COUNCIL OF THE CITY OF PHILADELPHIA

COMMITTEE ON RULES

Room 400, City Hall
Philadelphia, Pennsylvania
Wednesday, October 23, 2012
10:00 a.m.

PRESENT:
COUNCILMAN WILLIAM K. GREENLEE, CHAIR
COUNCILWOMAN CINDY BASS
COUNCILMAN BILL GREEN
COUNCILMAN BOBBY HENON
COUNCILMAN JAMES KENNEY
COUNCILMAN DENNIS O'BRIEN
COUNCILWOMAN BLONDELL REYNOLDS BROWN
COUNCILMAN MARK SQUILLA

RESOLUTION 120147 - Resolution authorizing the Committee on Rules to hold public hearings investigating the use of qualified interest rate management agreements by the City and School District; assessing whether corrective actions, including legal remedies, should be pursued...

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COUNCILMAN GREENLEE: Good morning, everyone. Can I have everyone's attention. Folks, please have a seat. Thank you.

This is the Committee on Rules. First, let me make an announcement that there were three other bills scheduled today that will be continued - Bill Nos. 120720, 120727, and 120728 - because of an advertising error will be continued until Tuesday, November 13th at 10:00 a.m. So if you're here -- I don't think anybody is here for those bills, but if they are, they will not be heard today. They will be on Tuesday, November 13th at 10:00 a.m.

Ms. Marconi, will you please read the resolution that's before us today, the title of the resolution.

THE CLERK: Resolution No. 120147, resolution authorizing the Committee on Rules to hold public hearings investigating the use of qualified interest rate management agreements by the City and School District; assessing whether corrective actions, including legal remedies, should be pursued; and determining the conditions, if any, under which it would be appropriate to enter into future agreements; and in furtherance of such investigation, authorizing the issuance of subpoenas to compel the attendance of witnesses and the production of documents to the full extent authorized under Section 2-401 of the Home Rule Charter.

COUNCILMAN GREENLEE: Thank you.

And before we take any testimony, the Chair recognizes the Vice-Chair of the Committee and the sponsor of this resolution, Councilman Kenney.

COUNCILMAN KENNEY: Thank you, Mr. Chairman. I just want to state for the outset that as reports have come out in the past few years sounding the alarm about huge losses experienced by our local governments due to these complicated financial tools known as swaps, it is vitally important that we find out the facts. Investing public funds is not like investing private funds. We need to make sure that the stewards of our taxpayers' dollars are limiting risks.

There are two separate issues here. One is taking appropriate risks in the market to earn us more money or to save us money. The other is being defrauded by our banks, many of those same ones that our taxpayer dollars have had to prop up in the 2008 bailout.

And there's a couple different aspects of this hearing. First of all, the beginning of the hearing will be trying to explain this very complicated process or complicated instruments. I've been dealing with them for months and months now and still there's certain nuances that I'm not aware of. And there's been a 60 Minutes piece just recently talking about some of the banks in New York and one of the Goldman Sachs' Vice-Presidents quitting, because part of their -- his view was part of their goal was to find investors that were not sophisticated and try to sell them complicated instruments.

So there's all this underlying of what really went on during the course of this whole thing. It may turn out in the end that the swap stuff that we entered into was a good thing for the taxpayer. I don't know. There's two sides of that story, and we want to just get started from an informational perspective and then have some discussion later on as to whether or not we did the right thing.

The other issue is, far as I'm aware of now, the City currently has ten outstanding swap deals with a total current national amount approximately $1.05 billion, and the School District has two outstanding swaps with a total

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current national amount of approximately 500 million.

Also, the aspect of swaps that are particularly galling to me is the necessity of having to buy our way out of a bad deal. I was here when we were dealing with swaps back when it happened and we were told it was a good deal for the taxpayer. I believe that some of the bad actions of the banking institutions in our country threw our economy off the cliff, which put governments and school districts on the wrong side of swaps. That's galling enough that they're making money, we're losing money, but if we want to get out of the deal, we have to pay them to get out of the deal. On top of that, taxpayers nationally were paying to bail them out for their bad behavior with TARP money. So all of this cumulative is a big aggravation.

So maybe we can sort through some of this today and be less aggravated by the end of the hearing or more aggravated by the end of the hearing. I don't know.

So thank you, Mr. Chairman.

COUNCILMAN GREENLEE: Thank you, Councilman.

The record will also reflect Councilman Henon, a member of the Committee, is present.

Ms. Marconi, will you please call the name of the first witness.

THE CLERK: Jeffrey Pearsall.

(Witness already seated at witness table.)

COUNCILMAN GREENLEE: Mr. Pearsall, good morning. Please identify yourself for the record and proceed.

MR. PEARSALL: Hi. My name is Jeff Pearsall. I'm Managing Director at PFM. I run our swap advisory practice.

COUNCILMAN GREENLEE: Proceed.

MR. PEARSALL: Stephanie, would it be possible to get a copy of my presentation, because I'm not sure I'm going to be able to read the screen from back here. I promise I'll give it back at the end.

COUNCILMAN GREENLEE: See, that's the advantage of having to wear glasses when I was in first grade, I could see everything.

MR. PEARSALL: Okay. So what I'm going to try to provide for the Council is an overview of the swap market, how it works, who are the players, and then some observations from the financial crisis that caused some of these problems that the hearing is investigating.

Why don't we flip to Page 4. What is an interest rate swap? An interest rate swap is a financial contract, first and foremost. And what we're going to focus on here is interest rate swaps. There are a bunch of different types of swaps, commodity swaps, equity derivatives, things like that. But in an interest rate swap, two parties to the contract agree to exchange payments. Typically one side pays a fixed rate, as you can see in the boxes there, and the other side pays a floating rate. The floating rate is represented by the squiggly line there.

The principal amount of the contract is defined as "notional." It's another way of saying that it's not -- it's not real. It's not -- if you do a hundred million dollar bond deal, an issuer of bonds receives a hundred million dollars from the investors and then over time pays back that principal amount. In a swap, no principal is exchanged. The principal amount is simply used as a placeholder against which to calculate interest each period.

Historically, these swaps have traded over the counter, meaning via telephone or computer. Increasingly, they -- well, the vast majority of them after the Dodd-Frank Financial Reform Act are going to have to trade either on an

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exchange or through a clearinghouse. There will be certain exemptions, and it's expected the municipal issuers will be exempted from having to trade on an exchange or a clearinghouse.

Page 5, who are the participants in these contracts? Well, obviously there's the issuer or the customer, and then the other three key players in these transactions are the swap counterparty, which is a financial institution, a bank or an investment bank; the swap or bond counsel, the legal counsel that advises the clients, the issuer, on the legal ramifications of using these contracts, makes sure that they're in compliance with all authorizations, and this is key, because the providers won't enter into these contracts without this. Also provides an enforceability opinion that the contract is legal, valid, and binding on the user, on the municipality. And then the other -- typically the other party involved in a swap will be the advisor, and that advisor should be independent and have no connection to the counterparty or the financial provider. And Dodd-Frank will mandate that.

The next page shows a list of the currently active municipal swap providers. It's a little small, so it may be hard to see if you're looking at the screen. But it's a shrinking list than existed in 2008, before 2008. And then the other salient feature of this list is that the credit ratings of these firms are significantly lower in almost every case than they were pre-2008, before the financial crisis.

Page 7, why use swaps? Why do municipalities use these contracts? There are several main reasons, the first being expected savings. Frequently an issuer can issue variable rate bonds, for instance, and then enter into an interest rate swap because they don't want to be exposed to floating rates in the event that they should rise. And that combination of variable rate bonds and the interest rate contract produces a lower expected all-in rate than if the issuer had just gone out and done a traditional fixed rate bond.

Similarly, an issuer might want floating rate debt, but they might find that they don't have access to the bank letter of credit market, which is typically required to issue floating rate bonds. What could they do if they wanted floating rate exposure? They could issue a fixed rate bond, enter into a contract to convert it to a floating rate.

And then swaps have other uses, such as being able to hedge a future -- if you've got a big capital plan and you're expecting to issue bonds three or four years from now and you like today's interest rates and you want to protect yourself against a rise, you can do that. The bottom line is, they're primarily used for risk management, to increase budgeting certainty, and to avoid an unexpected spike in interest rate, or the case of commodities, energy costs.

COUNCILMAN GREENLEE: Sir, Mr. Pearsall, just one second.

Councilman Kenney.

COUNCILMAN KENNEY: Just one question at this juncture. Like with all financial transactions, it's kind of a bet. Is that a fair statement? That you're betting something is going to happen, and if it happens, you're okay, and if it doesn't, you're not.

Can you give me an idea as to where the bet went wrong and why you think the paradigm wherein the bet was made, what happened to take this, I guess, relatively stable, dependable operation or transaction, what pushed our bet to the wrong side of the ledger? Before you go on to who uses them. I still need to know -- our financial advisors and our treasurer at the time was making a calculated bet that

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something would happen or continue to stay the same. What changed? And explain to me how it affected the dynamic of the relationship, if you can.

MR. PEARSALL: I'll try. I would differ, however, with the characterization of swaps as a bet. I mean --

COUNCILMAN KENNEY: I'm not saying swaps are a bet. I'm saying all financial transaction are a bet. You're betting -- your actuary, they're betting something. When you do a pension, you do a DROP program, you're making a calculation and you're betting -- "bet" may be a bad word, but it's basically what it is. You think something is going to happen and you put your money where you think it's going to happen, and it doesn't. Sometimes you win the bet; sometimes you lose the bet. How did we lose the bet?

MR. PEARSALL: Right. Similar to if you decided to issue all fixed rate bonds in your description, that would be betting that interest rates are not going to go lower.

Where these products encountered problems was that unlike a fixed rate bond, it required some underlying raw material in order to make this look like a fixed rate bond. That underlying raw material was variable rate bonds. And the variable rate bond market pre-2008 relied on a couple of things to make it successfully work. One was insurers, bond insurers at the time, all of whom were rated AAA, they primarily insured auction rate securities. And then the other form of credit support for those variable rate bonds -- because the investors wouldn't buy those variable rate bonds even from highly rated issuers typically unless they had this credit backing. The other support for that was bank letters of credit.

When both of those types of financial institutions ran into trouble in 2008 and were severely downgraded, the floating rate bonds were no longer attractive to investors. Investors were putting them back, meaning forcing redemption of those bonds, and the issuers who sold those variable rate bonds had to refinance them somehow.

Now, the problem that swaps created was, this all occurred in declining interest rates. Rates were lower. The contracts had negative values, and so refinancing a variable rate bond when there was no swap attached would have been, if not relatively straightforward, simpler. Refinancing a variable rate bond that had a swap with a negative value, an underwater value, became more complicated.

COUNCILMAN KENNEY: Thank you.

MR. PEARSALL: Page -- and I'll try to speed up here. Page 8, who uses swaps? Financial institutions, banks, mutual funds, hedge funds; corporations, General Electric, Coca-Cola, Comcast

Corp. Sovereign governments in some cases have used interest rate or cross-currency swaps; municipalities, cities, states, airports, school districts; not-for-profits, hospitals, universities, museums, et cetera. Other large cities besides Philadelphia that have entered into swaps include Baltimore, Detroit, the District of Columbia, Houston, Miami, New York, Oakland, San Francisco. I'm leaving some off here, I'm sure, but they were widely used by major cities.

COUNCILMAN KENNEY: Why doesn't the U.S. government use swaps?

MR. PEARSALL: I think the U.S. government doesn't use swaps because they're such a huge player in the market, especially the market for treasuries. They would affect -- they would be the elephant.

COUNCILMAN KENNEY: Are you aware of any of the track records of any of the other cities that have entered into these transactions?

MR. PEARSALL: I can speak to Oakland and San Francisco where PFM was the advisor. And in the case of both of those, they encountered problems with their variable rate bonds and had varying degrees of success in refinancing them. In the case of San Francisco, specifically the airport there, they were able to successfully restructure the variable rate bonds, and the swaps continue to work. Oakland, we haven't been an advisor for a long time. I think they're still working through some difficulties there.

COUNCILMAN KENNEY: Thank you.

MR. PEARSALL: I won't spend too much time here. Key terms of interest rate swap on Page 10. These are the elements of the contract. The floating rate has to be defined, the principal amount, the maturity date, similar to a bond issue.

Page 12 shows the, what we

call, the boxes and the arrows. This is for a floating-to-fixed swap. It looks complicated. What I always -- when I'm teaching this, I always say if you just cross out the squiggly lines here, what you're left with, if everything is working the way it should be, is just one straight, solid line that looks like a fixed rate bond.

The net effect in that box in the corner on a swap like this is to produce, again when the hedge is working properly, a lower fixed rate than could be obtained by issuing traditional fixed rate bonds.

Page 13 talks about some of the benefits and risks. We mentioned lower expected cost savings, budgeting certainty, the ability to customize the terms. When you issue a bond, there's certain features that maybe an investor won't take. In a swap it allows for much more customization.

The risks, we're aware of these

now. There's termination payment risk if you're forced to early terminate the swap, if you're not allowed to, for whatever reason, to let it run to maturity. You have exposure to your counterparty, credit exposure. Lehman Brothers is the case that comes to mind there.

You risk that the rates that you're using to hedge and the rate that's on your bonds, the floating rate bonds, may not move exactly together. Those are some of the risks.

The next page, Page 14, is the one that everyone always seems confused about. So we go to great lengths to explain it to clients and rating agencies and everyone else, is how do swap dealers make money? They're not betting against issuers. That's the key point to understand. If they've done -- if their trading desk has done their job properly, they're running what's called a matched book, which means they don't care which way interest rates go. In this example, what they want to do, their objective is to stand in the middle and make a spread from each of the parties that trade with them. In this example, the swap dealer is receiving fixed from Counterparty A. They find an offsetting trade for another customer of the bank, which they're paying fixed, and the rates -- the fixed rate that they're receiving is higher than the fixed rate that they're paying and they earn a spread there.

What does that spread compensate them for? It compensates them for standing willing to trade, when you want to trade as an issuer as opposed to, okay, you can come back and trade in three months when we've lined up somebody on the other side. It covers their costs of hedging their transaction and it provides a shareholder -- a return on their shareholders' equity. Those are for-profit companies.

COUNCILMAN KENNEY: I'm sorry,

Mr. Chairman.

How do advisors get paid?

MR. PEARSALL: Advisors are typically paid a fee for arranging or advising on the transaction.

COUNCILMAN KENNEY: A fixed fee?

MR. PEARSALL: A fixed fee.

COUNCILMAN KENNEY: And they're paid by the party issuing the debt?

MR. PEARSALL: That's correct.

COUNCILMAN KENNEY: They're not paid by banks ever?

MR. PEARSALL: They're occasionally paid by the banks, but it's fully disclosed to the issuer.

COUNCILMAN KENNEY: Are you aware of any in Philadelphia, both in the School District and the City, are you aware of any of those arrangements that were fully disclosed about incentive payment or payment by the bank in addition to the fixed fee by the issuer, if you're aware?

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MR. PEARSALL: I'm not. We only advised the School District of Philadelphia. In those swaps, all of the fees were fully disclosed.

COUNCILMAN KENNEY: Thank you.

MR. PEARSALL: Flipping over to the indexes, Page 11, the two primary floating rate indices that are used in a swap are a LIBOR, which is a corporate rate. So if a municipality is going to use a corporate rate, a taxable rate, they'll use just a percentage of it, because tax-exempt rates are lower than taxable rates. LIBOR has been in the news a lot recently. There are allegations that it was understated or artificially suppressed during the financial crisis by banks to make them look healthier than they were.

And then SIFMA is the other major index that's used. It's a true tax-exempt index. It's comprised of a bunch of different variable rate bond issues that go into a composite.

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Flipping ahead to the market, Page 17, the market for muni swaps versus muni bonds. There are two different markets that's important to understand. The offsetting counterparties for the banks that enter into these swaps, they tend to be other banks or other clients. They don't tend to be municipal bond investors. So the markets tend to trade slightly separately. Credit differences are treated differently. There are some unique features in municipal market that affect how those bonds trade versus swaps.

Page 18 shows a chart of the SIFMA Index, which is this short-term rate. It's a one-week rate. And it shows kind of how it should trade relative to the implied tax rate. I won't get into too much of the theory, but in general, if you put your money in a taxable money market fund and you put your money in a tax-exempt money market fund, at the end of the day when the dust settles, you should be indifferent between the two rates. Otherwise, everybody would move their money from one fund to the other, which you can see the red line here is the U.S. marginal tax rate over the last 20-some years. What you see is, this rate has moved around, especially during periods of financial crisis, but it's tended to be during sort of normal times, pretty stable, and a reasonable match for the -- where it should trade.

Why don't we skip to Page 22 -- I'm sorry; 21, swap terminations. How is a swap -- how is the value of a swap determined? The day that you enter into a swap, the value is approximately zero, excluding the transactions costs. It's deemed to be a fair exchange of value for you and the bank. After that, however, as interest rates move, the contract can either add value to you or the bank. What is that value? How is it determined? Well, the fixed rate that

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you pay is compared -- that fixed rate that's on your contract is compared to the now current market rate. So if you entered into it and you're paying fixed at 5 percent and now rates are 4 percent, the difference between those two rates, present value; in other words, discounted back to today, represents the value of the contract.

Page 22 shows an example here, very simple example. If you had entered into a swap and were paying fixed at 5 percent and now interest rates have gone down to 4 percent, the long-term rate -- that's what really drives the value of these contracts. If the long-term rate goes down to 4 percent, there's a 1 percent difference between what you locked in and now what you could have locked in. That difference represents value to your counterparty, right? Because if you were to break that contract, they would now have to go out and -- they could only replace your contract with a swap that pays them 4 percent, not 5 percent. The present value of that difference represents a value of the swap contract.

This concept of termination value is very similar in the corporate world. If you take out a fixed rate loan, there's something called a make-whole provision. You make whole the difference. That value can be positive to you or it can be negative. It's analogous to that.

COUNCILMAN KENNEY: Mr. Chairman?

COUNCILMAN GREENLEE: Councilman Kenney.

COUNCILMAN KENNEY: Thank you.

Generally, in general terms, how much of a reduction in rate creates the discussion whether to terminate? One point or more? Less than a point?

MR. PEARSALL: What I would say is, the decision to terminate is really independent of the value of the swap.

The value of the swap is just an accounting entry. If you're a buy-and-hold issuer, you're intending to keep that swap in place to maturity, the value will fluctuate on your books, but like a lot of other things on your books or your financial records, you don't really pay attention to it, unless you have to terminate it early. What the financial crisis did is, it forced many issuers to have to terminate those swaps early.

COUNCILMAN KENNEY: Can you give me an example of during the financial crisis what the fixed rate was and what it fell to?

MR. PEARSALL: The fixed rates -- if you look at like, for instance, the ten-year U.S. Treasury, before the financial crisis it was 4 percent or higher, and today that rate is 1.80, 1.80. So some two and a half percent below where it was.

COUNCILMAN KENNEY: Were any of

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the swaps that we entered into, to your knowledge, in a higher rate than 4 percent?

MR. PEARSALL: I don't --

COUNCILMAN KENNEY: If you don't know it off the top of your head --

MR. PEARSALL: I don't believe so.

COUNCILMAN KENNEY: Maybe the Treasurer will be able to give me more enlightenment.

Thank you.

MR. PEARSALL: Page 23 is an important point. We've tried -- there's been a lot of misinformation in the financial press. We've tried to disabuse people of the notion that this termination payment somehow represents a windfall gain to the bank or the counterparty. It doesn't. Let me emphasize that. It does not. If they've hedged themselves properly, right, and you're an issuer who owes a termination payment, you make that payment to -- pick a financial institution -- Wells Fargo or Goldman Sachs, they turn around and they have to make a similar size payment to whoever they hedge their transaction with. Now, they'll make a small profit, the spread, for trading that I talked about earlier, but when I read some of these policy papers and things that a windfall gain of a hundred million dollars was made by Goldman Sachs on a termination swap, not true. They paid away almost all of that to their hedging counterparty.

Let's flip to general considerations, documentation. The documentation was developed in the late '80s. It's standardized. It allows -- it's negotiated. You don't have to take it or leave it when you're negotiating with these contracts. It's called the ISDA Agreement, and it should be reviewed by legal advisors and financial advisors.

Again, I mention at the bottom this point here that the counterparties won't enter into these contracts with municipalities unless they believe that the contract is enforceable, and they get an opinion to that effect from the issuer's bond counsel.

Page 27, swap procurement. It can be done on either negotiated or competitively bid basis. There may be reasons to do it one way or another. Typically when you do it on a competitively bid basis, the cost is lower to the issuer.

Page 28, we talked about the costs. The dealers, the providers, are in the spread. Just as you're buying or selling stocks, there's a spread that's earned by the middle man. There are legal fees involved in executing one of these swaps. There are swap advisory fees, if you have a swap advisor. Not every issuer in the past has hired a swap advisor. Under Dodd-Frank, they'll be required to hire a financial advisor. And then there may be some fees to monitor the swap on an ongoing basis for financial reporting and tracking it.

Why don't we flip to the last section, the financial crisis, what happened that was unusual and why did these not work the way they were supposed to. Well, during the great financial crisis, Page 32, we saw a tremendous increase in credit spreads and the cost of borrowing. I have a graph here of the three-month LIBOR rate compared to the three-month Treasury bill rate. The three-month LIBOR rate is a risky rate. It involves bank risk. The three-month Treasury bill rate, as you probably know, is a risk-free rate. It's the U.S. government's credit.

What you can see is that for most of the time, the last three decades, it was a relatively small difference between those two rates. During the financial crisis, that big spike, it widened out quite a bit and became very expensive for issuers, corporate municipalities, others to borrow.

Page 33 talks about one of the other problems that occurred during the financial crisis. In general, different types of interest rates move similarly. They move together. They're correlated, is the term, the statistical term.

During 2008, what we saw -- for instance, this is a chart of long-term bond yields compared to long-term swap rates. What we saw was, long-term bond yields actually went up, while at the same time long-term swap rates went down. So what was the effect to issuers that had swaps in which they were paying a fixed rate? Well, it meant that the values of their swaps became very negative, large negative values, but if they wanted to terminate those swaps and issue fixed rate bods, their cost of borrowing had skyrocketed.

Now, what you note on this chart is, that period didn't last for all that long, six months or eight months, and then the rate started to normalize. But if you were terminating a swap in December of 2008, for instance, and going into the fixed rate bond market, you would have been hit with a double whammy.

COUNCILMAN KENNEY: Mr. Chairman?

So it would have been better to hang on to the swap, is what you're saying?

MR. PEARSALL: Correct.

COUNCILMAN KENNEY: And who advises the treasurer to hang on or to cut bait?

MR. PEARSALL: Typically their swap advisor, their financial advisor.

COUNCILMAN KENNEY: All right.

MR. PEARSALL: Page 34 shows the -- I showed you that chart earlier of who were the financial institutions that acted as market makers or swap providers in this business. The chart on the left is from June 2008. The chart on the right is from just a few weeks ago.

What's interesting there, of course, is the number of firms that have disappeared, number one, and then number two, a significant majority of the firms that have all been downgraded either the -- the one fact I look at on the left is, there were five AAA rated financial institutions that were swap providers in June 2008. Today there are none that carry that top rating.

So what are some of the observations we saw during the financial crisis? This has recurred throughout sort of financial history. Credit crises tend to be associated with lower interest rates. We've seen that again and again. The Fed -- it makes sense if you think about it. The Fed comes in, it eases, it lowers interest rates. Normally you'd think that would be good, but if you have a swap in which you're paying fixed, it's bad, because it makes the swap's value negative. If everything is working fine with your underlying bonds, as I said, that raw material, then you don't care. It's just a book entry. It's an accounting matter. But if you have to early terminate, then it becomes a problem.

So the negative values of the swaps created problems, potential collateral calls for some issuers, potential early termination events as specified in the contracts.

The other thing that the financial crisis caused was what we describe as basis risk, which means that the floating rates on the swap contracts didn't follow the floating rates paid on bonds. We had cases where some of these auction rate securities, the rates were resetting at 10, 11, 12 percent, with the floating rate that an issuer was receiving that was supposed to hedge that rate, which is -- because it was based on a market index, it wasn't based on a particular issuer's credit, might have only stayed at 2 or 3 percent. So that created some problems. That tended to be a short-term problem and those two rates normalized.

What we found is remedies to -- and this is common sense -- remedies to restructure swaps during a credit crisis, during a financial crisis, are going to be expensive. This is the old example, if you need an umbrella and it's a monsoon, you're going to pay more for an umbrella than if you're buying one on a sunny day.

So a lot of issuers, to their surprise -- and perhaps it shouldn't have been to their surprise -- found that it was very expensive to restructure these contracts in 2008 when the world seemed to be spinning off its axis.

And then the last point I would make is that most swaps, the vast majority of swaps, performed the way they were supposed to, the way they were advertised. When you enter into that swap, your counterparty was contracting to make a payment to you at certain intervals, and with the exception of Lehman Brothers, that's the way it worked. They continued to make payments, Wall Street did, the financial institutions, just as the contract said they should, as I said, with the exception of just a couple firms, Lehman being the most notable.

So the last page is just the summary of what -- if you're contemplating using these products, what should you know? Well, they can be valuable tools for risk management. There are potential risks as we saw in them. You need to seek out independent informed advice. In some cases -- we saw the headlines -- that wasn't always true. And the risks and rewards, the risks and benefits should be clearly understood by the issuer and by all the relevant parties that are planning to make use of the swap.

COUNCILMAN GREENLEE: Thank

you, Mr. Pearsall.

Any other questions for Mr. Pearsall?

Councilman Kenney.

COUNCILMAN KENNEY: Thank you.

Mr. Pearsall, just one second.

COUNCILMAN GREENLEE: Just a couple more questions.

COUNCILMAN KENNEY: I'm trying to wrap my arms around the issue of advice, because I was here when we did these transactions, and the advice was then it was a solid thing for us to do, was not exceptionally risky and that we were advised to proceed.

Now, when that six-month, eight-month really messy percentage difference occurred, I assume we were advised again to either hold or to get out. Is that the same people giving us the advice or is it different parties giving us the advice? Were you guys involved in that initial advice and the "get out of the deal" advice?

MR. PEARSALL: We weren't involved here. We certainly had clients nationwide where we advised either to get out or to stay in it. In some cases there were clients who were lower rated, lower than the City of Philadelphia, who had no choice, they had to get out. Their financial institution, their provider was going to force them to get out of it. In those situations you look at the least worst alternative.

In other cases the issuer just decided, you know what, I don't want to be in this anymore. There's too many moving parts. I'm going to bite the bullet, in some cases over our advice, over our objections, but they just wanted out, wanted to clear the decks.

COUNCILMAN KENNEY: Historically, how long have swaps been part of the, I guess, arsenal of tools to be able to be used for any investor, whether they're private or public?

MR. PEARSALL: Really the swap

market developed in the 1980s, but municipalities started using them in the 1990s.

COUNCILMAN KENNEY: So it's not a long-term tried and tested?

MR. PEARSALL: It hasn't been through multiple financial crises, yes.

COUNCILMAN KENNEY: Thank you.

COUNCILMAN GREENLEE: Thank you.

First, the record will reflect that Councilman Green, a member of the Committee, is present, as is Councilman Squilla.

Councilman Green.

COUNCILMAN GREEN: Yes.

Mr. Pearsall?

COUNCILMAN GREENLEE: I don't blame you for wanting to get out of here, but...

Councilman Green.

COUNCILMAN GREEN: I apologize for missing the beginning of your testimony. This is a very interesting topic. It seems to me that there's a lot of demagoguery with respect to this particular topic, and I just wanted to see if I could understand some basic principles while we have the benefit of your expertise here at the table.

How much, when a city or a school district reversed out of their swap, did it hurt their current operating funds?

MR. PEARSALL: I mean, the answer, I think, would be it depends.

COUNCILMAN GREEN: In most cases didn't they simply finance the cost and not actually hurt their operating expenses?

MR. PEARSALL: That's right.

COUNCILMAN GREEN: And is that what happened at the School District?

MR. PEARSALL: I believe so. We were no longer the transaction advisor of the School District when they did that, but I believe that's correct.

COUNCILMAN GREEN: So it didn't

cost any current dollars. It did cost dollars that have to be paid back over time, which obviously slightly increases carrying costs every year of whatever that number is, a million, 2 million, which I guess hurts operating cash flow, but that is the extent of the cost of reversing out of a swap on a yearly basis?

MR. PEARSALL: That's right.

COUNCILMAN GREEN: Okay. The other question I have is, who is really responsible for advising cities to get into swaps? We have a City Controller who has to sign off on all these debt deals and take a look at them. We have a City Council that has to approve them. We have a Mayor that has to -- or in the case of the School District, the SRC that has to think about these issues and determine what's in the best interest of the entity at the time. And if you could take us back to that time, why were firms -- I don't know if your firm advised any, but why were firms like yours advising as the financial advisor? I don't mean the investment banker, because it wouldn't have been done if the City's financial advisor, the School District's financial advisor hadn't agreed and their experts that it was in the best interest of the District.

What was going on that would cause people to advise them to go ahead and do a swap?

MR. PEARSALL: I mean, I could speak to the School District of Philadelphia's swaps back when we advised on those originally in 2004, and I believe it was Michael Harris was the CFO then. And the opportunity there for them and the reason we thought it was a good idea was, they had some callable bonds that were not yet callable. They would be callable in a few years, but if they were to take action today, meaning back in 2004, they could lock in savings, if you're with me, that might not be available two or three years later when the bonds actually became callable. So the notion was that by locking in that savings today, they can guarantee that they would achieve their savings goal. And we looked at the structure. We put what we felt were belt and suspenders on it. We had AAA insurance backing the swap, and I believe that AAA insurance had been purchased for the bonds that would be issued in the future.

So we ran the numbers. The market was functioning normally. No one foresaw the storm on the horizon in 2004 that would occur. So we recommended it, and we stand by that recommendation today. It made economic sense.

COUNCILMAN GREEN: So what you're really saying is, the School District's hedge was against existing debt and not sort of a bet on interest rates in the future? It was locking in specific savings for something that they were going to refund two years down the

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road. Do you recall how much entering into those swaps actually saved the District?

MR. PEARSALL: Eight and a half percent on a present-value basis, eight and a half percent of the principal amount of the bonds.

COUNCILMAN GREEN: Which was?

MR. PEARSALL: Fifty-six million dollars, I believe.

COUNCILMAN GREEN: Fifty-six millions dollars, okay.

So would you say that with their -- and how are financial advisors paid? Are they paid any more money if swaps are done or not done or the structuring of the deal? Is there an incentive system for the financial advisor of a school district or a city or a state that would cause them to, in their own financial interest, advise their clients to take swaps?

MR. PEARSALL: Well, I can only speak to our firm. At PFM, I'm a specialist within a firm of financial advisors. We obviously are paid a transaction fee if the swap is executed. At the same time, you don't want to put clients into bad deals, right? I mean, you want repeat business, repeat customers. And then the check and balance within a firm like PFM, for instance, is that the financial advisor, the bond advisor, is also going to be saying, hey, does this make sense for the clients within their plan of finance.

COUNCILMAN GREEN: Well, it seems to me that maybe one of the things that needs to be looked at from the perspective of the City or the School District is not paying additional fees to our advisors dependent upon the kind of transaction that we do. In other words, flat fees that don't depend upon any particular transaction such that there's no incentive to go one way or another may be something that's worthwhile exploring from the City's or School District's perspective.

I do not think that PFM did anything that it wouldn't have advised if it were on a flat fee basis, but just so we can avoid any sorts of even appearance of conflicts of interest in the future, it may make sense for us to consider that as a policy as a city.

I think those are all my questions for you. Thank you.

COUNCILMAN GREENLEE: Thank you, Councilman.

Councilman Kenney.

COUNCILMAN KENNEY: Thank you.

Mr. Pearsall, just in conclusion of your testimony -- and thank you for walking us through some complicated stuff, and I appreciate your time.

Overall would you argue that the School District and the City did the right thing in entering into the swaps that they did?

MR. PEARSALL: Again, I can't

speak --

COUNCILMAN KENNEY: Would you do it again?

MR. PEARSALL: I can't speak to the City's transactions.

COUNCILMAN KENNEY: The School District.

MR. PEARSALL: The School District? Yeah. I believe based on the best information they had at the time, that was the correct economic decision to make for the School District.

COUNCILMAN KENNEY: Okay. Thank you.

COUNCILMAN GREENLEE: Thank you.

Any other questions?

(No response.)

COUNCILMAN GREENLEE: Seeing none, Mr. Pearsall, thank you very much. Thank you for your time and your expertise.

Ms. Marconi, please call the next witness.

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THE CLERK: Auditor General Jack Wagner.

(Witnesses approached witness table.)

COUNCILMAN GREENLEE: Mr. Wagner, good morning.

AUDITOR GENERAL WAGNER: Good morning.

COUNCILMAN GREENLEE: As you're being seated, I just want to say I know you're approaching the end of your terms as Auditor General, so just for the record, I'd like to thank you for all the work you've done on behalf of the Commonwealth.

AUDITOR GENERAL WAGNER: Thank you. I appreciate that very much.

With me today is Nate Lipton, Regional Special Investigator in charge within my Office of Special Investigation, and is really the expert on staff related to interest rate swaps.

MR. LIPTON: Good morning.

COUNCILMAN GREENLEE: Good

morning.

AUDITOR GENERAL WAGNER: Chairman Greenlee, Vice-Chairman Kenney, Councilmember Green, Councilmember Henon, Councilmember Squilla, I know Councilwoman Tasco is here, and other members of Council, thank you for the opportunity to come here today and to testify on a very important issue, interest rate swaps. And before I go any further, I sincerely mean that. You are the first government of any size to begin to analyze this issue in Pennsylvania. So my hat is off to all of you --

(Applause.)

AUDITOR GENERAL WAGNER: -- for your scrutiny on this very important issue.

A swap is a contract between a bond issuer, such as a school district or other public entity, and an investment bank, in which the parties bet on which way interest rates will move. In theory, swaps allow government entities to enter into variable rate debt financing in order to take advantage of low interest rates and, at the same time, hedge against the possibility of those same interest rates going up. In many instances, the public entity is given an up-front financial incentive to enter into the agreement. That was not discussed earlier.

In reality, swaps are nothing more than a form of gambling with public funds. The party that guesses right wins and gets paid. The party that guesses wrong loses and must pay the other party. How much is won or lost is determined by the size of the underlying debt, how much interest rates fluctuate, and other factors related to the deal.

How risky are swaps? Just ask President Obama's former top White House Economic Advisor, Larry Summers, who, as President of Harvard University from 2001 to 2006, approved swaps so toxic that the school paid banks a total of almost 1 billion, I repeat 1 billion, to terminate the swaps.

Hardly a day goes by without a news report of someone else getting burned by a swaps deal gone sour. Organizations of every stripe, public and private; for-profit and not-for-profit; universities; hospitals; state, local, and even foreign governments such as Greece; school districts; and public authorities have been hurt and none are immune to the toxic effects of these transactions. Any benefits that these deals may confer, even to the fortunate few who do not lose money, pale in comparison with the enormous risk involved, risk that may lurk for literally dozens of years in the future, as I will indicate through a few examples. Is it any wonder that many commentators are now recognizing that the only reason that swaps continue to be sold so aggressively is the enormous fees and profits that they generate for the investment banks and financial services firms that sell them? Wall Street is vehemently opposed to the elimination of swaps with public entities for obvious profit reasons.

The Department of Auditor General's involvement in this issue began with a special investigation, led by the gentleman to my right, which we released in November 2009, three years ago. In addition, I should mention Act 23 of 2003, six years before that, enacted into the Pennsylvania law, authorized local governments to enter into qualified interest rate management agreements, or swaps. Our investigation three years ago found that the Bethlehem Area School District in Lehigh and Northampton Counties -- it's in two different counties -- had entered into the most swaps of any school district in Pennsylvania during a three-year period, 13 swaps in total. We reviewed just two of the District's swaps because those were the only two that concluded by the time of our investigation.

We found that the District was the victim of a variety of deceptive marketing tactics and that it lost at least 10.2 million on those two swaps, largely due to excessive fees and other charges and a termination payment. The taxpayers of the District were then hit with property tax increases to pay for the losses incurred.

Because the District still has three swaps in effect, the ultimate financial impact on the District's taxpayers remains to be seen. The District's three active swaps, which are tied to 100 million in debt, had a net negative fair value as of last month of $32 million. Since the issuance of our report, the District has heeded our advice and terminated many of its active swaps, some with positive results and some with negative results, but it still has a long road ahead to correct its problems.

On a statewide basis, our 2009 investigation found that 107 of 500 school districts in Pennsylvania, a shocking 21 percent, and 86 local governments in the Commonwealth had 15 billion, and I repeat, billion in public debt tied to swaps with at least 13 investment banks between the years of October 2003 through 2009. The precise number of different swaps and the precise amount of debt could not be determined because Department of Community and Economic Development data may include some double counting, and some of the swaps agreements filed may not have been fully acted upon. Furthermore, this analysis does not include public authorities because their use of swaps is not tracked by state government.

All of you know there's 3,000 public authorities in Pennsylvania.

Regardless, these are large and disconcerting numbers, and the numbers have since increased to over 17 billion in public debt tied to swaps encompassing 108 school districts and 101 local governments. Unfortunately, when it comes to gambling taxpayer money in swaps, Pennsylvania school districts and municipalities are number one in the nation, according to Moody's Investors Service. That's not a good distinction.

The true extent of potential losses to taxpayers across Pennsylvania remains unknown, but could be catastrophic. For example, consider the enormous potential liabilities from swaps entered into by three public entities that are of particular interest right here in Southeastern Pennsylvania.

Example number one: In March 2011, we released our cyclical performance audit of the School District of Philadelphia. We found that the District had in excess of 1 billion in debt tied to swaps. By comparison, the Bethlehem Area School District debt tied to swaps, the second largest among the school districts of the Commonwealth, was one-quarter of that amount. Our audit found that the Philadelphia School District's use of swaps has cost taxpayers 35 million more than if the District had merely issued conventional fixed rate debt, particularly because the District had to make a termination payment of 63 million to exit a batch of soured swap deals in 2010. While we are pleased that the District has heeded our recommendation to divest itself of its remaining swap contracts, we are still disappointed that it refused to renounce the use of swaps in the future. The Philadelphia School District, with its long history of financial serious problems, has an obligation not to gamble away its limited resources on discredited financial schemes.

Example No. 2 --

(Applause.)

AUDITOR GENERAL WAGNER:

Example No. 2: Just two months ago, August 2012, we released a performance audit of the Southeastern Pennsylvania Transit Authority, SEPTA. Our audit found that SEPTA's use of swaps associated with its issue in 1999 of 262 million in debt cost the taxpayers and SEPTA fare-paying customers over $40 million, and if SEPTA had -- than if SEPTA had financed with conventional fixed rate bonds. We also found that 27 million of the money that SEPTA lost by terminating the swaps was merely rolled into a refinancing of its debt, disguising the fact and magnitude of the losses and forcing SEPTA to incur an additional 8 million in interest rate costs over 18 years.

That happens quite commonly. Where monies are lost, simply that loss is rolled over into a refinancing of debt within the particular organization.

Third example: The Delaware River Port Authority, a bi-state agency

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between Pennsylvania and New Jersey, entered into seven swaps in 2000 and 2001 related to over 1 billion in debt. Although the DRPA collected 45 million in up-front payments for those swaps, which they thought was a great advantage, it has now paid out 101 million in termination fees and additional interest to terminate several of them. The remaining active swaps have a net negative fair value of approximately $248 million, nearly the equivalent of one year, I repeat, one year of toll revenues on all four of the agency's bridges. I, as Auditor General, joined the DRPA Board as an ex-officio member several years after it entered into the swaps back in 2004, 2005. They entered into them three or four years earlier. In December 2009, I succeeded in passing a resolution to prohibit the agency from entering into future swaps agreements and to begin a process of terminating its current swaps.

These are just a few examples

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gone bad in this region. I cannot comment on other local agencies' use of swaps because we have not examined all of those deals. However, my position remains the same: Swaps are inherently dangerous financial instruments for public entities and subject taxpayers to enormous, and I repeat, enormous potential loss.

I also want to mention that the Department of Auditor General is currently conducting an audit of the Pennsylvania Turnpike Commission. We will report updated data and information on the Commission's experience with swaps in our upcoming report, but the Commission's financial report as of May 31, 2011 and 2010 shows that the Turnpike Commission had more than 2 billion in debt tied to 23 active swaps. If the Turnpike Commission terminated or was forced to terminate all those swaps, it would cost approximately $47 million, which is equivalent to more than three weeks of toll revenues on the Pennsylvania Turnpike.

These are important figures to consider as the General Assembly in Pennsylvania grapples with the issue of transportation funding across Pennsylvania. Public money that could be funding transportation has been lost through swaps, and additional tax dollars are seriously at risk. Instead of spending our money -- instead of sending our money to Wall Street, we should be investing obviously in our infrastructure, including the Pennsylvania Turnpike.

(Applause.)

AUDITOR GENERAL WAGNER: As the Commonwealth's independent fiscal watchdog, I have repeatedly urged the General Assembly to immediately prohibit school districts and other local governments and municipal authorities from entering into swaps. I have also urged these entities to take the following actions on their own. As a matter of fact, we sent a letter to every School district, 500 school districts, approximately two years ago indicating the following points:

Stop using swaps and other types of exotic financial instruments. If you do not understand the risk, then the instrument is not in the best interest of taxpayers. We suggest that City Council here in Philadelphia, along with other councils across Pennsylvania, enact a resolution banning the use of interest rate swaps.

Number two --

(Applause.)

AUDITOR GENERAL WAGNER: Number two, terminate any active swaps as soon as it is fiscally responsible to do so and refinance with conventional debt instruments. And today more than ever you can get great interest rates.

Number three, assess the financial consequences of active swaps if they were to suffer the same negative experience as Bethlehem Area School District and other public entities. There are a number of other issues involved in Bethlehem that I can't discuss today.

And number four, hire financial advisors through a competitive selection process and periodically evaluate the quality, cost, and independence of the service provided. We suggest that with anyone involved in financial deals or bond deals throughout Pennsylvania.

We have worked closely with legislators in both houses of the General Assembly to implement our recommendations, primarily that swaps be prohibited from public schools and local governments. However, as of this date, there has been no legislation, and, quite frankly, the financial institutions have been fighting us on that.

You may hear a different view today from proponents of swaps and defenders of the status quo, as well as from those who would argue for a reform of swaps rather than a ban. We urge you to ask them tough questions such as the following:

Do the local elected officials who vote to enter into these transactions really understand them? And I have to tell you, I've been dealing with this issue, I've been dealing with this issue for three years. I am fortunate to have someone beside me who understands them, but just to listen to the presentation -- and I know the presenter before me tried to really explain swaps. They are extremely complicated. You must work in the field eight hours a day, 40 hours a week to even be able to properly explain them to taxpayers. And that is our first responsibility.

Number two, none of the other parties involved - the financial advisor, bond counsel, swaps counsel, local government solicitor or the investment bank - appear to get paid unless the deal goes through. So everyone advocating them wants the deal to go through, and there are a variety of types of conflicts involved in these transactions that are inherent and must be avoided.

Number three, do the investment banks or financial advisors involved in swaps ever lose money with these transactions? We haven't found any that have lost money.

How much are the fees and commissions to the various parties in the average swap transaction? Every time there's a transaction, from the beginning, in between, throughout the process, at the end, there are fees and commissions, not similar to a conventional fixed rate borrowing.

How do the fees and commissions compare to the issuance of a simple standard fixed rate bond? Obviously they are greater over time.

Are fees and losses rolled into

refinancing deals and, therefore, are they transparent to the public? Does the public know when money is lost? In most instances, I would say no, they don't know when money is lost.

Can there ever be enough training, disclosure, and other types of reforms to level the playing field between local officials and Wall Street financial experts? The answer to that question is obvious. They are the dealer here in this gambling event. They hold the ace in the hole in every deal.

Are the benefits of a swap worth exposing taxpayer funds to potentially enormous risk if the local government loses the bet? Absolutely not.

Are you prepared to fully explain the risk of swaps to taxpayers? And as an elected official and I have to say to all of you again, I commend you. I was once a Councilmember in Pittsburgh. If you can't explain something to your constituents, it's not in their best interest.

(Applause.)

AUDITOR GENERAL WAGNER: The fundamental guiding principle in handling public funds is that they should never be exposed to the risk of financial loss. Swaps may be perfectly acceptable in the private sector. Let me repeat that. Swaps are perfectly acceptable in the private sector with private funds, where private citizens are free to decide how much risk they can tolerate when their money is at stake. But they should have no role in government. Swaps should have no role in government, where it is the taxpayer money that is at stake. Public debt should be financed with fixed interest rates that are transparent, reliable, and easily understood by decision-makers and the public. And guess what? Wall Street still makes money. Everyone is still happy.

I also reject the

counter-argument that we have heard over and over and over again, that not all swap deals turn sour and that many swap deals have saved a great deal of money. That position brings no comfort to the many public entities that have been badly served by swap deals that backfired. Any finance vehicle that produces winners and losers is, by definition, unsuitable for the public sector. Unsuitable for the public sector.

(Applause.)

AUDITOR GENERAL WAGNER: I will continue to warn public entities of the dangers of swaps and urge those entities to avoid entering such agreements. Remember that we, the public officials, not the investment bankers on Wall Street, are the stewards of public dollars.

Thank you. We'd be happy to answer any questions.

COUNCILMAN GREENLEE: Thank you, Mr. Wagner. Thank you for your testimony.

Councilman Kenney.

COUNCILMAN KENNEY: Thank you very much, General, for your testimony. It certainly is totally the other side of the coin that we've heard before and will probably hear the rest of the day.

Does Act 23, in your opinion, prohibit us from banning the use of swaps in the municipal level, similar to some of the things you try to do in our own city and in Pittsburgh also where the state supersedes because of an act of the legislature allowing it? Do you believe we can ban it on a local level?

AUDITOR GENERAL WAGNER: I believe so, and we have suggested -- I mean, the decisions that all of you make in terms of the direction in which you proceed, when you need to borrow money or refinance money, is up to you. All that has done is given you the opportunity to use other forms of financing.

COUNCILMAN KENNEY: And I guess

that would only apply to the City of Philadelphia, because as the state takeover of the School District, they are now a state agency and not a city agency, although we fund a substantial amount of money into it. I'm wondering whether or not they're independent of us enough to be able to continue to do what they want to do.

I guess we can put pressure economically from them from a tax side, because we do fund a lot of -- most of the School District. So I'm just wondering whether -- and SEPTA again, another state agency that really doesn't -- we have two members of the Board there out of many members. I just wondered --

AUDITOR GENERAL WAGNER: I believe that at the end of the day, it's what's in the taxpayers' best interest.

MR. LIPTON: I was going to say that prior to Act 23 --

COUNCILMAN KENNEY: I'm sorry.

Could you please identify yourself for the stenographer.

MR. LIPTON: Nathan Lipton with the Office of Special Investigations, Department of the Auditor General.

Prior to Act 23, in order for school districts and local government units to enter into the agreements, they had to run them through the authorities, and that was an issue of great concern to the Auditor General and us, because there is no tracking of what authorities are doing specifically with interest rate swap agreements. There's no reporting to DCED and, therefore, it's kind of hidden and it lacks that transparency that I think the public deserves.

COUNCILMAN KENNEY: Also, in your investigation did you determine whether or not there was any actionable -- anything we could do from a court proceeding, filing in federal court or state court, to try to, number one, recover some of the money; number two, get us out of these exit fees?

MR. LIPTON: Actually, I worked very closely with the Securities and Exchange Commission in Washington, DC and their investigators and counsel to provide them with the information that we gathered during our Bethlehem Area School District investigation, and I believe that the evidence that I supplied to them ultimately provided school districts in Pennsylvania with a settlement of in excess of a hundred million dollars that was to be distributed amongst them proportionately. I don't know the exact figures, but I will say that it basically had to do with the poor advice that was given by the financial advisors and this lack of transparency and conflicts of interest that were inherent to the deals.

So, yeah, and it's continuing. The FCC I believe is still continuing to investigate financial advisors at school districts like Bethlehem Area School District and make sure that they're held accountable for the actions and decisions that they made.

COUNCILMAN KENNEY: Have they asked you to provide any information relative to the School District of Philadelphia or SEPTA?

MR. LIPTON: They have not.

COUNCILMAN KENNEY: Does that have to be their request?

MR. LIPTON: That would have to be their request. I only receive the requests, and I honored them as we saw fit.

COUNCILMAN KENNEY: Are you aware of any statute of limitation issues that we might be running into?

MR. LIPTON: I am not aware of statute of limitation issues, but I'm sure they exist. My guess would be that they're in the five- to eight-year range for any type of criminal activity.

COUNCILMAN KENNEY: The other issue that was made aware to me by talking to legal counsel about it is, some view that the statute doesn't start to run until you're aware of the misdeed or the potential misdeed.

MR. LIPTON: That's correct.

COUNCILMAN KENNEY: So the clock doesn't start ticking until after you find out about it?

MR. LIPTON: That's correct.

COUNCILMAN KENNEY: But I do appreciate you coming in and enlightening us on all the things that you've been doing over the years, and we will be looking at perhaps legislating a ban on future such instruments based on what you've been able to give us today, and we hope to be able to use you as a source, a resource moving forward as we muddle through this.

AUDITOR GENERAL WAGNER: Councilman, we're here to help.

COUNCILMAN KENNEY: Thank you.

MR. LIPTON: Absolutely.

COUNCILMAN GREENLEE: Thank you. Thank you. Thank you both.

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(Applause.)

COUNCILMAN GREENLEE: Ms. Marconi, the next witness, please.

THE CLERK: Nancy Winkler.

COUNCILMAN GREENLEE: And as Ms. Winkler is approaching, I just want to tell all future -- we still have a lot of people who want to testify. We have a hearing, a separate hearing, this afternoon, which will probably have a lot of people attending too. So if people -- I know this is a very complicated and important matter, but if all witnesses can be as concise as possible, we'd all appreciate it. Thank you.

(Witnesses approached witness table.)

COUNCILMAN GREENLEE: Ms. Winkler, if you could just identify yourself for the record and proceed.

MS. WINKLER: Hi. I'm Nancy Winkler, City Treasurer.

Good afternoon, Chairman Greenlee and members of the Committee on

Rules. I'm Nancy Winkler, City Treasurer. I'm here to testify at the request of Councilman Jim Kenney. Councilman Kenney asked me to provide information regarding the City of Philadelphia and its related entities' historic use of swap agreements. I want to thank Councilman Kenney's office for providing an outline of topics to be covered today in my testimony and for participating with me in several planning sessions, with me and with my staff, to prepare and reviewing this complex financial area.

Specifically, I have been asked to describe the City's swap transactions, to explain how these swaps have related to the City's debt, and to indicate the economic outcome of the swaps to date and for us to then reasonably estimate by projecting into the future the future economic effect through the final maturity of the swaps and the related bonds.

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Just by way of background, I've been asked to state my qualifications. Prior to joining the City in 2011, I served as an independent financial advisor to state and local governments since 1982. I was a Managing Director at Public Financial Management and served for approximately 15 years running PFM's New York office.

Assisting me in the analysis of the City's swaps is James Lanham, who I have sitting here to my right. He is Deputy City Treasurer. Prior to joining the City, from 2008 to 2011, he was a Quantitative Specialist at PFM in the New York office supporting complex transactions. He completed PFM's challenging quantitative consultant training program and is a graduate of Yale University.

First, let me offer a general background of swap activities for the City of Philadelphia and related entities. The City and PICA entered into

20 separate swap transactions from 1990 to 2007, for a total amount of $3.3 billion. With the exception of one $148 million swap, which was entered into in 1990, all other swaps were entered into between 2001 and 2007. The last swap contract expires in 2031.

Since the Nutter Administration came into office, the Office of the Director of Finance and the Treasurer's Office have had to manage the swaps and the related bond programs. The 2008 credit crisis presented a series of financial challenges for the City, which I'll get into, including severe market disruption that required the Finance Department and Treasurer's Office to restructure bond issues related to the swaps and to terminate certain swap transactions.

No new swap transactions have been undertaken during Mayor Nutter's administration. The economic recession stressed the City's budget, threatening our credit rating and making it imprudent to enter into new swap transactions. The City's financial circumstances have now stabilized, enabling us in the last 18 months to stabilize the remaining swap transactions and enter into economically advantageous terms for variable rate debt that is associated with the swaps. So our situation has now stabilized.

Given that neither I nor anyone in Mayor Nutter's administration participated in the establishment of the City and PICA swaps, I'm not able to provide an explanation of the actual decision processes or considerations used to select and execute the specific swap transactions that were undertaken. While there were transaction records on file, there was insufficient documentation to identify the precise decision-making process or to justify or explain the policy-maker's rationales for the decisions made. However, through considerable research and analysis, the

Treasurer's Office has recreated a comprehensive list of important swap facts. We have completed a quantitative analysis of the swaps since inception, excluding the one swap which was undertaken in 1990. My testimony is based on our research, our analysis, our actual historical cash flow, recreating those historical cash flows and then analyzing them, and then we've also made a number of assumptions about how the remaining swap transactions will perform in the future in order to provide responses to the questions about the future economic performance of the swaps.

While we believe our assumptions to be reasonable, we've chosen to present a range of potential future outcomes which reflects what we believe to be a reasonable range of future risks and costs. The assumptions do not consider the effect of a future financial crisis that could potentially occur. We're unable to make those projections.

I'm about to now go into the PowerPoint which I've provided to you, but before we review that PowerPoint, I'd like to make a couple of other comments beyond my previously submitted written testimony.

I want to assure you that I share your concerns to understand the history of the City's swap transactions and to accurately determine the likely effect on the City. The City's Treasurer's Office, we've done our best to prepare this presentation given the limited amount of time that we have and the limited amount of resources that we have available to dedicate to this effort.

While we believe our analyses are reasonable and complete, they are driven by many assumptions, including, but not limited to, our estimates of how alternative financings might have priced in the market, assumptions about the future performance of the variable rate market, and the future cost of credit facilities. So, finally, also please bear with me. A presentation of financial transactions to non-financial professionals is a challenge, and I'm going to do my best.

Swaps and their interplay with the credit markets is complicated. It's a complicated subject and not one that many non-financial people find easy to follow, especially because we financial people sometimes may lapse back into financial lingo. So I'll try to do this in plain English as I can.

COUNCILMAN GREENLEE: We deal with lawyers a lot, so we understand.

MS. WINKLER: So even with these challenges, I hope that by the end of this presentation, you will be left with a good overall history of the City's swap transactions. And if you have questions, I'm going to do my best to answer them today, and if not, if the information is not available, we will work with you to get you the answers afterwards.

So now I'd like to begin. It looks like we've managed to figure out how to get the PowerPoint to work.

Saturation of the colors is a little light, but why don't we move now to an overview of the presentation on the next page.

First what I'm going to do is give an overview of the City's outstanding debt and swaps. It's important to do that, because as has been mentioned, the dollars that we're talking about need to be placed in context with the overall dollars, overall debt portfolio and overall budgets of the City.

The second thing I'm going to talk about are the City's financial policies, the City's debt policy and the City's swap policy, so you can be aware of what kind of protections we currently have in place, new policies that have been adopted under Mayor Nutter's administration.

The third thing I'm then going to go into is the Treasurer's Office analysis of the financial performance of the City's swaps, looking at the history of the timing of these swaps, looking at the cash flows of those swaps, and then comparing the actual performance to date and projected performance of the swaps to fixed rate bond issues that we imagine, we've estimated what the cost of fixed rate bond issues may have been, and then we tried to calculate the economic effect.

I'd like to then talk about the current status of the City's swaps and then reflect a little bit on some of the lessons that we've learned from this exercise and from observing the financial markets.

Thank you. Next page.

So the first thing to do is to

place all of this in context with the City's overall debt portfolio. I mentioned earlier that we have a total -- had executed a total of $3.3 billion worth of swaps. The total amount of debt outstanding for the City, I believe, is approximately $8.7 billion, including the PICA debt. The City has approximately -- and I'm going to use my pointer here -- $3.66 billion of General Fund-supported debt. That General Fund-supported debt is rated A2 by Moody's, BBB plus with positive outlook from S&P, and A minus by Fitch. During the fiscal crisis, the City's ratings were a little lower, in the BBB category, from some of the other -- from the rating agencies, and I think that's an important fact to hang on to.

Then we have about 1.37 billion of airport bonds outstanding, rated slightly higher. Those bonds are secured with the revenues of the airport system.

Then we have approximately 1.1

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billion of Philadelphia Gas Works debt outstanding. Those bonds are supported with the revenues of the Philadelphia Gas Works.

And then we have approximately 1.86 billion of Water Revenue bonds, and those bonds are supported with the revenues of the water system.

The City primarily issues traditional fixed rate debt. That debt is structured with -- so that we pay debt service each year, that we pay principal and interest each year, and when we issue the debt, we lock in the rates to maturity. We also typically obtain the right to call in those bonds. We get a call option to call those bonds in. Typically the right to exercise that call option would be between eight and ten years after the date we issue the bonds and then would be available at any time at the City's discretion thereafter. So that provides the City with budgetary certainty, fixed rate bonds. We know what the interest rates will be; we have budgetary certainty.

The right to call the bonds gives the City the right, albeit many, many years after they issue the bond, but the right in the future, should interest rates be lower, to refinance those bonds for budgetary savings.

The City does have a portion of its total debt portfolio in variable rate bonds, approximately 10 percent. And virtually all of that debt has been, as we say, synthetically converted to fixed rate debt.

Now I'd like to just give you a highlight of an overview of the City's history with swaps, some of which I've already mentioned.

The 3.3 billion had been entered into, all but 148 million, between 2001 and 2007. The total number of swaps in aggregate, 20. The total number of bond issues associated with the swaps, 11. Eight swaps have been fully terminated. Six of the 12 outstanding swaps have been partially terminated. The total amount of swaps that have been terminated is 1.7 billion.

The current amount of swaps outstanding, aggregate, 1.405 million. General Fund supports 583.2 million. The revenue credits support 464 million of swaps, and then PICA has 358.5 million of swaps outstanding.

In going back and looking at the swap transactions and trying to imagine specifically why the City of Philadelphia used these swaps, we believe there were three reasons. The first was to save interest costs versus fixed rate bonds. The second was to lock in interest rates today for a financing that they wanted to do at some point in the future where they weren't able -- they hadn't gotten to that call date that I referred to earlier. And then the third option was to front-load savings; that is, to extract a cash payment up front, sometimes tens of millions of dollars, which was taken into the budget at that time and used for other purposes. So those were the three reasons that the City entered into swaps.

Now, the next two pages provide for you a fair amount of detail, although still at a very high level, about each of the 20 swap transactions that I have referred to. They're presented in alphabetical order by issuer. So we start with the airport, then we do the General Fund-supported swaps, then the PGW, and then on the following page, we cover the Water and then the PICA swaps.

So just to help you figure out how to read this chart, I'm not going to walk you through every single swap transaction, but we provide you the name of the credit, the date, the trade date. That would be the date that the contract, the swap contract, was entered into. The next column gives you the size of the swap, and in swap terms we call that notional amount rather than par or bond par. And then we give you the type of swap.

Almost all of these swaps were fixed payer swaps in which the City agreed to receive a floating rate and make a fixed rate payment.

The next column gives you a sense of why the City -- what the City was using the swap to accomplish, and in most cases, it was to do a refunding in advance of the call date on the bonds, and that's called an advanced refunding.

In some instances -- and you can see this in the next column, which is this column here -- the City received up-front money.

If you could go to the next page, please.

You can see there were, for the Water and PICA swaps in particular, there were a number of cases where the payments were actually made up front.

The next column gives you the

swap counterparty, the entity with whom we entered the swap, and then the bond insurance provider. As the prior witness mentioned, the underlying mechanics involved variable rate bonds. Those bonds had bond insurance associated with them, and it was the failure of the bond insurance companies during the fiscal crisis that really began to trigger the problems that we experienced with the swaps.

So with that, I'd like to move on to the next page, which just graphically presents to you, in aggregate, the total City debt, excluding PICA, and how much of that debt is related to the swaps today. This is our -- I'm sorry. It is including PICA. And this light green shows how much of the total debt has a swap associated with it.

I think it's interesting to note that at the time that the City was doing these swaps, the rating agencies were evaluating the swap transactions and they were rendering ratings on these transactions, and then they were also looking at the effect of the swap transactions on the underlying credit quality of the municipality, and, in fact, they were doing their own assessment of what the likelihood of risk exposure was, and they -- for example, Standard and Poor's assigned to each issuer something called a DDP, a debt derivatives profile, which could be from one to four, one being the highest credit quality, if you will, the least amount of risk, and four being the riskiest. And the City was assigned a two, which in my experience was essentially -- I don't really know how to say it other than an external good keeping -- good housekeeping stamp of approval. Virtually all issuers who were using swaps got a two, and nobody sort of treated that as a red flag, and I've extracted for you some of the particular rationale that S&P used for that.

On the next page, just a little more detail. The General Fund in green, Water in blue, Gas Works in red, and Airport in yellow, the amount of swaps relative to the total debt portfolio. So you can see it is fairly evenly spread out among all the different credits.

Now, I'd like to go to the next slide, please. This slide is an attempt to answer the question of why did the City or really why did any entity choose to go with the swap transaction rather than a fixed rate transaction. The green line along the top here is the relative funding cost in basis points, incremental additional basis points, that the City would have had to pay versus the red line, which is a AAA rating. So, in other words, because the City has relatively weak ratings related to most municipalities and has had for many years, for the City it was much more cost effective to move from this funding line down to the purple funding line, fixed rate funding line, 30-year costs. That's the swap rate. Okay? In order to hit that swap rate, though, they needed to buy that bond insurance that I talked about earlier. That bond insurance insured the underlying bonds that were being sold, those variable rate bonds. So that at the time -- so the City paid up-front bond premiums, in some instances millions of dollars for each one of these transactions, to the bond insurance companies to get -- to buy AAA insurance on the bonds, which would be used to pay the bondholders, so that the City felt -- I think probably reasonably felt at the time that they did this that they had protected themselves from what they perceived to be the biggest risk at the time.

Now, there was one other thing to notice here, is that this green line, that green line is a callable line. In other words, that funding rate, you have

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the right to call those bonds in the future. This purple line down here, that is not callable. And I think that what happened -- and I have another slide on the next page to show you what I'm imagining happened -- is that many issuers liked the interest rate at the time, they liked this relative funding difference, and they imagined, if you could go to the next slide please, they would be -- let's say this is -- I think this year is, say, 2005 here, right around here. Issuers may have been looking at 20 years of declining interest rates, and they looked at that time period and they said, wow, interest rates have been falling, in some cases very precipitously, for many, many years. Gee, this level of interest cost looks very attractive. And then -- if you could go back to the prior page, please. And then whatever the funding difference is, adding that benefit. Gee, I'll give up the call option, because I like this rate and why do -- I don't think I'm going to ever get a lower rate, because I have the benefit of looking back over time and seeing we're in such a low interest rate environment.

So I'm speculating. I could not find anything in the files to verify this speculation, so it's just speculation, but that is my guess. And in my view, that's one of the very unfortunate aspects of the swap transactions, is that we were locked into them to the final maturity because we didn't obtain that right to call like we had on our fixed rate bonds.

And then if we could go to the next slide, please. Thank you.

So if you go to the next slide, this slide is simply showing you a very long history of short-term interest rates. The tax-exempt interest rates are the red line. Is that right? Sorry. The blue line are the tax-exempt rates and the red line are one-month LIBOR, which was sort of the benchmark against which municipalities sort of looked at their variable rate -- their likely variable rates. And what you see is, this is a period of the fed government easing. This is a period of the Fed raising rates, stable rates, Fed dropping rates down again, and then you can see here we're now in this extended period of very low, near zero, short-term rates, and that's due to the federal policy associated with trying to provide stimulus into the economy to provide for recovery after the fiscal collapse in 2008.

And I should note, if you could go back to the prior page, we see extremely low interest rates today, almost unimaginably low rates, well below the average of the period. The average for a municipal market over -- what is this period of time, about 30 years -- is 5.41 percent. The current AAA rating is about 3 percent. So we're in -- we are currently in an historically low interest rate environment and now are standing here today, looking back at these swap transactions which were made between 2001 and 7 primarily and with the benefit of knowing where we are today and evaluating these swaps. That's where we are.

Could we go to the next page, please.

So I apologize to the audience for the difficulty in reading the slides. We do have some copies of the books that we can make available.

This slide just highlights some of the City's key debt policies, which were developed by the Finance Department, the Treasurer's Office at the start of Mayor Nutter's administration, and they're designed to overall seek -- to move the City into the A level credit ratings, and in so doing, to provide what I would consider to be fairly conservative debt management practices, including a specific set of criteria that

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are used for issuing variable rate bonds and criteria for issuing refunding bonds, minimum amount of savings, and specifically providing the need for much higher level of benefit associated with any future financings that would be done using swaps.

So the next slide provides you with highlights of the swap policy, which is -- both the swap policy and the debt policy are quite lengthy, and they can be obtained on the City Treasurer's website if you would like to read them in detail. But the highlights on the swap policy -- again, just to note, we have not entered into any new swap transactions since Mayor Nutter has been in office, but we have built a new swap policy.

The first thing is documenting compliance, and this is important. Prior to entering into any swap going forward, the policy requires written documentation that the City evaluates the transaction for compliance with the swap policy and adequately addresses a wide range of risks and administrative responsibilities that are highlighted in the policy.

So really, quite frankly, at this point we're really not entertaining doing any swaps, but that standard was not in place before, and certainly in going back and looking through the files, we found it very difficult to find the documentation I would have liked to have seen about why the City chose to do the swaps they did.

The policy also provides a cap on the total number of -- total dollar amounts of swaps and prohibits certain types of swap structures. And it requires substantial monitoring of the swaps and certain risk management activities as well.

So now getting into the meat of the actual analysis that our office undertook to measure the economic effect of the swap transactions versus what we believe to have been the expectations that the City had at the time they entered into the swaps.

As the prior speaker testified, beginning in 2007, the credit markets began to experience substantial stresses. At first, the bond insurers' credit qualities became suspect, and auction rate securities began to fail. Then that cascaded over into the variable rate market itself, markets where the bonds had bond insurance and liquidity instead of just an auction rate product which did not have liquidity. And as that occurred, interest rates kept rising on variable rate bonds. And we go back to that PowerPoint, the page -- two pages before. You can see here, the short-term interest rates began to just spike up tremendously. And for the City, that created very substantial fiscal stress.

Specifically, what were the specific stresses that we had? We had variable rate receipts based on an index that did not match the variable rate expenses we were experiencing. Our assessment, our economic assessments, that produced about 36 percent of the economic losses that the -- 36 percent of the economic losses were incurred solely with respect to the failure of the swap variable rate receipt to match the variable rate we were paying.

The second is that the bond insurance where we had paid that premium up front, that bond insurance became valueless to us and we had to restructure those deals with new credit. We believe that was about 13 percent of the losses that we incurred.

The next was that those new letter of credits that we had to buy have been much more expensive, although we've brought those costs down recently, but there was a period where they were much more expensive, and we are projecting, for the purpose of making the projections out into the future, that they're going to remain more expensive. And so that we think is about another 13 percent of the losses that have incurred.

And then, last, the replacement liquidity was not available for all of our swaps. So we had to terminate swaps. We had to make termination payments and then we had to issue variable rate bonds at high interest rates. I think one of the -- it was Jeff Pearsall indicated to you that while the rates -- we thought rates would be correlated during the period of time where the City did fix out certain bonds. They weren't correlated, and so our fixed rate -- we had to both pay a termination payment and fix out at higher rates, and that actually was about 80 percent.

Now, those numbers add up to more than 100 percent, and the reason why it adds up to more than 100 percent is, we actually had savings in the beginning. There was a period of time when those swap transactions were performing well. We had savings, so we factored that in, and we also received money up front, those tens of millions of dollars that we received up front. So we factored that in.

So that is just a very high summary. And then moving on, the next page just gives you the methodology that we used, which is to present the swap transactions versus a fixed rate bond issue, and we've identified what we -- we are using our own Treasurer's Office guesstimate of what the expected economics would have been at the time the swap was executed and then -- and we've made assumptions around what we think a theoretical fixed rate bond issue would have been sold at. So it's a judgment call. Honestly and admittedly, it's a judgment call. We think it's reasonable.

And then we've tried to break the economics down into two time periods, from the inception of the swap until the end of Fiscal '12 and then from issuance to maturity. So the entire period of time the swap was outstanding. And that's important because we talk about -- people talk, how much have we lost? How much has the City lost? And we know we can sort of speak to how much -- where are we today versus what we think the expectations were, and then we can make some projections around where we think we will wind up when all is said and done.

There are some limitations to this methodology that we've used, and I'd like to speak to them for a moment.

First, we really don't -- as I've said before, we were not able to locate the documents that demonstrate the actual expected economics.

Second, we need to estimate those fixed interest costs in a market that could have been as much as ten years ago. So there's going to be some inaccuracy there.

The third point is that we really -- we've made reasonable estimates about what the future liquidity costs and

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other costs and performance of the variable rate bonds will be. We have assumed that the variable rate bonds will not match the receipts. We have assumed a loss going forward on the receipts for the purposes of this exercise, ten basis points per year.

We've also not evaluated any future refundings that could occur, and we have not factored in a future fiscal crisis.

Could we go to the next two pages. Thank you.

This page is very dense, but it's really the meat of the analysis that we've undertaken. Essentially what it does is provide by credit -- so in some instances, we've aggregated multiple swap transactions into a single credit. And on the left-hand side, under the heading entitled Actual/Estimated Savings Versus Hypothetical Fixed Rate Bond Issue, we've valued what we believe to be the economic gain or loss from inception of the swap to June 30th, 2012. That's under the title To Date, which is really June 30th, 2012. And then we've made a projection over the entire life of the swap transaction. And what you can see is, in aggregate, if you were to look at it in aggregate, the City General Fund has either lost 2.8 million or gained 10 million to date. But over the entire life of the swap transaction, we estimate that the City General Fund will lose, versus fixed rate bonds that they could have sold, between $23 and $84 million. Now, why is that?

COUNCILMAN KENNEY: I'm sorry. I just need some clarity on the page. The page I'm looking at is Page 18?

MS. WINKLER: I'm on Page 17.

COUNCILMAN KENNEY: Oh, I'm sorry. That's why I need clarity. Thank you. Never mind. Thanks.

MS. WINKLER: Do you want me to go back over that?

COUNCILMAN KENNEY: No.

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MS. WINKLER: So it's interesting, right? So the City to date probably hasn't really lost any money on the General Fund on the swaps they've done, but in aggregate -- because we're taking into account money that's been received up front, when some of these swaps were done in that early period, where there were years of benefit that were aggregated up, where we were doing better than we would have done if we had done a fixed rate bond issue. But largely all that benefit that was accumulated from the start of those General Fund-supported swaps to the fiscal crisis have been wiped out by the economic effects of the fiscal crisis. And I'm just using the General Fund as an example here. And the City was not able to obtain liquidity to replace their bond insurance that they lost when the bond insurers became essentially insolvent. And so the City both had to pay, I believe it was, 14 times more on the

General Fund, 14 times more for letters of credit than they had to pay in the past and, in addition, the City -- because the City could not get letters of credit equal to the total amount of variable rate debt that they had outstanding, they had to terminate some of the swaps, make swap termination payments -- I'm sorry. Excuse me. 14 percent is the Water -- I'm sorry; not percent, times; 14 times as much for the Water, 14 times as much for PGW, for the General Fund an average of about 10 times as much expense.

COUNCILMAN KENNEY: Mr. Chairman, what's the -- can you just give me totals?

MS. WINKLER: Yeah. The total is on Page 17.

COUNCILMAN KENNEY: And that's -- okay. Go ahead.

MS. WINKLER: So do you want me to -- I can just walk back through that again.

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So what we're saying is that we believe, for example, for the General Fund, which is this first set of numbers here for those of you in the audience, 2.8 million, that first box says 2.8 million negative. In other words, we may have lost 2.8 million, but we also may in this range that we've established made as much as 10 million. However -- and that's because we accumulated benefits versus a fixed rate bond issue to today. However, because we had to sell fixed rate bonds into a high interest rate environment and terminate those swaps at the same time and we are carrying much higher credit costs on the remaining variable rate bonds, we're projecting that the General Fund-supported debt in aggregate is going to cost the City versus a fixed rate bond issue somewhere between $23 and $84 million over the entire life of that swap.

COUNCILMAN GREEN: Mr. Chairman?

COUNCILMAN GREENLEE: Councilman Green.

COUNCILMAN GREEN: Thanks.

Sorry. Are all these numbers present value?

MS. WINKLER: No, they are not present value. They're budgetary.

COUNCILMAN GREEN: So --

MS. WINKLER: We just thought if we did present value, it would be just two sets of numbers and then -- we can provide -- we have run the present value numbers and we can provide them.

COUNCILMAN GREEN: I think that would be useful. If it's $84 million in 30 years, that's a small number. So I'd like to know -- I don't need -- if you want to provide the numbers to the Chair so we don't --

MS. WINKLER: We have them.

COUNCILMAN GREEN: Thank you.

MR. LANHAM: I have them if you'd like, Councilman.

COUNCILMAN GREENLEE: Just

identify yourself. I know it was mentioned before.

MR. LANHAM: James Lanham, Deputy City Treasurer.

Total General Fund present value, present value over the life of the transactions, they range between a loss of $45 million and a loss of $2.6.

COUNCILMAN GREENLEE: That's a big range, isn't it?

MR. LANHAM: As the Councilman noted, these go out a very, very long time. So the loss --

MS. WINKLER: We made -- right.

MR. LANHAM: The losses towards the end of the transactions have --

MS. WINKLER: Let me help you out on that as well. What we did, we felt it was really important to create a range, because we're making an estimate about what that fixed rate bond issue would have been in many instances many, many years ago, and the municipal market is just not -- it's not that precise like the bond market -- I mean like the Treasury market is, where you can go and look at what Treasury rates were on a date ten years ago. You know exactly what the borrowing rate would be. So we had to create a range around that fixed rate bond issue. So that's the only difference, is the range that we've created between what the theoretical fixed rate might have priced at.

COUNCILMAN GREENLEE: Okay. Thank you.

MS. WINKLER: So --

COUNCILMAN GREENLEE: I'm sorry. Excuse me.

Councilwoman Reynolds Brown.

COUNCILWOMAN BROWN: Good morning. On Page 12 of your document here, you say that you engaged -- "you" being the Treasury Department, is that accurate -- engaged a nationally recognized swap advisor --

MS. WINKLER: Yes.

COUNCILWOMAN BROWN: -- who

rewrote -- what was the trigger for that?

MS. WINKLER: Well, the City engaged around a competitive process at the start of the Nutter Administration to select a swap advisor, and we selected -- that was prior to my tenure, but we selected Swap Financial of New Jersey as our swap advisor. And it was very, very important to us that we select an advisory firm who had an independent practice, that we knew had a reputation in the market of being very aligned, their interests being completely aligned with issuers, and not tainted by some of the prior transactions where there may have been problems. As you may know, the City did have a swap advisor before, and that firm -- the principals of that firm have been convicted, and most of them are either in prison or awaiting sentencing.

COUNCILMAN KENNEY: I'm sorry. I apologize.

COUNCILWOMAN BROWN: Please.

COUNCILMAN KENNEY: Just based

on that statement, why aren't we as a government -- and considering this Administration didn't do any of this -- why wouldn't we as a government be outraged and be looking for every possibility to sue everybody and their mother to get this money back?

(Applause.)

COUNCILMAN KENNEY: Or to do something?

I mean -- and I'll say from the outset, this is not a Nutter Administration doing. I got it. So there should be no reticence to going after whoever we can go after. And it seems to be there's this like, Well, you know, over 30 years, it's not that much money. But, I mean, these guys went to jail, and they were advising us. I don't understand why we wouldn't be going -- I'd hire every big law firm I can find to go after everybody, including Merrill Lynch and all of them.

(Applause.)

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COUNCILMAN KENNEY: And this is not your policy decision, I understand. I just don't understand the lack of kind of like anger over it. It just seems to be -- we should be more angry about what these people -- if it were a doctor, we'd be suing them for malpractice. But that's not the case. It doesn't seem like it's the case here.

I mean, Auditor General Wagner's testimony was angry and he was waving this thing around. He's mad about the loss of taxpayers' money.

I mean, maybe you believe or the Administration believes this is de minimus. I don't know. But I tend to disagree with you, and I'd --

MS. WINKLER: I hope you don't take my tone to in any way imply that I don't take this seriously --

COUNCILMAN KENNEY: No.

MS. WINKLER: -- or that I don't --

COUNCILMAN KENNEY: I'm not

saying that, but I know when I talked to the Administration about the potential of following up, following through with this with a lawsuit, people are doing due diligence, but it seems like it's just like, Well, okay, we don't know if we'll get to it or not. And that's to me my concern, is that as the clock ticks, are we losing opportunities to at least get ourselves out of these buy-out deals? Could a settlement in a lawsuit, a settlement be potentially to get or diminish or get us out of these exit payments? Something?

I mean, I'm just -- I'm not thinking you're not thinking this is serious, but I just -- I didn't realize the guys went to jail.

MS. WINKLER: Yeah. And my understanding is that --

(Applause.)

MS. WINKLER: -- that particular company, basically there are no assets. There's nothing to attach.

COUNCILMAN KENNEY: But there's other bad doers in this whole thing, all over, all throughout. We were advised badly, I think. Now, you may disagree, but I think we were advised badly, and I think someone ought to stand up and take that hit.

Sorry, Councilwoman.

COUNCILMAN GREENLEE: Councilwoman, you still have questions?

COUNCILWOMAN BROWN: I do.

So given this harsh reality, the one safeguard going forward is -- I think you said it in here -- evaluating transactions on an X basis. So what are the safeguards?

MS. WINKLER: Well, I mean, I think at this stage, the safeguards would be the fact that we're not really actively looking at this time to --

COUNCILMAN KENNEY: That's a good safeguard.

MS. WINKLER: -- undertake additional swap transactions, number one.

And, number two, we do evaluate our exposure to the swaps that we have and the economic ability to extract ourselves from the swaps in an economically neutral manner. So, in other words, we don't really want to lock in any more losses. We did in the teeth of the fiscal crisis, largely because we were not able to obtain alternate liquidity to support the variable rate bonds. Because we couldn't get other letters of credit, because they were -- the banks themselves were in free fall in their own ratings, we were forced to sell fixed rate bonds to pay termination -- and pay termination payments. So we've already locked in some losses that are on my chart and on my page here. We tried to value that.

COUNCILWOMAN BROWN: Sure.

MS. WINKLER: Right now we've been working very aggressively over the past really 18 months to two years to get the City's credit rating improved and use that to improve our relationship with the letter of credit bank providers to lower the costs. And we've lowered, radically lowered, the costs of liquidity, which we have not fully reflected. We've assumed maybe a little bit of deterioration in the improvements that we've gotten in our loss projections, but we've -- I think it's really sustaining the City's credit rating, trying to push S&P, push ourselves to get into the A category so that we can have a stable and very diverse group of banks that we're doing business with.

One of the problems the City had in the past was, they only had a few banks they were doing -- they had lined up for liquidity, and when those banks went away, they didn't have other banks that were comfortable extending credit to support the variable rate bonds.

We've substantially reduced the City's risk by bringing in -- running competitive processes and bringing in many more banks, and that has lowered the

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costs and reduced our risk exposure, because we don't have such huge amounts exposed to one particular bank.

COUNCILWOMAN BROWN: When was the last swap transaction?

MS. WINKLER: It was in December of 2007, except we did terminate some swaps since then.

COUNCILWOMAN BROWN: So none during the Nutter Administration?

MS. WINKLER: Nothing other than terminations of swaps. The last swap we terminated, we terminated about $29 million worth of a PGW swap in 2011.

COUNCILWOMAN BROWN: And to Councilman Kenney's question, is there or does there remain active engagement in the Law Department or in the Administration to go after those who --

MS. WINKLER: Yes.

COUNCILWOMAN BROWN: Any read on the status of that? Has that been since 2008 and we're now 2012?

MS. WINKLER: Well, I'm not

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familiar with and it's probably not appropriate for me to speak to the Law Department's detailed legal analysis, but I can assure you that there are a number of people in the Law Department meeting with outside firms and examining the City's likely success in various suits.

COUNCILWOMAN BROWN: Okay. All right, then. Thank you for your testimony.

COUNCILMAN GREENLEE: Before you continue, if I can just note for the record obviously Councilwoman Reynolds Brown is present, as is Councilwoman Bass, and Councilman O'Brien was here, also a member of the Committee. Thank you.

I know we want to get to the lessons learned. I know that's your last -- I know Councilwoman Reynolds Brown likes to talk about lessons learned, so maybe you could go over those.

MS. WINKLER: Sure.

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COUNCILMAN GREENLEE: Briefly. Thank you.

MS. WINKLER: Would you like me to at least just speak to the current mark-to-market of our swaps? That's fine. I don't --

COUNCILMAN GREENLEE: Maybe we can just get --

MS. WINKLER: Okay. So on Page 18, we do provide you with the current value of the swaps, and you can see they're all negative. And the reason why they're negative is because the rates that we pay on those swaps is higher than what a rate would be if we were to enter into a new swap with the same terms today. And that's because interest rates have fallen and interest rates have fallen, and we don't have any call option on those swaps. We can't terminate them. And because we have still a very large total amount of swaps outstanding, the aggregate mark-to-market is very high.

Now, this is relevant in the

event we were to terminate the swaps, but it is not relevant if we just stay in the swap and stay through maturity, because over time if the swaps do continue to perform and we just keep the variable rate bonds outstanding, we will never incur these costs that are shown on this page. This is almost like a bookkeeping entry, if you will, of valuing where we are today with the swaps. It's not an economic loss. And if interest rates instead of having gone down the way they have and stayed down, if for some reason they had instead gone up, these mark-to-markets would have been positive, and in the future if interest rates go up, they can go up.

And then I can go to lessons learned.

The first lesson is to have a very rigorous and conservative swap policy, which we have proceeded with.

The second is to make sure that you comply with your swap policy, and we rigorously internally monitor our compliance with the swap policy.

The third is to value a truly independent third-party advisor, and we think we've done that by procuring a leading independent advisor. We are currently RFP'ing now for -- as the term, that four-year term is up on that agreement.

Very importantly, we think the City should, whether it's fixed rate bonds or swaps or any other kind of debt instrument, always try to preserve its right to exit without penalties. So preserve call options. And so from now on, we will never -- we're going to look to amend the swap policy to provide for preservation of call options on swap policy.

And then I think, very importantly, we need to realize that the rating agency information was less than perfect, and that reliance that we had on making those up-front payments for that bond insurance, that was probably a very risky thing to do. So going forward, we are not so likely to be using bond insurance.

COUNCILMAN KENNEY: I'm sorry. You're saying it was a risky thing to buy insurance?

MS. WINKLER: I'm saying that the bond insurance was not -- we relied on the rating agencies.

COUNCILMAN KENNEY: So the rating agencies gave us wrong information?

MS. WINKLER: The rating agencies' evaluation of the credit worthiness of the bond insurers was deeply flawed, because the bond insurers took our premiums and the premiums of many other municipalities around the country and they invested them in mortgage-backed securities, which the rating agencies had rated AAA, which in fact they weren't AAA. They were, as we all know now --

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COUNCILMAN KENNEY: A lot of bad actors there.

MS. WINKLER: -- bad securities.

COUNCILMAN KENNEY: A lot of bad actors in that process, including the rating agencies. Do they have no exposure for giving us such terrible information or do we need them to get our bond rating up? It's kind of like the people who are rating us are the people who helped cause the problem.

MS. WINKLER: Again, I think it's probably best for me not to comment on the legal hoots.

COUNCILMAN KENNEY: Okay.

MS. WINKLER: So that's it. Thank you for your time. I'm happy to answer any other questions you may have.

COUNCILMAN GREENLEE: Thank you. Councilman Green had a question.

COUNCILMAN GREEN: Thank you.

Just so we're clear, there's a couple of things mentioned that are related to the loss. One is the loss of the premiums for bond insurance. You could get bond insurance whether or not there was a swap in the transaction. Is that part of the loss calculation that you're doing? Are those losses included in what you're calling losses on swaps?

MS. WINKLER: The loss of bond insurance?

COUNCILMAN GREEN: Yes.

MS. WINKLER: Yes.

COUNCILMAN GREEN: So that's really not a loss at all related to swaps, is it? Because we bought bond insurance whether or not we had swaps in the deal in order to improve our credit rating.

MS. WINKLER: Yes, but we have factored in the --

COUNCILMAN GREEN: I understand.

MS. WINKLER: Well, I just want to say, we have included an assumption on that theoretical fixed rate bond issue that we would have had bond insurance on that deal too.

COUNCILMAN GREEN: I understand, but you're counting losses that have nothing to do with swaps, that have to do with the decision to buy bond insurance.

MS. WINKLER: That's true.

COUNCILMAN GREEN: Which is not at all what this hearing is about.

MS. WINKLER: That is true.

COUNCILMAN GREEN: So how much of the losses are related to that?

MS. WINKLER: About 13 percent.

COUNCILMAN GREEN: Thirteen percent?

MR. LANHAM: If I may make one extra point --

COUNCILMAN GREEN: I'm not being critical. I'm just trying to understand the assumptions.

MR. LANHAM: And I believe the difference is, yes, you're correct, that the City would have bought insurance on a

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fixed rate transaction. However, on a fixed rate transaction, it would still be outstanding, whereas on the swap transaction it no longer is.

MS. WINKLER: See, what happened is, when you sell a fixed rate bond issue, the investor is buying that bond insurance. They're essentially saying, okay, we'll take a little bit lower interest rate because you bought bond insurance. And then it's the investor's problem that the bond insurance is now worthless; it's not the City's problem.

COUNCILMAN GREEN: Sure. Yeah. Unless, of course, the deals are structured the way they were structured for us.

MS. WINKLER: Right.

COUNCILMAN GREEN: But still you would have bought bond insurance whether or not you did the swap structure. That's my point.

MS. WINKLER: Right.

COUNCILMAN GREEN: So it's not really a loss related to swaps.

I guess my other question is related to the current state of where we are as a city. It seems to me that one of the risks that you talk about in your new policy or one of the reasons you say we could buy permitted uses of swaps is locking in interest rates, which really is the subject of much of the testimony that we've heard here today, that sometimes it makes sense to lock in interest rates. I don't know if we as a city are qualified to like, Hey, interest rate is really low now, let's make a decision to lock them in. I mean, you saw what happened when we made those assumptions in 2005, 6, and 7.

So in terms of the City's policy going forward, could you explain why locking in interest rates is a permitted use of swaps?

MS. WINKLER: Well, the City does multi-year financial planning, and

the Water Department does very long --
I'm just giving some example. We do very long financial planning and often go -- for example, the Water Department goes for multi-year rate increases, and it is fairly common to try to keep -- to know what your costs will be, because the certainty of knowing what your costs will be has value in planning.

Now, when you sell a fixed rate bond issue, you're making a bet too, right? You're making a bet at the time that you -- if you want to use that term, making a bet. You're making -- you like those rates.

COUNCILMAN GREEN: You're happy with that rate for the next 30 years, the next 10 years, whatever it is.

MS. WINKLER: Right.

COUNCILMAN GREEN: And you're happy to pay and your projections show that you can afford to pay that, and so you don't want to take -- you're taking risk off the table when you issue a fixed rate bond, right?

MS. WINKLER: You're getting certainty of what the expense will be, yes.

COUNCILMAN GREEN: Right. You have complete certainty.

So a swap essentially provides that same certainty without a fixed rate bond.

MS. WINKLER: It provides that same certainty. The theory is that it gets you much lower all-in costs. The problem with that was that the underlying mechanics, the credit that we were buying to support the variable rate bonds, that credit quality that we paid for didn't really exist and we thought we were buying AAA.

COUNCILMAN GREEN: I understand, but what does that have to do with swaps?

MS. WINKLER: It doesn't. Well, I mean, it has to do because you need that liquidity for the variable rate bond.

COUNCILMAN GREEN: I understand, but what was the loss related to? Was the loss related to swaps? Was the loss related to the fact that we locked in -- we made a decision like you're just describing, which makes perfect sense, we made a decision to lock in interest rates for a long time because we were happy with the cost that it was going to be compared to the benefits we were going to get from borrowing money for a capital project or whatever it is? My question is, what was the loss related to? Was it related to the fact that we bought swaps or was it related to the fact that the underlying credit quality that we were basing this whole transaction on, which had nothing to do with swaps, didn't really exist?

MS. WINKLER: Yes. Most of the problems, most of the expenses were associated with the underlying bonds and their failure to perform.

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COUNCILMAN GREEN: So how much of the loss was related to that as opposed to the locked-in interest rate which the swap represented?

MS. WINKLER: We'd have to go back and --

COUNCILMAN GREEN: Because it seems to me that that's really the loss that for which, as Councilman Kenney points out, we may have significant damages and probably people, somebody should have liability. But it's not -- I don't want to take what is a valuable tool for a city to have off the table for reasons that have nothing to do with the actual loss that the City incurred, which was related to the underlying instrument that had nothing to do with the swap. The swap enabled that transaction, but that transaction in itself was the foolish transaction, not the swap, and I want to make this point again, which is the same thing as issuing a fixed rate debt, except that you can lower the rate with a swap as compared to issuing fixed rate debt. Would you agree with that statement?

MS. WINKLER: I do.

COUNCILMAN GREEN: You do agree with that?

MS. WINKLER: I do agree with that.

COUNCILMAN GREEN: So if you would get back to the Chair about how much of the loss was actually related to the instrument of underlying transaction as opposed to the swap, I think then we'll be talking apples to apples in terms of policy discussions about whether or not swaps make sense to have in the financial tool belt of the City, even if we as a policy say we're not going to use it except to lock in a -- for example, let's just say we do -- we know that we'll be borrowing billions potentially at the airport over the next ten years for runway expansion and other things. The airport could make a decision that interest rates are never going to be lower or not likely to be lower for the airport given where the economy is and what we expect to happen in five years in broader economics. They could make a decision that we're happy with 4 percent for all this infrastructure that we're going to do, and so we want to do a swap to lock in borrowing that we know is going to happen. And that could make rational sense. I'm not arguing for it, but is that the sort of thing that we might want to use a swap for in the future?

MS. WINKLER: The City could use that. The City could also say, Hey, I really like that rate, but I wouldn't mind providing some protection for myself by paying a slightly higher rate, still getting -- but getting a call option on the swap. You can have a call option on the swaps.

COUNCILMAN GREEN: But that would still be on a swap.

MS. WINKLER: And that would be much lower -- could still be much lower cost of funding than the fixed rate bond market. And, yes, I think that is an important tool -- I think what we don't want to do is remove a financial tool that, if properly managed and with certain precautions taken to manage risk -- I really do want to emphasize the importance of maintaining credit quality and embedding call rights in the swaps. If you do those two things, I think in certain scenarios there can be very wide incremental benefit that could be derived that would help both lower the cost of capital and enable long-term planning, which it could theoretically be useful.

So I would hope that we can have a dialogue around how to maintain some legal authority for the City to be able to use its better understanding that we have derived today with respect to how to manage a swap portfolio and to have a policy in place and apply that policy conservatively potentially in the future for some swaps. I'm not -- although I'm not here to present a swap or support doing any new swaps at this point, I just would hate the idea of forever removing that as a tool.

COUNCILMAN GREEN: Okay. In terms of accountability for the portion of the transaction that I think you said created most of the loss that we're talking about, to the extent we realize a loss -- I recognize we're not marking the market -- but who are the people involved in those transactions that really are accountable? Obviously City Council passed the bonds, so there's certainly accountability here, the Administration. But in terms of outside -- the City Controller signed off on it. In terms of outside of City government, who is accountable? Is it the underwriters? Is it the politically connected law firms that we hire to represent us? Is it -- who are the people that should have accountability to us if we were to pursue legal action? Who are the parties? Our financial advisors?

MS. WINKLER: I don't think we -- I mean, there are a number of different financing participants, but you'd have to go back and look and understand what each one of those roles were. It may be that some of those firms may not have really had any role at all in saying let's do this transaction. There may have been some firms that were very closely involved. We could not ascertain any of that from looking at the written record that was on file in our office.

COUNCILMAN GREEN: Okay. Because the one thing I absolutely agree with Councilman Kenney on is if people are accountable for structuring that transaction that's not the swap but the underlying financial instrument that the swap applied to, I see no reason why we should not pursue them vigorously, unless you advise us that it's going to impact the City's ability to borrow or get favorable interest rates in the future.

But I learned a lot today, and I really appreciate the hard work you and James put into this, and thank you very much for your testimony.

MS. WINKLER: Thank you.

COUNCILMAN GREENLEE: Thank you, Councilman.

Councilman Kenney.

COUNCILMAN KENNEY: Thank you.

In my view as far as exposure, I would probably -- I'm not a plaintiff lawyer. I would do what a plaintiff lawyer would do, and that's sue everybody and see what shakes out. That would be just my advice. Whatever their roles were, we can sort it out in depositions as opposed to trying to figure out which ones are the best. But that's not my call.

Auditor General Wagner's testimony you were here for was very,

very clear on his position and his
investigator's position on the role of
swaps and the use of taxpayers' dollars.
He believes unequivocally we should never
use an instrument like that when it comes
to the use of taxpayers' dollars, that in
private sector, if you want to roll the
dice for your own company, that's up to
you and your shareholders and your
business partners, but that these types
of instruments that rely on people giving
us advice and making sure that they're
right and there's no nefarious
undercurrent intentionally trying to
screw things up, all that being the case,
it's a good instrument. But why would we
want to even continue looking at them
when -- unless you disagree with his
testimony on the losses of the School
District and SEPTA and the DRPA. If you
disagree with them, then you can tell me,
but it seems to me that this is something
that's -- as time goes on and the economy
gets better, we're going to be looking at

everything and scrutinizing everything, but assure you that some young person who has not yet been born, who is going to walk on Wall Street one day is going to figure out a way to screw us, and that's their -- money is king. That's their life. They try to figure out ways to get around the system. That's what all this derivative stuff came from. That's where all these giving people loans that they couldn't afford to pay back, knowing it going in. All that stuff created what we're talking about now.

So my question is, if we had all fixed rate securities and not any of these swaps, would we be here even having this discussion?

MS. WINKLER: No.

COUNCILMAN KENNEY: No. And I guess my point is, I would rather err --

(Applause.)

COUNCILMAN KENNEY: I think I would rather err on a conservative side of a return for the taxpayer than trying to be Gordon Gekko and try to figure out how to maximize all this stuff, because I don't think we should be doing that. I don't think as a government we should be doing it. And I will say I am guilty for voting for them, but as I go to my doctor, if he tells me what to do, I usually do it, until I like die or something from what he told me to do. Then I won't do it anymore. But, I mean, when it comes to our legislative body and taking people who are skilled and who are experts and giving us advice, I generally follow it, because I'm not an expert in financial management.

So, I mean, my argument and what I'm trying to figure out in my own brain is whether or not we should be doing these things at all ever. I know you said you want to have it as part of your toolbox, but I still think long term we're going to run into this same problem again when everybody forgets about the fiscal calamity we just went through and

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things get a little better and people get a little greedier, I think things then tend to happen. That's just my opinion. Thank you.

COUNCILMAN GREENLEE: Thank you.

COUNCILMAN KENNEY: And thanks for your testimony. I appreciate it.

COUNCILMAN GREENLEE: Thank you. Thank you both for your time.

The next witness, Ms. Marconi.

THE CLERK: Sharon Ward.

COUNCILMAN GREENLEE: And, again, as I said before, we are starting to run up against a time limit. So if you could hit the main points, because we still have a number of people who would like to testify.

(Witness approached witness table.)

MS. WARD: I'd like to give you copies of testimony.

COUNCILMAN GREENLEE: We will get it. Go ahead. If you identify yourself for the record and proceed, please. And, again, if you could summarize any statement, it really helps.

MS. WARD: I will be as quick as I can. Thank you very much, Councilman Greenlee, Councilman Kenney, and other members of the Rules Committee. My name is Sharon Ward. I am the Director of the Pennsylvania Budget and Policy Center. We are a non-partisan, non-profit policy and advocacy organization. We focus on tax equity and the impact of state and federal budget decisions on working families in Pennsylvania communities.

Let me go through my testimony very briefly.

Our organization has looked at the impact of the national recession on Pennsylvania municipalities and on Pennsylvania communities. And let me express to you that part of what our mission is is to take very complex but very important information about the

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operations of federal, state, and local government and try to make them understandable to policymakers, to advocates, and the public so that we can better scrutinize the actions of government. So I appreciate the opportunity to speak today.

You see that we have issued a report earlier this year, which attempted to view -- look at the cost of both the School District and the City interest rate swaps to the taxpayers. So I want to just make three points for you today.

The first is that the instruments have been and are likely to continue to be costly to City taxpayers. You've heard testimony about that today both from City Treasurer Winkler and also from Auditor General Jack Wagner.

The second is that the use of these instruments has been widespread in Pennsylvania, and it is the result of a deliberate attempt by the financial services industry to de-regulate a practice that was for many years considered to be a form of gambling, and we have seen the results.

And the third is that Philadelphia ought to take action to recover some of the losses that it incurred as a result of these financial transactions.

So first I just want to remind you about the impact and the cost of the recession to people in the City of Philadelphia. You need to look at the table to fully understand unemployment because of this recession. Unemployment in the City rose from 6.4 percent to 11.1 percent where it sat in September of 2012, with unemployment among African Americans and Latinos much higher. Over the period before the recession to current -- the most recent data, poverty in the City increased from 23.8 percent to 24 -- to more than 28 percent, and child poverty increased to 39 percent.

As you know, thousands of City

residents have faced foreclosure, and actually the number of foreclosures has increased in the first half of this year. And you also know that City taxpayers have paid a price for this recession, including a doubling of the City's sales tax rate in order to make up for the lost revenue.

The toll of this recession on individuals and families is extremely large. The rates of long-term unemployment are very high, and we have a whole generation of students who have graduated from college with record high debt who do not have very bright prospects of obtaining employment that's commensurate with their education. We have paid dearly for this recession.

And the point I want to make and I think others want to make is that there is blame to be assigned for all of this and that the actions of the large financial institutions, including the very ones who were involved in these swaps agreements here in the City of Philadelphia, played a role in precipitating what has been a catastrophic event for Philadelphians and indeed for all Americans.

Again, as I wanted to point out to you that there has been a deliberate systematic attempt by the financial services industry to de-regulate the industry in order to bring more local governments into using these types of derivatives, and you have seen frankly the result. In Pennsylvania, Act 23 of 2003 expressly authorized local governments and school districts to enter into these swaps agreements, and then the race was on. And between 2003 and 2009, local governments entered into 628 separate swaps agreements.

You heard Auditor General Jack Wagner talk about the investigation that was done in Bethlehem. That was the first look, detailed look, at the impact of swaps agreements on school district or municipal finances, and at that very moment, in 2009, the Auditor General characterized swaps as highly risky and impenetrably complex transactions that quite simply amount to gambling with public money, and he reiterated those comments today.

Now, again, we would agree that in theory the municipal derivatives should have provided some benefit to local governments, and you've heard in excruciating detail about that, so I won't go into it anymore. But the reality was in fact very different, and it is unclear whether the risks were really made clear to local government entities here but also across the state and across the nation. And a different Auditor before the Auditor General has, I think, made a comment that is quite telling saying that swaps derivatives and other complex financial instruments are typically understood only by the people who sell them.

So I think as you heard the testimony today, a very important question is who has the wherewithal to make the determination that these agreements are in the best interest of the taxpayer? I think the City of Philadelphia should be commended for entering into a swaps policy, setting ground rules for the use of these instruments, but I think that doesn't go far enough.

So look at exactly what the cost has been for local governments of these swaps agreements. According to Bloomberg, taxpayers have paid more than $4 billion to banks just between January 2008 and November 2010 to get out of swaps agreements, and like many other local governments, the City and School District made the decision to terminate the swaps that were costly and at that point had highly unfavorable terms.

I think the point that we want to make is to Councilman Kenney's point, has the City of Philadelphia really done all that it can do to help recover some of the costs and to turn the balance of payments back towards the City's favor and towards the taxpayers' favor? And we would simply argue that that should occur.

A report, which you have in front of you, identified and we think was very important to begin to raise awareness about this problem, the fact that the City and School District from our calculations had lost about $331 million in net interest payments and cancelling fees and that the City could lose, using a very static analysis, more than $240 million in additional net interest payments, depending on how interest rates move forward through the life of the swaps, the existing swaps agreements.

We identify again what the swaps agreements were for the City and the School District. I do want to point out to you that our analysis did not look at a comparison between the cost of a fixed -- the comparison of whether the School District or the City had entered into fixed rate agreements versus the variable rate agreements with the swaps that they did, but even then, as the Auditor General pointed out, the cost to the School District would be about $35 million, and you've certainly heard the Treasurer's cost analysis, which ranged -- again, created additional costs. And, again, this all happened in a time when the City could least afford it.

So let me make two points and then I know you have to get on. I think the first is that we would argue that at a time of financial crisis, the Department of Treasury had taken this very unpopular step of providing taxpayer dollars to help insure the financial solvency of the financial institutions. We, certainly our organization and most organizations, would argue that that was an absolutely necessary step. However, there is nobody who is taking that step to help compensate the taxpayers, and we believe that good corporate citizens should take the step to begin to redress some of the imbalance in terms of taxpayer dollars.

We would argue, therefore, that the City needs to do two things. The first would be that you should use your power to try and renegotiate some of the termination fees or to get a better rate on some of these agreements that exist. And we think it's very important that the City take the opportunity to try to lower its costs and, in fact, change some of the imbalance that exists in its current payments with respect to the swaps agreements.

So in the best of circumstances, these swaps are risky business. During normal economic downturns when interest rates are low, they can become very costly. I think we have seen that here. I think one question that has been posed is whether or not municipalities or local governments should continue to use these instruments, and I think the answer is we have to look at what the history has been, and you have to answer the question has this worked out to the benefit of City taxpayers or has it not. And doing so I think will answer the question of how to proceed moving forward.

So I want to thank you for the opportunity to testify today. I'm happy to answer any questions.

COUNCILMAN GREENLEE: Thank you.

Councilwoman Bass.

COUNCILWOMAN BASS: Hi, Sharon. How are you?

MS. WARD: Hello, Councilwoman.

COUNCILWOMAN BASS: Forgive me, I'm suffering with a cold.

Just a couple of quick

questions for you. And, number one, I want to thank you for your report. I look forward to getting a chance to read it later. I know that you're always very thorough in what you provide. But in thinking about this issue, there was recently a piece, just this past Sunday, on 60 Minutes about Goldman Sachs and about some of the sort of funny business in terms of investments and kind of luring investors into products that they knew were not good products, that they knew were complex and really too complex for those investors to really understand what it was that they were actually purchasing, all in the interest of profit.

And so as we think about pieces like that and other information that we have, I just wanted to say that this is very disconcerting. It's good that we have policies that protect us here in the City of Philadelphia. We obviously could have more, but beyond that, we need the protection of the Commonwealth. We need for our state to do much more to look out for its citizens and for municipal authorities such as Philadelphia and many others that have been mentioned today.

So as we talk about the imbalance, about taxpayer support to financial institutions that were considered to be too big to fail, but at the same time, the support to individuals has not been nearly as aggressive or as supportive. And so there's just a lot of work to be done, and I just wanted to thank you for the report that you provided. I know that it's great information and I look forward to reading it. So thank you, Sharon.

COUNCILMAN GREENLEE: Thank you.

No other questions?

(No response.)

COUNCILMAN GREENLEE: Thank you very much.

MS. WARD: Thank you.

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COUNCILMAN GREENLEE:
Appreciate it.

Next witness, please.

THE CLERK: Michael Krauss.

(Witness approached witness table.)

COUNCILMAN GREENLEE: Good afternoon. Please identify yourself for the record and proceed.

MR. KRAUSS: Mike Krauss, Mr. Chairman.

Mr. Chairman, Councilman Kenney, thank you all for taking this work up. It is indeed important work, and it's to your credit that you're doing it.

I'm a Director of the nationally recognized Public Banking Institute and Chair of the Pennsylvania Project. We are non-profit, non-partisan public policy organizations, and we're engaged in campaigns of public education to achieve public banks in the United States. But we're here today to challenge you, to challenge you to fight for the people of this city and to just say no to the too-big-to-fail banks that failed --

(Applause.)

MR. KRAUSS: -- that failed and that are gouging this city and its people for hundreds of millions of dollars in the interest rate swap swindle that is the subject of this hearing. And I say "swindle" because really to think that Goldman Sachs and J.P. Morgan sold products in which they had a 50/50 chance of taking big losses simply (unintelligible). I say "swindle" because people are going to jail now because interest rates were fixed. I say "swindle" because we know the LIBOR rates were fixed. The rates in which your losses were calculated were all fixed. It's a swindle.

This at a time when the long recession caused by these same banks that sold the swaps has resulted in unemployment, home foreclosures, lost revenue, and budget cuts that are having catastrophic effects in this city. Everybody knows what's going on and should be quite properly angry.

But what everybody needs to know is that these causes, these losses could have and should have been avoided altogether. Swaps were never necessary to hedge against interest rate fluctuations. For almost 100 years, that insurance was provided by responsible municipal finance managers who employed the technique referred to as "laddering."

As Pam Martens, a widely read critic, has explained, To hedge risk, an insurer simply has bonds maturing along a short, intermediate, and long-term yield curve. If rates rise, they are hedged with the intermediate and long-term bonds. If rates fall, the short-term munis will mature and can be rolled over into the lower interest rate environment.

Further, she says, Municipal

insurers are further protected by being able to establish call dates of typically five years, seven years, or ten years when they issue long-term bonds. They pay moms and pops and seniors across America, who buy these muni bonds, a small premium of usually 10 to 20 per thousand face amount and call in the bonds if the interest rate environment becomes more attractive for issuance of new bonds.

Philadelphia paid a lot of money to advisors and bankers who made long presentations, about 39 pages, about how good swaps would be. They were a disaster. We just explained in two minutes why they were never necessary, and we did it for free.

The Auditor General agrees, he wants the act of the legislature that allow these swaps to be rescinded. That's for the future, but what are the damages done? What is the relief and where will it come from?

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A handful of banks crashed the economy, virtually the same banks that sold the swaps. They were rescued. But the long recession they caused has collapsed municipal tax revenues, putting enormous pressure on budgets. The state cut spending, and the cuts grew even more severe.

Now these same banks that caused the crash are demanding payment on their one-sided interest rate deals or huge fees to exit the swaps.

This isn't adding insult to injury. It is adding yet more injury to already injured people of this city.

In a March 15th article in Counterpunch, entitled "An Inside Glimpse into the Nefarious Operation of Goldman Sachs: A Toxic System," Darwin Bond-Graham writes, "Virtually all interest rate swaps between local and state governments and the largest banks have turned into perverse contracts whereby cities, counties, school districts, water agencies, airports, transit authorities, and hospitals pay millions yearly to the few elite banks that run the global system, for nothing meaningful in return."

This is an outrage, and it must be ended.

Earlier this month, we testified in support of the Responsible Banking Review ordinance and suggested that important as it is to review how the banks conduct their business, it is vital for the City to review how it conduct its banking and look for new models to replace those that have failed. We advocate a public bank. A public bank keeps the taxes of the City certainly in the City for economic development.

But today, right now, the City needs a champion to stand up for its people against the abuses of a handful of Wall Street banks. We hope the City Council will be that champion and do what is now being done in Baltimore, New

Haven, Oakland, and a growing list of cities nationwide that are taking the looted money back.

We urge Council to do what is required to form a task force of the District Attorney, Treasurer, Controller, acquire whatever additional forensic accounting expertise is needed, identify the cost to the people in the manipulation of the LIBOR rate, the rigging of the bond market, the interest rate swap swindle, and seek to recover that money from the banks involved.

Further, while the Auditor General has called for a negotiation to reach an equitable resolution between the banks and the municipalities, which these banks and other agencies from which these banks are extracting huge payments and fees, we urge Council to give serious consideration to a strategic default on these swaps -- just say no -- and suspend any and all payments until there is a settlement to the City's satisfaction.

Remember --

(Applause.)

MR. KRAUSS: -- the banks have no money at risk. They invested not one nickel in the swaps and have nothing to lose, just billions to be made by gouging the people whose lives they've already burdened with lost jobs, lost homes, lost futures, deteriorating education, slashed vital service, and deteriorating neighborhoods.

We think the time for talking needs to be over. We all know the damage done and who was responsible. They need to be made to pay up. This Council needs to make them.

And we need new models for municipal banking and finance, nothing short of a revolution in the way public funds are managed.

What better place for that revolution to begin than right here in Philly where the First American Revolution was declared.

Come on, Philly. Fight. Take the money back.

Thank you.

(Applause.)

COUNCILMAN GREENLEE: Thank you for your testimony.

MR. KRAUSS: You're welcome, sir.

COUNCILMAN GREENLEE: Our next witness.

THE CLERK: Is there a representative from the Philadelphia Coalition Advocating for Public Schools?

(Witness approached witness table.)

COUNCILMAN GREENLEE: Good afternoon.

MS. WALLACE: Good afternoon.

COUNCILMAN GREENLEE: Please identify yourself and proceed.

MS. WALLACE: I'm Carmen Wallace. I'm speaking on the behalf of Dawn Hawkins. She's sick right now.

Good afternoon, Councilmen and

Councilwomen. This is the letter that she sent.

She said, Hello. My name is Dawn Hawkins. I am a parent of two children, one who has graduated from college and one who is a 7th grade student at LP Elementary at 31st and Ridge in North Philadelphia. There is no question my son will go to college as well, but I am very concerned that depleted resources in our public schools is making the path more and more challenging. My son's school does not have a library or a computer room. We share a school nurse with three other schools, so she comes out to our school only once a week.

I am so concerned about the bleeding of money away from our public schools that I joined with Action United and, through them, have became part of a larger group called a Philadelphia Coalition Advocating for Public Schools, or PCAPS.

We believe that the School Reform Commission's plan to close dozens of public schools is exactly the wrong prescription at this time when we need more investment in our schools, not less. My son's school with students from K to 8 grade is very crowded. Most classes have 30 to 35 students. We have 6th, 7th, and 8th graders on one floor. You have big kids picking on little kids.

Thank goodness for the public library about seven blocks from our house, where my son can get help with his algebra on coolmath.com and for a positive after-school program with the Franklin Institute to teach engineering, math, and science. We also have students from Temple and other schools come to help students study.

These are all great -- this is all great help, but it's like bailing water from a sinking boat because our schools keep seeing their funding go down and the only solution the SRC has is to

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close more schools. The District closed FitzSimons, Rhodes High Middle School is in our area and sent all the children to Strawberry Mansion High. That created a very crowded and dangerous situation.

When I heard that the Philadelphia School District pays $63 million to buy its way out of some complicated financial deals that were peddled by the big banks, I almost threw up. These banks crashed our economy, asked us to bail them out, and now they're taking money out of our already broken school district.

What could that $63 million have done for my child's school? Maybe he could have a functioning library or smaller class sizes. Maybe I would have sent my child to school and had a nurse to respond if he had an asthma attack four days a week, and no computer room for him to learn skills he will need in the future.

The School District of

Philadelphia says it will save $33 million by closing up to 64 schools in the next year. Maybe our neighborhoods and our children will not have to be sacrificed if these banks hadn't run off with almost twice the amount.

I understand that the District still has several swaps which are potentially even more risky than the ones they paid 63 million to get out of. How can we put our children in this kind of situation?

Our organization is calling on the banks that took $63 million to repay it. My children need the same kind of education that those bankers' children get. Bankers are making record profits while school budgets are cut to the bone. We're calling on the City and the School District to sever our ties with any bank that won't refund this money. It's only right.

COUNCILMAN GREENLEE: Thank you, ma'am.

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(Applause.)

COUNCILMAN GREENLEE: Thank you very much.

Ms. Marconi, our next witness.

THE CLERK: Anne Gemmell.

(Witness approached witness table.)

COUNCILMAN GREENLEE: Good afternoon. Please identify yourself. We have a copy of your testimony.

MS. GEMMELL: Okay. I'm going to get a little bit off the script, if it's okay, because I know some things have already been said.

COUNCILMAN GREENLEE: Right.

MS. GEMMELL: My name is Anne Gemmell. I'm the Political Director at Fight for Philly. Fight for Philly is a non-profit organization that's been organizing in Philadelphia's struggling neighborhoods since spring of 2011, and we work on things that generally beat the drum about Wall Street's culpability for the condition of our economy. So it's natural for us last January when we learned of the Pennsylvania Budget and Policy Center's paper to build a public campaign about it. So we've been taking action on that, as well as focused on corporate tax fairness during the state budget battles and advocating for things like an increase in the federal minimum wage for workers, along with other fight-for-fair-economy cities.

Locally, as I said, we started this campaign in January of 2011 and started talking to Council folks about it, and I want to thank Councilman Kenney for listening and showing the people that we've been organizing, that democracy does work, that when you learn about something and you have questions about it and you take it to your elected official, that they respond. And that we're able to have this public hearing I feel like is a huge victory and demonstrates to so many Philadelphians that may be dismayed by our process, dismayed by government generally that this is what democracy can look like when you engage. So I thank you for that.

Like so many other people have said already what swaps are, I don't -- I'm not a financial expert, but I'm not a dumb person either, and after 40 slides of two PowerPoints from the advisors that have built cottage industries on advising to purchase swaps and a City Treasurer that wasn't sure how they felt about it, I still don't understand the swaps any better. So I think that in itself is sort of self-evident, but I want to state it for the record, is that I've been listening. I've been trying to really listen, and I don't have a better understanding even after everything that's been said.

Some of the squiggly lines from the boxes and the bond insurance going here to there really reminded me of the inside job, which with the squiggly lines and boxes and taking insurance on this deal and taking insurance on that deal, that's what led to our mortgage crisis. That's exactly the kind of behaviors that crashed the economy in the first place.

Councilman Green, you asked a good question about bond insurance, did the losses to the bond insurance count. That's separate from the swaps. Well, sure, if you forget the whole forest of the problem, which is we bought insurance and it was meaningless. That's kind of the point that Fight for Philly is trying to make, is that we're dealing -- if everything was level and all the actors were transparent and everything was above board, sure, maybe swaps aren't so bad, but that's not the case. We know that's not the case. We have so much evidence that that's not how big banks behave, that it's hardly even news. People pick up the paper, another federal investigation, another settlement, Wells Fargo, predatory lending, $70 million settlement. It's not even news, barely even news anymore.

So we're dealing in a system that we don't understand, a system that's created which feels like it's created to prey upon regular people, from the checking account level where it's $7 fees suddenly one month and the next month you have to storm into a bank lobby and sit down to get banks to relinquish their checking account fees.

So the point is is that we should have a system where if you buy insurance, it means something. But we don't have that system, so that changes the evaluation of whether or not public money should be involved with swaps. Fight for Philly says no, that we don't think it should be involved in swaps.

So that's the thing. I think that we may not be smart enough to understand complicated derivatives. We still don't know who makes money on these deals. I can't find that out. I read this stuff all the time. Nobody is required to say how much money they make on these deals. I think that's a huge telling problem. But I do know the difference between scarce public dollars and plentiful private funds in the financial world. If you're a private hedge fund investor, go for it, get involved with swaps. But if you're a city like Philadelphia where a property taxpayer like me is looking at a 300 percent increase in her property tax values, as her local public school, highly successful, neighborhood public school, is being asked to reduce the number of per-pupil dollars every single year since the meltdown, this is difficult. This is difficult.

So, again, I want to thank Councilman and all the Councilpeople that came to this hearing and asked good questions. Thank you for listening and understanding what people see from the ground: Schools closing. Remember, Paul Vallas, pushed out of town for an $80 million deficit. It makes the conversation -- it makes that look silly, $80 million. Oh, what's that big deal? Now the District -- which where's the District? All we have is a PowerPoint for the District. We're looking at a $300 or $400 million deficit.

COUNCILMAN GREENLEE: Let me interrupt for a second. Just for the record, they were invited. I assume -- let me just ask the question. Is there anyone here from the School District?

(No response.)

COUNCILMAN GREENLEE: So for the record, they were invited. But please proceed.

MS. GEMMELL: I know they were invited, because their PowerPoint was on the table and they submitted testimony, but we also need public entities to be able to sit in a chair and answer questions.

So my point is again that if we can't understand it, public money shouldn't be involved in it, and Fight for Philly, we are going to continue. We want to work in coalition with innovative and creative ideas like the Public Banking Institute, which would have seemed like pie in the sky maybe a decade ago, but now I think we really need to evaluate those sorts of options. We're going to work in coalition with folks that are upset about school closings and keep reminding folks that how we got into this position in the first place was the banks, and once we recognize that and never forget it, it will be much easier for our champions in elected office to say, Look, banks, all the folks that want to underwrite airport bonds or underwrite any other, water, sewer -- all these water main breaks, how are we going to pay for that? Bonds. Who is going to underwrite that? The big banks that got us in this in the first place.

So we need to recognize that 2008 was a game changer for our swaps deals and the way we look at financial business moving forward. In a pre-crash environment, swaps were risky enough, but after the crash, large global banks, many of whom are under investigation for manipulating LIBOR, should reset the current swap deals to reflect the post-2008 historical shift in interest rates.

We have to be able to count on something, and they could help restore the faith in our financial system by resetting municipalities, districts. And this could be an act of Congress. You could call on it in the form of a resolution. That would be amazing.

Furthermore, large bailed-out banks should refund any swap cancellation fees collected since the crash in 2008.

When the Nutter Administration -- let me just say, there's no bad guys here that testified. I mean, the Nutter Administration has done everything to get our finances in better shape. The School District, the people who are there now, are probably looking back into the files and finding the same thing, Oh, we don't know. We don't know what happened. There's no record. It's probably the same problem.

There's no finger-pointing at this point, except above and beyond to Wall Street, but we still have to deal with them. And I think that we're in a moment politically where we can set the terms of those dealings a little bit more than we ever had in the past.

So to my point and concluding, barring good-faith renegotiations from large global banks, Philadelphia leaders, yourself included, Mayor Nutter, any future mayors, Philadelphia leaders need to protect all of our public funds, not only from derivative deals but also more generally from these banks that are too big to trust.

It's not hard to figure out. There are four major banks who have the vast majority of the derivative deals on their books. And I don't have evidence. I'm not a financial expert, but something tells me that we have another mortgage crisis on our hands with these derivatives. Nobody understands them. They're being labeled this way and that. How do we know they're not the next crash? We don't know. We don't know. And I don't see any evidence of big banks reforming themselves. I don't think Dodd-Franks is as effective as it could be, and their games continue on. It's in the headlines every day.

So in conclusion, we look forward to working with elected leaders, coalition partners, and we'll continue to work on this and explore and support folks that are willing to go out and talk about creative solutions for our financial needs and with the ultimate goal of protecting very scarce public dollars.

Thank you.

COUNCILMAN GREENLEE: Thank you very much.

(Applause.)

COUNCILMAN GREENLEE: Thank you for your testimony.

That concludes our witness list. As was pointed out today, there's a lot of things to discuss here, a lot of things to take in. It's a complicated matter. I'm sure there will be more going on here.

So to wit, this hearing of the Committee on Rules on Resolution 120147 is recessed to the call of the Chair.

Thank you.

(Committee on Rules recessed at 12:55 a.m.)

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CERTIFICATE

I HEREBY CERTIFY that the proceedings, evidence and objections are contained fully and accurately in the stenographic notes taken by me upon the foregoing matter on October 23, 2012, and that this is a true and correct transcript of same.

MICHELE L. MURPHY
RPR-Notary Public

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