Summary of Testimony of Jens H. Damgaard. Esquire
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I am a partner in the Harrisburg law firm of Rhoads & Sinon LLP, and a bond lawyer of 26 years, including as a past-president of the Pennsylvania Association of Bond Lawyers ("PABL") and a member of the National Association of Bond Lawyers. My firm represents over 20% of all Pennsylvania school districts as bond counsel including, since November, 2008, Bethlehem Area School District ("BASD"). My interview appears in the Auditor General's report, and I have been involved in several transactions seeking to restructure BASD's debt and swap portfolio.

Our shared mission is to acknowledge and address problems that have arisen since the enactment of Act 23 of 2003, allowing local government units to pledge their taxing power to secure swaps. I will make available to this Committee a PowerPoint presentation that I will make at the Pennsylvania Association of School Business Officials (PASBO) conference on March 11, which includes my comments in greater detail.

In that presentation, I discuss the pros and cons of repealing Act 23, which HB 1905 would accomplish, or attempting to cure its acknowledged deficiencies. It is important to keep in mind that we are analyzing the outcome of Act 23 through a historical prism, created by seven years of historically low and declining interest rates, and extreme market volatility and upheaval. Had interest rates increased over this period, and we managed to avoid an international banking crisis, our impressions of swaps undoubtedly would be very different.

There are really two general types of swaps, which I label for simplicity as "interest rate swaps" and "cash flow swaps". Ironically, the interest rate swaps, which most of us had in mind when the law was first enacted, as a tool to reduce interest rate risk and cost, have so far been the problem. The "fixed payer swaps" were designed to allow a borrower with existing variable rate debt to hedge against rising interest rates. However, the impact of these swaps in a declining interest environment is just the opposite, and they can create some debilitating liabilities. This is precisely what happened to BASD, and is sited extensively in the AG report and newspapers.

As detailed in my PowerPoint, a borrower must maintain potentially high cost variable rate debt in place to avoid paying even higher swap termination costs. After the variable rate bond market collapsed, many borrowers could not preserve or find sufficient variable debt and the result was to pay Wall Street firms millions of dollars to terminate the attached swaps. Many issuers, like BASD, put temporary loans in place to preserve some of their swaps, and reluctantly pay to terminate others.

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It has been reported that Pennsylvania local governments may lead the nation in the number and dollar amount of swaps. One reason for this distinction was the marketing concept of "synthetically fixed" rate debt. Variable rate debt mushroomed because issuers were told they no longer had to fear variable interest rate risk. A swap would effectively lock in a fixed rate. However, while the risks from the swap were explained (and actually performed as represented), the considerable risks inherent in the variable rate demand bonds were largely ignored.

Another big reason for the swap and variable rate debt proliferation was the fees. BASD paid an estimated $3,900,000 in fees over four years to its swap advisors. That amount does not even include the much higher compensation estimated to have been received by the participating Wall Street firms. I use "estimated" in each case because advisors quoted fees as a computer formula, not dollars, and the Wall Street firms still refuse to disclose their markups.

The discussions praising swaps have been almost exclusively focused on the second type of swap, the "cash-flow swaps", which have thrived in the recent low and volatile interest rate environment. Local governments have profited in most cases, and used these profits to offset reduced investment earnings on their general funds. Ironically, fixed payer swaps eliminated the traditional cash flow hedge, which was pure variable rate debt, so a second layer of swaps were introduced. Of course, when interest rates eventually move higher, payments will have to be made to Wall Street. School districts will have to fit their payments within the Act 1 Index limits and without increased state subsidies.

Cash flow swaps are useful but are, by nearly all accounts, treated as investment related vehicles, not debt related. Act 23 ties the total and annual amounts of swaps to outstanding debt, which could far exceed the actual fund balances to be hedged. Boards and administrators have to exercise self-restraint (and assume the consultants will do likewise) in choosing the appropriate sizing of these products.

HB 1905 has been characterized as "throwing the baby out with the bathwater," by banishing swaps altogether. This is troubling when some relatively simple regulations could cure most of the observed problems. The framework for Act 23 was never really finished. What other complex financial law has no supporting regulations? Moreover, DCED is not required by Act 23 to review or approve any swap documents. It also does not maintain any records illustrating swap fees or costs. A cost database would be extremely valuable to boards considering swaps.

As a lawyer involved in these transactions, charged with giving legal opinions on their validity, I need legal cause to object to inappropriate transactions. Well meaning financial advisers are also helpless in the face of abusive (but legally permitted) fees or structures. With common sense regulations, I believe we can curb excesses and maintain the potential benefits of swaps.

DCED should be given the opportunity, with the assistance of PASBO and other organizations, such as PABL, to draft regulations to curtail the interest rate swaps that have distressed BASD and other local governments. Cash flow swaps should be preserved but sized appropriately. Finally, we must mandate much better public disclosure of fees, including counterparty spreads. Attached is a summary of some suggested regulations.

SUGGESTED LGUDA SWAP REGULATIONS

Limitations on the terms of a Qualified Interest Rate Management Agreement (enforceable swap contracts):

- o The length of a QIRMA attached to variable rate debt shall not exceed the lesser of the term of the bond issue or the length of the letter of credit or other third party liquidity facility supporting the tender option on such bonds
- o The enforceability of the QIRMA shall be conditional on the related bonds being issued within 90 days of its date
- o In the case of school districts, the counterparty may not terminate the QIRMA prematurely as a result of a credit rating downgrade unless both (1) the Local Government Unit's ("LGU"), and (2) the Commonwealth's general obligation bond ratings fall below a specified level

The Interest Rate Management Plan (IRMP) shall include the following:

- o A copy of the independent financial advisor's ("IFA") service agreement with the LGU which includes the scope of services and fiduciary standard of care on that transaction (and include agreements with any other party engaged by the IFA for the transaction)
- o Specify the following fees and costs:
  - IFA, attorneys and other professional fees and expenses associated with the transaction in total (or maximum) dollars (not basis points or other formula)
  - Maximum acceptable counterparty spread (including dollar calculation if expressed in basis points)
- o A description of the methodology and objective criteria for selecting the counterparty and alternatives considered (including competitive bidding)
- o If the related bonds are variable rate, a discussion of the risks inherent in the bond structure, as well as the QIRMA, and a fee, cost and payment comparison with conventional fixed rate bonds
- o A certificate signed by the chief financial officer of the LGU outlining and acknowledging the maximum fees and spreads (in dollars) associated with the transaction
- o A discussion of the LGU's debt structure illustrating principal amounts and percentages of variable and fixed rate in light of published recommendations by at least two rating agencies (distinguishing those recommendations if appropriate)

Miscellaneous requirements and conditions to a QIRMA:

- o Any funds received by an LGU as a result of entering into, modifying or terminating a QIRMA shall be used exclusively to pay debt service (current or future) on the related bonds, or to terminate such QIRMA
- o A QIRMA cannot be approved by formal action of the LGU until at least three calendar days after a public hearing conducted at a public meeting of the LGU having principal financial responsibility for the QIRMA payments, at which the IFA presents and answers public questions regarding the proposed QIRMA
- o DCED should maintain a list of IFAs submitting annually qualifications prescribed by the LGUDA, including evidence of professional liability insurance with minimum coverages established by DCED

o DCED should include in readily accessible public records from QIRMA filings the identity of the IFA, attorneys and counterparty identified in each IRMP, and include all fees and counterparty spread for each