Issue 14 Update 2

Proposed refunding and defeasance

October 17, 2011

Overview

The Administration of the Cleveland Metropolitan School District is proposing to refinance part of the $40 million in Issue 14 bonds sold in 2002 and to defease, or retire early, part of the 2002 bonds using excess cash in the District's Bond Retirement Fund. The immediate goal of the refunding/defeasance proposal is to reduce future interest payments on the debt that the District incurred to fund its construction and renovation program.

This strategy would allow the District later, pending voter approval, to issue enough bonds to complete the construction program without raising the annual tax burden on District taxpayers beyond the 6.1 mills currently levied to pay off Issue 14 bonds and previously issued Cleveland Public Library debt. (The District is the agent for the Library under Ohio law.) If the amount of additional bond authority requested by the District is low enough, the tax burden could actually decline slightly even if voters approve issuance of more bonds.

The benefits of the District's debt strategy are obvious. However, the District's advisers have recommended a method of refunding bond sale and a method of underwriter selection that are contrary to the best practices recommended by BAC consultants in their 129-page report Issue 14 Bond Issues, released in May 2010. These best practices are predicated on the idea that a bond issuer should pursue a course of action with the best chance of getting the lowest interest rates for those who must pay off the debt – the District's taxpayers.

The Board of Education is expected to vote on the proposal at its October 25 meeting.

'No additional taxes'

It should be noted here that, as reported in published press accounts at the time, the $335 million in bonds authorized by voters under Issue 14 in May 2001 was not nearly enough money to execute the entire construction program. Indeed, the amount would have needed to be in excess of $500 million *in 2002 dollars.* Nationally, construction costs have increased roughly 40 percent since then.

At this point, with many schools cut from the construction program due to declining enrollment, it appears that the District will need between $140 million and $200 million in additional bond authorization to complete the construction/renovation program and repair its other schools.

The window for a “no additional taxes” bond vote in the future has already been opened by the District's previous aggressive bond retirement strategy and the expiration of Library bond payments, which will be complete in December. The proposed refunding and defeasance would simply open that window a little wider. Although the numbers involved will have changed, this window is illustrated on Page 111 of Issue 14 Bond Issues. The report is on the CMSD Website at http://www.cmsdnet.net/en/Resources/Community/~/media/Files/Resources/Community/BAC/Black%20%20White%20Commissions.ashx and the relevant portion is reprinted at the end of hard copies of this report.

Two options

So what the District is trying to do is to use cash currently in its Bond Retirement Fund to reduce the amount of 2002 bond debt on its books (defeasance) and lower the interest rate on some of the remaining debt (refunding) by taking advantage of historically low current interest rates, similar to a home mortgage refinancing. The plan also would brace the District against further declines in on-time tax collections, which have now declined to about 81 percent of taxes due.

The District's advisers foresee two options**:** 1) Do both a refunding and a defeasance to retire and refinance as much existing debt as possible, or 2) if bond-market interest rates rise too much to make a refunding financially worthwhile by the time the deal date arrives, then defease as much debt as possible and delay a refunding until a time when it would produce significant interest-cost savings.

Refunding

The refunding-bond proceeds and any available cash would be used to buy U.S. Treasury securities that are held in escrow until the selected 2002 bonds may legally be prepaid. The District would pay the interest on the refunding bonds, which is lower than the interest on the bonds being prepaid.

The refunding should be done only if the new interest rates available at the time of the refunding-bond issuance are low enough to create a substantial net savings.

The District's advisers have expressed belief that $28.6 million of existing 2002 Issue 14 bonds, carrying an average interest rate of 4.961 percent, would be good candidates for refunding at recent market rates of about 2.76 percent. This would lower necessary future tax collections by an estimated $14.3 million.

Defeasance

Excess cash in the District's Bond Retirement Fund, estimated to total $8 million by year’s end, would used to buy U.S. Treasury securities, which would be held in escrow until the targeted bonds may be repaid.

In 2010, the District reported defeasance of $14.675 million in bonds from the 2002 issue. This resulted in a reported reduction of more than $25 million in necessary future tax collections.

Negotiated vs. competitive

The District's financial advisers are recommending a **negotiated underwriter process,** in which a group of underwriters are solicited and selected according to the District's criteria before the securities are structured. The selected underwriters participate in the structuring efforts and they are able to engage in pre-marketing efforts because they have confidence that they will be able to purchase and resell the securities.

The other method of sale is a **competitively bid deal,** in which offered securities are structured by the issuer, its financial advisers, and its bond counsel. Under this method, the sale occurs through a bidding process that advertises the sale, provides an official statement (prospectus) and other information, and solicits bids by underwriting firms. The firm proposing the lowest overall interest cost in a competitive bid wins the bid.

The Resolution pending before the Board of Education specifies that a negotiated deal is permissible. The District’s chief financial officer says either approach would be allowed by the Resolution.

The District's advisers said negotiated deals allow flexibility to change the sale date and amount/identity of targeted bonds in response to changing market conditions, provide transparency in fees charged by underwriters, can be used to provide for inclusion of minority underwriting firms, and can provide District residents with first access to investment in the refunding bonds. The advisers noted that the vast majority of municipal bond sales are negotiated.

These are the same reasons that the District's advisers have previously given for preferring negotiated deals over competitive deals.

The BAC's consultants in the 2010 report (Pages 12-22) essentially rejected such arguments as being irrelevant to achieving the ultimate goal: the lowest possible interest rate to be borne by Cleveland's taxpayers. The report noted that under the circumstances of CMSD's bond issues, a competitive deal would be most likely to yield the best results for local taxpayers [emphasis added]:

> "One of the ironies of the municipal securities market is that large numbers of issuers that otherwise are frugal and that carefully evaluate costs and money-saving alternatives in making even relatively small purchases nevertheless choose to ignore strong evidence that competitive bidding produces better pricing in certain securities financings of significant size. That is especially true in connection with the issuance of what might be described as “commoditized” securities. In general, commoditized securities ... are those that have strong easily recognizable credit support, that incorporate standardized terms, and that carry satisfactory ratings. ....
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> "While it is true that a high percentage of municipal securities are sold through negotiated sales, in general for commoditized securities that is not the preferable course. ....

"In general, CMSD's bonds are not complex or novel; they are not variable-rate bonds and they do not otherwise incorporate features that make them difficult to market.

Given those conditions, study after study has concluded that competitive bids produce the best results.

"At those rating levels and given CMSD's unlimited general obligation tax pledge backing its securities, CMSD's securities are a true commodity. Under those facts and circumstances, and with market conditions having improved significantly during 2009, the benefits of competitive bidding are optimal, and CMSD should capture those benefits. ....

"With CMSD's own credit level, the enhanced ratings provided through CMSD's participation in the Department of Education's enhancement program, and standardized terms of unlimited tax general obligation Bonds, a competitive bid is preferable in terms of producing optimized yields for CMSD and the taxpayers."

The BAC consultants' report did not specifically address a refunding, as one was not anticipated at the time. The BAC recently asked the lead consultant, Robert Doty of American Government Financial Services Co. in Sacramento, Calif., asking whether the report's advice would apply to refundings as well. His reply was concise: "Refundings also benefit from competitive bidding." This response was endorsed in a separate email from Lori Raineri, president of Governmental Financial Strategies Inc. in Sacramento, which provided much of the analysis for the report to the BAC.

The Government Finance Officers Association (GFOA), widely regarded as the good-government advisory body for the industry in the United States and Canada, notes in its official "Best Practices" recommendations that the desire to include minority underwriters or local firms is one factor that could favor use of a negotiated, rather than a competitive, method of sale. It also lists a number of factors applicable to the District's situation that would favor a competitive deal. For the entire "Best Practices" statement of the GFOA on this subject, go to
http://www.gfoa.org/index.php?option=com_content&task=view&id=1582

The GFOA statement includes this passage: "Concerns have been raised about the lack of a competitive Request for Proposals (RFP) process in the selection of underwriters in a negotiated sale and the possibility of higher borrowing costs when underwriters are appointed based on factors other than merit. As a result, issuers have been forced to defend their selection of underwriters for negotiated sales in the absence of a documented, open selection process."

It is on this point, notwithstanding the District's good results using negotiated sales in its 2002 and 2004 bond issues, that the BAC's consultants took issue with CMSD's past practice, a practice that the District's advisers defended anew at a recent informational meeting.

Selection of underwriters

A key component of the negotiated process is the selection of underwriters. This is typically done through an RFP process in which an issuer, such as the District, would evaluate underwriter proposals according to set criteria and then select a syndicate of underwriters with one or two designated as the lead managers.

In advocating a negotiated sale, the District's advisers cited that method's ability to provide for inclusion of MBE underwriters and underwriters with a corporate presence in the District, the latter in turn touted as a means of getting underwriters familiar with Ohio securities and as a way to give investors within the District first access to the refunding bonds.

The GFOA's Best Practice statement "Selecting Underwriters for Negotiated Bond Sales," is available in full at
http://www.gfoa.org/index.php?option=com_content&task=view&id=1585
It says in part [emphasis added]:

> "The issuer's goal in a negotiated bond sale is to obtain the highest possible price (lowest interest cost) for the bonds. To maximize the potential of this occurring, the issuer's goal in the underwriter selection process is to select the underwriter(s) that has the best potential for providing that price. Those underwriters are typically the ones that have demonstrated both experience underwriting the type of bonds being proposed and the best marketing/distribution capabilities. ... **No firm should be given an unfair advantage in the RFP process.**"

The BAC's consultants found that the District's general-obligation bonds were essentially marketable commodities on a national scale. In other words, that an underwriter's experience with such bonds in Ohio would not be an advantage for the local taxpayers (In earthier terms, a five-pound sack of white flour sells pretty much the same way in any state.).

More importantly, the BAC's consultants found that the District's underwriter selection criteria, employed for a possible 2007 Issue 14 refunding that was not executed and for a planned 2009 bond issue that was not executed, were weighted in such a way as to potentially exclude firms that could provide the lowest interest cost for the bonds. The consultants' complete discussion of the issue is on Pages 23-29 of the April 2010 report. In part, the consultants said [emphasis added]:

> "We do not have information on the process or criteria by which the prior CMSD Administration selected underwriting teams for the 2002 and 2004 Bond issues. The current Administration is unable to locate documentation regarding the selection process used at the time. We are informed, however, that CMSD's Financial Advisors were not involved in that process, so CMSD made the underwriter selection without the benefit of independent professional advice.
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> "More recently, in late 2008 at a time when market conditions were adverse and volatile in the midst of the worst part of the financial crisis, CMSD's current Administration, this time with the active participation of its Financial

Advisors, selected an underwriting team expecting to complete a negotiated bond sale in 2009. That bond sale did not take place. ...

"The criteria and weighting factors used by CMSD in evaluating underwriters involved criteria that tilted the selection process heavily in a particular direction. The emphasis was not upon what GFOA termed "merit," with a specific focus upon 'obtain[ing] the highest possible price (and lowest interest cost) for the bonds.'

"The criteria and weighting utilized by CMSD were as follows—

Fees and expenses—25%
Ability to distribute tax-exempt debt—20%
Commitment to and/or ownership by minority groups—20%
Corporate presence in the District—20%
Performance on previous District bond or note issues—15%

"That is, CMSD gave a 20% credit for local firms and another 15% credit for firms that performed satisfactorily in prior CMSD transactions. The reference to "Fees and expenses—25%" does not relate to interest costs, but rather to the underwriters' compensation and expenses for selling the securities. Although CMSD awarded the highest credit to "Fees and expenses," in relation to interest costs ... such fees and expenses normally are a significantly less important element in overall issuer costs.

"In the recent selection process, members of prior CMSD underwriting teams, at least two of which teams were selected without professional financial advice, had a significant 35% head start that could not be overcome easily by other, potentially more qualified firms. Meanwhile, the ability to sell tax-exempt debt at optimal yields for CMSD and the taxpayers—the most important component to be considered—rated only 20%. It would have been more meaningful to place a significantly heavier emphasis upon 'Ability to distribute. ...'

"With the 35% aggregate local and prior service weighting, it would have been very difficult, if not impossible, for other firms to have been selected. That would have discouraged some other well-qualified firms even from submitting proposals. Such a result, especially in combination with the criteria weighting, would have denied CMSD an effective process for selecting the optimal underwriting team.

"As does GFOA, we believe that the ability to provide issuers, such as CMSD, with the lowest overall costs is the key factor to consider for CMSD and the taxpayers.

"As noted, we also believe that, in general, low Bond yields are significantly more important to CMSD than the level of underwriting fees and expenses. That is because the Bond yields represent, by far, the largest cost for the District and the taxpayers. A 'true interest Cost' ("TIC") analysis, taking into account both the present value of bond yields (interest payments) and costs of issuance, is used customarily in the market to demonstrate the lowest overall cost to the issuer. A firm that may charge a little more compensation for its work in order to motivate its sales staff to a greater extent, but which overall

> produces the lowest yields, is almost invariably the firm that will benefit the District and the taxpayers the most. **The weighting criteria should be changed to reflect what is most important to the taxpayers, namely the lowest *overall cost."***

In 2002, the underwriting team was led by NatCity Investments and also included Banc One Capital Markets and Loop Capital Markets (an MBE based in Chicago with a Cleveland office). The 2004 issue went to NatCity and KeyBank Capital Markets. The team chosen for the abandoned 2009 issue was Huntington Investment, JP Morgan, KeyBank Capital, Loop Capital, and National City/PNC Capital Markets.

Best chance for taxpayers

In conferring with Mr. Doty recently, the BAC inquired as to what value, in practical terms, a school district's taxpayers would accrue from giving their business to a local underwriter. His response, seconded by Ms. Raineri, was “If the local underwriter does not give the best results, what is the point?”

An analogous situation might be one’s personal decision to buy locally grown vegetables at a food market, even if those vegetables might cost more than those grown on a mega-farm in California, because one wishes to foster development of the local agriculture industry and hence the local economy. But a key difference is that one is making a decision on how to spend one’s own money; the School District in contrast is making decisions on how to spend the money of someone else – the local taxpayers. That is the basis for the recommendations to go with the sale method – competitive – that is deemed to have the best chance of obtaining the lowest interest rate for the taxpayers or, if a negotiated route is nonetheless chosen, to select the underwriters according to criteria designed to get the best results for the taxpayer.

In regard to preference for local underwriters, the Municipal Securities Rulemaking Board, the industry’s self-regulating body, recognized that in the past some municipal securities dealers had contributed to the election campaigns of public officials of governmental entities that issue municipal bonds. Seeking to avoid the appearance that such contributions might be made to curry favor with bond issuers in the selection of underwriters, or that issuers might favor those who had made such political contributions, the MSRB instituted its Rule G-37, which generally bans dealers from doing business with issuers represented by officials to whom they have made contributions. The only exception to the rule’s ban on business is for small ($250 per election) contributions by municipal finance professionals to issuer officials for whom they are entitled to vote.

The MSRB has considered, but not approved, a similar ban on broker contributions to bond referenda campaigns by issuers with whom they do business. The MSRB has instead opted to require reporting of any such contributions outside the exception cited above. An example of a bond referendum campaign would be the campaign undertaken to win voter approval of Issue 14 in 2001.

It is anticipated that the District will undertake another campaign to win voter approval of a successor to Issue 14 in order to complete the construction/renovation program. The last of the bonds authorized by Issue 14 were issued in September 2010. The Issue 14 proceeds and other sources of funds are expected to be sufficient to complete Segments 5 and 6 of the 10-segment program and possibly a portion of Segment 7.

Conclusion

It must be noted that the BAC's consultants, using a yield analysis by Delphis-Hanover Corp. of Southbury, Connecticut, found that the School District -- using the negotiated method of sale -- received very good results on its 2002 and 2004 bond issues. "CMSD and the taxpayers could not expect better results," they said in their 2010 report.

The consultants nonetheless recommended the competitive method of sale and, if a negotiated route is chosen – underwriter selection criteria that are revamped to reflect what is most important to easing the burden of taxpayers.

The District's advisers have presented no new arguments to counter these recommendations.

Whichever method the District ultimately chooses, the BAC will ask for a comparative analysis of the results in order to determine whether taxpayers received a good deal.