Back-Door Taxes Hit Americans With Public Financing in the Dark

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By Peter Robison, Pat Wechsler and Martin Z. Braun

Oct. 26 (Bloomberg) -- Salvatore Calvanese, the treasurer of **Springfield, Massachusetts**, for four years, had a ready defense for why he risked $14 million of taxpayer money on collateralized-debt obligations laden with **subprime** mortgages in 2007.

He didn't know what he was buying, he says, and trusted the financial professionals who sold them and told him they were safe.

"I thought they were money markets that were just paying more," Calvanese said in an interview. "Nobody ever used the term 'CDO,' and I am not sure I would have known what that was anyway."

Such financial mistakes, often enabled by public officials' lack of disclosure and accountability for almost 90 percent of government financings in the $2.8 trillion municipal bond market, are costing U.S. taxpayers as much as $6 billion a year, according to data compiled by Bloomberg in more than a dozen states.

The money lost to taxpayers -- when the worst recession since the Great Depression is forcing local governments to cut university funding, delay paying bills and raise taxes -- is enough to buy health care for everybody in Minneapolis; Orlando, Florida; and Grand Rapids, Michigan, according to figures from the U.S. Census Bureau and the U.S. Department of Health and Human Services.

Florida county commissioners approved no-bid deals with their favorite banks in an arrangement that led to criminal convictions. Pennsylvania school board members lost $4 million on an interest-rate swap agreement they didn't understand in the unregulated $300 billion market for municipal derivatives.

Trouble With Swaps

Local agencies in Indianapolis, Philadelphia, Miami and Oakland, California, spent $331 million to end interest-rate swaps with banks including **JPMorgan Chase & Co.** of New York and Charlotte, North Carolina-based **Bank of America Corp.** during the past 18 months. The swaps, agreements to exchange periodic interest payments with banks or insurers, were intended to save borrowing costs. Payments increased instead.

New Jersey taxpayers are sending almost $1 million a month to a partnership run by **Goldman Sachs Group Inc.** for protection against rising interest costs on bonds the state redeemed more than a year ago, Bloomberg News reported Friday.

The interest-rate swap agreement, which the state entered in 2003 under former Governor **James E. McGreevey**, remained in place even after the state **Transportation Trust Fund Authority** replaced $345 million in auction-rate bonds that had fluctuating yields with fixed-rate securities last year.

Harvard Pays

Now, the 3.6 percent the trust fund is paying on the swap has pushed the cost on the original debt to 7.8 percent, the most the authority has paid since it was formed in 1985, according to records on its Web site. Canceling the swap before 2011 would require the state to pay an estimated $37.6 million fee, according to state records.

Even Harvard University, whose endowment of $26 billion makes it the world's richest academic institution, fell for Wall Street's financing in the dark: The Cambridge, Massachusetts- based university paid $497.6 million to investment banks during the year ended June 30 to cancel $1.1 billion of swaps.

The public needs more transparency in municipal debt transactions, said **Elizabeth Warren**, chairwoman of the Congressional Oversight Panel for the Troubled Asset Relief Program. Proposed reforms, such as an oversight agency for

consumer finance, could help spur improvements, she said in an interview this month.

'Worldview Change'

"We need a worldview change about transparency, and that includes municipal finance," said Warren, a professor of bankruptcy law at Harvard Law School.

The public paid extra costs for borrowing with tax-exempt bonds because local governments resist providing investors the same level of disclosure as corporate borrowers, which file quarterly reports.

Municipalities typically file financial statements only once a year. Detroit, the largest U.S. city with a less-than-investment-grade credit rating, released its annual report for fiscal 2007 in March, more than 18 months later.

State and local governments that share more financial information than the minimum required pay yields as much as 0.20 percentage points lower than others, said Lisa Fairchild, professor and chairman of the finance department at Baltimore's Loyola University Maryland, who produced a 1998 study on disclosure.

Applied across the tax-exempt bond market, that's $5.6 billion a year, enough to buy more than 12,000 $465,608 pumper- tender fire trucks. That's more than one truck for every county in the U.S. The rest could form a parade 50 miles (80 kilometers) long.

Build America Bonds

State and local governments that sold $43.8 billion of taxable Build America Bonds this year will pay $385 million a year more in interest than similarly rated corporate borrowers, based on data compiled by Bloomberg.

The bonds, for which the federal government subsidizes 35 percent of interest costs, pay an average yield that's 0.8 percentage points more, relative to benchmark rates, than yields for corporate securities with the same credit ratings, the data show.

As a result, it costs New Jersey road authorities, Georgia sewer districts and other agencies more to borrow, even though they, unlike corporations, can raise fees or taxes to make up for deficits. Corporations are at least 90 times more likely to default than local governments, according to Moody's Investors Service.

Discounted to their present value, those additional payments by municipal borrowers add up to $6.1 billion over the life of the debt.

'It's Horrendous'

"I think it's horrendous, but it's very hard to get anybody to pay much attention to it," said **Stanley Langbein**, a law professor at the University of Miami and a former tax counsel at the U.S. Treasury in Washington.

Underwriters -- banks or securities firms that guarantee the purchase of debt issuers' bonds -- have an interest in keeping prices low, and yields high, because it means higher returns for them and the first investors, Langbein said.

Many Build America bonds traded at higher prices immediately after agencies sold them, a sign that taxpayers lost, he said.

The Government Finance Officers Association, a professional group based in Chicago, warns municipalities of "competing objectives" in their relationships with underwriters. Many don't heed that warning, said **Christopher "Kit" Taylor**, who was the top regulator of the municipal bond market from 1978 to 2007.

'Stockholm Syndrome'

"They're suffering from **Stockholm syndrome**," he said, referring to the psychological phenomenon in which hostages begin to identify with and grow sympathetic to their captors. "They are being held hostage by their investment bank."

Public officials shunned competitive bids for more than 85 percent of the $308.9 billion in new tax-exempt bond sales in the first nine months of this year, according to data compiled by Bloomberg. That's up from 17 percent in 1970 and 68 percent in 1982, according to the **Government Accountability Office**.

Most borrowing costs that state and local taxpayers incur are set in private negotiations. Finance professionals say no-bid sales allow them to market debt to particular investors, helping issuers find demand when credit markets are tight.

The method boosts interest rates by as much as 0.06 percentage point, according to several academic studies reviewed by the GAO.

Excess Fees

Palm Beach County, Florida, paid $880,000 in excess bank fees and as much as $1.3 million a year in unnecessary interest because its commissioners sold bonds without bids, according to a county report in April.

Each commissioner nominated his or her favorite bank and work was parceled out on a rotating basis, the report showed. That allowed former commissioner **Mary McCarty** to steer more than $600 million in debt issues to banks that employed her husband, Kevin McCarty, according to federal charges that led to guilty pleas from both this year.

After the McCartys were charged, the county adopted a policy stating a preference for competitive bond sales. When bonds are sold by negotiation, a financing committee will circulate a request for proposals, evaluate them and then recommend an underwriter to commissioners, said Liz Bloeser, Palm Beach's budget director.

No Bids

Beaver County, Pennsylvania, commissioners haven't taken bids for bond underwriters since 1986, county records show. After relying on the same firm for more than two decades, they paid as much as $2.8 million more than they had to on a bond sale in January, based on trading records from the Municipal Securities Rulemaking Board, which oversees the tax-exempt bond market.

Using the same underwriter repeatedly for negotiated sales increases borrowing costs each time, according to a study published in the Winter 2008 edition of the Municipal Finance Journal. The study found that if an issuer had used the same bank twice before, its borrowing cost on $100 million of 10- year bonds increased by more than $1 million over the life of the debt.

Other financial mistakes can be difficult to quantify. Taylor, who studied government finances for 30 years as the executive director of the MSRB, said as many as five out of 10 local governments "aren't getting the best deal by a long shot" on their investments.

Overpaid for Securities

Apache County, Arizona, overpaid its broker almost $500,000 for U.S. government securities, county records show. A price check would have caught the problem. The county has no record that it ever did one.

Many local officials are unprepared for Wall Street's sales pitches, said **Mary Christine Jackman**, Maryland's director of investments in Annapolis.

"When you combine people who are less sophisticated with people who can sell as those on Wall Street usually can, you end up with a very big problem," she said. Jackman tries to offer basic training and advice to small municipalities, she said.

There are more than 89,000 cities, counties, school districts and other municipal authorities in the U.S., according to data from the Census Bureau. Each year, about 5,000 people attend training sponsored by the Government Finance Officers Association, which has 18,000 members, said **Jeff Esser**, the group's executive director.

'Doing Nothing'

The GFOA has never tried to make a comprehensive tally of its members' educational attainment or professional backgrounds, he said. He added that during his 30 years with the organization, he has seen "a significant increase" in members' education, training and professionalism.

Supervisors in Mohave County, Arizona, took issue with the professionalism of its treasurer, Lee Fabrizio, during an investigation last year in which employees reported that he played a lot of golf and was rarely in the office.

"It's nice to get this paycheck for doing nothing," Fabrizio told employees once, according to the July 2008 report by the county manager.

Fabrizio, who received a $56,500 annual salary, said he doesn't remember making that statement and was in the office every day. He said he played nine holes of golf a day for two hours at lunchtime.

An employee's grievance sparked the investigation and ultimately a state audit, which reported Aug. 28 that the treasurer bought corporate bonds with no evidence of competitive bidding, didn't vet brokers' backgrounds and continued to value a $5 million Lehman Brothers Holdings Inc. bond at full cost even after the firm's Sept. 15, 2008, bankruptcy.

Not an Expert

The Lehman bond was purchased in late 2007, when the treasurer put $50 million, about 25 percent of the county portfolio, into 11 corporate bonds, 10 of them in financial firms including Lehman and Bear Stearns Cos.

"Even if it was a bad investment, I wouldn't have known the difference; I'm not an investment expert," Fabrizio said, adding that he relied on his hired deputy for those decisions. The deputy e-mailed competing brokers and had them fill out questionnaires, he said.

The county never sanctioned him, and he was voted out of office last year.

The Lehman loss cost the 7,000-student district in Kingman, Arizona, the county seat, almost $1 million, according to Wanda Hubbard, the schools' finance director. The real losers are taxpayers, who will be levied more as a result, she said. The owner of a $250,000 house in the district may pay $25 extra this year, Hubbard estimated.

'Back-Door Tax'

"It was kind of a back-door tax increase," she said.

Officials are up against increasingly sophisticated financial products, including interest-rate swaps and so-called swaptions. A swaption grants the owner the option to force a particular party into a swap.

The Butler Area School District in western Pennsylvania paid JPMorgan $5.2 million last year to cancel such a pact. The payment was about seven times more than the district had received under the contract. Statewide, 55 Pennsylvania school districts have paid counterparties to exit interest-rate swaps since 2003, according to state records.

Some officials now say they didn't understand the deals.

"The financial guys would come in with a lot of stuff that nobody at the district understood," Penelope Kingman, a former member of the Butler school board who voted against the deal, told Bloomberg News last year. "Local governments are entering into these without fully understanding what they are doing."

Market Has Grown

While such contracts aren't traded on regulated exchanges, the market for municipal derivatives has grown to as much as $300 billion annually, the MSRB says. Derivatives are a category of contracts whose value is tied to assets including stocks, bonds, commodities and currencies, or events such as changes in interest rates or the weather.

One type of derivative, the interest-rate swap, helped put **Jefferson County, Alabama**, on the brink of bankruptcy.

The county refinanced $3 billion of sewer debt in no-bid deals earlier this decade, issuing variable-rate bonds that were hedged with swaps. The plan backfired last year as the global credit crisis took hold. Interest payments due on the bonds more than tripled to 10 percent, while the swap income decreased.

Last week, the former president of the county commission, **Larry P. Langford**, went on trial in federal court in Tuscaloosa. Langford, now the mayor of Birmingham, pleaded not guilty in December to charges including bribery, conspiracy and filing false income tax returns.

'Political Witch Hunt'

Prosecutors say he took cash, clothes and Rolex watches from a banker who received $7.1 million in fees on debt sales in 2003 and 2004. Langford has called the case "a political witch hunt."

The Justice Department and the Securities and Exchange Commission are investigating whether Wall Street banks conspired with some brokers to rig bids and fix prices for municipal derivatives. The probe centers on interest-rate swaps and on investments that cities, states and schools buy with bond proceeds, according to subpoenas received by agencies in Alabama, Illinois, Pennsylvania and New Mexico.

While many municipalities turn to professional consultants for guidance on derivatives, the MSRB reported in April that 73 percent of financial advisers who participated in the municipal bond market in 2008 weren't subject to the board's rules because they weren't registered securities dealers.

Legislation Considered

Congress is considering legislation to regulate the financial advisers. Still, there are other gaps.

Federal law exempts the municipal market from rules regarding disclosure and enforcement that apply to companies. And transactions between broker-dealers and municipalities are rarely scrutinized by the self-regulatory agencies that banks and securities firms use to police themselves, including the Financial Industry Regulatory Authority, said Taylor, the former MSRB chief.

Finra and other regulators presume that institutional clients are sophisticated enough to look after themselves, he said.

"Typically, what happens is, nobody looks," he said. "Finra doesn't look, the firm doesn't look, the city council doesn't look and the populace, the taxpaying populace, has no idea any of this is going on."

Nancy Condon, a spokeswoman for Finra, declined to comment. The Strategic Programs Group of the authority's enforcement department in May sent letters to dealers seeking **information** about interest-rate swaps, structured notes and other products they may have sold.

Enforcement Questions

Taylor questioned why the information-gathering hasn't led to anything further.

"Finra wants the world to think it is doing something for investors and the good of the markets without actually bringing any enforcement actions or adopting any rulemaking," he said.

In Orange County, the home of both Disneyland and the largest municipal bankruptcy in U.S. history, officials echoed the mistakes of 15 years ago by investing in another Wall Street innovation.

Robert Citron, who was county treasurer leading up to the 1994 bankruptcy, bought structured notes that paid off when short-term interest rates were lower than medium-term rates, and increased his gamble with funds from issuing new debt. The county lost $1.6 billion when interest rates rose.

Cost of Insolvency

Payments from the resulting insolvency still cost more than $80 million annually, about 1.5 percent of the county's proposed fiscal 2010 budget.

County supervisors responded by creating an oversight committee to monitor the treasurer and banning investments in derivatives and the use of leverage to amplify returns.

Under **John Moorlach**, the accountant who exposed the bad bets and succeeded Citron as treasurer, the county later invested in structured investment vehicles, or SIVs. Banks set up the pools of loans to shift risk from their own balance sheets. They borrowed money at short-term rates to finance longer-term investments such as British credit-card receivables or home mortgages.

Moorlach said he got into SIVs, which often yielded more than the county's other investments, after a ratings officer from Fitch Ratings told him that such exotic instruments were becoming more mainstream.

By 2007, one year after Moorlach won election to the county's board of supervisors and was succeeded as treasurer by **Chriss Street**, the investments in SIVs totaled more than $800 million. They made up 14 percent of a county investment pool that manages money for the county, schools and local agencies.

'Weren't Paying Attention'

The county sold one SIV at $6.4 million below par last year and so far has recovered about $30 million of the $80 million it invested in Whistlejacket Capital LLC, created by London-based bank Standard Chartered Plc. Whistlejacket, which listed Citigroup Inc. debt and U.K. home loans among its assets, went into receivership last year.

"Despite the oversight, despite the audits, they weren't paying attention -- and should have been," said Terry Fleskes, a member of an independent panel that chastised the treasurer and county auditor in June for allowing more investments in complex financial products. Fleskes is a former controller at a unit of San Diego-based **Sempra Energy**.

"The lessons of the past have been forgotten," the Orange County Grand Jury said in its **report**. The group, which doesn't have the authority to compel changes, serves as a kind of ombudsman to examine county policies.

'Best Stuff Around'

The structured vehicles were difficult to evaluate, Moorlach said. He relied on rating companies, which "were treating it like it was the best stuff around."

"I think the rating agencies have a lot of explaining to do because of the overreliance by hardworking municipal treasurers," he said.

A Fitch spokesman, **Kevin Duignan**, declined to comment.

"It's easy to point the finger at others," said **Bart Hildreth**, dean of the Andrew Young School of Policy Studies at Georgia State University in Atlanta and a former finance director of Akron, Ohio. "The rating agency didn't authorize the allocation of the money."

Orange County auditor **David Sundstrom** said the amount at risk in SIVs was nothing like the leveraged wagers made by Citron.

"The controls compared to pre-bankruptcy are incredibly strong," he said.

Out of SIVs

The county has exited all of its SIV investments except Whistlejacket, in which it has notes in a restructured successor that's being liquidated. Taking into account interest earned, the county hasn't lost on the SIVs, said Deputy Treasurer Keith Rodenhuis. Interest totaled $58.6 million, with $50.2 million in capital still outstanding in the Whistlejacket

successor. County officials expect to get that money back in time, he said.

While Moorlach said Orange County did what it could, sending an analyst to London to investigate one SIV and examining financial reports, the investments may have been a mistake.

"If something's taking up so much of your time, maybe it ain't worth it," he said in his Santa Ana, California, office, overlooking a courtyard where volunteers from local churches serve hot dinners and distribute essentials like socks and toilet paper to a 40-deep line of needy people.

King County, Washington, the home of Seattle, has recovered less than half of $207 million that it put into four failed SIVs. It sued rating companies in federal court this month, saying it was misled by their assessments.

No Clue

"There's a basic rule of finance: Don't get into anything you don't understand," said **Michael Granof**, an accounting professor at the University of Texas in Austin. "Many municipalities had no clue as to what they were buying."

Apache County, Arizona, an area the size of Maryland where 70,000 people live among vast mesas dotted with shrubs, stuck to safe investments, such as U.S. Treasury securities and federal agency bonds. It just didn't know how to value them.

County treasurer Katherine Arviso, a school administrator on the Navajo reservation for 40 years until she won election in 2004, said she arrived to find investment records packed away in boxes.

"I had to put the whole office back together," she said.

Then came an August 2005 letter from **Piper Jaffray Cos.'sBradley Winges**, the head of sales and trading for the Minneapolis-based firm's public finance group. He wrote that the firm had reviewed trades in the county's account and found unacceptable commissions. The firm credited $247,060.79 to the county's account.

Eventual Refund

Piper Jaffray eventually refunded $472,060.79, according to a settlement obtained by Bloomberg News under the state public records act. That's more than double the $194,870 that the county, one of the poorest in the U.S., spent on immunization, teen pregnancy prevention and home health care last year. Apache County's per capita income was $8,986 in the 2000 U.S. Census, less than half the U.S. figure, $21,587.

Three days after sending the letter, the firm fired broker Eric Ely, according to Finra records. Ely didn't return telephone messages or respond to an e-mail seeking comment for this story.

From Oct. 20, 2003, to June 29, 2005, Ely executed 103 trades for Apache County, buying and selling bonds, according to a subsequent investigation conducted by Edward "Buzz" France, a former deputy county attorney.

Estimated Commissions

In a presentation to county supervisors, France estimated that Piper Jaffray earned commissions of just over $1 million on $158.6 million in principal, an average rate of 0.638 percent. Investment bankers told France the commissions should have been no more than 0.3 percent.

"Our clients' interests come first," Piper Jaffray said in a statement. "Four years ago, we discovered a situation in which we believed one employee had run counter to this guiding principle, and we proactively and quickly worked to rectify any client impact, and terminated the employee."

There was no need for so many trades if the goal was steady, reliable returns, said **Charles Anderson**, the former manager of field operations for the tax-exempt bond division of the Internal Revenue Service.

A reasonable commission for the $158 million of securities that Apache County purchased would have been $50,000 to $100,000, said **Thomas Tucci**, head of U.S. government bond trading at RBC Capital Markets Corp. in New York, one of 18 firms that trade directly with the Federal Reserve.

Not Unusual

Basic financial mistakes trip up many local governments, said Kevin Camberg, a partner with **Fester & Chapman P.C.**, a Phoenix accounting firm that has checked the books of Apache County and others in Arizona for the state auditor.

"It's not as unusual as it should be," he said.

France, the county investigator, never determined how Piper Jaffray was chosen to handle Apache County's investment fund. The treasurer at the time, Betty Montoya, declined to comment on the selection process for this story.

Had the county checked Ely's licensing history with Finra, which oversees almost 4,800 brokerage firms, it would have

found previous allegations of infractions. Since 2002, investors have been able to access **BrokerCheck** reports of disciplinary histories online, said Condon, the Finra spokeswoman.

Ely paid $80,000 toward a $260,000 settlement of a customer's 1989 complaint of "unauthorized and unsuitable transactions," according to Finra records. Ely worked for Merrill Lynch & Co. from 1983 to 1990, the records show.

Settlement in Wyoming

In 2002, Piper Jaffray reached a $42,500 settlement of a customer's allegations that Ely had purchased and sold securities contrary to Wyoming state law or local investment policy, the records show.

Ely, now affiliated with Public Asset Management Group in Greenwood Village, Colorado, and First Financial Equity Corp. in Scottsdale, Arizona, continued seeking business with small local governments. The broker gave a speech called Investment Management Alternatives for the School at a meeting of the Montana Association of School Business Officials in June 2008.

"He said he was interested in all the smaller players," said Dustin Zuffelato, who attended as business manager of the 2,400-student Columbia Falls School District Six in Flathead County, Montana.

Zuffelato recommended that his school board consider investing about $8 million with Ely. The board declined, citing the logistical hurdles of switching investments from a pool managed by the county treasurer, he said. Zuffelato said he didn't check for complaints against the broker first.

Investing 101

In June, the broker appeared again at the Montana schools conference, this time teaching a class called Investing 101.

In Springfield, Calvanese, the former city treasurer, said brokers told him he was investing in money-market funds.

City officials could have learned that they were really buying securities that bundle various issuers' bonds or loans, or both, if they had insisted on seeing disclosure documents about the securities. Calvanese said in an interview that he rarely looked at such documents, which outline risks.

Calvanese was fired after the CDO investment came to light. He has filed suit challenging his dismissal.

Springfield officials and the Massachusetts attorney general argued that the city was misled by its brokers from Merrill Lynch, who sold it financial instruments that violated a state restriction on public investments. Calvanese said the brokers assured him the transaction complied with state law.

Merrill Lynch, now owned by **Bank of America**, returned the $14 million the city had invested, and agreed to pay an additional $300,000 in July.

A $75,000 portion of that money was set aside for educating municipal officials on investment management.

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