Chicago's Dirty Deals

The financialization of the United States economy has distorted our social, economic, and political priorities. Cities and states across the country are forced to cut essential community services because they are trapped in predatory municipal finance deals that cost them millions of dollars every year. Wall Street and other big corporations are engaged in a systematic effort to suppress taxes, making it difficult for cities and states to advance progressive revenue solutions to properly fund public services. Banks take advantage of this crisis, which they helped create, by targeting state and local governments with predatory municipal finance deals, just like they targeted cash-strapped homeowners with predatory mortgages during the housing boom. Predatory financing deals are ones that prey upon the weaknesses of borrowers. They are characterized by high costs and high risks, are typically overly complex, and are often designed to fail. Some of Chicago's dirty deals are highlighted below.

INTEREST RATE SWAPS

Banks sold risky interest rate swaps to state and local governments by convincing them it would save money on borrowing costs. But these interest rate swaps have instead turned into a cash cow for banks, putting taxpayers on the hook for hundreds of millions of dollars. Table 1 illustrates the costs of these bad deals to the City of Chicago and Chicago Public Schools (CPS).

TABLE 1: City of Chicago & Chicago Public Schools Swap Payments to Banks

Entity	Estimated Net Payments thru Aug 2014	Termination fee as of Fiscal Year 2013[i]	TOTAL Net Payments And Term Fees
City of Chicago	$533.6 million	$257.4 million	$791.0 million
Chicago Public Schools	$237.0 million	$212.4 million	$449.4 million
TOTAL	$770.6 million	$469.7 million	$1.2 billion

Interest rate swaps were laden with a whole host of risks that materialized in the aftermath of the financial crash in 2008. Perhaps the biggest risk was posed by the egregious termination clauses embedded in the swap agreements. Because these clauses are typically triggered when cities and states fall under financial distress, they serve to compound financial woes by hitting municipalities with stiff penalties when they can least afford them. For example, the City of Chicago could have to pay more than $200 million if its credit rating gets further downgraded.[ii] The city already had to pay a $36 million penalty in September 2014 in order to terminate a swap so that it could refinance the underlying debt at a lower fixed rate.[iii]

The federal "fair dealing" rule prohibits financial institutions from misrepresenting or omitting "facts, risks, potential benefits, or other material information" when doing business with municipal clients like the city or CPS. It is likely that the banks that pitched interest rate swaps to Chicago and CPS violated this rule. Mayor Rahm Emanuel can try to recover this money from the banks by filing a legal challenge, either through arbitration with the Financial Industry Regulatory Authority, or by suing under state law.

AUCTION RATE SECURITIES

Auction rate securities (ARS) are variable-rate bonds whose interest rates typically reset every seven, 28, or 35 days (there are also other, less common reset periods). At the end of every reset period, bondholders who want to sell their ARS auction them off to investors who bid the lowest interest rate they are willing to accept for the bond. The interest rate therefore resets at every auction. Banks collect exorbitant fees for conducting these auctions.[iv] However, if no investors submit bids at the auctions, then the state and local governments that issued the debt could be forced to pay double-digit penalty interest rates to the bondholders that are unable to sell. That is precisely what happened in 2008 during the financial crisis. Furthermore, because ARS are often linked to interest rate swaps, the collapse of the ARS market caused related swaps to go haywire.

Chicago Public Schools had a number of ARS that were linked to swaps blow up in 2008. A *Chicago Tribune* investigation into these deals estimates that just four of these deals will cost CPS $100 million more than an equivalent fixed-rate bond would have.[v] Moreover, the *Tribune's* expose showed that officials at Bank of America, one of the underwriters on CPS's ARS, were aware that the ARS market was headed for a "meltdown" but did not warn CPS, in violation of the federal fair dealing rule.[vi]

In fact, ARS were packed with many hidden risks that banks typically did not adequately disclose, that were not widely understood by municipal borrowers, and that ended up costing taxpayers millions of dollars. As with swaps, Emanuel can also take legal action to try to recover CPS's losses from ARS.

CAPITAL APPRECIATION BONDS

A capital appreciation bond (CAB) is a long-term bond with compounding interest on which the borrower is unable to make any principal or interest payments for the first several years, and, in some cases, until the final maturity of the bond. In this way, it is similar to a negative amortization mortgage, in which the outstanding principal actually grows over time because the unpaid interest gets tacked onto the amount owed and compounds. Because of this structure, borrowers often end up paying extraordinarily high interest rates over the life of the bonds. California State Treasurer Bill Lockyer has likened CABs to payday loans.

The City of Chicago has several CABs. Table 2 details the costs of just a handful of these.

TABLE 2: Partial Sampling of the City of Chicago's Capital Appreciation Bonds[vii]

Bond	Principal Amount Borrowed	Total Cost to Repay	Interest Rate over the Life of the Bond
1995 General Obligation Bonds	$22.1 million	$123.6 million	459%
2000A General Obligation Bonds	$7.4 million	$39.5 million	434%
2009C Sales Tax Bonds	$20.0 million	$81.0 million	304%

Chicago Public Schools has three CABs. Table 3 details the costs of these deals.

TABLE 3: Chicago Public Schools' Capital Appreciation Bonds[viii]

Bond	Principal Amount Borrowed	Total Cost to Repay	Interest Rate over the Life of the Bond
1997A Bonds	$38.0 million	$91.5 million	141%
1998B-1 Bonds	$328.7 million	$1.1 billion	248%
1999A Bonds	$299.5 million	$916.8 million	206%

CREDIT ENHANCEMENTS

Getting a credit enhancement is similar to getting a cosigner on a loan. Though there are some variations between different types of credit enhancements (e.g., letters of credit, standby purchase agreements, liquidity facilities, etc.), the basic idea is that a city or state that has a lower credit rating can pay a financial firm with a higher credit rating to cosign its loan. Through this, the city or state effectively borrows the higher credit rating from the financial firm and is able to get a lower interest rate on its debt. This is a ruse. According to Moody's, one of the three major credit rating agencies in the country, the default rate for municipal issuers that it rates was 0.012 percent between 1970 and 2012.[ix] Municipal borrowers in the United States have such extremely low rates of default because their debt is ultimately backed by tax revenues. In many cases the higher-rated financial firms actually have a riskier credit profile than the lower-rated municipal borrowers whose debt they are insuring.

Credit enhancement providers, which are typically either investment banks or insurance companies, can charge high fees for this service, which are typically a percentage of the amount of the total debt issuance. They justify these fees because presumably they are assuming the risk if the city or state is unable to pay back the debt.

Chicago Public Schools has a letter of credit with Wells Fargo in connection with its 2000B bonds. A letter of credit is a type of credit enhancement. When CPS's credit rating was downgraded in 2013, Wells Fargo spiked the fees on this letter of credit by 0.10%, or nearly $100,000 annually. According to its 2013 financial statements, CPS now pays $903,450 in annual fees to Wells Fargo for this letter of credit,[x] even though Wells Fargo bears no cost and virtually zero risk for providing this service.

As of November 2014, the City of Chicago has approximately 40 different deals with credit enhancements.[xi] The city's credit enhancement providers include JPMorgan Chase, Bank of America, Citigroup, Wells Fargo, PNC Bank, US Bank, State Street Bank, Barclays, BMO Harris, Northern Trust, Royal Bank of Canada, Bank of New York Mellon, Morgan Stanley, and CalPERS.

WHAT WE CAN DO ABOUT IT

This is just the tip of the iceberg. We need transparency and better disclosure so that we can understand the full scope of the predatory municipal finance problem in Chicago and hold Wall Street accountable for the hundreds of millions banks are draining from our communities. Public officials should publicly disclose all payments they make for financial services and borrowing and

they should conduct an independent investigation into all financial deals to determine whether they are trapped in any with features that could be considered predatory.

When it comes to interest rate swaps and auction rate securities in particular, we already have options for recovering our money. Mayor Rahm Emanuel should make every effort to renegotiate these toxic swap deals *without* paying termination fees, and he should try to win back the money we have paid Wall Street thus far on these predatory deals. That includes taking legal action against banks and using the financial and economic leverage of the third largest city in the country to bring banks to the bargaining table to renegotiate these deals. Chicago does billions of dollars of business with Wall Street every year. We need to start making our money work for us.

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[i] The city and/or CPS would have to pay this amount if they wanted to cancel the swap deals or if the termination clauses on their swaps were triggered. This amount is the fair value of the swaps, as represented in the city and school district's 2013 Comprehensive Annual Financial Report (CAFR).

[ii] *A Financial Time Bomb in Chicago*, Dan Mihalopoulos, Chicago Sun-Times, June 17, 2014

[iii] Substituted official statement for the City of Chicago's General Obligation Variable Rate Demand Bonds, Project and Refunding Series 2003B, September 25, 2014, 17, http://emma.msrb.org/EP831428-EP643774-EP1045409.pdf

[iv] "Auction Rate Securities: A Crisis Foretold," Glenn S. Gitomer, *Securities Arbitration 2008: Evolving and Improving,* The Practicing Law Institute, 2008

[v] *Risky bonds prove costly for Chicago Public Schools*, Jason Grotto and Heather Gillers, Chicago Tribune, November 7, 2013

[vi] *Banks kept CPS in shaky bond market*, Heather Gillers and Jason Grotto, Chicago Tribune, November 10, 2014

[vii] Calculations based on data in the official statements of the bonds

[viii] Calculations based on data in the official statements of the bonds

[ix] *Announcement: Municipal Bond Defaults Have Increased Since Financial Crisis, but Numbers Remain Low*, Moody's Investor Service, May 7, 2013

[x] Chicago Public Schools Comprehensive Annual Financial Report for Fiscal Year 2013, pp. 87

[xi] City of Chicago Debt Management website, "Bond Liquidity, Letter of Credit and Direct Purchase Providers," http://www.cityofchicago.org/content/dam/city/depts/fin/Bonds/LOC_Bonds_and_CP_Providers_082514.pdf