FILED
OFFICE OF THE CITY CLERK
OAKLAND

12 JUN 20 PM 3: 19

MEMORANDUM

To:	Alliance of Califomians for Community Empowerment (ACCE), Oakland Community Organizations (OCO), SEIU Local 1021
From:	Saqib Bhatti
Re:	Oakland Interest Rate Swap with Goldman Sachs
Date:	June 19, 2012

I have reviewed the City of Oakland's interest rate swap deal with Goldman Sachs on the $131.5 million Oakland Joint Powers Financing Authority Lease Revenue Bonds, 1998 Series A1/A2.

Here are my key findings:

- The city is losing $353,000 per month on this deal, or $4.2 million annually.
- The city has already lost $32 million through May 2012, and if current interest rates hold, it stands to lose another $20 million over the remaining life of the swap.
- Because the variable-rate bonds that the swap was connected to were defeased in 2008, the swap is no longer serving its intended purpose.

As such, rather than reducing the cost of borrowing to the city, the interest rate swap has actually increased the cost. Goldman Sachs has obtained approximately $17.5 million in profits since the underlying bonds were defeased in 2008.

Deal Structure

To help you fully understand the situation, I will first explain the basic structure of Oakland's interest rate swap deal, based on information contained in publicly available documents. The city floated the 1998 bonds to help finance its pension obligations, but instead of taking out fixed-rate bonds, the city used variable-rate bonds. These are similar to adjustable-rate mortgages because interest rates can fluctuate depending on market conditions.

To protect itself from sudden spikes in interest rates, Oakland took out an interest rate swap with Goldman Sachs. An interest rate swap is a type of derivative that allows bond issuers to effectively swap out variable-rate payments for fixed-rate ones, thereby protecting them from swings in the market.

According to the city's Comprehensive Annual Financial Report (CAFR) from FY 2011, Oakland agreed to pay Goldman Sachs a fixed 5.6775% interest on the amount of the bond, and the bank agreed to pay back a variable rate that was equal to the Bond Markets Association (BMA) Index, which tracks market movements for variable-rate bonds. The BMA Index was 3.090% at the time the bonds were issued in July 1998. The bank also paid the city $15 million upfront to enter into the deal.

The premise behind swaps is that the variable rate that the bank has to pay the city should approximate the interest rate on the variable-rate bonds, so the city's only cost should be the fixed rate it pays to the bank. In effect, Oakland was able to obtain a bond with a "synthetic fixed rate" of 5.6775%, which is likely cheaper than what it would have had to pay for a conventional fixed-rate bond in 1998.

In March 2003, the city agreed to amend the deal. Under the new terms, the city continued to pay Goldman Sachs 5.6775% interest, but the bank now had to pay the city 65% of the one-month London Interbank Offered Rate (LIBOR), which at the time lowered the rate the bank had to pay the city from 1.080% to 0.857%. In exchange for the reduced payments, the city got an additional $5.975 million from the bank. In all, Oakland has received $20.975 million in upfront payments from Goldman Sachs.

The bonds were supposed to mature in 2021, so the deal was structured to last through then. If the city wants to terminate the deal early, it has to pay Goldman Sachs a $15.5 million penalty.

Oakland Is Locked into Swap Deal Even Though Bonds Were Retired in 2008

In 2005, Oakland refinanced the 1998 bonds with the 2005 Series A1/A2 bonds. The new 2005 bonds were for $126.975 million, more than the $93.9 million that was still owed on the 1998 bonds to which the swap was connected. That meant that the swap only offered the city protection on 74% of the value of the new bonds. The city retired the 2005 bonds early, in 2008, and replaced them with fixed-rate bonds.

Because the swap was originally connected to the 1998 bonds, which were set to mature in 2021, the swap remained in effect. The city cannot terminate the swap unless it pays Goldman Sachs the $15.5 million termination fee. The purpose of the swap was to protect the city against spikes in interest rates on variable-rate bonds. Since 2008, Oakland has been paying Goldman Sachs for that protection even though no such bonds actually exist.

Goldman Sachs Has Reaped Millions in Profits from Oakland

I conducted an analysis looking at historical LIBOR and BMA Index rates and the amortization schedule of the 1998 bonds from their official statements to determine how much the bank has paid on the swap since 1998. I also looked at the actual interest rates that Oakland had to pay to bondholders between 1998 and 2008 on the underlying 1998 and 2005 bonds.

From this analysis I found that through May 2012, Oakland had paid Goldman Sachs an estimated $80 million in fixed-rate payments, and Goldman Sachs had paid the city back approximately $28 million in variable-rate payments. The bank's average variable interest rate had been 1.948%, less than half of the 5.6775% the city pays the bank. That means that, overall, the city had paid $53 million on the swap more than it had gotten back. If we take out the $20.975 million that Oakland received upfront, this means that **through May 2012, the city had effectively lost $32 million on the deal**.

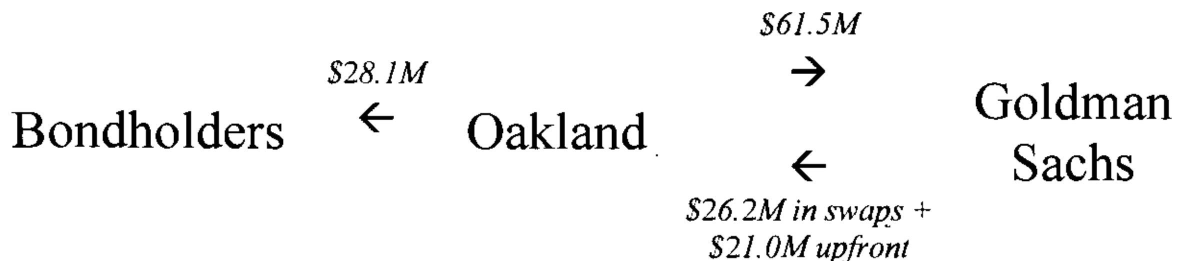
If the city continues to pay the swap and current interest rates hold, then over the life of the swap, the city will pay an estimated $101 million and receive approximately $28 million. Once you take out the upfront payment, it amounts to a net loss of $52 million to the city over the life of the swap.

This swap deal has two distinct phases: Phase 1 before the bonds were defeased in 2008 and Phase 2 afterwards. The performance of the swap over these two phases is detailed below.

Phase 1: Before the Variable-Rate Bonds Were Retired in 2008

The basic premise behind an interest rate swap is that sometimes the rate that the bank has to pay the city will be higher than what the city pays back and sometimes it will be lower. That way, over the life of the deal, the city should pay the bank an amount that is approximately equal to what it gets back. However, in the case of Oakland's swap with Goldman Sachs, this did not happen. Interest rates tended to favor Goldman Sachs. Before the 1998 bonds were defeased (between July 1998 and April 2008), there was only one month when the bank's payment was higher than the city's. Based on the BMA Index at the time, I estimate Goldman Sachs paid 5.710% to Oakland in May 2000, slightly higher than the 5.6775% the city owed the bank. Prior to April 2008, Oakland paid the bank $61.5 million and received back $26.2 million. This means that the city paid $35.4 million more than it got back. Goldman Sachs recovered its entire upfront payment of $20.975 million during this time.

Meanwhile, during this time the actual interest payments that the city had to make on the 1998 and 2005 bonds were $28.1 million. That means Oakland paid $28.1 million to the bondholders and $61.5 million to Goldman Sachs, and received $26.2 million in swap payments and $20.975 million upfront payment from the bank:



Altogether, taking into account the bond payments, the swap, and the upfront payments, this arrangement ended up costing Oakland $67.2 million. If the city had not hedged the original bonds with an interest rate swap, it would have made only $28.1 million in interest payments. The interest rate swap was supposed to decrease the cost of borrowing for Oakland, but even while the bonds were outstanding, the city ended up overpaying as a result of the deal. Goldman Sachs would likely claim that this was the cost of protecting the city from the threat of interest rate spikes.

FILED
OFFICE OF THE CITY CLERK
OAKLAND

12 JUN 20 PM 3:19

The New York Times

RUBY SPARKS
COMING SOON

June 9, 2012

How Banks Could Return the Favor

By GRETCHEN MORGENSON

LIKE millions of homeowners, shrewd state and local governments are looking to refinance. Interest rates have hit rock bottom. So why not save some public money by replacing old debts with new ones at lower rates?

The bad news for taxpayers is that such easy refis are out of the question for many governments and agencies short on cash. And that's because these borrowers have been trapped by Wall Street.

Behind all of this is — you guessed it — derivatives. Bankers have embedded interest-rate swaps in many long-term municipal bonds. Back when, they persuaded states and others to issue bonds and simultaneously enter into swaps. In these arrangements, the banks agreed to make variable-rate payments to the issuers — and the issuers, in turn, agreed to make fixed-rate payments to the banks involved.

These swaps were supposed to save the public some money. And, for a while, they did. Then the financial crisis hit — and rates went south and stayed there. Now issuers are paying bond holders above-market rates as high as 6 percent. In return, they are collecting a pittance from banks — typically 0.5 percent to 1 percent.

Why not just refinance the old bonds? Well, if you think it's costly to refinance a home mortgage, try refinancing a derivatives-laced muni. The price, in the form of a termination fee, can be enormous. New York State, for one, has paid $243 million in recent years to extricate itself from swaps-related debt. That money went straight from taxpayers' pockets to Wall Street.

Corporations rarely do deals like these, because they generally avoid making long-term bets on interest rates. But bankers sold the idea to public borrowers. The total bill to terminate all of these swaps-related deals would run into many billions.

Officials who have done such financing typically defend it. They say these deals were struck at lower rates than those associated with fixed-rate debt at the time. Therefore, the

defenders say, the deals have saved money for issuers and taxpayers.

But if states, cities and others had issued plain vanilla fixed-rate debt to begin with, they could have refinanced much of it by now at little or no cost. They would be paying significantly lower financing costs and would not be facing huge penalties to get out of the deals.

LAST week, a study was published by the Refund Transit Coalition, a group that supports public transit, detailing some of these harmful deals. Entitled "Riding the Gravy Train," it said it had found 1,100 swaps deals at more than 100 government agencies that are costing taxpayers $2.5 billion a year.

The report delves into the high costs of swaps-related debt at 12 transit agencies nationwide, including authorities in Boston, Chicago, Detroit, New York, San Francisco and Baton Rouge, La. In these 12 systems alone, swaps deals are costing riders $529 million a year, the study says. That's the difference between the fixed rate paid by the issuers and the floating rates they receive.

This difference certainly adds to the burden that cash-starved transit agencies already shoulder. A 2011 study by the American Public Transportation Association found that of 117 transit agencies surveyed, half had cut service or raised fares. Money that might go toward services is going to swaps instead. So think of these swaps as a kind of Wall Street-driven austerity measure. Everybody else — workers, riders, taxpayers — makes concessions. Banks give up nothing.

When issuers do decide to escape these snares, the hefty termination fees are typically paid for with new debt deals. For example, of the $243 million that New York State paid to terminate its swaps deals recently, $191 million was financed by new debt issuance. This may dull the immediate pain, but it only adds to taxpayers' burden by piling an interest rate onto the termination cost.

The trillion-dollar question is why debt issuers don't push the banks to cut or reduce these exit fees. Yes, swaps are contractual arrangements that were agreed to in better days. But issuers that raise a lot of money in the debt markets have considerable leverage, given how much they pay Wall Street banks to underwrite their debt.

In New York, for example, the Metropolitan Transportation Authority plans to issue $2.2 billion in new debt this year and may refinance an additional $6 billion.

Why doesn't the M.T.A. use that leverage to prod banks to lower exit fees on some of the $3.3 billion in debt issued with swaps? Patrick McCoy, the M.T.A. finance director, was asked precisely that when testifying in a recent arbitration case between the Amalgamated Transit Union and New York City Transit.

First, Mr. McCoy expressed surprise at the idea. Then he said he had no plans to use any leverage the M.T.A. might have, like suggesting that the agency wouldn't place new bonds with a bank unless it agreed to renegotiate on the swaps.

That led the arbitration panel's chairman to say, "Such renegotiations may not be successful, but it is more than difficult to understand why the authority is of the opinion that it should not even try."

In an interview on Friday, I asked Mr. McCoy why he wouldn't ask the banks that underwrite M.T.A. bonds for concessions on the swaps debt.

"It's working," he said. "Why would I want to incur the costs, aggravation and bad faith that goes with it to suggest that we want out?"

The fight has been taken up by Rebecca Kaplan, a councilwoman in Oakland, Calif. Trying to negotiate an escape from a swap that is costing her city $4 million a year, she wrote a letter in 2011 to Goldman Sachs, the banker on the deal, asking it to reduce the exit fees, which stand at $15.5 million.

"When taxpayers bailed out these big banks there was a social contract made," said Jason Overman, Ms. Kaplan's spokesman. "We did them a favor, but then when they're back on their feet they're not extending us that same courtesy."

A few weeks ago at Goldman's annual meeting, Lloyd C. Blankfein, its C.E.O., was asked about tearing up the Oakland swap. He said: "I don't think we're in a position to do that," adding that it would not be fair to shareholders.

James A. Parrott, deputy director and chief economist at the Fiscal Policy Institute in New York, criticizes these deals along with officials who don't try to get out of them.

"Government officials need to acknowledge that they made a mistake when they signed up for these ill-conceived, high-risk financial bets," Mr. Parrott said. "But that mistake is woefully compounded when they then impose austerity rather than stand up to the banks."

You know the score. Once again, it's Wall Street 1, Main Street 0.

This article has been revised to reflect the following correction:

Correction: June 17, 2012

The Fair Game column last Sunday, about state and local governments that are aiming to refinance bonds containing interest rate swaps, misidentified the recipients of fixed rates of interest in these instruments. The issuer pays a fixed rate to banks involved in the transaction, not to bond holders.