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Hidden Swap Fees by JPMorgan, Morgan Stanley Hit School Boards

By Martin Z. Braun and William Selway

Enlarge/Details

Feb. 1 (Bloomberg) -- James Barker saw no way out. In September 2003, the superintendent of the Erie City School District in Pennsylvania watched helplessly as his buildings began to crumble.

The 81-year-old Roosevelt Middle School was on the verge of being condemned. The district was running out of money to buy new textbooks. And the school board had determined that the 100,000-resident community 125 miles north of Pittsburgh couldn't afford a tax increase. Then JPMorgan Chase & Co., the second-largest bank in the U.S., made Barker an offer that seemed too good to be true.

David DiCarlo, an Erie-based JPMorgan Chase banker, told Barker and the school board on Sept. 4, 2003, that all they had to do was sign papers he said would benefit them if interest rates increased in the future, and the bank would give the district $750,000, a transcript of the board meeting shows.

``You have severe building needs; you have serious academic needs,'' Barker, 58, says. ``It's very hard to ignore the fact that the bank says it will give you cash.'' So Barker and the board members agreed to the deal.

What New York-based JPMorgan Chase didn't tell them, the transcript shows, was that the bank would get more in fees than the school district would get in cash: $1 million. The complex deal, which placed taxpayer money at risk, was linked to four variables involving interest rates. Three years later, as interest rate benchmarks went the wrong way for the school district, the Erie board paid $2.9 million to JPMorgan to get out of the deal, which officials now say they didn't understand.

``That was like a sucker punch,'' Barker says. ``It's not about the district and the superintendent. It's about resources being sucked out of the classroom. If it's happening here, it's happening in other places.''

$12 Billion in Deals

It is. During the past four years in Pennsylvania alone, banks have pitched at least 500 deals totaling $12 billion like the one JPMorgan Chase sold to Erie, according to records on file with the state Department of Community and Economic Development. Most of the transactions -- which occurred outside the state's largest cities of Philadelphia and Pittsburgh -- have been made without public bidding, which means that banks and advisers privately arranged the deals with small school districts, the records show.

JPMorgan's Chief Executive Officer Jamie Dimon declined to say if he thought the bank's fee disclosure was proper and whether the bank acted in a fair, responsible and moral manner in Erie.

Banker DiCarlo declined to comment. JPMorgan spokesman Brian Marchiony says the deal gave the school district immediate debt savings and protected it against unpredictable interest rate risk in the future. He declined to answer specific questions.

Overpaying Fees

The Pennsylvania transactions involve interest-rate swaps, which are derivatives. Derivatives are financial contracts whose value is based on other securities or indexes; interest-rate swaps are tied to future changes in lending rates.

The Pennsylvania deals show that school districts routinely lose when making derivative deals. They pay fees to banks that are as much as five times higher than typical rates and overpay advisers by as much as 10-fold. That means banks often underpay schools on upfront amounts, as JPMorgan Chase did in Erie, public records show. And school officials aren't always well served by their supposedly independent advisers, whose fees are paid by the banks selling the deals -- only if the sale is made.

`Getting Fleeced'

In 15 Pennsylvania school districts, officials entered into interest-rate-swap deals worth $28 million since 2003, according to data compiled by Bloomberg. Of that dollar amount, the schools took in $15 million, and banks and advisers got the rest as fees, Bloomberg data show.

``The school districts are getting fleeced,'' Pennsylvania Governor Edward Rendell says. The governor, 64, a Democrat who has been in office since 2003, says the state might in the future advise schools and municipalities on derivatives contracts before they sign with banks. Christopher Cox, chairman of the U.S. Securities and Exchange Commission, says he's concerned that municipalities are taking on more risk than in the past when they raised money primarily from bond sales.

``It's a serious issue, not only in Pennsylvania but across the country,'' says Cox, 55, who has headed the SEC since 2005. ``That is what we have seen repeatedly. More often than not, the municipalities aren't configured to have financial sophisticates in charge of these offerings -- and the result is that the firms are the only ones who know what's going on.''

Just five years ago, municipal derivative deals weren't sanctioned in Pennsylvania, the sixth-most-populous U.S. state. Then, in September 2003, the state Legislature adopted a law allowing schools and towns to use interest-rate swaps to lower borrowing costs and raise cash.

Exchanging Payments

In a swap, two parties agree to exchange payments over a period of time that can last as long as 30 years. Typically, one agrees to pay a fixed rate and the other to pay a variable rate that changes with a benchmark index or formula defined in the contract.

Public agencies can benefit by using derivatives to guard against swings in borrowing costs or to lock in current interest rates for bond sales they might not make for years. In many cases, school districts use swaps as a way to refinance bonds they've issued in the past.

Derivative deals can bring banks fees three times higher than the traditional selling of municipal bonds, public records show. School districts don't know whether they're getting fair market values with swaps because the contracts are private; they don't know how to compare their deals with those done by other districts.

`Profits Are Greater'

This lack of transparency is a boon for the banks, says Christopher ``Kit'' Taylor, executive director from 1978 to 2007 of the Municipal Securities Rulemaking Board, a panel that issues rules on municipal bond sales.

``Business moves from transparent and competitive markets to markets where there is less transparency and the profits are greater,'' he says. ``If you don't know how much you're paying, you're going to be paying too much.''

The Pennsylvania swap law was passed after lobbying by financial advisory firms that stood to profit from such deals.

The legislation made the state a member of an expanding club. Forty states give government bodies explicit authority to make derivative deals, up from none 20 years ago, says David Taub, a lawyer who specializes in derivatives and is a partner at McDermott Will & Emery in New York.

Derivatives aren't regulated by the SEC, the MSRB or by states. Pennsylvania offers a clear look at these deals because, by law, all the contract records must be publicly filed with the state.

Pennsylvania Adviser

One derivative advisory firm that backed the Pennsylvania swaps legislation is Investment Management Advisory Group Inc., or IMAGE. The Pottstown, Pennsylvania-based company was raided by the Federal Bureau of Investigation in November 2006 in connection with a criminal antitrust investigation of bid rigging of investment contracts that are sold to states and municipalities.

The U.S. Justice Department is also probing municipal derivative deals. IMAGE has said it's cooperating with the probe. No charges have been filed.

In some Pennsylvania transactions, banks bought from school districts rights to exercise options on an interest-rate swap, or swaptions. Banks can choose to exercise the option if they stand to make money or can let the option expire if interest rates aren't favorable to them.

Banks Hedge Risk

The banks that arrange these deals create the swap contracts before pitching them to schools. Using software programs designed for valuing swaps, they calculate prices for which they can sell them after a school signs a contract. That's how the banks make money. For example, if a bank agrees to pay a district $800,000 in a deal it valued at $2 million, it could reap $1.2 million for itself and middlemen.

``They load it off instantly,'' says Taylor, who's now on the advisory board of Rockwater Municipal Advisors LLC, an Irvine, California-based investment firm.

Banks hedge their risk in derivative deals by making trades to cover possible losses to school districts. The banks make their money from fees, regardless of interest rate movements.

The reason Erie and other districts don't know how much the bank makes from a deal is because banks don't tell them, the records show. The money isn't paid immediately out of school budgets. Fees are hidden from schools because banks include those costs in the contract by adjusting interest rates up or down.

SEC Disclosure Rules

While the SEC doesn't regulate derivatives, it has authority to oversee how banks conduct transactions. SEC Chairman Cox says all financial firms should tell clients what their fees are before signing any deals.

``Brokers and advisers should disclose their compensation and conflicts of interest to their customers, and to the extent that they are regulated by the SEC, they must,'' he says.

Cox also says school district officials have a responsibility to the public and to bond investors to ensure their advisers are actually independent and acting in the best interests of taxpayers. ``To the extent that municipalities are participating in transactions they are not qualified for, there is an obligation to get good independent advice,'' he says.

More than two dozen Pennsylvania school districts bought swaps that bet on the spread between two interest rates. Many bet wrong. Since 2006, at least 27 school districts gambled that the spread would widen between either the five- or 10-year London interbank offered rate on the one hand and weekly municipal bond yields or the one-month Libor on the other.

The opposite happened: Spreads narrowed as long-term interest rates fell. The schools had to pay banks, or they could pay a steep exit fee, as Erie did with its swaption to cancel the deal.

Historical Fluke

School district officials say their advisers have told them the contracting of the spreads was a historical fluke. In the Exeter Township School District, 55 miles (88.5 kilometers) northwest of Philadelphia, Financial S&lutions LLC told the schools their swap deals shouldn't have lost them money.

``They tell me that's never happened before,'' says Ernest Werstler, who was business manager of the district until November, when he retired. ``It's happening to us now.'' Financial S&lutions didn't respond to requests for comment. Deane Yang, head of research at financial advisory firm Andrew Kalotay Associates Inc. in New York, says local officials are putting too much stock in financial advisers who are paid by banks--and in many cases are referred to schools by banks.

``It's like trying to decide whether a used-car dealer is offering you a good price or not,'' says Yang, who doesn't work with school districts. ``There's a car appraiser down the street who tells you he will provide an independent evaluation. But he's paid only if there's a sale.''

`Pound Someone's Brains'

School board members usually have a poor understanding of derivatives, says Peter Egan, a financial adviser and former public finance banker at a unit of Cherry Hill, New Jersey-based Commerce Bancorp Inc.

``A derivative is a very powerful tool,'' says Egan, who's now managing director of Bordentown, New Jersey-based Phoenix Advisors LLC, which advises local governments on bond sales. ``It's like a hammer. You could use it to hammer in a nail with perfect precision. But you could also use it to pound someone's brains out.''

In many cases, the banks repeatedly sell more derivatives to replace old ones. In Bethlehem, Pennsylvania, JPMorgan and Morgan Stanley sold the school district eight swaps on just two bond issues, records show.

Outside Advice

``It sure looks a lot like churning,'' Yang says. Churning is a term used to describe how stockbrokers or insurance agents sometimes continually sell and resell the same or similar products to clients in order to make more in fees. ``Doing more than one swap against a single bond issuance definitely benefited the swap adviser and bank, but probably not the school district.''

In Pennsylvania, it's the financial advisers who are supposed to keep school district officials from getting fooled. That's why the 2003 law allowing for swaps requires districts to use independent advisers.

``There was a fear that these deals were being pushed on the unsuspecting, perhaps, without them getting any other advice,'' says Steve Nickol, a Republican member of the Pennsylvania House of Representatives who introduced the legislation.

Lobbyist Leads Change

Financial advisers -- especially IMAGE, which opened in 1992 -- backed the swaps bill from the beginning. At an Oct. 16, 2002, hearing in Harrisburg, the state capital, Rick Frimmer, a public finance attorney, and Martin Stallone, managing director of IMAGE, said swaps would save taxpayers money. Since 1998, IMAGE's founder, David Eckhart, has personally contributed $469,400 to Pennsylvania elected officials, political action committees and candidates for office, campaign records show.

IMAGE said in a written response to questions that the firm never lobbied for the law. It said Eckhart's contributions had no bearing on the 2003 legislation.

Nickol says he was first approached about approving swaps for school districts and municipalities in 2002 by Elmer Heinel, a public finance lobbyist whose clients have included bond underwriters Meridian Capital Markets Inc., Stallone's former employer, and Wheat First Securities Inc.

Authority to Buy

Heinel has contributed $141,245 since 2000 to state lawmakers, political action committees and candidates running for office. Heinel says the donations weren't tied to the legislation.

The law gave cities, counties and school districts the explicit authority to buy swaps.

Municipal derivatives had been gaining ground in other states, as well as in large cities such as Philadelphia and at agencies like the Pennsylvania Turnpike Commission, as a means to lower borrowing costs, Stallone told the legislature at the time. The law passed 197-0 in the House and 45-0 in the Senate.

``There could be huge cost savings for many of the local governments,'' Nickol said. Rendell signed the bill in September 2003. That same month, the Erie school district signed the swaption deal with JPMorgan.

Erie Buys In

Once an iron and steel center, Erie is now left with shuttered factories and an aging population. While General Electric Co.'s $4 billion transportation unit, which mainly builds locomotives, maintains its headquarters in Erie, much of the city's manufacturing base has disappeared.

Since 1970, the city's population has declined 30 percent. Seventy-six percent of students in the district are eligible for free or reduced-price lunches, according to the state Department of Education.

JPMorgan and IMAGE had pitched the swaption to the school board in June 2003. JPMorgan's DiCarlo and IMAGE's Mike Garner said at that meeting the district had locked in high interest rates in 2001, when it issued $38.7 million in bonds, according to an audiotape of the June 17, 2003, meeting.

In the two years after that, interest rates had declined. Using traditional bond financing, the district couldn't take advantage of the lower rates because tax law prohibited refinancing before 2011, Garner said.

Money Now

By agreeing to a swaption with JPMorgan, the district could cash in immediately, Garner told the board. The bank would make an upfront payment to Erie. In return, the school allowed the bank to enter a swap with Erie in the future, from 2011 to 2029.

The value of the swap hinged on four factors: the length of time before the option was exercised, credit market expectations of future interest rates, the relationship between a fixed rate to be paid by Erie and changing interest rates and volatility of lending rates.

The bank could choose to exercise or decline the option. The school district had no say in that decision.

JPMorgan had recommended IMAGE to the school district's law firm, Knox McLaughlin Gornall & Sennett PC, says Tim Sennett, a partner in the firm who worked with the school district on the derivatives deal. IMAGE's Garner told school board members he thought the district should make the deal.

'Risks Are Reasonable'

``Given your situation, the economics are very good for the district,'' Garner said, according to the tape of the meeting. ``The risks are reasonable. I believe everyone on the board has a good grasp of what the risks are.''

The board didn't make a decision that day. ``This was a new concept we'd never heard of,'' says Richard D'Andrea, the district's business administrator. ``Given the tight budget situations that we're always under, that's a very strong motivation to help balance the year's budget.''

On Sept. 4, 2003, as a new school year was starting, the board met again with DiCarlo, who said the district should sign the deal and the bank would give it $750,000. Board members asked DiCarlo how much the bank would make in fees.

DiCarlo said, ``Everybody has asked, and it's a reasonable question: What does JPMorgan, what do we get on this transaction? I can't quantify that to you,'' according to a transcript of the meeting.

$2 Million Asset

DiCarlo, who was a state representative from Erie from 1973 to 1980, didn't tell the board that the contract was worth $2 million in global derivative markets. Based on interest rates that day and terms of the deal, Bloomberg data show that was the value of the contract.

JPMorgan's gross markup on the swaption was 0.82 percentage point of the rate compared with a 0.16 percentage point charge Goldman Sachs Group Inc. collected from the Philadelphia School District on a comparable swaption the city had bid competitively in March 2004.

In a written response to questions, IMAGE disputed the amount of fees paid to JPMorgan. ``The numbers your analysis produces for the districts are clearly way off the mark,'' it wrote.

IMAGE said it didn't know the bank's fees, estimating they were $365,000-$495,000. IMAGE said it doesn't know who recommended the firm to Erie as an adviser. ``Regardless, there are no conflicts,'' IMAGE wrote. IMAGE said its fees were normal for the industry.

Two-Page Opinion

D'Andrea says he relied on assurances from IMAGE that the deal was right for the district. IMAGE wrote a two-page opinion saying the deal was fair. It didn't say how much the fees were, according to a copy obtained under a public records request.

``The net swaption premium to the district was adjusted to reflect the forward starting and option-adjusted nature of the swaption, a reasonable hedging spread in the Libor markets and a fee to JPMCB reflective of its time and effort dedicated to the district as well as the inherent credit, operational and market underwriting hedging risk of the transaction,'' it said. Board member Eva Tucker, a retired professor of geoscience at Penn State University's Erie campus, says the board didn't fully understand the deal and trusted IMAGE, which recommended the transaction.

``We're not financial experts,'' Tucker, 72, says. ``We relied on the best advice we thought we could get.''

James Herdzik, a school board member who works as a sales manager at a machine shop, says the district couldn't turn down the deal because it was desperate for money.

``We're scrambling for every penny we can get,'' Herdzik, 48, says. The board approved the deal in a 6-0 vote.

Paying to Cancel

JPMorgan actually gave Erie $785,000 -- $35,000 more than DiCarlo had promised. The bank paid IMAGE $60,000, gave bond insurer Financial Security Assurance Inc., known as FSA, $57,585, paid lawyers and other middlemen $106,000 and kept $1 million as its revenue, according to public records and Bloomberg data.

By June 2006, the swaption had left Erie's district with a $2.9 million liability because expectations of future short-term interest rates had risen, narrowing the difference between future costs to borrow for one year and for 30 years. In July 2006, the district paid JPMorgan $2.9 million to terminate the swaption.

The district got the cash from the proceeds of two new derivative deals it did with Pittsburgh-based PNC Financial Services Group Inc.'s PNC Capital Markets unit. The transactions paid Erie schools $732,000 up front. One deal was an interest- rate swap that so far has lost $32,000 for the district, according to local records.

Most In Need

Erie revised the terms of the swap in October 2006, betting that beginning in March 2008, long-term rates would rise faster than short-term rates. The other deal is a swaption; PNC hasn't exercised the option yet.

Herdzik says he can't see why banks would take advantage of struggling school districts.

``It's kind of like preying on the municipalities that are most in need of money,'' he says. ``It's like we got raped.''

Other Pennsylvania school districts are paying banks excessive fees. Bethlehem, 50 miles north of Philadelphia, is also a former steel-making center. With a population of 72,000, the city has maintained its historic buildings.

The Central Moravian Church is a symbol of the group that founded the city on Christmas Eve in 1741. In the industrial area of the city, Las Vegas Sands Corp. is converting an old steel mill into a casino.

Money-Making Plan

Bethlehem's school district has used derivatives to try to make money. At an April 2005 meeting, Les Bear, of advisory firm Arthurs Lestrange & Co. in Pittsburgh, told the school board by arranging two interest-rate swaps tied to $110 million in bond issues, the 15,350-student district could generate more than $11 million over 25 years.

School finance director Stan Majewski supported the plan.

``Mr. Majewski commented that we all try to surround ourselves with people who know more than we do,'' minutes of the meeting say. ``He believes Arthurs Lestrange is the best public financing department of any organization in this country.''

None of the board members asked Bear or Majewski how much the district would pay for the swaps, the minutes show.

A month later, Lestrange, working with a Lancaster, Pennsylvania, firm called Access Financial Markets, negotiated two swaps with JPMorgan and Morgan Stanley without competitive bidding.

$3 Million Fees

So far, the district has taken in about $900,000 from the deals, Bloomberg data show. That compares with $3 million in transaction fees. Lestrange and Access made $630,000 each for arranging the swaps, according to school district records. New York-based Morgan Stanley made $840,000 and JPMorgan received fees totaling $900,000, Bloomberg data show.

Lestrange and Access earned a fee 10 times more than the Easton Area School District, Bethlehem's neighbor, paid its adviser on a comparable interest-rate swap in 2004. In a memo to school board members, Majewski said the fees included annual interest rate monitoring that would cost the district hundreds of thousands of dollars.

Bear of Lestrange and Matthew Kirk of Access didn't respond to requests for comment.

The rates the banks charged Bethlehem were twice the average for comparable swaps deals. In this kind of swap, in which both sides pay floating interest rates, a bank calculates its fees by subtracting an amount from the rate it will pay.

In the average deal of this type, banks lower the rate by 0.06 percent, says Jeff Pearsall, a managing director of Philadelphia-based Public Financial Management, the largest municipal adviser in the U.S.

JPMorgan subtracted 0.13 percent in the Bethlehem deal, and Morgan Stanley lowered its rate by 0.11 percent. Morgan Stanley spokeswoman Jennifer Sala declined to comment.

`What's Going On?'

``It's obscene,'' says Peter Shapiro, managing director of South Orange, New Jersey-based adviser Swap Financial Group, who doesn't advise Pennsylvania school districts. ``What is going on in Pennsylvania?''

Bethlehem has paid Lestrange $1.6 million and Access $1.3 million for their work on eight of the district's 12 swaps, public records and Bloomberg data show. JPMorgan and Morgan Stanley made a total of $5 million on those transactions.

Board member Joseph Craig, who approved the deals, says he's not qualified to discuss the deals and doesn't know how much they cost.

``I really don't remember a whole lot of specifics about it,'' says Craig, 64, a retired special education teacher who's been on the board for 10 years.

School district business manager Majewski declined to answer questions about swaps and fees.

``They've worked very successfully for me,'' he says. ``Everything I've done is done publicly with my local taxpayers.''

Never Told Fees

The school district didn't know that it had overpaid the banks by about $870,000 because the banks and Lestrange never told them what the fees were, according to minutes of school board meetings.

Sometimes school districts have agreed to swaptions even when a local financial official warns against no-bid deals. In Butler County, a rural area dotted with working farms 40 miles north of Pittsburgh, County Controller Jack McMillin says the lack of competitive bidding for public finance has cost taxpayers.

``It's a form of institutionalized larceny under the guise of getting taxpayers a good deal,'' McMillin says. He wasn't involved in the school board decisions.

The board relied on an old friend, with the kind of connections that go far in western Pennsylvania: football and politics. The district put its trust in municipal finance firm Russell Rea Zappala & Gomulka Holdings Inc., known as RRZ.

Hall of Fame

Greg Zappala, head of JPMorgan's office in Cranberry Township just north of Pittsburgh, is the son of former Pennsylvania Supreme Court Chief Justice Stephen Zappala and the brother of Allegheny County District Attorney Stephen Zappala Jr. Greg Zappala, 46, played football for the University of Miami Hurricanes in the early 1980s.

He was a roommate of Jim Kelly, a Pittsburgh-born, Hall of Fame quarterback who led the Buffalo Bills to four Super Bowls. Zappala's uncle, Charles Zappala, was an RRZ executive.

In 1990, Greg Zappala became a broker with the firm. One of the founders was Andy Russell, formerly of the Pittsburgh Steelers.

In 2003, JPMorgan bought the firm's municipal unit: RRZ Public Markets Inc., which Zappala ran. The company had worked for the Butler Area School District since 1991. There was no competition when the former RRZ bankers paid $730,000 for an option to refinance, five years in the future, $39 million of bonds sold by the school district in 1998.

`No Secrets'

Russ Greer, 61, who served on the Butler school board at the time of the deal, says it provided much-needed cash and was approved at an open meeting.

``There were no secrets,'' he says.

Except one. Since the school district didn't know what JPMorgan made on the transaction, it didn't realize it had become another Pennsylvania municipality that was underpaid up front on a swaption deal.

``The school district has no knowledge of the specific fees made by JPMorgan,'' Superintendent Edward Fink said in a written response to questions.

The contract had a market value more than three times what the district was paid, Bloomberg data show. JPMorgan decided how much of the $2.2 million it would give the district, without ever telling the school board.

The bank paid $165,813 to bond insurer FSA, $40,000 to IMAGE, $147,500 to five law firms and $23,000 to the Butler County General Authority. JPMorgan kept the remaining $1.1 million as its own revenue.

The Board's Understanding

Controller McMillin, a Republican, says he doubts whether the elected school board had the skills needed to know whether it was getting enough for the option.

``I can't imagine how they could have understood that,'' he says.

Penelope Kingman, a former member of the school board, voted against the derivatives deal in 2003. She felt her colleagues had failed to grasp the risk they were taking in exchange for the money offered by JPMorgan.

``The financial guys would come in with a lot of stuff that nobody at the district understood,'' she says. ``Local governments are entering into these without fully understanding what they are doing.''

JPMorgan spokesman Marchiony says, ``the swaps used by Erie and Butler, which were vetted by independent financial advisers and voted on in publicly attended meetings, enabled both districts to realize immediate debt service savings, while protecting them against unpredictable interest rate risk over several years.''

`Beyond Angry'

Swap deals in Pennsylvania work out well for banks, advisers and lawyers who are paid for putting them together. Schools, parents and students see it differently.

In Erie, Rosena Wright says she's growing angry as her son, Desmond, 13, has been transferred from Roosevelt Middle School, which the city shut down in 2007 after the heating failed, the roof leaked and a ceiling tile fell on a student's head. Desmond is now in a temporary space the school district is leasing from a church. Wright, 44, a day-care worker, says no one told her about the deal that cost her schools $2 million.

``I'm beyond angry,'' she says. ``I really want to tar and feather somebody.''

Erie schools superintendent Barker says he had thought the 2003 derivatives deal would save some money for the district.

``We're always at the mercy of the experts that advise us,'' he says, adding that schools have to find a better way to raise money. One option would be to return to old-fashioned, publicly bid bond sales. He says he doesn't begrudge the banks or advisers their right to get paid.

``We expect people to make a profit,'' Barker says. ``But they don't have to put their interests over the kids'.''

To contact the reporters on this story: Martin Z. Braun in New York at **mbraun6@bloomberg.net** ; William Selway in San Francisco at **wselway@bloomberg.net**

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