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THE RECKONING

From Midwest to M.T.A., Pain From Global Gamble

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“People come up to me in the grocery store and say, ‘How did we get suckered into this?’ ”

— Marc Hujik, of the Kenosha, Wis., school board

On a snowy day two years ago, the school board in Whitefish Bay, Wis., gathered to discuss a looming problem: how to plug a gaping hole in the teachers’ retirement plan.

It turned to David W. Noack, a trusted local investment banker, who proposed that the district borrow from overseas and use the money for a complex investment that offered big profits.

“Every three months you’re going to get a payment,” he promised, according to a tape of the meeting. But would it be risky? “There would need to be 15 Enrons” for the district to lose money, he said.

The board and four other nearby districts ultimately invested $200 million in the deal, most of it borrowed from an Irish bank. Without realizing it, the schools were imitating hedge funds.

Half a continent away, New York subway officials were also being wooed by bankers. Officials were told that just as home buyers had embraced adjustable-rate loans, New York could save money by borrowing at lower interest rates that changed every day.

For some of the deals, the officials were encouraged to rely on the same Irish bank as the Wisconsin schools.

During the go-go investing years, school districts, transit agencies and other government entities were quick to jump into the global economy, hoping for fast gains to cover growing pension costs and budgets without raising taxes. Deals were arranged by armies of persuasive financiers who received big paydays.

But now, hundreds of cities and government agencies are facing economic turmoil. Far from being isolated examples, the Wisconsin schools and New York’s transportation system are among the many players in a financial fiasco that has ricocheted globally.

The Wisconsin schools are on the brink of losing their money, confronting educators with possible budget cuts. Interest rates for New York’s subways are skyrocketing and contributing to budget woes that have transportation officials considering higher fares and delaying long-planned track repairs.

And the bank at the center of the saga, named Depfa, is now in trouble, threatening the stability of its parent company in Munich and forcing German officials to intervene with a multibillion-dollar bailout to stop a chain reaction that could freeze Germany’s economic system.

"I am really worried," said Becky Velvikis, a first-grade teacher at Grewenow Elementary in Kenosha, Wis., one of the districts that invested in Mr. Noack's deal. "If millions of dollars are gone, what happens to my retirement? Or the construction paper and pencils and supplies we need to teach?"

The trail through Wisconsin, New York and Europe illustrates how this financial crisis has moved around the world so fast, why it is so hard to tame, and why cities, schools and many other institutions will probably struggle for years.

"The local papers and radio shows call us idiots, and now when I go home, my kids ask me, 'Dad, did you do something wrong?' " said Shawn Yde, the director of business services in the Whitefish Bay district. "This is something I'll regret until the day I die."

Selling Risk

Whitefish Bay's school district did not intend to become a hedge fund. It and four nearby districts were just trying to finance retirement obligations that were growing as health care costs rose.

Mr. Noack, the local representative of Stifel, Nicolaus & Company, a St. Louis investment bank, had been advising Wisconsin school boards for two decades, helping them borrow for new gymnasiums and classrooms. His father had taught at an area high school for 47 years. All six of his children attended Milwaukee schools.

Mr. Noack told the Whitefish Bay board that investing in the global economy carried few risks, according to the tape.

"What's the best investment? It's called a collateralized debt obligation," or a C.D.O., Mr. Noack said. He described it as a collection of bonds from 105 of the most reputable companies that would pay the school board a small return every quarter.

"We're being very conservative," Mr. Noack told the board, composed of lawyers, salesmen and a homemaker who lived in the affluent Milwaukee suburb.

Soon, Whitefish Bay and the four other districts borrowed $165 million from Depfa and contributed $35 million of their own money to purchase three C.D.O.'s sold by the Royal Bank of Canada, which had a relationship with Mr. Noack's company.

But Mr. Noack's explanation of a C.D.O. was very wrong. Mr. Noack, who through his lawyer declined to comment, had attended only a two-hour training session on C.D.O.'s, he told a friend.

The schools' $200 million was actually used as collateral for a complicated form of insurance guaranteeing about $20 billion of corporate bonds. That investment — known as a synthetic C.D.O. — committed the boards to paying off other bondholders if corporations failed to honor their debts.

If just 6 percent of the bonds insured went bad, the Wisconsin educators could lose all their money. If none of the bonds defaulted, the schools would receive about $1.8 million a year after paying off their own debt. By comparison, the C.D.O.'s offered only a modestly better return than a $35 million investment in ultra-safe Treasury bonds, which would have paid about $1.5 million a year, with virtually no risk.

The boards, as part of their deal, received thick packets of documents.

“I’ve never read the prospectus,” said Marc Hujik, a local financial adviser and a member of the Kenosha school board who spent 13 years on Wall Street. “We had all our questions answered satisfactorily by Dave Noack, so I wasn’t worried.”

Wisconsin schools were not the only ones to jump into such complicated financial products. More than $1.2 trillion of C.D.O.’s have been sold to buyers of all kinds since 2005 — including many cities and government agencies — an increase of 270 percent from the four previous years combined, according to Thomson Reuters.

“Selling these products to municipalities was pretty widespread,” said Janet Tavakoli, a finance industry consultant in Chicago. “They tend to be less sophisticated. So bankers sell them products stuffed with junk.”

From the Wisconsin deal, the Royal Bank of Canada received promises of payments totaling about $11.2 million, according to documents. Stifel Nicolaus made about $1.2 million. Mr. Noack’s total salary was about $300,000 a year, according to someone with knowledge of his finances. And Depfa received interest on its loans.

In separate statements, the Royal Bank of Canada and Stifel Nicolaus said board members signed documents indicating they understood the investments’ risks. Both companies said they were not financial advisers to the boards but merely sold them products or services. Stifel Nicolaus said its relationship with the boards ended in 2007. Mr. Noack now works for a rival firm.

“Everyone knew New York guys were making tons of money on these kinds of deals,” said Mr. Hujik, of the school board. “It wasn’t implausible that we could make money, too.”

A Bank Goes Global

By the time Depfa financed the Wisconsin schools’ investment, it had already become an emblem of the new global economy. It was founded 86 years ago as a sleepy German lender, and for most of its history had focused on its home market.

But in 2002 a new chief executive, Gerhard Bruckermann, moved Depfa to the freewheeling financial center of Dublin to take advantage of low corporate taxes. He soon pushed the company into São Paulo, Mumbai, Warsaw, Hong Kong, Dallas, New York, Tokyo and elsewhere. Depfa became one of Europe’s most profitable banks and was famous for lavish events and large paychecks. In 2006, top executives took home the equivalent of $33 million at today’s exchange rates.

Mr. Bruckermann was a gregarious leader who joked that he hoped to make all employees into millionaires. He divided his time between a London home and a vast farm in Spain, where he grew exotic medicinal plants. And his success fueled an arrogance, former colleagues say.

Mr. Bruckermann once told a trade publication that Depfa, unlike German banks, understood how to benefit from the global economy. “With our efforts, we are like the one-eyed man who becomes king in the land of the blind,” he was quoted as saying.

Mr. Bruckermann, who left the bank earlier this year, did not respond to requests for an interview.

But as Depfa grew, other European banks began competing with the firm. So executives stretched into riskier deals — the sort that would eventually send shockwaves across Europe and the United States.

Some of Mr. Bruckermann's employees grew concerned about deals like one struck in 2005 with the Metropolitan Transportation Authority of New York, the agency overseeing the city and suburban subways, buses and trains.

For years, municipal agencies like the M.T.A. had raised money by issuing plain-vanilla bonds with fixed interest rates. But then bankers began telling officials that there was a way to get cheaper financing.

Bankers said that cities, like home buyers, could save money with adjustable-rate loans, where the payments started low and changed over time. What they did not emphasize was that such payments could eventually skyrocket. Such borrowing — known as variable-rate bonds — also carried big fees for Wall Street.

The pitches were very successful. Municipalities issued twice as many variable-rate bonds last year as they did a decade earlier.

But variable-rate bonds had a hitch: many investors would purchase them only if a bank like Depfa was hired as a buyer of last resort, ready to acquire bonds from investors who could find no other buyers. Depfa collected fees for serving that role, but expected it would rarely have to honor such pledges.

Mr. Bruckermann's salespeople traveled the world encouraging officials to sign up for variable-rate loans. And bureaucrats and politicians, including some in New York, jumped in.

By 2006 Depfa was the largest buyer of last resort in the world, standing behind $2.9 billion of bonds issued that year alone. It backed a $200 million bond issued by the M.T.A.

But as Depfa grew, it became more reliant on enormous short-term loans to finance its operations. Those loans cost less, and thus helped the bank achieve higher profits, but only when times were good. Indeed, some employees were worried about that debt.

But Mr. Bruckermann plowed ahead, and it paid off. In 2007, even as the global economy was softening, Mr. Bruckermann persuaded one of Germany's biggest lenders, Hypo Real Estate, to purchase Depfa for $7.8 billion. Mr. Bruckermann's cut was more than $150 million. He left the company to grow oranges on his Spanish estate.

The Risks Turn Bad

Last March the delicate web tying Wisconsin, Dublin and Manhattan became an anchor dragging everyone down.

Mr. Yde, the director of business services for the Whitefish Bay district, began receiving troubling messages indicating the district's investments were declining. Worried, he started coming into his office at dawn, before the hallways of Whitefish Bay High School filled with students.

As the sun rose, Mr. Yde searched for explanations by the light of his computer screen. He Googled "C.D.O.'s." He called bankers in London and New York. Each person referred him to someone else.

Then notices arrived saying that the bonds insured by Whitefish Bay's C.D.O.'s were defaulting. It became increasingly likely that the district's money would be seized to pay off other bondholders. Most, if not all, of the $200 million would probably be lost.

As other districts received similar notices, panic grew. For some boards, interest payments on borrowed money were now larger than revenue from the investments. Officials began quietly warning that they might have to dip into school funds.

"This is going to have a tremendous financial impact," said Robert F. Kitchen, a member of the West Allis-West Milwaukee school board. Officials say some districts may have to cut courses like art and drama, curtail gym and classroom maintenance, or forgo replacing teachers who retire.

Problems were emerging elsewhere, as well.

Depfa's executives were realizing that their loans to the Wisconsin schools were unlikely to be repaid. Additionally, bonds all over the world were declining in value, exposing the company to the possibility they would have to make good on their pledges as a buyer of last resort. And Depfa was still borrowing billions each month to cover its short-term loans. By autumn, the short-term debt of the bank and its parent company, Hypo, totaled $81 billion.

Then, in mid-September, the American investment bank Lehman Brothers went bankrupt. Short-term lending markets froze up. Ratings agencies, including Standard & Poor's, downgraded Depfa, citing the company's difficulties borrowing at affordable rates.

That set off a crisis in Germany, where officials worried that Depfa's sudden need for cash would drag down its parent company and set off a chain reaction at other banks. The German government and private banks extended $64 billion in credit to Hypo to stop it from imploding.

"We will not allow the distress of one financial institution to endanger the entire system," Angela Merkel, the German chancellor, said at the time.

That crisis spread almost immediately to the M.T.A.

The transportation authority, guided by Gary Dellaverson, a rumpled, cigarillo-smoking chief financial officer, had $3.75 billion of variable-rate debt outstanding.

About $200 million of that debt was backed by Depfa. When the bank was downgraded, investors dumped those transportation bonds, because of worries they would get stuck with them if Depfa's problems worsened. Depfa was forced to buy $150 million of them, and bonds worth billions of dollars issued by other municipalities.

Then came the twist: Depfa's contracts said that if it bought back bonds, the municipalities had to pay a higher-than-average interest rate. The New York transportation authority's repayment obligation could eventually balloon by about $12 million a year on the Depfa loans alone.

On its own, that cost could be absorbed by the agency. But, as the economy declined, the M.T.A. had lost hundreds of millions because tax receipts — which finance part of its budget — were falling. And its ability to renew its variable-rate bonds at low interest rates was hurt by the trouble at Depfa and other banks. The transportation authority now faces a $900 million shortfall, according to officials. It is "fairly breathtaking," Mr. Dellaverson told the M.T.A.'s finance committee. "This is not a tolerable long-term position for us to be in."

In a recent interview, Mr. Dellaverson defended New York's use of variable bonds.

"Variable-rate debt has helped M.T.A. save millions of dollars, and we've been conservative in issuing it," he said. "But there are risks, which we work hard to mitigate. Usually it works. But what's happening today is a total lack of marketplace rationality."

In a statement, the transportation authority said that it was exploring options to reduce the cost of the Depfa-backed bonds, that its variable-rate bonds had delivered savings even during the current turmoil and that the agency had remained within its budget on debt payments this year.

However, the transportation authority has already announced it will raise subway and train fares next year because of various fiscal problems, and may be forced to shrink the work force and reduce some bus routes. Some analysts say fares will probably rise again in 2010.

The Depfa fallout doesn't end there. Rating agencies have downgraded the bonds of more than 75 municipal agencies backed by Depfa, including in California, Connecticut, Illinois and South Dakota. Officials in Florida, Massachusetts and Montana have cut budgets because of C.D.O.'s or similar risky bets.

And Hypo, the German company that bought Depfa, last week asked the German government for financial help for the third time. Depfa has frozen much of its business, according to Wall Street bankers, and though it continues to honor its commitments, some wonder for how long.

The Wisconsin school districts have filed suit against the Royal Bank of Canada and Stifel Nicolaus alleging misrepresentations. Board members hope they will prevail and schools and retirement plans will emerge unscathed. The companies dispute the lawsuit's claims. Mr. Noack is not named as a defendant and is cooperating with the school boards.

In Mrs. Velvikis's classroom at Grewenow Elementary in Kenosha, students have recently completed a lesson in which each first grader contributed a vegetable to a common vat of "stone soup." The project — based on a children's book — teaches the benefits of working together. The schools have learned that when everyone works together, they can also all starve.

"Our funding is already so limited," Mrs. Velvikis said. "We rely on parent donations for some supplies. You hear about all these millions of dollars that have been lost, and you think, that's got to come out of somewhere."

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