State Auditor's Office
Lawrence F. Alwin, CPA
State Auditor

An Audit Report on

Certification of the Permanent School Fund's Bond Guarantee Program

April 29, 2002

Members of the Legislative Audit Committee:

We certify that the amount of bonds guaranteed by the Permanent School Fund's (PSF) Bond Guarantee Program (Program) is within the limit prescribed by Section 45.053(a) of the Texas Education Code. As of August 31, 2001, the bonds guaranteed by the Program totaled $23,531,512,922. The limit set forth in the Texas Education Code was $37,142,761,998. The Internal Revenue Service (IRS) limit for the maximum amount allowable for guarantee was $36,984,964,367. Therefore, the total amount guaranteed has reached approximately 63.6 percent of the more restrictive IRS limit. In fiscal year 2000, the Texas Education Code limit was more restrictive than the IRS limit. That year, the total amount guaranteed was 57.9 percent of the Texas Education Code limit.

Program Savings to School Districts

The Program is saving school districts millions of dollars in interest and bond guarantee premium costs annually by enhancing school district bond ratings to the highest possible rating. Without this program, school districts could only improve the credit rating and marketability of their bonds by paying private bond guarantors a fee to guarantee their bonds.

On average, having its bonds guaranteed by the Program saves a district private guarantee fees ranging from 0.38 to 0.40 percent of principal and total interest. For example, a 5 percent, 30 year, $30 million bond issue on the average would cost about $220,000 to $232,000 in up-front fees for a private bond guarantee.

This certification is required by Section 45.053(b) of the Texas Education Code. The Program was created as a way for school districts to improve the credit rating and marketability of their bonds. When the Program guarantees school district bonds, this enhances school district bond ratings up to the highest possible bond rating. The Program especially helps poorer school districts that have relatively low bond ratings. Without the Program, school districts would have to pay for private bond guarantee coverage or pay higher interest rates (see textbox).

There are two limits for the total amount of bonds the Program can guarantee:

- The Texas Education Code sets the limit at two times the cost or market value of the PSF (whichever is lower), excluding real estate.
- A 1991 IRS Letter Ruling sets a limit of 250 percent of the amortized cost or market value of the PSF (whichever is lower), adjusted for land income after May 15, 1989. Noncompliance with the IRS limit may result in school district bonds becoming taxable or it may result in a rebate to the IRS.

Although the total amount of bonds guaranteed by the Program is within the limits prescribed by the Texas Education Code and the IRS, we identified three related issues that the PSF must address to ensure that it continues to comply with these limits. Specifically:

- PSF includes only the principal amount of Capital Appreciation Bonds (CABs) in its calculation of total bonds guaranteed when monitoring its compliance with statutory and IRS limits. If PSF included the accretion of all CABs when calculating the total bonds guaranteed, the total amount guaranteed would reach current Texas statutory and IRS limits sooner than PSF currently forecasts. We previously provided the Legislative Audit Committee *A Briefing Report on School District Debt* (SAO Report No. 98-027, February 1998) regarding the need to report CAB accretion at school districts.

  There is bond industry support to consider only bond principal amounts in determining debt capacity limits. On the other hand, there is support in *Generally Accepted Accounting Principles* (GAAP) for considering CAB accretion as part of total bonds guaranteed. The GAAP requirement that school districts must follow when reporting CABs on their financial statements is that accreted interest must be reported as an addition to bonds payable each year. PSF has had plans for several years to work on quantifying the outstanding accretion on CABs for disclosure purposes.

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- According to the PSF's analysis, the amount of bonds guaranteed by the Program could meet the limit set forth in the Texas Education Code within the next five years. This would compel the Program to reject future bond guarantee requests and, therefore, increase costs at the school district level. Based on our risk analysis the statutory limit could be safely increased without risking the PSF's bond rating or the soundness of the PSF for a variety of reasons outlined in the attachment to this letter.

- According to the PSF's analysis, the amount of bonds guaranteed by the Program could meet the IRS limit within the next five years. For the first time ever, in fiscal year 2001 the IRS limit became more restrictive than the Texas statutory limit primarily because of market decline. However, the IRS ruling that specifies this limit does not appear to recognize that Texas schools are operated independently from the State and that the arbitrage of interest rates that the IRS limit seeks to prevent is not possible at the PSF level.

The attachment to this letter contains additional details on the three issues summarized above. The Texas Education Agency (Agency), which approves bonds guaranteed by the PSF, generally agrees with our recommendations, and its responses are included in the attachment. We appreciate the Agency's cooperation on this audit. If you have any questions, please contact Carol Smith, CPA, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment

cc: Members of the State Board of Education
Dr. Felipe Alanis, Commissioner of Education, Texas Education Agency
Mr. Paul B. Ballard, Executive Administrator, Permanent School Fund

Section 1:

PSF Includes Only the Principal Amount of Capital Appreciation Bonds In Its Calculation of Total Bonds Guaranteed

When monitoring its compliance with statutory and IRS limits, the Permanent School Fund (PSF) includes only the principal amount of Capital Appreciation Bonds (CABs) in its calculation of the total bonds guaranteed by the Bond Guarantee Program (Program). If PSF included the accretion of all CABs when calculating the total bonds guaranteed, the total amount guaranteed would reach current Texas statutory and IRS limits sooner than PSF currently forecasts.

What is a Capital Appreciation Bond?

Capital Appreciation Bonds (CABs) are different from traditional bonds. The investment return on CABs is considered to be in the form of compounded interest, rather than the accreted original principal. For this reason only the initial principal amount of a CAB is counted against an issuer's statutory debt limit, rather than counting the total book value against the issuer's debt limit as is the case with a traditional bond.

PSF excludes the CAB accretion amount when it calculates total bonds guaranteed.

In several cases we examined, the accretion amount at maturity for certain CABs was four to five times greater than the principal amount PSF reported for those CABs in total bonds guaranteed. There is bond industry support to consider only bond principal amounts in determining debt capacity limits. However, regardless of bond industry practice, in the unlikely event that a default occurred, PSF would need to pay the fully accreted bond amount at maturity.

There is support in Generally Accepted Accounting Principles (GAAP) for considering CAB accretion as part of total bonds guaranteed. The GAAP requirement that school districts must follow when reporting CABs on their financial statements is that accreted interest must be reported as an addition to bonds payable each year. GAAP also requires school districts to adequately disclose accreted interest in the notes to their financial statements.

We previously provided the Legislative Audit Committee *A Briefing Report on School District Debt* (SAO Report No. 98-027, February 1998) regarding the need to report CAB accretion at school districts. PSF does not currently have the ability to readily determine the amount of principal reported that is related to CABs or the applicable accretion guaranteed. PSF has had plans for several years to work on quantifying the outstanding accretion on CABs for disclosure purposes.

<u>Recommendations</u>:

PSF should:

- Complete its planning and set a target date for systematic accounting for CAB accretion. After PSF quantifies outstanding accretion, it should disclose the amount in the notes to its financial statements.
- Obtain an opinion from the Office of the Attorney General to validate PSF's interpretation that CAB accretion can be excluded from the calculation of total bonds guaranteed.

Management's Response:

Management agrees that the PSF accounting system should have the capacity to produce both the original issue principal amount and fully accreted value of CABs. The project to generate this information will be completed in fiscal year 2003. In the interim, management will seek to acquire accrued interest amounts for both CABs and interest paying bonds from the Texas Municipal Advisory Council (MAC) for purposes of financial disclosure. Management is consulting with bond counsel as to the appropriateness of disclosing CAB accruals in disclosures required of the fund with the Securities and Exchange Commission.

Management does not agree with the need to seek an opinion from the Attorney General to validate the interpretation that CAB accretion can be excluded from the calculation of total bonds guaranteed for purposes of compliance with Section 45.053 of the Texas Education Code. The current practice as to CAB bonds was in place when that statute was enacted and has remained unchanged since that time, including the reenactment of that section in 1995 and the enactment of the applicable Internal Revenue Service regulations in 1993. Management will bring this issue to the attention of legislators prior to the 2003 legislative session but does not believe it is currently prudent to make an accounting change that restricts the amount of school district bonds that can be guaranteed.

Section 2:

The Amount of Bonds Guaranteed Could Meet the Statutory Limit Within the Next Five Years

According to the PSF's analysis, the amount of bonds guaranteed by the Program could meet the limit set forth in the Texas Education Code within the next five years. This would compel the Program to reject future bond guarantee requests and, therefore, increase costs at the school district level. Media reports have been cautioning that the continuation of the Program is at risk because the Program is approaching the statutory limit and no solutions are being offered. The PSF has only one or two legislative sessions to coordinate statutory relief from the Texas Education Code limit through the legislative process before the amount guaranteed reaches the current statutory limit.

It is important to note that an exact calculation of the point in time when the program will meet the statutory limit and cease to provide new guarantees is difficult to forecast. This is because the guarantee status is affected by changes in school districts' bonded debt, securities market conditions, PSF investment objectives, oil and gas revenue from PSF land, and federal and state legal restrictions on the PSF.

Based on our risk analysis the statutory limit could be safely increased without risking the enhancement of bond ratings or the soundness of the PSF for the following reasons:

- The Program has a zero-loss default history.

- The Program has an adequate default prevention mechanism that incorporates professional guidance for school districts and continuous financial monitoring.
- The Texas Education Agency, which approves PSF bond guarantees, can require school districts to consolidate to eliminate a financially weak school district and prevent defaults.
- PSF's capital leverage is far lower than the accepted levels of private bond guarantors.
- Default payments by the PSF, if any, will be recovered from the school district pursuant to statute by diverting state funding from the school district to repay the PSF.

Recommendation:

PSF should discuss an appropriate limit for the Program with bond rating agencies and submit draft legislation to the Legislature to increase the statutory limit for the program.

Management's Response:

Management agrees that a review of the statutory limits for the program by the Legislature is in order. The TEA will pursue the subject with appropriate committees of the Legislature. Current agency projections indicate that the guarantee limit imposed by Internal Revenue Service regulation is likely to be more restrictive than the statutory limit in Section 45.053 for the foreseeable future. However, the agency will also consider any flexibility that is possible under existing IRS regulations (see response to Section 3 below). The Legislature may wish to consider rephrasing the statutory limit to be the higher of the existing limit or any applicable IRS limit.

Section 3:

The Amount of Bonds Guaranteed Could Meet the IRS Limit Within the Next Five Years

What is Bond Arbitrage?

Bond arbitrage occurs when an issuer of tax-exempt bonds invests bond proceeds at a yield that is materially higher than the yield on the tax-exempt bonds. Under such circumstances, the issuer profits from the exchange at the expense of federal tax receipts.

According to the PSF's analysis, the amount of bonds guaranteed by the Program could meet the Internal Revenue Service (IRS) limit within the next five years. For the first time ever, in fiscal year 2001 the IRS limit became more restrictive than the Texas statutory limit primarily because of market decline.

In 1991, PSF obtained an IRS Letter Ruling that interprets IRS tax law on bond arbitrage that was implemented effective May 15, 1989. PSF is still following the limit for total bonds guaranteed that is specified in that 1991 IRS ruling. However, the IRS ruling does not appear to recognize that Texas schools are operated independently from the State and that the arbitrage of interest rates that the IRS limit seeks to prevent is not possible at the PSF level.

The PSF was funded in 1854 as a perpetual gift to future generations of school children. School districts and the PSF are totally separate entities and the PSF does not receive any funds from school district bond proceeds. Therefore, the PSF itself and its continuously earned and reinvested income (including its land grant income) is not and could not be an arbitrageur of bonds issued by independent school districts.

Recommendation:

PSF should, in conjunction with the Legislature, informally discuss with appropriate parties the applicability of the arbitrage tax laws to the Program and determine whether the IRS limit can be reevaluated.

Management's Response:

Management has begun discussions with legal counsel regarding the applicable IRS regulations and appropriate means to respond to those limits on the Fund's guarantee capacity.

Summary of Objective, Scope, and Methodology

Our objective was to determine whether the total amount of school district bonds guaranteed by the Program exceeded the limits established by state statute and the IRS. We limited the scope to the amount of outstanding guaranteed bonds as of August 31, 2001.

To analyze bond information, we:

- Gained an understanding of governing statutes and business processes.
- Interviewed Program personnel.
- Compared bond information with external sources including independent audit reports of certain school districts.

This audit was conducted in accordance with generally accepted government auditing standards.