Turned Around

How the Swaps that Were Supposed to Save Illinois Millions Became Toxic

Report by
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About the Authors

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**The ReFund America Project** tackles the structural problems in the municipal finance system that cost state and local governments across the United States billions of dollars each year at the expense of public services. We research the role of financial deals in contributing to public budget distress and work with policy experts, community leaders, and public officials to develop, advocate for, and implement solutions to save taxpayer dollars.
Executive Summary

Illinois is in the throes of a major budget crisis. Even though residents have had to bear draconian cuts as critical services have been defunded, Wall Street has gotten a free pass in the state’s budget stalemate. More than halfway through the current fiscal year (as of January 2016), the Illinois General Assembly has still been unable to pass a budget because Governor Bruce Rauner has refused to make a budget deal until he gets his anti-union “Turnaround Agenda”. As a result, Illinois has delayed, reduced, or ceased funding for critical services, like low-income child care programs, domestic violence services, immigrant family services, need-based college grants, youth programs, and homeless services, to name a few. At the same time that the state has been unwilling to meet its obligations to social service providers, Illinois has nevertheless been paying banks for a whole host of financial services, like interest rate swaps.

Illinois’s Swaps Could Cost Taxpayers $1.45 Billion. Illinois has 19 hedging interest rate swap deals, which backfired in light of the 2008 financial crash. This was a result of the emergency action taken by the Federal Reserve to slash interest rates to near zero to get the economy back on track. Even though interest rate swaps were marketed and sold as instruments that would save taxpayers money by protecting cities and states from rising interest rates on their variable-rate bonds, these deals became toxic drains on public coffers because Wall Street crashed the economy.


- The state continues to pay the banks another $68 million a year on these deals and is expected to pay $832 million over the remaining life of these deals, from fiscal year 2016 through 2033.

- To get out of these deals early, Illinois would have to immediately pay the banks $286 million in termination penalties.

The Governor’s Swaps Failed Taxpayers in Multiple Ways. In this report, we provide an in-depth case study of the five swaps held by the Governor’s Office of Management and Budget (GOMB), which were linked to the state’s 2003B General Obligation bonds. We call these the Governor’s swaps. We found that the Governor’s swaps failed to provide the promised benefits to the state in a number of ways:
The swaps misfired: As a result of the 2008 financial crash, the state's net payments on the Governor's swaps shot up. As a result, Illinois paid banks $192 million on these five swaps from October 2003 through June 2015.

The state will never break even on the swaps: Given how much money Illinois has already paid its bank counterparties on these swaps, it is virtually impossible for interest rates to rise high enough for long enough for the state to break even on these deals, contrary to bankers' assertions that swaps are designed so that both parties' payments will even out over the long run.

The "synthetic fixed-rate" structure broke down: Even though interest rate swaps are supposed to allow cities and states to effectively convert variable interest rates into synthetic fixed rates by protecting them from interest rate volatility, that did not happen with the Governor's swaps. Instead, these swaps actually added an additional layer of risk on top of the variable-rate bonds and served to magnify the state's losses.

The swaps cost more: Entering into a variable-rate financing structure with interest rate swaps also required Illinois to use add-on products and services. Once the costs of those add-ons are factored in, the variable-rate structure for the 2003B bonds actually cost taxpayers more than if the state had just issued traditional fixed-rate bonds and avoided swaps altogether.

The swaps can still get a lot worse: If the state's credit rating continues to tumble and it is unable to renew its credit enhancements on the 2003B bonds in November 2016, that could trigger termination clauses on the Governor's swaps and force the state to pay $124 million in penalties to the banks. JPMorgan Chase is both a credit enhancement provider for the 2003B bonds and a counterparty to one of the related swaps. This would potentially put the bank in a position to be able to collect termination penalties on the swap by refusing to renew the credit enhancement—a tactic the bank has used elsewhere in the past.

Illinois Could Have to Help Foot the Bill for Chicago's Swaps. Chicago Mayor Rahm Emanuel is seeking $800 million in assistance from the State of Illinois for the City of Chicago, Chicago Public Schools (CPS), and Chicago Transit Authority budgets. Meanwhile he has refused to act to recover money from the city and school district's interest rate swaps. Chicago and CPS also entered into a number of hedging swaps that have gone haywire. When the city and CPS both had their credit ratings downgraded in the spring of 2015, that triggered
termination clauses on many of Chicago’s and all of CPS’s hedging swaps, leaving the city and CPS on the hook for approximately $419 million in termination penalties. Mayor Rahm Emanuel also decided to voluntarily terminate most of the city’s remaining swaps. That decision could drive Chicago and CPS’s total termination penalties up to $636 million. As of January 2016, the city and CPS have already paid at least $455 million of these penalties.

What We Can Do About It. The banks that sold interest rate swaps to cities and states typically misrepresented the risks inherent in the deals. This likely violated the federal fair dealing rule and the Illinois state law for fraudulent concealment or misrepresentation. The State of Illinois can take legal action to allow it to stop paying banks $68 million a year, potentially recover up to $618 million in past swap payments, and eliminate the threat that it could have to pay up to $286 million in termination penalties in the future. The state has two options at its disposal, and it could pursue both strategies simultaneously:

- Illinois’s elected leaders can petition the federal Securities and Exchange Commission (SEC) to bring an enforcement action against the banks for disgorgement of their ill-gotten gains from Illinois taxpayers. Although the Emanuel Administration has signed waivers releasing some of the banks of liabilities arising from the swaps they sold to Chicago, state officials may also petition the SEC to bring enforcement actions on behalf of their constituents living in the city as well. Mayor Emanuel’s waiver does not preclude SEC action.

- Illinois can also sue the banks under state law for fraudulent concealment or misrepresentation. In so doing, the state could also request an injunction from the judge to stop making payments during the legal proceedings, which could provide immediate budgetary relief.

Turning Illinois Around. Governor Rauner has made a choice to give Wall Street banks a free pass during the budget crisis and to force Illinois’s most vulnerable communities to sacrifice until he gets his anti-union Turnaround Agenda. However, to truly turn Illinois around, the governor should enact policies that put the interests of communities first by fully funding public services. Taking legal action against the state’s toxic swaps would be a great first step.
The State of Illinois is in the midst of an unprecedented budget crisis. The state has gone more than half of its fiscal year without a budget and there is no end in sight to the impasse in Springfield that has crippled public services across Illinois. In October 2015, two of the three major rating agencies downgraded the state’s credit rating, citing the budget stalemate. Governor Bruce Rauner has refused any budget deal until the General Assembly passes his “Turnaround Agenda”, which is primarily aimed at destroying labor unions in the state.

The budget crisis has had disastrous consequences for the state’s most vulnerable residents. Without a budget, the state has stopped or delayed payments to many providers of critical human services. As a result, more than 36,000 low-income children have been dropped from the state’s Child Care Assistance Program. The state did not provide any funding for domestic violence services in the first half of the fiscal year, putting 75,000 survivors at risk. Ninety percent of homeless service providers in Illinois have been forced to reduce or eliminate programs because of a lack of state funding. The state violated a federal consent decree requiring it to make payments to human service providers even in the absence of a state budget. Advocates were forced to take the Rauner Administration to federal court to compel it to make federally-mandated Medicaid payments to safety net healthcare providers. The state has slashed funding for immigrant family services, senior support services, youth programs, funeral and burial assistance for low-income residents, state universities, and need-based college grants. State aid to cities, towns, villages, and state universities has also been put on hold. The state’s social safety net has been shredded, with devastating results for communities across Illinois.

But even though the state has failed to make payments to social services providers in cities like Peoria and Decatur as a result of the budget crisis, Illinois has still been making payments to financial services providers on Wall Street. Although there is a countless number
of financial deals that Illinois is involved in, this report focuses on one particular type of deal: hedging interest rate swaps.

We focus on swaps because there is abundant evidence that many banks did not adequately disclose the risks of these deals when selling them to state and local governments. For example, banks typically did not disclose that the swaps that they were selling to government entities, with 30- or 40-year terms, were unheard of in the corporate world, where interest rate swaps typically last no longer than five to seven years because anything longer is considered too risky. There is a clear path for the state to avoid these payments going forward and potentially recover up to $618 million in past payments by suing the banks that marketed and sold the deals for fraudulent concealment or misrepresentation.

The State of Illinois holds 19 hedging interest rate swaps that currently cost taxpayers approximately $68 million annually. So far this fiscal year, the state has paid Wall Street banks an estimated $34 million in net swap payments, enough money to restore funding for domestic violence services and homeless services. Rather than continuing to make swap payments, the state should sue the banks to get out of these toxic deals, and instead use the money to restore funding for critical services.

What Is an Interest Rate Swap?

Interest rate swaps are a type of derivative instrument that banks pitch to cities, states, and other municipal borrowers as a way to protect against rising interest rates on variable-rate bonds. Banks sold these complicated, risky deals to state and local governments by convincing them they would save money on borrowing costs. However, these deals were laden with a whole host of risks. 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, in the spring of 2015, both the City of Chicago and Chicago Public Schools had their credit ratings slashed to junk. As a result, the city and the schools owed banks approximately $419 million in termination penalties on their swaps. If the state's credit rating for the state to just one notch above junk status. If the state's
credit rating continues to slip, it could eventually trigger termination penalties on some of Illinois’s swap deals.

**How Interest Rate Swaps Work**

Although interest rate swaps can serve many functions, this report focuses on hedging interest rate swaps, which are meant to protect against spikes in interest on variable-rate debt. Although interest rate swaps have existed since the 1980s, these deals became especially popular with municipalities in the late 1990s and early 2000s.\(^1\) When governments and other public entities issued variable-rate bonds to borrow large sums of money, banks offered them a deal. The banks said that if the agencies would pay them a steady, fixed interest rate, then the banks would pay back a variable rate that could be used to pay the bondholders. Banks sold these deals, called interest rate swaps, as insurance policies, giving state and local governments a “synthetic” fixed rate that would let them lock in lower interest rates without having to worry about those rates shooting up in the future.

**Figure 1: Structure of a Variable-Rate Bond with an Interest Rate Swap**

Figure 1 shows the structure of a synthetic fixed-rate deal, which includes a hedging interest rate swap. The state’s payments on the variable-rate bond are on the right side, and the interest rate swap is on the left side. The idea is that the variable rate that the bank pays the state on the swap should approximate the variable rate that the state pays the bondholders, which means the two should effectively cancel each other out. As a result, the state’s only actual payment will be the fixed rate it pays to the bank on the swap.
However, for the government entities, these deals actually turned out to be more of a gamble than an insurance policy. If variable rates fell really low, then the banks could take millions of dollars from the public entities. That is exactly what happened when the banks crashed the economy in 2008 and the Federal Reserve slashed interest rates in response. Not only did the net payments on the swaps rise when the Fed cut interest rates to bail out the banks, but many cities and states were unable to take advantage of the low interest rate environment to refinance because they could not get out of their 30- or 40-year interest rate swaps without paying harsh penalties.

Furthermore, the sharp decline in variable interest rates actually caused the termination penalties on these deals to balloon, since the penalties are based on the net present value of future payments on the deals. Because the low variable rates caused government entities’ net swap payments to go up, as interest rates dropped, the net present value of the future payments that the cities and states had to make banks rose in tandem. So at precisely the time that it would have been most advantageous for cities and states to refinance their bonds, the penalties to get out of the corresponding swap deals were higher than ever before. In essence, the swaps trapped public entities into deals that became immensely profitable for the banks at taxpayers’ expense.

In addition to the 19 active hedging interest rate swaps held by the State of Illinois, it also has a number of investment swaps that are not covered in this report. Illinois’s hedging swaps are with Bank of America, Loop Financial, Goldman Sachs, JPMorgan Chase, Citigroup, Bank of New York Mellon, Deutsche Bank, Morgan Stanley, Wells Fargo, and AIG. The state paid banks $618 million in net payments on these swaps through fiscal year 2015 and the Illinois Comptroller’s office estimates that it will pay another $832 million over the remaining life of these deals, through 2033. That means these toxic swaps could cost Illinois taxpayers up to $1.45 billion. If the state wants to end these deals earlier, it has to pay $286 million in termination penalties.

The Governor’s Swaps

Four different Illinois agencies hold the state’s 19 hedging interest rate swaps: the Illinois State Toll Highway Authority (THA), the University of Illinois, the Illinois Housing Development Authority (IHDA), and the Governor’s Office of Management and Budget (GOMB). The GOMB manages the state’s general obligation bonds. General obligations bonds are the debt of the state itself. They are backed by the full faith and credit of the state and are payable out of the state’s General Funds.
Five of Illinois's swaps are connected to general obligation bonds and are managed by the GOMB.

In this section, we will walk through the example of the five swaps directly overseen by the GOMB, which we call the Governor's swaps, as a case study. We are focusing on the Governor's swaps because they are connected to the state's general obligation bonds, which means they directly impact the state's budget, rather than that of any particular agency. There is also a greater level of publicly available information about the Governor's swaps, which makes an in-depth analysis possible.

Illinois issued $963 million in general obligation bonds in October 2003, while Governor Rod Blagojevich was in office. The bond issuance was divided into two series: the 2003A series consisted of $363 million in fixed-rate bonds, while the 2003B series consisted of $600 million in variable-rate bonds. The state entered into interest rate swap agreements (the Governor's swaps) with five banks in connection with the 2003B bonds: Lehman Brothers, Bank of America, Merrill Lynch, Bank One, and AIG. Because of bank failures and bank mergers, three of these swaps are now held by Loop Financial, JPMorgan Chase, and AIG, and the other two are both held by Bank of America.

Illinois also had to incur some additional expenses because of its choice to take out variable-rate debt with the 2003B series. Because variable-rate bonds have to be remarketed, the state had to hire a remarketing agent. Illinois also had to enter into a standby purchase agreement with Depfa Bank for the 2003B bonds. A standby purchase agreement is a form of credit enhancement—something that makes debt more marketable to potential investors. Bondholders typically want assurances that they will be able to sell their investments whenever they want. Because variable-rate debt is riskier than traditional fixed-rate bonds, bondholders often require the borrower to find a buyer of last resort who will agree to buy the bond if the bondholder is unable to sell it. States do this by entering into a standby purchase agreement with a bank. The bank that provides the agreement is the buyer of last resort.

It is important to note that while Illinois's General Obligation Bond Act requires the state to make payments on the "principal of, interest on, and premium, if any" on all of its general obligation bonds, the statute does not require it to make payments for any of these add-on products or services like interest rate swaps, credit enhancements, or for remarketing bonds. Those are distinct from the bond principal, interest, and premium, which are rolled into the payments the state makes to bondholders. Payments for these add-ons accrue to banks, not
bondholders. They are fees that the state pays the banks in exchange for financial services. They are not debts of the state, and therefore not covered by the General Obligation Bond Act. As such, swap payments, credit enhancement fees, and remarketing fees are no more important than the payments that social services providers or municipalities are due from the state.

Ultimately, this variable-rate financing scheme, which was supposed to provide the state a "synthetic fixed-rate" structure, failed Illinois taxpayers in a variety of ways:

- **The swaps misfired**: The swaps did not work the way they were supposed to. When the Federal Reserve slashed interest rates in response to the financial crisis in 2008, the deals became extremely costly for the state, which was locked into a significantly higher interest rate. As a result, the state paid banks $192 million in net swap payments through fiscal year 2015 for the Governor's swaps alone.

- **The state will never break even on the swaps**: Given how much the state has already paid the banks for the Governor's swaps, it is highly unlikely that variable rates will rise enough for the swaps to become profitable for the state. The one-month US Dollar London InterBank Offering Rate (USD LIBOR), one of the variable-rate indices that these swaps are based on, would have to immediately jump to 10.72% and stay there until the swap deals expire in October 2033 in order for the state to recover the $192 million it has already paid the banks. One-month USD LIBOR has never gone that high in the 30-year history of the rate.

- **The "synthetic fixed-rate" structure broke down**: After the financial crash, the banks' payments on the swaps no longer covered the state's payments to bondholders, so the swaps stopped doing their job. Rather than save the state money, the Governor's swaps actually served to magnify taxpayer losses since the state was stuck paying high payments on both the swaps and the bonds.

- **The swaps cost more**: The add-ons that Illinois had to purchase when it decided to take out variable-rate debt as part of its 2003 bond issuance added to the total debt service cost to the state. Once the costs of the swaps, credit enhancements, and remarketing fees are factored in, the state actually paid $29 million more than if it had used a traditional fixed-rate structure for the 2003B bonds instead of a variable-rate structure. The added costs accrued to banks like Loop Financial, JPMorgan Chase, Wells Fargo, and Bank of America, among others.
The swaps can still get a lot worse: If the state’s credit rating continues its downward tumble and the state is unable to renew its credit enhancements when they expire in November 2016, that could trigger $124 million in termination payments on the Governor’s swaps.

The Swaps Misfired

The Governor’s swaps have proven disastrous for Illinois, having cost taxpayers $192 million through the end of fiscal year 2015. Under the terms of the swaps, which are essentially identical for all five deals, Illinois pays its bank counterparties a fixed interest rate of 3.89% and in return, the banks pay the state a variable rate that is currently equal to the Securities Industry and Financial Markets Association (SIFMA) Index, but that was based on the one-month US Dollar London InterBank Offered Rate (USD LIBOR) when interest rates were higher. The SIFMA Index is supposed to track the interest rates on variable-rate municipal bonds across the country.

When the banks crashed the economy, the Federal Reserve responded by slashing interest rates to near zero in October 2008. This caused both the SIFMA Index and one-month USD LIBOR to plummet, which meant that even though Illinois was still paying the banks a fixed interest rate of 3.89% on the Governor’s swaps, the variable rate that banks paid the state plummeted. In December 2007, the banks’ interest rate on the swaps was 3.36%. By December 2008, it was down 0.85%. This caused the state’s net payments on the swaps to skyrocket, from approximately $264,000 per month at the end of 2007 to $1.5 million per month at the end of 2008.

The variable rate on the swaps continued to tumble, bottoming out in early 2015 at 0.02%. From November 2008 through June 2015, Illinois paid banks approximately $1.8 million per month in net swap payments for its 2003B swaps, a total of $148 million. In the five years prior, the state had paid only $735,000 per month, or $45 million total. Figure 2 and Figure 4 show how the state’s fixed payments to the banks on the Governor’s swaps have compared to the banks’ variable payments. The difference between the two lines in Figure 2 is the state’s net payment. When the lines were closer together, the state was paying less money. When they were farther apart, the state was paying more.
The State Will Never Break Even on the Swaps

Under the typical interest rate swap agreement, swaps are priced at par. This means that when the swap deal is inked, interest rates are expected to fluctuate in such a way that both parties will break even over the life of the deal. In theory, the bank is supposed to make its profit from the fee it charges for entering into the deal, not from the difference between the two sides of the swap.

Banks have already made $192 million in profit on the Governor's swaps because of how high the state's net payments have been. It is now nearly impossible for Illinois to break even on these swaps. Because the variable rate that the banks pay on the swaps has been close to zero for more than seven years, and because the principal on the underlying bonds will start to decline in 2020, variable rates will need to swing even more aggressively in the opposite direction for the remaining life of the swaps to offset the state's losses.

*Interest rate swap payments are not necessarily made on a monthly schedule. Instead, the payment dates for each party are specified in the swap agreement. We chose to represent the payments on a monthly basis to allow for an easy comparison. This provides an approximate representation of the costs of the deals.
In order for Illinois to get back the $192 million it has paid the banks on the Governor’s swaps and break even, the variable rate that the banks pay to state would have to immediately jump to 7.18% in January 2016 and stay there over the remaining life of the swaps, until October 2033. In order for the banks’ variable rate to reach 7.18%, the one-month US Dollar London InterBank Offered Rate (USD LIBOR) would have to jump to 10.72% and stay there for the next 17 years (one-month USD LIBOR is a variable-rate index that reflects the rate that the world’s largest banks charge each other to borrow money in US Dollars for a 30-day period).* That would be unprecedented. The highest one-month USD LIBOR ever recorded was 10.313%, in 1989. The rate has not exceeded 7.00% since 1991 (see Figure 3).

Figure 3: Historical One-Month USD LIBOR, January 1986-December 2015

*The rate the banks pay the state is calculated based on a formula that is written into the swap agreements. When one-month USD LIBOR is below 2.50%, the banks pay Illinois a rate that is equal to the SIFMA Index. When one-month USD LIBOR is higher than 2.50%, then the banks pay the state 67% of one-month USD LIBOR.
The “Synthetic Fixed-Rate” Structure Broke Down

The legislation that allowed the State of Illinois to enter into interest rate swaps explicitly exempted variable-rate debt that was paired with interest rate swaps from the state’s limits on variable-rate debt. This was because the banks had claimed that hedging interest rate swaps would turn variable-rate debt into a “synthetic fixed-rate” deal. This meant that the variable interest rate that the banks paid Illinois on the swap would match the variable interest rate the state had to pay bondholders, and the state’s only cost would be the fixed-rate it paid banks for the swap. The swap was in effect supposed to be a way to allow variable-rate bonds to perform like fixed-rate bonds, with a steady and predictable interest rate. This did not happen with the Governor’s swaps.

When the banks’ variable rate on the Governor’s swaps plummeted in 2008, the variable rate that the state had to pay bondholders on the underlying bonds did not follow suit. Illinois’s variable interest rate on the underlying bonds actually went up from 3.45% in December 2007 to 4.00% in December 2008, at the same time that the banks’ variable rate on the swaps took a dive, from 3.36% to 0.85%. Rather than protecting the state from spikes in interest rates, the Governor’s swaps actually served to magnify Illinois’s losses. In fact, the interest rate the state paid to bondholders fluctuated between 2.00% and 3.50% for most of the period after the financial crash until November 2013. As a result, Illinois paid nearly twice as much in interest to the bondholders than it received in variable-rate swap payments from the banks, even though the banks had promised that those two numbers would be approximately the same.

**Figure 4: Total Payments on the 2003B Bonds & Interest Rate Swaps through June 2015**
In November 2013, Illinois decided to replace its standby purchase agreement with Depfa Bank with letters of credit from a consortium of banks. A letter of credit, like a standby purchase agreement, is a form of credit enhancement. Both make bonds more marketable to potential bondholders, which can help borrowers like Illinois get lower interest rates. The bank that provides a credit enhancement is in some ways similar to a cosigner on a loan. By getting a cosigner, an individual is able to take advantage of the cosigner’s higher credit score. Similarly, credit enhancements allow cities and states to pay banks to use their higher credit ratings in order to get more favorable interest rates. The higher the credit rating of the enhancement provider, the lower the interest rate the borrower has to pay.

The banks that provided the new letters of credit—JPMorgan Chase, PNC Bank, Wells Fargo, State Street Bank, Royal Bank of Canada, and Northern Trust—had better credit ratings than Depfa, allowing Illinois to lower the interest rate it had to pay on the 2003B bonds. Since November 2013, the state’s interest rate on the underlying bonds has in fact tracked the banks’ variable rate on the swaps. However, this came at a cost. In its Comprehensive Annual Financial Report (CAFR), the state itself acknowledges that, although this change has resulted in lower interest rates on the bonds, it actually caused the total cost of the 2003B bonds and credit enhancement to increase by 0.04%. This is because while Illinois had paid Depfa an annual fee equal to 0.32% of the outstanding principal of the bonds for the standby purchase agreement, the annual fee it pays the bank consortium for the letter of credit was 2.35%. As a result, the total cost to the state remains higher than 2%, despite the fact that the interest rate on the bonds has been close to zero since November 2013. This move simply transferred profits from bondholders to the banks providing the letters of credit, and did not save the state any money.

Figure 5 shows how the state’s payments on the bonds have compared with the banks’ payments on the swaps over time. In order for the swaps to give the state a synthetic fixed-rate on the financing scheme, the green and red lines would have to track each other. That stopped happening when the green and red lines diverged in the fall of 2008. Even though the two lines came back together in November 2013, once the added cost of the 2.35% letters of credit fees are factored in, it becomes clear that the swaps have failed because the banks’ payments are nowhere near sufficient to cover the state’s total costs.

This move simply transferred profits from bondholders to the banks... and the state did not save any money.
The Swaps Cost More

Because the state issued 2003A fixed-rate bonds alongside the 2003B variable-rate bonds, it is possible to compare the cost of the two structures. When the state issued variable-rate bonds, it incurred additional costs that do not exist with fixed-rate bonds. Two of these costs were discussed above in detail—payments for interest rate swaps and credit enhancements like standby purchase agreements and letters of credit. Additionally, Illinois also had to hire and pay a remarketing agent for its variable-rate bonds. Through fiscal year 2015, Illinois paid an estimated $160 million in interest on the 2003B variable-rate bonds, $192 million in net swap payments, $38 million in credit enhancement fees, and $3 million in remarketing fees. That means that the total debt service costs on the 2003B bonds have added up to $394 million (See Figure 6).

If, instead, the state had issued these bonds at a fixed interest rate under the same deals as the 2003A bonds, the total debt service costs would have been just $364 million in interest. In other words, not only has the variable-rate financing scheme been riskier for the state, it has also been more costly.
In fiscal year 2015 alone, the state paid approximately $15 million more as a result of the variable-rate structure on the 2003B bonds than it would have if the bonds had instead been issued at the same fixed interest rate as the 2003A bonds (see Figure 7).

Although the state saved nearly $36 million in interest payments with the variable rate, it paid an extra $51 million in fees to nine different banks. The banks captured all of the state’s savings from the lower interest rates. Figure 8 breaks down these fees for fiscal year 2015 by bank.
The Governor's swaps are a ticking time-bomb for Illinois taxpayers. According to the state's CAFR for fiscal year 2014, which is the most recent currently available, the state would have to pay $124 million in termination penalties to exit the deals. However, the decision to terminate may not be fully in the hands of the state. The typical interest rate swap agreement specifies a number of termination triggers that give the bank the right to terminate the swap and collect penalties. According to the official statement of the 2003 General Obligation bonds, Illinois's swap counterparties may terminate the swaps “if the State's [credit] rating falls below 'BBB' from [Standard & Poor’s], ‘Baa’ from Moody’s and ‘BBB’ from Fitch.” In October 2015, Moody’s downgraded Illinois to Baa1, just three notches above the termination trigger, and Fitch downgraded Illinois to BBB-, just one notch above the termination trigger. Both rating agencies cited the state’s budget stalemate as a key reason for the move. If the stalemate drags on, it could lead to further downgrades. Because the state has taken letters of credit on the 2003B bonds, the Governor's swaps are relatively insulated from these downgrades for now. As mentioned above, letters of credit are a form of credit enhancement, which allow borrowers to take advantage of banks’ higher credit ratings. In fact, Moody's released a report in November

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**Figure 8: State of Illinois Fees on 2003B Bonds in FY 2015**

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<tr>
<td><strong>Total</strong></td>
<td><strong>$23 million</strong></td>
<td><strong>$14 million</strong></td>
<td><strong>$14 million</strong></td>
<td><strong>$51 million</strong></td>
</tr>
</tbody>
</table>

**The Swaps Can Still Get a Lot Worse**

The Governor's swaps are a ticking time-bomb for Illinois taxpayers. According to the state's CAFR for fiscal year 2014, which is the most recent currently available, the state would have to pay $124 million in termination penalties to exit the deals.
2015 affirming its Aa1 and Aa2 ratings on the 2003B bonds because they are backed by letters of credit.26

However, these letters of credit all expire on November 27, 2016. That puts Illinois taxpayers in a precarious position. If the state’s own credit rating continues to slide and any of the six banks that have provided the letters of credit on the 2003B bonds—JPMorgan Chase, PNC, Wells Fargo, State Street Bank, Royal Bank of Canada, or Northern Trust—refuse to renew them when they expire, then that additional layer of protection would vanish and taxpayers could be on the hook for $124 million in termination penalties. Even if the banks do agree to renew the letters of credit, they can charge the state substantially higher rates because they will have Illinois over the barrel. The state will need those letters of credit to avoid an even larger $124 million payment.

JPMorgan Chase is Illinois’s largest letter of credit provider on the 2003B bonds and also counterparty to one of the Governor’s swaps. That means the bank has a conflict of interest. If Illinois’s credit rating gets downgraded to junk and JPMorgan Chase refuses to renew its letter of credit, that could trigger the termination clause in the bank’s swap agreement with the state. That would allow JPMorgan Chase to collect approximately $11 million in swap termination penalties from Illinois taxpayers.

This very scenario has played out elsewhere. In 2010, JPMorgan Chase did this exact thing with the Asian Art Museum of San Francisco, which is a public-private partnership that is financially backed by the City of San Francisco. The bank provided the letter of credit to the museum for a bond and was also the counterparty for a related swap. When the bank refused to renew the letter of credit, it caused Moody’s to slash the museum’s credit rating to junk, which triggered termination clauses on the swap and an accelerated payment clause on the underlying bond (which meant that the museum would have had to pay back the entire outstanding bond principal that was due over 23 years on a highly accelerated schedule).27 The city forced the bank to the bargaining table and was eventually able to secure a favorable settlement that avoided the termination penalties and refinanced the museum into a fixed-rate bond.28 In November 2016, the State of Illinois could find itself in a similar position, with JPMorgan Chase squeezing on one end (by refusing to renew the letter of credit) in order to get paid on the other (by collecting termination penalties on the swap).
The Other Swaps

The Governor’s swaps are just five of the 19 hedging interest rate swaps that the State of Illinois holds that are currently active. The other 14 are held by the THA, University of Illinois, and IHDA. Figure 9 illustrates the costs of these 19 swaps to Illinois taxpayers (it does not include swaps that were terminated prior to fiscal year 2015).

The state paid Bank of America, Loop Financial, Goldman Sachs, JPMorgan Chase, Citigroup, Bank of New York Mellon, Deutsche Bank, Morgan Stanley, Wells Fargo, and AIG $618 million in net interest rate swap payments through the end of fiscal year 2015. Taxpayers pay the banks $68 million a year—nearly $6 million every month. According to estimates by the State Comptroller’s office, Illinois will pay the banks an additional $832 million over the life of these deals, the last of which does not end until 2033.29 That means these deals could cost Illinois taxpayers an estimated $1.45 billion by the time they expire. If the state either wishes to or is forced to terminate its swaps, it must pay the banks $286 million in penalties to exit the deals.30 These figures do not account for the remarketing fees or credit enhancements associated with the variable-rate bonds underlying any of these other swap agreements.

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Governor’s Office of Management and Budget</td>
<td>$192 million</td>
<td>$124 million</td>
<td>$316 million</td>
<td>$19 million</td>
<td>$273 million</td>
<td>$465 million</td>
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<td>Illinois State Toll Highway Authority</td>
<td>$359 million</td>
<td>$137 million</td>
<td>$496 million</td>
<td>$43 million</td>
<td>$535 million</td>
<td>$894 million</td>
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<tr>
<td>University of Illinois</td>
<td>$61 million</td>
<td>$24 million</td>
<td>$84 million</td>
<td>$6 million</td>
<td>$22 million</td>
<td>$83 million</td>
</tr>
<tr>
<td>Illinois Housing Development Authority</td>
<td>$6 million</td>
<td>$2 million</td>
<td>$8 million</td>
<td>$600,000</td>
<td>$3 million</td>
<td>$9 million</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>$618 million</strong></td>
<td><strong>$286 million</strong></td>
<td><strong>$904 million</strong></td>
<td><strong>$68 million</strong></td>
<td><strong>$832 million</strong></td>
<td><strong>$1.45 billion</strong></td>
</tr>
</tbody>
</table>

*Some of the totals do not add up precisely because of rounding error.

These deals could cost Illinois taxpayers an estimated $1.45 billion.
Fallout from Chicago

Illinois taxpayers may indirectly have to help the City of Chicago and Chicago Public Schools (CPS) foot the bills for their swaps as well. Like the state, Chicago is also embroiled in a budget crisis, and Mayor Rahm Emanuel is seeking $800 million in assistance from the State of Illinois for the city, CPS, and the Chicago Transit Authority budgets.35

Both Chicago and CPS had their credit ratings downgraded to junk in the spring of 2015, which triggered termination clauses on many of Chicago’s and all of CPS’s interest rate swaps. Chicago Mayor Rahm Emanuel also made the decision to voluntarily terminate most of Chicago’s remaining swaps. As a result, the city and CPS are on the hook for up to $636 million in termination penalties. Chicago has already paid at least $221 million of these penalties, has authorized payment for another $75 million, and is considering authorizing another $106 million.36 CPS has paid $234 million in penalties to terminate its swaps.37

As Figure 10 shows, the only termination penalties that the Emanuel Administration was required to pay were the ones that resulted from the credit rating downgrades—approximately $419 million. Mayor Emanuel’s decision to voluntarily terminate most of the Chicago’s remaining swaps could cause that figure to jump by more than 50%, to $636 million.

If it were not for the city and CPS’s swap penalties, Mayor Emanuel would have an additional $636 million to put toward those budgets...

If it were not for the city and CPS’s swap penalties, Mayor Emanuel would have an additional $636 million to put toward those budgets...

If it were not for the city and CPS’s swap penalties...

Figure 10: The Cost of Swaps to the City of Chicago & Chicago Public Schools

<table>
<thead>
<tr>
<th></th>
<th>Net Swap Payments through June 2015</th>
<th>Mandatory Termination Penalties</th>
<th>Voluntary Termination</th>
<th>Total Net Payments and Termination Fees</th>
<th>Termination Fees Already Paid as of June 2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>City of Chicago</td>
<td>$537 million</td>
<td>$185 million</td>
<td>$217 million</td>
<td>$939 million</td>
<td>$221 million</td>
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<tr>
<td>Chicago Public Schools</td>
<td>$268 million</td>
<td>$234 million</td>
<td>N/A</td>
<td>$502 million</td>
<td>$234 million</td>
</tr>
<tr>
<td>Total</td>
<td>$805 million</td>
<td>$419 million</td>
<td>$217 million</td>
<td>$1.4 billion</td>
<td>$455 million</td>
</tr>
</tbody>
</table>

Figure 10 shows that interest rate swaps have proved very costly for Chicago and CPS. Once the outstanding termination penalties are factored in, the total price tag for these deals for the city and CPS will top $1.4 billion.
Holding Wall Street Accountable

The State of Illinois can take legal action to allow it to stop paying banks $68 million a year for its interest rate swaps, potentially recover up to $618 million in past swap payments, and eliminate the threat that it could have to pay up to $286 million in termination penalties on its swaps as the budget crisis continues.

The federal “fair dealing” rule prohibits financial institutions from misrepresenting or omitting “facts, risks, potential benefits, or other material information” when doing business with state and local governments, like the State of Illinois. However, it was standard industry practice for the banks that pitched interest rate swaps to cities and states to violate this rule by emphasizing the potential savings from the deals and downplaying the risks or failing to mention them altogether. For example, the banks typically did not disclose that the swaps that they were selling to government entities, with 30- or 40-year terms, were unheard of in the corporate world. Corporate interest rate swaps typically last no longer than five to seven years because corporations do not want to take on the risk of exorbitant termination fees that come with swaps with longer terms. Illinois can take legal action against the banks that sold the interest rate swaps for violating the fair dealing rule.

At the federal level, the state can petition the Securities and Exchange Commission (SEC) to bring an enforcement action against the banks to disgorge them of their ill-gotten gains. The banks broke federal law by violating the fair dealing rule, and the SEC has the authority to investigate and prosecute the banks and win back taxpayer money. Governor Rauner, Attorney General Madigan, members of the General Assembly, and other Illinois elected officials can press the SEC to use its enforcement authority to recoup the state’s losses from swaps.

But elected officials do not have to rely on the SEC to take action. The state can also sue the banks under Illinois state law for fraudulent concealment or misrepresentation. In Zimmerman v. Northfield Real Estate (1986), an Illinois Court ruled, “Where a person has a duty to speak, his failure to disclose material information constitutes fraudulent concealment.” This creates a similar standard to the federal fair dealing rule. Under Illinois state law, there is no statute of limitations for these types of claims brought by government entities. Moreover, the state could petition the judge for an injunction on ongoing swap payments during the legal proceedings, which could provide immediate budgetary relief.
Community and labor leaders have been calling on Mayor Emanuel to take legal action against the City of Chicago and CPS's interest rate swaps as well. When the termination penalties were triggered on several of the City of Chicago's swaps, the Emanuel Administration entered into forbearance agreements with the banks to avoid having to pay the penalties right away and to give the city time to come up with the money. Tucked away in these forbearance agreements was a clause that released many of the banks of liabilities arising from the fair dealing rule. In other words, the Emanuel Administration signed away the city's right to sue the banks to recoup taxpayer losses on many of its swaps.

Now the mayor is requesting assistance from the state to help the city pay its bills. However, even though Mayor Emanuel refused to take legal action against the banks, state officials can still intervene on behalf of their constituents who live in Chicago by petitioning the SEC to bring an enforcement action against the banks that sold swaps to the city. The mayor's forbearance agreements do not prohibit the SEC from taking legal action against the banks on behalf of the city.

**Turning Illinois Around**

A budget is a series of choices. The two biggest choices elected officials make through the budgetary process are which of the state's needs they will fund and who will pay to fund those needs. The lack of a budget in Illinois is also a choice. Governor Rauner and Illinois Comptroller Leslie Geissler, who writes the checks for the state, have chosen to let the state's most vulnerable residents' needs go unmet at the same that they have chosen to continue paying Wall Street banks approximately $6 million per month, on average, for toxic swaps.

Governor Rauner has been holding the Illinois budget hostage in order to get his anti-union Turnaround Agenda. However, ratcheting up attacks on working families would hardly be a turnaround for Illinois. It would be more of the same in a state that has been prioritizing payments to Wall Street ahead of vital community services for years. To truly turn Illinois around, we need a budget that chooses to fully fund the public services on which all Illinoisans depend and that makes banks, major corporations, and the wealthy pay their fair share. We can start by taking on the banks that sold Illinois the toxic swaps that are projected to cost taxpayers nearly $1.5 billion if left intact. That is the kind of turnaround that Illinois working families can get behind.
Endnotes

3 Testimony by Roselyn Harris, Manager of Policy Development and Appeals for the Office of Early Childhood in the Illinois Department of Human Services, November 17, 2015.
13 30 ILCS 330, Section 14(c).
According to the official statement for the 2003 General Obligation bonds, the fee for the original standby purchase agreement was 0.22%. We conservatively assumed that this fee stayed the same until September 2011, when we know that the state entered into a new standby purchase agreement with a 0.32% fee. Starting in November 2013, we applied the new 2.35% fee that the state has to pay for the letters of credit that replaced the standby purchase agreement with Depfa Bank.

According to the official statement for the 2003 General Obligation bonds, the original remarketing fee on the 2003B bonds was 0.05%. We conservatively assumed that fee has stayed the same since then.

We applied the interest rates that the state paid on the 2003A bonds (which we obtained from the official statement for the 2003 General Obligation bonds) to the outstanding $600 million principal on the 2003B bonds.


Calculated based on information in the State of Illinois’s Comprehensive Annual Financial Reports and the official statements for the bonds underlying the interest rate swaps.


38 Includes $36 million in voluntary termination penalties that the city has already paid in Fall 2014, $75 million that it authorized in Fall 2015, and $106 million that the city is currently considering authorizing, in January 2016.

39 The City of Chicago’s forbearance agreements with its swap counterparties can be found on the Debt Management/Investor Relations of the city’s website on this page: http://www.cityofchicago.org/city/en/depts/fin/supp_info/bond_issuances0/ForebearanceAgreements.html.