Statement to the Pennsylvania State Legislature

This statement dated September 5, 2013, is by Michele T. Cann, current School Director for Bethlehem Area School District (since July 2007) and Judith A. Dexter, former School Director for Bethlehem Area School District (December 2005 through August 2010). This statement is intended as a joint statement from the individuals stated, and is not intended to represent the opinion or policy statement of Bethlehem Area School District. The School Board and School District Administration have not formally adopted position statements regarding the pending legislation. We are both attorneys in the Commonwealth of Pennsylvania, but our testimony is provided from the perspective of our service as school board members.

BACKGROUND

In 2003, Pennsylvania enacted legislation that permitted school districts and municipalities to enter into "swaps." This legislation legalized a series of complicated financial transactions that almost bankrupted the Bethlehem Area School District (BASD), and ultimately cost the district millions of dollars to terminate.

From 2003 through 2007, as shown in Exhibit A to this statement, the BASD entered into 11 swap transactions, representing layers of derivative obligations on each single borrowing, and Pennsylvania lacked any law or regulation preventing these transactions. As a result, by way of example, BASD's weekly debt obligation attributable to the 2003 Bonds and Fixed Payer Swap rose from approximately $60,303 for the week of September 4, 2008 to approximately $152,604 for the week of September 25, 2008. The district's weekly debt obligation attributable to its 2007 SBA Bonds and Fixed Payer Swap and CMS Swap rose from approximately $21,723 to approximately $121,172 over the same 21 day time period.

In April of 2003, the Bethlehem Area School District entered into its first Fixed Payer Swap, in the amount of $74,175,000, and received for this transaction an upfront payment of $3,465,000. This transaction synthetically fixed the interest rate on the 2003 variable rate bonds issued to refund other previously issued bonds. In December 2003, the District received additional upfront monies of $2,425,000 for a 2007A Fixed Receiver Swaption, a transaction that created the option for a variable rate hedge on $71,215,000 of fixed rate debt. (This swaption was never executed and was terminated in October 2011.) In May of 2004, a Basis Cap Swap was added onto the original 2003 swap to capitalize on variances between taxable and tax exempt interest rates.

By 2008, in addition to the 2003 layered swaps, the district had a Fixed Payer Swap on $55 million of 2005 variable rate bonds, along with a Basis Swap later replaced by a Constant Maturity Swap on that same bond issue, a Fixed Payer Swap on another $55 million of 2007 variable rate bonds, along with a Basis Swap also later replaced by a Constant Maturity Swap layered on top of those 2007 bonds, and a Fixed Payer Swap on a $40 million 2007 variable rate bond issue along with a Constant Maturity Swap layered on top of that borrowing.

By 2008, unchecked by any law or regulation, the district had bet its financial health on various contracted rates with swap counterparties, including LIBOR, SIFMA, and fixed and variable rate contracts. Notably, the 2005 and 2007 Fixed Payer Swaps were entered into in December of 2003 through a "Forward Starting Swap" mechanism. These swap arrangements would bear a contractual obligation binding the district for 20 years out – both locked in during 2003 with actual bond borrowings not occurring until 2004 and 2007. The particular interest rates involved had to work in favor of the school district for 20 years, plus the 2 and 4 year periods of lead time that the forward starting transactions required.

Eventually, eleven swap transactions would occur between 2003 and 2006, representing layers of derivative obligations on each single borrowing. Over time, some of the swaps operated to the benefit of the district by generating a positive cash flow, but the devastating impact of the swap borrowing was felt in 2008 and the years following the collapse of the financial market, as the district began a long and painful road to recovery.

When the swap transactions were proposed to Board members, the presentations left much to be desired, and did not reveal to Board members the actual fees that would eventually be paid to the various entities who stood to gain from these complicated transactions. Not only were fees concealed, but Board members were led to believe that the risk of swaps was extremely low, that synthetic fixed rates operated essentially as fixed rates, and that the benefits of entering into swap transactions were so great that prudence required that such transactions be approved because the constituent taxpayers would benefit by the infusion of upfront cash.

In 2008, when the financial market collapsed, Bethlehem Area School District Board members learned the truth. It was a harsh and shocking reality. School operations were almost immediately jeopardized in September 2008 as weekly payments skyrocketed to levels not anticipated in budget planning.

Such payments caused concern over whether there would be funds to meet teacher payroll through the end of the school year. Questions were posed as to when it was appropriate to notify the Commonwealth of Pennsylvania of the dire situation, because it appeared that if interest payment obligations continued at the high rates dictated by the market conditions, it was conceivable that the school year could not be completed as funds were quickly depleting.

The devastating financial market collapse had a very real effect on the Bethlehem Area School District, and contributed to a combined loss of $7.1 million in the District by the end of the 2007-08 school year. The impact of this loss, including a $3.1 million negative fund balance from 2008, necessitated dramatic cuts in spending. Positions were eliminated, including teaching positions. Services to students were reduced, programs were reduced or eliminated, and many salaries were frozen. Taxes for citizens were increased by 5.38 % in 2008, 5.1% in 2009, 6.18% in 2010, and 1.7% in 2011, to generate additional income needed to improve the district's financial position.

During the years immediately following the financial losses, the District's credit rating was downgraded, and the ability of the District to go forward with some desired academic programs and capital projects was hindered.

BASD embarked on a series of public meetings to plan for the recovery of our financial health. The district changed our financial adviser to the PFM Group, who helped our district implement a series of planned terminations of swap transactions. Over time, from 2009 through the present, the District dramatically revised its debt portfolio to reduce risk. The Board was unaware that these synthetic fixed rate instruments actually increased the amount of what was considered variable rate debt by rating agencies. While our proportion of variable debt had once been a dangerous 79.64 percent, at this time, the District maintains only 35.59% of debt in variable rate obligations. PFM Group financial advisers have prepared helpful pie charts showing the proportion of variable rate debt in Bethlehem after the 11 swaps were executed by 2008, and then after several swaps were terminated through 2011, which are attached to this statement as Exhibit B.

SWAP TRANSACTIONS ARE RISKY

The discussion of the swap story in Bethlehem is important as the legislature goes forward to consider whether swap transactions by municipalities and school districts should be banned. The answer is a resounding "yes." Swap transactions have no place in public debt financing, because the transactions are essentially gambling with taxpayer money. The risks are REAL, and though some districts have benefited at times (including Bethlehem, even after the collapse of the financial market), overall it can be said with certainty that the benefits do not outweigh the potential risks. When an individual or entity bets against Wall Street, it is likely that Wall Street will win. Swap transactions are similar to gambling in a casino -- while there are going to be occasional payoffs for some, overall, the house will win.

THE DYNAMICS OF BOARDS

School boards and governmental councils that include multiple individuals have varying methods of obtaining information at meetings. Generally, a presentation is made by an administrator, or by a designated expert or salesperson, who will try to persuade a board to approve a certain program, financial decision, or purchase. Questions can follow, but individuals who frequently ask questions are sometimes limited by board rules, which may be formal or informal, or by individual personalities who urge the questioner to "move on." Sometimes, board members urge one another to be satisfied with short or incomplete answers. At times, board members or even elected council representatives may see their roles differently, resulting in conflict when there is a need to get absolutely complete information on a topic. Some may perceive they are there to support the administrative recommendations, some may perceive that they are not "experts" on a topic and so must rely on and trust those chosen to present information, and others may be accused of "micromanagement" or of stalling the meeting when questions are asked.

Individuals who serve on school boards are often busy people who have worked a full business day, perhaps 8-10 hours, and then arrive for evening meetings. At times, Board members are hungry, irritable, and may have to take care of family or personal matters in between agenda items. There are pressures from some members to keep meetings to a limited time frame, and there are members who will routinely leave at a certain hour to return to their homes regardless of whether business has been completed.

Those who pose many questions can be accused of "incessant" or "irrelevant" questioning, and social pressures can operate to shut down a complete vetting of any proposal, whether it is academic, personnel, or financial. It is rather common to have overt as well as subtle pressures NOT to ask questions, or at least, to keep questions at a minimum.

In the situation such as the presentation of swap transactions, the above dynamics were factors in the Bethlehem Area School District, but this organization was not unique. The dynamics being what they are, it is safe to say that it would be the rare situation when complicated financial transactions are fully understood by all Board members of any organization. Some Wall Street firms actually rely upon school boards and municipal boards as easy targets for such financial transactions. Greg Smith, author of the book, *Why I Left Goldman Sachs,* writes about such officials and indicates his colleagues in the financial industry refer to them as “muppets.” In other words, they were easy sources of approvals for risky transactions. He publicly resigned due to his own misgivings about the ethics of the financial world and wrote specifically in his book about swap transactions.

In Bethlehem, Board members were offered opportunities to ask questions during presentation meetings, and some members did. However, the complexities of the swap transactions were never fully realized, as most Board members were not financial experts and did not have the underlying knowledge of all of the layers of the transactions. For this, some criticized the Board, because it is easy to ask how such transactions were authorized if they were not fully understood. The answer to this is that school boards place trust in individuals almost every time decisions are made. This includes architectural decisions, health care decisions, technology issues, and safety issues as well as financial transactions. No one Board member generally has the expertise needed for all of the decisions required, and trust is necessary.

PRESENTATION OF SWAP TRANSACTION INFORMATION

Presentations to the School Board were made by sharp financial professionals, who stood to gain hundreds of thousands of dollars, or even millions in fees and commissions. One of the presenters was an “independent advisor” required by law to represent the School District, but this “independent advisor” actually also represented one of the parties to the transaction. This was not known to BASD board members when the transaction was discussed.

In the case of the swaps, the presentation of information was muddled, but on the surface, did not appear so. Each swap was presented in isolation, and the big picture was never fully realized until the financial crisis of 2008. The individual presentations were at times oversimplified, emphasizing the anticipated benefits to the district, and reassuring the Board members of the advisability of the transaction. At times, presentations were complicated, utilizing terms and language that perhaps were common to those in the financial world, but were almost a foreign language to Board members. Terms such as “LIBOR”, “SIFMA”, “Constant Maturity Swap”, “Yield Curve”, and “Counterparty” were used, intermingled with assurances that the financing that was explained was a “synthetic fixed rate” and that it operated “like a fixed rate.”

In fact, during one presentation at a Board Finance Committee meeting, the minutes reflect that the Board was told that “[a]ssuming a 10-year average generated yield curve, the savings over the life of the financing would be $34 million. This assumes the yield curve to be at this level continuously for 25 years. There is no direct cost to the school district for this technical amendment. If the amendment does not prove advantageous to the district, we can unwind it because the original Swap Agreement remains unchanged.” (BASD Finance Committee Minutes, June 12, 2006)

This tempting deal appeared to the Board members to propose a potential gain of $34 million, but appeared to present no real risk because the deal could be undone. Minutes of that meeting do not reflect any revelation that hefty termination feeds would be required If the District desired to pull out of a deal; this reality was later experienced by the School District.

Termination fees paid by the BASD now total $23,555,000. When offset by $5,890,000 of upfront payments received and termination gains of $3,656,000, the district financed the majority of the net $14,009,000 in fees through refunded bond proceeds to minimize the annual budgetary impact. A chart prepared for BASD by PFM financial advisers showing termination fees is attached as Exhibit C to this statement.

Presenters focused mostly on the benefits of the swaps to the district that included lower rates, millions in upfront money, and the ability of the district to do capital projects it dearly wanted to complete. What was not revealed to Board members is that the upfront money was actually paid back by the District over years, and that the financial institutions were being paid fees paid by the District through the transactions; many of the fees were not disclosed during presentations to the Board.

The Auditor General Report of November 2009 regarding Bethlehem Area School District's swaps references the likelihood that swaps are often marketed to unsophisticated board members. This is probably true in most districts. It was true in Bethlehem even though the Board members who voted for swaps were mostly educated people with college degrees who had successful careers in teaching, law, medicine, and business. Though most of the Board members had little or no experience in the world of finance, one member held a Master's degree in Finance. Still, the complexities and risks of the swaps were not known to the Board.

It may be difficult to understand why elected school board members would essentially gamble with taxpayer money, and in the media there have been multiple articles focusing on perspectives regarding this important question. At the time of the Board decisions, Board members did not know that the transactions were a gamble. Risks were not perceived, and the volatility of the market that occurred in 2008 did not appear to be even a remote possibility that would impact the budget because the transactions were described as operating essentially as a fixed rate. The lure of upfront payments that totaled millions cannot be underestimated. It was later that the true nature of the swaps was revealed, in a crisis setting that required hundreds of hours of Board and Administrative time to unravel.

FUTURE CONSIDERATIONS IN LEGISLATION

Gambling is a decision that individuals should be free to make for their own portfolios; governmental bodies entrusted with taxpayer funds should not be authorized or permitted to do so. There are too many variables, and this type of debt financing is simply too complicated for most people to fully understand, even if they are well-educated and intelligent professionals.

We hope to enlighten the legislature to enable you to gain a better understanding of what happened in Bethlehem as you consider the pending legislation, and determine whether school districts and municipalities can or should be permitted under the law to utilize “swaps” for debt financing in their financial portfolios.

As stated by the Auditor General in a special report on the swaps in November 2009, the swap transactions are highly risky, impenetrably complex, susceptible of being marketed deceptively, and benefit mostly investment banks and the intermediaries who market them. While they conceivably could benefit some districts or municipalities, they are too risky and can result in the eventual devastation of the school districts or municipalities that are drawn to them.

RECOMMENDATIONS

Based on our district’s experience, we recommend that municipalities and school districts be prohibited from entering into swap option agreements. These transactions carry great risks, and these risks are usually not fully explained to council and board members. Presentations are often structured to minimize discussion of risks while emphasizing potential benefits that are unlikely to be realized. Municipalities and school districts should not have the authority to gamble with taxpayer money, and swap options are sophisticated wagers.

If this legislature does decide to prohibit school districts and municipalities from entering into swaps, it is imperative to allow those entities that have existing swaps to terminate them prudently, over time, and with the advice of their business managers and financial advisors. Termination prices change over time, and school districts and municipalities must not be forced into the untenable financial position that ill-timed terminations can cause. Bethlehem School District has moved forward with a sound financial plan that includes unwinding our variable debt and has achieved a more favorable financial position, including the attainment of a healthy fund balance. This has happened with prudent advice from our current financial adviser and business manager, and a series of carefully timed terminations has been planned to allow for a better balanced debt portfolio with lower risks. The best plan for districts such as ours includes carefully timed transactions that permit the lowest possible termination fees.

Michele T. Cann, current School Director for Bethlehem Area School District (July 2007 to present)

Judith A. Dexter, past School Director for Bethlehem Area School District (December 2005 to August 2010)