Pennsylvania Association of School Business Officials

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Testimony of Thomas Delaney

Pennsylvania Association of School Business Officials

Senate Local Government Committee

Interest Rate Swaps

September 9, 2013

My name is Thomas Delaney. I recently retired from the Garnet Valley School District (District) in Delaware County, having served there 27 years as its school business administrator. I am a past PASBO president, a CPA, and I have served on PICPA, PASBO, and ASBO International local government accounting committees.

I appreciate the committee's effort to limit local governments' exposure to excessive swap issue fees, termination fees, and annual administrative fees charged by consultants. It is appropriate to try to eliminate unnecessary exposure to interest rate market changes and to stop local governments from speculating changes in future interest rates.

But I urge the committee to distinguish between direct SWAP transactions that are initiated by school districts vs. indirect SWAP transactions that occur only when a district joins a multi-county, multi-government, financing pool, such as the Delaware Valley Regional Finance Authority (DVRFA). DVRFA is rated by national credit rating bureaus and it is administered by financial professionals. For purposes of this presentation, an indirect SWAP transaction occurs when a district becomes liable for a share of the pool's unfunded SWAP fees by entering into a loan arrangement with the pool in the form of a general obligation note.

The DVRFA pool does not accept fees from counterparties; and, it does not get paid commissions from any financial institutions for converting participant loans from variable rate to fixed rate. I believe that financing pools would be willing to file annual disclosure statements with the Department of Community & Economic Development, (DCED), to document that no fees are being exchanged with any financial institution.

The Garnet Valley School District has never entered into a direct SWAP transaction. It has however entered into over 20 indirect SWAP transactions with DVRFA since 1997.

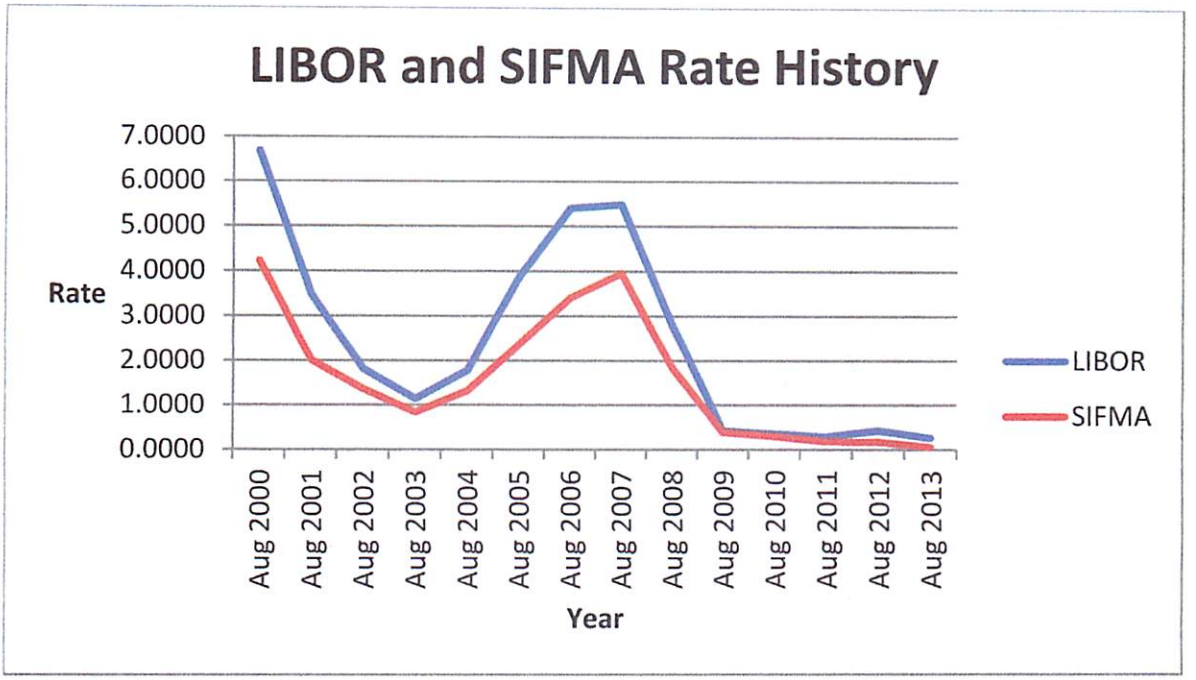
During the past 17 years, the District has typically saved over $150,000 each year by using the fixed and variable rate debt options offered by DVRFA. The District's variable interest rate for its debt service has averaged about two thirds of its average fixed interest rate. Even when the Great Recession of 2009 happened, the district's variable rate only spiked a few points for about six weeks.

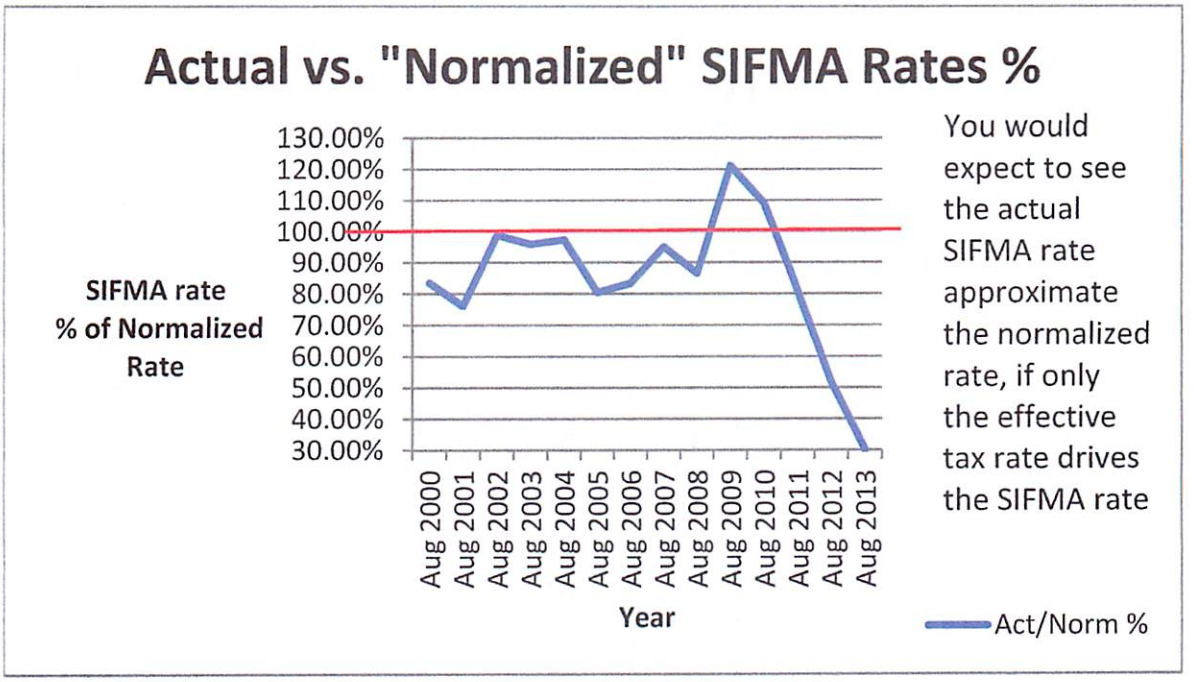
Financing pools save school districts substantial issue costs, since the legal fees, printing fees, and filing fees are a lower percentage cost of the issue. Garnet Valley has repeatedly issued $1,250,000 annual equipment general obligation notes through the DVRFA pool with "all-in", issue costs of about $5,000 per deal, (40 basis points, or bps), while the issue costs for a direct bank loan or a direct general obligation bond would typically cost as much or more, and before paying for legal, printing, or filing fees. Since most 20 year bond issues are refunded several times over the course of 20 years, the costs of re-issuing through a pool saves a district even more dollars.

It is a good business practice to balance a district's debt portfolio with both variable and fixed rate debt in order to take advantage of the lower, variable interest rates. Garnet Valley's current outstanding debt is comprised of 13% variable rate debt (all through DVRFA) and 87% fixed rate, general obligation debt. The District has ranged its debt mix from 10% to 22% over the past 17 years, in order to take advantage of current market rates, and only after consulting with its independent financial advisor. The District would be unable to maintain its debt mix if it were not able to participate in a financing pool, because of the longer lead time that would be necessary to close a variable rate deal, and because of the added issue costs would offset much of the projected savings.

Loans with DVRFA can be readily prepaid by the District, in whole or in part. The loan documents between the District and DVRFA allow the District to give DVRFA 30 day notice of its intent to prepay or terminate its loan with DVRFA. At Garnet Valley, the District has exercised this redemption option several times, usually to prepay a portion of a loan, or to refund a loan, in order to change the mix of the debt portfolio. When these prepayments have occurred, the district did not pay any termination fees to DVRFA or to any counter-party.

Thank-you for this opportunity to speak with you, and to emphasize how financing pools regularly generate savings in a district's annual operating budget.


LIBOR and SIFMA Rate History
7.0000
6.0000
5.0000
4.0000
3.0000
2.0000
1.0000
0.0000
Rate
Aug 2000
Aug 2001
Aug 2002
Aug 2003
Aug 2004
Aug 2005
Aug 2006
Aug 2007
Aug 2008
Aug 2009
Aug 2010
Aug 2011
Aug 2012
Aug 2013
Year
LIBOR
SIFMA


Actual vs. "Normalized" SIFMA Rates %
130.00%
120.00%
110.00%
100.00%
90.00%
80.00%
70.00%
60.00%
50.00%
40.00%
30.00%
SIFMA rate
% of Normalized
Rate
Aug 2000
Aug 2001
Aug 2002
Aug 2003
Aug 2004
Aug 2005
Aug 2006
Aug 2007
Aug 2008
Aug 2009
Aug 2010
Aug 2011
Aug 2012
Aug 2013
Year
You would expect to see the actual SIFMA rate approximate the normalized rate, if only the effective tax rate drives the SIFMA rate
Act/Norm %

Comparative Rates End of Month (EOM) - August, Annually
Note that the taxable LIBOR rate should be higher than the tax exempt SIFMA Rate

	90 Day LIBOR	Weekly SIFMA Use End of Mo Actual	Memo	SIFMA % of LIBOR	Memo	SIFMA Normalized @ 1.32 (This is the rate you would expect SIFMA to be if it were only a % of the tax rate effect on LIBOR)	SIFMA Normalized vs SIFMA Actual (ie BPS over or under expected rate)	SIFMA Actual vs. Normalized
Aug 2013	0.2633	0.06	Lows	22.7877%	Low	0.20	-0.14	low
Aug 2012	0.4323	0.17		39.3245%		0.33	-0.16	low
Aug 2011	0.2932	0.18		61.3915%		0.22	-0.04	low
Aug 2010	0.3626	0.30		82.7358%		0.27	0.03	high
Aug 2009	0.4245	0.39		91.8728%	High	0.32	0.07	high
Aug 2008	2.8063	1.84		65.5668%		2.13	-0.29	low
Aug 2007	5.4837	3.95		72.0317%		4.15	-0.20	low
Aug 2006	5.4014	3.41		63.1318%		4.09	-0.68	low
Aug 2005	3.8720	2.36		60.9504%		2.93	-0.57	low
Aug 2004	1.7901	1.32		73.7389%		1.36	-0.04	low
Aug 2003	1.1420	0.83		72.6795%		0.87	-0.04	low
Aug 2002	1.8160	1.36		74.8899%		1.38	-0.02	low
Aug 2001	3.4870	2.01		57.6427%		2.64	-0.63	low
Aug 2000	6.6840	4.23	Highs	63.2855%		5.06	-0.83	low

At this point in time, (2009) when the SIFMA rate approached the LIBOR rate, a basis swap was attractive.
Dealers would pay an abnormally high percentage of LIBOR to get a SIFMA based payment from a district.
Dealers were offering to pay districts up to 95% of the LIBOR rate in exchange for their SIFMA based pmt.
Note that only two years: 2009, and 2010, had an unusually high SIFMA rate vs the LIBOR rate.
This leads one to believe that there are other factors in the SIFMA & LIBOR rate trends besides the tax rate.

Both LIBOR and SIFMA are trading at historic lows as of August 2013. Their highest rates were in August 2000. In August 2009, the SIFMA rate was trading at 91.8728% of the LIBOR rate, making swaps very attractive.

The actual SIFMA rate is typically below the "normalized" SIFMA rate, which means that other factors besides the effective tax rate are affecting the SIFMA vs LIBOR % relationship.

A "basis swap" is a "floating to floating" interest rate swap. Under a basis swap, the issuer (district) agrees to receive some % of the taxable LIBOR rate and in exchange, it agrees to pay a short-term, tax exempt SIFMA rate to its counterparty.

Market values for basis swaps are not as susceptible to market movements. Typically, the mark to market volatility for basis swaps is a fraction of that of fixed rate swaps.

Risk Definitions:

Interest Rate Risk: At a given SIFMA/LIBOR ratio, LOWER short-term interest rates should tend to decrease the cashflows from the Basis Swap.

Basis Risk: The risk that there is a dislocation of the historical relationship of SIFMA /LIBOR that results in negative cashflows.

Counterparty Risk: The risk that the swap counterparty experiences credit quality deterioration resulting in a premature termination of the basis swap.

Tax Rate Risk is the potential for reduced or negative cashflows under the Basis Swap due to a change in the taxation of interest income.

Termination risk is the risk that the swap could be terminated as a result of any of several events, which may include a ratings downgrade for the issuer or counterparty, covenant violation by either party, bankruptcy of either party, swap payment default by either party, and default events as defined in your bond indenture.

From time to time, the issuer may ask the counterparty to provide a termination value. Product values after execution and before maturity are subjective judgments based on projected future market conditions. Also, reference prices or indices underlying the product may change, possibly increasing the issuer's cost of unwinding a transaction if it chooses to do so. Termination may require a payment to be made by the issuing district or it may result in a payment being made to the issuer, depending on prevailing market conditions at the time of termination.

Delaware Valley Regional Finance Authority
Testimony to the Senate Local Government Committee
September 9, 2013

DelVal was created by Bucks, Chester, Delaware, and Montgomery Counties in 1985 to provide loans to local governments. DelVal has:

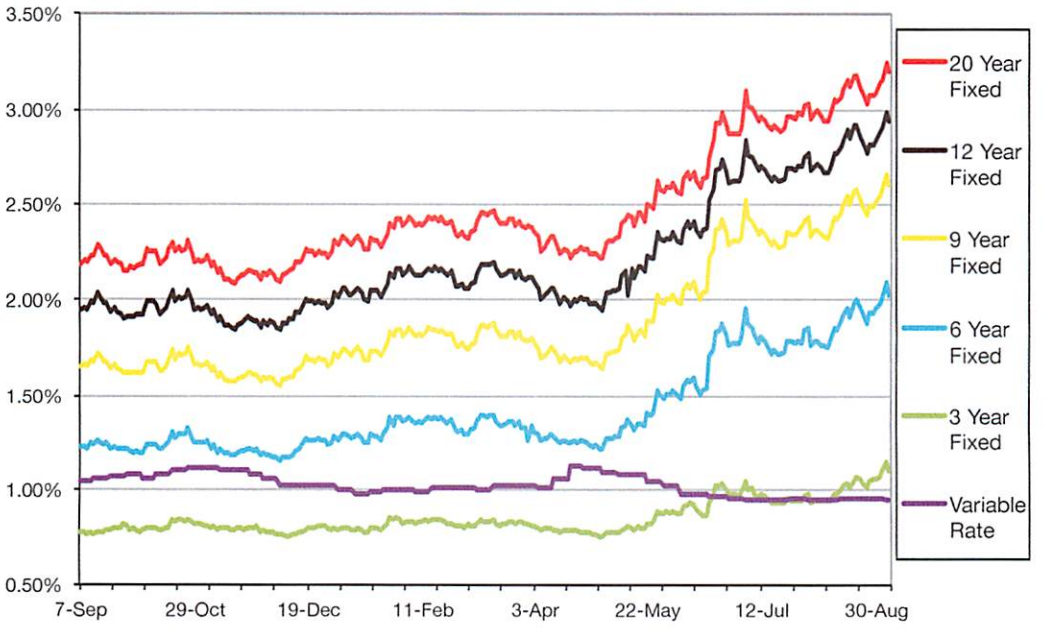
- Issued $1.3 billion of bonds and entered $2.0 billion of interest rate swaps to provide fixed and variable rate loans and
- Originated more than $2.9 billion of loans to more than 185 local governments.

Currently, 130 local governments in 14 different counties have approximately $900 million of loans from DelVal.

The Loan Program has been successful because:

- The issuance costs are typically 25% - 50% of the costs of bonds,
- Interest rates are 0.10% to 0.90% lower than bonds or bank loans,
- Borrowers have total flexibility in structuring their debt, and
- Borrowers can avoid the churning of refundings.

Daily Trend of Loan Rates for the Past Year



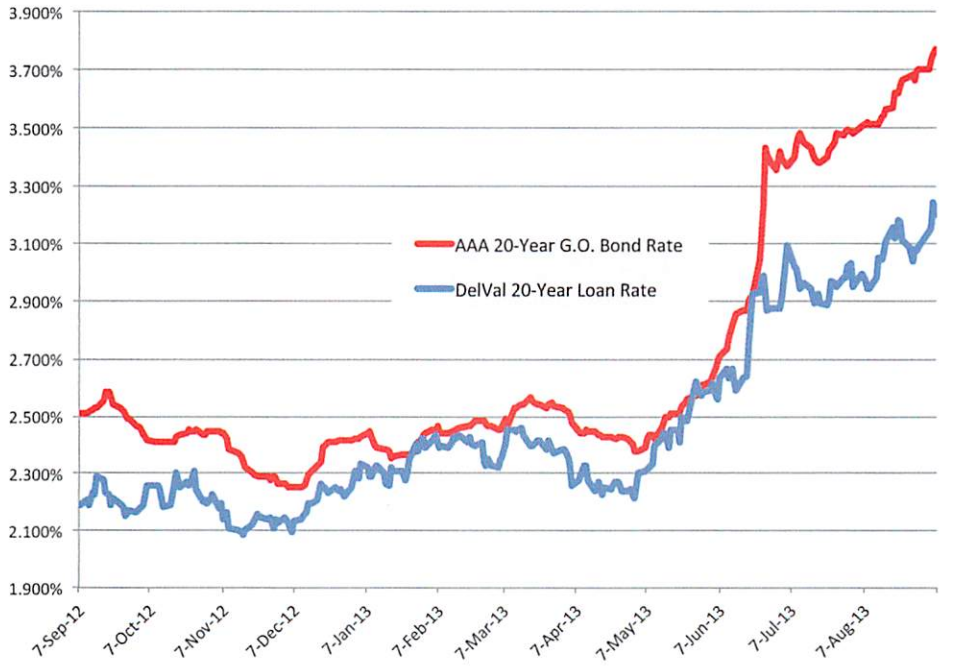
Daily Trend of Loan Rates for the Past Year

Loan Rate*:	Average Rate* Since 1999	Past Year	Past Quarter	Current Rate*
20-year fixed rate:	4.070%	2.466%	2.958%	3.202%
15-year fixed rate:	4.014%	2.373%	2.866%	3.110%
12-year fixed rate:	3.909%	2.205%	2.696%	2.942%
9-year fixed rate:	3.716%	1.893%	2.363%	2.600%
6-year fixed rate:	3.410%	1.422%	1.814%	2.029%
3-year fixed rate:	2.895%	0.851%	0.983%	1.109%
Variable rate:	2.231%	1.025%	0.959%	0.950%

*Assumes 20 year loan amortized to produce level debt at the 20-year fixed rate, no options.

Rates as of:
September 6, 2013

Comparison of DelVal Loan Rates with Bloomberg AAA General Obligation Bond Indices for a 20-Year, Fixed Rate, Level Debt Structure



The proposed legislation would cripple the DelVal Loan Program, and every year it would increase the debt service costs of 25 local governments (the average annual number of DelVal loans) by $3.5 to $10 million.

DelVal has not abused interest rate swaps.

Swaps have been used to obtain the lowest fixed and variable interest rates possible for borrowers, not to speculate.

DelVal has formally adopted a Swap Policy, and DelVal requires all borrowers to adopt the same policy.

If all of DelVal's swaps were terminated today, DelVal would receive approximately $123 million from the Counterparties.

Most abuses of swaps have occurred when the local governments:

- Faced budgetary problems and used swaps to borrow working capital or
- Tried to lock long term rates years before debt was issued.

Below are tenets of DelVal's Swap Policy that would eliminate abuses:

- Prohibit any transaction that provides an "up front" payment to the local government,
- Prohibit any trade that is not effective within one year,
- Prohibit the Swap Counterparty from compensating the financial advisor or law firm representing the local government, and
- Prohibit any trade based on LIBOR ("basis trades") if the local government has not issued bonds with interest rates based on LIBOR.

All of DelVal's bond issues and all of the loans to local governments have been, and need to be, negotiated sales.

Timing is the most important decision in any sale.

DelVal's costs of issuance for its bond issues have been lower than 1%.

The typical borrower's costs of issuance for a DelVal loan is about 0.5%.

Recent Bond Sales by Local Governments

Par Amount	$9,990,000	$34,745,000	$5,700,000	$10,000,000	$10,000,000
Type of Sale	Competitive	Competitive	Competitive	Negotiated	Negotiated
Costs of Issuance	2.544%	2.732%	3.636%	1.800%	2.227%
Maturity	2026	2035	2031	2030	2043
All-In True Interest Cost	3.565%	4.871%	4.752%	4.297%	5.238%
Spread over AAA Indices	0.034%	0.502%	0.249%	0.585%	0.810%

A blanket prohibition on the use of interest rate swaps, statutory competitive bid requirements and "price controls", and an expansion of the Commonwealth's bureaucracy are not a panacea for poor policy decisions.

These changes will most adversely affect the cost of borrowing of the smaller townships, boroughs, authorities, and school districts in the Commonwealth.

These changes punish the majority or the local governments in Pennsylvania that do manage their finances responsibly for the transgressions of a few that failed in their fiduciary responsibilities.