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Taxpayers watchdog since 1945
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Assembly Bill 182: School Bond Financing Reform – Capital Appreciation Bonds

March 2013

SDCTA Position: **SUPPORT with amendments**

Rationale for Position: The proposed legislation will eliminate the abusive use of risky financing tools school districts have recently been using to finance capital projects authorized by voters. The use of long-term Capital Appreciation Bonds defers bond payments to future years and relies on rising home prices in order to pay back principal and accrued interest payments. Until the bill is passed and becomes law, each school district within the county should comply with the elements within AB 182 to ensure no further debt issuances harm taxpayers. SDCTA recommends one amendment to the bill to provide further transparency when CABs are proposed to be issued.

Title: Assembly Bill 182 Proposed by Assembly Members Buchanan and Hueso – Bonds: school districts and community college districts
Jurisdiction: State
Type: Statutory
Vote: Simple Majority
Status: Referred to Assembly Committee on Education
Issue: School districts and community college districts have used long-term risky financing known as Capital Appreciation Bonds to pay for capital improvement projects. CABs that have been issued locally have as high as a 9.5-to-1 debt service ratio. Some argue that inflation will make this ratio reasonable.
Description: Legislation intended to:

1) Limit bond maturities to 25 years;
2) Reduce maximum allowable interest rate to 8%;
3) Require each capital appreciation bond maturing more than 10 years to include callable feature;
4) Require governing board to adopt resolution prior to sale of bond that includes information pertaining to debt; and
5) Establish the ratio of total debt service to principal for each bond series not to exceed 4 to 1.

Fiscal Impact: No direct fiscal impact to the state but could impact borrowing costs for school districts and community college districts. The overall increase in borrowing could be minimal. An increase in borrowing costs would increase the cost to property owners within each district. Eliminating the ability to issue 40-year CABs would also produce savings.

Background[1]:

When a bond measure passes to provide funding to a school district, voters approve two dollar amounts: (1) a total amount that can be borrowed, and (2) a maximum increase to their property taxes, otherwise called the district's "taxing authority." The amount of debt a

[1] For more information on school bond financing, please review SDCTA's "Backgrounder: Alternative Funding Methods for School District General Obligation Bonds."

district can issue can be no more than the amount of revenue that is generated in a given year by the new property tax. Projections are made with regards to assessed value growth within the district to estimate the total amount that can be borrowed given the revenue expectations. Due to the loss in assessed value through the recession, districts that passed measures in 2006 and 2008 are unable to issue their remaining "authorized, but unissued" bonds because taxes would have to be raised above their taxing authority in order to service the higher total debt. [2]

This inability to issue bonds creates an environment in which districts must slow or halt their bond programs, find bridge financing to keep bond programs alive, propose another tax increase to be approved by voters, or use risky debt-financing mechanisms in order to issue debt while staying below their taxing authority.

Capital Appreciation Bonds

One method that has seemed to catch the attention of districts as a means to generate capital to complete bond projects is the sale of Capital Appreciation Bonds (CABs) (also known as Zero Coupon Bonds). Unlike conventional bonds that make regular, semi-annual interest and principal payments to investors until the bond matures, CABs require a series of deferred payments consisting of accrued interest and principal made to investors. The payments consist of the principal and all unpaid interest that has accumulated and compounded for a period of up to 40 years.

By issuing CABs, districts are able to maintain their current taxing level while issuing additional debt in order to raise funds for projects. In order to avoid exceeding this authority and calling another election to increase tax rates, the appeal of deferring debt to future generations while receiving the funds today has enticed districts to use this type of financing.

The following is one example of a school district within San Diego County that has recently issued CABs.

Figure 1[3] outlines the debt service schedule for a $105 million CAB – Series B bonds issued by the Poway Unified School District (PUSD) in August 2011 for its Proposition C program passed by voters in 2008. Between 2011 and 2032, PUSD is not required to pay any debt service toward this bond issuance. In total, **<u>the cost of the $105 million bond issuance is approximately $982 million</u>** over the 19 year period, which means the district is going to be **<u>paying $877 million in interest</u>**.

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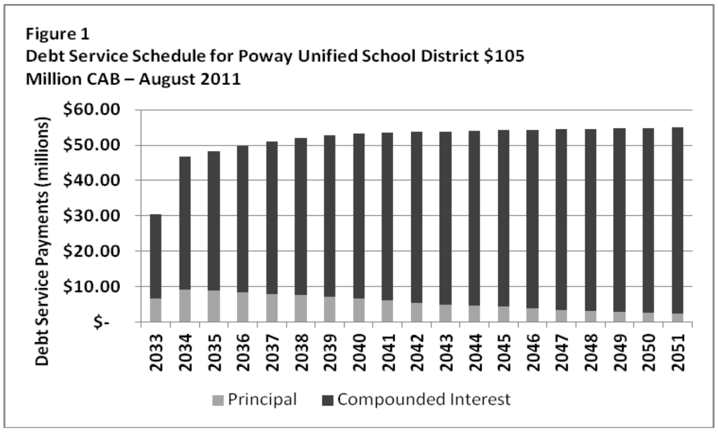
[2] Districts that also passed bond measures that "extended the current rate" have also experienced difficulties since they must still pay off past debt and issue new debt, at a tax rate that was not increased.

[3] Poway Unified School District Preliminary Official Statement. General Obligation Bonds Election of 2008, Series B. http://emma.msrb.org/EA475815-EA365414-EA764813.pdf



SDCTA Past Position

In 2012, the San Diego County Taxpayers Association (SDCTA) released its review of alternative financing methods for school district general obligation bonds. The report outlined various bond financing methods, including the use of Capital Appreciation Bonds. SDCTA also adopted the following policy recommendation:

> *"In connection with the sale of any bonds, capital appreciation bonds (CABs) should only be pursued if it can be demonstrated that their use will result in less debt service than other bond structures or other financial alternatives. Other financing options that should be compared to the potential use of CABs include additional voter approved tax increases. It is further stipulated that the District will not authorize the sale of any form of Capital Appreciation Bonds or Convertible Capital Appreciation Bonds without review by the District's citizens' bond oversight committee. Defensible assumptions for growth in assessed value shall be used for development of any proposed financing method."*

SDCTA advocated adoption of this policy from all school districts attempting to pass a general obligation bond measure on the November 2012 ballot. Districts adopted this policy either via their respective ballot resolution or as a board policy.

Proposal & Policy Implications:

Assembly Members Joan Buchanan and Ben Hueso, with input from County of San Diego Treasurer-Tax Collector Dan McAllister, introduced Assembly Bill (AB) 182 to reform the current school bond financing structure. The legislation is specifically aimed at eliminating the risk to taxpayers that is borne by the issuance of long-term capital appreciation bonds.

The legislation aims to make four (4) major reforms which are outlined below.

Bond Maturities

The proposed legislation amends Section 53506(a) of the Government Code:

> "This article is full authority of the issuance of bonds or refunding bonds by any city, county, city and county, ~~school district, community college district,~~ or special district, secured by the levy of ad valorem taxes, authorized in accordance with the Constitution and, in the case of a chartered city, county, or city and county, with the charter thereof, or in the case of a special district, with the

> district's principal act. *This article shall not apply to a school district or a community college district."*

Currently when a school district or community college district issues debt, they can do so under California Government Code or California Education Code. Under the California Government Code, public agencies, including school districts and community college districts, are able to issue debt with maturities of up to forty (40) years. The California Education Code limits debt maturities to twenty-five (25) years. The proposed legislation would remove school districts and community college districts from issuing debt allowed for under California Government Code, and instead limit those school and community college districts to issuing debt under the California Education Code. Additionally, limiting school and community college districts strictly to the Education Code would require the interest rate on bonds to bear a rate of interest that does not exceed 8 percent per annum. AB 182 would remove other references to school districts and community college districts in other sections of the Government Code.

Ratio of Total Debt Service
AB 182 adds Section 15144.1 to the Education Code:

> *"The ratio of total debt service to principal for each bond series shall not exceed four to one."*

The ratio of total debt service measures the total cost of the bonds including interest against the amount borrowed. In the case of the Poway Unified School District and San Diego Unified School District, the ratio reached as high as 9.5-to-1 with a $105 million bond issuance costing taxpayers over $1 billion in total principal and interest payments. Financial advisors have stated that a best practice is to limit this ratio to 4-to-1 for any bond issuance.

Callable Option for Bonds
The proposed law includes the following language proposed to be added to the Education Code as Section 15144.2:

> *"A capital appreciation bond maturing more than 10 years after its date of issuance shall be subject to mandatory tender for purchase or redemption before its fixed maturity date, with or without a premium, at any time, or from time to time, beginning no later than the 10th anniversary of the date the capital appreciation bond was issued."*

One noticeable feature that is rarely included in the issuance of CABs is a prepayment option should a school district wish to pay the outstanding debt earlier than the final maturity date. Therefore, districts are locked into the payment schedule outlined and must rely on the housing market to increase at a pace that generates enough property tax revenue to make the payments in future years.

A byproduct of requiring a "call option" to these bonds is the increase in borrowing costs. The issuer (school district) must compensate investors for providing this option. Therefore, the interest rate on callable bonds is typically higher than those on noncallable bonds of the same credit quality. That is, the borrowing costs increase on bonds with a call feature. The potential increase in borrowing costs may be minimal.

Under the proposed law, this feature is only required on CABs with a maturity date of more than 10 years.

District Transparency
The proposed law adds Section 15146(c) to the Education Code, which reads:

> *"If the sale includes capital appreciation bonds, the agenda item shall identify that capital appreciation bonds are proposed and the governing board shall be presented with all of the following:*
>
> *(1) An analysis containing the total overall cost of the capital appreciation bonds.*
> *(2) A comparison to the overall cost of current interest bonds.*
> *(3) The reason capital appreciation bonds are being recommended.*
> *(4) A copy of the disclosure made by the underwriter in compliance with Rule G-17 adopted by the federal Municipal Securities Rulemaking Board."*

Currently the governing board of a district must include a number of items within the resolution allowing for the issuance of debt. AB 182 would require the addition of a number of items in the resolution if that district is pursuing capital appreciation bonds. Included is a comparative analysis that SDCTA has called for within its policy relating to CABs. Rule G-17 of the Municipal Securities Rulemaking Board states, "In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice."

Fiscal Impact:

State and Local Government
The proposed legislation has no direct fiscal impact to the state but the requirement of a call option for all CABs with a maturity date of ten (10) years or more could impact borrowing costs for school districts and community college districts. The overall increase in borrowing could be minimal.

Local Taxpayers
An increase in borrowing costs to school districts and community college districts would increase the cost to property owners within each district. If the overall borrowing costs increase, the length of time needed to pay off that debt through the increase in property tax would be extended. Property owners may also see relief by eliminating the ability of districts to issue 40-year CABs, thereby reducing debt payments.

SDCTA Recommended Amendments:

SDCTA recommends the author(s) of this legislation include the following amendments:

1. **Add section (5) under Section 15146(b):**

Prior to the November election, SDCTA worked with all school districts with a proposed bond measure on the ballot to adopt language either within the ballot resolution or through board policy to demonstrate the issuance of CABs is cost-effective as well as require districts to be more transparent about their use. SDCTA recommends this language be included within the proposed legislation as Section 15146(b)(5):

"If the sale includes capital appreciation bonds, review by the district's citizens' bond oversight committee."

List of Proponents:

- Assemblyman Ben Hueso
- Assemblymember Joan Buchanan
- County of San Diego Treasurer-Tax Collector Dan McAllister
- State Senator Marty Block
- State Senator Mark Wyland

Proponent Arguments:

- Bill establishes fiscally prudent policies in a financing system that has been regularly misused.
- Districts should not spend so much on debt that today's children finance their education as tomorrow's adults.
- Reforms are needed to toughen taxpayer protections, increase transparency, strengthen oversight of CABs issuance and improve quality of information provided to decision-makers and the public about CABs.

List of Opponents:

- None as of yet