# COMMENTS
# REGARDING GUIDELINES FOR
# INTEREST RATE AND FORWARD PURCHASE AGREEMENTS
# (the "Guidelines)

**Specific Comments about Derivative Financial Products**

I think the Guidelines effectively accomplish my thoughts relative to SWAPs and other derivative products. Except in very unusual cases, public entities should not speculate with public funds as many public entities have done since 1994. These products were used to lock-in long-term variable rate obligations and receive exceptionally high ongoing fees, especially the administrator's fee. One county in Tennessee had been programmed with about $200 million in variable rate obligations and about 7 swaps. The firms that provided these financial products/services were to receive between $15,000,000 and $20,000,000 including swap advisor fees over the life of the VRDO issues, remarketing fees, trustee fees, administrator's fees, and other fees plus the upfront payments. The swap termination payments this public entity had reached about $25 million in April. Another public agency providing hospital services in Tennessee had to pay over $19 million in swap termination payments plus $2,596,034 of upfront costs for refunding bonds.

**Actual Case Summary**

This case study is based on actual, recent experience.

For about ten years, this public entity (the "PE") had used a broker/dealer firm in Tennessee (the "Firm") providing financial advisory and underwriting services. Whenever the PE needed funding of capital improvements, it contracted in writing with this Firm to provided financial advisory services. Whenever the original bonds could be refinanced, the PE would hire the Firm to issue refunding bonds and serve the PE as underwriter, sometimes as financial advisor. This worked fine with the PE issuing obligations at reasonably low fixed rates. However, mid 1999, the PE decided on a school building program of approximately $30 million and contacted the Firm to issue some fixed interest rate bonds. The Firm developed a plan for issuing VRDO and presented it to the PE. The PE relied upon the Firm to do what was in the best interest of PE and entered into a 25 year VRDO with normal upfront costs plus about .53% ongoing, add-on fees until the final maturity. This ongoing fee was about $159,000 per year until the PE began to make principal payments. Then, the ongoing fee would begin to decline

When 911 occurred in New York in 2001, the PE decided to avoid the risks associated with the VRDO and would issue fixed interest rate bonds. Again the Firm came with a plan for the PE to enter into swap agreement to receive a variable (floating) rate payment and to pay fixed rate. The Firm presented the swap showing a fixed interest rate of 4.75%, and there would be no cost to the PE like issuing fixed interest rate bonds. Upon questioning the Firm, the Firm stated that the rate would not exceed 4.75%. The PE entered into the swap assuming the Firm was representing the PE's best interest and at no cost to the PE. The bond insurance for the VRDO issue was Ambac Assurance Corp.; the swap provider was Ambac Financial Services LLP ("AFSLLP"); and insurance for both the PE and AFSLLP for swap payments was Ambac Assurance Corp. It was later determined that the Firm did receive payment from Ambac, but this was not disclosed at time the swap was entered into by the PE.

The PE, VRDO, and swap worked fine until the financial crisis of 2008. Ambac Financial Group. Inc. (Holding Company) credit rating has been downgraded to non-investment grade by Moody's and A by S & P. The VRDO bonds are no longer investment grade for money market funds or other bond funds. The VRDO are now trading at prime with a possibility of the standby bond purchase agreement being terminated forcing an acceleration of principal payments and the interest rate being increased to prime plus 4% or 7.25%. At the present time the PE is paying prime of 3.25% plus .53% add-on cost plus the swap fixed rate of 4.22% less the floating rate portion of the swat at 1.87% for a total 6.13% effective rate with the possibility of the rate increasing to over 10%. This would more than double the 4.75% fixed rate that the Firm sold the PE.

The PE can replace the VRDO with fixed rate bonds, but there is no way to terminate the swap based on the swap contract according to most authorities without paying over $2,500,000. Remember the hospital paid over $19,000,000 to terminate its swaps.

**Major Financial Catastrophes**

Historically, Jefferson County, Alabama is probably the worse financial catastrophe to occur in America. It issued $3 billion plus in variable rate debt including auction rate obligations, and entered into swaps exceeding $5 billion plus. The present status of the County involves bankruptcy court and a very difficult financial future.

Orange County California is another public entity that entered into risky investments at the encouragement of Wall Street firms.

In Tennessee, we witnessed a financial crisis with two public entities involving repurchase investment agreements and lost nearly $10 million.

Hopefully, there will not be a Tennessee public entity to encounter a major financial crisis, but it is possible with all the swaps and VRDOs that public entities have issued since 2000.

## ***Why would a public entity enter into this risky agreement?***

Public entities have traditionally dealt with firms serving as financial advisor or underwriter. The VRDOs introduced remarketing agents, liquidity providers, corporate trustees, and administrators without an explanation, no engagement agreements, no disclosure of upfront and ongoing costs and no clear description of services or role of each party. There is no clear fiduciary duty to the PE; no transparency of full and complete disclosure; and the role of service provider is not described or clear to the PE. The PE was relying on the traditional financial advisor firm that had conflicts of goals --- income, profits, and the number of bond issues.

The PEs received traditional financial advisor that provided charts, statistics and other information about other users, but risk factors were lightly reviewed, if at all. Historical facts and options that PE should consider were rarely presented. Contracts providing for options were very limited. The PE officials never studied the contracts/agreements nor did most local counsel serving the PE. The variable interest rate markets have been very favorable to PEs, since 2001.

### *What went wrong with the many VRDO transactions?*

The PEs did not carefully study the facts and options available in these VRDO transactions. They assumed the financial advisor was performing the traditional fiduciary duty of performing in the best interest of PE. PEs also thought the financial markets would continue as they had before 2008; bond insurance companies would continue with AAA/Aaa ratings, there would always be liquidity providers; and remarketing agents at the low fees without ever increasing. Murphy's law in WWII established the basic principle that whatever can go wrong will go wrong at the most critical time.

Now there are few liquidity providers and at very high rates. Triple A bond insurance firms are gone with the exception of one firm with a AAA by S & P. Now, investors are skeptical of purchasing investments relying only on bond insurance. Obligations issued by PEs with credit ratings of below AA/Aa are not as easy to market in the current transition financial markets. As a result of these changes, VRDOs are trading a prime or prime plus.

### *Why did PEs enter into swap agreements?*

Again, the PE was relying on the traditional financial advisor to serve the PE in a fiduciary role. The Firm would make convincing presentations; discuss how the PE could enter into a fixed rate issue without any costs. All the PE had to do was sign the agreements that no one understood or read. Just sign on the dotted line and great things will happen to the PE. The financial advisor did not considered the suitability of the PE to manage risks and monitor markets with an exit plan if necessary. Were there savings from VRDOs? Yes, until 2008 and 2009. Now, most PEs are replacing the VRDOs with some form of fixed rate obligations --- short-term or long-term. If it is short-term, the goal is to issue new VRDOs in the near future. Whatever the future holds, the PE should study the facts and options to improve upon any future program of capital financing or refinancing.

### *What should public officials do in the future to avoid or reduce problems related to various financial products?*

Most public officials have not had the opportunity, the training, or the experience with the most basic business tool --- the contract or agreement (the "Contract"). The Contract rules the business world, and the one that writes the Contract becomes the ruler. The Contract is the summation of studying the facts, options and having a plan. The swap is a good example of public officials not understanding the International Swap Dealers Association (ISDA) multiple agreements, the available options, and the method of exiting the Contract. This is a contractual document prepared by the Swap Dealers Association and for the Swap Dealers. Almost 100% of the risks associated with swaps have been transferred to the PE. In a variable to fixed rate swap, the Swap Dealer never invest one ($1) dollar in the swap; the risk are shifted to the PE and the likelihood that the Swap Dealer will ever pay one dime is practically zero. However, the PE is going to pay millions of dollars to swap provider that pay the swap advisor a fee. At the time the PE enters into a variable to fixed rate swap, the PE could have entered into a fixed rate obligation at about the same cost and at a locked-in fixed rate to final maturity at about the same swap fixed rate plus the add-ons of the VRDO. If public officials were required to read the ISDA agreements before any resolution is passed, it is doubtful any PE would enter into a swap.

# Recommendations

1. **Role of the Financial Service Provider.** Any person, firm, or organization providing financial services for a fee to be paid by the public entity, another firm or organization shall be by a contractual agreement of all parties and with a description of services to be provided, itemized list of costs associated with the services and any compensation to be received by the provider, firm consultant or any other related party or firm. Any fee, compensation, reward, or benefit to be received by the financial service providers if not completely disclose shall be subject to reimbursing the PE double the undisclosed compensation.
2. **Licensed or Certified Financial Service Provider to Public Entities.** Any person, firm or organization providing financial services to public entities must be licensed by a nationally recognized license provider --- the SEC, MSRB, FINRA, or be certified by the State of Tennessee Commerce and Insurance Department resulting from successfully passing a test as developed by the Comptroller of the Treasury.
3. **Documents and Contracts to be Signed.** Before any public official signs any documents or contracts, the legislative body of the PE must authorize and designate the public official to study, seek legal advice, or any specialized consultant to review and recommend the signing of the documents and contracts. Before any resolution is approved to enter into a variable rate obligation or derivative financial product, the documents and contracts in near final form shall be provided to the chief executive officer, the chief financial officer, and the legal council hired by the PE. Copies of the contracts and documents shall be electronically sent to the Division of Local Finance. Before the State Division of Local Finance approves a variable rate obligation or derivative financial product, a representative of the Division of Local Finance shall conduct a telephone interview with the PE's chief executive officer, chief financial officer and legal counsel to determine the understanding of the contracts and documents to be signed. (Similar to Moody's and S & P's interview.) If PE's staff fail to demonstrate a level of understanding of the documents, the Division of Local Finance shall postpone the approval until the PE officials understand the documents.

**Some basic observation of the Guidelines**

There are some words through out Guidelines that I would propose to changes as follows:

1. "Level of sophistication" to level of knowledge or experience or training.
2. "Synthetic fixed rate". According to the dictionary, "Synthetic" means artificial, fake, mock, copied, unreal, imitation, man-made, sham, bogus, and phony. Most public officials were lead to believe by the swap marketing agent that the public entity would be locking a fixed rate. Even the audits prepared by the County Audit Division stated that swap formed a fixed rate. **There are too many moving parts of the transaction and risks associated with the floating rates of the VRDO and swap to even consider the rate being a fixed rate. The rate is either fixed or it is NOT a fixed rate. In this case it is not a fixed rate.** A public entity in Tennessee thought they had locked in a fixed rate of 4.21% plus the add-ons of .54% making a fixed rate making a total fixed rate of 4.75%. Since January 2009, the fixed rate has increased to 7.13%. Now, if it was

a fixed rate why did increase to 7.13%. **The point is very clear; there is no fixed rate call if it is synthetic.**

3. "Enforceable". Who has the power to enforce policies of public entities?
4. There are others, but time ran out.