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August 5, 2010

Exotic Deals Put Denver Schools Deeper in Debt

By **GRETCHEN MORGENSON**

In the spring of 2008, the Denver public school system needed to plug a \$400 million hole in its pension fund. Bankers at [JPMorgan Chase](#) offered what seemed to be a perfect solution.

The bankers said that the school system could raise \$750 million in an exotic transaction that would eliminate the pension gap and save tens of millions of dollars annually in debt costs — money that could be plowed back into Denver's classrooms, starved in recent years for funds.

To members of the Denver Board of Education, it sounded ideal. It was complex, involving several different financial institutions and transactions. But [Michael F. Bennet](#), now a United States senator from Colorado who was superintendent of the school system at the time, and Thomas Boasberg, then the system's chief operating officer, persuaded the seven-person board of the deal's advantages, according to interviews with its members.

Rather than issue a plain-vanilla bond with a fixed interest rate, Denver followed its bankers' suggestions and issued so-called pension certificates with a derivative attached; the debt carried a lower rate but it could also fluctuate if economic conditions changed.

The Denver schools essentially made the same choice some homeowners make: opting for a variable-rate mortgage that offered lower monthly payments, with the risk that they could rise, instead of a conventional, fixed-rate mortgage that offered larger, but unchanging, monthly payments.

The Denver school board unanimously approved the JPMorgan deal and it closed in April 2008, just weeks after a major investment bank, [Bear Stearns](#), failed. In short

order, the transaction went awry because of stress in the credit markets, problems with the bond insurer and plummeting interest rates.

Since it struck the deal, the school system has paid \$115 million in interest and other fees, at least \$25 million more than it originally anticipated.

To avoid mounting expenses, the Denver schools are looking to renegotiate the deal. But to unwind it all, the schools would have to pay the banks \$81 million in termination fees, or about 19 percent of its \$420 million payroll.

John MacPherson, a former interim executive director of the Denver Public Schools Retirement System, predicts that the 2008 deal will generate big costs to the school system down the road. "There is no happy ending to this," Mr. MacPherson said. "Hindsight being 20-20, the pension certificates issuance is something that should never have happened."

A spokesman at JPMorgan, which led the Denver deal, declined to comment. [Royal Bank of Canada](#), which acted as the school system's independent adviser even though it participated in the debt transaction, declined to comment. Denver school officials said that they had agreed to sign a conflict waiver with Royal Bank of Canada.

Denver isn't the only city confronted with budgetary woes aggravated by esoteric financial deals that Wall Street peddled in the years before the [credit crisis](#). Banks have said the deals were appropriate for the issuers and that no one could have predicted the broad financial collapse that put pressure on the transactions.

Still, some municipalities have found such arguments wanting and are pushing back.

Last March, the Los Angeles City Council told its treasurer and city administrative officer to renegotiate interest-rate deals the city had used to try to lower its debt payments with the banks that sold them. "If they are unwilling to renegotiate, then those financial institutions should be excluded from any future business with the City of Los Angeles," noted a report by the City Council.

In Pennsylvania, some school districts have unwound interest-rate deals, and the state's auditor general, Jack Wagner, has urged other issuers to follow suit. "For the sake of Pennsylvania taxpayers, I call on the other school districts that have entered into similar swaps contracts to get out of these risky agreements as soon as they possibly can," he said in a statement in February.

Financial stress from these deals could not come at a worse time for cities, towns and school districts already saddled with high costs and falling revenue. Although it is

difficult to tally how many public entities entered into interest-reduction deals, a recent analysis by the [Service Employees International Union](#) estimated that over the last two years, state and local governments have paid banks that arranged these transactions \$28 billion to get out of the deals, seeking to avoid further crushing payments.

Many transactions remain on public issuers' books. S.E.I.U. estimates that New Jersey would have to pay \$536 million to get out of its [derivatives](#) contracts, while California faces \$234 million in such payments. Chicago is looking at \$442 million in termination fees to unwind its transactions, and Philadelphia would have to pay \$332 million.

Both Mr. Bennet, whom the White House has praised for his innovative approach to education, and Mr. Boasberg defend the deal they recommended in Denver back in 2008. They say that it has saved the school district \$20 million it would have otherwise had to pay to cover the pension shortfall, and they maintain that no one could have predicted the credit crisis of 2008 that elevated the deal's costs.

But the savings cited by the two men do not take into account termination fees associated with the complex deal. And had the school district issued fixed-rate debt, Wall Street would not have received the cornucopia of fees embedded in the more complex deal.

While the expenses associated with more complex transactions vary depending on the terms of the deal, Denver offers an example of the additional costs they can impose. So far, Denver has paid about \$9.7 million more in fees for its deal than it would have had it chosen a simpler transaction.

Joseph S. Fichera, chief executive of Saber Partners, a financial advisory firm that specializes in structured finance, said that the type of transaction pursued by the Denver schools was a false solution for what the issuers want to achieve — lower long-term costs — because the banks selling the deals rarely quantified all of the potential risks involved.

“The issuer made a simple financing highly complex and took on substantial risk without knowing how large its downside could be,” he said, referring to the Denver deal. “The advisers and bankers may have disclosed that there were risks, but apparently did not help the issuer truly understand them. They typically present economic outcomes to the issuer only on projected savings and assume away any chance of the risks happening.”

THE PROBLEM

\$400 Million Gap

In a Pension Fund

The Denver public schools needed to do financial contortions because, like many other public agencies nationwide, its pension plan did not have enough funds to meet the payments due to retirees. And for years, the school system had not met its required annual pension payments to ensure a fully funded plan; by 2007, the school system faced a \$400 million gap.

The school system solicited advice from several banks on how to handle this problem and ultimately decided to issue bonds that allowed it to refinance its existing debt of \$300 million, which had a fixed interest rate. It also raised an additional \$450 million, most of which went into the pension to fill the gap in that plan. Together, \$750 million was raised using the riskier pension certificates.

The Denver certificates contained debt issues that had variable rates and were to be resold to investors in weekly auctions; the arrangement carried an annual interest rate of around 5 percent, not counting fees and costs associated with that type of debt. Fixed-rate debt would have cost 7.2 percent.

Denver schools had issued pension certificates before, but this time the banks added a little spice to the recipe: an interest-rate swap that made the variable debt mimic a fixed-rate instrument. If prevailing rates fell, the school system would have to make up the difference to the banks. But if interest rates rose, the swap would protect the school system from having to pay higher debt costs.

It was a heady brew, one that required an unusual amount of financial expertise to assess. In that regard, Denver had an apparent advantage: Mr. Bennet and Mr. Boasberg.

Unlike many school district officials, both men were financially sophisticated and had worked together in the private sector. Mr. Bennet handled investments and structured financial deals for the Anschutz Investment Company, a private concern owned by the billionaire Philip Anschutz that has stakes in telecommunications and oil. Mr. Boasberg, meanwhile, was a deal maker in mergers and acquisitions at [Level 3 Communications](#), a telecommunications concern.

“We looked at what the risks were,” said Mr. Boasberg, who has been superintendent of the Denver public schools system since early 2009.

But according to several members of the board of education, the bankers’

presentations for the 2008 debt deal outlined its risks only in broad terms, discussing, for example, what would happen if interest rates shifted or the economy weakened a bit. The banks provided no full-blown worst-case situations to the board, focusing instead on the transaction's upside: lower debt costs and a potential saving of \$129 million in pension costs over the next 30 years.

School board members also said that bankers had not discussed problems in the variable-rate debt market that arose the previous year — a development that would have alerted them to troubles they might have had securing a manageable rate on the debt that they were refinancing.

Nor, they said, had the bankers discussed the outright collapse of trading in auction-rate securities, a \$330 billion market that ran aground in mid-February 2008. Auction-rate securities are very similar to the variable-rate debt the Denver schools were considering at the time; both types of securities involve periodic auctions sponsored by financial institutions to determine what interest rates will be paid by the issuer.

Like the structural weaknesses in the variable-rate market, turmoil in the auction-rate market should have been a warning sign for the Denver school system and its financial stewards. But according to board members, its bankers and advisers never sent up warning flares of this sort.

“I think there was discussion around financial markets as a whole,” said Bruce Hoyt, a board member since 2003 and treasurer at the time the deal was done. “I don’t recall specific discussions about the freezing of auction-rate securities.”

In the end, Denver became ensnared in the financial maelstrom that was stirring even before it restructured its debt and that gathered force as the credit crisis deepened through the summer and fall of 2008. Prevailing interest rates collapsed, and the market for the Denver public school system’s debt shrank markedly.

Denver’s funding costs rose further when Dexia, a Franco-Belgian company that had facilitated the transaction and insured the pension certificates, ran into trouble. Worried about Dexia’s financial position, investors fled any securities the company had insured, including Denver’s debt.

In the end, a deal that JPMorgan said would have an interest rate of around 5 percent spiked to 8.59 percent during its first fiscal year, and has since settled down to an average rate of 7.12 percent today.

THE MISSTEP

Locked In for Years

As a Deal Sours

Financial advisers say that deals like Denver's might work for some issuers. But they say that their complexity can mask the fact that they often require issuers to give up far more than they get in return.

Like a homeowner, Denver essentially started out with the equivalent of a standard, fixed-rate mortgage that allowed it to refinance if interest rates fell. But the 2008 deal gave that up for the equivalent of a 30-year loan with a lower rate but significant penalties and costs if investor interest in the debt declined, as it did once the credit crisis kicked in.

Moreover, refinancing was extremely costly, given the hefty termination fees.

While such deals have become common in public finance circles, they are rare in the private sector. If corporations issue such debt, they will typically limit their terms to five years, which gives them room to maneuver as economic circumstances evolve.

Agreeing to be locked into a 30-year contract, as public entities have done, is especially costly because getting out of it requires paying penalties to the banks for every remaining year of the transaction.

Andrew Kalotay, founder of Andrew Kalotay Associates, a debt management advisory firm, said a deal like Denver's would be highly unusual among private sector issuers like corporations because they recognized the pitfalls of locking themselves into an arrangement for 30 years.

"I'm not aware of any corporations trying to get a better fixed rate" by issuing long-term instruments such as those used by Denver. "Why would the school district want to do this transaction with all the attendant risks of mispricing and the possibility of unfavorable unwind costs when they could have done a conventional, taxable fixed-rate deal?" he asked.

Bankers, however, love these deals. In addition to the enormous termination fees they can snare, bankers also get remarketing fees and swap advisory fees.

Termination fees, however, top them all. Like the punishing prepayment penalties some homeowners have to come up with when paying off a mortgage early, termination fees on deals like Denver's are essentially charges levied to rewrite the terms of a contract.

To some issuers, termination fees feel easier to swallow if they pay for it by issuing yet another round of debt, like a consumer using one credit card to pay the penalty charges on another. But even though no upfront cash is paid out, yet another layer of debt is incurred, adding to the cost of getting out of the deals.

Denver is considering paying its termination fees in this fashion, Mr. Boasberg said. It was unclear what the interest rate would be on the new debt, but he maintained that the school system would unwind the transactions only if it were economical and the interest rate on the debt were low enough to offset the termination fees.

Had Denver issued a standard, fixed-rate bond in 2008, it would not be facing termination fees now. While it is possible that the annual costs of the Denver deal will come down in the future, they are now roughly in line with what the school system would have paid in a fixed-rate transaction.

Jeannie Kaplan, a board of education member for almost five years, supported the 2008 deal but now regrets it because of its costs and complexity. "Bennet and Boasberg had been presented as financial saviors of the Denver school system, and I sat there wanting to believe what they were saying," she said. "The board probably should have had their own financial consultant."

Mr. Boasberg said critics of the deal were politically motivated, pointing to the close primary runoff pitting Mr. Bennet, the former superintendent, against Andrew Romanoff, another Democrat, for a place on the ballot for the Senate in the November elections. But Ms. Kaplan said she started questioning the deal before Mr. Bennet was appointed to the Senate in early 2009.

The school system's 2008 refinancing is one of several issues that have come up in the runoff, including campaign financing, general integrity issues and Washington effectiveness.

Mr. Bennet became superintendent of the Denver schools in 2005 after he left the Anschutz organization to work for the mayor of Denver, John Hickenlooper.

From the campaign trail in mid-July, Mr. Bennet reiterated his support of the deal, saying that it had achieved the school system's goal of improving its cash flow and merging with Colorado's Public Employees' Retirement Association, which meant the schools no longer had to pay 8.5 percent interest on its annual pension shortfall.

"Despite going through the worst recession since the Great Depression, we did that," he said in a statement.

THE RESULTS

Another Shortfall,

And Cloudy Future

As Denver weighs its refinancing problems, it faces another conundrum: the money the city raised to shore up its pension fund has turned out to be inadequate because of the stock market's plunge.

The fund turned in a dismal performance in the credit crisis — as was the case with most such funds — losing almost twice the \$400 million borrowed by the school district to plug the pension gap. As a result, the school system's pension shortfall recently stood at around \$386 million, only slightly lower than it was two years ago, and even though \$400 million had been funneled into it in 2008.

While the pension's merger with the state system allows Denver's school system to avoid paying interest on shortfalls, that benefit is temporary. If a shortfall still exists in 2015, the merger requires that it be closed.

Mr. Boasberg maintains that the deal has allowed Denver to hire teachers while other school districts are cutting back. But Henry Roman, president of the Denver Classroom Teachers Association, said that fewer teachers had been hired this year than in previous years.

Some board of education members fear that the human costs of Denver's exotic refinancing deal are yet to be fully realized — and when they are, it will be in classrooms.

Ms. Kaplan says she is particularly concerned about the impact of having to fund the Denver school's pension plan fully in 2015 if investment losses have not been recouped by then.

"How is that going to affect kids and teachers and classrooms?" she asked. "It makes it difficult for board members to do a budget now."