Oakland City Council Joins Fight Against Toxic Interest Rate Swaps

By Darwin Bond Graham

In 1997, the city of Oakland, California entered into an interest rate swap agreement with Goldman Sachs. The bank promised that the swap would provide savings and allow Oakland to better fund crucial services. But the swap became a toxic liability in 2008 when Wall Street's greed crashed the economy and neither the bank nor the federal government helped the city unwind the deal.

“It’s a second bailout for the big banks,” said Yvonne Michelle of Decolonize Oakland. “They were first bailed out by the administration when the market crashed. Now we’re in limbo with one foot in recovery and one foot in recession mode, and Goldman Sachs continues to prosper from our monies a second time over.”

“We think that this is outrageous when our city is suffering from budget cuts to basic services,” says Luz Calvo, another Oakland resident and member of Decolonize Oakland. “We think it’s time to fight back.”

Oakland is by no means alone—hundreds of local governments nationwide face onerous payment obligations under interest rate swap deals struck in the 1990s and 2000s—but Oakland has led the fight against this injustice. Organizers Calvo, Michelle and others have educated their friends and neighbors and pressured elected officials to address toxic financial contracts. They have shamed the bankers reaping profits off swaps and debt and succeeded in politicizing municipal finance. As the swap crisis continues to harm communities nationwide, grassroots organizers have managed to lift the veil on the structural racism of public debt, advancing efforts to build a movement for financial justice.

Oakland Takes On the ‘Vampire Squid’

In early 2012, propelled by the energy of the Occupy movement, a diverse group of organizers from ACCE, Bay Natives for Peace and Justice, Decolonize Oakland, ILWU Local 10, Occupy Oakland’s Interfaith Tent, Research Group, and Labor Solidarity Committee, Oakland CAN, SEIU Local 1021, and ROOTS, among others, formed the Coalition to Stop Goldman Sachs. Overcoming differences in organizing styles and political beliefs, they utilized a variety of tactics—from meeting with and educating city officials, to disrupting Goldman’s San Francisco office with street theater protests—to wage a simple but highly effective campaign, which culminated in a demand for Goldman to terminate the swap with Oakland at zero cost to the city and return the profits.

“We broke down the city’s finances [into] accessible and understandable information for everyone,” said Déborah Santana, a member of the Coalition.

Last October, the City Council announced plans to implement a moratorium on swaps, and in November, after further lobbying from Coalition members, it began the process of barring the bank from future business with Oakland unless it agreed to terminate the swap at no cost to the city.

Although the Coalition’s success has worried Wall Street titans, according to an article in the Financial Times—the world’s leading business newspaper—Oakland is not a massive debt issuer, so the impact is small. One professional financial analyst quoted in the story said, “It would be a bigger deal if it were San Francisco or Los Angeles; if you have more than a handful of issuers asking for concessions, it becomes more of an issue for banks.” Oakland’s organizers are in fact working to create a broader coalition to take on the banks.
Why Did Cities Fall for the Swap?

An interest rate swap is a contract between two parties in which they agree to trade interest rate payments on a certain sum of money called the "notional amount." The notional amount corresponds to the debt payments associated with a specific bond, but the swap itself is actually a free-standing contract (or "derivative," because it derives its value from another asset) that works independently of the bond with which it is associated.

Imagine that a government issues a $100 million bond with a variable interest rate to build a school. The city has to pay a rate of interest on the debt that varies depending on market conditions. In some years, interest payments could be as low as 3 percent but in others it might rise to 6 percent. To hedge against the danger that the variable rate might spike at some future date—to upwards of 10 percent, for example—cities agree to interest rate swaps. The swap obligates the bank counterparty to pay a variable rate that mirrors the variable rate on the city's bond debt. So, the bank essentially ends up paying the city's variable interest rate payments to the bank.

To understand why local governments ever agreed to such a strange arrangement it's necessary to understand something of the history of municipal finance.

Local governments have always borrowed money to pay for infrastructure and services. This debt was paid back over a span of about 10 years with interest. Until recently, most public borrowing came with a fixed interest rate period after which the bonds in question were "callable," and could be refinanced with new loans, or retired.

In the 1990s, Wall Street's biggest banks convinced local governments that they could borrow money more cheaply if they issued bonds that had floating interest rates. (The shift paralleled the banks' insistence on adjustable rate mortgages for many home buyers.) At the time that the banks sold the variable rate loans, interest rates on variable rate bonds were less than on fixed rate bonds. Public borrowers eagerly agreed to the cheaper variable rate loans, not anticipating either of the following scenarios that would derail the balance:

- If the economy heated up too much, the Federal Reserve might hike up the Federal Funds rate which determines the cost of borrowing money for the financial system's biggest banks, a possibility that would cause variable rates to spike.
- In the event of some kind of serious financial shock, interest rates could spike as banks withdrew liquidity from money markets.

In either case, cities would pay enormous sums on their variable rate bonds. If they carried too much debt, cities could be forced to make severe budget cuts or even go bankrupt. As insurance against either possibility the banks sold them interest rate swaps, which promised local governments both the cheaper price of variable rate loans and the security of a fixed rate payment that would be slightly below the interest rates attached to traditional fixed rate bonds.

The arrangement seemed to work throughout the '90s and the first part of the 2000s. Cities under severe budgetary constraints—especially the ones harmed by decades of deindustrialization and suburban capital flight; or with large Black and immigrant communities—were ready to follow the advice of financial corporations and sell variable rate bonds with interest rate swaps attached because they promised access to levels of credit that had previously been denied them.

When in 2008 the financial markets crashed, interest rates were artificially depressed by central banks to virtually zero. And while big financial companies benefitted from government assistance to offload their toxic assets, cities that had bought interest rate swaps were forced to pay out huge sums as the very tools that were supposed to give them access to cheaper loans and provide insurance against interest rate volatility became expensive liabilities. —DBG

A City-Sized Problem of National Proportions

Oakland is by no means the only or the most affected local government. The Bay Area’s Metropolitan Transportation Commission (MTC) has lost over $100 million because of toxic rate swap deals with banks, such as Wells Fargo and Morgan Stanley. Since the MTC funds public transportation systems across the Bay Area, cuts and fare increases indirectly linked to toxic swap liabilities have disproportionately impacted communities of color. Activists with ACCE, SEIU 1021, and Urban Habitat have held multiple protests at banks in San Francisco demanding “bus stops, not swaps,” and called on the MTC’s directors to “refund transit.”

Elsewhere in the U.S., swaps have sucked billions from local governments caught in similar predicaments. In Philadelphia, the city and its school district have lost more than $331 million to the handful of Wall Street banks that sold 90 percent of these toxic deals to local governments. Goldman Sachs, Morgan
Stanley, and Wells Fargo each made tens of millions off Philadelphia’s taxpayers while the school district and city were forced to lay off teachers and employees and slash essential services at the bottom of the economic collapse in 2010. City officials held investigative hearings on swaps last fall, with a goal of canceling the deals and possibly taking legal action against the banks and financial advisers who profited from them. In New York, unions and community groups have focused on how swaps are harming transit services. In Boston, activists brought attention to their metro transit agency’s $26 million a year loss on swaps, leading the Boston Globe to call on city officials to end the deals using Oakland as a model.

How Did We Get Here?

In response to white flight, capital flight, and the nationwide “tax rebellion” that began with California’s Proposition 13, local governments throughout the U.S. have been forced over the last three decades to do a lot more with much less. Cities, counties, and other local agencies increasingly rely on heavy debt loads and complicated financial strategies just to pay for the most basic public goods and services. The worst affected have been jurisdictions populated by working class people of color where, because of racist disinvestment, unemployment rates are higher, property values are lower, and tax proceeds routinely fall short of actual needs. The result is that the poor, as always, pay more. Swaps were supposed to be a clever solution to local fiscal problems, making it easier for debt-strapped governments to pay their bills.

The financial crisis that began in 2008 precipitated a series of events that caused esoteric financial products, such as interest swaps, to blow up, costing cumulatively tens of billions. But the federal government has not stepped up—as it did with the big banks—to bail out cities, school districts, and transit authorities.

How Do We Get Out?

Oakland’s financial justice activists say that resisting Wall Street requires building broad coalitions of community, labor, religious, and advocacy organizations. Progress in campaigns around injustices hidden in local government finances and debt depend on whether activists can develop strong critiques of the means by which banks exploit the public and extract wealth from tax and revenue mechanisms. Such a movement will need to focus on much more than just swaps and other onerous examples of financial exploitation. For lasting impact, a movement for financial justice centered around city government will need to shift the thinking of local officials and residents, so that whole communities are more vigilant against the financial sector. Some positive signs in this direction include the recent adoption of responsible banking ordinances by numerous local governments, and the proliferation of stricter local rules pertaining to public finance contracting. Cities must also build coalitions with one another, to create broader fronts against the banks.

Ultimately, however, the only thing that can really empower local communities against banks will be a rollback of the chronic austerity imposed on the public sector as a reactionary means of sabotaging the integrationist push of the Black freedom movement. Only when local governments are freed from the logic of privatization, regressive taxation, and the suburban exodus of the affluent middle class, will they be able to free themselves from the bondage of debt finance and its various instruments of wealth extraction.

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