Bond Accountability
Commission 2, Inc.

Issue 14 Update 5

Proposed refunding and defeasance

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Overview

The Administration of the Cleveland Metropolitan School District is working to refinance up to $75.52 million of the $125 million in Issue 14 bonds sold in 2004. It wants to defease or retire early part of the 2004 debt using proceeds of a bond refunding and available cash in the District's Bond Retirement Fund. As in a similar deal last December, the immediate goal of the refunding/defeasance plan is to reduce future interest payments on the debt that the District incurred to fund its construction and renovation program.

This strategy could allow the District, pending voter approval, to issue enough bonds in the future to complete the construction program without raising the annual tax burden on District taxpayers beyond the target rate of 5.25 to 5.45 mills currently levied to pay off Issue 14 bonds.

The effect of the refunding is similar to that achieved when a homeowner refinances a mortgage that was obtained when home loan rates were much higher. The targeted bonds carry interest rates of 5.00 percent to 5.25 percent. As of Dec, 13, 2012, the Bond Buyer index for 20-year tax-exempt general obligation municipal bonds with a credit rating similar to the District's was 3.44 percent. Before this year, the last time 20-year rates were that low was in the mid-1960s.

Refinanced bonds generally mature in 10 years or less and hence have even lower interest rates. The recent rate for 10-year municipal bonds with a credit rating similar to the District's was about 2.00 percent.

Although interest rates for tax-free municipal bonds are historically low, the rates began to rise sharply in mid-December as negotiations over the federal "fiscal cliff" raised the possibility of new limits on the tax-free aspect of such bonds for wealthier individuals. Previously, market analysts had said that investors, fearing higher tax rates on dividends and other income as a result of the federal "fiscal cliff" negotiations, were flocking to municipal bonds as a source of tax-free investment income, depressing the interest rates. Any continuing uncertainty about tax provisions could affect the benefit that the District will reap from a refunding in January.

In short, the District seeks to pay off part of its 2004 more quickly and at lower interest rates than would otherwise be the case.

Last December's refunding and defeasance of $28.6 million in bonds issued in 2002 saved District taxpayers the then-current equivalent of about $2.3 million in interest payments, according to the District.

The Board of Education authorized the current refunding effort at its meeting on October 23, 2012. The bond issue itself is expected to occur in January 2013.

Although the Board of Education, as requested by the District Administration, authorized refunding of up to $75.52 million of the 2004 bonds, the District's financial advisers identified about $47.17 million in bonds as the most likely candidates.

A debt-repayment schedule by the financial advisers, based on refinancing the $47.17 million in bonds, shows the final Issue 14 2004 Series debt payment in 2022 instead of the current 2027.

The principal and interest payments for 2013 through 2027 would total $115.042 million without refinancing, but only $89.865 million from 2013 until full retirement in 2022 under the plan. This would result in a gross long-term taxpayer savings of $25.177 million, which, according to the District' financial advisers, has a present value of $13.952 million (the amount that, invested at 2.765 percent annual interest, would yield the gross savings amount over the specified time).

The District anticipates using about $7.0 million in existing cash on hand to pay off bonds, which would make the net present value of the taxpayer savings (adjusted for contingencies) a predicted $6.959 million.

In view of the current historically low interest rates for municipal bonds, the benefits of the District's plan are obvious.

However, the District's advisers recommended a method of refunding bond sale contrary to that recommended by BAC consultants in their 129-page report "Issue 14 Bond Issues," released in May 2010. The underwriter-selection criteria are also at odds with those recommended by the BAC's consultants. The BAC consultants said their recommended practices were predicated on the idea that a municipal bond issuer should pursue a strategy with the best chance of getting the lowest interest rates for taxpayers.

Finally, the District has not undertaken a results analysis of its last refunding transaction. Such analyses are a "Best Practice" recommendation of the Government Finance Officers Association.

'No additional taxes'

It should be noted here that, as reported in 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 35.5 percent since then.

Now, with many schools cut from the construction plan due to declining enrollment, it appears the District will need $140 million to $200 million in additional bond authorization to complete construction to repair its other schools.

The window for a "no additional taxes" bond-authorization vote in the future has been opened by the District's previous aggressive bond-retirement strategy. The proposed refunding and defeasance would keep that window open a little longer. A somewhat outdated illustration of this window is on Page 111 of Issue 14 Bond Issues. See:

http://cmsdnet.net/Resources/Community/~/media/Files/Resources/Community/BAC/Issue%2014%20Bond%20Issues%20REPORT51410%201.ashx .

Refunding and defeasance

Refundings involve issuance of new debt, the proceeds of which are used to repay previously issued debt either immediately (a current refunding) or later (an advance refunding). In the latter case, the new issue's proceeds may be placed into escrow and invested until they are used to pay principal and interest on the old debt at a future time, which could be at full maturity or at the call date, which is the earliest date on which a bond can be redeemed.

Most advance refundings result in defeasance of old debt, which means that the debt is no longer reported as a liability on the balance sheet; only the new debt, if any, is reported as a liability. Debt is considered defeased if the debtor irrevocably places cash or other essentially risk-free assets with an escrow agent in a trust to be used solely for satisfying scheduled payments of both interest and principal of the defeased debt.

Under the District's current plan, the refunding-bond proceeds and any available cash in its Bond Retirement Fund would be used to buy U.S. Treasury securities to be held in escrow until the selected 2004 bonds may legally be redeemed. The District would pay the interest on the refunding bonds, which is lower than the interest on the bonds being prepaid.

A 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 net present-value savings estimated for this deal by the District's financial advisors -- $6.959 million, or 14.75 percent of the refunded principal of $47.165 million in 2004 bonds – would certainly be worthwhile.

Defeasance can also be accomplished without a refunding. In 2010, the District reported that it used excess cash in its Bond Retirement Fund for defeasance of $14.675 million in bonds from the 2002 issue. This resulted in a reported gross reduction of more than $25 million in necessary future tax collections.

Negotiated vs. competitive

The District's financial advisers recommended a negotiated method of sale**,** 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.

In a competitively bid deal, securities are structured by the issuer, its financial advisers, and its bond counsel, and the sale occurs through a bidding process in which the District 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 Board of Education voted to allow a negotiated deal, and that is what the Administration is pursuing.

The District's advisers said in this case, as they have in the past, that 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 have noted that the vast majority of municipal bond sales are negotiated.

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. ....
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> *"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 subsequently asked the lead consultant, Robert Doty of American Government Financial Services Co. in Sacramento, Calif., whether the report's advice would apply to a refunding 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.

Selection of underwriters

If a negotiated method of sale is chosen, selection of underwriters is typically done through a Request for Proposals (RFP) process in which an issuer, such as the District, evaluates underwriter proposals according to set criteria and then selects a syndicate of underwriters with one or two designated as the lead managers.

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:

> "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."

Go to http://www.gfoa.org/index.php?option=com_content&task=view&id=1585 to read the full GFOA Best Practice statement "Selecting Underwriters for Negotiated Bond Sales."

The weighted underwriter-evaluation criteria chosen for the pending deal are the same as those used for the December 2012 sale:

Ability to distribute tax-exempt bonds – 35%.
Fees and expenses – 35%.
Experience with Ohio school bonds and tax-exempt bonds – 15%.
Commitment to and/or ownership role by minority groups – 5%.
Corporate presence in the District – 5%.
Performance on previous District bond or note issues – 5%.

The weights assigned to the criteria are a marked improvement from those used previously by the District, which gave a combined 35 percent rating to corporate presence in the District and performance on previous District issues, factors that have little or nothing to do with getting the highest possible price for the bonds. The BAC's consultants had said that the 35 percent head start for local firms with prior District service would deter other firms from even submitting a proposal. That head start is now 10 percent, which is better but which still has little benefit as far as getting the best interest rate for the District.

The BAC's consultants found that the District's tax-exempt general-obligation bonds were essentially marketable commodities on a national scale. This would mitigate the value of an underwriter's experience with such bonds in Ohio.

More importantly, the BAC's consultants took issue with the District's customary 25 percent weighting for fees and expenses, a category that they noted "does not relate to interest costs, but rather to the underwriters' compensation and expenses for selling the securities." Compared with interest costs, the consultants said, "such fees and expenses normally are a significantly less important element." Despite that, the current criteria gives fees and expenses the same weight as "ability to distribute," the ability to sell tax-exempt debt at optimal yields for CMSD and the taxpayers.

The consultants said:

> "... Bond yields represent, by far, the largest cost for the District and the taxpayers. ... 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."

According to the District, a Request For Proposal for underwriting services was sent to Browning & Associates, Columbus; Huntington Investment Co., Columbus office; KeyBanc Capital Markets, Cleveland office; Loop Capital Markets, Cleveland office; PNC Capital Markets, Columbus office; Rice Financial Products, Columbus office;

Robert W. Baird & Co., Columbus office; Ross Sinclaire & Associates, Columbus office; RBC Capital Markets, Cincinnati office; Stifel, Nicolaus & Co., Cleveland office; Siebert, Brandford, Shank & Co., Detroit office; JP Morgan Chase Securities, Chicago office; Morgan Stanley, Chicago office; and Piper Jaffray, Westlake office.

The deadline for submission of proposals was Dec. 7, 2012.

Evaluating results

BAC reports on the previous, $20.9 million refinancing said that the District would not know whether it had gotten a good deal in the sale unless it commissioned a comparative analysis of the actual sale results. Apparently it never did so.

At a briefing attended by the BAC on Oct. 3, a CMSD official asked its financial advisors whether an analysis had been done. One of the advisors produced a single page from the post-sale report by RBC Capital Markets, the lead underwriter, comparing the CMSD results with those of a negotiated sale of $41.2 million in bonds about a month earlier by the Philadelphia School District, which had a credit rating similar to the District's.

For comparable maturities, the RBC analysis showed that CMSD had better results, ranging from 0.07 to 0.23 percentage points.

We must note that in this case the District relied on an underwriter, which is technically its adversary in a bond deal, for a trustworthy analysis of whether the underwriter had given the District a good deal. Was there only one comparable bond issue in the United States around that time, or did the underwriter simply select one that indicated favorable performance? We don't know because the analysis was not done by someone representing the District.

Instead, a post-sale comparative analysis should be provided after every bond issuance by the District's financial advisors and/or its bond counsel or an independent consultant. This is especially so in light of the District's underwriter-selection criterion "performance on past District bond issues." If bottom-line performance has not been properly evaluated, then how is that criterion judged?

The GFOA's Best Practice statement "Selecting and Managing the Method of Sale of State and Local Government Bonds" says (emphasis added):

> "If an issuer, in consultation with its financial advisor, determines that a negotiated sale is more likely to result in the lowest cost of borrowing, **the issuer should** undertake the following steps and policies to increase the likelihood of a successful and fully documented negotiated sale process: ... *Prepare a post-sale summary and analysis that documents the pricing of the bonds relative to other similar transactions priced at or near the time of the issuer's bond sale. ...*"

Conclusion

The District continues to follow its advisers' recommendation to use the negotiated method of bond issuance, counter to the BAC consultants' advice that competitive deals offer the best chance of winning the lowest interest rates for taxpayers.

Having chosen that course, the underwriter-selection criteria adopted by the District and its advisers still attach too much relative weight to factors that are incidental to getting the best interest rate for the District and its taxpayers.

In any case, the District should engage someone independent of the underwriters to assess results of this and every bond issuance.