):	**$194.5 million**

Swaps Deal Costs city **52.8 million in missed savings**

NEXT SLIDE

This is what we call the swap trap

- **The City gave up its option to refinance when interest rates hit historic lows.**
- **The City was locked into swap deal for 22 years.**
- Financial institutions sold these deals to municipalities to extract profits.

- In the private sector, swaps deals range from 1 to 7 years.