April 9, 2007

Proposed Refinancing: Interim Report

Introduction:

The Cleveland Metropolitan School District would like to refinance approximately $118.8 million of the outstanding available bonds resulting from Issue 14-authorized school-improvements bond issues of 2002 and 2004. Those issues totaled some $230 million. The district administration has said that the refunding will achieve savings for those paying property taxes in the district.

The Bond Accountability Commission, assigned to monitor and report on the districtwide construction/rehabilitation project and the spending of Issue 14 funds, has engaged in a preliminary review of the proposed advance refunding of the bonds. The focus of the review is on areas in which errors have occurred in the past. It is aimed at ensuring that the proposed refunding is worthwhile and properly executed.

The commission also intends to review the results of the refunding.

Analysis:

The BAC's preliminary findings are based on interviews with district personnel and documents provided by them. Subject to further review and monitoring, the findings are as follows:

- **Benefits, risks.** The savings to individual taxpayers will be minimal, less than $1.50 a year on a $100,000 home. In the aggregate, however, the deal could give the area's economy additional disposable income of, by the district's latest estimates, $5.14 million to $8.16 million over 20 years. However, if interest rates rise very much at all, the deal should be scrapped, as further refinancings, when rates might be lower, are prohibited. If rates decline, savings will be greater.
- **Advisor strategy.** Fifth Third Securities Inc. and SBK-Brooks Investment Corp. have been the district's financial co-advisors since 2002. Such experience should stand the district in good stead, but the district's arrangement to pay specific compensation for the refunding, rather than a simple retainer, runs counter to recommendations of the nationally recognized Government Finance Officers Association (GFOA) designed to ensure that the district gets unbiased advice on the wisdom of the refunding.
- **Method of sale.** The district has elected to pursue the refunding as a bond sale negotiated with underwriters that it solicited for proposals rather than through competitive bidding by potential underwriters

responding to open advertisements. There is divergence of opinion on whether a competitive deal would be more likely to result in the best interest rates and lowest costs for a government issuer and in the least intrusion of political favoritism in the process. This deal does include factors recognized by municipal finance experts as possibly favoring the negotiated mode.

- **Underwriter Strategy.** The district solicited proposals from 12 firms, many of them national, which should be enough to produce an optimal deal. The district generally followed guidelines of the Government Finance Officers Association in requiring information designed to ensure that a firm has the requisite experience, analytic capability and capitalization and in establishing a systematic rating process. However, the selection criteria may give unnecessary weight to geographic factors that could tend to result in the district paying a higher interest rate.
- **Cost controls.** The district has committed to obtaining insurance and letters of credit that will give the bonds the highest rating available. The higher the rating, the lower the interest rates. The district has also taken measures to limit underwriter charges in a way that appears to meet or exceed recommendations of the GFOA.

Conclusions:

The advanced refunding of Issue 14 bonds appears to be feasible at this time, but bond market volatility could quickly push interest rates to the point that the only significant beneficiaries of the deal would be the firms conducting it. The district must continue to keep a sharp eye on the market and closely evaluate its options, especially since the law allows only one refinancing of these bonds. The district appears to have taken adequate cost-control steps to increase its likelihood of a good outcome. However, the commission recommends that the district consider a competitive, rather than negotiated, approach to future bond deals under Issue 14 and that underwriters be selected from the largest possible pool to ensure the lowest costs and best rates.

Further Discussion:

Benefits, Risks. This level of savings is very near the minimum at which financial professionals say a proposed refinancing should go forward, because only one refinancing of these bonds is allowed by law. By refinancing now, the district will forgo the opportunity to do so at a later date, when interest rates might be lower. Neither the district administration nor the construction project would get any financial gain from the refinancing.

The district is using a 3% rule of thumb on whether to proceed with the refinancing. The industry uses “aggregate net present value (NPV)” of savings to taxpayers – the amount in today’s dollars, after costs, of the dollars to be saved

over the next 20 years – as the standard of measurement. If the NPV is 3% or better, then the refunding is considered worthwhile doing; if not, the conventional wisdom is to keep the powder dry for a shot at getting lower rates and better savings later. The district's latest analysis, using rates on April 4, 2007, foresees an NPV ranging from 3.022% to 3.085%.

Since no one, especially in volatile economic times, can be sure whether rates will decline further, the district is taking a sort of bird-in-hand approach. Its advisor notes that current interest rates are among the lowest seen in 25 years.
See http://www.gfoa.org/services/rp/debt/debt-analyzing-advance.pdf

Advisor Strategy. The GFOA recommends that financial advisors in an advanced refunding such as this be paid on an hourly or retainer basis. The fees "should not be contingent on the sale of bonds to remove the potential incentive for the financial advisor to recommend the issuance of bonds." In this case, fees paid to the financial advisor are reported to be $.50 per $1,000 financed, plus $35,000 per bond issue for refunding issues.

Neither of the co-advisors is permitted to participate as an underwriter in the refunding. The district also says that each of the advisors has reported having no financial dealings that would pose a potential conflict of interest with regard to its CMSD responsibilities. The district's chief financial officer has said that if he became aware of a direct financial relationship with an underwriter such as one that existed with a district advisor in the 1990s, "we would be looking for a new advisor."

Method of Sale. The district's financial advisor deems a negotiated, rather than competitively bid, deal to be the district's best choice because of instability of interest rates and the complex structuring of the refinancing of two large bond issues. The negotiated route allows the district to pick and choose among various bonds to be refinanced on the sale date, including only those bonds that would significantly contribute to savings. A competitively bid deal would have committed the district to refinancing the whole package, which may have caused it to miss its 3 percent savings target.
See http://www.gfoa.org/services/rp/debt/debt-selecting-managing.pdf

Underwriter Strategy. At the time of this drafting, the district has not announced its underwriter selection.

All but one of the solicited firms has an office in Ohio, though most are national companies. The district's advisor contends that experience with bond issues of this type in Ohio and familiarity with Ohio law are necessary. Therefore, the rating criteria being used by the district give such experience a weighting of 20%.

However, only 50% of the weighted rating criteria directly pertain to costs and the ability to negotiate competitive interest rates. The criteria give 10%

weighting to corporate presence within the school district, and 5% to performance on previous CMSD bond or note issues.

While fostering the local business community would seem a laudable goal, the marginal benefit of this bond refunding would seem to dictate forgoing such considerations to focus the selection more closely on getting the best deal. The latter criterion would be useful in weeding out a firm that had done poorly on a past district issue, but it would also serve unnecessarily to penalize a firm that has not done business here before and is willing to offer a good deal to land another client. The more that local firms perceive an advantage that "outsiders" can't match, the less likely they are to keep their proposed compensation competitive.

The weighted selection criteria mirror those that the advisor gave for selecting which firms to solicit for a proposal: experience in underwriting Ohio K-12 bond financings; experience, adequate capital & bond distribution capabilities; a presence in the State of Ohio; firms that have done past bond underwriting for the CMSD; and firms that asked to be included or expressed interest in doing bond underwriting with the CMSD.

It seems redundant to solicit the firms according to geographic criteria and then judge their proposals by geographic criteria as well. These do not seem well suited to achieving the best deal for the taxpayers.

See http://www.gfoa.org/services/rp/debt/debt-preparing-RFPs.pdf

Cost Controls. The district limited underwriters to charging for actual expenses incurred, including for underwriter's counsel, closing costs and disclosures. It has required an expense budget and capped such expenses at the level estimated in each proposal. The district urged firms to propose a management fee that takes into account the district's employment of a financial adviser that is to prepare necessary financial analyses. The financial advisor has estimated that the district will pay an underwriter management fee of under $3 per $1,000 of bonds. In deals in which a financial adviser is involved in developing the financing plan and helping the district obtain insurance, some municipal finance authorities have advised that a district seek a minimal underwriter management fee. Finally the district is limiting underwriter takedown, or commission, to a rate that will be negotiated at a level not higher than a maximum specified in the firm's proposal. The district is obtaining insurance and other support to improve the credit rating of the bonds and thus lower interest rates. Although the financial advisors expect a Triple-A rating for the bonds, the district, being in an economically depressed area, can expect to pay a slightly higher rate than one that could obtain a top credit rating on its own, without insurance, etc.

See http://www.gfoa.org/services/rp/debt/debt-payment-expense.pdf
Also see http://www.gfoa.org/services/rp/debt/debt-preparing-RFPs.pdf