

## Legislation Text

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**File #:** 120147, **Version:** 0

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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.

WHEREAS, Qualified interest rate management agreements, also known as interest rate “swaps,” belong to the class of financial instruments known as derivatives. The use of swap agreements in public financial management was encouraged by the federal Commodity Futures Modernization Act of 2000, and authorized by the Pennsylvania Legislature in Act 23 for use by local government units in 2003; and

WHEREAS, Swaps are complex financial transactions used to hedge against the risk posed by fluctuating interest rates. In the most common form of a swap, two parties exchange one stream of variable interest payments for a stream of fixed interest payments. The party agreeing to make fixed interest payments seeks to avoid the risk of future increases in the variable interest rate that it would otherwise have to pay; and

WHEREAS, In such a transaction, a municipality (or other local government unit) that had to make variable interest rate payments on an outstanding bond would exchange ("swap") that obligation for an obligation to make fixed interest rate payments to a banking institution. In return, the bank would agree to make periodic payments that would rise (or fall) according to a benchmark interest rate such as LIBOR (the interest rate that high-credit quality banks charge one another for short-term financing). If the swap worked as intended, the payments due on the outstanding bond would be covered even if interest rates rose, and the municipality's only cost would be the fixed rate it paid to the bank; and

WHEREAS, In 2008, the worst financial crisis since the Great Depression triggered the Federal Reserve Bank to continually lower interest rates to near zero. The stream of payments exchanged by the parties engaged in swap agreements no longer approximated each other. As a result, municipalities and school districts faced the requirement of making significant payments to maintain or terminate the swap agreements; and

WHEREAS, In 2009, the Auditor General of Pennsylvania published a special investigation of the use of swaps by the Bethlehem Area School District, which had incurred significant financial losses after entering into at least thirteen swaps between 2003 and 2009. The Auditor General's report went beyond the Bethlehem experience to consider the impact of swaps throughout the Commonwealth; and

WHEREAS, The investigation reported that 107 school districts and 86 local governments in Pennsylvania had entered into 626 swaps between October 2003 and June 2009, involving \$14.9 billion in public debt. As a result of the enormous sums of public money at risk and the subsequent losses incurred, the Auditor General has urged the General Assembly to repeal Act 23 and is advising local governments units to discontinue their use of swaps and terminate their active agreements. To protect themselves from such risk in the future, local government units are implored to hire financial advisors using a competitive selection process, and periodically evaluate the quality, cost, and independence of the services provided; and

WHEREAS, Focusing on Philadelphia, the Pennsylvania Budget and Policy Center ("PennBPC") recently published a report evaluating swaps entered into by the City and Philadelphia School District. The report explained that, at a time when there was a real possibility that interest rates could have increased, the City of Philadelphia entered into swap agreements with respect to outstanding general obligation, lease, airport and water bonds that had been issued to fund various capital projects, and the School District issued ten fixed-to-variable rate swaps; and

WHEREAS, When interest rates dropped precipitously in 2008, however, what started out as approximately equal swap payments became completely imbalanced, with the City and School District paying out far more than it received from the participating banks. The School District has since cancelled nine of the swap agreements, and has paid its financial lenders millions of dollars in the form of commissions, fixed interest yields from the swaps, and termination fees; and

WHEREAS, Interest rate swaps are by nature complex and involve financial risk, but the level of transparency and the quality of the advice furnished to the City by its financial institutions is unclear. The questionable business practices of many of these same institutions effected the unstable economic conditions that caused the City and School District of Philadelphia to sustain significant financial losses. Meanwhile, the PennBPC report asserts that all but one of the financial institutions that engaged in swaps with the City and School District received more than \$160 billion in "bailout" funds through the federal government's Troubled Asset Relief Program ("TARP"); and

WHEREAS, The current Administration has not entered into swap agreements, but officials are urged to re-examine the City's active swap agreements and to evaluate the future use of swap agreements as viable instruments of financial investment; now, therefore, be it

RESOLVED, BY THE COUNCIL OF THE CITY OF PHILADELPHIA, That the Committee on Rules is hereby authorized 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 swap agreements; and, be it

FURTHER RESOLVED, That in furtherance of such investigation, the Committee is hereby authorized to issue subpoenas as may be necessary or appropriate to compel the attendance of witnesses and the production of documents to the full extent authorized under Section 2-401 of The Philadelphia Home Rule Charter.