PENNSYLVANIA DEPARTMENT OF THE

AUDITOR GENERAL

NEWS RELEASE

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Auditor General Jack Wagner Calls on General Assembly to Ban Risky "Swap" Contracts by Schools, Local Governments

Urges new efforts to recover millions in taxpayer losses in Bethlehem Area School District and throughout Pennsylvania

HARRISBURG (Nov. 18, 2009) – Auditor General Jack Wagner said today that the General Assembly should ban the use of "swaps," after a special investigation completed by his department found that the Bethlehem Area School District lost at least $10.2 million of taxpayers' money in these risky and complex financial instruments. Wagner also recommended that all Pennsylvania school districts, local governments, and municipal authorities stop entering into swap agreements and immediately terminate any active swaps to which they are a party.

"Quite simply, the use of swaps amounts to gambling with public money," Wagner said. "The fundamental guiding principle in handling public funds is that they should never be exposed to the risk of financial loss. Swaps have no place in public financing and should be banned immediately."

While the investigation focused on the Bethlehem Area School District, Wagner called his report a "case study" of the use of swaps by all local governments in Pennsylvania. The Department of Community and Economic Development's records indicate that 626 swap filings were made in Pennsylvania between October 2003 and June 2009, which related to $14.9 billion in debt. The precise number of different swaps and the precise amount of debt cannot be determined because the DCED data may include some double-counting.

During this time period, 107 of Pennsylvania's 500 school districts, or 21.4 percent, and 86 other local governments reported to DCED that they entered into swap agreements. At least 13 investment firms,

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including Citibank, Goldman Sachs, J.P. Morgan, and Morgan Stanley, have entered into swap agreements with Pennsylvania school districts and other local governments.

In 2003, the General Assembly passed, and the governor signed, Act 23, which amended state law to explicitly permit local governments to enter into "qualified interest rate management agreements" or "QIRMAs," commonly referred to as interest rate swaps, or just swaps, which are a type of derivative. Swaps were an attractive investment instrument when interest rates on variable-rate bonds and notes were low in comparison to fixed-rate bonds and notes, because they allowed local governments to take advantage of the lower rates while, in theory at least, providing a hedge against large increases in those rates. These exotic financial instruments are neither investments nor debt; they are contracts between a bond issuer (such as a school district) and an investment bank to exchange ("swap") cash flows during an agreed-upon term based on other securities or indices. When the two sets of cash flows are exchanged, the side that generates the larger payments receives the difference between the sums.

Until September 2008, the swap agreements were generally favorable to the Bethlehem Area School District, and it received cash payments from its investment bank counterparties. However, the swaps became unfavorable to the school district after the worldwide collapse of the banking system. The district was forced to pay $12.3 million to investment bank J.P. Morgan in May 2009.

Wagner's investigation focused on the Bethlehem Area School District's swap agreements entered into between April 29, 2003 and June 27, 2006. During that period, the district entered into 13 different swaps – the most of any school district in Pennsylvania. The 13 agreements related to $272.9 million in debt for school construction projects.

Wagner reviewed just two of the district's swaps because those were the only two that had concluded by the time of his investigation. The two swaps cost district taxpayers $10.2 million more than if the district had issued a standard fixed-rate bond or note. Ironically, the swaps cost taxpayers $15.5 million more than if the district had simply paid the interest on the variable-rate note without any swaps at all. The district's losses were largely due to excessive fees and other charges and the termination payment. "Because the district has many other swaps still in effect, the ultimate financial impact on the taxpayers remains to be seen," explained Wagner.

Wagner noted that, while Act 23 was written primarily for the benefit and protection of the financial services industry, the swaps problem is not peculiar to Pennsylvania. The state of Tennessee has banned local governments from using these risky investments, New York State's attorney general is investigating a possible ban, and the U.S. Congress is considering federal regulations.

Wagner also found that the district was the victim of a variety of deceptive marketing tactics: fees that were characterized as being paid by the investment banks were actually ultimately charged to the district; the agreements resulted in huge hidden profits for the investment banks that were not required to be, and have not been, disclosed to the district; the intermediaries involved in the deals – such as the district's former financial advisor – had apparent conflicts of interests as a result of representing the interests of counterparties as well as the district; and at least two of the transactions were structured to provide the district with substantial up-front cash payments at the inception of the agreements as an additional inducement, totaling $5.8 million, while failing to disclose to the district that the investment bank was making a huge and immediate profit on the deal that was far in excess of the cash paid to the district. As a result, Wagner recommended that local governments should hire their financial advisers through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

Wagner urged the General Assembly to act on his legislative recommendations immediately. "These toxic products are being peddled to well-meaning but relatively unsophisticated local officials every day throughout the commonwealth," he said. "The risk of huge losses is compounded by a lack of transparency in the deals and the failure of federal regulators to impose accountability on firms who created and marketed these products in the first place. These dangerous deals work in favor of the gambling houses and not the gamblers, and they must stop now."

Wagner referred his findings to numerous state, federal, and independent entities. Among the recipients are the Pennsylvania Office of Attorney General, Pennsylvania Securities Commission, State Ethics Commission, U.S. Departments of Justice and the Treasury, U.S. Securities and Exchange Commission, and U.S. Commodities Futures Trading Commission.

"I encourage the law enforcement agencies, in particular, to investigate and prosecute any conflicts of interest involved in these transactions," Wagner said, "and to pursue all avenues that may be available

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to recover funds for the taxpayers of this district and elsewhere."

Wagner conducted his investigation at the request of State Sen. Lisa Boscola, following a series of investigative reports by the media about the Bethlehem Area School District's use of swaps. This is the second investigation report of the district released by Wagner in as many months. In October, Wagner reported that the district had maintained inadequate controls over more than $11.5 million of laptop computers and also had exercised poor oversight of an internal investigation related to the drug arrest of a former middle-school principal that cost the district $52,726.

Wagner commended the district for its cooperation with the investigation and its positive response to most of the recommendations in the report. He said that he would follow up in the future to determine the status of action on his recommendations by both the district and the General Assembly.

A complete copy of Wagner's special investigation report is available at *www.auditorgen.state.pa.us*.

Auditor General Jack Wagner is responsible for ensuring that all state money is spent legally and properly. He is the Commonwealth's elected independent fiscal watchdog, conducting financial audits, performance audits and special investigations. The Department of the Auditor General conducts more than 5,000 audits per year. To learn more about the Department of the Auditor General, taxpayers are encouraged to visit the department's Web site at www.auditorgen.state.pa.us.

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