Bad Bank Deals Sting Los Angeles

Introduction

When Los Angeles wanted to improve its sewers, it did what most cities do. It borrowed money by issuing bonds and arranged to repay bond-holders, with interest, over time. Los Angeles agreed to pay its bond-holders a fixed interest rate.

Then, in 2006, as sewer work continued and interest rates were declining, the City decided to try a different approach. It refinanced it debts, converting bonds to variable rates.

Like a home buyer with an adjustable rate mortgage, the city was gambling that interest rates would not rise dramatically. If they did, the City would have to make much higher payments. If they fell, the City's payments would be lower.

At that point, two of the world's biggest banks, Bank of New York Mellon and Dexia, stepped in, offering the city a way to hedge its bet with a complicated derivative they were offering that they called an "interest rate swap."

The swap would not affect the city's variable rate payments to its bondholders. The city would continue making those. But the city would have a side bet with the banks.

In the side bet, the city would make more money if interest rates rose— exactly the opposite of its position with its bondholders.

Here is the way the side bet worked: The city would swap interest rates with the banks. They promised to pay the banks a fixed rate, while the banks promised to pay the city a variable rate. If interest rates rose, banks would have to pay more to the city and the city could use that money to help meet its rising interest rate obligations to its bondholders.

On the other hand, if interest rates fell, banks would do better. They would owe the city less, while the city would be stuck paying a higher fixed rate to the bank. Things would still not be all bad for the city, because falling interest rates would also mean lower interest payments to its bondholders.

This kind of arrangement is called a "hedge." Theoretically, in normal times, the city and the banks would come out about even-- although the banks would make a profit by charging fees to handle the swap.

Financial Crisis is Lose-Lose for Los Angeles

But in 2008, normal times ceased and the assumptions underlying the side bet changed dramatically. Walls Street greed crashed the economy and the federal government stepped in. It used billions of dollars in taxpayer money to bail out banks like Bank of New York Mellon that were considered to big to fail. Then the federal government reduced interest rates to record lows to try to stimulate banks to lend money to businesses to revive the economy.

Year after year, as the economy continued to struggle, the federal government has maintained these artificially low interest rates for banks.

In their side bet with the city of Los Angeles, suppressed interest rates have meant big paydays for Bank of New York Mellon and Dexia. Los Angeles has been on the hook to pay them $46.8 million, which has been the difference between the fixed rate payments it has been obligated to make to the banks and the variable rate payments the banks have been obligated to make to the city.

Meanwhile, the variable rate payments the city receives from the banks have not been enough in most years to cover the variable rate payments the city owes its bondholders.

For the City of Los Angeles, the swaps deal has been lose-lose.

This is especially painful to contemplate because the city didn't need a swaps deal as a hedge.

If there had been no swap and interest rates had declined, the city would have been fine. It would have owed its bondholders less and been able to spend the savings on providing services to residents.

On the other hand, ifl there had been no swap and interest rates had spiked, the City had an existing hedge—called a "call option"—that it could have used to refinance the bonds at a fixed rate.

For Bank of New York Mellon and Dexia, the deal has been win-win. Besides the fees they charge to run the swap and the $46.8 million they have collected to date from Los Angeles taxpayers, they charged the city an additional $26.1 million to get out of a portion of the swap in 2012. They want to charge the city an additional $24 million to get out of the rest.

The banks say the city's alternative is to keep on paying until the swaps contract ends in 2028. That would mean an additional $69 million at current interest rates.

Time to Renegotiate Bad Deals

On May 2, 2014, LA City Councilman Paul Koretz introduced a motion that calls on NY Mellon and Dexia to either renegotiate contracts with the city at no cost, or for the City Council to terminate business with the banks altogether if they refuse. According to Councilman Koretz, "New York Mellon Bank and Dexia need to do what many others have done for the sake of this city, and that is to make sacrifices, not obscene profits."

We think that's the least these banks should do. They helped crash the economy, creating a situation in which they continued to profit at public expense, while residents of Los Angeles continue to suffer from service cutbacks because the city is spending its money to pay off banks.