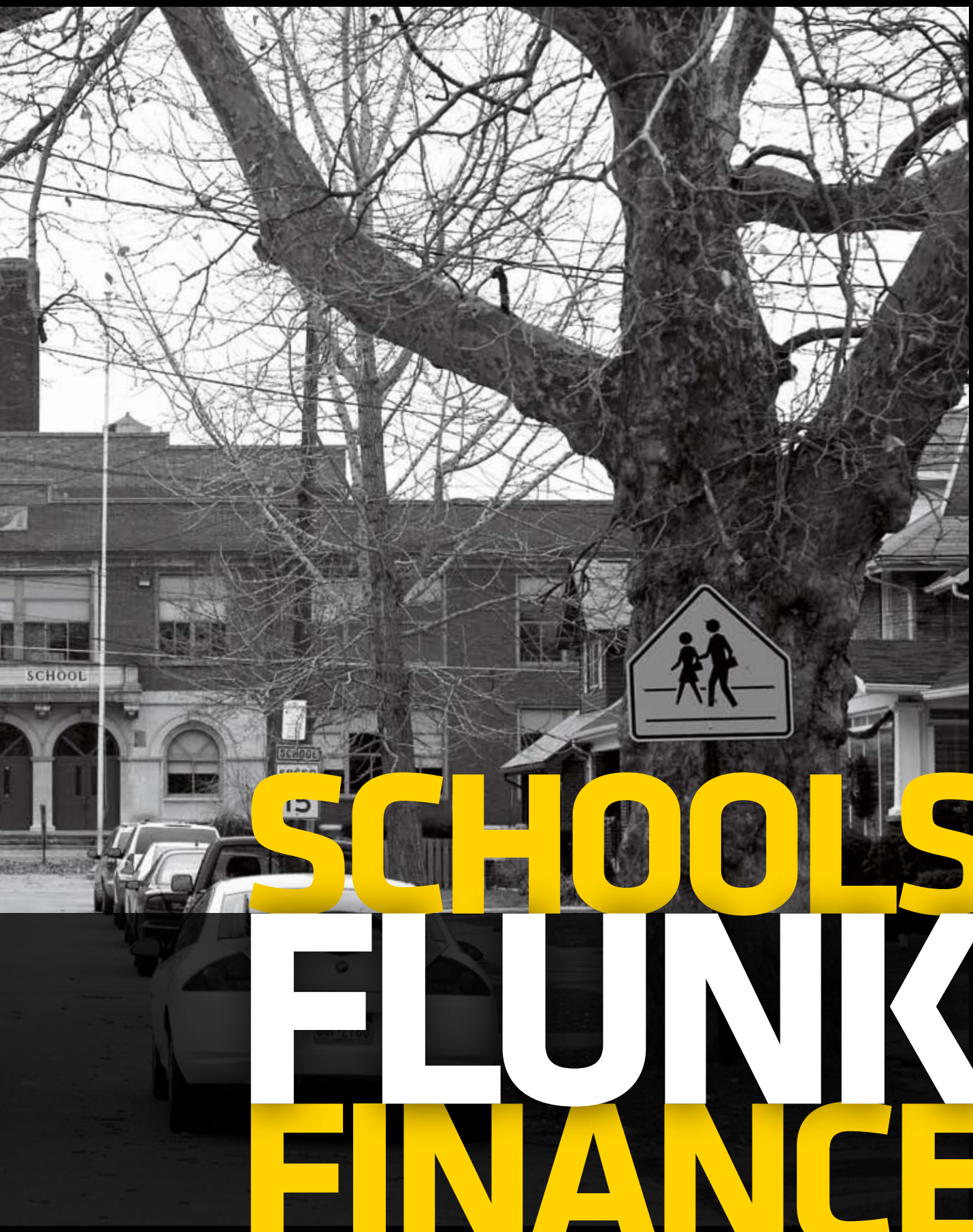
The **Roosevelt Middle School** in Erie was falling down when the school board agreed to the swaptions deal.

Education officials in Erie and Bethlehem, Pennsylvania, were so impressed with the quantitative skills of JPMorgan and Morgan Stanley that they bought interest-rate swaps without ever knowing the price. That cost taxpayers millions of dollars for the errant financings.

By MARTIN Z. BRAUN and WILLIAM SELWAY
Photograph by ANDREW GARN



SCHOOLS FLUNK FINANCE

Rosena Wright and her son, **Desmond**, stand in front of the middle school that's now condemned.

James Barker saw no way out. In September 2003, the superintendent of the Erie City School District in Pennsylvania watched helplessly as his buildings began to crumble. The 81-year-old Roosevelt Middle School was on the verge of being condemned. The district was running out of money to buy new textbooks. And the school board had determined that the 100,000-resident community 125 miles north of Pittsburgh couldn't afford a tax increase. Then JPMorgan Chase & Co., the third-largest bank in the U.S., made Barker an offer that seemed too good to be true.

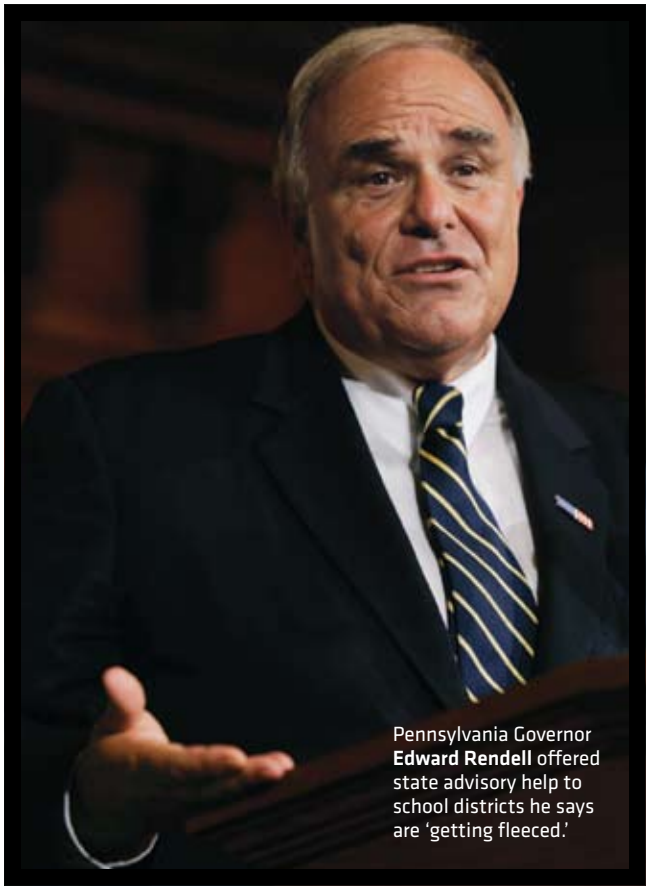
David DiCarlo, an Erie-based JPMorgan Chase banker, told Barker and the school board on Sept. 4, 2003, that all they had to do was sign papers he said would benefit them if interest rates increased in the future, and the bank would give the district $750,000, a transcript of the board meeting shows. "You have severe building needs; you have serious academic needs," Barker, 58, says. "It's very hard to ignore the fact that the bank says it will give you cash." So Barker and the board members agreed to the deal.

(LEFT) DOUGLAS LEVERE; (RIGHT) CAROLYN KASTER/AP WIDEWORLD

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

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

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



Pennsylvania Governor **Edward Rendell** offered state advisory help to school districts he says are 'getting fleeced.'

JPMorgan's Chief Executive Officer Jamie Dimon declined to say if he thought the bank's fee disclosure was proper and whether the bank acted in a fair, responsible and moral manner in Erie. Banker DiCarlo declined to comment. JPMorgan spokesman Brian Marchiony says the deal gave the school district immediate debt savings and protected it against unpredictable interest rate risk in the future. He declined to answer specific questions.

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

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

'More often than not, the firms are the only ones who know what's going on,' SEC Chairman Christopher Cox says.

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

"The school districts are getting fleeced," Pennsylvania Governor Edward Rendell says. The governor, 64, a Democrat who has been in office since 2003, says the state might in the future advise schools and municipalities on derivatives contracts before they sign with banks.

Christopher Cox, chairman of the U.S. Securities and Exchange Commission, says he's concerned that municipalities are taking on more risk than in the past when they raised money primarily from bond sales. "It's a serious issue, not only in Pennsylvania but across the country," says Cox, 55, who has headed the SEC since 2005. "That is what we have seen repeatedly. More often than not, the municipalities aren't configured to have financial sophisticates in charge of these offerings—and the result is that the firms are the only ones who know what's going on."

Just five years ago, municipal derivative deals weren't sanctioned in Pennsylvania, the sixth-most-populous U.S. state. Then, in September 2003, the state legislature adopted a law allowing schools and towns

'If you don't know how much you're paying, you're going to be paying too much,' former MSRB Executive Director Kit Taylor says.

to use interest-rate swaps to lower borrowing costs and raise cash.

In a swap, two parties agree to exchange payments over a period of time that can last as long as 30 years. Typically, one agrees to pay a fixed rate and the other to pay a variable rate that changes with a benchmark index or formula defined in the contract. Public agencies can benefit by using derivatives to guard against swings in borrowing costs or to lock in current interest rates for bond sales they might not make for years. In many cases, school districts use swaps as a way to refinance bonds they've issued in the past.

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

This lack of transparency is a boon for the banks, says Christopher "Kit" Taylor, executive director from 1978 to 2007 of the Municipal Securities Rulemaking Board, a panel that issues rules on municipal bond sales. "Business moves from transparent and competitive markets to markets where there is less transparency and the profits are greater," he says. "If you don't know how much you're paying, you're going to be paying too much."

The Pennsylvania swap law was passed after lobbying by financial advisory firms that stood to profit from such deals. The legislation made the state a member of an expanding club. Forty states give government bodies explicit authority to make derivative deals, up from none 20 years ago, says David Taub, a lawyer who specializes in derivatives and is a partner at McDermott Will & Emery in New York. Derivatives aren't regulated by the SEC, the MSRB or by states. Pennsylvania offers a clear look at these deals because, by law, all the contract records must be publicly filed with the state.

One derivative advisory firm that backed the Pennsylvania swaps legislation is Investment Management Advisory Group Inc., or IMAGE. The Pottstown, Pennsylvania–based company was raided by the Federal Bureau of Investigation in November 2006 in connection with a criminal antitrust investigation of bid rigging of investment contracts that are sold to states and municipalities. The U.S. Justice Department is also probing municipal derivative deals. IMAGE has said it's cooperating with the probe. No charges have been filed. (See "Probing 'Broken Promises,'" page 53.)

SEC Chairman **Christopher Cox** says municipalities across the U.S. need better financial advisers.

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

The banks that arrange these deals create the swap contracts before pitching them to schools. Using software programs designed for valuing swaps, they calculate prices for which they can sell them after a school signs a contract. That's how the banks make money. For example, if a bank agrees to pay a district $800,000 in a deal it valued at $2 million, it could reap $1.2 million for itself and middlemen. "They load it off instantly," says Taylor, who's now on the advisory board of Rockwater Municipal Advisors LLC, an Irvine, California–based investment firm.

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

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

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

(LEFT) EVAN KAFKA; (RIGHT) DANIEL ACKER/BLOOMBERG NEWS

COSTLY LESSON

1. JPMorgan Chase gets a $1 million fee for an option on an interest-rate swap giving Erie schools $785,000.
2. September 2003–June 2006: In three years, interest rates go the wrong way for the school district.
3. July 2006: Erie schools terminate the deal, pay JPMorgan $2.9 million.

Sources: Bloomberg data, Pennsylvania public records

customers, and to the extent that they are regulated by the SEC, they must," he says.

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

More than two dozen Pennsylvania school districts bought swaps that bet on the spread between two interest rates. Many bet wrong. Since 2006, at least 27 school districts gambled that the spread would widen between either the five- or 10-year London interbank offered rate on the one hand and weekly municipal bond yields or the one-month Libor on the other. The opposite happened: Spreads narrowed as long-term interest rates fell. The schools had to pay banks, or they could pay a steep exit fee, as Erie did with its swaption to cancel the deal.

School district officials say their advisers have told them the contracting of the spreads was a historical fluke. In the Exeter Township School District, 55 miles (88.5 kilometers) northwest of Philadelphia, Financial S&lutions LLC told the schools their swap deals shouldn't have lost them money. "They tell me that's never happened before," says Ernest Werstler, who was business manager of the district until November, when he retired. "It's happening to us now." Financial S&lutions didn't respond to requests for comment.

Deane Yang, head of research at financial advisory firm Andrew Kalotay Associates Inc. in New York, says local officials are putting too much stock in financial advisers who are paid by banks—and in many cases are referred to schools by banks. "It's like trying to decide whether a used-car dealer is offering you a good price or not," says Yang, who doesn't work with school districts. "There's a car appraiser down the street who tells you he will provide an independent evaluation. But he's paid only if there's a sale."

School board members usually have a poor understanding of derivatives, says Peter Egan, a financial adviser and former public finance banker at a unit of Cherry

Probing 'Broken Promises'

Following a November 2006 Bloomberg Markets article, "Broken Promises," the U.S. Justice Department and the Securities and Exchange Commission investigated banks and financial advisers who were paid for derivative deals with state and local governments. The article documented sales of more than $7 billion of bonds that produced millions in fees for banks and advisers. Almost none of the money was used for its original intent: low-cost housing and elderly care. Much of the money was parked in investment contracts, providing banks and insurers with gains, until it was later used to buy back the debt from investors, closing out the bonds.

In November 2006, more than a dozen banks, insurers and advisers to local governments were subpoenaed by regulators in the biggest criminal probe ever conducted of the 200-year-old municipal bond market.

The Federal Bureau of Investigation and SEC are looking at whether the advisers conspired to rig the bidding for the investment contracts that governments buy with the proceeds of tax-exempt bonds. Federal investigators are also seeking information on the sales of derivatives to municipalities, documents show. The SEC has settled cases with American International Group Inc. in New York and Beverly Hills, California–based adviser CDR Financial Products Inc. No criminal charges have been filed in connection with the investigation.

WILLIAM SELWAY

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

In many cases, the banks repeatedly sell more derivatives to replace old ones. In Bethlehem, Pennsylvania, JPMorgan and Morgan Stanley sold the school district eight swaps on just two bond issues, records show. "It sure looks a lot like churning," Yang says. *Churning* is a term used to describe how stockbrokers or insurance agents sometimes continually sell and resell the same or similar products to clients in order to make more in fees. "Doing more than one swap against a single bond issuance definitely benefited the swap advisor and bank, but probably not the school district."

In Pennsylvania, it's the financial advisers who are supposed to keep school district officials from getting fooled. That's why the 2003 law allowing for swaps requires districts to use independent advisers. "There was a fear that these deals were being pushed on the unsuspecting, perhaps, without them getting any other advice," says Steve Nickol, a Republican member of the Pennsylvania House of Representatives who introduced the legislation.

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

Beaver County's Debt Jam

Like school districts across Pennsylvania, Beaver County, in the steel country north of Pittsburgh, turned to derivatives to raise cash. The money is gone. What's left is an $11.7 million debt to Lehman Brothers Holdings Inc.

Beaver County Commissioner Joe Spanik, a Democratic member of the three-person board, says speculating with derivatives was better than raising real estate taxes that already weighed heavily on the county's aging working-class population.

"We're always looking out for the taxpayers," Spanik says. "We try to balance our budgets as best we can, and if there are other alternative ways to do that, we look."

In a 2002 derivatives deal with Lehman Brothers, the county was paid $1.5 million. In a deal with JPMorgan Chase & Co. in 2004, the county raised another $1.4 million.

By Dec. 31, 2006, Beaver County taxpayers owed $11.7 million, four times the $2.9 million officials raised with derivative deals. That left a net loss of $8.8 million, according to its annual financial statement.

The county's advisers made $1.2 million in fees, records show. Most of that went to Commonwealth Securities & Investments Inc., a Pittsburgh-based firm headed by Henry Fisher. His firm has handled bond sales for the county since at least 1980.

"He has had a relationship with every politician in Beaver County at one time or another," says Jerry Hodge, a former treasurer and secretary of the Beaver County Democratic Party. "He has friends at all levels of government."

Fisher's firm and RRZ Public Markets split a fee of $400,000 for arranging the sale of a swaption on $59.9 million of county bonds to New York–based Lehman Brothers. Pottstown, Pennsylvania–based advisory firm IMAGE got $50,000. The swaption gave Lehman the right to force the county to refinance the bond and enter a swap with the bank.

Fisher didn't return phone calls or respond to a letter seeking comment. Lehman Brothers spokeswoman Kerrie Cohen declined to comment. IMAGE, in a written response to questions, said it is unable to evaluate the price of the deal.

County fiscal administrator Rob Cyphert says the advisers and Lehman Brothers never told the county how much the bank made. "I don't think I ever knew that," he says.

In September 2006, the county entered two new interest-rate swaps with Lehman Brothers to replace the earlier deals with JPMorgan Chase and Lehman. The transactions didn't pay the county any upfront money, and it rolled its losses into the new swaps. Those deals offered Beaver County gains if interest rates moved as it had bet. The county hasn't yet reported any results of the 2006 deal.

Beaver County took on $11.7 million in debt from four derivative deals with two banks.

SCOTT GOLDSMITH

The deals didn't fix the county's budget shortage. Strapped for cash, the county was forced to lay off employees. One was Anthony Harb, a maintenance worker. He couldn't find another position. As the steel industry shrank, it took the good jobs with it, he says. "Once those went down, everything else went down with them," Harb, 52, says. "It puts you through a lot of hardship when you're laid off."

Harb was later hired back by the county in 2006 to work as a clerk in the Elections Department, making less than the $34,000 job he lost. He says public officials let down the citizens of the county. "They got the bad advice and they take it out on the workers," he says.

WILLIAM SELWAY

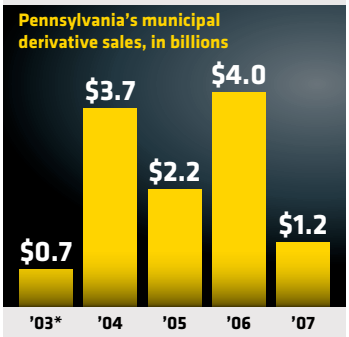
committees and candidates for office, campaign records show.

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

Nickol says he was first approached about approving swaps for school districts and municipalities in 2002 by Elmer Heinel, a public finance lobbyist whose clients have included bond underwriters Meridian Capital Markets Inc., Stallone's former employer, and Wheat First Securities Inc. Heinel has contributed $141,245 since 2000 to state lawmakers, political action committees and candidates running for office. Heinel says the donations weren't tied to the legislation.

Swaps Bonanza

When the law changed in 2003, a billion-dollar industry was created.



*From October. Source: Pennsylvania Department of Community and Economic Development

The law gave cities, counties and school districts the explicit authority to buy swaps. Municipal derivatives had been gaining ground in other states, as well as in large cities such as Philadelphia and at agencies like the Pennsylvania Turnpike Commission, as a means to lower borrowing costs, Stallone told the legislature at the time. The law passed 197–0 in the House and 45–0 in the Senate. "There could be huge cost savings for many of the local governments," Nickol said. Rendell signed the bill in September 2003. That same month, the Erie school district signed the swaption deal with JPMorgan.

Once an iron and steel center, Erie is now left with shuttered factories and an aging population. While General Electric Co.'s $4 billion transportation unit, which mainly builds locomotives, maintains its headquarters in Erie, much of the city's manufacturing base has disappeared. Since 1970, the city's population has declined 30 percent. Seventy-six percent of students in the district are eligible for free or reduced-price lunches, according to the state Department of Education.

JPMorgan and IMAGE had pitched the swaption to the school board in June 2003. JPMorgan's DiCarlo and IMAGE's Mike Garner said at that meeting the district had locked in high interest rates in 2001, when it issued $38.7 million in bonds, according to an audiotape of the June 17, 2003, meeting. In the two years after that, interest rates had declined. Using traditional bond financing, the district couldn't take advantage of the lower rates because tax law prohibited refinancing before 2011, Garner said.

By agreeing to a swaption with JPMorgan, the district could cash in immediately, Garner told the board. The bank would make an upfront payment to Erie. In return, the school allowed the bank to enter a swap with Erie in the future, from 2011 to '29.

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

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

JPMorgan had recommended IMAGE to the school district's law firm, Knox McLaughlin Gornall & Sennett PC, says Tim Sennett, a partner in the firm who worked with the school district on the derivatives deal. IMAGE's Garner told school board members he thought the district should make the deal. "Given your situation, the economics are very good for the district," Garner said, according to the tape of the meeting. "The risks are reasonable. I believe everyone on the board has a good grasp of what the risks are."

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

On Sept. 4, 2003, as a new school year was starting, the board met again with DiCarlo, who said the district should sign the deal and the bank would give it $750,000. Board members asked DiCarlo how much the bank would make in fees. DiCarlo said, "Everybody has asked, and it's a reasonable question: What does JPMorgan, what do we get on this transaction? I can't quantify that to you," according to a transcript of the meeting.

DiCarlo, who was a state representative from Erie from 1973 to '80, didn't tell the board that the contract was worth $2 million in global derivative markets. Based on interest rates that day and terms of the deal, Bloomberg data show that was the value of the contract. JPMorgan's gross markup on the swaption was 0.82 percentage point of the rate compared with a 0.16 percentage point charge Goldman Sachs Group Inc. collected from the Philadelphia School District on a comparable swaption the city had bid competitively in March 2004.

In a written response to questions, IMAGE disputed the amount of fees paid to JPMorgan. "The numbers your analysis produces for the districts are clearly way off the mark," it wrote. IMAGE said it didn't know the bank's fees, estimating they were $365,000–$495,000. IMAGE said it doesn't know who recommended the firm to Erie as an adviser. "Regardless, there are no conflicts," IMAGE wrote. IMAGE said its fees were normal for the industry.

Pennsylvania approved swaps for school finance in an effort to save taxpayers money, the legislator who proposed the law says.

D'Andrea says he relied on assurances from IMAGE that the deal was right for the district. IMAGE wrote a two-page

opinion saying the deal was fair. It didn't say how much the fees were, according to a copy obtained under a public records request. "The net swaption premium to the District was adjusted to reflect the forward starting and option-adjusted nature of the swaption, a reasonable hedging spread in the LIBOR markets and a fee to JPMCB reflective of its time and effort dedicated to the District as well as the inherent credit, operational and market underwriting hedging risk of the transaction," it said.

Board member Eva Tucker, a retired professor of geoscience at Penn State University's Erie campus, says the board didn't fully understand the deal and trusted IMAGE, which recommended the transaction. "We're not financial experts," Tucker, 72, says. "We relied on the best advice we thought we could get."

James Herdzik, a school board member who works as a sales manager at a machine shop, says the district couldn't turn down the deal because it was desperate for money. "We're scrambling for every penny we can get," Herdzik, 48, says. The board approved the deal in a 6-0 vote.

JPMorgan actually gave Erie $785,000—$35,000 more than DiCarlo had promised. The bank paid IMAGE $60,000, gave bond insurer Financial Security Assurance Inc., known as FSA, $57,585, paid lawyers and other middlemen $106,000 and kept $1 million as its revenue, according to public records and Bloomberg data. (For more on bond insurers, see "Downfall of the Bond Insurers," page 62.)

Greg Zappala, a former college football player, heads JPMorgan Chase's office in a suburb north of Pittsburgh.

ROB BENNETT

proceeds of two new derivative deals it did with Pittsburgh-based PNC Financial Services Group Inc.'s PNC Capital Markets unit. The transactions paid Erie schools $732,000 up front. One deal was an interest-rate swap that so far has lost $32,000 for the district, according to local records. Erie revised the terms of the swap in October 2006, betting that beginning in March 2008, long-term rates would rise faster than short-term rates. The other deal is a swaption; PNC hasn't exercised the option yet.

Herdzik says he can't see why banks would take advantage of struggling school districts. "It's kind of like preying on the municipalities that are most in need of money," he says. "It's like we got raped."

Other Pennsylvania school districts are paying banks excessive fees. Bethlehem, 50 miles north of Philadelphia, is also a former steel-making center. With a population of 72,000, the city has maintained its historic buildings. The Central Moravian Church is a symbol of the group that founded the city on Christmas Eve in 1741. In the industrial area of the city, Las Vegas Sands Corp. is converting an old steel mill into a casino.

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

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

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

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

'We're not financial experts,' Erie school board member Eva Tucker says. 'We relied on the best advice we thought we could get.'

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

The district got the cash from the

So far, the district has taken in about $900,000 from the deals, Bloomberg data show. That compares with $3 million in transaction fees. Lestrange and Access made $630,000 each for arranging the swaps, according to school district records. New York–based Morgan Stanley made $840,000 and JPMorgan received fees totaling $900,000, Bloomberg data show. Lestrange and Access earned a fee 10 times more than the Easton Area School District, Bethlehem's neighbor, paid its adviser on a comparable interest-rate swap in 2004. In a memo to school board members, Majewski said the

fees included annual interest rate monitoring that would cost the district hundreds of thousands of dollars. Bear of Lestrange and Matthew Kirk of Access didn't respond to requests for comment.

The rates the banks charged Bethlehem were twice the average for comparable swaps deals. In this kind of swap, in which both sides pay floating interest rates, a bank calculates its fees by subtracting an amount from the rate it will pay. In the average deal of this type, banks lower the rate by 0.06 percent, says Jeff Pearsall, a managing director of Philadelphia-based Public Financial Management, the largest municipal adviser in the U.S. JPMorgan subtracted 0.13 percent in the Bethlehem deal, and Morgan Stanley lowered its rate by 0.11 percent. Morgan Stanley spokeswoman Jennifer Sala declined to comment.

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

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

Board member Joseph Craig, who approved the deals, says he's not qualified to discuss the deals and doesn't know how much they cost. "I really don't remember a whole lot of specifics about it," says Craig, 64, a retired special education teacher who's been on the board for 10 years.

School district business manager Majewski declined to answer questions about swaps and fees. "They've worked very successfully for me," he says. "Everything I've done is done publicly with my local taxpayers."

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

Sometimes school districts have agreed to swaptions even when a local financial official warns against no-bid deals. In Butler County, a rural area dotted with working farms 40 miles north of Pittsburgh, County Controller Jack McMillin says the lack of competitive bidding for public finance has cost taxpayers. "It's a form of institutionalized larceny under the guise of getting taxpayers a good deal," McMillin says. He wasn't involved in the school board decisions.

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

Greg Zappala, head of JPMorgan's office in Cranberry Township just north of Pittsburgh, is the son of former Pennsylvania Supreme Court Chief Justice Stephen Zappala and the brother of Allegheny County District Attorney Stephen Zappala Jr. Greg Zappala, 46, played football for the University of Miami Hurricanes in the early 1980s. He was a roommate of Jim Kelly, a Pittsburgh-born, Hall of Fame quarterback who led the Buffalo Bills to four Super Bowls. Zappala's uncle, Charles Zappala, was an RRZ executive.

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

Butler County Controller **Jack McMillin** says the lack of competitive bidding hurts taxpayers.

BILL CRAMER

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

Russ Greer, 61, who served on the Butler school board at the time of the deal, says it provided much-needed cash and was approved at an open meeting. "There were no secrets," he says.

Except one. Since the school district didn't know what JPMorgan made on the transaction, it didn't realize it had become another Pennsylvania municipality that was underpaid up front on a swaption deal. "The school district has no knowledge of the specific fees made by

JPMorgan," Superintendent Edward Fink said in a written response to questions.

The contract had a market value more than three times what the district was paid, Bloomberg data show. JPMorgan decided how much of the $2.2 million it would give the district, without ever telling the school board. The bank paid $165,813 to bond insurer FSA, $40,000 to IMAGE, $147,500 to five law firms and $23,000 to the Butler County General Authority. JPMorgan kept the remaining $1.1 million as its own revenue.

Controller McMillin, a Republican, says he doubts whether the elected school board had the skills needed to know whether it was getting enough for the option. "I can't imagine how they could have understood that," he says.

Penelope Kingman, a former member of the school board, voted against the derivatives deal in 2003. She felt her colleagues had failed to grasp the risk they were taking in exchange for the money offered by JPMorgan. "The financial guys would come in with a lot of stuff that nobody at the district understood," she says. "Local governments are entering into these without fully understanding what they are doing."

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

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

'I'm beyond angry,' says Rosena Wright, the mother of a 13-year-old Erie student. 'I really want to tar and feather somebody.'

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

Erie schools superintendent Barker says he had thought the 2003 derivatives deal would save some money for the district. "We're always at the mercy of the experts that advise us," he says, adding that schools have to find a better way to raise money. One option would be to return to old-fashioned, publicly bid bond sales. He says he doesn't begrudge the banks or advisers their right to get paid. "We expect people to make a profit," Barker says. "But they don't have to put their interests over the kids'." **B**

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With reporting by **Jeff Ward** in Princeton, New Jersey, and **Cate McKissick** in Harrisburg.

Valuing Muni Derivatives

You can use the Swap Manager (SWPM) function to value interest-rate swaps and swaptions. Swaps typically exchange a stream of interest payments on a notional amount at a fixed rate for payments at a floating rate. A swaption is an option that grants the right, but not the obligation, to enter into a swap.

To create a fixed-float swap on a municipal bond issue, type SWPM <Go> and click on the New Deal button on the red tool bar. Select Non-Vanilla Swaps and then Muni and click on Fixed-Float. Tab in to the NOTIONAL field on either side of the screen and enter a notional value for the deal. To display the value of the swap at a given coupon for the fixed leg, tab in to the CPN field and enter a value. Press <Go> to display the net market value of the deal at the bottom of the screen.

To create a swaption with a floating payment based on a percentage of the London interbank offered rate, click on New Deal again. Select Swaption and then Libor and click on European for a European-style swaption, which can be exercised only at expiration. Click on the gray Detail button on the float leg panel on the right side of the screen. Then click on the More button under the Leg Information heading. In the Options window that appears, click on the box to the left of Percent Libor so that an *X* appears in it. Press <Menu> and click on the Main button to return to the main SWPM screen.

Enter details of the deal and press <Go> to display a market value, as shown below. Type VCUB <Go> to use the Interest Rate Vol Cube function to view the volatility data used to value swaptions in SWPM.

JON ASMUNDSSON

The Fleecing of Alabama:

The Bills Come Due

JPMorgan Chase led four banks in selling interest-rate swaps to Jefferson County at six times the going rate. Now, the FBI is investigating the bankers, the SEC has sued a local politician and the county is on the verge of going bust.

By WILLIAM SELWAY and MARTIN Z. BRAUN

Photographs by JEAN SHIFRIN

Jefferson County fell into its debt mess that could lead to bankruptcy because of sewer financing.

As nighttime temperatures plunged in Birmingham, Alabama, last October, Dora Bonner had a choice: either pay the gas bill so she could heat the home she shares with four grandchildren, or send the Birmingham Water Works a $250 check for her water and sewer bill. Bonner, who is 73 and lives on Social Security, decided to keep the house from freezing. "I couldn't afford the water, so they shut it off," she says.

Bonner's sewer bills have risen more than fourfold in the past decade. So have those of others in Jefferson County, which has 659,000 residents and includes Birmingham, the state's largest city. What's threatening to increase them even more isn't the high cost of treating waste; it's the way county officials chose to finance the $3.2 billion in debt they took on to build a new sewer system. The county relied on advice from a bank, JPMorgan Chase & Co., to arrange its funding, rather than use competitive bidding.

Like homeowners who took out mortgages they couldn't afford and didn't understand, Jefferson County officials rejected fixed-rate debt and borrowed instead at rates that varied with the market. The county paid banks $120 million in fees—six times the prevailing rate—for $5.8 billion in interest-rate swaps. That was supposed to protect the county from rising rates for their bonds. Lending rates went the wrong way, putting the county $277 million deeper into debt. In February, the county's interest rate soared to as much as 10 percent, up from 3 percent just weeks earlier. The swaps have now compounded the risk that Jefferson County will file for bankruptcy as it faces its worst financial crisis since it was founded in 1819.

The same subprime chaos that has felled chief executive officers on Wall Street and forced banks to write off $322 billion has plowed into Jefferson County and other municipalities. That means local officials now have to pay to banks money that otherwise might have been used to build schools, hospitals or public housing. Meanwhile, the U.S. Securities and Exchange Commission and the Justice Department are now investigating bankers

and officials involved in Jefferson County's swap agreements. Bankers who worked for New York–based Bear Stearns Cos. and JPMorgan when Jefferson County bought its swaps have been told they might face criminal charges under an antitrust investigation of the municipal derivatives industry, according to

Dora Bonner lost her running water because it was too costly.

records filed with the Financial Industry Regulatory Authority Inc. On April 30, the SEC sued Larry Langford, the former county commission president, for fraud in allegedly accepting $156,000 from a local banker while refinancing the sewer debt. Langford denies any wrongdoing. JPMorgan spokesman Brian Marchiony declined to comment for this article.

The Federal Bureau of Investigation has raided financial advisers in California, Minnesota and Pennsylvania to get files. In January 2007, Charlotte, North Carolina–based Bank of America Corp. agreed to cooperate with federal prosecutors in exchange for leniency. Bank of America spokeswoman Shirley Norton declined to comment.

Jefferson County—which weathered the U.S. Civil War in the 1860s and racial strife in the 1960s—is now scrambling to avert what would be the biggest municipal bankruptcy in the nation's history, measured by outstanding bonds. "It's going to come back to us, to the people," says Bonner, a retired waitress. "Whether you're poor or you're rich, you're going to end up paying."

JPMorgan, Bank of America, Bear Stearns, and Lehman Brothers Holdings Inc. charged Jefferson County about $50 million above prevailing prices for 11 of the interest-rate swaps the county bought between 2001 and '04, according to the September 2005 issue of Bloomberg Markets ("The Banks That Fleeced Alabama"). None of the fees were disclosed to the commissioners, records show. Porter, White & Co., the Birmingham-based financial advisory firm later hired by the county to analyze its swaps, said the banks raked in as much as $100 million in excessive fees on all 17 of its swaps. The swaps are contracts in which the

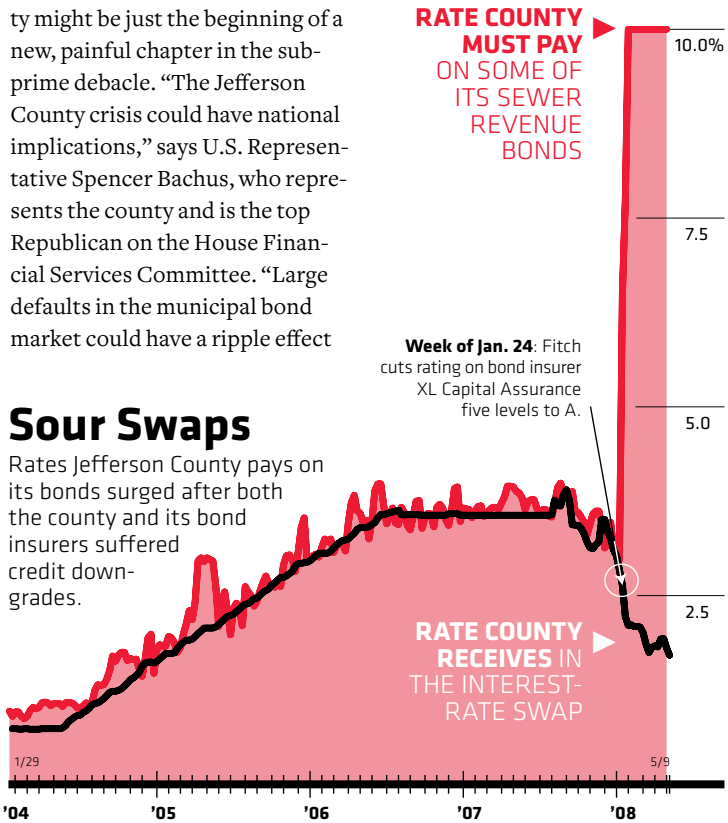
'It's ironic that the Fed can do corporate welfare for the banks, but they can't bail out a county that was victimized by these banks,' says Craig Greer, a Birmingham chaplain.

county and the banks agreed to exchange periodic payments based on the size of the outstanding debt and changes in prevailing lending rates. Swaps are derivatives, which are unregulated financial contracts tied to the underlying value of a security, commodity or index.

JEFFERSON COUNTY'S DEALS started to unravel in January after its bond insurers, Financial Guaranty Insurance Co. and XL Capital Assurance Inc., suffered hundreds of millions of dollars in losses on securities tied to home loans. Standard & Poor's downgraded Financial Guaranty's credit rating to AA from AAA on Jan. 31. The next week, Moody's Investors Service cut XL Capital six levels to A3. Moody's then downgraded Financial Guaranty to A3.

When a bond insurer takes a ratings hit, so do the bonds it has guaranteed; the insurer effectively lends its high rating to the bond issuer. That's what happened to about $3 billion of Jefferson County's debt, causing its interest rate to balloon to as high as 10 percent in February and March from 3 percent in January. That helped increase its total monthly debt payments to $23 million from $10 million. "It happened overnight," County Commission President Bettye Fine Collins says. "It became a situation that worsened every day."

The turmoil in Jefferson County might be just the beginning of a new, painful chapter in the subprime debacle. "The Jefferson County crisis could have national implications," says U.S. Representative Spencer Bachus, who represents the county and is the top Republican on the House Financial Services Committee. "Large defaults in the municipal bond market could have a ripple effect on the larger U.S. financial system, again causing systemwide financial stress."



Sour Swaps

Rates Jefferson County pays on its bonds surged after both the county and its bond insurers suffered credit downgrades.

The bond rate is set weekly on Thursday (started Jan. 29, 2004); the swap rate, on Friday.
Sources: Bloomberg; Porter, White & Co.

The banks that sold the toxic financing to Jefferson County have themselves fallen victim to the subprime crisis—none more so than Bear Stearns. The firm, which sold $1.6 billion in swaps to the county, saw its shares plunge 95 percent from Jan. 1 to March 17 before it was bailed out by the Federal Reserve in March. The Fed negotiated a deal in which JPMorgan bought Bear for $10 a share. JPMorgan had sold $3.2 billion in swaps to Jefferson County. "It's ironic that the Fed can do corporate welfare for the banks, but they can't bail out a county that was victimized by these banks," says Craig Greer, a Catholic chaplain at a Birmingham hospice.

The SEC and Justice Department are probing whether the banks that financed Jefferson County conspired nationwide to fix prices for derivatives, violating the Sherman Antitrust Act, according to target letters sent to bank employees. At least four JPMorgan bankers who worked for the bank at the time Jefferson County deals were done, including Douglas MacFaddin, the former head of municipal derivative sales, have been told by the U.S. Attorney's office that they could face criminal charges, records show. MacFaddin, who was fired in March, couldn't be reached for comment.

"In Jefferson County's case, the people who were allegedly doing the price fixing were right at the center of the scandal," says Christopher "Kit" Taylor, who ran the Municipal Securities Rulemaking Board, the public finance regulator in the U.S., from 1978 to 2007. Jefferson County could use the federal probe of the

County Commissioners **Bettye Fine Collins**, at far left above, and **Jim Carns**, at far right, say the financing was wrong for the county. Birmingham Mayor **Larry Langford**, left, was sued by the SEC in May.

BIRMINGHAM NEWS (BOTTOM)

banks that financed the sewer debt as leverage to stop the firms from demanding more money, Taylor says. So far, the county has won agreements with JPMorgan and the other banks to keep from being forced to buy back as much as $847 million of unwanted bonds or pay up the $277 million it owes on its swaps.

The banks might be worried that Jefferson County, if pressed, could walk away from the derivatives trades on the grounds that they were signed in what might have been fraudulent deals written by the banks, Taylor says. That threat could be enough for the county to bide its time as it works for a solution. "The big boys don't want to pull the trigger," Taylor says. "Then they might end up upsetting the whole derivatives apple cart because of what a judge may do in a court case."

Some Jefferson County residents have taken to joking about the mess local officials and banks have dumped on them. Greer, the chaplain, is selling what he calls look-alike bonds, for $2.50. He says they should be used as toilet paper. He's also distributed bumper stickers saying "Wipe Out Sewer Debt."

Not everyone is laughing. Outside a Piggly Wiggly grocery store in western Birmingham, Charles Boyd, a construction supervisor, says it seems like the only thing he does is pay bills. "It's just not like it used to be," Boyd, 67, says. "It's rough. And I'm working, so when people talk about their sewer bills, I know it's hard. The sewer bill is higher than the water bill. It's ridiculous. It's outrageous."

The seeds of Jefferson County's debt crisis were planted in December 1993, when three citizens filed a lawsuit against the county commission, alleging untreated sewage was being discharged into the Black Warrior and Cahaba rivers during heavy rains, in violation of the federal Clean Water Act.

The U.S. Environmental Protection Agency in 1994 joined the taxpayers who filed the complaint. In December 1996, the county settled the case by agreeing to build a sewer system for collecting overflows and cleaning the water. In 1997, the county began selling bonds to raise money for the project. Most of the bond sales, all done without competitive bidding, were arranged by Charles LeCroy, a banker at St.

In **Birmingham**, Alabama's largest city, residents are bracing for possible bankruptcy.

Petersburg, Florida–based Raymond James & Associates Inc.

By November 2002, the county had issued $2.9 billion in sewer bonds, with an average rate of 5.25 percent; the cost of building the sewer system doubled from initial projections. Meanwhile, LeCroy had been hired by JPMorgan, taking the county's debt work with him. "Jefferson County became a cash cow," says County Commissioner Shelia Smoot, a Democrat.

In 2002, with municipal bond interest rates near a 34-year low, LeCroy told Jefferson County officials they could save millions of dollars by refinancing their sewer debt. He recommended that the county use a combination of adjustable-rate bonds and interest-rate swaps.

The officials took JPMorgan's advice, and in 2002 and '03 Jefferson County issued $3 billion of adjustable-rate bonds, including $2.2 billion of auction-rate securities, bonds whose interest rates reset at periodic auction sales by banks. Those bonds provided the banks with about $55 million in fees, county records show. JPMorgan sold Jefferson County $2.7 billion of interest-rate swaps, Bank of America sold the county $373 million in swaps and New York–based Lehman Brothers sold the county $190 million more. The swaps, if they worked as designed, would allow Jefferson County to pay about 4.2 percent on its debt for 40 years.

Jefferson County was so enthusiastic about its sophisticated debt management techniques that in 2003 and '04 it held "Investor Relations" seminars each year in a Birmingham hotel. The events were sponsored by 32 banks, advisers, law firms, bond insurers and rating companies, including CDR Financial Products, the county's Beverly Hills, California–based swap adviser, Bear Stearns and JPMorgan. County officials solicited sponsorships, including $27,000 from JPMorgan, $15,000 from Bear Stearns and $10,000 from CDR.

"We have so many little municipalities around here that can't afford to go for any kind of training," says Linda Goldblatt, the county's investor relations director. "We thought it would be a good idea to help get them some idea of what's going on out there."

Bankers from Bear Stearns and JPMorgan, along with advisers from CDR, led the sessions. "The worldwide use of privately negotiated derivatives has generated considerable momentum," a JPMorgan presentation said. "The need for prudent financial management continues to drive the wider use of privately negotiated derivatives." The phrase *privately negotiated* is a euphemism bankers use to describe debt deals that are struck without competitive bidding—as all of Jefferson County's were.

Then JPMorgan banker Matthew Roggenburg quoted Federal Reserve Chairman Alan Greenspan's lauding derivatives for creating a more flexible and efficient financial system. "New financial products have enabled risk to be dispersed more effectively to those willing, and presumably able, to bear it," Greenspan said in an April 2002 speech. "Shocks to the overall economic system are accordingly less likely to create cascading credit failure."

In 2004, three months before one of the seminars, Bear Stearns, along with Montgomery, Alabama–based underwriter Blount Parrish & Co.

Shortfall

Credit rating downgrades caused bond interest rates to spike, creating a gap in Jefferson County's books.

$15.5 million per month (sewer system revenue)

—$22.8 million per month (interest on sewer debt)

—$7.3 million per month

Source: Porter, White & Co.

and Mobile, Alabama–based Gardnyr Michael Capital Inc., pitched the county another swap deal, its largest yet. The county sought to generate millions in upfront cash to hold down sewer bills by agreeing to pay 67 percent of the one-month rate on the London interbank offered rate. In return, the banks would pay the county 56 percent of one-month Libor plus 0.49 percentage point.

In June 2004, the county entered into $1.5 billion of swaps with Bear Stearns on those terms and another $380 million swap with Bank of America on those terms. Jefferson County received $25 million in upfront cash. The deals also gave Jefferson County the distinction of holding the most interest-rate swaps—$5.8 billion in all—of any county in the U.S.

County Commissioner Jim Carns, 67, says the banks used the lack of transparency in derivatives to overcharge Jefferson County. "It's easier for mischief to take place in an unregulated market," he says. "You don't have a teacher watching the playground."

A YEAR AFTER the swaps deals with Jefferson County, JPMorgan's LeCroy ran into legal trouble. He was indicted in June 2004 on federal fraud charges in a municipal finance corruption scandal in Philadelphia. JPMorgan fired him. In January 2005, LeCroy pleaded guilty and was later fined $15,000 and imprisoned for three months. He declined to comment.

The SEC's action against Langford, the former county commission president, hit closer to home. In April, the agency accused Langford in federal court of fraud for failing to disclose he had accepted more than $156,000 from William Blount of Blount Parrish. Langford steered a portion of the work on every swap and bond deal in 2003 and '04 to Blount, which was paid more than $6.7 million in fees, according to the complaint. The SEC said in an April 30 press release that it was still investigating.

Langford says the SEC's allegations are untrue. "It was a political witch hunt from day one," he says. "Blount and I have been friends for 30 years. He wouldn't have had to buy no involvement in no bond deal from me."

Andrew Campbell, a lawyer for Blount, denies any wrongdoing and says the SEC doesn't have jurisdiction over swaps.

The SEC has asked the Jefferson County commissioners to turn over information regarding payments, fees and gifts relating to the county's bond deals and swaps since January 2002, according to Commissioner Collins. The agency specifically asked for all communications with Bank of America, Bear Stearns, JPMorgan and Lehman Brothers.

Bachus, the Alabama congressman, says the entire controversy would have been avoided if Jefferson County had simply used the kind of financing all municipalities once used: fixed-rate bonds, which through the early 1970s were almost always sold through competitive bidding. "On a 30-year issue at a fixed rate, then everybody knew the risk," Bachus says. "Now, with these swaps and these different transactions, the taxpayers, the ratepayers, even the county—I don't think they understood what they were getting into."

Municipal Bankruptcies

If Jefferson County defaults, it would be the largest U.S. failure ever based on outstanding bond debt.

Outstanding debt at time of bankruptcy

1994: Orange County, California Investment losses from derivatives spur default.	**$1.6 BILLION**
1991: Bridgeport, Connecticut Tax base falls as companies, residents leave.	**$173.0 MILLION**
1999: Camden, New Jersey Revenue falls as manufacturing declines.	**$128.3 MILLION**

Sources: Annual audits, bond offering documents

Some of Jefferson County's commissioners agree. Collins, a Republican and one of the two current members of the five-person board who were there when the deals were struck, says it's now clear that the financing was wrong for the county. Commissioner Smoot says the commission misplaced its confidence in the bankers and advisers. "I blame the people who said they were the experts," Smoot says. "The big Wall Street bankers. Where are they now? We trusted them. We asked our folks to trust them. And you know what—they violated our trust."

The interest rate on $2.2 billion of the county's bonds was determined by bond auctions to investors, periodically run by banks. Because of the global debt crisis, investors and banks began pulling money away from the auction-rate-securities market at the start of 2008. When

'I blame the people who said they were the experts,' says Jefferson County Commissioner Shelia Smoot. 'The big Wall Street bankers. Where are they now? We trusted them. And you know what? They violated our trust.'

those auctions failed because no one bought the securities, Bank of America and JPMorgan, seeking to shore up their own capital, didn't step in and buy the Alabama debt, as banks that had run such auctions had in the past. That forced Jefferson County to almost double the interest payments on its auction-rate bonds.

Meanwhile, the payments the county received under its swap agreements, which were supposed to cover the interest payments on its floating-rate bonds, went down. The payments were supposed to track the county's bonds, covering any increase to its bills. Instead, they added to them. "We were already on the razor's edge of what we could afford," Commissioner Carns says. "We're going into the Superbowl with one arm in a cast and another tied behind our backs."

February brought even worse news, Carns says. On Feb. 26, Moody's cut the sewer bonds to Baa3, one step above junk. The downgrade triggered clauses in the county's swap agreements. Bank of America, Bear Stearns, JPMorgan and Lehman Brothers now had the right to cancel the deals—at a cost of $277 million to the county. The group of banks left holding almost all of its $847 million of unwanted bonds could also cancel the deals to act as buyers of last resort and force the county to buy the bonds back. On Feb. 29, Standard & Poor's cut the sewer bonds to junk. "Once we got cut to junk status, we couldn't go any lower without just leaving the scene and turning over a corpse to somebody," Carns says.

In March, the county sent its financial advisers from Porter White to meet with JPMorgan, other banks and bond insurers in New York. They tried to convince the bank to take about $30 million of the revenue from the one-cent sales taxes it collects for a $1 billion school construction bond and add those funds to the $115 million of annual income the county's sewer system can use to pay for the debts. That would still have left the county with at least $100 million less than what it says it's annual interest bill would be. The banks and insurers didn't accept the offer. They told the county to find ways to increase sewer revenue, Porter White's President Jim White says.

"We cannot raise sewer rates," Commissioner Collins says. "We've done that and we've done that."

Birmingham resident Dora Bonner, the grandmother who lost her water, says she feels betrayed by the county's politicians. "They're not interested in us," she says. "We elect them, then they turn the other way."

Bonner and other residents are paying for a lesson that Warren Buffett, the world's richest man, wrote about in 2003. Derivatives are like hell, he said: "Easy to enter and almost impossible to exit." **B**

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Tracking Rates on Jefferson County's Bonds

Rates on some of Jefferson County's sewer bonds jumped in February after credit rating companies downgraded its bond insurers. Type 472682KJ1 <Muni> MFLD <Go> to track the weekly rates on a variable-rate sewer bond using the Adjustable Coupon Muni function. For a description of the bond, type DES <Go>. Type 40365Z <Equity> CRPR <Go> for a credit profile of XL Capital Assurance, the bond's insurer.

Just as the county's monthly debt payments were increasing, the rate that the county received as part of an interest-rate-swap agreement declined. Interest-rate swaps exchange payments at one interest rate for payments at another. In its swap, Jefferson County received payments based on the London interbank offered rate. When Libor declined, the gap between the county's payments on its sewer debt and what it received in the swap widened.

Type BTMM US <Go> to use the Treasury & Money Markets function to find U.S. dollar Libor rates. To graph one-month Libor, the rate used for one of the county's swaps, click on 1M in the Libor Fix panel and select GP on the menu that appears. Type MFVI <Go> for a menu of indexes you can use to compare yields on municipal bonds of various ratings. Type MARS <Go> for the Municipal Auction Rate Calendar function. MARS displays a sortable list of variable-rate muni securities, as shown below.

In April, the U.S. Securities and Exchange Commission filed a complaint in federal court accusing former Jefferson County Commission President Larry Langford of accepting money from a local finance firm when the county was refinancing its sewer debt. You can use the Bloomberg Law Search function to display the complaint in the case. Type BBLS <Go>, tab in to the Enter Search Terms field, enter *2:08-cv-00761-SLB* and press <Go> 1 <Go>. Scroll down to the Docket Proceedings box and click on 1 under Req # to display the complaint.

MARYANN BUSSO

JPMorgan's MUNI

The bank that the U.S. government relied on to rescue Bear Stearns reaped excessive fees on municipal derivative deals that are backfiring on taxpayers. The Justice Department is investigating.

By WILLIAM SELWAY and MARTIN Z. BRAUN

JOSEPH AMBROSINI SAYS the deal looked so easy. JPMorgan Chase & Co. bankers told him there was really no risk. All he had to do was sign a public financing contract, and the bank would give $280,000 to his school district in New Castle, Pennsylvania. "They basically said, unless the world goes under the sea, we'd be in good shape," says Ambrosini, the district's business manager.

In September, Ambrosini says, his 3,400-student district went underwater. On Sept. 25, the week after Lehman Brothers Holdings Inc. collapsed, the New Castle Area School District's interest rate on $9.7 million of financing arranged by JPMorgan hit 10.6 percent, more than doubling since the month began, as investors demanded skyrocketing returns for municipal debt.

While JPMorgan has been relatively unscathed by the subprime crisis that hit Bear Stearns Cos., Merrill Lynch & Co., Lehman and other Wall Street firms, a little-known part of the largest bank in the U.S. made a tidy profit peddling a different kind of corrosive debt to hundreds of counties and school districts earlier this decade. As the credit crunch froze lending globally, causing stock markets to plunge, local officials who say they trusted JPMorgan faced a crisis of their

Employees at **JPMorgan's Manhattan headquarters** put municipalities at risk with exotic derivatives.

Photograph by JB REED/BLOOMBERG NEWS

MORASS

own. Wall Street's drive for profits over the past decade has backfired on towns, cities and counties that borrow in the $2.7 trillion municipal bond market.

Financings arranged by JPMorgan and other banks are forcing hundreds of public agencies to spend billions of dollars they don't have to pay for increased interest payments and penalties. These come in municipal bond and derivative deals that have turned poisonous. Unlike JPMorgan, which has benefited from federal bailouts, the towns and schools the bank has financed have received no help from Washington.

In the midst of the Wall Street collapse, JPMorgan and Jamie Dimon, its chief executive officer, have stood as pillars. The bank helped the Federal Reserve bail out a tumbling Bear Stearns in March, as the U.S. Treasury pledged $29 billion to Dimon's firm to cover losses. In October, JPMorgan took over failing Washington Mutual Inc., the largest savings and loan institution in the U.S., with $188 billion in deposits.

BEHIND THE GLOW of favorable publicity in which JPMorgan has basked, its municipal derivatives unit has operated in obscurity. The financings it arranged have sparked lawsuits from local governments alleging fraud. The muni derivatives unit has become snarled in the largest-ever criminal investigation of public finance by the Department of Justice. Prosecutors have informed at least five former JPMorgan derivative bankers that they're targets in an investigation of whether banks conspired to overcharge local governments, according to the Financial Industry Regulatory Authority, or Finra, the largest self-regulator for securities firms doing business in the U.S. The Securities and Exchange Commission is conducting a civil probe of the deals.

On Sept. 3, JPMorgan shut down its unit selling debt derivatives to municipalities because the risks outweighed the profit. Even so, localities are still on the hook for explosive contracts arranged by the bank.

"The legacy of this is going to resonate in state and local governments for years," says Christopher Taylor, who ran the Municipal Securities Rulemaking Board, the industry's regulator, from 1978 to 2007. "The culture started before Jamie Dimon got there. The question is, Is he going to clean it up once and for all? Because it stands in contrast to the rest of JPMorgan's public image."

The bank declined to make Dimon or any other executives available to comment for this story.

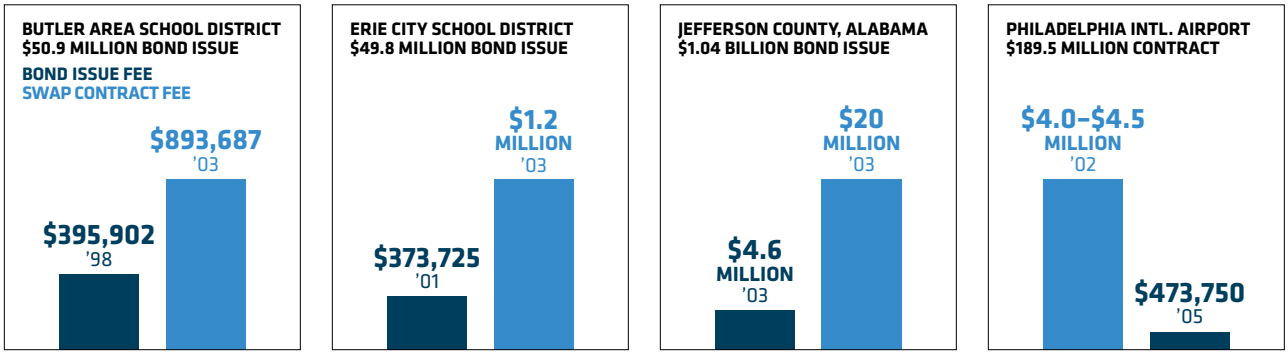
JPMorgan lured municipalities into derivative deals by offering upfront cash payments in exchange for a pledge by the local government to agree to enter interest-rate swaps with the bank at a future date. In these deals, which were rarely put out for public competitive bidding, the bank said its clients would come out ahead if interest rates increased in the future. JPMorgan and competitors routinely didn't disclose their fees for these contracts, public records show. In some cases, the bank made more money than it paid out. In Erie, Pennsylvania, JPMorgan gave the school district $755,000 upfront and collected $1.2 million in fees. The bank was able to lock in its income by selling a mirror-image swap contract on the open market for the higher amount. The transactions involved derivatives, which are unregulated contracts tied to the value of securities, indexes or interest rates.

The deals JPMorgan arranged used floating-rate

The **Butler, Pennsylvania, school district** paid $5.2 million to JPMorgan to end a deal in which the bank paid it $730,000.

Giant Fees

JPMorgan got more money from selling derivatives on municipal debt than from arranging the bond issues.



Sources: Bloomberg; Butler Area School District; Erie City School District; Jefferson County, Alabama; official statement, City of Philadelphia and testimony by JPMorgan banker Charles LeCroy at December 2006 SEC administrative hearing

TIMOTHY FADEK

bonds and interest-rate swaps. The swaps required a municipality and the bank to exchange payments as frequently as every month. The amounts that changed hands were based on various global lending rates. Some deals also gave JPMorgan the power over decisions about taxpayer funds by allowing the bank to decide whether an agency would enter a swap in the future.

The bonds were backed by AAA-rated insurance companies and worked well for several years because Wall Street had easy access to cash. By the end of 2007, mortgage losses were undermining insurance company credit ratings and money flows began to tighten.

Nowhere have JPMorgan's derivative deals wreaked more havoc than in Jefferson County, Alabama, home of Birmingham, the state's largest city. A combination of soaring rates on its bonds and interest-rate swaps is threatening the county with the biggest municipal bankruptcy since Orange County, California's default in 1994. Jefferson County said it couldn't make its $84 million interest payment on Oct. 1. JPMorgan and other creditors gave it a month to come up with a plan to rework its debts.

In April, the county's financial adviser approached the Fed and the Treasury in Washington to explain its dilemma. On Oct. 6, Alabama Governor Bob Riley asked the Treasury for financial help for Jefferson County. Washington hasn't offered assistance.

County Commissioner Shelia Smoot says that if the U.S. government was willing to rescue Wall Street, it should have responded to requests for help from a county on the brink of bankruptcy. "If they're bailing out some of the very people who got us in this mess, I think at least we could get a conversation," she says.

JPMorgan and other banks have turned away from traditional, competitively bid, fixed-rate municipal bond sales in the past decade. Fees banks collected for selling bonds that build roads, schools and hospitals dropped 25 percent to $5.27 for every $1,000 of debt in 2007 from 1998, as fixed-rate bonds became like commodities dropping in sales value. Banks found they could charge 10 times as much for selling municipal derivatives, public records show.

'The legacy of this is going to resonate in state and local governments for years,' a former regulator says. 'The question is, Is Jamie Dimon going to clean it up?'

"The Street was driven into this stuff because the cash products weren't profitable," says Christopher Whalen, a former Bear Stearns bond trader who's now managing director of research firm Institutional Risk Analytics. "You've got to find new participants or the game shrinks."

If local authorities had stayed with old-fashioned, fixed-rate municipal bonds for financing, they wouldn't be facing the rate blasts hitting them today. But banks realized that plain-vanilla municipal bond sales didn't make them enough money, says Steve Kohlhagen, former head of debt derivatives at Wachovia Corp. "It just wasn't a very profitable business, but the derivatives part was," says Kohlhagen, who retired in 2002. "So we kept a minor presence in bonds. The reason was the derivatives."

JPMorgan was the sixth-largest municipal bond underwriter in 1985, with Citicorp and Merrill Lynch at the top of the list, according to data compiled by Thomson Reuters. JPMorgan managed to gain on its New York–based rivals by developing new methods of public finance. Using derivatives, JPMorgan pitched a host of deals whose names alone are indecipherable. For Philadelphia International Airport, the bank sold something called a "path-dependent knock-out swaption." JPMorgan also sold interest-rate swap options, which are also known as swaptions, to school districts. When JPMorgan exercises those options, municipalities must issue floating-rate bonds and enter into interest-rate swaps with the bank.

Philadelphia International Airport's interest rate on bonds that were part of a JPMorgan derivative deal rose fourfold in one June week.

SAM OBERTER

The contracts allowed borrowers to tap money market funds to secure short-term rates on bonds that wouldn't mature for decades. The derivatives were meant to protect them against soaring rates. For the arrangements to work, banks would have to find buyers of municipal debt as often as every day. That included the so-called auction-rate bond market, which for decades ran smoothly with a surplus of buyers. When the credit crunch hit in the second half of 2007, demand for such sales withered away. That sent the market for variable-rate municipal debt and derivative contracts into a frenzy.

When banks couldn't find buyers for auction-rate bonds, they stopped purchasing them themselves, so municipalities were left high and dry, stuck with spiking interest rates. The turmoil later rippled through the market for other variable-rate bonds as investors demanded high yields for them, too. That increased interest rates each month for cities and towns.

Municipalities were stung again when the swap contracts, which were written to protect against rising rates, didn't work. Since the second half of 2007, lending rates have declined, causing the payments banks made to municipalities to drop.

On Aug. 14, JPMorgan settled with regulators, agreeing to buy back $3 billion of auction-rate bonds to settle industrywide investigations of whether banks misled investors about the risks of the auction bonds. JPMorgan neither admitted nor denied wrongdoing. That action didn't help Jefferson County.

"A lot of people are getting killed; they're getting crushed," says Steve Goldfield, a financial adviser at Public Resources Advisory Group in Media, Pennsylvania, which was hired by a school district now suing JPMorgan. "Nobody is talking about the impact on the debt side to taxpayers, how much school districts are going to pay in extra interest expense because of this blowup."

The seeds of JPMorgan's municipal derivative deals were planted in the late 1980s. In 1987, the Fed relaxed provisions of the Glass-Steagall Act, the Depression-era legislation that prevented commercial banks from underwriting corporate securities and many types of local bonds. The decision, which followed requests from Bankers Trust Corp., Citicorp and JPMorgan, allowed all banks—not just securities firms—to expand their sales of public debt.

The **New Castle Area School District** in Pennsylvania is wrestling with interest rates that jumped as high as 10.6 percent in September.

TIMOTHY FADEK

JPMorgan seized the opportunity. It turned to its strength: derivatives, says Peter Shapiro, managing director at Swap Financial Group LLC, a South Orange, New Jersey–based financial adviser. "More than anybody else, they used derivatives to go from nowhere as an underwriter in 1987 into the group of leaders," Shapiro says.

The most common derivative JPMorgan sold to municipalities was the interest-rate swap, in which two parties agree to exchange periodic payments based on two different interest rates, one fixed and the other floating. Municipalities liked the deals because they could get cash upfront. "They were able to create very appealing products for municipal issuers on what is known as the exotic side of the market," Shapiro says.

In 2000, J.P. Morgan & Co. and Chase Manhattan Corp. merged. Douglas MacFaddin, the head of Chase's municipal derivatives group, took over from Ajay Nagpal, who had headed J.P. Morgan's desk. MacFaddin joined with former Chase bankers Samuel Gruer, James Hertz and Hugh Nickola.

The Justice Department told Gruer, Hertz and MacFaddin beginning in November 2007 that they were targets in the criminal investigation of the municipal derivatives market, according to Finra. JPMorgan fired MacFaddin and Hertz after learning of the probe, federal records show. Nickola wasn't named as a target and still works at JPMorgan. Gruer, who joined Deutsche Bank AG in 2006, denies wrongdoing, records show. MacFaddin, Nickola and Hertz didn't return requests for comment. Gruer declined to comment.

MacFaddin, 47, a graduate of Union College in Schenectady, New York, took J.P. Morgan's emphasis on exotic derivatives and merged it with Chase's goal of doing many deals quickly, Shapiro says.

Just as lenders that offered subprime mortgages relied on an army of local brokers to sign up less-than-creditworthy borrowers, JPMorgan developed ties with local municipal bond firms, advisers and lawyers to land deals.

JPMorgan gave these firms work in return for promoting the bank to elected officials, Charles LeCroy, JPMorgan's top revenue producer in public finance, told an outside lawyer for the bank in 2004, according to court filings in Philadelphia.

In 2005, LeCroy, 54, and JPMorgan banker Anthony Snell pleaded guilty in Philadelphia to charges of filing false invoices in connection with swap and bond deals steeped in corruption. LeCroy was sentenced to three months in jail. Snell was sentenced to 90 days of house arrest and fined $15,000. Philadelphia Treasurer Corey Kemp was found guilty after a trial in Federal

District Court in Philadelphia in 2005 and is serving 10 years in prison.

In Philadelphia, JPMorgan turned to bond lawyer Ron White, a confidant and fundraiser for Mayor John Street. "He carries a lot of stroke with the city," LeCroy wrote of White to a fellow JPMorgan banker in a December 2001 e-mail.

All of the deals that JPMorgan and White discussed involved derivatives, LeCroy said during an SEC administrative hearing in December 2006. JPMorgan agreed to train White so he could become the lawyer on Philadelphia's interest-rate-swap deals, LeCroy told investigators. In 2002, LeCroy held a meeting between White and MacFaddin, who outlined what White would have to do, according to court records.

JPMorgan also agreed to contribute to White's charities. It gave $70,000 to a foundation for youth leadership and $20,000 for a minority scholarship fund in White's name at his alma mater, Wesleyan University in Middletown, Connecticut. JPMorgan also paid White $50,000 in a Mobile, Alabama, public finance transaction in which he played no role, court records show.

On Feb. 19, 2003, White told Kemp that JPMorgan was pushing swaps to generate fees, not because they were in the city's interest, according to a tape recording by the Federal Bureau of Investigation. "You know, they don't watch your back," White said. "They're about getting fees and getting the most fees they can get. If there was an issue between whether to do a bond deal or a swap, they gonna take the swap, even though it may not be the best thing." White died of cancer before the trial.

Richard Metcalfe, head of policy for the International Swaps and Derivatives Association Inc., says swaps help to manage risk. "While an interest-rate swap will hedge against movements in interest rates, it is simply not designed to address other forms of risk," he says.

Targeted

The Justice Department has notified JPMorgan bankers that they're under investigation in its probe of the derivatives industry. No charges have been filed.

EMPLOYEE, TERM AT JPMORGAN	JUSTICE DEPT. LETTER
Peter Ghavami January 1997–April 1999	Nov. 30, 2007
Samuel Gruer, vice president February 1994–June 2006	Nov. 30, 2007
Douglas MacFaddin, managing director February 1994–April 2008	Dec. 1, 2007
James Hertz, vice president February 1994–January 2008	Dec. 1, 2007
Michael Lena, vice president November 2001–June 2008	Dec. 1, 2007

Source: Financial Industry Regulatory Authority records

The **Erie, Pennsylvania, school district** sued JPMorgan for fraud regarding fees.

TIMOTHY FADEK

In April 2002, Philadelphia International Airport entered into a high-stakes derivative trade with JPMorgan. The airport got $6.5 million; JPMorgan acquired the right to put the bank into an interest-rate swap on $189 million of bonds. JPMorgan took in $4 million–$4.5 million on the deal in fees, according to LeCroy's SEC testimony. That was 10 times what the bank earned for underwriting a floating-rate-bond issue for the airport after the bank exercised the option. The deal has turned out terribly for Philadelphia. In June 2008, the interest rate on the floating-rate bonds the airport issued surged to 7.2 percent from 1.8 percent the week before, after MBIA Inc., the company that guaranteed the bonds, lost its AAA credit rating. The rate on the debt reached a high of 10 percent on Sept. 23.

That wouldn't be so bad if the floating rates the airport received from JPMorgan matched the increased rate it pays the bond investors, which is what the contract is designed to do. That hasn't happened. The average rate the bank paid the airport from June to September was 2.27 percent.

Philadelphia officials say they don't really have the choice of canceling the swap. Based on prices at the end of September, termination would cost Philadelphia about $24.4 million, according to the city. That's almost $20 million more than what it received in 2002. "Obviously, the termination payment would be significant," City Treasurer Rebecca Rhynhart says. "It's something we'd rather not have to do."

JPMorgan turned to other politically connected friends to win contracts in Western Pennsylvania in 2003. That year, it bought Cranberry Township–based underwriter RRZ Public Markets Inc., near Pittsburgh. Greg Zappala, the son of former Pennsylvania Supreme Court Chief Justice Stephen Zappala and the brother of the Allegheny County district attorney, brought his local government clients to the Wall Street bank. Along with them, according to two lawsuits, came windfall profits on derivative deals.

Zappala urged the Butler Area School District, in the countryside 40 miles (64 kilometers) north of Pittsburgh, to take cash out of bonds that couldn't be refinanced until 2008. In September 2003, the school district got $730,000 from JPMorgan by selling the bank the option to push the school district into a swap beginning in 2008. That exchange was more valuable to JPMorgan. The bank made $894,000 at the same time, according to a lawsuit filed by the district in September. The district alleged that JPMorgan conspired with adviser Investment Management Advisory Group Inc., or IMAGE, to hide the fees and push the district into an unfair trade. As of mid-October, JPMorgan and IMAGE hadn't filed a court response.

In July, JPMorgan told the school district it would exercise the option on Oct. 1. That would lock the district into potentially huge interest rate

increases. So the district paid JPMorgan $5.2 million to walk away, seven times more than the bank paid it in 2003.

Edward Fink, superintendent of the school district, says it's now clear the risky deal was a mistake. "The last few months have led us to conclude that swap transactions, although legal for public school districts in Pennsylvania, are inappropriate transactions for public school districts," he says.

The New Castle school district is learning the same lesson. In September, Ambrosini, the district's business manager, found that the cash the schools accepted left him exposed to market chaos he never anticipated. In 2004, JPMorgan banker Michael Lena, one of those under investigation by the Justice Department, made a deal with the district in which the bank gave the schools $280,000 for the option to force the district into interest-rate swaps on $9.7 million of bonds. It also purchased options on two other district bond issues. Lena didn't respond to requests for comment.

Ambrosini says JPMorgan's bankers told him the deal was nearly fail-safe and would allow the schools to collect money that would disappear if interest rates rose. "They assured me, 'You're going to be in great shape,'" he says.

He's not. The credit crisis caused the interest rate to jump on Sept. 25 to 8.75 percent on $9.7 million of bonds he sold in May as JPMorgan called in its option. The swap added another 1.9 percentage points, bringing the district's interest rate to 10.6 percent. Phil Conti, vice president of the New Castle school board, says he doesn't know what to do. "We're in a dilemma," he says. "We're struggling just to keep our head above water."

Many municipalities, including Butler County, Jefferson County and Philadelphia, hired financial advisers to analyze prices, fees and interest rates to determine whether swap contracts were fair. Local officials failed to recognize the conflicts of interest created by the relationships between the advisers and the banks. Banks routinely pay these advisers and often refer them to government issuers.

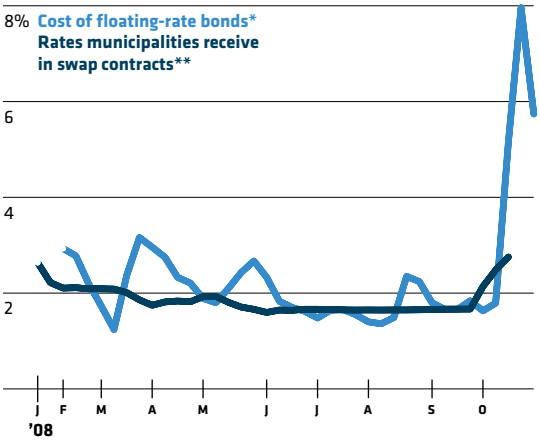
In Erie, JPMorgan recommended Pottstown, Pennsylvania–based IMAGE to be the school district's independent financial adviser. During a Sept. 4, 2003, meeting of the Erie City School District's board, JPMorgan banker David DiCarlo praised the firm. "There's only probably three or four firms in the world that do these things, and IMAGE is probably the premier firm," DiCarlo said, according to a transcript of the meeting. As in Butler, IMAGE never disclosed JPMorgan's fee. Neither did the bank. In a written statement, IMAGE said it could only estimate the bank's fees, which it described as normal for the industry. The firm denied any conflict of interest.

Erie school board member Eva Tucker asked DiCarlo how much JPMorgan would make in the deal. "Everybody has asked, and it is a reasonable question, what does JPMorgan, what do we get on this transaction?" DiCarlo said, according to minutes of a school board meeting. "I can't quantify that to you. What this transaction is, is a financial transaction that is put into a huge hedge fund that JPMorgan controls. There's a trillion dollars of investments in that hedge fund. There's some other issuer in Tokyo or somewhere else who's got an opposite bet and they're going to offset each other."

'They're about getting the most fees they can,' a former bond lawyer testified. He said banks sell swaps to local officials at the expense of the public.

Swaps Backfire

Municipalities have been forced to pay out more in interest on their bonds than they got from contracts designed to offset debt costs.



*SIFMA Municipal Swap Index. **Based on 67 percent of the London interbank offered rate. Bond data, Jan. 16–Oct. 1; swap data, Jan. 18–Oct. 3. Sources: Bloomberg, Securities Industry and Financial Markets Association

JPMorgan, which, like other banks, balances the swaps by selling similar derivative deals on the open market, took a fee of $1.23 million, according to data compiled by Bloomberg. That's almost 10 times the fair rate, according to a lawsuit filed by the school district against JPMorgan and its adviser in federal court. There had been no court-filed responses as of mid-October. DiCarlo, Zappala and IMAGE didn't return requests for comment.

The JPMorgan municipal finance deals that have drawn the most national attention are those in Jefferson County, Alabama. The county, with a population of 660,000, has $5.4 billion in swaps on its books—the most of any county in the U.S. In "The Banks That Fleeced Alabama" (September 2005), Bloomberg Markets reported that JPMorgan overcharged the county by $45 million on its derivative deals.

The interest rate Jefferson County must pay on its bonds jumped as high as 10 percent in February from about 3 percent two months earlier. The swap agreements drove the county deeper in the hole. It may be forced to file for bankruptcy.

Clarence Arnold, who lives in Birmingham on $738 a month from Social Security, worries that people like him will wind up paying the bill. "We didn't get them in

this mess," Arnold, 66, says. "But it doesn't matter what we do. It's going to end up in our hands. It always does."

In 2002 to '03, Jefferson County refinanced into floating rate bonds almost all of the $3.2 billion of debt it sold to build a sewerage system. The county paid JPMorgan and a group of banks $120.2 million in fees for derivatives that were supposed to protect it from the risk of rising interest rates. Those fees were about $100 million more than they should have been based on prevailing rates, according to James White, an adviser the county hired in 2007, after the SEC said it was investigating the deals.

JPMorgan and seven other banks in the deals were left holding most of the bonds after credit markets froze in early 2008. The banks asked to get paid back with county tax money or higher sewer fees. Such proposals caused a public outcry. "We were boxed in because we couldn't raise taxes and couldn't raise rates, which are already too high anyway," County Commissioner Jim Carns says.

White traveled to Washington in April to tell members of Congress and officials at the Federal Reserve and the Treasury Department about the crisis that was threatening Jefferson County with bankruptcy. "We were told Jefferson County didn't have national implications," he says.

The crisis triggered a seven-month standoff between the county and the banks. In negotiations with the county, banks have sought to be released from any liability in the swap and bond deals, Carns says. "My constituents do not want to let Wall Street off the hook," he says. Carns says he opposed the $700 billion Wall Street bailout. "Motivated by overwhelming greed, Wall Street thrashed around creating financing structures divorced from reality and good sense—and paid lots of people way too much money," he says.

In Jefferson County, the local consequences may be dire. In Birmingham, one in four people lives below the poverty line, according to the U.S. Census Bureau. Those residents may be forced to bail out the debt mess by paying higher sewer bills. "The poor people are going to be suffering for it," retiree Arnold says.

Jefferson County, Alabama's deals could force bankruptcy.

It's not just in Birmingham. Across the country, Wall Street made windfalls peddling risk and the illusion it could be kept under control. Beverly Schenck, a 71-year-old paralegal who lives in Center Township, Pennsylvania, in the Butler school district, is livid. "Why wasn't someone investigating these deals?" she says. "If it looks too good to be true, it is."

For municipal governments, as for many of the financial institutions themselves, the opaque derivative deals have broken down. And taxpayers are left picking up the pieces. **B**

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Comparing Muni Debt Costs and Insurance

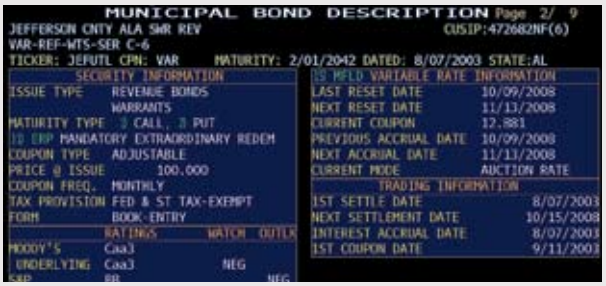
Local governments that entered into derivatives contracts that were intended to protect them by offsetting adverse interest rate changes have seen the contracts backfire.

This year, some municipalities were forced to pay higher rates on their variable-rate bonds when interest costs jumped as credit became scarce and investors demanded higher rates to lend cash. Meantime, the payments that local governments got from derivatives contracts didn't keep up.

You can track the average rate that local governments pay on their variable rate debts by typing MUNIPSA <Index> GP <Go>. In September, the rate soared to 8 percent. As of Oct. 8, it was 4.82 percent. In comparison, the payments that municipalities receive from swap contracts are typically based on the benchmark London interbank offered rate. Type US0001M <Index> GP <Go> to graph one-month Libor. In September, the rate hit a high of 3.9 percent, about half of what municipalities had to pay on their bonds. As of Oct. 10, one-month Libor was 4.6 percent.

For a description of a Jefferson County sewer revenue bond, type 472682NF <Muni> DES <Go>. Press <Page Fwd> for more information on the bond, as shown below. Type MFLD <Go> to use the Adjustable Coupon Muni function to track the weekly rates set on the variable rate bonds.

MARYANN BUSSO


MUNICIPAL BOND DESCRIPTION Page 2/ 9
JEFFERSON CNTY ALA SWR REV CUSIP:472682NF(6)
VAR-REF-WTS-SER C-6
TICKER: JEFUTL CPN: VAR MATURITY: 2/01/2042 DATED: 8/07/2003 STATE:AL

SECURITY INFORMATION		15 MFLD VARIABLE RATE INFORMATION	
ISSUE TYPE	REVENUE BONDS	LAST RESET DATE	10/09/2008
	WARRANTS	NEXT RESET DATE	11/13/2008
MATURITY TYPE	3 CALL, 3 PUT	CURRENT COUPON	12.881
15 ERP	MANDATORY EXTRAORDINARY REDEM	PREVIOUS ACCRUAL DATE	10/09/2008
COUPON TYPE	ADJUSTABLE	NEXT ACCRUAL DATE	11/13/2008
PRICE @ ISSUE	100.000	CURRENT MODE	AUCTION RATE
COUPON FREQ.	MONTHLY	TRADING INFORMATION	
TAX PROVISION	FED & ST TAX-EXEMPT	1ST SETTLE DATE	8/07/2003
FORM	BOOK-ENTRY	NEXT SETTLEMENT DATE	10/15/2008
RATINGS	WATCH OUTLK	INTEREST ACCRUAL DATE	8/07/2003
MOODY'S	Caa3	1ST COUPON DATE	9/11/2003
UNDERLYING	Caa3 NEG		

JEAN SHIFRIN