TESTIMONY OF FORMER AUDITOR GENERAL JACK WAGNER

Senate Local Government Committee
September 9, 2013

Chairman Eichelberger, Chairman Teplitz, and committee members, thank you for inviting me to discuss my views on interest-rate swap agreements. During my time as the Commonwealth's Auditor General, I exposed the dangers of these risky financial instruments and repeatedly called for a ban on their use in the public sector. I continue to believe strongly that legislative action is needed. Therefore, I am pleased to testify in support of Senate Bills 903 and 904, which would prohibit local governments and municipal authorities from using swaps.

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

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

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

Hardly a day goes by without a news report of someone else getting burned by a swaps deal gone sour. Organizations of every stripe – public and private; for-profit and not-for-profit; universities; hospitals; state, local, and even foreign governments; school districts; and public authorities – have been hurt and none are immune to the toxic effects of these transactions. Any benefits that these deals may confer – even to the fortunate few who do not lose money – pale in comparison with the enormous risks involved, risks that may lurk for literally years in the future. Is it any wonder that many commentators are now recognizing that the only reason that swaps continue to be sold so aggressively is the enormous fees and profits that they generate for the investment banks and financial services firms that seek them? Wall Street is vehemently opposed to the elimination of swaps with public entities for obvious profit reasons.

It is my understanding that the bills under consideration were prompted by the City of Harrisburg's experience with swaps, which were a contributing factor to our capital city's debt

crisis. My own involvement with this issue began with a special investigation conducted by the Department of the Auditor General and released in November 2009. We found that the Bethlehem Area School District in Lehigh and Northampton counties had entered into the most swaps of any school district in Pennsylvania during a three-year period, 13 swaps in total. We reviewed just two of the district's swaps because those were the only two that had concluded by the time of our investigation.

We found that the district was the victim of a variety of deceptive marketing tactics and that it lost at least $10.2 million on those two swaps, largely due to excessive fees and other charges and a termination payment. The taxpayers of the district were then hit with property tax increases to pay for the losses incurred. Since the issuance of our report, the district heeded our advice and terminated many of its active swaps, some with positive results and some with negative results, but it still has a long road ahead.

Unfortunately, when it comes to gambling taxpayer money in swaps, Pennsylvania school districts and municipalities are No. 1 in the nation, according to Moody's Investors Service. On a statewide basis, according to the Department of Community and Economic Development (DCED), 108 of 500 school districts – a shocking 21 percent – and 105 local governments in the Commonwealth had $17.25 billion in public debt tied to swaps between October 2003 and September 2012. The precise number of different swaps and the precise amount of debt could not be determined because DCED data may include some double-counting and some of the swap agreements filed may not have been fully acted upon.

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

As Auditor General, I repeatedly urged the General Assembly to prohibit school districts, other local governments, and municipal authorities from entering into swaps. I also urged these entities to take the following actions on their own:

- Stop using swaps and other types of exotic financial instruments;
- Terminate any active swaps as soon as it was fiscally responsible to do so and refinance with conventional debt instruments; and
- Hire financial advisers through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

This committee will probably hear others argue that large public entities should be permitted to continue using swaps because they have the "sophistication" and "expertise" to use them appropriately. I have heard that argument before and do not find it persuasive. Let's review the record:

- As Auditor General, I was an *ex-officio* board member of the Delaware River Port Authority (DRPA), a bi-state agency that operates the four toll bridges and the commuter train between Pennsylvania and New Jersey. Before I joined the board, the DRPA entered into seven swaps in 2000 and 2001 related to over $1 billion in debt. Although the DRPA collected $45 million in upfront payments for those swaps, it has paid out $101 million in termination fees and additional interest to terminate several of them, according to data provided by the agency last fall. The remaining active swaps had a net negative fair value of approximately $248 million, nearly the equivalent of one year of toll revenues on all four of the agency's bridges. In December 2009, I succeeded in passing a resolution to prohibit the agency from entering into future swaps agreements and to begin a process of terminating its current swaps.

- In March 2011, the Department of the Auditor General released our cyclical performance audit of the School District of Philadelphia. We found that the district had in excess of $1 billion of debt tied to swaps. By comparison, the Bethlehem Area School District's debt tied to swaps, the second largest among all 500 school districts in the Commonwealth, was just one quarter of that amount. Our audit found that the Philadelphia School District's use of swaps cost the taxpayers $35 million more than if the district had merely issued conventional fixed-rate debt, particularly because the district had to make a termination payment of $63 million to exit a batch of soured swaps deals in 2010. While I was pleased that the district has heeded our recommendation to divest itself of its remaining swaps contracts, I was disappointed that it refused to renounce the use of swaps in the future. The Philadelphia School District, with its long history of financial distress, has an obligation not to gamble away its limited resources on discredited financial schemes.

- In August 2012, we released a performance audit of Southeastern Pennsylvania Transportation Authority (SEPTA). Our audit found that SEPTA's use of swaps associated with its issuance in 1999 of $262 million in debt cost the taxpayers and SEPTA's fare-paying customers over $41.4 million more than if SEPTA had financed with conventional fixed-rate bonds. We also found that $27 million of the money that SEPTA lost by terminating swaps was merely rolled into a refinancing of its debt, disguising the fact and magnitude of the losses and forcing SEPTA to incur an additional $7.8 million in interest costs over the next 18 years.

- One of the last major audits that I released during my term was of the Pennsylvania Turnpike Commission. We found that the turnpike's involvement in swaps cost Pennsylvania taxpayers and turnpike motorists at least $108.9 million between December 1998 and August 2011. These are important figures to consider as the General Assembly grapples with the issue of transportation funding across the Commonwealth. Public money that could be funding transportation has been lost through swaps, and additional tax dollars are seriously at risk. Instead of sending our money to Wall Street, we should be investing it in our critical transportation needs here in Pennsylvania.

The true extent of potential losses from swaps to taxpayers across Pennsylvania remains unknown, but could be catastrophic. Despite these facts, you will hear a different view from proponents of swaps and defenders of the status quo, as well as from those who would argue for a "reform" of swaps rather than a ban. I urge you to ask them tough questions, such as the following:

- Do the local elected officials who vote to enter into these transactions really understand them?

- None of the other parties involved – the financial adviser, bond counsel, swaps counsel, local government solicitor, or the investment bank – appear to get paid unless the deal goes through. Do you believe that local governments are ultimately protected against conflicts of interest in these transactions?

- Do the investment banks or financial advisers involved in swaps ever lose money on these transactions?

- How much are the fees and commissions to the various parties in an average swap transaction, and how do they compare to the issuance of standard fixed-rate debt?

- Are fees and losses rolled into refinancing deals and, therefore, not transparent to the public?

- Can there ever be enough training, disclosure, or other types of "reforms" to level the playing field between local officials and Wall Street financial experts?

- Are the benefits of a swap worth exposing taxpayer funds to potentially enormous risk if the local government loses its bet?

- Are you prepared to fully explain the risk of swaps to the taxpayers?

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

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

I would be happy to take your questions.