CABs Restrictions Limited to Schools

By Mark Epstein, California Financial Services

When politicians dabble in highly technical areas, the temptation to substitute "political instinct" and "common sense" for expertise is often irresistible. And so it goes with AB 182, a bill that began as an initiative to limit the use of Capital Appreciation Bonds (CABs) that has blossomed into the most sweeping, broad-based restructuring of school bond laws since Proposition 39. As with most spontaneous reform efforts born on a wave of sensational press coverage, there are unintended consequences and unrelated provisions in this bill that threaten to undo the fragile balance between State, local and developer fee revenues needed to fund the State Allocation Board's estimated $87 billion of school construction and modernization needs. Recently passed unanimously by the Assembly Education Committee and the Assembly as a whole, AB 182's sponsors resisted significant changes to the bill from its draft form despite a series of forums they held where school groups and bond industry leaders expressed concerns that the bill would unnecessarily slash every local bond initiative by 20 to 25%. All major school groups oppose AB 182 unless it is amended to fix its defects.

Because most districts continue to assume that AB 182 is only a CABs limitation bill, this article will be presented in two parts. This month, we will recap the history of the controversy and discuss the ostensible reason for the bill: the abuse of CABs. Next month, a second article will explore key lesser known provisions of this bill that have nothing to do with CABs but promise to greatly magnify the harm AB 182 will do to school construction funding.

Genesis of the CAB Issue

The story of AB 182 begins with a San Diego blogger who posted a story that Poway USD was paying ten dollars of debt service for every dollar it borrowed in a 2012 financing. This outrageous sounding calculation made its way to the San Diego County Treasurer who, despite his early and ongoing involvement in the Poway CAB sale, reversed himself to become the most visible champion of CAB reform. He found a natural ally in the L.A. County Treasurer's office that had issued a "White Paper" decrying various practices related to school bond issuances in 2011. For years before the L.A. County "White Paper" was released, the California Association of County Treasurers and Tax Collectors (CACTTC) had been promoting a series of frustrated efforts to limit perceived excesses in school bond issuances. And so, Poway, the "L.A. White Paper" and the list of failed CACTTC legislative initiatives became the starting point for AB 182. The catalyst for change in 2012 – "the crisis that was not to be wasted" – was Poway, but the push for restricting school bonds had, in fact, begun years earlier in a series of initiatives promoted by CACTTC.

CABs – the Black Sheep of Debt?

CABs are not a new debt instrument invented for school bonds. CABs are simply compound interest bonds, like U.S. Savings Bonds. Many of us received Savings Bonds as children that matured years later in a single payment of principal and interest. Like U.S. Savings Bonds, CABs reinvest interest at a compounded rate of return rather than regularly paying interest like Current Interest Bonds ("CIBs"). At least thirty years before the Poway CABs were sold, billions of dollars of CABs had already been sold by states, cities, counties, water districts and public power agencies. Even the County of San Diego (the epicenter of this story) used CABs to fund its unfunded actuarial liability for its pension fund just a few years before Poway USD exploded into headlines.

An inexplicable aspect of this story is why all these other CABs, including U.S. Saving Bonds, still remain free of criticism while school district CABs have been branded the "black sheep" of debt. And if CABs with a ratio of greater than 4 to 1 are bad for taxpayers, no explanation has been made as to why AB 182 will not apply to cities, counties, water districts or the State itself. What we do know is that the elected officials who oppose CABs for use by school districts -- few of them formally trained in finance -- find themselves at odds with economists, investors, rating agencies and most trained professionals in the financial world.

Why Do School Districts Use CABs?

GO bonds are paid by tax collections based on assessed value. Assessed value grows when real estate values rise, when new construction occurs and when homes owned for a decade or more are sold to new buyers. Because revenue for a bond is determined by multiplying the tax rate by the assessed value, the revenue is generally lowest in the first year and highest in the last – much like the salary of an individual over a career lifetime. CABs are used to keep payments low when the tax base is small and to grow payments as the tax base expands. Just like Social Security collects less when our salary is low and more as our salary rises, this growing of debt service over time is meant to make GO bonds as affordable for taxpayers today as for future taxpayers, adjusted for inflation and real estate values.

In cases when bond interest payments alone would exceed the maximum tax rate approved by voters, CABs allow districts to borrow more dollars for construction today without increasing payments unfairly on the current generation or postponing or cancelling projects. By compounding interest and paying interest in the future, the debt service is kept at the same tax rate for all taxpayers until the bonds are retired. To date, the use of CABs has not been the cause of taxpayers paying higher taxes than originally promised by districts and no one has claimed that CABs have caused a crisis in tax rates.

What Economists and Finance Professionals Believe

Early in the media frenzy over Poway's CABs, Nuveen Asset Management, a household name in mutual funds and a respected source of research on municipal bonds, released a report defending and explaining the practice of using CABs. The report clashed with the opinions of AB 182 supporters. Nuveen argued that the advocates of AB 182 failed to appreciate the "time value of money" (TVM). Put simply, TVM means that $1 today buys less than $1 in the future. The Nuveen article suggested that the proper ratio for debt repayment is not an absolute ratio but based on an individualized analysis that takes into account the cost of all alternatives.

Let us consider some examples that show TVM outside of the area of school facilities. Forty years ago, at age 12, I could get a Snickers bar for 10 cents. That same Snickers bar will cost me $1.25 today. The debt service ratio (the compounded price) of a Snickers bar would be higher than a Poway CAB at 12.5 to 1 – but no one attacks the price of a Snickers, much less tries to make it illegal. Another example of TMV is the debt created by unfunded pension liabilities. For every unfunded dollar owed to a current employee, actuaries tell us approximately $16 will be owed to that same retiree in 40 years – which is a debt ratio of 16 to 1. An impartial economist might ask, "Why should it be legal for the State, cities, counties and even school districts to borrow funds at a debt ratio of 16 to 1 by not funding their pension obligations, but illegal for districts to borrow above 4 to 1 to fund facilities?"

Construction Inflation is a Form of Compounded Interest

In the area of school facilities, we call TVM "escalation." Architects use escalation to ensure that today's cost estimates are adjusted to reflect inflation between the date of the estimate and the date of construction. Using the Engineering News Record's 40 year index for construction inflation of 5.47%, $1 of construction today would cost $8.60 forty years from now. This estimate is probably low because it doesn't include inevitable expensive building code changes, redesign costs, extra interim housing costs or damage resulting from postponing needed modernization for years. Construction inflation alone produces the equivalent debt service ratio of 8.6 to 1 over 40 years – close to Poway's 10 to 1 ratio and well above the 4 to 1 ratio for school bonds. If you ask the bill's supporters the relationship between the proposed 4 to 1 ratio and construction inflation you will not get an answer rooted in a principle of economics.

An economist would likely say that Poway should not issue CABs unless there are tangible or intangible benefits that justify the 10 to 1 ratio. If 8.6 to 1 is 40 year inflation, the Board would need to justify the additional 1.4 to 1 if it chose to proceed with CABs rather than wait 40 years to build its project. An economist would likely say that a policy maker should be indifferent as to whether tax dollars are spent paying bond interest for a CAB or paying fees to architects and contractors in the form of construction inflation. The Board and staff, of course, would need to evaluate the potential costs described above: including avoiding the costs of interim housing, code changes and facility damage from delays. Then there are the intangible costs of teaching in overcrowded classrooms, classrooms that are too hot or cold, buildings that lack modern technology, bathrooms that are inaccessible, etc.

Attack on Local Control Limited to School Districts

As a former school board member, I believe the policy questions surrounding CABs should be made locally by school boards -- as they were made by the Board of Supervisors for the San Diego pension bonds and the State when it decided not to fully fund its pension obligations or to fund its operating deficit with long term bonds. Reasonable people disagreed over the pension bonds and the State's deficit plan, but in the end elected officials made the choice by balancing the interests represented by various available options against the consequences of each choice. Undeniably there is no perfect solution, but it is reasonable to ask why school districts should be the only governmental entity limited in their power to issue CABs by a policy that substitutes debt ratios for judgment and political consequences. It is hard to avoid the conclusion that, at its root, AB 182 is a no confidence vote expressing a lack of faith in elected school boards while exempting all other governmental entities.

When understood in a longer context, AB 182 is not really about Poway or CABs. It is about addressing a longstanding lack of confidence in school boards and a suspicion of the finance industry. For years, CATTC has been trying to compel competitive sales, prevent finance firms from donating to bond campaigns and to restrict the options available to districts when issuing debt. When San Diego and other counties issued long term taxable CABs to fund their pension funds – often incurring significant investment losses in the process – there was little to no outcry about CABs. There is still no outcry. The advocates of AB 182 believe that San Diego County knows what it is

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doing and must have a good reason for doing it. In the case of districts, there is not even a respectful presumption that some school districts might be issuing CABs with a purpose and a plan that might justify the ratios they object to.

Other State Initiatives Magnify Losses Created by AB 182

We are in the midst of an institutional struggle to protect school districts from themselves that, in fact, threatens to harm school districts. Not once during the AB 182 discussions and hearings did the bill's sponsors float a proposal to mitigate the cost of bonds already approved by voters that cannot be sold for a decade or longer if AB 182 becomes law. In fact, while this controversy has been brewing, the State has increased the burden on local school bonds by failing to put a bond on the ballot for the School Facility Program (SFP) in 2012, slowing the sale of outstanding bonds, suspending the level 3 developer fees and threatening to potentially reduce the SFP program in the future. Right about now, it is fair for districts to wonder whether the politics of AB 182 have triumphed over the policy implications of the bill.

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