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TRACKING THE NUMBERS

Outside Audit

Sweet Hedge Alabama:
A County Defends
Rate-Swap Strategy

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Jefferson County, Ala., is counting on a large portfolio of sophisticated interest-rate swaps to help save millions of dollars on pedestrian public-debt projects like a new sewer system.


Federal authorities are hoping the county's finances don't go down the drain instead. Critics point out that the swaps currently cost taxpayers money.

Welcome to the front of a growing debate over the use of swaps by municipal governments. In their most basic form, interest-rate swaps allow parties to trade exposure to fixed- and floating-rate debt. Swaps are often used by companies, and traders, including hedge funds, often take swap positions.

Wall Street banks, such as J.P. Morgan Chase and others, and boutique municipal underwriters like Rice Financial Products in New York have been pitching local governments on swaps that can help reduce debt -- or greatly magnify it. Some of the terms of these swaps are complicated and reset frequently.

The proliferation of swaps among smaller municipalities in recent years "concerns me because these things are complicated," says Martha Haines, chief of the Securities and Exchange Commission's municipal-securities unit in Washington. "I'm concerned that little guys are getting in and don't know what they're doing."

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Towns of various sizes are turning to swaps. But Jefferson County -- population 660,000, about one-third of whom live in Birmingham, and 2004 revenue of \$534 million -- has exposure that rivals some of the biggest hedge funds: 18 interest-rate swaps with a notional, or total underlying value, of \$5.8 billion. By way of comparison, Houston -- the Texas town of two million people with 2004 revenue of \$2.6 billion and about 80% more debt than Jefferson County -- has two swaps with a total notional value of \$850 million.

Bankers and consultants say Jefferson County has the biggest swap exposure for a government of its size, and the portfolio is raising eyebrows.

"The fact that they're doing all of these trades indicates they're speculating," says Robert

Whaley, a business-school professor of finance at Duke University in Durham, N.C. "The question is whether they have any expertise."

Jefferson officials bristle at suggestions that they aren't on top of the swaps portfolio.

"We feel we've been wise in managing the county's debt and swaps," says Steve Sayler, Jefferson County's director of finance, noting that bond insurers, rating agencies and lawyers approved all the county's swap transactions. "It's easy to pick on us because we're supposedly a bunch of dumb country bumpkins and rednecks."

Standard & Poor's last month assigned the bulk of the county's swaps a so-called Debt Derivatives Rating of "2" -- meaning the portfolio has a "neutral" risk.

Mr. Sayler says the county entered into its swaps to offset the costs of its debt, which now amounts to about \$4 billion, with a goal of saving about \$215 million over the 40-year life of the swaps in present-value terms. J.P. Morgan sold the county about half of the swaps in the portfolio, while Bank of America, Bear Stearns and Lehman Brothers are the counterparties to the rest of the swaps.

Mr. Sayler won't say how much the swaps have gained or lost to date, but an audit of the county's finances released in April by Alabama's chief examiner of public accounts concluded that the county had made net payments on its swaps from 1997 to September 2004 of about \$85 million. Mr. Sayler says that while that number was "materially accurate," the conclusions were not "totally accurate." He declined

to elaborate. The chief examiner, Ronald Jones, didn't return several calls.

By another measure -- the market value of the swaps portfolio were all the contracts to be canceled -- Jefferson County would have faced a loss of about \$231 million at the end of May. Both Mr. Saylor and S&P say it is rare for municipalities to be forced into early termination of their swaps.

Unlike the bankruptcy situation a decade ago of Orange County, Calif., which gambled with regulated securities and lost, any blow-ups in municipal swaps have an even greater chance of catching markets -- and taxpayers -- off guard because they are unregulated. Auditors and regulators stress that the benefits and risks of the swaps need to be made clear in governments' financial disclosures.

Such clarity is lacking in some of Jefferson County's disclosures, contends Robert Fuller, principal at New Jersey swaps adviser Capital Asset Management. Mr. Fuller and Prof. Whaley point out that the swaps' potential benefit to the county isn't easily discernible by reading the footnotes to the county's financial statements or the latest 19-page monthly swap-monitoring report compiled by the county's swaps adviser. That report, released on May 2 and packed with coded-data tables, pie charts and graphs, doesn't discuss the risks and benefits of the individual swaps. Instead, it concludes that based on market prices at the time, the portfolio's losses had increased because of increases in short-term interest rates and will continue to grow if rates continue to rise.

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