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What Makes Muni Swaps So Special? Nothing, Actually

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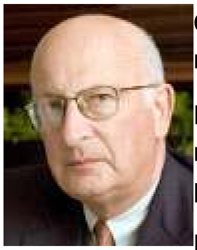
By Andrew Kalotay



Given the recurrent rumblings in the financial press about the need to reform the “municipal swap market,” it may be worthwhile to identify what distinguishes it from the regular swap market.

In substance, these markets are basically the same. But there is a stark difference in practice: municipalities pay significantly more than other market participants for essentially the same product.

For starters, the bid-ask spreads, which determine the dealers’ profits, are much wider for municipal swaps than for standard swaps. In addition, municipal governments are often duped into paying a “transaction fee” — unheard of among sophisticated players.

The swap dealer obviously will charge what the market will bear. Unfortunately, the municipality’s grossly overcompensated hired guns — swap advisers, lawyers and such — provide inadequate protection and are conflicted by self-interest.

Do municipal swaps have special features that warrant higher transaction fees than regular swaps? The answer is they don’t.

Swap dealers attempt to justify the higher pricing of the municipal swaps based on their “complexity” (they pay a percent of the London Interbank Offered Rate, and they may be amortizing).

In fact, as far as the swap dealer is concerned, municipal swaps are the same as the rest. All swaps go into the same “derivative book.” They are valued with the same software, and managed synthetically, without particular attention to the specifics of individual contracts.

Another potential source of confusion is tax treatment, but municipal swaps are the same as other swaps in this respect also.

With the cards stacked against it, what is a municipality to do? The best answer is abstinence. But if swaps are irresistible, here are a few simple safeguards:

Avoid interest rate derivatives that have optionality

Establish well-defined unwinding terms at the time of entry

Handle credit issues with collateral

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