Fair Game

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Wall Street's Tax on Main Street

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AMID all the talk of debt and default in Washington last week, tiny Central Falls, R.I., went bankrupt.

Joe Songer/The Birmingham News, via Associated Press

A protest of potential sewer rate increases in Jefferson County, Ala. One sign took aim at JPMorgan Chase, an adviser to the county on a bond deal.

Like many states and cities in these hard economic times, Central Falls — population: 19,000 — was caught short by hefty pension obligations and weak tax revenue. It may not be the last municipality to file for bankruptcy. Jefferson County, Ala., is now on the brink of it, thanks to a sewer bond issue gone wildly bad.

But while pensions and the economy are behind many of municipalities' troubles, Wall Street has played a role, too. Hidden expenses associated with how local governments finance themselves are compounding financial problems down at city hall.

Wall Street banks have peddled to municipalities all sorts of financial products, some of which have turned out to be costly mistakes. Testifying on July 29 at a public hearing on municipal securities sponsored by the Securities and Exchange Commission, Andrew Kalotay, an expert in financial derivatives who runs a debt management advisory firm in New York, asserted that poorly structured financial transactions involving bonds and derivatives known as interest rate swaps represented "Wall Street's multibillion-dollar hidden tax on Main Street."

Mr. Kalotay is talking about a type of complex financing that big banks have pushed on state and local authorities in recent years. The arrangements are typically made when borrowers want to exchange variable-rate debt for fixed-rate obligations.

These deals are lucrative for the banks, but many of the issuers don't seem to understand them. Mr. Kalotay told the S.E.C. that excessive fees charged by banks had cost issuers, and therefore taxpayers, $20 billion over the last five years. Real money, in other words, that could have been used in other ways by states and towns short on cash.

There's much for banks to love about these deals. Because there is no central market for interest rate swaps, prices of swaps are shrouded in secrecy. Banks can mark up costs significantly, often without their clients' knowledge.

Banks offering such deals can act as both adviser and counterparty to borrowers, putting the banks in direct conflict with their customers. And under agreements governing many of these swaps, borrowers that want to unwind these deals must go back to the banks that created them, putting the issuers at a disadvantage.

The costs of unwinding swaps can be onerous. Banks justify their fees by saying they are exposed to credit risk. But Mr. Kalotay asked, "What is the justification for a high margin on unwinding, when credit risk is nonexistent?"

Another plus for the banks is that they book immediately the entire amount earned over the life of the swap; salespeople working on the deals receive bonuses — typically 10 percent — on these windfalls.

Alexander T. Arapoglou, a professor at the Kenan-Flagler Business School of the University of North Carolina, says states and cities often pay too much and don't get what they bargained for. "Very often, swaps are sold to a customer who sees the bank as a financial adviser," Professor Arapoglou says. "They are expecting a charge of some sort but expect it to be relatively modest."

Marketing materials for these deals often say interest rate swaps will be executed at prevailing market prices, he says. But when the deals are about to close, additional costs typically appear. "Many banks say that what's defined by the Financial Industry Regulatory Authority as fair market practice, such as rules prohibiting excessive markups, does not apply to interest rate swaps," he says.

As banks have become more risk-averse, debt financings containing swaps have become more common. Unwilling to take on interest rate risk, banks often make borrowers finance operations with variable-rate debt. Borrowers that prefer the predictability of fixed-rate debt have to take on a swap.

Municipalities aren't the only ones being harmed. Small-business owners are overpaying as well. Consider what happened to Boca Raton Medical and Surgical Specialists, a Florida company that did a $21 million, five-year financing with Wachovia Bank in late 2005.

The deal financed an 80,000-square-foot office complex. But a lawyer for the company says its officials did not realize at the time that Wachovia had incorporated a 25-year interest rate swap into the transaction. This meant that the Boca Raton company would end up paying for a swap with a life five times as long as its financing.

Now the medical company is trying to unwind the deal. It has asked Wells Fargo, which acquired Wachovia in 2008, to return some of the money it paid to put on the swap. Wells has refused.

"We're in effect trapped with what we have because of the size of the unwind fees," says David Menkhaus, the lawyer at Moore & Menkhaus who represents Boca Raton Medical and Surgical Specialists. "The industry portrays swaps as if it is an established market with consistent rates. That's not true, but you only find out when you are trying to unwind a swap."

Greg Warren, managing member of Swap Negotiators, a firm in Winter Park, Fla., that represents borrowers in such transactions, calculated that the Boca Raton deal contained $800,000 in undisclosed fees, equal to roughly 3.8 percent of the loan. Another independent company confirmed this amount.

"The bank has a reason to make a profit — they have to cover their risk," Mr. Warren says. "But in this situation they had already covered their risk many times over."

A Wells Fargo spokeswoman declined to talk about specific borrowers. Noting that the bank is among the smaller players in this arena, she said the bank still worked hard "to ensure our customers fully understand the transactions."

SOME borrowers are questioning the cost of swaps and persuading lenders to reduce them. Wells Fargo, for instance, agreed to cut its price in a recent $10.4 million financing for Hillcrest Convalescent Center in Durham, N.C. Fees associated with the transaction were initially around $200,000, but after Hillcrest asked Swap Negotiators to vet the deal, Wells agreed to reduce its fees. Hillcrest saved $93,000, net of Swap Negotiators' fees. Mr. Warren says his company charges 0.04 to 0.09 percent on a new transaction, and 0.02 percent when a swap is unwound.

Ted Smith, Hillcrest's administrator, says, "It turned out to be a great business decision."

Mr. Warren says unseen fees on such deals can be 1 to 5 percent of the loan. "The size of the hidden profits relative to the loan amounts is disproportionate to any other negotiated fee," he says.

It is easy to see why big banks want to keep swap prices in the shadows. Until transparency comes to this arena, buyer beware.

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