HOUSE FINANCE COMMITTEE

TESTIMONY ON INTEREST RATE SWAPS

Auditor General Jack Wagner

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Good morning, Chairman Levdansky, Chairman Rohrer and committee members.

Thank you very much for the opportunity to appear before you today to discuss the issue of interest rate swaps. I would like to commend Rep. Scavello for introducing the legislation to repeal the law that allowed swaps, along with all of the co-sponsors, including Chairman Levdansky. I would also like to commend Senator Lisa Boscola, who brought this important issue to our attention last year and who has also drafted legislation to address this problem.

Most Pennsylvanians would be upset if members of their school board or municipal government gambled away their hard-earned tax dollars at the local slots casino. They should be just as upset if their school district or council has tied up local funds in interest-rate swaps, because these exotic financial instruments are tantamount to gambling with public money.

Swaps are bets between two parties -- say, a school district and an investment bank -- on which way interest rates will move. 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 how much interest rates fluctuate and other factors. The bigger the swing in interest rates, the higher the potential losses.

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. A recent investigation by the Pennsylvania Department of the Auditor General confirmed Moody's conclusion. Our investigators found that 107 of 500 school districts – a shocking 21 percent – and 86 municipal governments had almost $15 billion in public debt tied to interest-rate swaps with at least 13 investment banks between October 2003 and June 2009. The Philadelphia School

District had the most debt tied to swaps contracts, in excess of $1 billion. If interest rates gyrate, Pennsylvania taxpayers would potentially be on the hook for hundreds of millions of dollars.

Our special investigation found that the Bethlehem Area School District lost at least $10.2 million in interest-rate swaps when the banking industry collapsed in the fall of 2008. The district had entered into the most swaps during a three-year period, 13.

We reviewed just two of the district's swaps because those were the only two that had concluded by the time of our investigation. The two swaps cost district taxpayers $10.2 million more than if the district had issued a standard fixed-rate bond or note. Ironically, the swaps cost taxpayers $15.5 million more than if the district had simply paid the interest on the variable-rate note without any swaps at all. The district's losses were largely due to excessive fees and other charges and a termination payment. Because the district has many other swaps still in effect, the ultimate financial impact on the taxpayers remains to be seen.

Unfortunately, since the results of our investigation were provided to the public last November, officials of several school districts have defended their use of swaps rather than attempt to disentangle themselves from these risky investments. Using rhetoric that eerily reflects gamblers at a Las Vegas blackjack table, they have rationalized their conduct by saying that there is little risk because they know what they are doing; they try to reassure taxpayers that the school districts and municipal governments that lost their shirts on swaps simply weren't as savvy as they are.

I wholeheartedly disagree. The truth is this: The Bethlehem School District thought it knew what it was doing, too; after all, it initially profited from its swaps agreements – before the banking system collapsed in the fall of 2008. The Delaware River Port Authority claims it earned $40 million on its swaps agreements signed in 2000 and 2001 – before they soured. The DRPA is now facing $240 million in liabilities on its swaps contracts.

How risky are interest rate swaps? Just ask President Obama's top White House economic adviser, Larry Summers, who, as president of Harvard University from 2001-2006, approved swaps so toxic that the school recently agreed to pay banks a total of almost $1 billion to terminate them.

As anyone who has ever been to a casino knows – even if you win a couple of bucks early, over the long haul, you never beat the house. The same holds true with swaps. Any Pennsylvania school official or borough manager who thinks that he or she can beat a Wall Street investment bank at a game that it invented is only deluding himself (or herself) and taxpayers.

As Pennsylvania's independent fiscal watchdog, I have urged the General Assembly to immediately prohibit local governments and municipal authorities from entering into swaps. I also continue to urge school districts and other local governments to take the following actions:

- Stop using swaps and other types of exotic financial instruments;
- Terminate any active swaps and refinance with conventional debt instruments;
- Assess the financial consequences if they were to suffer the same negative experience with their active swaps as discussed in our report; and
- Hire financial advisers through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

I am encouraged by the progress that has been made on the swaps issue in the short amount of time since we released our report. The Delaware River Port Authority, of which I am an ex-officio member, unanimously adopted my resolution to prohibit that bi-state agency from entering in to future swaps agreements and to begin a process of terminating its current swap agreements. Furthermore, several Pennsylvania school districts, including New Hope-Solebury in Bucks County, Nazareth Area in Northampton County, Central Dauphin in Dauphin County, and Erie School District, have recently terminated their swaps.

With regard to House Bill 1905, the Department of the Auditor General supports the legislation inasmuch as it repeals Act 23 of 2003, which expressly enabled local government units to enter into swap agreements. However, this bill does not address our recommendation regarding the competitive selection and monitoring of financial advisers, or our recommendation that municipal authorities should also be prohibited from entering into swaps. We would suggest an amendment to House Bill 1905 that would, at a minimum, require a local government unit to use a competitive selection process if it feels the need to hire a financial adviser, to evaluate the quality, cost and independence of the financial adviser's performance on a quarterly basis, and to report the results to the results of the evaluation to the public. We would also suggest that the Municipality Authorities Act be amended to expressly prohibit authorities from entering into swaps in connection with their bond issues. Finally, just to be absolutely clear, we would suggest that a similar provision be added to the Local Government Unit Debt Act to expressly prohibit local government units from entering into swaps ever again.

Exotic investment instruments like swaps may be perfectly acceptable in the private sector, but they should have no role in government. Public debt should be financed with fixed interest rates that are transparent, reliable and easily understood by the public.

As most homeowners would agree, a fixed-rate mortgage is preferable to a variable-rate mortgage because the monthly payments are stable, making it easier to plan your budget from month to month. The same common sense rule should apply to school districts and local governments.

You will hear today 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 transparent?
- How do the fees and commissions compare to the issuance of a standard fixed-rate bond issuance?
- 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 to the local government worth exposing taxpayer funds to potentially enormous risk if a swap turns sour? Cost | benefit

In closing, I would again like to commend the chairmen and committee members for seeking to ban the use of swaps by public entities. I can assure you all that the Department of the Auditor General will continue to monitor this issue. I would be happy to answer your questions.

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