Kern County Superintendent of Schools

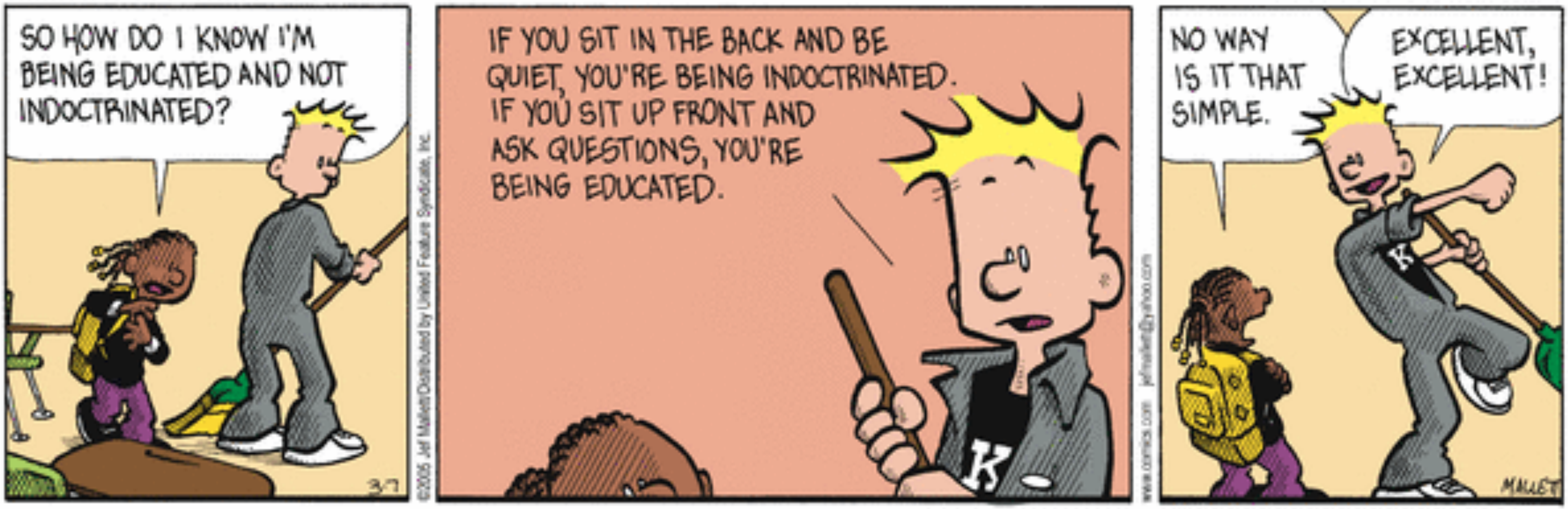
Integrity in Debt Planning Training- Financial Planning and Financing Vehicles

Government Financial Strategies

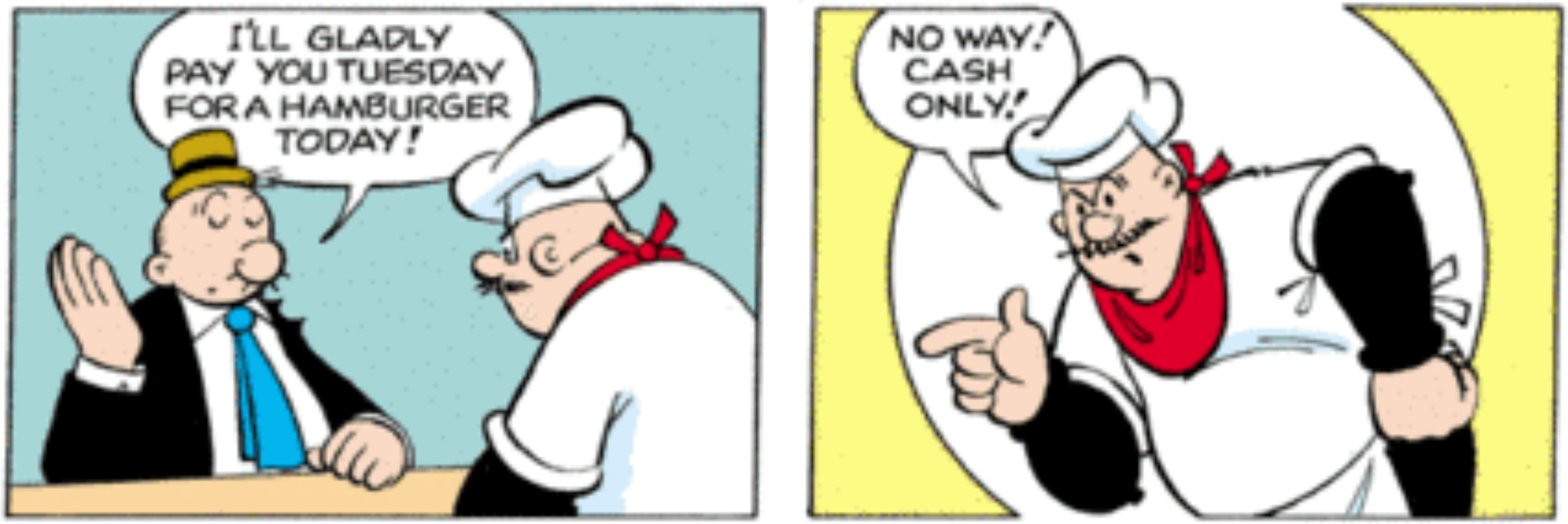
Presented by Lori Raineri
November 9, 2015

Presentation materials provided for distribution to class participants and are not meant to stand alone without the class discussion.

Please Ask Questions



What is Debt?



J. Wellington Wimpy and Rough House

- ✔ *With your colleagues, please make a list of as many types of debt as you can think of.*

Debt Definitions

- Debt: "money, services, or materials owed to another person as the result of a previous agreement"

  Dictionary of Banking & Finance

  1982 - John Wiley & Sons

  - Or simply put, a promise to do something in the future in return for something today

- Debt happens (promises made and accepted) when there is good faith and trust.

- ✔ *"I will gladly pay you Tuesday for a hamburger today."*

  » *J. Wellington Wimpy*

The Least You Should Know …

- Answers to these 6 questions:
  1. Why is the District borrowing?
  2. What will the District's annual obligation be, including debt service payments and administrative costs?
  3. What is the risk that the annual obligation will vary from year to year and by how much?
  4. What are the planned repayment sources?
  5. What is the likelihood the planned repayment sources will be sufficient?
  6. What is the cost of funds and is this reasonable?

✔ *With your colleagues, select one of the types of debt previously discussed that a school district could issue, and think about how one could know the answers.*

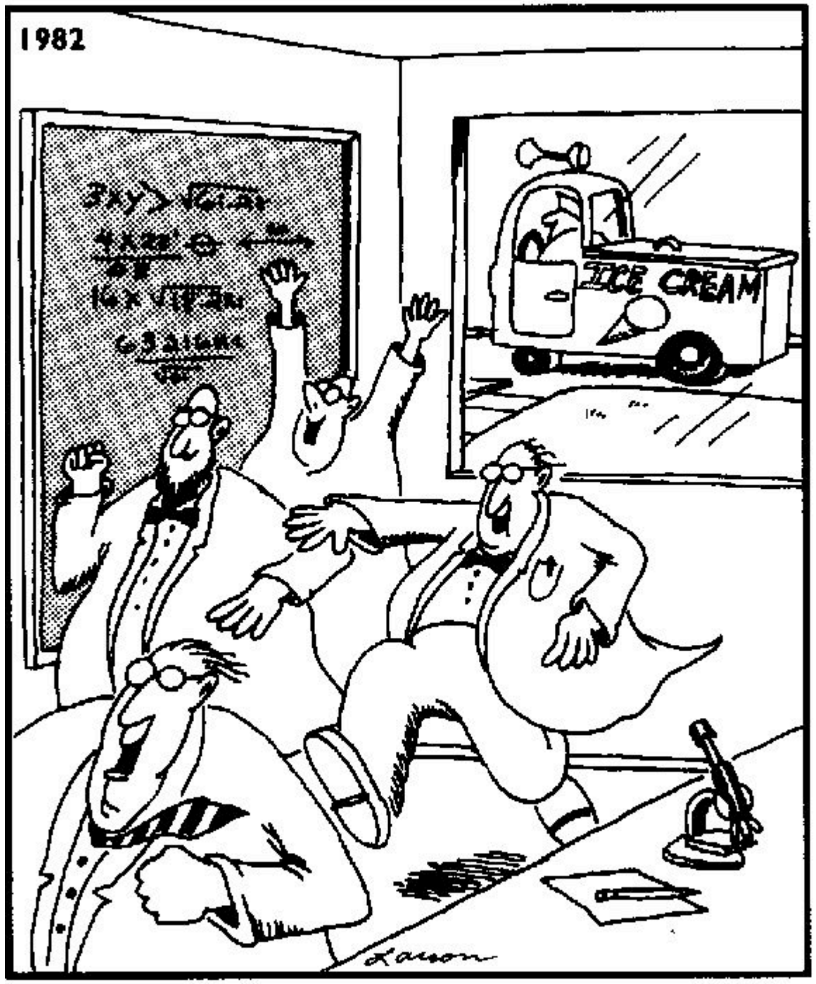
Modified for Voter Approved Bonds

- Answers to these 6 questions:
  1. Why is the District wanting to issue bonds (meaning *taxpayers* are borrowing)?
  2. What will the District's annual obligation be, including debt service payments and administrative costs?
  3. What is the risk that the annual obligation will vary from year to year and by how much?
  4. What are the projected tax rates?
  5. What is the likelihood the projected taxes will be sufficient to repay the bonds?
  6. What is the cost of funds and is this reasonable?

3 Ways For School Districts to Borrow

- Notes
  - Short term borrowing in “anticipation” of specified revenue
  - Repaid from specified revenue or General Fund
  - Tax Anticipation Notes, Grant Anticipation Notes, Bond Anticipation Notes
- Bonds
  - Require voter approval
  - Repaid from taxes
  - General Obligation Bonds or Special Tax (Mello-Roos) Bonds
- Lease Financing
  - No voter approval
  - Repaid from budget
  - Lease-Purchase Agreements, Certificates of Participation

Almost Everyone Likes Ice Cream



How is Debt Risky?

- For each of the three types of financing vehicles
  - Notes
  - Bonds
  - Lease Financing
- Please write down a risk associated with each particular type of debt. Here's a sentence stem to help:
  - If we borrow by issuing ________________ (choose notes, bonds, or lease financing), we face the risk that __________________________ happens and that means __________________________ for ___________________ (choose students, staff or the community).

GFOA Best Practices

- The Government Finance Officers Association (GFOA) publishes best practices related to debt management and issuance including:
  - *Selecting and Managing the Method of Sale of Bonds*
  - *Analyzing and Issuing Refunding Bonds*
  - *Selecting and Managing Municipal Advisors*
  - *Selecting Bond Counsel*
  - *Selecting and Managing Underwriters For Negotiated Bond Sales*
- Additional debt management best practices can be found at: www.gfoa.org/topic-areas/debt-management
- Kern County Superintendent of Schools debt toolkit can be found at: http://kern.org/finance/wp-content/uploads/sites/26/2015/03/Debt-Toolkit-Final.pdf

Best Practices Case Study

- How a newly minted CBO faced down potential insolvency utilizing GFOA Best Practices, wisdom and good humor.
  - Previously a kindergarten teacher and administrator on the curriculum side
  - Here's the story . . .

Government Finance Officers Association
Since 1906

Early Warning System

- New CBO appointed.
  - Immediate need to implement budget cuts and focus on fiscal solvency.

- County Office of Education asked the CBO about District's bond anticipation note repayment.
  - CBO didn't know anything about BANs generally or the District's BANs, and began to investigate.

✔ *CBO wanted to understand the situation and why COE was signaling an alert.*

How the Situation Began

- The District had a general obligation bond measure in 2006
  - Requested bond authorization of $275.0 million
  - Based on tax base at the time, bonding capacity was only$157.6 million

- Running out of road:
  - The District first issued bonds in 2006
  - As tax base declined, bonds (with CAB structure) were issued in 2008
  - As tax base decline continued, District issued a BAN (which obligated the General Fund) in 2009

✔ *The District issued increasingly more expensive and risky debt to continue with a plan which could not be implemented as originally envisioned.*

The Crisis Facing the CBO

- BAN payment of $106 million due December 2012
  - Remaining bonding capacity down to $85 million
  - Tax levy was at $75 per $100,000 of assessed value
    - Maximum projection under Proposition 39 (55% voter approval bonds) is $60 per $100,000 of assessed value for a unified school district
- General fund obligated to repay the debt in the event the District could not issue a sufficient amount of bonds

✔ *The CBO made a very wise and crucial decision: stop the failing plan.*

- *The District halted expenditures from its BAN funds and reserved the remaining $58 million to repay the BAN. Financial shortfall dropped; $106 million ➔ $48 million*

We Can Tell the Difference

Why Not Issue COPs?

- Apparently, there was some historical thinking related to the issuance of the BANs, that the District would be able to issue COPs to repay the BANs.

- The District had outstanding COPs that were being repaid by CFD revenues.
  - Available CFD revenues could only support $12 million in new borrowing
  - General Fund could not afford COP payments
  - COE would not approve issuance of COPs

Seeking Advice

- The CBO initially thought the underwriter was its advisor.
- COE helped the CBO understand the difference between an underwriter and an advisor.
  - An advisor represents the District.
  - An underwriter represents investors.
    - New rules have been set for underwriters by the Securities and Exchange Commission and Municipal Securities Rulemaking Board as a result of the Dodd-Frank Act to make this more clear.
    - However, many underwriters and other consultants provide advice – but are not fiduciaries.

U.S. Securities and Exchange Commission

MSRB Municipal Securities Rulemaking Board

First GFOA Best Practice

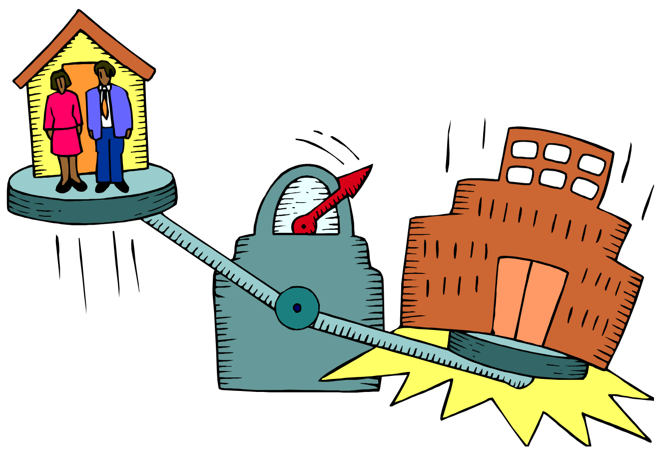
- The CBO decided to hire an *independent* financial advisor.

  "Unless the issuer has sufficient in-house expertise and access to market information, it should hire an outside financial advisor prior to undertaking a debt financing. A financial advisor represents the issuer, and only the issuer, in the sale of bonds."
    - GFOA Best Practice on Selecting Financing Advisors
- The financial advisor created a plan that, through debt structuring, cut the estimated cost of repaying debt issued to repay the BAN in half (from $400 million to $200 million) from what the underwriter had proposed.

District Adopted a New Perspective

- District started to think about finance strategically
  - In terms of financial risk management
  - Not just in terms of facilities goals and community politics



District Sought Input

- Public workshops were held
  - As meetings of the School Board and the Citizens' Bond Oversight Committee
- The Superintendent and CBO held meetings with:
  - The COE Staff
  - County Treasurer Staff
  - County Counsel
  - County Administrator's Office Staff
  - County Supervisors
  - City Staff
  - City Council Members

Another's Publicity Affects District

Poway Unified residents fume over expensive bond

School district officials explain, defend decision behind $1 billion debt

By Ashly McGlone

Originally published August 20, 2012 at 10:09 p.m., updated August 20, 2012 at 10:37 p.m.

POWAY — Residents of the Poway Unified School District came out in droves Monday night to voice concerns about a bond deal that saddles them with nearly $1 billion in long-term debt — about nine times the amount of the bond.

U-T San Diego

School bond reform gaining support

By Ashly McGlone

Originally published August 21, 2012 at 12:12 p.m., updated August 21, 2012 at 7:52 p.m.

A top county financial official is urging state lawmakers to make changes to school construction financing laws in the wake of concern over a controversial and expensive bond issued by the Poway school district.

The proposals unveiled Tuesday by the San Diego County Treasurer/Tax Collector Dan McAllister were greeted with a positive response from some legislators and state Treasurer Bill Lockyer.

THE SUN

[redacted] - A [redacted] Unified School District plan to finance a $106 million bond payment due in December to stave off a likely state takeover has drawn fire from the county's top financial official and two county supervisors.

Political and Management Milieu

- At School Board meeting where financing was to be approved, full capacity audience, unrelated to the financing.
- Board's legal counsel changed firms midway through financing process.
- Prior underwriter and bond counsel needed to be extracted from the process.
- District's new bond counsel forced to quit because while personally supported effort, blocked by firm's internal politics.
- School Board member from outside the County commenting.

View of Those Burdened With Expense

- Taxpayers and community generally unconcerned.
  - Public comment suggested the District get on with solving the financial problem.
  - Community valued the facilities improvements.
  - Consistent with our experience
    - Since the Attorney General issued its January 2009 legal opinion that "cash out general obligation bond refinancings" were unconstitutional, we know of no taxpayer lawsuit over the higher resulting taxes.

  - If taxpayers are willing to pay, why not get more value for students and the community with those taxes?

Second GFOA Best Practice

- The CBO decided to use a competitive bid process to sell the bonds.

"The GFOA believes that the presence of the following factors may favor the use of a competitive sale:

- The rating of the bonds, either credit-enhanced or unenhanced, is at least in the single-A category.
- The bonds are general obligation bonds or full faith and credit obligations of the issuer or are secured by a strong, known and long-standing revenue stream.
- The structure of the bonds does not include innovative or new financing features that require extensive explanation to the bond market."
  - GFOA Best Practice on Selecting Method of Sale

Third GFOA Best Practice

- Because of outstanding non-callable bonds, the District had to utilize Capital Appreciation Bonds, which are expensive, and lately, have been negatively portrayed in the news.
  - However, by including an option for the bonds to be called and repaid early, the District preserved the flexibility to improve its debt situation in the future should market conditions improve.

    "Evaluate carefully whether structural features, such as call features and original issue discount, that impact the true interest cost (TIC) of a bond offering, but limit future flexibility in managing the debt portfolio, will result in greater overall borrowing costs."

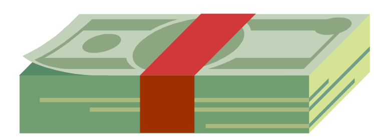
    - GFOA Best Practice on Pricing Bonds in a Negotiated Sale

Fourth GFOA Best Practice

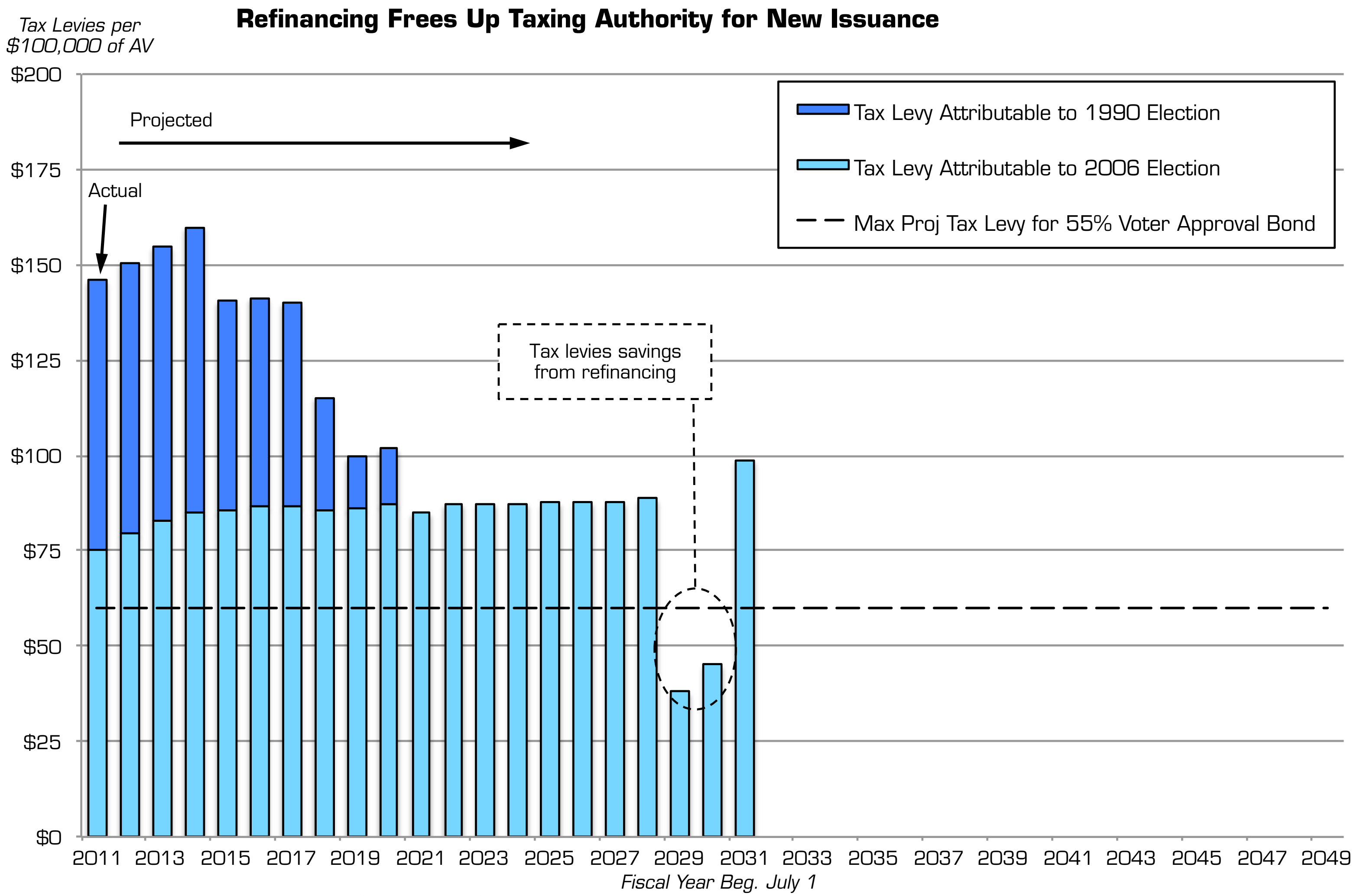
- District issued bonds to repay the BANs combined with a refinancing.
  - Refinancing enabled the bonds which needed to be issued to repay the BANs to be structured more efficiently.
  - Economies of scale saved on costs of issuance.

    "Refundings may be undertaken for a number of financial and policy objectives, including to achieve debt service savings, eliminate restrictive bond/legal covenants, restructure the stream of debt service payments, or achieve other policy objectives."

    - GFOA Best Practice on Analyzing and Issuing Refunding Bonds

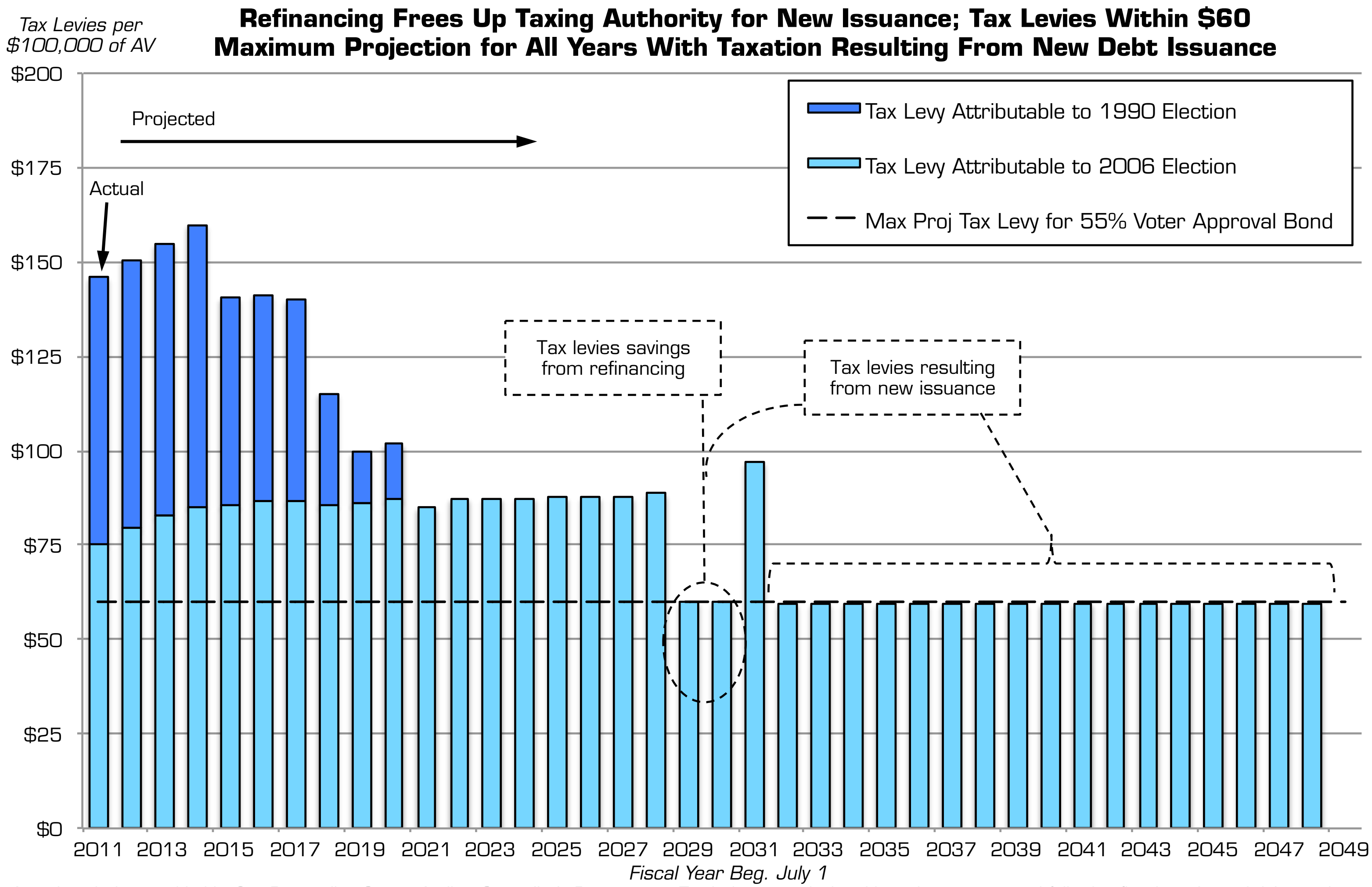


Projected Levies After Refinancing



Actual tax levies provided by San Bernardino County Auditor-Controller's Department. Tax levies are calculated based on current and following fiscal year's total debt service collection required, with one levy being assigned per year for the District's voter-approved debt. Net local secured assessed value is assumed to grow at 0% for 2012-13, 1.0% for 2013-14, 2.0% for 2014-15, 3.5% for 2015-16, and 5.0% annually thereafter, while all other types of assessed value are assumed to remain unchanged.

New Issuance Stays Within $60 Constraint



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Competitive Bidding Produces Savings

- New Money Borrowing to Repay BANs
  - *$5 million difference from last to first place bid*

COMPETITIVE BIDDING RESULTS

Bid #	Name of Bidder	True Interest Cost (TIC%)	Approximate Difference in Present Value From Winning Bid
1	**Citigroup Global Markets Inc.**	**5.589100%**	
2	Barclays Capital Inc.	5.877361%	$3,659,520
3	Morgan Stanley & Co, LLC	5.929144%	$4,288,599
4	Bank of America Merrill Lynch	5.990789%	$5,026,611

* Note: subsequent to the bidding, the winning bid was restructured, changing the TIC to 5.586326%.

- Refinancing for Taxpayer Savings
  - *$2.2 million difference from last to first place bid*

COMPETITIVE BIDDING RESULTS

Bid #	Name of Bidder	True Interest Cost (TIC%)	Approximate Difference in Present Value From Winning Bid
1	**Raymond James & Associates, Inc.**	**2.907152%**	
2	Bank of America Merrill Lynch	2.918249%	$92,320
3	Morgan Stanley & Co, LLC	2.939772%	$260,662
4	Barclays Capital Inc.	3.033029%	$1,044,313
5	Citigroup Global Markets Inc.	3.150225%	$2,080,136
6	Wells Fargo Bank, National Association	3.162056%	$2,170,642

* Note: subsequent to the bidding, the winning bid was restructured, changing the TIC to 2.940814%.

Continual Improvement

- District planned to issue $50,173,254 to repay the BANs, but was able to lower the par amount to $47,259,440, due to identification of the additional $963,905 of available Building Fund balance for the BAN repayment plus savings on financing costs to be paid from bond proceeds (costs of issuance and underwriting discount).
  - Thus, the District has an additional $2.9 million of bonding authority remaining beyond the $25.2 originally estimated (an improvement of more than 10%).
- The County Treasurer was concerned about the ratio of debt service to gross borrowing, which we originally projected at 3.9 to 1.
  - Borrowing less, at less cost, brought this ratio down to 3.7 to 1.

Beyond GFOA Best Practices

- GFOA Best Practices followed:
  - Hiring a financial advisor
  - Selecting a competitive sale
  - Considering call features
  - Refinancing for savings

- Additional practices done well:
  - Responsiveness to COE Concern
  - Coordination with COE
  - Having the courage to change course
  - Research and analysis to make and support decision
  - Transparency
  - Seeking input
  - Active management
  - Cost control

Debt Can Be a Good Tool . . .

"I'd like to borrow just enough to get myself out of debt."

✔ *. . . but caution is advised!*

What's At Stake?

- At the conclusion of the Constitutional Convention in 1787, Benjamin Franklin was asked, "What have you wrought?"

- He answered, *". . . A Republic, if you can keep it."*