Testimony of Senator Mike Folmer
Senate Local Government Committee
10:00 a.m., Monday, September 9th
Hearing Room 1, North Office Building

THANK YOU for the opportunity to testify in support of my **Senate Bill 903** to ban so-called "swaps". This initiative is in response to the many problems we have seen across the Commonwealth and across the nation.

Act 23 of 2003 amended the Local Government Unit Debt Act (LGUDA) to permit local governments, including counties, cities, boroughs, townships and school districts, to enter into interest rate management agreements, commonly known as "swaps" or "derivatives". In addition, the Municipality Authorities Act has been interpreted to permit municipal authorities to enter into swaps.

Swaps are contracts under which parties agree to exchange (or swap) cash flow payment obligations. Under Act 23, a swap is required to relate to specific debt being issued by a local government under LGUDA. The swap is entered in between the local government and a financial institution, commonly referred to as the counterparty.

The most generic swap structure involves the local government issuing variable rate debt, and then entering into a swap under which the counterparty makes a variable rate payment to the local government, and the local government makes a fixed rate payment to the counterparty. The goal is to create a "synthetic" fixed rate issue at a lower rate than if the local government issued regular fixed rate debt.

There are many other variations of swaps. One is a "basis swap" in which the local government makes payments to the counterparty based on one type of variable rate, and the counterparty makes payments to the local government based on another type of variable rate. This produces a winner and a loser at any point in time.

Even more complicated swap structures include "synthetic refundings" or "swaptions" in which a counterparty makes a payment up front to the local government for a refunding that could not be accomplished today, and the local government agrees to issue variable rate refunding bonds and enter into a swap at a future date.

Swaps have also been done under which the counterparty pays the local government an upfront payment to give the local government short term cash, and the swap is then priced to have the local government pay back the upfront amount over time.

All of these swap structures involve the local government assuming risks it does not assume when it does a normal fixed or variable rate bond issue. In addition, if the local government wants to get out of a swap early, the local government can end up having to pay a large termination fee to the counterparty.

When the Great Recession hit in 2008, and interest rates went low and stayed low, many of the risks inherent in the swap structures came to pass and caused multi-million dollar losses for local governments and authorities.

From October 2003 to June 2009, Pennsylvania local governments, authorities and schools entered into 626 swaps transactions on $14.9 billion in debt and a number of them lost millions in taxpayer dollars due to swaps. In 2009, then Auditor General Jack Wagner called swaps “gambling with the public's money," and recommended they be banned. I agree, which is why I introduced SB 903.

These losses were not just limited to small municipalities. Large local governments, such as the City of Philadelphia and the Philadelphia School District, have incurred hundreds of millions of dollars of losses. Swaps are too complicated and involve too much risk. Taxpayers cannot afford, in these difficult economic times, to pay losses incurred by their local governments on risky financial products.

I believe swaps represent gambling with the public’s money, which is why I believe we should ban swaps for all local government units and municipal authorities. If private entities want to gamble with their own money, fine. But, no one should gamble with taxpayers’ money.

Over the last ten years, 108 of 500 school districts (22 percent of districts) and 105 local government units had $17.25 billion in public debt tied to swaps.

Examples can be found across the Commonwealth:

- The most notable example were the eight swaps used to finance the Harrisburg incinerator project over a short period of time, which continue to cost taxpayers of the Capitol City hundreds of millions of dollars

- In 2011, the Pittsburgh Port Authority paid $39.2 million to rid a bond deal it entered into in 2004

- In January of this year, the State College Area School District settled a lawsuit with the Royal Bank of Canada, costing the district $9 million dollars over the five years

- If York County chooses to cancel three of its swap deals, it would come at a price tag $23 million

- The Bethlehem School District entered into at least 13 swaps over six-years time on principal of $273 Million in debt

- Over the course of 12 ½ years, the Pennsylvania Turnpike lost $109 million in interest rate swaps

Pennsylvania is not alone in having problems with swaps. There are similar examples across the country, the most notable being the City of Detroit, which is $474 Million in debt, with the largest portion being caused by $350 in swaps meant to lower borrowing costs.

Hundreds of other municipalities face similar issues, including:

- Oakland, California lost a reported $5 Million but looked at estimated costs of $19 Million to terminate a swap

- In 2009, the Alabama Public School and College Authority paid $19 Million to void a swap agreement

- In 2008, there were 136 defaults on municipal securities. The largest was the default on $3.8 billion worth of sewer bonds by Jefferson County, Alabama, which lost money on swaps

When private investors lose money on swaps, they pay the price. When public entities lose money on swaps, taxpayers pay the price.

I believe we need to protect taxpayers by banning swaps. No one should be allowed to gamble with public tax moneys.

I would be happy to answer any questions that you may have.

Thank you.