Pennsylvania School Boards Association

Testimony of Pennsylvania School Boards Association
Senate Bill 903 Interest Rate Swaps
Presented to the Senate Local Government Committee
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by
Jay Wenger, Vice-President, Central Dauphin School Board

Good afternoon, Chairmen Eichelberger and Teplitz and members of the Senate Local Government Committee. My name is Jay Wenger and I am the vice-president of the Central Dauphin School Board. I am here today representing the Pennsylvania School Boards Association with Karen McConnell, Assistant Superintendent for Finance and Administrative Operations at Central Dauphin School District. PSBA is appreciative for the opportunity to discuss generally school districts' use of interest rate management agreements, or swaps, to manage their debt obligations and investment returns and, in particular, our transactional experience at Central Dauphin School District.

Although often mischaracterized, a swap is simply an exchange of one interest rate for another. Swaps allow school districts to quickly and efficiently manage interest rates on debt without needing to issue a new bond. For instance, one way a school district can utilize an interest rate management agreement is to convert a variable rate debt to a fixed interest rate with a "variable to fixed rate swap." Swaps can not only save school districts money, but can also result in earnings for districts at the termination of a swap, as was the case with Central Dauphin School District in 2009.

Additionally, school districts use interest rate swaps to take advantage of lower interest rates when a traditional refunding does not work for tax or economic reasons. This can help districts take advantage of market opportunities, short-term low interest rates, and reduction of overall cost of the debt. Swaps allow school districts more flexibility in managing necessary debt and to use limited resources more efficiently.

Accordingly, PSBA would oppose the elimination of swaps as a financial instrument that can help school districts better manage their limited resources in favor of instituting increased safeguards and regulations in Act 23. Instead, PSBA recommends revisions to Act 23 that would address weaknesses in the law and provide more comprehensive guidance by the Department of Community and Economic Development (DCED). PSBA has identified the following deficiencies with Act 23 from a school district perspective:

1. We fear that some financial advisors may be less than independent and, as a result, school directors may not be receiving full disclosure of the risks and the straightforward information that they need to employ a successful interest rate swap. The only qualifications listed in Act 23 under the definition of "independent financial advisor" (IFA) are (a) the IFA may not by employed by or an "agent" of the swap seller, and (b) the IFA must be "experienced in the financial aspects and risks" of swaps. We are concerned that there is not a higher standard required to qualify as an IFA and that frequent monitoring of these agreements from an impartial financial advisor seems to have been ignored to the detriment of school districts.
2. There is no requirement for a written agreement specifying the scope of services or standard of duty the financial advisor has for the government unit, nor is there a requirement for malpractice insurance or disclosing past transactions and relationships to determine the prior experience of the IFA.
3. The interest rate management plan that is required by Act 23 before a swap can be approved does not have a prescribed format within the act and none is set forth by the Department of Community and Economic Development (DCED). As such, the interest rate management plan may contain a very generic coversheet of risk definitions followed by complex spreadsheets. Further, dollar amounts for fees, which need to be calculated by a computer, might not be set forth in the interest rate management plan, but will eventually appear on the swap contract itself. This is the result of the law not requiring full disclosure of all costs by the independent financial advisor and the bank.
4. Limiting the size and length of a swap to the amount of the annual principal outstanding on the debt was established as a safeguard in Act 23 that did not prove meaningful. This limit is ineffective because there is no maximum number of swaps that can be placed on a single bond issue. Consequently, multiple embedded swaps can be sold to local governments, thus making the limit ineffective.

Although PSBA did not advocate for the statutory changes embodied in Act 23 of 2003, we suggest a different approach than that of Senate Bill 903's complete ban on these transactions and immediate disentanglement, which would undoubtedly cost school districts millions of dollars. PSBA believes that a measured legislative response is appropriate to address concerns regarding problems resulting from school districts' use of interest rate swaps. As such, PSBA suggests the following general principles for enactment in legislation:

1. **Overall Updates:** Updating Act 23 should include provisions that ensure a fair balance of protection of school districts' funds and strong financial return, and prevent overreaching by financial advisors to school districts.
2. **Independent Financial Advisor:** We recommend that the role and duties of the IFA should be made more explicit in Act 23. As such, PSBA suggests that Act 23 require certain duties and specify a standard of care of the IFA, including an engagement letter showing IFA fees expressed as an hourly rate or total dollars if fixed fee, without reference to basis points, to be attached to the Interest Rate Management Plan (IRMP). Furthermore, the act should specify the "fiduciary" standard of care for the IFA's role in the transaction. Legislation should specify that the IFA may not be the underwriter of any debt issued by the local government unit within the past two years and is prohibited from underwriting for bonds attached to the current swap. The law should contain provisions to ensure that there are no conflicts of interest or payments from or agency or direct business relationship with, the counterparty and list the number of swaps and relevant details pertaining to each in which an IFA has been involved during the past three years.

   Other necessary disclosures by the IFA that should be required by law to be included in the written letter of engagement are: disclosure of any/all companies that will perform financial advisory work on the transaction, including affiliated companies or subcontractors; description of the methodology of selecting the counterparty, errors and omissions carriers and policy limits; any monitoring role or other duties of the IFA post-closing on the swap without separation of agreements; ensure fee disclosures and other requirements apply to post contract services as well as pre-contact services; and clarification that IFA retains principal responsibility for preparation and contents of the IRMP. One final suggestion with regard to IFAs would be to require IFA registration with DCED.
3. **Include "reasonableness" opinion with the engagement letter to the client school district:** We suggest that this document needs to describe the intended purpose of the swap and how its structure is expected to accomplish that purpose; describe assumptions and conditions to the structure that could defeat or undermine the intended purpose of results; confirm that the IFA

was present on the recorded phone call and identifies all other parties present; include a final counterparty spread in basis points and in total dollars; describe any other payments to be made to the counterparty by the local government unit and their impact; and confirm that the swap is not "off-market," and, therefore, deviating from currently prevailing rates.

4. **Specify the contents of the Interest Rate Management Plan (IRMP):** We suggest that legislation require specific details to be included in the IRMP, such as a narrative describing the purpose of the particular transaction, methodology for structure chosen, application of payments (debt service to be paid), and source of payments by the local government unit. Further, we recommend that risks applicable to the transaction be disclosed as well as specific terms of both the swap and underlying bonds, engagement letters, schedules, any relevant resolution or ordinance, and maximum chargeable fees by the IFA. To confirm that all parties have been informed accordingly, a certificate to be signed by an authorized representative of the school board and the chief financial officer of the local government should also be included stating they have been apprised of the financial terms of the swap.
5. **Require specific disclosures:** Act 23 must require full disclosure of normal and extraordinary risks and options, as well as all agreement terms to elected school officials and administrators. All fees, including spread fees, should be required to be disclosed in advance of execution of a swap document and disclosed in the swap document in dollars, not merely in basis points or the present value of basis points, and all risks must be disclosed, including best case and worst case scenarios, equivalent to the official statement in a bond issue to investors.
6. **Provide for a cooling-off period:** Legislation must provide for a minimum 10-day cooling-off period before the execution of a swap agreement.
7. **Set restrictions:** Act 23 should specifically ban "credit default swaps" and "currency swaps," as well as "off-market" Qualified Interest Rate Management Agreements (QIRMAs) resulting in any up-front payment from the counterparty, with the exception that fully disclosed fees associated with the QIRMA's execution can be included in the transaction. Likewise, forward starting swaps should be limited to starting within one-year of the trade date for debt incurred but not yet issued, and two years for debt concurrently or previously issued. The aggregate swap notional amount should be limited to the lesser of the annual outstanding debt on related bonds, or 100% of the local government's "borrowing base" (average revenues during the past

three years), and no direct payments of advisor compensation should be allowed by the counterparty. Costs generated on the swap must be deposited in an account of the local government unit prior to paying contracted professionals, instead of any amount of earnings bypassing the local government to directly pay the IFA.

8. **Disengagement of current agreements:** No school district should be required to immediately withdraw or terminate current swap agreements, but should consult an independent financial agent or monitor to discuss agreement terms and their consequences.

In addition to legislative changes to Act 23, PSBA advises that school districts engage in both independent monitoring of their swaps and competitive selection of service contracts. A school district entering into a swap transaction should consult with an independent financial advisor and ensure that they retain an independent monitor/evaluator to conduct a periodic evaluation of the swap over the length of the swap. That monitor/evaluator must be separate from the swap provider. This monitor/evaluator should also limit any negative exposure and poor liquidity or diversity concerns. Furthermore, school districts should engage in a competitive selection process like other professional service contracts prior to entering into a swap agreement.

From my professional experience, interest rate swap products have served my district well and provide a useful financial tool that have resulted in positive non-tax revenue for the school district. We feel that amending Act 23 is the best option to both resolve concerns regarding interest rate swaps and still leave this valuable financial tool available for school districts' use. At this point, let me introduce Karen McConnell who will discuss this issue with regard to the experiences of Central Dauphin School District. Mrs. McConnell is the Assistant Superintendent for Finance and Administrative Operations for the district and holds a MBA and a CPA. We would be happy to answer any questions at the conclusion of Mrs. McConnell's comments. Thank you.