US nonprofit groups, cities lose millions in Wall Street derivative scams

Luis Arce
6 April 2009

An examination of the complex financial derivatives sold to hospitals, universities and local governments sheds light on the operations of Wall Street.

Bankers deliberately created financial products with hidden risks to lure public officials who did not understand the investments. The unnecessary level of complexity served to justify excessive profits and fees.

The large number of complex derivatives used to swindle non-profit organizations and municipalities across America by the likes of Merrill Lynch and JPMorgan Chase shows how criminality and fraud have become an integral part of Wall Street business practice.

The banks and investment houses promised clients extra benefits in the form of cost savings, higher returns or upfront cash payments. One local school official said JPMorgan Chase told him "the deal was nearly failsafe and would allow the schools to collect money that would disappear if interest rates rose," according to the December 2008 edition of *Bloomberg Markets* magazine.

The bank claimed that the benefits far outweighed the small probability of the economy moving in the wrong direction. In the event, two of the supposedly unlikely negative economic scenarios occurred: interest rates went down and insurance companies backing the derivatives, like American International Group (AIG) and MBIA, became submerged in debt and had their credit downgraded.

What happened to these "nearly failsafe" transactions? *Bloomberg Markets* wrote, "Wall Street's drive for profits over the past decade has backfired on towns, cities and counties that borrow in the $2.7 trillion municipal bond market ... forcing hundreds of public agencies to spend billions of dollars they don't have to pay for increased interest payments and penalties."

Public service organizations also experienced losses from derivatives transactions. South County Hospital in Wakefield, Rhode Island, for example, saw the "interest rate on $52 million of its debt doubled to 12 percent a year ago," according to a March 18 report in *Bloomberg News* entitled "Swaps Backfire on Hospitals Firing Workers to Pay Wall Street."

The trades produced an increase in interest payments precisely when interest rates hit historical lows not seen since the Eisenhower administration in the 1950s. Instead of benefiting from low borrowing rates, the hospital had to pay more to fund its operations. This did not affect Merrill Lynch, the bank that made the deal with South County Hospital. Its profits were paid upfront in the form of fees.

The trouble escalated when hospitals and universities were forced to post collateral, which consumed cash and created a liquidity problem precisely when more funds were needed to deal with the impact of the recession. *Bloomberg News* noted: "It cost [South County Hospital] $12.7 million of collateral for an interest-rate swap that backfired."

An interest rate swap is a contract between two parties where counterparty "A" pays a fixed rate to counterparty "B" while receiving a floating rate usually pegged to the London Inter-Bank Offered Rate (Libor). When the Libor rate falls, the payer of the floating rate—the bank in the above-mentioned case—benefits. To compensate, the fixed-rate payer has to post collateral.

Other institutions that fell prey to Wall Street derivatives schemes include Vanderbilt University in Nashville, Tennessee, which had to post $190 million in collateral for a $1.7 billion swap. In order to make the payment, the school was forced to sell $250 million in taxable notes in January.

The University of Maryland Medical System in Baltimore paid its bankers $105.7 million in December. The university had $610 million in swaps with Bank of America and JPMorgan Chase.

How widespread is this problem? According to Moody's Investors Services, South County is one of at least 500 nonprofit organizations that entered into derivatives with Wall Street with the hope of cutting costs.

Bloomberg News reported that the University of Maryland Medical System "reported a net loss of $224.2 million in the six months ending December 31 after it posted $105.7 million in collateral for its swaps, according to a financial report from the nonprofit."

The investment income nonprofit organizations use to subsidize their operations fell $881.5 million in the third quarter of 2008, fueling concerns about their ability to meet future swap payments. As result, swap counterparties began demanding higher collateral postings, creating an additional financial strain.

This occurred precisely as revenue fell, in the case of medical centers due in large part to an increase in the number of patients who had lost their medical insurance because they had been laid off.

Vanderbilt University derives 64 percent of its revenue from its 600-bed hospital as well as from other medical facilities. Similarly, the University of Maryland Medical System consists of eight hospitals in and around Baltimore and depends on its 1,809 beds for revenue.

In the case of South County Hospital, the *Bloomberg News* notes, the funds handed over to the bank could have been used "to counter a drop in state aid for treating uninsured patients, compensate for declining admissions, or buy four years' of orthopedic supplies. Instead, the facility is firing workers and cutting pay."

There is an obvious contradiction between the Obama administration's campaign promises to develop a comprehensive health care system and its multi-trillion-dollar efforts to rescue the very financial institutions that are responsible for bilking hundreds of millions of dollars from hospitals and universities.

Rating agencies' culpability

In a special comment entitled "Interest Rate Swaps Cause New Liquidity Stress for Some Healthcare, Higher Education and Other Not-for-Profit Borrowers," published in February, the rating agency Moody's explained how the trades worked and what went wrong.

"Mark-to-market liabilities for long-dated fixed payer interest rate swaps have grown considerably over the last few months and pose new credit risks for not-for-profit hospitals, higher education institutions, and other not-for-profit borrowers," wrote Moody's.

"Recent unprecedented developments in the debt capital markets," the report continued, "have caused short term taxable rates and short term tax-exempt rates to trade at unusual levels."

What were the "recent unprecedented developments" that ended up costing hospitals and universities millions? Moody's doesn't have the spine to tell. This should come as no surprise since it is a well-accepted fact that the rating agencies were in bed with the bankers when they rubberstamped high-risk products as triple-A.

The "unprecedented developments" involved the disclosure of huge losses incurred by MBIA, AIG and other firms in credit default swap contracts. Moody's culpability lies in the fact that it assigned the highest rating to MBIA's credit default swaps in the first place. Eventually, rating agencies had no choice but to downgrade MBIA.

Since MBIA is a large player in the municipal bond market, its downgrading adversely affected the ability of counties, cities and public agencies to raise money. The end result was that tax-exempt rates rose from 67 percent to 108 percent of taxable rates. Hospitals and universities found themselves in a situation where they had to post collateral for the 41 percent difference.

The JP Morgan story is worth telling because so far it is one of the few, if not the only, major financial institution not dragged down by the credit collapse. Not surprisingly, it turns out that the "good guys" at JPMorgan are as corrupt as any one else on Wall Street.

JPMorgan was among the most active banks involved in structuring financial products for municipalities. Playing a game in which the bottom line is everything, the bank found it "could charge 10 times as much for selling municipal derivatives, public records show," wrote *Bloomberg Markets*.

Among JPMorgan's victims was the Butler County school district, 40 miles south of Pittsburgh, which paid $395,000 in bond issue fees and $893,000 in swap contract fees for a $50.9 million bond. Another was the Erie, Pennsylvania school district, which paid $373,000 and $1.2 million in debt issue fees and swap contract fees, respectively, on a $49.9 million bond.

Similarly, the Philadelphia International Airport paid $475,000 in fees and $4.0 million-$4.5 million for the swap on a $189.5 million bond.

In the south, Jefferson County, Alabama paid $4.6 million in fees and $20 million for the swap derivative on a $1.04 billion bond issuance.

The *Bloomberg Markets* article narrates how JPMorgan showed no regret for the consequences, demanding that Jefferson County pay back "with county tax money or higher sewer fees." The report added, "Such proposals caused a public outcry .... In Birmingham, one in four people lives below the poverty line."

According to *Bloomberg Markets*, "JPMorgan lured municipalities into derivative deals by offering upfront cash payments in exchange for a pledge by the local government to agree to enter interest rate swaps with the bank in the future."

Similarities with the subprime market

There are obvious parallels here with the subprime fiasco. Subprime mortgage originators lured unsophisticated homebuyers with so-called "teaser" interest rates. In exchange for the teaser rates, the mortgage originators got home buyers to agree to higher interest rates in the future.

The originators didn't disclose their fees. Similarly, in the municipal bond market, as the *Bloomberg Markets* article notes, deals "were rarely put out for public competitive bidding." JPMorgan "routinely didn't disclose their fee for these contracts ... In some cases, the bank made more money than it paid out."

JPMorgan was not adverse to exploiting political connections and influence to market its bonds. "In Philadelphia, JPMorgan turned to bond lawyer Ron White, a confidant and fundraiser for Mayor John Street," *Bloomberg Markets* reports, describing White as a man who "carries a lot of stroke with the city." It added that the bank "agreed to contribute to White's charities" a total of $90,000, plus an extra $50,000 for a deal in which White played no role.

When investigated by the FBI, White said JPMorgan "was pushing swaps to generate fees, not because they were in the city's interest," according to the *Bloomberg Markets* article.

It has been revealed that the financial advisers hired by Butler County, Jefferson County and Philadelphia to analyze fees and prices and determine whether swap contracts were fair maintained business relations with JPMorgan.

When asked by Erie school board members how much JPMorgan would make in the deal, the independent advisor, IMAGE, said, "I can't quantify that to you ... this is a financial transaction that is put into a huge hedge fund that JPMorgan controls. There's a trillion dollars of investments in that hedge fund. There's some other issuer in Tokyo or somewhere else who's got an opposite bet and they're going to offset each other."

In essence, Wall Street created financial products to lure customers into deals that promised large advantages at the beginning in exchange for postponing the risk of high payments in the future. There is nothing in this corrupt business that deserves saving. The only answer lies in turning the financial industry into a public utility under the democratic control of the working class.