Interest Rate Swaps

How Citibank and UBS Are Costing Palm Beach Schools Millions

This report by Florida Public Services Union demonstrates our commitment to work with the Palm Beach County School District in identifying solutions to the ongoing budget crisis. This is the first of a series of other reports that will present various revenue generation and cost saving ideas which the school district can adopt to counter current financial challenges while increasing efficiencies. This report focuses on "interest rate swap" agreements between the school district and major banks, including Citi and UBS.

The District entered into interest rate swap deals to protect against possible interest rate increases on bonds to finance public projects. In these swap agreements, the District pays the banks a steady fixed rate, and in exhange the banks pay back the fluctuating variable rate to cover the bond payments. While those deals made sense at the time, the Fed has dramatically cut interest rates since the financial collapse which has ultimately changed the basic assumptions of these deals. According to the District's recent Comprehensive Annual Financial Report (CAFR), the District is locked into a fixed rate of about 4% while the banks are now paying less than 0.25%. The difference between what the District pays (~4%) and what the banks pay (~0.25%) equates to more that $16 million annually. These deals, we believe, can be renegotiated if the District and the banks agree to do so. We are not asking the District nor the banks to cancel these deals (and assess the associated penatly), but rather come back to the table in light of the current economic conditions to settle on a more reasonable rate.

KEY FINDINGS OF ACTIVE SWAP DEALS

The School District of Palm Beach County has three hedging interest rate swap deals that are currently active with Citigroup and UBS. These swaps are related to the 2001B, 2002B, and 2003B certificates of participation (COPs), which are debt instruments similar to bonds. The district is losing an estimated $16.4 million a year on these deals. Another deal with Citigroup could go into effect this August, which would cost the district an additional $4.6 million annually.

- The district is losing $1.4 million per month on these three deals alone, or $16.4 million annually.
- The district has already lost $55.8 million on these deals through since the first deal went into effect in March 2002, even if we account for money that the district received upfront as part of these deals.
- If current interest rates hold, it stands to lose an additional $188.7 million over the remaining life of the swaps, which mature in 2025, 2027, and 2029.
- The losses to the district jumped precipitously after the Federal Reserve slashed interest rates in October 2008 in response to the financial crisis. Prior to October 2008, the district's average monthly loss was $333,000. Between November 2008 and August 2011 (before the third swap went into effect), the average monthly loss was $754,000. Since August 2011, it has been $1.4 million.
- The district has paid the banks $38.7 million on these deals since the bailout.

As such, rather than reducing the cost of borrowing to the district, the interest rate swaps have actually caused it to increase substantially.

UNDERSTANDING INTEREST RATE SWAPS

Interest rate swaps deals can be complicated, so here is an explanation of how they work, using the district's swap related to the 2002B certificates as an example, based on information contained in publicly available documents. The district issued the 2002B certificates in March 2002, but instead of taking out a fixed-rate, it issued variable-rate debt, which is similar to adjustable-rate mortgages because interest rates can fluctuate depending on market conditions.

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

According to the district's Comprehensive Annual Financial Report (CAFR) from FY 2011, the district agreed to pay the bank a fixed 4.22% interest on the amount of the 2002B certificates, and the bank agreed to pay back a variable rate that was equal to the lesser of the Securities Industry and Financial Markets Association (SIFMA) rate and 67% of the London Interbank Offering Rate (LIBOR), which tracks the rates that banks charge each other for short-term borrowing.

The premise behind swaps is that the variable rate that the banks have to pay the district should approximate the interest rate on the variable-rate debt, so the district's only cost should be the fixed rate it pays to the banks. In effect, the district was able to obtain certificates with a "synthetic fixed rate" of 4.22%, which is cheaper than what it would have had to pay for conventional fixed-rate debt in 2002. In 2007, before the economic crisis, the banks were paying 3% to 4%. After the 2008 economic crisis, the rates banks pay fell below 1%. Today, the banks' rate is 0.16%.

The 2002B certificates mature in 2027, so the deal is structured to last through then. If the district wants to terminate the swap early, it has to pay the bank the fair value of the swaps, which, as of June 30, 2011, was $22.4 million. The combined termination fees on all three swaps are $56.5 million.

A DETAILED ANALYSIS OF THESE INTEREST RATE SWAPS DEALS

We conducted an analysis looking at historical LIBOR rates and SIFMA rates and the amortization schedules of the 2001B, 2002B, and 2003B certificates from their official statements to determine how much the banks have paid on the swaps thus far. We also looked at the actual interest rates that the district had to pay to debtholders on the underlying certificates.

From this analysis we found that through May 2012, the district has paid the Citigroup and UBS an estimated $99.5 million in fixed-rate payments and the banks have paid the district back approximately $34.4 million in variable-rate payments. That means the banks have paid only a third of what the district has paid on the swaps. Overall the district has paid $65.0 million on the swap more than it has gotten back. The banks paid the district $9.3 million upfront in connection with the 2001B and 2003B swap deals. Once we factor that in, **through May 2012, Palm Beach County Schools have effectively lost $55.8 million on the deals** (see Table 1).

Table 1: Swap Payments on Palm Beach County Schools' Swaps Through May 2012

Related COP	**District Payments to Bank**	**Bank Payments to District**	**Upfront Payments to District**	**Net Cost to District**	**Bank**
2001B	$6,233,985	$190,143	$6,250,000	-$206,158	Citigroup
2002B	$49,894,643	$17,063,712	$0	$32,839,931	Citigroup
2003B	$43,334,416	$17,172,390	$3,010,000	$23,152,026	UBS
Total	**$99,463,043**	**$34,426,245**	**$9,260,000**	**$55,776,798**	

If the district continues to make these swap payments and current interest rates hold, then over the life of the swaps, the district will pay an estimated $298.1 million and receive approximately $44.4 million—**a net loss of $244.5 million to the district** over the life of the swaps after accounting for the upfront payments (see Table 2).

Table 2: Total Projected Swap Payments Through Maturity

Related COP	**District Payments to Bank**	**Bank Payments to District**	**Upfront Payments to District**	**Net Cost to District**	**Bank**
2001B	$73,459,360	$3,558,685	$6,250,000	$63,649,675	Citigroup
2002B	$104,996,238	$19,163,317	$0	$85,832,920	Citigroup
2003B	$119,680,522	$21,663,337	$3,010,000	$95,007,185	UBS
Total	**$298,135,120**	**$44,385,340**	**$9,260,000**	**$244,489,780**	

The basic premise behind an interest rate swap is that sometimes the rate that the bank has to pay the district will be higher than what the district pays back and sometimes it will be lower. Consequently, over the life of the deal, the district should pay the bank an amount that is approximately equal to what it gets back. However, in the case of the Palm Beach School District's swaps, this did not happen. As Figures 1, 2 and 3 show, interest rates have almost always favored the bank since those deals went into effect. Whenever the solid line was below the dashed, the district lost money.

Furthermore, since the Federal Reserve slashed interest rates in October 2008 in response to the financial crash, the district's losses have grown precipitously (notice the sudden drop in the solid lines in Figures 2 and 3 in October 2008). Prior to October 2008, the district lost $333,000 per month on average on these swaps. Between November 2008 and August 2011, before the 2001B swap went into effect, the district lost $754,000 per month—more than twice what it was losing before the crash. Since the 2001B swap went into effect, the district's monthly loss has grown to $1.4 million. **The banks have taken $38.7 million from Palm Beach County Schools since the bailout.**

Figure 1: District and Bank Interest Rates on 2001B Swaps

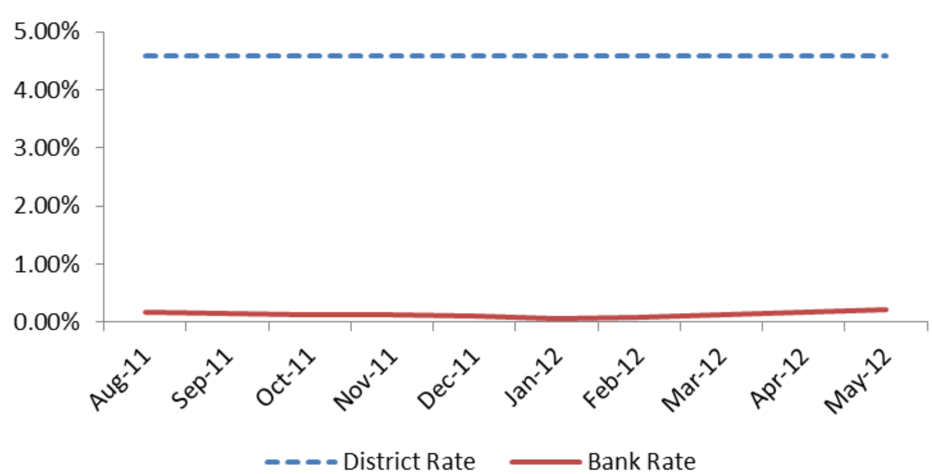


Figure 2: District and Bank Interest Rates on 2002B Swaps

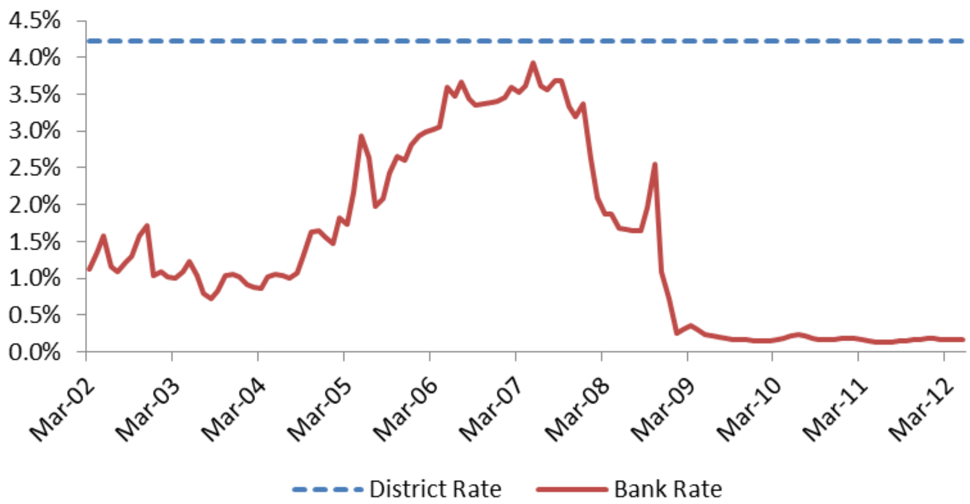
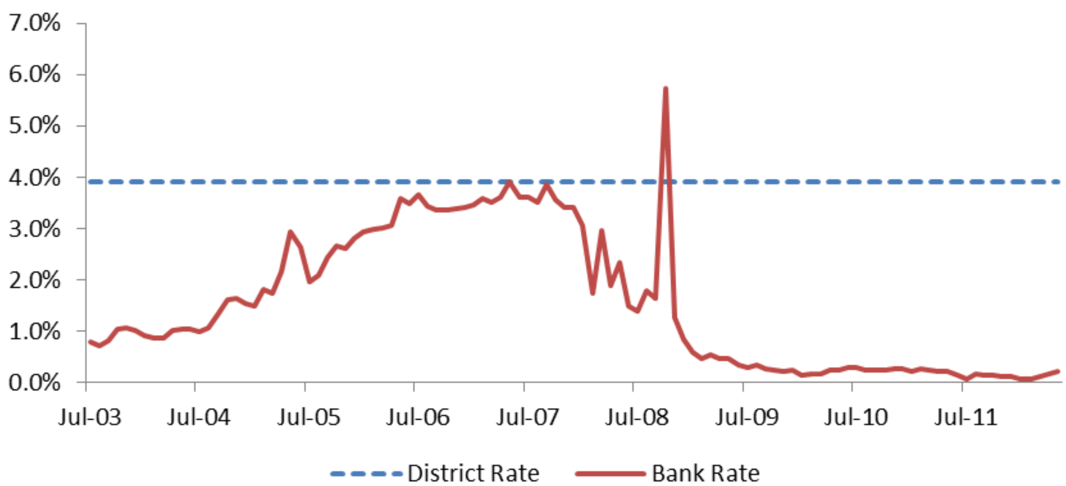


Figure 3: District and Bank Interest Rates on 2003B Swaps



Meanwhile, the actual interest payments that the district has had to pay on these certificates during the period that the corresponding swaps were in effect was approximately $55.3 million. That means the district paid $55.3 million in interest to the debt holders on the certificates and $99.5 million to Citigroup and UBS, and received $34.4 million in swap payments back from the banks and the $9.3 million in upfront payments (see Figure 4).

Figure 4: Flow of Cash

Debt holders	*$55.3M* ←	Palm Beach Co. Schools	*$99.5M* → ← *$34.4M swap payments +$9.3 M upfront*	Citigroup & UBS

Altogether, taking into account the interest payments on the certificates and the swaps, this arrangement has cost the district $111.1 million thus far. Without these interest rate swaps, it would have paid only $55.3 million in interest payments to the debtholders. The interest rate swap was supposed to decrease the cost of borrowing for Palm Beach County Schools, but the district ended up overpaying as a result of the deal. Furthermore, the district has more than repaid the upfront payments to both banks through its swap payments dating back to 2002.

CITIBANK AND UBS sSHOULD RENEGOTIATE THE EXCESSIVE INTEREST RATES ON SWAP DEALS WITH THE SCHOOL DISTRICT

The District is stuck in these toxic swap deals for another 13 to17 years unless it pays the banks $56.5 million to get out. However, the deals can be changed if the banks agree to do so. The District should call on Citibank and UBS to renegotiate its swaps immediately, adjusting interest rates to match current market rates without any penalties. If Citibank and UBS refuse to negotiate, the District should stop doing business with them. Wall Street banks can't be allowed to rip off our schools with impunity, and they shouldn't be rewarded with our tax dollars if they continue to do so.

The School District of Palm Beach County has already lost $55.8 million on the interest rate swap deals with Citigroup and UBS and it stands to lose another $188.7 million over the next 17 years, which will further exacerbate its budget crisis. This does not even take into account the last Citigroup swap that has not yet gone into effect. The banks do not actually stand to lose any of their own money from ending this deal. Their only loss will be future revenue from the deal—the $1.4 million per month that the district pays the banks. The upfront money that the district received from the banks is not an issue, since both banks have already recovered that money from the district over the past ten years.

Citibank and UBS should renegotiate the swap deals immediately, adjusting interest rates to match current market rates without any penalties. If Citibank and UBS refuse to negotiate, the District should stop doing business with them. Wall Street banks can't be allowed to rip off our schools with impunity, and they shouldn't be rewarded with our tax dollars if they continue to do so.

In 2008, taxpayers bailed out the big banks, including Citigroup and UBS, to the tune of trillions of dollars. It is time for the banks to return the favor.