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REFORM SCHOOL BOND LOAN PROGRAM

House Bill 5832 as introduced
House Bill 5833 with committee amendments
First Analysis (5-30-00)

Sponsor: Rep. Ron Jelinek
Committee: Education

THE APPARENT PROBLEM:

Since 1961 when the state created the Michigan School Bond Loan Fund, school districts have been able to receive the state's guarantee of their bond issues. The benefit to the districts is that when they sell their debt on Wall Street, they are able to use the state's credit rating (now AA+). School districts also can borrow from the loan program, which many do in order to level out their millage rate over the life of the bonds' repayment. (See *BACKGROUND INFORMATION*, below.)

According to testimony before the Education Committee, the recent surge in Michigan school district debt and the parallel increase in borrowing from the state's School Bond Loan Fund (SBLF) have left the state vulnerable to significant future financial liabilities. The Department of Treasury reports that when the state last sold debt on Wall Street to finance environmental clean-up projects, Moody's Investor Services, the national credit rating agency, specifically expressed concern regarding the growth in the state's contingent, qualified school debt. When Michigan's SBLF program debt is included in debt ratios (that is, "gross" state debt versus net tax-supported state debt), Michigan's debt burden triples.

Since 1994, the treasury department says state-qualified debt held by school districts has doubled to more than $8.8 billion. Debt service owed by school districts' fiscal year 1998-99 debt service payments totaled approximately $710 million. Borrowing from the SBL fund has also increased. In 1994, a total of 42 school districts borrowed from the fund to support their debt service on local bonds; today the SBL program loans funds to 111 school districts (about 20 percent of all districts). The total outstanding direct loans owed by districts to the fund increased from $58 million in fiscal year 1993-94 to $327 million in fiscal year 1998-99.

The Department of Treasury has expressed concern about this level of borrowing. For example, twenty participating school districts have been borrowing from the fund over 20 years, and five districts for more than 30 years. Further, 22 districts have recently issued new bonds without repaying outstanding SBL fund loans, and without a millage increase. Instead, they borrow from the SBL fund and defer loan repayment, and accumulate interest costs on new loans.

Bonding and borrowing under the SBL fund program may be initially attractive to district school boards and their taxpayers, since annual debt millages are lower. However, by exchanging bonded debt for a school bond loan, total interest costs for the issue rise significantly. For example, a school district that issues bonds with no borrowing from the school bond loan fund might spend $1 in interest costs over the life of the debt for every $1 in bond proceeds. However, a school district that issues bonds that are partially financed by borrowing from the school bond loan fund might expend $1.50 in interest costs for every $1 in bond proceeds. What's more, a school that is already borrowing from the fund for previously issued bonds and is then proposing to issue yet additional bonds financed by borrowing from the fund will pay significantly more. Indeed, the Department of Treasury reports that recent proposals submitted by some school districts for review have indicated interest costs of $2 to $4.80 for each $1 of bond proceeds. Estimates indicate that the potential SBL fund borrowings of existing participants in the program could reach $1.2 billion in additional interest costs for these districts. It then follows that when funds are used for these higher interest payments, they are not available for capital projects.

In order to protect against fiscally irresponsible school bond issues, the state treasurer took action on July 22, 1999. At that time the department issued five parameters that evaluators follow when they review applications in order to give a district's bond proposal its preliminary qualification. (A preliminary

qualification precedes a vote of the district's taxpayers, after which final qualification is given, and bonds are issued.) The five parameters require that preliminary qualification be contingent on several limiting conditions: *the financial impact of the bond issue* (including among other things a millage increase for current school bond loan fund borrowers, and an interest cost- to- bond ratio no higher than 1.5 to 1); *construction costs* (limits on costs per square foot, depending on region); *utilization of teaching station capacity* (a district-wide utilization rate of 85 percent); *amortization of bonds for a period not greater than the useful life of the assets*; and *new construction in combination with discontinued use* (demonstrated through a well-documented physical plant study that illustrates cost savings of abandonment and new construction).

Since the Department of Treasury put parameters in place last year, some school districts have argued that the state treasurer does not have the authority to administer the program following these rules. So, legislation has been proposed to update the School Bond Loan Program, and to place the parameters that ensure fiscally responsible borrowing into the enabling statute. Further, some have proposed to expand the SBL program so that it can help to finance the growth and development of more charter schools in the state. Capitalizing charter schools has been difficult since they seldom have property to secure loans, and are without the authority to levy millage.

THE CONTENT OF THE BILLS:

House Bill 5832 would amend Public Act 112 of 1961, the School Bond Loan Fund Financing Act (MCL 388.981 and 388.982) to expand the financing instruments available to the state administrative board.. Currently the state administrative board may, under certain conditions, issue its notes or bonds for the purpose of making loans to school districts. Under the bill, the administrative board could also designate notes or commercial paper for this purpose. Further, the state administrative board could authorize and approve insurance contracts, agreements for lines of credit, letters of credit, commitments to purchase bonds, notes or commercial paper, and any other transaction to provide security to assure timely payment or purchase of any bonds, notes, or commercial paper issued under the act. Under the bill, the administrative board also could authorize and approve, among other financial arrangements, an interest rate exchange or swap, hedge, or similar agreement or agreements in connection with the issuance of bonds, notes, or commercial paper. The board also could approve interest rates, if any, or methods for determining interest rates, including fixed or variable rates; prices; discounts; maturities; principal amounts; purchase prices; purchase dates; remarketing dates; denominations; dates of issuance, interest payment dates; redemption rights at the option of the state or the owner; the place and time of delivery and payment; and other matters and procedures necessary to complete the authorized transactions.

House Bill 5833 would amend Public Act 108 of 1961, the School Bond Qualification and Loan Act (MCL 388.951 et al). The bill would:

- Permit borrowing of up to 75 percent over the minimum debt levy from the School Bond Loan Fund. [Section 2(1)]

- Limit debt parameters to no more than 20 percent of taxable value (unless that condition is waived with compelling justification). [Sections 4(1)(f)-(n)(*v*)]

-Require school districts to publicize project and bonding costs prior to an election to approve a bond issue. [Section 4(1)(e)]

-Allow waiver of the 60-month School Bond Loan Fund repayment requirement for "needy" districts. [Section 2(1)]

-Define methods to determine taxable value growth projections. [Section 2(2)(b)]

-Simplify bond maturity requirements. [Section 4(1)(b)]

-Establish procedures to draft and publish bulletins on program details. [Section 4(3)(a)-(e)]

-Authorize the state treasurer to consider the adverse financial impact of a bond issue in the approval of the application parameters. [Section 9c]

-Clarify the qualification requirements regarding reasonable project costs and enrollment needs.

-Update the loan application and fund repayment administrative processes, as well as other out-dated references. [Sections 6, 7, 8 and 9]

-Create a grant program for school districts in the lower one-tenth of taxable value per membership pupil. A grant equal to 12.5 percent of the total bond amount, not to exceed $5 million, would be available to eligible districts. If the total amount of all eligible district applications exceeded the amount available, proration would be required. [Section 10b]

-Create an interest-subsidy program for school districts in the lower one-third of taxable value per pupil. (The amount of interest subsidy would equal the product of the difference between the district's adjusted taxable value per student, and that of the district just above the bottom third, times the number of students, times the millage rate levied.) The annual amount of the program could not exceed the school bond loan interest accrued for the year, or $1 million, whichever was less. If the total amount of all eligible district applications exceeded the amount available, proration would be required. Funds appropriated but unawarded as grants for purposes of this provision would be awarded as a revolving fund grant to the Michigan Municipal Bond Authority and could be used to make loans for capital purposes to public school academies (more commonly referred to as charter schools). [Section 10c]

BACKGROUND INFORMATION:

In an explanation given to the Education Committee, the Department of Treasury included a program overview of the Michigan School Bond Loan (SBL) program. According to the overview, the program provides a state-sponsored credit enhancement and loan mechanism for K-12 public school district unlimited tax bond issues. The bonds must be *qualified* by the state treasurer to participate in the program. Bond proceeds must be used for capital purposes as authorized by applicable state law (primarily the Revised School Code).

Participation in the SBL program benefits a school district in two ways: 1) Qualified bonds receive a rating equal to the state's credit rating, usually resulting in a lower interest rate and cost than a school district can achieve on its own. The state guarantees to pay debt service (i.e., to make an immediate loan to a district) whenever there is risk of default. Approximately 400 districts (about 80 percent of all districts) have qualified bonds outstanding. 2) A district may borrow on an ongoing basis from the state an amount sufficient to assist the district to pay principal and interest requirements on its outstanding qualified bonds. Borrowing from the SBL fund levels the ordinarily fluxuating debt millage that would have to be levied over the life of the bond issue (typically, 20 to 30 years). Approximately 111 school districts (about 20 percent of all districts) currently borrow from the SBL fund to augment their debt service payment.

The Department of Treasury explains the bond issue qualification process, as follows. A school district that seeks to issue qualified bonds must receive preliminary qualification of the proposed bond issue from the Department of Treasury before calling for a local election. The criteria for authorizing preliminary qualification are based on the proposal's compliance with requirements regarding the maturity structure of the bond issue, and the school district's demonstration both that the cost of project is "reasonable", and that it is needed, in order to adequately address current and probable future enrollment. After preliminary qualification, the school district holds an election. If a majority of the district's voters vote in favor of the proposal, the district may apply for final qualification. Upon approval of final qualification, a Certificate of Qualification is issued, and the district may proceed to sell the bonds to prospective investors with the credit enhancement that state qualification provides.

Further, the department explains borrowing from the School Bond Loan Fund, as follows. If a local debt levy of at least seven mills does not raise sufficient funds to pay the full annual debt service on the school district's bonds, the district may elect to borrow the additional necessary funds from the SBL fund. Loans are made to districts on a semi-annual basis. The loan approval process involves submitting an application to the SBL program, which includes information pertinent to qualified bonds outstanding, debt service obligations, state equalized valuation, debt mills, tax collections, and the district's loan needs. School districts repay loans, plus accrued interest, when local debt levies yield more revenue than the annual debt service on the bonds. The school district continues to levy debt millage until the SBL loan plus SBL accrued interest is repaid. Since 1991, districts must levy at least seven mills or a high "computed" millage sufficient to repay the school bond loan funds within 60 months of the final bond maturity date. However, this repayment requirement is, in effect, extended if a school district issues a subsequent bond issue, and borrows from the SBL fund.

The Department of Treasury notes that with regard to state funding for the School Bond Loan Fund, Article IX, Section 16 of the constitution grants the state authority to issue general obligation debt without voter approval, to provide the funds necessary to issue loans. This is the only non-voted general obligation debt the state of Michigan may issue. The interest charged to school districts with outstanding loans is based on the interest cost to the state for these general obligation debts.

FISCAL IMPLICATIONS:

Fiscal information is not available. [It should be noted that the House Education Committee amended the bill

to remove a provision from House Bill 5833 that specified "there is appropriated from the state school aid fund for the purposes of this section the amount of $20 million for the 2000-2001 fiscal year. The legislature shall appropriate funds for subsequent fiscal years for the purposes of this section."]

ARGUMENTS:

For:

Many large urban school districts have dilapidated buildings in which they offer instruction. These buildings can be modernized or replaced at a savings to local taxpayers when school superintendents and school boards develop bond proposals, and then seek to qualify the bonds they would issue by making application to the school bond loan program. The infrastructure needs of districts have been documented in a two-year study undertaken by the Middle Cities Education Association (which represents 34 large urban districts), in conjunction with the Wayne County Regional Education Services Agency (RESA), and published in 1999. In order to address these needs, the School Bond Loan Fund must remain strong.

House Bills 5832 and 5833 would amend the two acts that govern the school bond loan program to protect and improve the state's credit rating, ensure prudent use of state general obligation debt, maintain the school bond loan program to assist school districts in financing infrastructure needs, and reduce the associated accumulated interest costs that school districts incur on fund loans. They would modernize the financing provisions for issuing bonds and notes issued to finance school bond loan program loans to school districts to reduce financing costs for the state's bonds and school district bonds, provide for additional financing capabilities for making an emergency loan to avoid a potential school district bond payment default, reduce accumulated interest costs for taxpayers, and protect taxpayers by limiting debt parameters.

For:

The total outstanding direct loans owed to the School Bond Loan Fund increased from $58 million in fiscal year 1993-94, to $327 million in fiscal year 1998-99. Moody's Investor Service has expressed concern that the size of outstanding school debt may threaten the overall financial security of the state. When Michigan's SBL fund program debt is included in debt ratios (that is, "gross" state debt vs. net tax-supported state debt), the state's debt burden triples. In response to the bond rating service's concern, the state treasurer issued parameters that the Department of Treasury follows when evaluators review proposed school bond projects, in order to give their preliminary qualification. These parameters, and other financial safeguards, must be put into the law, since the Department of Treasury had indicated some school districts have questioned the state treasurer's authority to require that districts meet conditions not explicitly included in the program's enabling statute.

Against:

New grant funding for this program--originally at least $20 million--is no longer contained in this bill. Neither is it contained in the Department of Treasury's fiscal year 2001 budget. Some have argued that instead, funding for the program should be included in the state school aid fund. However, the School Aid Fund has never been used to fund capital projects. In contrast to a capital fund, the school aid fund exists exclusively to pay for school operations. Its purpose is to provide a foundation allowance for the state's schoolchildren, in order to ensure an adequate level of teaching, learning, curriculum and assessment. It would be unwise public policy to deviate from the rule that has historically governed appropriations from the fund: revenue in the school aid fund is reserved only for school operations. That rule has governed appropriations during years when revenue has fluxuated considerably; it is a principle that should be upheld whether tax revenue years are "fat" or "lean".

Against:

The School Bond Loan Fund should not be available to fund charter schools. This legislation would allow public school academies, more customarily referred to as charter schools, to apply for project grants, through a revolving fund grant made to the Michigan Municipal Bond Authority under section 10b(6) of this bill. Charter schools generally do not have property to secure loans, and they do not have the authority, as do school districts, to levy mills in order to repay debt. They should not, therefore, have access to funds through the Michigan School Loan Fund and program.

POSITIONS:

The Department of Treasury supports the bills. (5-26-00)

The Middle Cities Education Association supports House Bill 5833 and has no position on House Bill 5832. (5-24-00)

Analyst: J. Hunault

■This analysis was prepared by nonpartisan House staff for use by House members in their deliberations, and does not constitute an official statement of legislative intent.