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Swaps & Derivatives: Panelists Express Biggest Worries About Structured Muni Products

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Posted on Thursday, September 13, 2007
Source: Bond Buyer

by *Matthew Hanson*

Once considered taboo in the public finance world, swaps and derivatives have become commonplace in many of the municipal market's daily bond transactions.

But as new swaps and structured municipal products continue trickling into the market, there are still some aspects of these complicated offerings that issuers, bankers, lawyers, and financial advisers worry about, according to a panel Tuesday at The Bond Buyer's California Public Finance Conference.

On a panel that began with explanations of some of the market's prevailing swap and derivative ideas, a diversion toward panelists' biggest worries shed light on what they thought were the most critical parts of crafting swaps to benefit state and local governments.

Marcia Maurer, chief financial officer of the Sacramento Regional County Sanitation District, said the things she worries about have physically kept her up at night. She's had to stay late at the office to iron them out.

"I have three different counterparties, and every one of their back offices has made errors," she said. "My biggest concern is that I will not catch all these errors."

While Maurer still considers swaps for her district's balance sheet, she advised other issuers to make sure they scrutinize the scheduled transfers of funds that take place once a swap has been started.

"Just because you are promised one thing while you are doing the swap, it is not necessarily what the back office will deliver," she said.

Bankers said their biggest worries include doing enough due diligence to ensure their clients fully understand the transactions they are entering, as well as the risk that the media and the general public will misunderstand the complexities of a transaction. Such situations can make for troublesome and unsubstantiated criticism, the bankers said.

Marko Issever, managing director at the Bank of New York Mellon, added that he often worries about the length of time it takes to close some deals. He said a deal might make sense when it is proposed, but could later fall out of the money as interest rates move during a drawn-out transaction approval process.

From the lawyer's perspective, Nixon Peabody associate Daniel Deaton said one of his biggest concerns is that a client might not completely understand what they are signing up for in a swap contract. He added that he worries that a client's swap book will create extra problems in the event that the issuer's credit deteriorates and it needs to reorganize its balance sheet.

A third potential headache, Deaton said, is that a swap might not be priced fairly.

"There is a bit of horse trading that is involved, and as lawyers, we're pretty distant from that," he said. "But it has tax consequences and a lot of other issues that are in play. If the swap is not fairly priced it's a real concern of mine."

Swap Financial Group LLC managing director Peter Shapiro, who often helps run the swap pricing for issuers, said he worries most about what he thinks many of his clients do not - the risk that a counterparty's credit will fail.

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While Maurer said she takes comfort in the fact that her district's counterparties typically have credit ratings of double-A or better, Shapiro said municipal issuers often lose sight of the fact that such high corporate credit ratings do not imply the same level of credibility that an identical rating on the municipal scale would.

Every so often, even some of the nation's largest, most well-respected banks and insurers have been known to fail, he noted.

"At some point, my big fear is that somebody big goes down and we're not prepared for it," Shapiro said.

Another fear, he added, is that fundamental changes in market conditions could make the models used to evaluate potential swap and derivative transactions wrong.

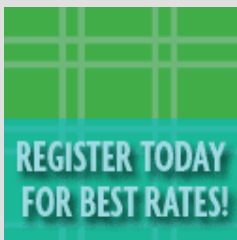
"We live in a world of models," Shapiro said. "One thing we know about models is that, while they do regress to the mean, means shift. These things are inherently unstable. The market has a way of humiliating the maximum number of people possible." (c) 2007 The Bond Buyer and SourceMedia, Inc. All rights reserved. <http://www.bondbuyer.com> <http://www.sourcemedia.com>

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