The Washington Post

Fears of crushing debt spread to cities, provinces

By Anthony Faiola
Tuesday, April 27, 2010; A01

RECANATI, ITALY -- This 12th-century gem, birthplace of the poet Giacomo Leopardi, rests on a lyrical hilltop in the Apennine Mountains. But these days, Recanati is also sitting on something else: a pile of financial trouble.

Concern over near-bankrupt countries forced Greece on Thursday to request a huge international bailout. The plight here, however, underscores fears of a new front in the battle against global debt -- at the state and local level.

Recanati is one of hundreds of municipalities around the world facing a deepening financial crunch from bad investments, plummeting tax revenue, high debt levels and rampant overspending. In the United States, at least six states have budget gaps bigger than Greece's, with Hawaii shifting to a four-day school week to cope. In Spain, a substantial drop in tax revenue from a bust in construction is battering budgets in the cities of Madrid and Valencia, as well as in the provinces of Catalonia and Andalusia, raising the threat that ratings agencies will downgrade their debt.

The picture is particularly bleak in Italy, where many cities and towns invested heavily in complex bets on interest rates. Now deep in the red, Recanati is being forced to sell off parkland, unload a public kindergarten, scale back aid to the elderly and scrap costly repairs on leaking churches and ancient cobblestone streets.

"We are in a financial emergency because of our debts; it has become the sword of Damocles hanging over our heads," said Francesco Fiordomo, Recanati's mayor.

Experts are not yet predicting cascading bankruptcies, but they warn that increasing problems in heavily indebted municipalities and provinces are creating financial time bombs that could lead to defaults. Those concerns are already raising cities' borrowing costs on both sides of the Atlantic and contributing to budget woes, forcing many struggling jurisdictions to raise taxes and cut services.

Analysts are also warning that national coffers could be further strained if heavily indebted countries are forced to spend precious resources to rescue local jurisdictions. Portugal, under fire for allowing its cash-strapped regional governments to assume more debt, was hit by a debt downgrade by Fitch Ratings last month.

"We are only now beginning to understand the full scope of the global debt problem. This isn't just about national governments; you're talking about local governments and municipalities," said Eswar Prasad, an international economics expert at the Brookings Institution. "Many of them were engaged in risky investments in the past, and now we are seeing those problems come to a head."

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Across Italy, budget problems have been severely compounded by growing liabilities on complex bets placed on interest rates during the credit boom of the past decade. Similar bad bets are well documented in the

United States. Los Angeles, for instance, is losing $19 million a year off interest rate contracts; a wager by Jefferson County, Ala., has left it struggling to avoid bankruptcy.

But problems with these exotic financial instruments are only now emerging in Europe, putting a fresh spotlight on the excesses of borrowers and the ethics of bankers who sold them.

Greece has come under scrutiny for using such deals to hide the extent of its debt. In Italy alone, an estimated 519 cities and towns are facing more than $1.3 billion in losses from derivatives deals, according to a report from the Bank of Italy.

Such deals were popularized as a way for municipalities to shield themselves from the possibility of higher interest rates. In many cases, analysts say, they have done just that. In the Washington area, for instance, the largest user of interest-rate swaps has traditionally been the District, which now owns $262.2 million worth of such swaps. City officials say they have no complaints about them.

But a minority of the deals, critics say, were put together by banks in ways that made it almost impossible for local jurisdictions to service their obligations in the long run without suffering losses. The growing number of problematic contracts has ignited a debate in European capitals and Washington, and on Wall Street, over new oversight and curbs on derivative sales, as well as restrictions on municipal borrowing.

Bad deals in Italy are hitting small towns the hardest. Here in Recanati, a town of 22,000, more than a dozen swap contracts were signed between 2001 and 2004. Local officials said they were told they could not lose.

The deal worked this way: To guard against sudden surges in interest rates, Recanati agreed to take out special contracts on the city's $106 million in debt. It would pay banks a fixed annual interest rate of about 5 percent on the total. In return, the banks would pay the city back an adjustable rate tied to a key European interest rate index, theoretically ensuring that Recanati would not see wild swings in its interest payments.

When European interest rates were high in the mid-2000s, the deal worked out well, allowing Recanati to pocket about $400,000 between 2001 and 2008. When interest rates fell to record lows in 2009, the tables turned dramatically. The city was forced to keep making fixed-rate interest payments to the banks averaging about 5 percent, while receiving adjustable-rate payments of less than 1 percent in return.

The deals cost the city $420,000 in just one year and more than wiped its previous gains. With adjustable rates still at rock-bottom levels, Recanati officials calculate that they are set to lose nearly $700,000 this year. City officials here and in other localities across Italy said the possibility of such vast losses was never explained.

On top of that, the swap contracts carried hidden fees of more than $650,000, according to Marco Fabio Delzio, a Rome-based partner at Martingale Risk, a firm hired to audit the town's contracts. Given those fees, officials say, Recanati would very likely have lost money in the long run even if interest rates had remained high for years.

Yet canceling the swap contracts would cost $2.2 million more, money this town says it does not have. "We would have to sell our crown jewels, important buildings, more land," said Antonio Bravi, financial adviser for Recanati. "And we would have to cut services."

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Like many municipalities in Italy, Recanati is trying to negotiate a deal to close out the contracts. In the meantime, its fiscal problems are so bad that officials are considering scaling back the city's internationally renowned festival marking the birth of Leopardi, the poet and essayist whose statue looms over the town square. Green spaces on the edge of town are being sold to investors, and Recanati has sought to raise tax revenue by rezoning land for commercial use.

At Recanati's senior-care center, Aliandri Franco, 72, said the city's financial problems have delayed plans to build low-cost housing. Officials are also unable to meet their goal of expanding in-home care to some of Recanati's neediest elderly residents.

"It was a big mistake, getting involved in all this nonsense," Franco grumbled. "I hope they have learned their lesson."

In Italy, the troubles have raised the prospect that bankers may do jail time. Two weeks ago, an Italian court indicted 11 officials at four global banks, including New York-based J.P. Morgan Chase and Germany's Deutsche Bank, on fraud charges linked to the sale of interest rate swaps to the city of Milan. Those swaps, authorities say, have cost Italy's fashion and financial capital $140 million since 2003 and were knowingly misrepresented to city officials. All four banks have denied the charges.

"The way these deals were structured, there was just no way any city could win," said Alfredo Robledo, the chief prosecutor in the case. He called it another example of banks "taking advantage" during the 2000s.

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