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I N S T I T U T E

Dirty Deals: **How Wall Street's Predatory Deals Hurt Taxpayers and What We Can Do About It**

Report by
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The Refund America Project
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EXECUTIVE SUMMARY

The financialization of the United States economy has distorted our social, economic, and political priorities. Cities and states across the country are forced to cut essential community services because they are trapped in predatory municipal finance deals that cost them millions of dollars every year. Wall Street and other big corporations engaged in a systematic effort to suppress taxes, making it difficult for cities and states to advance progressive revenue solutions to properly fund public services. Banks take advantage of this crisis that they helped create by targeting state and local governments with predatory municipal finance deals, just like they targeted cash-strapped homeowners with predatory mortgages during the housing boom. Predatory financing deals prey upon the weaknesses of borrowers, are characterized by high costs and high risks, are typically overly complex, and are often designed to fail.

Predatory municipal finance has a real human cost. Every dollar that cities and states send to Wall Street does not go towards essential community services. Across the country, cuts to public services and other austerity measures have a disparate impact on the working class communities of color that were also targeted for predatory mortgages and payday loans, further exacerbating their suffering.

The primary goal of government is to provide residents with the services they need, not to provide bankers with the profits they seek. We need to renegotiate our communities' relationship with Wall Street. We can do this by implementing common sense reforms to safeguard our public dollars, make our public finance system more efficient, and ensure that our money is used to provide fully-funded services to our communities. Taxpayers do trillions of dollars of business with Wall Street every year. It is time we start making our money work for us.

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KEY RECOMMENDATIONS

- *Transparency:* Officials should disclose all payments for financial services and conduct an independent investigation of all financial deals to identify predatory features.
- *Accountability:* Cities and states should take all steps to recover taxpayer dollars when bank deal unfairly with them, including taking legal action, renegotiating bad deals, and refusing future business.
- *Reducing Fees:* Officials should identify financial fees that bear no reasonable relationship to the costs of providing the service and use their leverage as customers to negotiate better deals.
- *Collective Bargaining with Wall Street:* Cities and states should agree to a common set of guidelines for an efficient municipal finance system and refuse business with any bank that does not abide by them, creating a new industry standard.
- *Creating Public Options for Financial Services:* Cities and states should determine which services they could do themselves more cheaply if they hired the right staff, and make a plan to insource those functions.
- *Establishing Public Banks:* Cities and states should establish public banks that are owned by taxpayers, can deliver a range of services, including municipal finance, and provide capital for local investment.

Dirty Deals: How Wall Street's Predatory Deals Hurt Taxpayers and What We Can Do About It

By Saqib Bhatti, November 18, 2014

INTRODUCTION

There is a saying that a budget is a moral document. If that is true, then cities like Detroit are bankrupt in more ways than one. Across the country, elected officials in financially distressed cities and states are cutting essential community services like mental health clinics and public schools in order to address budget crises, but they are faithfully paying Wall Street for predatory financial deals. In public budgeting parlance, funding for services is called discretionary spending but payments to Wall Street are considered mandatory.

Most people would agree that the most important debt that a school system owes is to students, to provide them with a decent education. In reality though, school districts like Philadelphia's are routinely forced to increase class sizes, lay off teachers and guidance counselors, and close schools to pay predatory debts to Wall Street.¹ The financialization of the United States economy over the last 35 years has distorted our social, economic, and political priorities. The primary function of government is to provide services to residents (e.g., streets, schools, fire protection, national defense), not to provide a profit to Wall Street. However, in the financialized economy, Wall Street profits trump all other priorities.

The financial crash of 2008 ushered in the largest economic downturn in the United States in 80 years and exposed the fundamental problems that underpin the American economy. Millions of families that had worked hard to earn a middle class lifestyle found themselves facing foreclosure, unemployment, and bankruptcy. Moreover, at the very moment that they most needed to rely on the social safety net, they found that their elected officials were slashing essential public services to close revenue shortfalls, even as they spent trillions of dollars on taxpayer bailouts for Wall Street.

We need to renegotiate our communities' relationship with Wall Street so that we can provide residents with the services they deserve. We can do this by implementing common sense reforms that could save taxpayers millions of dollars by making the municipal finance system more efficient.

This report will look at the impact that the financialization of our economy has had on the public sector, detail how Wall Street has exploited the situation to sell predatory deals to taxpayers, describe the human toll this has taken on local communities, and lay out a policy framework for reforming the system to make our taxpayer dollars work for us.

THE FINANCIALIZATION OF OUR ECONOMY

The financial sector has ballooned in size and come to dominate our economy over the past 35 years. Finance accounted for approximately 3 percent of U.S. gross domestic product (GDP) in the 1950s, but has more than doubled to 6.5 percent today.² In 1950, 9 percent of total corporate profits in the U.S. were derived from the

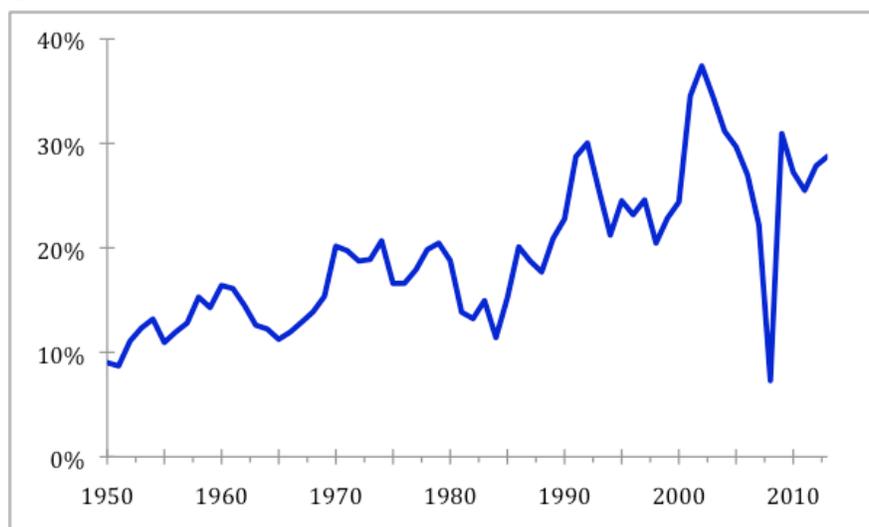
¹ *Too Big to Trust? Banks, Schools, and the Ongoing Problem of Interest Rate Swaps*, Sharon Ward, Pennsylvania Budget and Policy Center, January 17, 2014.

Back to school: It's worse than you think, Valerie Strauss, Washington Post, September 7, 2013.

² *Frenzied Financialization: Shrinking the financial sector will make us all richer*, Michael Konczal, Washington Monthly, November 2014.

financial sector. By 2013, that number had skyrocketed to 29 percent, down from a high of 37 percent in 2002 (see Figure 1).³ These figures are actually understated because they do not include the portion of profits at nonfinancial firms, like General Electric and Ford, that are derived from financial operations, like GE Capital and the Ford Motor Credit Company.

Figure 1: Percent of Total U.S. Corporate Profits Derived from the Financial Sector



Source: Bureau of Economic Analysis⁴

Financialization has had a profound effect on all aspects of the American economy. Mike Konczal, who runs the Financialization Project at the Roosevelt Institute, defines financialization as the “increase in the size, scope, and power of the financial sector – the people and firms that manage money and underwrite stocks, bonds, derivatives, and other securities – relative to the rest of the economy.”⁵ Through financialization, Wall Street has made the rest of our economy subservient to the financial sector.

One of the ways this has happened is through a strategic shift in the banking business model. Whereas the core business of banking used to be based on interest income, or the money that banks earn from interest on loans they make, bank earnings are now driven by fees. Big banks no longer hold on to most of the loans they make, so they do not actually collect the interest on those loans. Instead, they securitize the loans and sell them off to investors in the secondary market. They make their money based on the fees they charge to make the loan, securitize it, sell it off to investors, and then service it. In fact, a report by the Service Employees International Union found that noninterest income accounted for approximately 70 percent of earnings at the nation’s top three banks in 2009, up from less than 45 percent in 1995.⁶

The fee-based business model allows Wall Street banks to make a profit regardless of the financial health of their customers. Banks make their money based on the quantity of loans they make, not the quality of those loans. In fact, clients in poor financial health that constantly need to take out more loans, refinance their loans, or enter into more complex financing structures that entail multiple transactions are more profitable to Wall Street than financially stable customers with plain vanilla loans who can pay their bills on time.⁷ This is true for banking

³ BEA Data: <http://www.bea.gov/iTable/iTableHtml.cfm?reqid=9&step=3&isuri=1&903=239>.

⁴ *Ibid.*

⁵ Konczal, *op. cit.*

⁶ *Big Banks Bonus Bonanza*, SEIU, December 2011, 10.

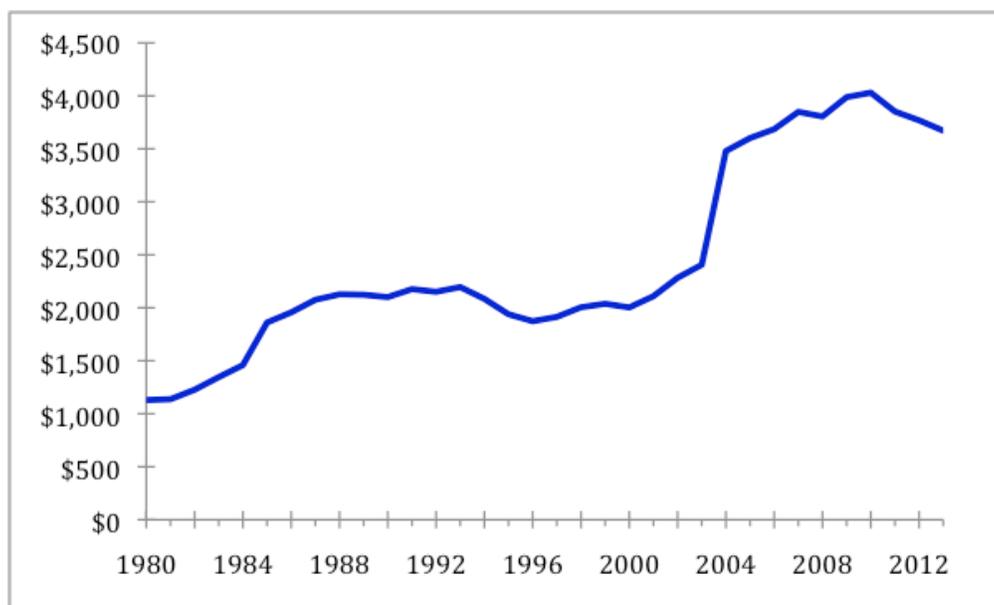
⁷ *For the Poor, the Costs of Life Can Be Higher*, Hannah Rapple, NBC News, August 2, 2013.

customers of all stripes – individual consumers, corporate clients, and municipal borrowers. This encourages banks to pursue predatory lending practices, like steering customers towards financial products that are more expensive, more complex, and contain hidden risks. Unfortunately, working families, small business owners, and state and local governments in particular are easy prey.

In the financialized economy, Wall Street firms actually benefit from economic inequality because poor people, struggling small businesses, and tax-starved governments are all great sources of fee revenue. As a result, there has been a systematic effort by Wall Street and Corporate America to suppress both wages and taxes over the past 35 years. Wall Street’s sole focus on shareholder returns rewards companies that avoid taxes and pay their workers low wages.⁸ Banks and other financial firms like hedge funds and private equity firms use loopholes and other financial shenanigans to avoid paying their fair share in taxes,⁹ and they lobby to prevent progressive revenue solutions, denying public officials revenue they desperately need.¹⁰ For example, the Oregon Bankers Association was one of the leading funders of the campaign against Measures 66 and 67 in Oregon in 2010 to institute a high-earners tax and raise the \$10 corporate minimum tax.¹¹

The current Wall Street business model is premised on extraction. The more money bankers can extract from the economy, the bigger their end of year bonuses will be. In municipal finance, this means diverting public dollars that are supposed to be spent on Main Street back to Wall Street. As tax rates for corporations and top income-earners have declined over the past 35 years, cities and states have been forced to take out debt to pay for things they used to be able to afford. This has provided banks with the opportunity to extract vast amounts of taxpayer dollars. Outstanding municipal bond debt has grown tenfold since 1981, from \$361 billion to \$3.7 trillion (see Figure 2).¹²

Figure 2: Outstanding U.S. Municipal Bond Debt, in billions (2013 dollars)



Source: Securities Industry and Financial Markets Association, Bureau of Labor Statistics¹⁵

⁸ *How the cult of shareholder value wrecked American business*, Steve Pearlstein, Washington Post, September 9, 2013

⁹ *Reducing the Deficit: Eliminating Wall Street Loopholes*, U.S. Senator Carl Levin, September 19, 2011

¹⁰ *Wall Street Trains Fire on Idea of a Bank Tax*, Stephanie Armour and Ryan Tracy, Wall Street Journal, March 17, 2014

¹¹ *Public-Employee Unions Flex muscle in Measures 66 and 67 Tax Battle*, Brent Walth, The Oregonian, January 20, 2010

¹² *The State of the Municipal Securities Market*, U.S. Securities and Exchange Commission, May 13, 2014, <http://www.sec.gov/spotlight/municipalsecurities.shtml>

While it is sound public policy to use debt to fund long-term capital projects, it is deeply problematic when cities and states are forced to borrow money to deal with revenue shortfalls, especially if those shortfalls are the result of a concerted effort to suppress taxes by the very banks they are borrowing from. When this happens, taxpayers ultimately suffer because it provides financial firms with greater opportunities to extract more money from the public sector, which comes at the expense of public services.

For example, between 2010 and 2012, school districts in Minnesota were forced to borrow nearly \$2 billion to meet their short-term cash flow needs when the state legislature indefinitely delayed state education funding to fill a budget hole.¹⁴ While school districts across the state were forced to cut instructional staff, they had to pay banks and other Wall Street firms more than \$6 million in fees.¹⁵ Governor Mark Dayton put forth a plan to help the state recover from the 2008 financial crisis by raising taxes on corporations and the wealthy, but the Minnesota Chamber of Commerce and the Minnesota Business Partnership, which were headed by executives from Wells Fargo and U.S. Bank, respectively, successfully lobbied to block the legislation.¹⁶ The state was finally able to pay back the schools after raising taxes on high earners and cigarettes in 2013.¹⁷

As public officials have been forced to increase borrowing to keep up with the growing demands of their communities, Wall Street firms have taken advantage of this crisis by steering municipal borrowers toward more complex debt deals that generate more fee revenue, turning a plain vanilla corner of banking into a complicated goldmine for bankers. The financialized economy allows Wall Street to extract wealth out of every transaction. Whether a parent takes out a loan to send a kid to college or a public agency issues a bond to pay for basic services, banks get to take a cut through fees and interest. This enriches the financial sector at the expense of working families, contributing to the growing inequality in our country.

As a result, cities like Chicago and Philadelphia are closing schools and sacrificing our children's education so they can make good on their predatory deals with Wall Street. University boards are filled with Wall Street executives who vote to raise students' tuition to pay for expensive debt financing schemes that profit their own banks. For example, Bank of America board member Monica Lozano served as a University of California (UC) Regent and voted to raise tuition for students at the same time that the bank was profiting off of an interest rate swap with the UC San Francisco Medical Center.¹⁸ The financialization of our economy has fundamentally distorted our nation's priorities.

PREDATORY MUNICIPAL FINANCE

By now it has been well-documented that working class homeowners, especially in communities of color, were targeted for predatory mortgages during the subprime boom of the 2000s. These deals were typically characterized by hidden costs and hidden risks, and were often designed to fail because the lender did not have a long-term interest in the ability of the borrowers to repay their loans. In many cases homeowners, especially African Americans and Latinos, who were eligible for prime loans were targeted for more expensive subprime loans.¹⁹ Homeowners who took out mortgages that had balloon payments that would skyrocket after five years often were never fully informed about the risks inherent in those deals and the fact that they had a ticking time

¹³ SIFMA data: <http://www.sifma.org/uploadedFiles/Research/Statistics/StatisticsFiles/CM-US-Bond-Market-SIFMA.xls?n=25899> and Historical CPI-U data from the BLS.

¹⁴ *IOU: How Wells Fargo and U.S. Bank Have Shortchanged Minnesota Schools*, SEIU Local 284, May 2012, 3.

¹⁵ Calculations based on data provided by the Minnesota Department of Education.

¹⁶ SEIU Local 284, 8-9.

¹⁷ *Minnesota budget deal: Tax hikes on High Earners, Tobacco*, Bair Helgeson and Jennifer Brooks, Star Tribune, May 13, 2013.

¹⁸ *Swapping Our Future*, Charlie Eaton, Jacob Habinek, Mukul Kumar, Tamera Lee Stover, and Alex Roehrkaase, Sociologists at Berkeley, November 2012, 9.

¹⁹ *Unequal Opportunity Lenders? Analyzing Racial Disparities in Big Banks' Higher-Priced Lending*, Andrew Jakabovics and Jeff Chapman, Center for American Progress, September 2009.

bomb on their hands. Lenders sold these mortgages on the secondary market as soon as the deals closed, so they did not bear any of the risk of borrower default. Instead, they got paid based on the number of loans they originated.²⁰

However, it was not just unsuspecting or unsophisticated homeowners who got trapped into predatory deals. Just like cash-strapped homeowners were targeted for predatory mortgages, cash-strapped state and local governments were similarly targeted for predatory municipal finance deals. These deals were also marked by hidden costs and hidden risks, and many were designed in such a way that it should have been easy to predict that they could fail.

Deals That Were Designed to Fail

The City of Detroit entered into a complex series of transactions in 2005 and 2006 that involved variable-rate debt, a form of financing known as a certificate of participation and derivative instruments called interest rate swaps. This scheme was designed to allow the city to effectively borrow additional money without technically going over its state-imposed debt limit. As part of a larger transaction, Detroit took out \$800 million in variable-rate debt by another name. Because the interest rate was variable and could fluctuate over time (as with an adjustable-rate mortgage), the city used interest rate swaps to protect against the risk of sudden spikes in interest rates.²¹

However, the deal was doomed from the start. The interest rate swaps had triggers built in that would allow the banks to cancel the deals and collect hundreds of millions in termination penalties under a number of different scenarios. For example, if the city's credit rating was downgraded, that would trigger the termination clauses on the deals. However, even in 2005, Detroit had already been "hovering on the edge of a credit rating downgrade for years," according to a report by Demos examining the causes of the city's bankruptcy. The report adds, "Because the risk of a credit rating downgrade below 'investment grade' was so great, the likelihood of termination was imprudently high."²² These deals were designed to fail and ultimately did fail, contributing significantly to Detroit's bankruptcy.

High-Risk Deals

One of the reasons that cities like Detroit entered into these imprudently risky deals is that, in many cases, bankers did not adequately disclose the risks to public officials. Adjustable-rate mortgages typically had a teaser interest rate for the first five years that was fixed. Homeowners who took out these mortgages were often told not to worry about the risk of rising interest rates because they would be able to refinance their mortgages before interest rates increased.²³ In this common scenario, the risk of rising rates was disclosed, but the lenders downplayed the likelihood of the risk actually materializing.

This scenario has its parallels in the world of municipal finance. Projections of cost savings associated with deals like interest rate swaps were often premised on the notion that few, if any, of the risks associated with the deals would ever materialize. The banks that pitched these deals to public officials emphasized the potential benefits of the deals, but glossed over the potential downsides.²⁴

²⁰ Did Securitization Lead to Lax Screening? Evidence From Subprime Loans 2001-2006, Benjamin J. Keys, Tanmoy Mukherjee, Amit Seru, and Vikrant Vig, *Quarterly Journal of Economics*, 125(1), 2010.

²¹ *The Detroit Bankruptcy*, Wallace C. Turbeville, Demos, November 2013.

²² *Ibid.*

²³ *Dreams Deferred: Impacts and Characteristics of the California Foreclosure Crisis*, Debbie Gruenstein Bocian, Peter Smith, Ginna Green, and Paul Leonard, Center for Responsible Lending, August 2010, 3.

²⁴ Memorandum by Ross Wallin and Bradley Miller of Grais & Ellsworth, LLP regarding Potential Claims by Public Issuers of Synthetic Fixed-Rate Debt, October 9, 2014, https://www.scribd.com/document_downloads/242855660?extension=pdf&from=embed&source=embed.

In addition to being unethical, this was likely also illegal. Under Rule G-17 of the Municipal Securities Rulemaking Board (MSRB), which is a regulatory agency charged with protecting the interests of municipal borrowers, banks that pitch deals to public officials are required to “deal fairly” with them. According to the MSRB, this means that they “must not misrepresent or omit the facts, risks, potential benefits, or other material information about municipal securities activities undertaken with the municipal issuer.”²⁵ This means that they must ensure that public officials truly understand the risks of the deals they enter into and may not downplay the risks associated with those deals or mislead public officials about the likelihood of such risks materializing.

Interest Rate Swaps

Interest rate swaps are a type of derivative instrument that was often pitched to municipal borrowers as a way to protect against rising interest rates on variable-rate bonds. However, these deals were laden with a whole host of risks – termination risk, basis risk, counterparty risk, and credit risk, to name a few. Perhaps the biggest risk was posed by the egregious termination clauses embedded in the swap agreements. Because these clauses are typically triggered when cities and states fall under financial distress, they serve to compound financial woes by hitting municipalities with stiff penalties when they can least afford them. For example, Detroit was hit with stiff penalties when the city filed bankruptcy,²⁶ and Chicago could have to pay more than \$200 million if its credit rating gets further downgraded.²⁷ However, municipal borrowers can also be forced to pay millions to end these deals because of egregious, risky behavior by the banks. For example, if a city entered into a swap with a bank and that bank went bankrupt, the city could have to pay termination penalties to the bank. In an ironic twist, when Lehman Brothers went bankrupt in September 2008, many cities and states were on the hook for multimillion-dollar penalties to the bank.²⁸

Cities and states that entered into swaps also unwittingly took on other risks. For example, swaps were supposed to protect against spikes in interest rates, but they backfired when the Federal Reserve slashed interest rates in the fall of 2008 in response to the financial crisis. Not only did the net payments on the swaps rise, but many cities and states were unable to take advantage of the low interest rate environment to refinance because they were could not get out of their 20- or 30-year interest rate swaps without paying penalties. For example, the City of Chicago was forced to pay a \$36 million penalty in September 2014 in order to terminate a swap so that it could refinance the underlying debt at a lower fixed rate.²⁹ The City of Oakland refinanced a bond tied to an interest rate swap to a lower fixed rate in 2008, but continues to make payments on the swap to avoid the termination penalties.³⁰ That is like paying for insurance on a car that was sold years ago.

Furthermore, the sharp decline in variable interest rates actually caused the termination penalties on these deals to balloon, so at precisely the time that it would have been most advantageous for cities and states to refinance their bonds, the penalties to get out of the corresponding swap deals were higher than ever before.

Pension Obligation Bonds

Another example of an imprudently risky financing deal is a pension obligation bond (POB). A POB allows public officials to use borrowed money to cover their unfunded pension liability instead of paying it from existing revenues. A city that issues a POB can invest the proceeds from the bond sale. As long as it earns a rate of return on its investment that is higher than the interest rate it owes to bondholders, the city is able to meet its

²⁵ *Interpretive Notice Concerning the Application of MSRB Rule G-17 to Underwriters of Municipal Securities*, Municipal Securities Rulemaking Board, August 2, 2012.

²⁶ Turbeville, *op. cit.*

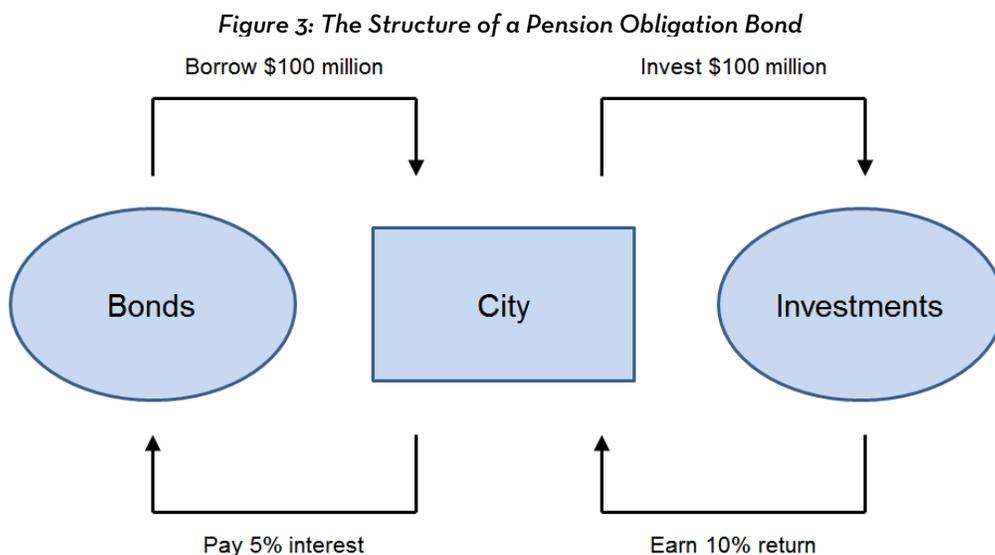
²⁷ *A Financial Time Bomb in Chicago*, Dan Mihalopoulos, Chicago Sun-Times, June 17, 2014.

²⁸ *Lehman Reaches Beyond Grave Seeking Millions From Nonprofits*, Martin Z. Braun, Bloomberg, May 14, 2013.

²⁹ Substituted official statement for the City of Chicago’s General Obligation Variable Rate Demand Bonds, Project and Refunding Series 2003B, September 25, 2014, 17, <http://emma.msrb.org/EP831428-EP643774-EP1045409.pdf>

³⁰ *Oakland Nears Firing Goldman as Swap Burdens City*, Alison Vekshin and Darrell Preston, Bloomberg, January 3, 2013.

pension obligation and pay the interest on the bonds without having to contribute any of its own money. Figure 3 presents the hypothetical example of a city that issues \$100 million on POBs at 5 percent interest and then invests the proceeds in securities that earn a 10 percent return. In this scenario, the city makes \$5 million a year on the transactions.



However, these deals are inherently risky because if the investments underperform, then the city may not make enough money to be able to cover the interest on the bonds. If the investments actually lose money, as happened when the stock market crashed in September 2008, then taxpayers will also be unable to cover the pension obligation and may have to find additional funding sources. A 2010 study by the Center for Retirement Research at Boston College found that only POBs that were either issued before 1996 or during “dramatic stock market downturns” provided positive returns.³¹ With POBs, the risks are often downplayed by the banks that sell them, just as they are with interest rate swaps.

Auction Rate Securities

Auction rate securities (ARS) are variable-rate bonds whose interest rates typically reset every seven, 28, or 35 days (there are also other, less common reset periods). At the end of every reset period, bondholders who want to sell their ARS auction them off to investors who bid the lowest interest rate they are willing to accept for the bond. The interest rate therefore resets at every auction. Banks collect exorbitant fees for conducting these auctions.³²

However, ARS require bidders. If no investors submit bids at the auctions, then the state and local governments that issued the debt could be forced to pay double-digit penalty interest rates to the bondholders that are unable to sell. That is precisely what happened in 2008. In February 2008, these auctions started to fail because there were no bidders for many ARS. The Port Authority of New York and New Jersey saw interest rates on their ARS jump from 4.3 percent to 20 percent in just one week.³³ At the height of the crisis, on February 13-15,

³¹ *Pension Obligation Bonds: Financial Crisis Exposes Risks*, Alicia H. Munnell, Thad Calabrese, Ashby Monk, and Jean-Pierre Aubry, Center for Retirement Research, *State and Local Pension Plans Journal*, 9, January 2010, 4.

³² “Auction Rate Securities: A Crisis Foretold,” Glenn S. Gitomer, *Securities Arbitration 2008: Evolving and Improving*, The Practising Law Institute, 2008.

³³ *Auction-Bond Failures Roil Munis, Pushing Rates Up*, Martin Z. Braun, Bloomberg, February 13, 2008.

2008, more than 80 percent of all auctions failed.³⁴ ARS were packed with hidden risks that were not widely understood by municipal borrowers and ended up costing taxpayers millions of dollars.

High-Cost Deals

Just like working class people with poor credit scores have very few good options for banking and are forced to rely on expensive check cashing services and payday lenders, state and local governments also have very few good choices when it comes to municipal finance deals. They are forced to take out high-cost loans and purchase mostly unnecessary add-ons like bond insurance and other credit enhancements because those are the only choices that Wall Street gives them. Although smaller borrowers with weaker credit profiles like San Bernardino, California and Reading, Pennsylvania are more likely to get forced into high-cost deals, large, sophisticated issuers like New York City and Los Angeles are also forced to pay unreasonably high fees. This too is predatory.

Capital Appreciation Bonds

A capital appreciation bond (CAB) is a long-term bond with compounding interest on which the borrower is unable to make any principal or interest payments for the first several years, and, in some cases, until the final maturity of the bond. In this way, it is similar to a negative amortization mortgage, in which the outstanding principal actually grows over time because the unpaid interest gets tacked onto the amount owed and compounds. Because of this structure, borrowers often end up paying extraordinarily high interest rates over the life of the bonds. For example, the Poway Unified School District in San Diego County borrowed \$105 million, but will end up paying \$877 million in interest over the life of the bond.³⁵ That amounts to 835 percent interest over 40 years. The West Contra Costa School District, just east of San Francisco, will pay \$34 million in interest on a \$2.5 million bond which represents 1,360 percent interest. District officials say they needed the money and the CAB was “the only way we could do it.”³⁶

CABs were pitched to public officials as a way to fill budget holes without having to worry about making payments in the near term. It is an appealing way to access cash without having to pay for it, since it is likely that the public officials who sign the deal are not the ones who will have to pay for them ten or twenty years later. However, because of the balloon payments down the line, these deals often become ticking time bombs. Because these deals are especially prevalent among school districts, California State Treasurer Bill Lockyer has called CABs the “school district equivalent of a payday loan or a balloon payment that you might obligate yourself for. So you don’t pay for, maybe 20 years – and suddenly you have a spike in interest rates that’s extraordinary.”³⁷

As with interest rate swaps, there is strong reason to believe that the banks that pitched CABs may have violated the MSRB’s fair dealing rule by not adequately disclosing the full costs associated with the deals.

Credit Enhancements

Municipal borrowers in the United States have extremely low rates of default because their debt is ultimately backed by tax revenues. According to Moody’s, one of the three major credit rating agencies in the country, the default rate for municipal issuers that it rates was 0.012 percent between 1970 and 2012.³⁸ Even though there has been a slight uptick following the financial crisis, the likelihood of municipal default is still virtually nonexistent. However, the credit rating agencies still rate municipal debt lower than the debt of similarly situated corporations, and as a result, cities and states often have to purchase credit enhancements like letters of credit or bond insurance to get lower interest rates on their bonds.

³⁴ *Auction-Rate Securities: Bidder’s Remorse?*, Stephanie Lee, NERA Economic Consulting, May 6, 2008, 2.

³⁵ *Where Borrowing \$105 Million Will Cost \$1 Billion: Poway Schools*, Will Carless, Voice of San Diego, August 6, 2012.

³⁶ *School District Owes \$1 Billion On \$100 Million Loan*, Richard Gonzalez, National Public Radio, December 7, 2012.

³⁷ *Ibid.*

³⁸ *Announcement: Municipal Bond Defaults Have Increased Since Financial Crisis, but Numbers Remain Low*, Moody’s Investor Service, May 7, 2013.

A credit enhancement is similar to a cosigner on a loan. Though there are some variations between different types of credit enhancements, the basic idea is that a city or state that has a lower credit rating can pay a financial firm with a higher credit rating to cosign its loan. Through this, the city or state effectively borrows the higher credit rating from the financial firm and is able to get a lower interest rate on its debt. The financial firms, which are typically either investment banks or insurance companies, can charge high fees for this service, which are typically a percentage of the amount of the total debt issuance. They justify these fees because presumably they are assuming the risk if the city or state is unable to pay back the debt.

This is a ruse. If the default rate for municipalities is 0.012 percent, then the reality is that in well above 99 percent of the cases, the financial firms are not taking on any risk at all. In many cases the higher-rated financial firms actually have a riskier credit profile than the lower-rated municipal borrowers whose debt they are insuring. In 2009, the country's two biggest monoline insurers, MBIA and Ambac, themselves got a credit rating downgrade because of their heavy exposure to the subprime mortgage market. Municipal borrowers like the City of Menlo Park, California that had purchased bond insurance from either of these insurance companies had to scramble to find new insurance to avoid accelerated payment clauses on their bonds, termination clauses on their interest rate swaps, and other costly consequences.³⁹ Ironically, the expensive credit enhancements that were supposed to make the bonds less risky for investors actually created additional risk for municipal borrowers.

Predatory Fees

Perhaps even more costly than specific types of predatory deals that cities and states enter into are the predatory fees they pay for financial services. In municipal finance, the price that banks charge municipalities for a particular service often bears no relationship to the actual cost of providing that service. For example, bond underwriting fees are typically calculated as a percentage of the total issuance amount, which means that the bigger the bond, the more money the underwriter makes. However, it is actually less work for banks to underwrite bigger bonds than smaller ones. There is no reason underwriting fees are not fixed, flat amounts.

Historically, the primary function of banking had been credit intermediation. Banks were middlemen who facilitated transactions between those who needed money (borrowers) and those who had it (depositors and investors). A good middleman is one who delivers services efficiently, without too much waste. Likewise, an efficient banker was one who matched up creditors and debtors without wasting their money. Therefore, the more fees a banker charged, the less efficient he was.

However, in the financialized economy, the Wall Street business model is based on extracting as many taxpayer dollars as possible out of every deal. This is inherently inefficient for taxpayers. But public officials who are facing down budget deficits and unable to raise new revenue believe they have no choice but to enter into finance deals to make ends meet, even if those deals are overpriced. They consider the cheaper of two high-cost deals to be a bargain, because the banks present it as the best deal they can get. But it is predatory for banks to take advantage of city and state governments' need for financing to charge arbitrary and capricious fees.

THE IMPACT OF PREDATORY MUNICIPAL FINANCE

Not surprisingly, the impact of predatory municipal finance is borne disproportionately by the same communities that were also targeted for predatory mortgages. Every dollar that cities and states send to Wall Street is a dollar that is not going towards essential community services. Across the country, cuts to public services and other austerity measures have a disparate impact on working class communities of color.

³⁹ *City of Menlo Park, California Comprehensive Annual Financial Report for the Fiscal Year Ended on June 30, 2009*, Carol Augustine and Geoffrey Buchheim, Menlo Park Finance Department, December 23, 2009, 63.

For example, the Detroit Water and Sewerage Department (DWSD) paid \$547 million in termination fees to banks on its interest rate swaps in FY 2012.⁴⁰ It has been estimated that more than 40 percent of Detroiters' water bills now go toward paying down these termination fees.⁴¹ This summer, the cash-strapped DWSD turned off the water at the homes of tens of thousands of residents in Southeastern Michigan because they had missed just a couple of payments.⁴²

In Chicago, Mayor Rahm Emanuel's Board of Education voted to close 50 schools in 2013, the largest mass school closing in American history.⁴³ This displaced 30,000 students, approximately 90 percent of whom were African American.⁴⁴ Chicago Public Schools (CPS) claimed each school it closed would save the district \$500,000 to \$800,000 annually.⁴⁵ Altogether, this means that the school closings would save the district at most \$40 million. CPS pays \$36 million a year on interest rate swap deals, enough money to keep at least 45 schools open. But instead of spending its money running schools, CPS is forced to prioritize payments to Wall Street ahead of children's education. Parents and teachers have called on the Mayor and the Board of Education to challenge the legality of the swap deals on the grounds that the deals likely violated the MSRB's fair dealing rule (see above), but to no avail.⁴⁶

The Los Angeles City Council was forced to cut spending on a per capita basis by 19 percent in real dollars between 2008 and 2013. In order to accomplish this, the city "all but stopped repairing sidewalks, clearing alleys and installing speed bumps," according to a report by the Fix L.A. Coalition.⁴⁷ In the meantime, the city paid \$290 million in publicly-disclosed financial fees FY 2013, nearly double the city's entire street services budget.⁴⁸ This figure from the Fix L.A. Coalition study did not include any interest payments or fees that were not publicly disclosed like investment management fees to hedge funds and private equity firms. The coalition has called on the city to "Invest in our streets, not Wall Street."

MAKING OUR MONEY WORK FOR US

There is currently a severe imbalance of power in the relationship between public officials and Wall Street banks. Under our existing municipal finance system, public officials choose from the options presented to them. This gives an inordinate amount of power to the banks, because they get to decide what the options are. Bankers can make a bad option look really good if they compare it to a terrible one and then calculate the cost difference between the two. In the current system, banks set the broad parameters of a transaction, and public officials bargain around the margins within the banks' framework. Public officials may genuinely believe they are getting a good deal, but it is only because they are confining themselves to the rules set by Wall Street. Banks are price setters, and public officials are price takers.

This does not have to be the case. In reality, public officials control trillions of dollars of capital that banks desperately want to access. American taxpayer dollars are among the largest pools of capital in the world, and they are the lifeblood of the financial sector. Public officials need to use their leverage as customers of Wall Street to change the rules of municipal finance to make our money start working for us.

⁴⁰ *City of Detroit, Michigan Comprehensive Annual Financial Report for the Fiscal Year Ended on June 30, 2012*, Dave Bing and Jack Martin, Detroit Finance Department, December 28, 2012, 32.

⁴¹ *Detroit Shows Wall Street Never Loses on Bad Swaps*, Darrell Preston, Bloomberg, September 13, 2012.

⁴² *In Detroit, city-backed water shut-offs 'contrary to human rights,' say UN experts*, UN News Center, October 20, 2014.

⁴³ *Amid mass school closings, a slow death for some Chicago schools*, Trymaine Lee, MSNBC, December 26, 2014.

⁴⁴ *Black students most likely to have their school on CPS closure list*, Lauren FitzPatrick and Art Golab, Chicago Sun-Times, March 6, 2013.

⁴⁵ *54 CPS schools closing, affecting 30,000 kids, 1,000 teachers*, Lauren FitzPatrick, Chicago Sun-Times, March 21, 2013.

⁴⁶ *Unions keep pushing Emanuel to challenge interest rate hedges*, Greg Hinz, Crain's Chicago Business, October 22, 2014.

⁴⁷ *No Small Fees: LA Spends More on Wall St. Than Our Streets*, Fix LA Coalition, August 2014, 8.

⁴⁸ *Ibid*, 2.

Transparency

Opacity is a threshold problem in municipal finance. Not only do financial institutions purposely obscure the terms and provisions of complicated financial contracts, but it can also be nearly impossible to get a full accounting of all the money that taxpayers are spending every year for financial services. Public officials are often contractually prohibited from disclosing fees and fee structures to the general public, sometimes in direct conflict with state open records laws.⁴⁹ Banks and other Wall Street firms, especially private equity firms and hedge funds, fight to maintain a shroud of secrecy over fees in order to hide arbitrary and disparate fee structures. This makes it difficult to bring any accountability into the system or to have effective taxpayer oversight over financial deals.

Between cash management, debt management, and investment management for state and local governments, school districts, public agencies, and public pension funds, taxpayers do trillions of dollars in business with Wall Street firms every year. We deserve to know how our money is being spent and where it is going, and we should be able to evaluate the terms of all financial transactions.

Cities, states, and public agencies should publicly disclose all payments they make for financial services and borrowing. Not only would this allow residents of that place to know how their money is being spent, but it would also allow public officials from different places to compare the prices they are paying for the same services and make it possible for them to assess the cost-effectiveness of their own deals. Price transparency would increase competition in municipal finance and would drive down fees, saving taxpayers money.

Public officials should also conduct an independent investigation of all of their financial deals to determine whether they are trapped in any deals with features that could be considered predatory, even if they are legal. They should make this information readily available to the public.

Accountability

On Wall Street, fraud pays. When financial firms fail to live up to their promises, engage in unethical or unlawful behavior, or otherwise cheat taxpayers, they are seldom held accountable. Even when they are subject to legal action, they typically settle any legal claims for a fraction of the profit they made through the illicit activity, without admitting to any wrongdoing, and get to keep the rest of their ill-gotten gains. For example, JPMorgan Chase paid \$228 million in 2011 to settle criminal and civil charges alleging that the bank rigged bids for guaranteed investment contracts, a type of investment derivative that municipal customers often use. The bank did not have to admit to the charges as part of the settlement.⁵⁰ Moreover, these fines often qualify as tax-deductible expenses, which means that taxpayers effectively foot the bill for up to 35 percent of the fine.⁵¹ Needless to say, this does not deter future misconduct by the banks. On the contrary, it incentivizes Wall Street to keep cheating taxpayers because they can rest assured that, even if they are caught stealing money, they will only have to give a small fraction of it back.

Furthermore, banks rarely have to worry about losing business from repeat customers whom they mistreat. It is common practice for cities and states to continue doing business with firms that have wronged them in the past. In fact, they will even do business with banks with which they have litigation pending. In 2014, the State of Rhode Island rehired First Southwest as a financial advisor, even though the state was suing the company for “fraud, negligence, legal malpractice – and a host of other alleged misdeeds” at the same time, according to the *Providence Journal*.⁵² This is due, in part, to the fact that many banking services are only provided by a relatively small number of financial institutions.

⁴⁹ *Behind Private Equity's Curtain*, Gretchen Morgenson, *The New York Times*, October 18, 2014.

⁵⁰ *JPMorgan to Pay \$228M For Muni Bid-Rigging*, Lynn Hume, *The Bond Buyer*, July 7, 2011.

⁵¹ *Too Big to Tax: Settlements Are Tax Write-Offs for Banks*, Lynnley Browning, *Newsweek*, October 27, 2014.

⁵² *Chafee Administration Rehires Company Being Sued in 38 Studios Fallout*, Katherine Gregg, *Providence Journal*, May 19, 2014.

When public officials learn that financial institutions may have dealt unlawfully or unethically with them, they should investigate the potential misconduct and take steps to fully recover all taxpayer dollars that were wrongfully taken by Wall Street. This includes invoking provisions in contracts that allow them to claw back taxpayer money when corporations fail to live up to their promises, taking aggressive legal action to fully recover all losses, renegotiating bad deals, and refusing to do future business with banks that have dealt unfairly with them in the past.

Reducing Fees

As explained earlier, the fees that banks charge cities and states for municipal finance services often bear no reasonable relationship to the actual cost of providing those services and are completely arbitrary. However, because financial institutions all tend to charge comparable rates for any given service, they are able to keep the market prices high. Public officials in large cities and states that control a lot of financial assets should identify these arbitrary financial fees and use their economic leverage as Wall Street customers to negotiate lower fees for taxpayers that are significantly below the “market rate” as it is defined by banks.

Currently, financial contracts are either awarded through competitive bidding or negotiated sales. In a competitive bidding process where the bids are not rigged (unfortunately, they often are rigged in the financial sector), different financial institutions submit blind bids to the client, who then awards the contract to the lowest bidder. In such a system, the banks’ goal is to be the lowest bidder, but not by much. This means some banks may bid slightly below the market rate, but they will not drastically deviate from it.

In a competitive bidding system, the most effective way to significantly alter fees is to simply cap bids above a certain rate. Public officials in large cities and states should determine the actual cost of providing the service, add a modest premium above that figure, and refuse to take fees above that total. If the city or state is a major customer and the bank will still make money off the transaction even with the cap – in other words, if the highest price that the officials are willing to accept is still higher than the bank’s cost of providing the service – then eventually bidders will come around.

In negotiated sales, public officials already bargain over fees with banks. In fact, typically officials agree to negotiated sales because they believe they can get better terms by guaranteeing a bank the contract rather than leaving it to chance and putting the contract out to bid. This is not actually true, since studies have shown that fees have gone up as negotiated bond sales have become more prevalent.⁵³ Public officials may believe that it is not possible to get a price that is substantially lower because of market conditions. However, it is important to remember that the market is not preordained. Especially when it comes to finance, the market is not free. Market rates are arbitrarily set by the banks to guarantee a large profit margin. Public officials need to drive a harder bargain that is based on their desire to save money, not the banks’ desire to make money. They should again cap fees and refuse to do any and all business with banks that do not abide by their caps. For example, any bank that refuses to abide by a city’s cap on bond underwriting fees should be barred from any business at all with the city. This would use the full economic leverage of the city to secure lower fees for each service.

Collective Bargaining with Wall Street

Being a lone crusader against “market rate” fees can be quite risky because banks could theoretically decide not to do business with that city or state anymore rather than risk starting a new trend of lower fees. Although it is not likely that banks could effectively sustain a boycott of a major city or state with tens of billions in assets for any significant period of time, the threat would nevertheless be scary.

⁵³ *Another Look at the Effect of Method of Sale on the Interest Cost in the Municipal Bond Market – A Certification Model*, Jun Peng and Peter F. Brucato, *Public Budgeting and Finance*, March 2003, 73-95.

In the workplace, workers are able to win higher wages from employers by forming a union and collectively bargaining with their boss. Although the boss could fire one worker who asks for a raise, it is significantly more difficult to fire all workers if they band together and act collectively. Public officials from different cities and states could likewise win lower fees from Wall Street if they banded together and collectively bargained for lower fees and fairer fee structures.

The market rate is what it is because a small number of large financial institutions dominate the municipal finance landscape and, over time, they have established industry norms that are driven by their profit motive. Cities and states need to do the same by establishing norms that are driven by their desire to save taxpayer money. They should adopt guidelines for an efficient municipal finance system with caps on fees and interest rates, prohibitions on predatory practices, transparency and disclosure requirements, and requirements that bankers exercise a fiduciary responsibility to taxpayers. Furthermore, they should collectively refuse to do any business at all with any bank that refuses to abide by those guidelines. In this way participating cities and states would be able to use their collective economic leverage to negotiate fairer terms with Wall Street.

Public officials from different cities and states could formalize this approach by founding either a nonprofit or a public organization and empowering it to develop guidelines that all participating cities and states agree to abide by. The organization should have a fiduciary duty to the state and local governments that it serves and it should be funded by those governments in a way that incentivizes taxpayer protection. Notably, funding of the organization should not be contingent on the number or dollar amount of the transactions that take place under its guidelines. The organization should also serve as a clearinghouse for data on pricing and fees for participating cities and states, to allow for greater market transparency.

If cities and states refused to do business with banks that did not meet the organization's guidelines, then it would effectively be empowered to negotiate with Wall Street on behalf of all of those state and local governments and set a new market rate that was based on taxpayers' interests. This mechanism would allow cities and states across the country to collectively bargain with Wall Street without any new federal legislation. Collective action would also disarm any potential threats of retaliation from Wall Street.

Creating Public Options for Financial Services

Banks and financial firms are for-profit enterprises. Their foremost goal in almost every relationship with their customers is to maximize their earnings. In public finance, these earnings come at the expense of taxpayer services. If one of the key diseases that ails public budgets is revenue extraction by banks, then the most effective way to contain that disease is through a quarantine: if possible, we should not let banks touch public dollars. We need to find more efficient ways to access financial services without actually having to engage directly with Wall Street.

There are certain financial functions for which state and local governments currently rely on Wall Street that they could do themselves for significantly less money if they hired the right staff. For example, public pension funds could save millions in fees if they hired in-house staff to manage their investments. There are other financial services that cities could band together to provide each other. For example, Build America Mutual is a bond insurer that is cooperatively owned by the municipalities it insures.⁵⁴ That same model could be applied to other financial services as well.

There are also certain functions that it might be possible for states to provide to cities, school districts, and other public agencies within their borders. For example, states should explore the feasibility of establishing their own bond underwriters that could underwrite bonds for municipalities. States and public pension funds with higher credit ratings could also provide credit enhancements to municipal borrowers with weaker credit ratings so that

⁵⁴ *BAM Overview and Mission*, Build America Mutual: <http://buildamerica.com/mission/>.

they do not have to pay millions to Wall Street on fees for products like bond insurance, letters of credit, and standby purchase agreements. In fact, the State of Washington and big California pension funds like the California State Teachers' Retirement System already do this.⁵⁵

Elected officials should determine which services could be brought in-house and should make a plan to insource those functions. In doing this, officials should also determine if some of these functions could be pooled at a regional or state level to create economies of scale.

Establishing Public Banks

Cities and states should establish public banks that are directly owned by taxpayers. Public banks can provide a range of services and provide capital to state and local governments that could be used to provide a local economic stimulus, invest in the local community, or plug budget deficits. Depending on local needs, revenue from these banks could be used to bolster affordable housing developments, early childhood education programs, infrastructure upgrades, green energy retrofitting programs, or other capital-intensive projects.

Public banks can better equip cities and states to manage the economic impact of boom-and-bust cycles in the economy. During an economic downturn, they can provide wholesale loans to local community banks to encourage them to increase small business lending to spur local job creation. Thus, public banks can effectively enable cities and states to implement countercyclical monetary policy at the local level.⁵⁶

Notably, public banks could also provide municipal finance services to local governments and public agencies. A city or state's in-house investment managers or bond underwriters could be based in a public bank. A public bank could also provide credit enhancements and other debt management services to municipalities. State and local governmental entities could house their deposits in a public bank. Depending on how it is set up, a public bank may also be able to take out short-term loans from the Federal Reserve's discount window at extremely low interest rates and pass those savings on to taxpayers. A public bank that is owned by a city would not necessarily have to limit its municipal finance business to that city alone. It could also provide services to other governmental entities in the state, and potentially beyond, depending on how it is set up.

North Dakota already has a thriving state-owned bank that returns an annual profit and helped the state weather the Great Recession relatively unscathed.⁵⁷ A new public bank would not have to be confined to the Bank of North Dakota model, but could be designed to meet the economic and financial needs of the city or state that it serves. Local communities in different places should determine the kinds of services their public bank should provide.

CONCLUSION

State and local government officials in the United States are forced to face down budget crises every year. They have to make unconscionable decisions about which services to cut in order to close budget gaps. The impact of their decisions is borne by working families, especially in communities of color. When our public officials are being forced to choose between providing residents with healthcare or an education, we cannot afford to be shipping millions every year to Wall Street.

The primary goal of government is to provide residents with the services they need, not to provide bankers with the profits they seek. We need to take reasonable steps to safeguard our public dollars, make our public finance system more efficient, and ensure that our money is used to provide fully-funded services to our communities. Taxpayers do trillions of dollars of business with Wall Street every year. We need to start making our money work for us.

⁵⁵ *Credit Enhancement Program Policy*, CALSTRS Investment Branch, July 2008

⁵⁶ *The People's Bank*, Abby Rapoport, *The American Prospect*, April 1, 2013

⁵⁷ *Ibid.*

