THE BANKS That Fleeced ALABAMA

Schools in Jefferson County, Alabama, are so underfunded that some can't afford soap, towels and toilet paper. Parents and other taxpayers blame the $160 million in fees JPMorgan Chase and other banks have charged to arrange the county's financing—in deals that were never put out to bid.

By Martin Z. Braun, Darrell Preston and Liz Willen

As school was about to begin last year in Birmingham, Alabama, Ted Garner went to Wal-Mart to buy the toilet paper, soap and paper towels his three children were asked to bring to class because their schools couldn't afford them. "It's really sad," says Garner, 45, a steelworker who belongs to parent and teacher associations for his children and other relatives in Alabama's largest city. Glenn Middle School, which his 14-year-old daughter, Labresha, attends, went through half of the year without a full-time math teacher.

Garner and his neighbors say they know who's to blame: the politicians who let the bankers, lawyers and consultants charge Jefferson County at least $160 million for refinancing $3 billion of debt for a new sewer system. The money paid to the deal makers is so exorbitant that the U.S. Securities and Exchange Commission and the Internal Revenue Service now are investigating the borrowing spree.

In the $2 trillion municipal bond market, where taxpayers rarely have any idea whether they got the least expensive financing for everything from buses to road work, Jefferson County is an example of what can go wrong for borrowers across the U.S. who avoid competitive bidding. Today, eight of 10 bond sales by states, cities and counties are done without bidding. Jefferson County officials made exclusive arrangements with a handful of Wall Street firms led by JPMorgan Chase & Co. Jefferson County's municipal bond offerings, like those of many local governments, include derivatives—complicated, unregulated and occasionally disastrous financial contracts whose values vary with the price of underlying securities or indexes.

"It's unbelievable to me that we have done this amount of financing without the public forcing us to go to competitive bidding, or at least competitive pricing," says Bettye Fine Collins, 69, a Republican and one of five Jefferson County commissioners. "These people come in, and they have no fiduciary relationship to this government. They're working for their particular banks or investment brokerages, not for the people of Jefferson County."

The man who masterminded Jefferson County's sophisticated borrowings, former JPMorgan Chase Managing

PHOTOGRAPH BY OWEN STAYNER

Ted Garner and his daughter, **Labresha,** have to buy toilet paper and soap to bring to school. Garner is one of many Jefferson County residents who say cozy deals between politicians and bankers hurt their families.

Director Charles LeCroy, 50, is in jail. He was sentenced to three months in prison and fined $50,000 on June 8 after pleading guilty to federal fraud charges in a municipal finance corruption scandal in Philadelphia.

Jefferson County, which has authority under state law to fund schools at its discretion, has paid a rich price for not seeking public bids for its financing. JPMorgan, the second-largest U.S. bank by assets, charged the county fees that are almost two times—or $45 million—higher than what banks normally collect in derivative transactions of this size, according to data compiled by Bloomberg. The county's other banks in the derivatives contracts are New York–based Bear Stearns Cos.; Charlotte, North Carolina–based Bank of America Corp.; and New York–based Lehman Brothers Holdings Inc. Jefferson County chose JPMorgan to arrange the derivatives deals and manage $3.36 billion in new sewer bond sales and refinancing without competitive bidding.

Not once in the past decade has the county invited competitive bids for financing. That's a trend that's become increasingly common across the country. States, counties and cities routinely ask multiple suppliers to vie for the right to sell police cars, computers and ambulances; they don't do that with public finance. Of the $360 billion in debt sold by U.S. municipalities in 2004, 81 percent was arranged without competitive bidding. That's a 27 percent increase from 1974, according to data from Bloomberg and Thomson Financial.

In these noncompetitive financings, which are known as negotiated deals, a municipality talks privately with a bank about public financing and negotiates an interest rate and price with the bank. In a competitive deal, the issuer posts a public notice asking banks to put in bids and awards bond work to the bidder who offers the lowest costs.

Robert Brooks, the SouthTrust professor of financial management at the University of Alabama, in Tuscaloosa, who has examined Jefferson County financing, says officials who strike secret deals with banks are vulnerable to being overcharged. "It's like the lion telling the rabbit that he'll take good care of him in the jungle," says Brooks, 44, co-author of *Interest Rate Risk Management: The Banker's Guide to Using Futures, Options, Swaps and Other Derivative Instruments* (Probus Publishing, 1993). "How big of a commission does Wall Street want? Well, unfortunately, sometimes I think the answer is, as big as they possibly can get away with."

Jefferson County's bankers have been pulling in fees at a time when local citizens are hurting. Annual home sewer bills have tripled to $665 from $182 in 1997, according to Moody's Investors Service. "The most egregious case I saw was an 85-year-old woman who flushed her toilet only every other day," says Scott Douglas, executive director of Greater Birmingham Ministries, a social services group assisting more than a dozen religions. Water rates for another woman, Helen Rivas, a Birmingham grandmother of five, have increased to $480 a year from $120 two years ago. "The bankers and the politicians are doing great, but the rest of us are picking up the tab for their mistakes," she says.

In 2002 and '03, JPMorgan Chase refinanced $2.1 billion of Jefferson County's debt using derivatives known as interest rate swaps. In these contracts—a part of the $248 trillion global derivatives market—the county agreed to pay a fixed interest rate to its banks, and the banks agreed to pay the county a variable rate that changes according to a formula defined in the contract. If the swaps work as designed, Jefferson County will pay relatively low interest rates on its debt for the next four decades. County Commission President Larry Langford says the swaps will save the county $214 million in interest charges.

Jefferson County Commission President **Larry Langford** says that even if he overpaid banks, the refinancing will save money for the public.

PHILIP BARR/THE BIRMINGHAM NEWS

Municipal interest rate swaps do backfire. In May, New Jersey spent $123 million to extricate itself from a swap contract that locked the state into paying above-market interest rates. In the first half of 2005, the New York Metropolitan Transportation Authority paid a total of $39 million to end swap contracts designed to lock in a specific rate as benchmark yields fell even lower. In February, Shelby County, Tennessee, spent $9 million to terminate two swap agreements for the same reason.

The most famous blowup involving municipal derivatives happened in 1994 in Orange County, California. The county, home to Disneyland and a population of 3 million, with a per capita income more than twice the national average, lost $1.6 billion and declared bankruptcy after its investments tied to derivatives turned toxic when interest rates rose. Bond rating companies gave little indication that Orange County

was poised for disaster. Until the day the county filed for Chapter 11 protection, New York–based Standard & Poor's rated its debt AA–, the fourth-best rating.

"Municipal derivatives are an opaque market," Brooks says. "It's very hard for places like Jefferson County to know if they're getting a clean bid."

In September, the SEC asked Jefferson County officials to hand over records relating to about $4 billion in swaps on the sewer debt from 2002 through 2004, says Langford, a Democrat. The commission is cooperating with the probe, he says. "I don't know what they're looking at," he says.

SEC spokesman John Heine declined to comment.

The construction of a new sewer system has already been hit by indictments unrelated to the bonds and swaps. Former County Commissioner Chris McNair, 79, was indicted July 14 on charges he took $350,000 in bribes from a sewer contractor; he pleaded not guilty. McNair is the father of Denise McNair, one of the four girls killed in the 1963 bombing of Birmingham's Sixteenth Street Baptist Church. Five other county officials supervising the project have been indicted for taking bribes during construction.

Former JPMorgan banker **Charles LeCroy**

The IRS probe into Jefferson County's sewer financing is focused on whether the county has complied with federal tax laws that require states and cities to pay to the federal government interest earned by investing the proceeds of municipal bonds in higher-yielding taxable securities, according to a letter the IRS sent the county on Oct. 21, 2004.

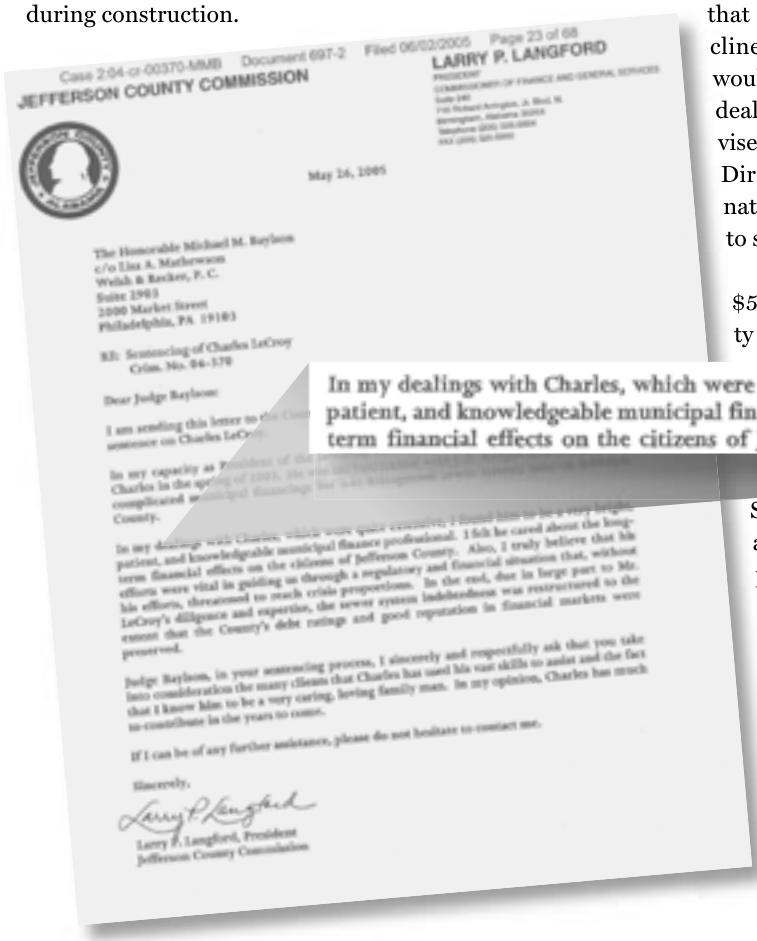
Charles Anderson, 54, a Baltimore-based manager of field operations for the IRS's tax-exempt-bond office, says a municipal swap fee "very often is a subterfuge" for extra fees paid to banks or a diversion of money improperly paid to public officials. Bond sales are regulated by the SEC; swap deals aren't. "A swap can be a very elegant disguise for nothing more than a kickback," Anderson says. "You basically have one regulated payment and one unregulated payment. That's the problem. If you transfer the dollars to the unregulated payment and have a secret deal on the regulated payment, then you're kind of bypassing the whole regulatory scheme." He declined to discuss the IRS investigation in Jefferson County specifically.

Jefferson County's derivatives may cost more money than anyone anticipated because interest rates did the one thing that JPMorgan's LeCroy said they wouldn't do: They declined. Because interest rates have dropped, the county would have to pay its banks $298 million if all of the swap deals were ended now, according to the county's swap adviser, based on data compiled on July 1. County Finance Director Steve Sayler says he has no intention of terminating the deals. Sayler, 55, says he still expects the swaps to save the county money.

Jefferson County, with a population of 660,000, has $5.8 billion in swaps on its books—the most of any county in the U.S. and about $1 billion less than New York State, the largest user of municipal swaps in the U.S., according to Bloomberg data. At least 27 states have public agencies using derivative contracts, according to Standard & Poor's.

LeCroy, the banker who suggested the bond and swaps to Jefferson County, was fired last year by JPMorgan Chase when he was indicted in the federal corruption case in Philadelphia. He began arranging public finance for Jefferson County in 1997 while working for St. Petersburg, Florida–based Raymond James & Associates.

The commission chose LeCroy to arrange its financing because it had confidence in the banker's



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JEFFERSON COUNTY COMMISSION

LARRY P. LANGFORD

May 16, 1995

The Honorable Michael M. Baylson
c/o Lisa A. Matheweon
Welsh & Recker, P. C.
Suite 1903
2000 Market Street
Philadelphia, PA 19103

RE: Sentencing of Charles LeCroy
Crim. No. 94-170

Dear Judge Baylson:

I am sending this letter to the Court in anticipation of the sentencing on Charles LeCroy.

In my capacity as President of the Jefferson County Commission, I have known Charles in the spring of 1995. He was [illegible] complicated municipal financings for our Management [illegible] County.

In my dealings with Charles, which were quite extensive, I found him to be a very bright, patient, and knowledgeable municipal finance professional. I felt he cared about the long-term financial effects on the citizens of Jefferson County. Also, I truly believe that his efforts were vital in guiding us through a regulatory and financial situation that, without his efforts, threatened to reach crisis proportions. In the end, due in large part to Mr. LeCroy's diligence and expertise, the sewer system indebtedness was restructured to the extent that the County's debt ratings and good reputation in financial markets were preserved.

Judge Baylson, in your sentencing process, I sincerely and respectfully ask that you take into consideration the many clients that Charles has used his vast skills to assist and the fact that I know him to be a very caring, loving family man. In my opinion, Charles has much to contribute in the years to come.

If I can be of any further assistance, please do not hesitate to contact me.

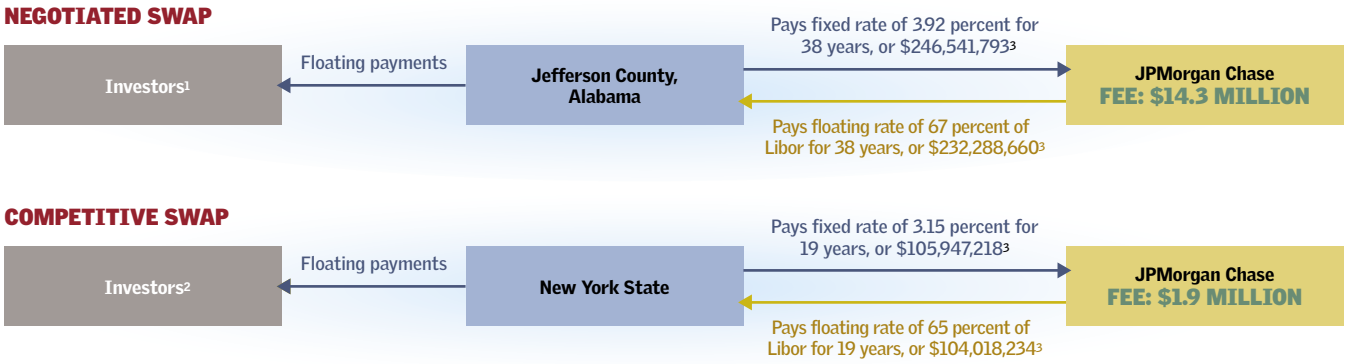
Sincerely,

Larry P. Langford, President
Jefferson County Commission

In my dealings with Charles, which were quite extensive, I found him to be a very bright, patient, and knowledgeable municipal finance professional. I felt he cared about the long-term financial effects on the citizens of Jefferson County.

BRADLEY BOWER/AP-WORLD WIDE

Fee gap Jefferson County, Alabama, negotiated an interest rate swap with JPMorgan Chase on a $539.5 million portion of the county's bonds issued in October 2002. The county's payments include $14.3 million in fees. In a separate deal, New York State's Local Government Assistance Corp. took bids on a swap for its February 2003 bond sale. JPMorgan Chase won $311.7 million of a $1 billion swap, accepting a fixed rate of 3.15 percent. The payments to the bank include $1.9 million in fees.



[1]In $839.5 million of floating-rate bonds, rated "Baa1" by Moody's Investors Service, issued in October 2002 and due in 2040. [2]In $1 billion of variable-rate bonds, rated "AA" by Standard & Poor's, issued in February 2003 and due in 2022. [3]Figures equal the present value of future cash flows on the underlying $539.5 million and $311.7 million in bonds, respectively, according to an analysis by Bloomberg. Libor = 1-month London interbank offered rate. Source: Bloomberg

ability and knowledge, Langford says. Langford, 57, wrote a letter on May 26 to U.S. District Court Judge Michael Baylson in Philadelphia after LeCroy pleaded guilty, asking for leniency in his sentencing. "I found him to be a very bright, patient and knowledgeable municipal finance professional," Langford wrote. "I felt he cared about the long-term financial effects on the citizens of Jefferson County."

Randy Wilhelm, a Birmingham-based consultant to Bank of America on two of the Jefferson County swap contracts, says no one in the county actually understood the pricing of the deals LeCroy and other bankers sold to the commission. "On the deals the Wall Street firms cook up, I don't know that there's anyone around here that could pick those apart and say, 'Hey, there's a problem with this deal,'" Wilhelm, 57, says. "In the land of the blind, the one-eyed guy is king. Charles LeCroy knew a lot about it, and there wasn't any scrutiny that anybody around here could give because they didn't have the level of knowledge that he had."

Jefferson County, 966 miles (1,555 kilometers) from Wall Street, is a tree-canopied area that sits on the southern reaches of the Appalachian Mountains in north-central Alabama. A 56-foot-tall cast iron statue of Vulcan, the Roman god of metalworking, stands at the top of a hill in Birmingham, a symbol of the city's past as an iron and steel center. Birmingham, which has a population of 242,000, has made headlines for more than a year as 15 executives of locally based HealthSouth Corp., the largest U.S. manager of rehabilitation hospitals, pleaded guilty to directing a $2.7 billion accounting fraud. The company's founder, Richard Scrushy, was acquitted of fraud on June 28.

Jefferson County's schools, like those throughout the state, are chronically underfunded, says Nez Calhoun, a spokeswoman for the county's schools, which are divided into 12 districts. Alabama ranks 43rd in the U.S. on spending per pupil; on average, the state spends $6,755 a year per student, according to a 2005 report by *Education Week*, a national education newspaper. Birmingham's school district anticipates funding cuts of $13 million—4.5 percent of its budget—in the year beginning in October 2006. Birmingham's student population of 32,142 has dwindled from about 50,000 in 1995 as families have moved out of the district or put their children in private schools.

Jefferson County has one example of scholastic excellence: The International Baccalaureate School in Birmingham was named the top public high school in the U.S. by *Newsweek* magazine in June. The 325-student school succeeds amid the county's financial constraints because it accepts only students with high standardized test scores who have to submit an essay and pass an interview before they're admitted, says Linda Jones, school administrator. In addition, parents donate to the school to ensure that courses aren't dropped because of budget cuts, she says.

Langford, who has been in office since Jan. 1, 2003, is a former television reporter who became familiar with noncompetitive public finance a decade ago as mayor of Fairfield, Alabama, a city of 12,000 people. Langford is best known as the founder of VisionLand, an amusement park funded from 1996 to '99 with $90 million in negotiated bond sales by Montgomery-based Blount, Parrish & Co. The bonds had lost 60 percent of their value by December 2000. The park filed for bankruptcy in 2002 and was sold for $5 million, according to public records. VisionLand includes a brick bas-relief monument—paid for by taxpayers—of Langford with his arms resting on the shoulders of two children.

The need for Jefferson County's sewer financing began in 1993, when three citizens filed a lawsuit against the commission, alleging that during heavy rain, untreated sewage was being discharged from county treatment plants into the Black Warrior and Cahaba rivers in violation of the federal Clean Water Act.

The U.S. Environmental Protection Agency joined the taxpayers who filed the complaint in 1994, and a year later, the U.S. District Court for the Northern District of Alabama

in Birmingham found in their favor. In December 1996, the court ordered Jefferson County to set up a countywide sewer system for collecting overflows and cleaning the water. In 1997, the county began selling bonds to raise money for building the system. Most of the bond sales, all done without competitive bidding, were arranged by LeCroy, who was then at Raymond James.

LeCroy, who is married and has four children, grew up with an alcoholic father who left when LeCroy was a boy, according to a letter his mother wrote to the judge in his Philadelphia trial. Raised by his mother and grandparents, who were officers in the Salvation Army, LeCroy was the first in his family to graduate from college. He earned a master's degree in public administration from Florida State University in Tallahassee in 1976.

County Commissioner Gary White says LeCroy was "reserved and polite" in casual conversation. White, 58, a Republican, says the banker impressed the commission with his grasp of municipal finance. "When it came time to sit down and talk about a deal, he was like a bulldog," White says. "You got the feeling there wasn't anyone else in the world who could do what he was doing."

LeCroy, who lives in Winter Park, Florida, was the top revenue generator in public finance at JPMorgan in each of his five years at the firm, between 1999 and 2004, according to a June 2 sentencing memorandum written by his lawyer, Lisa Mathewson of Welsh & Recker PC in Philadelphia. He delivered "tens of millions of dollars in revenue for the firm," she wrote. LeCroy made $4.2 million in two years, according to the memo. LeCroy and Mathewson declined to comment for this story.

The banker's guilty plea followed a three-year Federal Bureau of Investigation probe of corruption in Philadelphia, after Mayor John Street, 60, a Democrat, said in speeches in 1999 that he intended to direct city contracts to his political supporters. The probe led to the indictment of 12 people for fraud. Ten individuals, including LeCroy and another JPMorgan Chase banker, Anthony Snell, 45, pleaded guilty or were convicted. Street and JPMorgan weren't charged with any crime.

LeCroy's Philadelphia guilty plea has an Alabama connection. The banker admitted to filing false invoices that said a bond attorney who had raised campaign contributions for Mayor Street was paid a $50,000 fee for his work in 2003 on a $121.5 million school bond sale in Mobile, Alabama. The lawyer, Ron White, was indicted for taking $50,000 while doing no work on that deal. White died of cancer in November.

White's girlfriend, Janice Knight, received LeCroy's help with finding work in Jefferson County. According to county records, Knight's Philadelphia-based company RPC Unlimited Inc. was paid $5,442 for printing the county's October 2002 bond offering statement. Knight was convicted in the Philadelphia corruption trial for lying to the FBI. She declined to comment. Jefferson County Finance Director Sayler says he didn't select RPC to print the offering statement and referred questions to JPMorgan Chase. Bank spokesman Michael Dorfsman declined to answer questions about the printing contract.

With LeCroy as its main banker, Jefferson County paid for a series of financial obligations that included fixed-rate bonds, variable-rate bonds and the refinancing of earlier debt. In 1997 and again from 2001 to '04, LeCroy also sold the county derivatives contracts that were supposed to lower its overall interest payments. From 1997 to '99, while LeCroy worked at Raymond James, the bank sold $1.5 billion in county sewer bonds.

When LeCroy left Raymond James and went to JPMorgan Chase, the county's debt work went with him. From March 2002 through August '03, JPMorgan sold $3.36 billion in sewer bonds and debt refinancing for the county.

As early as June 24, 1998, Commissioner Collins, a grandmother and a delegate to the last five Republican presidential conventions, wrote a memo criticizing the bond sales without public bidding. "Today, the commission voted to enter into a private, negotiated transaction undertaken without competitive bids or proposals for approximately $300 million in securities with Raymond James & Associates," Collins wrote. "I voted against this financing because I have many questions about the merits of the proposal and because I strongly disagree with the procedures being followed."

'It's unbelievable to me that we have done this amount of financing without the public forcing us to go to competitive bidding,' Jefferson County Commissioner Bettye Fine Collins says.

Collins says no one on the commission ever responded to the memo. In the seven years since then, the commission has sold all of its bonds without competitive bidding.

One example of the multiple layers of financings JPMorgan Chase sold Jefferson County began in September 2002. JPMorgan led a group of 12 banks in the sale of $540 million of fixed-rate bonds that were priced with a top yield of 4.95 percent. JPMorgan earned about $1.6 million in fees, according to Jefferson County. Seven months later, the bank sold $1.04 billion in 39-year bonds, refinancing almost 40 percent of the bonds sold in September and other sewer debt sold in 1997, '99 and 2001. The interest rate on the 39-year bonds was set to go up or down based on an index maintained by the Bond Market Association, a New York–based group that represents Wall Street bankers.

LeCroy told the commissioners they could protect themselves against higher interest rates on the variable-rate bonds by buying swap contracts, Commissioner White says. In March 2003, Jefferson County bought a swap contract from JPMorgan Chase, paying a fixed rate of 3.678 percent on $1.04 billion. In return, JPMorgan agreed to pay Jefferson County a rate based on the Bond Market Association Municipal Swap Index through May 1, 2004. After May 2004 and for the last 38 years of the 39-year contract, JPMorgan agreed to pay 33 percent below the London interbank offered rate, the interest

rate banks charge each other on short-term money. In other words, if Libor were 3 percent, the bank would pay the county a rate of 2 percent. JPMorgan made $4.6 million selling the bonds and $20 million in fees on the swaps, according to Bloomberg data.

Three swap contracts Jefferson County bought on one day—Oct. 23, 2002—were money losers from the start. The market value of the derivatives on that day showed a $22 million loss on paper. The terms of the swaps show that Jefferson County would have to pay $383,728,268 over the contracted 38-year period. In return, the banks would pay the county $361,552,581 in the same period. The county pays the bank at a fixed interest rate of 3.92 percent; the banks' payment to the county is based on a rate that is 33 percent below Libor. A swap contract doesn't list the bank's fee, known as a premium. The banks assess a fee by adding basis points to the fixed interest rate the county has to pay, much the way a grocer marks up the wholesale price of a carton of milk when selling to shoppers. (A basis point is 0.01 percentage point.) In the Oct. 23 swaps, the fixed rate of 3.92 percent includes a markup of 19 basis points, Bloomberg data show.

Bill Slaughter, the county commission's bond counsel, says he isn't able to figure out the math on the $5.8 billion in swaps. "Neither I nor anybody in the Jefferson County commission—or for that matter, I'm not even sure that the JPMorgan people that we deal with—really understand how swaps are priced in the global financial market," Slaughter, 66, says.

Jefferson County Commissioner **Bettye Fine Collins** protested no-bid bond work beginning in 1998.

OWEN STAYNER

In many transactions, including swap contracts, a borrower hires a financial adviser to analyze prices, fees and interest rates to determine whether a contract is fair. Sayler, the Jefferson County finance director, says the county's fairness opinions leave him satisfied and comfortable with the pricing of the swaps. "All I have is the fairness opinions from the swap advisers that we have a good transaction," Sayler says.

Those fairness opinions by the county's swap adviser, CDR Financial Products Inc., of Beverly Hills, California, lack mathematical calculations and don't include any independent research. The opinions, available at the county courthouse, provide the terms of the county's financing, information that was attributed to the banks. The fairness opinions don't say the county will pay $100 million in fees or otherwise mention fees. The two-page memos don't say whether the county was paying a fair price for the deals. Sayler says the advisers—whose fees come from the public purse—didn't give him their working papers. "Their 'work product' implies that it belongs to them, and they do not give me those details," he says.

Jefferson County pays its advisers based on the size of a transaction; the larger the deal, the higher the fee. The county has paid CDR $1.8 million in fees since 2003. Morgan Keegan & Co., based in Memphis, Tennessee, was paid $1.3 million for advising on one deal comprising three swaps, in October 2002. Morgan Keegan didn't provide a written fairness opinion on that deal, Sayler says. Jason Rando of the New York–based public relations company Ruth Group, speaking for Morgan Keegan, says, "Morgan Keegan was not asked to give a fairness opinion. Our firm's fee for serving as swap adviser was fully disclosed and approved by the Jefferson County Commission." Rando says that the swaps were awarded to three banks, through a "competitive process." He didn't elaborate.

Most of the $100 million in fees Jefferson County agreed to pay for interest rate swaps are going to three banks: $57 million to JPMorgan Chase, $16.3 million to Bear Stearns and $13.4 million to Bank of America. The county paid about $60 million more in fees for refinancing sewer bonds, including $6 million in fees to politically connected consultants and advisers, including William Blount, a former chairman of the Alabama Democratic Party.

The fees Jefferson County owes its bankers are similar to the percentage points of a loan's principal that homeowners pay to a bank when they get a mortgage. The swap fees, like the mortgage points, are added into the cost of the loan and amortized over its entire term.

The fees Jefferson County agreed to pay its bankers are as much as three times higher than what a New York agency paid in a similar swap transaction four months later. Had Jefferson

County asked banks to compete for the swaps, it might have saved $45 million, Bloomberg data show. For example, the county paid 19–20 basis points per dollar in fees on its swaps from 2002-04. In a competitive deal in New York that same year, by contrast, JPMorgan charged just a third of that rate—6 basis points—on a $311.7 million interest rate swap for the state's Local Government Assistance Corp.

Sayler says the county is paying higher fees because the length of the deals is longer than most swaps. The New York deal is for 20 years.

CDR says the pricing in Jefferson County was fair because of the deals' unusual length. CDR Managing Director Stewart Wolmark and Vice President Doug Goldberg, in a written statement, also say the price was higher than other swaps because under state law, the banks would have to post collateral if the value of the swaps reversed and the banks owed the county money on paper. So far, the county owes the banks $298 million on paper.

The University of Alabama's Brooks, who has taught classes on risk management and derivatives for more than 15 years, says the average fee for an interest rate swap two years ago was 11 basis points, roughly half of what Jefferson County agreed to pay. "If it was really that much more expensive to do a 40-year deal, somebody in the food chain, some of these multimillion-dollar consultants should have pointed out, 'Listen, you can save $20 million by just doing a 20-year swap,'" he says. Brooks is also president of Tuscaloosa-based financial advisory firm called Financial Risk Management LLC.

Gary Gray, a visiting professor of finance at Pennsylvania State University's Smeal College of Business in University Park, Pennsylvania, says Jefferson County, like many municipalities, didn't have the expertise to do the swaps. "Derivative people are very smart and very good and very, very, very well paid," he says. "If you're talking about most municipalities that aren't overly sophisticated financially, they probably shouldn't be treading in municipal derivatives that have a lot of bells and whistles—options embedded—that make a transaction very difficult to value."

Gray, 55, a former managing director at New York–based E.F. Hutton Group and at Lehman Brothers, is the co-author of *Municipal Derivative Securities: Uses and Valuations* (Irwin Professional Publishing, 1994). He says a fair fee for swaps is 3 basis points, about one-sixth of what Jefferson County agreed to pay.

Robert Lamb, a former banker at L.F. Rothschild in New York and founder of the financial adviser Lamont Financial Services Corp. in Wayne, New Jersey, says the highest "reasonable fee" for Jefferson County would have been 15 basis points.

Dorfsman, JPMorgan's spokesman, said in a written response to questions that the bank charged Jefferson County a fair price and that the county is benefiting from low interest rates. "That Jefferson County was overcharged for swaps transactions is flat wrong," the statement said. "We are comfortable with the pricing and believe it was appropriate for the structure and risks associated with the transactions," Bank of America spokeswoman Shirley Norton says. Bear Stearns spokesman Russell Sherman and Lehman Brothers spokeswoman Kerrie Cohen declined to comment on anything related to Alabama.

'How big of a commission does Wall Street want?' an Alabama finance professor says. 'Unfortunately, sometimes I think the answer is, as big as they can possibly get away with.'

One municipality that paid more than Jefferson County did for a swap contract was Mobile, where school district officials bought a $121.5 million, 30-year interest rate swap from JPMorgan in 2003. The bank charged the district 50 basis points, more than four times the national average, giving the bank a fee of $6 million. Mobile schools spokeswoman Nancy Pierce says Superintendent Harold Dodge doesn't know enough about the financing to comment. The district's chief financial officer wasn't available to comment, Pierce says.

Langford, the county commission president, says he doesn't think Jefferson County overpaid for the swaps. Even if it paid too much, the resulting savings were worth it, he says. "You know, I get the impression that people think a bunch of rubes in Alabama shouldn't be smart enough to utilize these swaps," Langford says. "And let there be an understanding: As long as this is a legal instrument, and it drives down costs, if we have to do one tomorrow, I'll do it again."

Citizens who hold the commissioners responsible for the underfunding of schools are wrong because most school funding comes from the state, Langford says. "Blaming the county commissioners is the most ridiculous argument on the planet," he says.

State School Superintendent Joseph Morton says counties have the authority to fund schools at their discretion. "Local support for schools varies greatly," Morton says. Birmingham Schools Superintendent Wayman Shiver asked the Jefferson County

Costly advice Jefferson County, Alabama, paid $4.8 million to its top five advisers on interest rate swap transactions.

Firm (role)	No. of deals advised on	Fees, in thousands
CDR Financial Products (swap adviser)	3	$1,800
Morgan Keegan (swap adviser)	1	1,300
Haskell Slaughter Young & Rediker (counsel)	4	1,000
Katten Muchin Zavis Rosenman (special tax counsel)	1	350
National Bank of Commerce of Birmingham (financial adviser)	3	325

Figures are for Jefferson County sewer bond swaps from October 2002 through June 2004.
Source: National Bank of Commerce of Birmingham

Commission in a public meeting on Jan. 7, 2003, for a one-time grant to help close a $42 million budget deficit. The commission rejected the proposal because it said it would have been unfair to other school districts in the county.

As for LeCroy, Langford and Sayler each wrote supportive pre-sentencing letters to the Philadelphia judge. "I find him to be a bright, congenial, hardworking person," Sayler wrote on April 20. "He never tried to force a transaction on us that was unsuitable for Jefferson County."

In a June interview before LeCroy was sentenced, Langford said the commission had picked JPMorgan Chase for the sewer financing without seeking competitive bidding because LeCroy had been so reliable in the past. In an interview on July 15, a week before LeCroy started to serve his prison term, Langford distanced himself from the banker. "LeCroy's not my man," he said. "He was working for the commission before I got here."

'This is the ultimate parasite monopoly,' former independent presidential candidate Ralph Nader says. 'This is an informal cartel.'

Langford says he does municipal finance work only with his friends. "I know these people," he says. "I wouldn't do business with people I don't know." One of his friends, he says, is Blount, the former Alabama Democratic Party chairman. The commission paid Blount $2.4 million to broker a $2 billion swap in June 2004, according to county records. Blount, 52, declined to comment.

Others in Alabama have done well from the sewer deals. Birmingham-based consultant Wilhelm and his Mobile-based partner, Steve Windom, split a $1.1 million fee for persuading the county to choose Bank of America as one of the parties in the swaps. Windom, 56, was a Republican lieutenant governor of Alabama from 1999 to 2003. Wilhelm says Bank of America overpaid him. "I got paid to help Bank of America come into a place where they didn't know anybody and make sure people understood they would do a quality job," Wilhelm says. "It wasn't worth a million."

Jefferson County also sprinkled money around Wall Street to swap dealers that didn't directly participate in the sewer deals, according to a March 28, 2003, letter from JPMorgan Chase to Langford. The county required JPMorgan to include two New York firms, Goldman Sachs Group Inc. and Rice Financial Products Co., a minority-owned municipal derivatives dealer, to participate in a $1.04 billion swap with JPMorgan, the letter said. As a result, Goldman received 22.5 percent, or about $6 million, of JPMorgan's net profit on the deal, the letter said. JPMorgan transferred 10 percent of its net profit on the deal, about $2.5 million, to Rice Financial, the letter said.

Sayler declined to comment on the role Goldman Sachs and Rice Financial played in the swap, and he forwarded questions to Norman Davis, executive vice president at Birmingham-based First American Bank, another of the county's financial advisers. Davis said in an e-mailed statement that Goldman and Rice weren't active participants in the swaps and that it's common for dealers to participate in transactions through other firms to reduce time spent by the county negotiating the swap.

Goldman Sachs spokesman Michael Duvally and Cristal Baron, chief financial officer of Rice Financial, declined to comment.

That Jefferson County didn't hold public auctions for its debt financing is hardly unusual in the United States. Most states, cities and towns choose the lowest bidder when purchasing goods and services—and that is Jefferson County's policy for virtually everything except financial advice. "If it's a pencil up to a dump truck, we'll competitively bid it," says Jennifer Sherrod, the county's inventory manager.

Florida, Maryland, North Carolina, Utah and Washington—which have the benefit of high credit ratings—sell most or all of their debt by auction. "When we go to market on a competitive-bid basis, we know we're going to get the best price for the bonds," says Allan Martin, 51, Washington's deputy treasurer for debt management. "The gauge of whether or not it was priced in the best interest of our taxpayers is that we're able to take the best price that day. Why anybody would do it any other way is beyond me."

VisionLand, an amusement park founded by Jefferson County Commissioner Langford, includes this brick bas-relief of him with two children.

OWEN STAYNER

Selling bonds without competitive bidding is vital to public finance, says Micah Green, chief executive officer of the Bond Market Association. Negotiated transactions enable banks to time sales to get lower interest rates and are necessary when bonds have complex features that might require special efforts in marketing to investors, he says. Both competitive and negotiated bond sales are needed, he says. "I'm not saying that one method is better than the other," Green says. "Both are important tools for issuers. The issue is flexibility and choice."

Swaps spoils JPMorgan Chase pocketed more than half of the fees paid by Jefferson County, Alabama, for interest rate swaps the county negotiated without competitive bidding.

Firm	Total value of swaps, in millions	Fees, in millions*
JPMorgan Chase	$2,000	$57.0
Bear Stearns	1,570	16.3
Bank of America	753	13.4
Goldman Sachs	233	6.0
Lehman Brothers	190	5.0
Rice Financial Products	104	2.5

Figures are for Jefferson County sewer bond swaps from October 2002 through June 2004. *Estimates. Source: Bloomberg

Ralph Nader, founder of Washington-based Essential Action and a former independent candidate for U.S. president, says the national shift to no-bid public finance has been "orchestrated" by investment banks. "This is the ultimate parasite monopoly," Nader, 71, says. "This is an informal cartel. There's got to be collusion." He says he'll push for a federal investigation. "It begs for Congressional hearings," he says.

Alabama's own representatives in Washington aren't likely to lead that charge. Artur Davis, a Democratic congressman and a Harvard Law School graduate who represents Jefferson County, says he doesn't have a position on negotiated bond sales or the use of derivatives. "I talked to the congressman, and he felt like he wasn't educated enough about the issue to comment," says his spokesman, Corey Ealons. Davis, 38, sits on the House Financial Services Committee.

Richard Shelby, 71, a Republican who chairs the Senate Banking Committee, declined to comment on states' and cities' selling bonds without competitive bidding, although he says he does have a view on derivatives. "I am aware of the use of derivatives among municipalities as a means to reduce funding costs," he says. "Although derivatives serve a useful purpose by hedging against future costs, these instruments are associated with heightened risks."

While Moody's and Standard & Poor's rate municipalities and bonds and take into consideration the risks of swaps, they don't evaluate the size of the fees paid for the swaps. On July 12, Moody's gave Jefferson County's sewer bonds a rating of A3, its seventh highest of 10 investment-grade levels. Moody's investment analyst Brian Kennedy says he has no view on whether the financing fees Jefferson County agreed to pay were too much. "That's not my area of expertise," he says. "We're looking at the willingness and ability of the county to repay bondholders. The county commissioners make business decisions, and that's really their job."

At the Bright Star, a restaurant and bar in the town of Bessemer, 16 miles southwest of Birmingham, the owner's niece and part-time manager, Stacey Craig, says county schools are suffering because of the swaps. One-third of Bessemer's residents never graduated from high school, and 24 percent of its families live below the poverty line, more than twice the 9.2 percent national rate, according to the 2000 census. Everyone is complaining about the financing the county commission arranged because local sewer bills have tripled since 1997 to pay off the debt, Craig, 40, says. "There's a lot of cronyism," she says. "It's a good old boys network. They don't even understand the deal they got themselves into. How can they expect the public to understand it?"

Garner, the parent who went shopping for paper towels and toilet paper, is a lifelong Birmingham resident who works as a machine operator at United States Steel Corp. He says cozy deals by public officials and bankers have hurt his family and other taxpayers. He and his wife, Winifred, say they may have to leave Jefferson County because they're concerned about the quality of their children's education. "I am going to have to move, or I will lose my children," Ted Garner says. "It's all about contracts and who gets them. It's about fees to friends, not about helping the public."

Michaelle Chapman, director of communications for the Birmingham public schools, says that Glenn Middle School, which Labresha Garner attends, lacked a certified math teacher part of the year because of a national shortage of teachers. Even with the underfunding, Birmingham's schools are hiring necessary teachers, she says. "A teacher was assigned to Glenn as soon as one could be hired," she says.

The county, meanwhile, has raised sales taxes to pay for education. The money, however, won't be used to hire teachers or buy supplies; it will be used to service debt on bonds issued to pay for new schools. Without informing the public in advance, the Jefferson County Commission approved by a 3–2 vote a 1-cent-per-dollar sales tax increase in August 2004. The proceeds will be used to pay interest on a total of $1 billion in school construction bonds the commission decided to sell in December and February. The decisions to build new schools and sell the bonds underwritten by Raymond James were made without a public vote or consent and without public bidding, according to a lawsuit filed by Jefferson County taxpayers in the circuit court of Jefferson County in November.

"I'm extremely angry," says Jim King, 40, a Birmingham truck driver, whose 13-year-old daughter, Jessica, attends Bush Middle School. He says the commission's secret decisions to raise the sales tax and sell $1 billion in bonds for new schools are wrong. "The commissioners made all their decisions in

secrecy," he says. "No one ever knew what they were doing. This wasn't about helping us with basics in school, like toilet paper or textbooks. This was about contracts and fees."

The commission didn't ask for public comment because it wasn't required to, Langford says. "Every time a referendum comes up countywide, it gets defeated," he says. "We had to ask ourselves, Politically, did we have the guts to fix these schools?"

Retired middle school teacher Gene Edelman, 63, says Langford is using the sales tax to justify giving bond fees to commission friends in no-bid contracts. "It's a bond con game," he says. "Everybody is disgusted with it. We don't need new schools to be built when we are losing 2,000 students a year from Birmingham schools. What we need is more teachers and more supplies and more things to get to children."

Even supporters of the county commission say the backroom politics is hurting the public. Vi Parramore, 57, who represents teachers in the county through the American Federation of Teachers, says she's glad the commission increased the sales tax for the sake of better education. She also sees the damage the commission has done. "I don't want education in Jefferson County to get a bad rap because of bad deals done here in the past," she says. "But that's my deepest fear. The sewer deal and the bad rates have all led to a lack of trust, and now that is hurting the kids."

As long as local officials choose secret deals with banks rather than go to public auction for the lowest price for public finance, communities will lose money, the University of Alabama's Brooks says. And with $360 billion a year borrowed by local authorities and hundreds of millions in fees, there's a lot to lose, he says.

Mary Moore, 56, a state representative from Birmingham, says local officials such as Jefferson County's commissioners who choose not to use competitive bidding for public finance are bound to hurt taxpayers. "They are out of their league, and investment bankers understand this," she says.

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BLOOMBERG TOOLS

Valuing Muni Swaps

To begin valuing a municipal interest rate swap transaction, type SWPM <Go> for the Swap Manager function. Click on New Deal on the tool bar, and select either Fixed-Float Muni or Float-Float Muni, depending on the type of transaction you want to price. An interest rate swap is an exchange between two parties of interest rate payments that are fixed and payments that change with a benchmark rate such as the 10-year U.S. Treasury note. A fixed-float swap exchanges a fixed interest rate for a floating interest rate. A float-float swap exchanges two different interest rates that aren't fixed.

As shown at right, you'll notice that the screen is divided into two halves, one for each side of the transaction: receive and pay. Enter the notional amount for each leg of the swap along with the maturity, effective, and payment dates. The ticker MUNIPSA appears in the INDEX field on the Float side. The ticker represents the Bond Market Association Municipal Swap Index, which is the benchmark that most muni swaps use in their contracts. On another screen, type MUNIPSA <Index> DES <Go> for details on the BMA Municipal Swap Index Yield.

Once you finish entering details of your swap on SWPM, click on Save Deal to store it for later valuations. You can use the tabs at the bottom of the screen to adjust the yield curve used to price the swap, view projected cash flows, evaluate risk and run an analysis of possible outcomes.

For the main menu of interest rate and credit derivative information and valuation tools, type IRSM <Go>.

MARY K. WOOD

For the Interest Rate Derivative Update function, type SWPL <Go>.