OUR SCHOOL DISTRICTS DO NOT NEED ZEROS

Summary

The Santa Clara County Civil Grand Jury (the Grand Jury) investigated a complaint questioning the use of "Capital Appreciation Bonds" or CABs by the Luther Burbank School District (Luther Burbank). Capital Appreciation Bonds are bonds where payment of some or all of the interest is deferred, allowing the unpaid interest to compound. If all of the interest is deferred, these are also called Zero Coupon Bonds or "Zeros." The issuer of a conventional bond agrees to pay interest periodically. In contrast, the interest on a CAB is deferred and compounded resulting in significantly higher repayment costs.[1] While Luther Burbank has borrowed a significant amount of money through the issuance of CABs, other school districts in Santa Clara County and the State of California have also taken advantage of these CABs. We find that sale of school bonds that defer a significant amount of current interest is ultimately detrimental to our community, taxpayers, schools, and students. CABs borrow from future taxpayers and deprive schools of the revenues they require in order to provide for the needs of students.

Background

CABs appear to have no current cost because the payments of principal and interest are deferred to future years. The deferral is rationalized with speculative assumptions about rising real estate values. Recent experience has demonstrated that overly optimistic assumptions about long-term real estate values can have severe negative consequences for our community if the assumptions prove incorrect. Future districts will be compelled to pay our deferred interest, as well as their operating expenses. The affected districts will be underfunded, property values may be harmed, and State takeover may become inevitable. The prospect of default may affect the bond market and harm the ability of more prudent districts to finance their capital needs. Taxpayers outside the district may face "bail-out" costs as well. We believe that responsible school districts should avoid these practices and we support legislative action to limit school districts use of CABs.

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[1] For comparison, on a 30 year bond at 5% interest:

- if you make constant payments and pay off the principal and interest over the life of the loan, you will pay a total of about $93 in interest for every $100 borrowed or a total of $193 in debt service;
- if you pay interest only and pay the principal at the end, you will pay a total of $150 in interest for every $100 borrowed or a total of $250 in debt service; and
- if you defer the principal and interest to the end, as in a CAB, you will pay a total of about $340 in interest for every $100 borrowed or a total of $440 in debt service.

Methodology

The Grand Jury sent a survey regarding planned sales of CABs to each of the school districts in Santa Clara County covering grades K-12 ("K-12 School Districts). The districts were asked for copies of recent presentations received from financial advisors regarding CABs. In addition, the Grand Jury reviewed information from the State Treasurer's Office, pending legislation, and detailed terms of outstanding school bonds available in a public bond database.[2]

Discussion

Homeowners are accustomed to the idea of mortgages, where they borrow money to get a home now, and agree to pay off the principal and interest on the loan over 15 or 30 years. Over time and if real estate prices do well, they enjoy the use of the home and build equity in a valuable asset.[3]

School districts may use school bonds in a similar fashion, to borrow money to build or improve schools. In conventional practice, the property tax revenue paid by the people who live in the district (and benefit from the schools) pays off the bond over a period of time that is related to the time the new schools or improvements are useful. If the school district invests wisely, the quality of the schools is enhanced, and the value of residing in the district goes up. When the system works, that value translates into increased property values. The bargain is straightforward; by voting to issue (and repay) a school bond, taxpayers of the district benefit from an improved education for their children and increased real estate values.

When a school district finances its activities without paying the current interest, the interest compounds, the debt can grow dramatically, and the burden of repaying those costs is shifted to future taxpayers.

Assembly Bill 182, which is pending in the Legislature, would limit the use of CABs. AB 182 proposes to limit the use of CABs with a debt service more than four times the amount borrowed. While the bill appears to have bipartisan support, the language has not been finalized. The Grand Jury is particularly concerned that school districts may use the possibility of new legislative restrictions as an opportunity to issue more CABs before the law takes effect. In January 2013, State Superintendent of Public Instruction Tom Torlakson and State Treasurer Bill Lockyer called for a moratorium on the issuance of CABs pending approval of the proposed legislation. (See Appendix A).

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[2] http://emma.msrb.org.

[3] It is worth noting that the recent real estate crisis was fueled in part by borrowings made without due consideration of the uncertainty of the future real estate market. Importantly, an over-leveraged house might still be sold. However, for a school district that borrows too much, the only option is to borrow even more. If additional funds are needed at a time when financing terms are unfavorable and statutory borrowing limits have been reached, there may not be any reasonable options available.

The Grand Jury surveyed 31 K-12 School Districts in Santa Clara County regarding their planned use of CABs. Only the Franklin McKinley School District reported that it is preparing a bond issuance that would include a portion of CABs. The District indicated that it expected its issuance to comply with the limits set forth in AB 182.

The California State Treasurer's Office provided the Grand Jury with data regarding CABs already issued by school districts in Santa Clara County, which is excerpted in the table below.[4] The table lists the "CAB Principal," which is the amount borrowed. Another column lists the "CAB Debt Service (Interest & Principal)," which is the amount that will be paid on the CAB during the life of the CAB. The higher the ratio of "interest paid" to "amount borrowed" the more costly the CAB. As reflected in the table, K-12 School Districts in Santa Clara County issued 28 CABs between 2007 and 2012.

[4] The chart only reflects the CAB amount even if the bond many have included a conventional bond component.

Capital Appreciation Bonds Issued in Santa Clara County 2007-2012

Year Issued	Issuing School District	CAB Principal	CAB Debt Service (Interest & Principal)	Debit Service to Principal	Final Maturity Date
2008	Alum Rock Union Elementary	1,410,328.40	1,935,000.00	1.37	8/1/2033
2011	Campbell Union	2,499,400.05	23,495,000.00	9.40	8/1/2040
2010	Campbell Union	0.00	0.00		8/1/2035
2011	Cupertino Union	490,086.05	2,105,000.00	4.30	8/1/2027
2010	Cupertino Union	3,398,760.25	13,890,000.00	4.09	8/1/2034
2007	Cupertino Union	374,614.50	1,950,000.00	5.21	8/1/2032
2007	East Side Union High	19,997,738.75	51,390,000.00	2.57	8/1/2031
2009	Evergreen	22,498,711.75	64,425,000.00	2.86	8/1/2033
2011	Franklin-McKinley	3,788,985.00	21,924,599.62	5.79	8/1/2035
2011	Fremont Union High	16,090,108.00	99,540,000.00	6.19	8/1/2044
2010	Gilroy Unified	8,936,556.20	12,545,000.00	1.40	4/1/2013
2009	Gilroy Unified	2,351,615.00	30,600,000.00	13.01	8/1/2032
2012	Luther Burbank	1,385,043.90	13,645,000.00	9.85	8/1/2051
2008	Luther Burbank	39,999.40	140,000.00	3.50	8/1/2032
2008	Luther Burbank	3,829,994.45	21,175,000.00	5.53	8/1/2047
2007	Luther Burbank	2,974,962.25	6,580,000.00	2.21	8/1/2031
2012	Moreland	1,144,809.65	3,035,000.00	2.65	8/1/2024
2011	Moreland	11,499,682.75	13,925,000.00	1.21	7/1/2016
2007	Mount Pleasant	1,334,991.70	3,290,000.00	2.46	9/1/2017
2012	Mtn View-Los Altos Union High	10,647,986.35	18,000,000.00	1.69	8/1/2030
2010	Mtn View-Los Altos Union High	2,001,944.75	2,305,000.00	1.15	8/1/2018
2010	Mtn View-Los Altos Union High	8,555,263.10	16,280,000.00	1.90	8/1/2030
2011	Oak Grove	18,249,429.15	94,520,162.47	5.18	6/1/2041
2009	Oak Grove	19,999,922.80	61,935,000.00	3.10	8/1/2033
2010	Orchard	918,472.30	3,830,000.00	4.17	8/1/2036
2009	Orchard	1,330,303.15	2,955,000.00	2.22	8/1/2034
2008	Palo Alto Unified	109,414,248.80	277,865,000.00	2.54	8/1/2033
2012	Sunnyvale	14,998,663.45	68,025,000.00	4.54	9/1/2042

ISSUED CABs BUT NOT INCLUDED IN SURVEY:

2007	Foothill-De Anza CCD	13,381,686.15	47,900,000.00	3.58	8/1/2036
2007	Foothill-De Anza CCD	21,455,250.35	77,595,000.00	3.62	8/1/2036
2008	San Jose-Evergreen CCD	23,634,945.55	55,075,000.00	2.33	9/1/2032
2009	West Valley-Mission CCD	9,579,692.00	15,865,000.00	1.66	8/1/2017

Key:

Capital appreciation bonds with debit service of more than four times the amount borrowed

Table 1

The CABs that are the most troubling are those that are not fully repaid for more than 25 years and have payments totaling more than four times the amount borrowed. As a result of these provisions, the total amount of money that will have to be repaid by future taxpayers is many times the amount of money borrowed. In the case of a CAB issued by Gilroy Unified School District in 2009, over $30 million will have to repaid on a borrowed amount of only $2.35 million, a multiple of 13 times.

The State Treasurer's Office data showed that out of the 28 CABs, Luther Burbank issued four CABs, two that were among those with the highest ratios of "debt service" to "amount borrowed." One of the Luther Burbank CABs will require payment of approximately 10 times the amount borrowed. Two of Luther Burbank's CABs are not due to be repaid until nearly 40 years after issuance. It is not clear whether this is longer than the useful life of the corresponding assets, but it is certainly a long time.

Looking at the same data, the effects of the interest deferral can be measured another way. The total amount of new money raised by the four Luther Burbank CABs was approximately $7.5 million. The fees to issue these CABs (for the financial advisor, lawyers, underwriters and others) were over $700,000. After paying the fees of advisors, lawyers, bankers and others, Luther Burbank raised less than $7 million. Because the principal is not fully amortized and the unpaid interest compounds for almost 40 years, the total debt service for the four CABs will exceed $40,000,000. In a district with 570 students (Luther Burbank's current enrollment, according to their website), this equates to over $70,000 per student. For the last five years of the term of the CABs currently outstanding (beginning 34 years from now), the average debt service will be over $3600 per student per year, simply to repay for borrowed money, not including any of the costs of educating these students.

When a school district does not take responsibility for paying current interest and for amortizing the principal amount of the debt over an appropriate period, excessive costs are shifted to future taxpayers. As a result, the future taxpayers will have to pay the costs of building, maintaining and operating the school systems they need, plus the costs of paying the deferred interest and principal on the loans taken out by their predecessors.

Conclusions

The next generation of parents, students, teachers and taxpayers will have to pay for decisions made by those school districts that issue CABs in a fiscally irresponsible manner. School districts should finance their district's needs prudently. Legislation should be passed to insure that school districts stop issuing CABs with terms detrimental to the long-term interest of our community, its schools and students.

Findings and Recommendations

Finding 1

CABs shift large, compounding interest costs to future taxpayers and will inevitably compound the burdens school districts face in operating effective schools for their students in the future.

Recommendation 1

Each school district in Santa Clara County should adopt a Board policy and any necessary administrative regulation indicating its intent to comply with the moratorium called for by the State Treasurer and the State Superintendent of Public Instruction.

APPENDIX A

CALIFORNIA DEPARTMENT OF EDUCATION

NEWS RELEASE

TOM TORLAKSON
State Superintendent
of Public Instruction

Release: #13-12
January 17, 2013

Contact: Paul Hefner
E-mail: communications@cde.ca.gov
Phone: 916-319-0818

Contact: Tom Dresslar
E-mail: tdresslar@treasurer.ca.gov
Phone: 916-653-2995

State Schools Chief Tom Torlakson, State Treasurer Bill Lockyer Caution School Districts Against Issuance of Capital Appreciation Bonds

SACRAMENTO—State Superintendent of Public Instruction Tom Torlakson and State Treasurer Bill Lockyer today issued the following letter to local educational agencies regarding capital appreciation bonds:

Dear County and District Superintendents:

CAPITAL APPRECIATION BONDS

We understand many districts face a critical need to build or modernize facilities for their children, and we recognize that falling property tax assessments, revenue losses, and statutory debt service limits have all combined to reduce districts' debt financing options. As a result, some districts have turned to capital appreciation bonds (CABs), which have forced taxpayers to pay more than 10 times the principal to retire the bonds.

Thus, we urge you and your Board of Education not to issue CABs until the Legislature and the Governor have completed their consideration of this year's proposals to reform the CAB issuance process by improving transparency and protecting taxpayers against exorbitant debt service payments. Through this process, we welcome and encourage your input to ensure that the needs of districts are still being met.

In too many cases, CAB deals have forced taxpayers to pay more than 10 times the principal to retire the bonds. Also, the transactions have been structured with 40-year terms that delay interest and principal payments for decades, resulting in huge balloon payments and burdens on future taxpayers that cannot be justified. Too frequently, board members and the public have not been fully informed about the costs and risks associated with CABs. In some cases, board members have reported they were not even aware they approved the sale of CABs.

It is important to note that CABs with terms exceeding 25 years place the repayment obligation on future taxpayers who likely will not benefit from the capital improvements financed by the CABs. At the same time, the CABs payments will reduce those taxpayers' capacity to finance construction and modernization projects their own children will need.

We are convinced that remedial legislation is needed to prevent abuses and ensure that both school board members and the public obtain timely, accurate, complete, and clear information about the costs of CABs, and alternatives, before CABs are issued. The Governor has told us he wants reforms. Key lawmakers and legislative leaders have made clear they agree statutory changes are needed.

For all these reasons, we believe your district and every other district in the state should impose a moratorium on issuing CABs. The moratorium should remain in effect until the Governor and Legislature decide on reforms in the current legislative session. If reforms are enacted, subsequent CABs deals can be conducted in compliance with the new statutory requirements.

Thank you for your consideration. Should you have any questions or concerns, please contact Jeannie Oropeza, Deputy Superintendent, California Department of Education, by email at jorpeza@cde.ca.gov.

Sincerely,

Tom Torlakson
State Superintendent of Public Instruction
California Department of Education

Bill Lockyer
State Treasurer
California State Treasurer's Office

# # # #

This report was **PASSED** and **ADOPTED** with a concurrence of at least 12 grand jurors on this 9th day of May, 2013.

Steven P. McPherson
Foreperson

Lyn H. Johnson
Foreperson pro tem

Chester F. Hayes
Foreperson pro tem

Francis A. Stephens
Secretary