

**Derivatives Use in Municipal Finance**  
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Again, thank you for the privilege and honor of participating in this event. In these opening remarks, I would like to make four quick points.

First, I would like to repeat for emphasis my first comment from the Distressed Communities panel. The regulatory environment influences who chooses to enter this vocation. If the municipal finance landscape resembles a prison environment, then we should not be surprised that many highly ethical, competent, creative professionals opt for an alternative finance profession rather than be strip-searched every day, told what to eat, and when they can relieve themselves. Particularly in the financial derivatives space, we need highly ethical, innovative and creative professionals like never before. We do not want to risk stifling financial innovation where solutions could be developed to mitigate risk at dramatically lower cost and with increased precision and effectiveness. There are young aspiring American patriots who desire to invest their very lives in public service to our exceptional country. We should make every effort to provide a municipal finance environment where they can flourish and serve our country well.

Second, the most significant problem related to derivatives use in municipal finance is that derivatives are sold and not bought. Specifically, commission hungry and ethically questionable derivatives salespeople are not the best source of ideas for creative and innovative solutions to complex municipal finance problems.

It should be suspect that often the very idea promoted by the financial institution would never be done at that same financial institution. In my financial derivatives classes since 1998, I have used the 1997 swap transaction between Jefferson County, Alabama and J. P. Morgan to train my students on how *not* to do a swap transaction. The idea was to refinance an existing variable rate bond with a fixed rate bond and then enter a swap transaction to create a synthetic variable rate bond. After millions of dollars of transaction costs, the synthetic variable rate paid by Jefferson County was dramatically higher than the original variable rate bonds. I am not aware of any financial institution that would refinance their variable rate to a higher synthetic variable rate and take on more risks.

Third, every ISDA confirmation letter that I can recall contains explicit language related to representations, specifically non-reliance, evaluation/understanding, and status of parties. In essence, this portion of the derivatives documents state that each counterparty has made their own independent judgment or is relying on its own advisors. Most importantly, there is an explicit denial of a fiduciary relationship between the two counterparties.

However, in reality, the derivatives transaction idea emanated from the financial institution. The idea was “sold” to the municipality based on some sort of convincing pitch book where benefits are emphasized and well-known risks are omitted. Due to other demands, the municipal representatives rely on and trust the financial institution. From the municipality’s perspective, there is a practical fiduciary relationship. The municipal officials trusted the representations of the financial institution’s professionals. Ultimately, finance is and has always been a trust business. Historically, banks often had the word “trust” in their corporate name. The solution may lie more in financial institutions re-embracing their ancient fiduciary responsibilities, rather than the rule of law attempting to place layer upon layer of complex and ambiguous regulations. At a minimum, financial institutions should embrace transparency by providing

clear identification of conflicts of interest, written documentation of their profit margin, and strongly recommend that municipalities find their own independent, capable advisor who is willing to act as their fiduciary.

Finally, many concepts within financial risk management are not well defined and hence, not well understood. Most finance practitioners have a general understanding of “hedging,” but it is surprisingly difficult to pen down. For example, the 1997 Jefferson County swap transaction was promoted as a hedge of interest rate risk. Within a year, the 1997 swap transaction was terminated. If entering the swap was hedging, what was terminating the swap?

There are two general approaches to interest rate risk management, view-driven and needs-driven. Interestingly, financial institutions seek to balance out their interest rate risk using asset liability management techniques (needs driven). These financial institutions do not attempt to manage interest rate risk by guessing where rates are going. These same financial institutions will place a derivatives salesperson on a plane to pitch a view-driven derivatives transaction on an unsuspecting municipal official. It seems reasonable that the financial institution pitching the derivatives deal should be willing to do it themselves if they were facing similar circumstances.