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Swapping Rates to Save on Debt ... Maybe

Rice Financial Products Offers Cities, States Deal Rife With Benefits, Risks

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Officials in Durham, N.C., hope that a financial transaction with a private New York firm will save the city millions of dollars on its municipal debt.

But some say the deal -- an interest-rate swap with a formula that multiplies the city's potential savings as well as its potential losses -- may contain costly risk.

"They're entering into a gamble where they believe they're going to win more money than they're going to lose," says Robert Whaley, professor of finance and a derivatives expert at Duke University in Durham. "It's just speculation."

The Synthetic Fixed-Rate Refinancing Swap, as it is known, was created by Rice Financial Products Co., which has sold such deals in at least five states. It would work like this in Durham: On existing debt of $103 million, Durham would pay Rice Financial a still-to-be negotiated fixed interest rate over 15 years while Rice Financial would pay Durham a rate that is about 0.9 percentage point greater, plus a so-called adjustment factor. Rice Financial has said the deal could save the city $8 million.

"This proposal is so complex ... that I don't know that there are 30 or 40 people in this entire state who can fully comprehend it," says Eugene Brown, a Durham city councilman who has been lobbying against the swap.

"What you really want to focus on is the all-in cost of funds," says Donald Rice, founder and chief executive of Rice Financial.

The adjustment factor is based on a combination of the Bond Market Association (BMA) benchmark index rate for tax-exempt bonds and the taxable London interbank offered rate, or Libor. Supply and demand, credit risk, tax policy, interest rates and different maturities can result in unpredictable swings in that relationship. "Understanding the dynamics of how these two rates behave in relationship to one another is not an easy task," says Prof. Whaley

The formula effectively "magnifies both potential benefits and risks" by 1.54 times, according to an analysis of the swap structure by Public Financial Management in Philadelphia, Durham's financial adviser. The firm approved the deal but recommended that the city budget the expected savings conservatively.

Rice Financial made an "unsolicited proposal" to Durham City in August after it sold a similar swap to Durham County, says Kenneth Pennoyer, the city's director of finance. Prior to meeting with Rice Financial, he says, the city hadn't been contemplating any sort of swap because most of its bonds outstanding pay a fixed interest rate.

"There's a potential savings for the city, and I think that's a worthwhile goal in itself," Mr. Pennoyer says. He is confident that a final city-council vote April 18 will approve the deal since a commission of the state treasurer has approved it and Standard & Poor's Ratings Services recently gave it its highest rating for this type of transaction.

Mr. Rice is a Harvard Business School graduate who started structuring municipal interest-rate swaps at Merrill Lynch & Co. nearly 20 years ago. He says his company has executed more than $20 billion in swaps since its establishment in 1994. "There may be a circumstance where our transaction causes dis-savings, but it requires a substantial market move ... one that's unparalleled," says Mr. Rice.

Interest-rate swaps aren't new to the municipal-bond markets, but their use has grown over the past three years. As interest rates fell to record lows, municipal issuers were looking for ways to trim costs without issuing more bonds. But with interest rates rising, fixed-rate issuers betting on a formula involving two floating rates and a multiplier effect seems imprudent to some.

"Often the political pressures are such that ... when [potential benefits] are couched in terms of 'savings,' the risk is that people are doing things they don't understand," says Mike Marz, vice chairman of First Southwest Co. in Dallas. First Southwest has advised North Carolina finance officials against using the Rice Financial swap.

Mr. Rice declined to discuss his company's compensation from the swaps, except to say that issuers' financial advisers were responsible for negotiating rates that were "fair value" in the market. On average, municipal-swap deals generate fees of 0.05% to 0.10% of the deal for bankers. Durham City's Mr. Pennoyer said Rice Financial's compensation on the $103 million swap was in the ballpark of about $800,000, or 0.8%.

In 2003 the West Basin Municipal Water District in California sued its financial adviser, P.G. Corbin & Co., in California state court, alleging it gave faulty advice in deeming a Rice Financial swap in 2001 a "fair market transaction."

A spokesman for West Basin said he didn't know the status of the case. Lawyers representing P.G. Corbin didn't return phone calls seeking comment.

Separately, this month a West Basin official was sentenced in U.S. court in California to two years in prison for extorting $25,000 from a consultant at M.R. Beal & Co., then a partner of Rice Financial, to steer the water district's debt-refinancing contract in Rice Financial's favor.

"The well-publicized events among certain of West Basin's board members are unfortunate," Mr. Rice said. "Nonetheless, we are pleased with the products and services we have provided West Basin over the years and value them as a customer."

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