Legislative Analysis

Mary Ann Cleary, Director
Phone: (517) 373-8080
http://www.house.mi.gov/hfa

SCHOOL BOND QUALIFICATION AND LOAN PROGRAM

Senate Bill 770 (S-3 as amended)
Sponsor: Sen. John Pappageorge

Senate Bill 771 (S-1)
Sponsor: Sen. Howard Walker

Senate Bill 772 (H-1)
Sponsor: Sen. Phil Pavlov

House Committee: Appropriations
Senate Committee: Appropriations

Complete to 8-10-12

A SUMMARY OF SENATE BILLS 770-771 AS PASSED BY THE SENATE AND SENATE BILL 772 (H-1)

Authorized by Article IX, Section 16 of the State Constitution, the School Bond Qualification and Loan Program provides a credit enhancement on qualified school construction bonds that allows bonds issued by a school district to receive the state's credit rating. The program also authorizes districts to borrow funds from the state to make the debt service payments on qualified bonds (a bond approved by the department through the prequalification and qualification processes explained below), if the property tax rate necessary to make the debt service payments exceeds 13 mills (or a lesser millage rate established by the Legislature, currently 7 mills). Districts levy this millage rate each year, applying any excess revenue (above what is required for debt service obligations) to repayment of any outstanding loans, until the loans are repaid. The final loan repayment occurs not later than 6 years after the final maturity date of the qualified bonds, meaning that the millage may continue to be levied after the bonds have been paid off.

To ensure the state has sufficient resources to make loans to districts, the State Constitution permits the state to borrow funds through the issuance of bonds or notes pledging its full faith and credit (general obligation (GO) debt). In addition to GO bonds, the state may issue revenue bonds through the Michigan Finance Authority (MFA) to fund loans to districts.

In 2005, the Legislature reformed the School Bond Loan Program (SBLP) to create the School Loan Revolving Fund (SLRF) as a revolving fund that would enable the MFA to issue revenue bonds backed by districts' loan repayments. The 2005 amendments also allowed the Department of Treasury (herein referred to as "the department") to pre-qualify a bond issue only if it determined that the issuance of additional qualified bonds would not prevent the district from repaying its outstanding qualified loan on time.

Despite the 2005 reforms, the current structure of the SBLP allows districts to "roll-over" their qualified loan, issue additional debt, and delay repayment of their qualified loans.

A district is considered to have "rolled-over" its qualified loan debt by issuing new qualified bonds prior to beginning their scheduled repayment of the qualified loan. Rolling-over qualified loan debt does not create a new mandatory final loan repayment date. However, the district is able to delay reimbursement to the state by issuing another qualified bond and increasing its qualified loan borrowing. The district is not required to increase its debt millage when rolling-over its qualified loans.

While the SLRF was intended to be a self-sustaining revolving fund financing qualified loans to districts, the continued ability of districts to roll-over their qualified loan has adversely impacted the SLRF's ability to issue qualified loans to districts. Instead, the state has had to issue GO debt to finance the qualified loans leading to steadily increasing debt service appropriations in the School Aid budget.

Of the 122 districts with outstanding loan balances as of the June 30, 2011, more than two-thirds have been in the program for 15 years or less. However, a small number of districts have been in the program for more than 40 years, and none of those are currently in the process of repaying their loans.

Additionally, current law allows districts to issue qualified refunding (refinancing) bonds and use the proceeds to pay off the qualified loan balance to the state. With no outstanding qualified loan balance, a district receives a new mandatory final loan repayment date upon the issuance of new qualified bonds for additional construction projects. Despite having repaid its original qualified loan from the state, the district is able to receive another qualified loan to assist with debt service on the original qualified bond, the qualified refunding bond, and the new qualified bond.

The series of bills would make the following revisions to the School Bond Loan Program:

- Restrict availability of qualified loans for new bond issues after the outstanding loan balance reaches $1.8 billion.
- Set a single final mandatory repayment date by which all qualified bonds and qualified loans, whenever made, must be repaid.
- Allow districts to issue additional bonds and have a later final mandatory repayment date if the district levies an increased millage rate.
- Require that the millage rate necessary to repay all qualified bonds and qualified loans be recalculated annually based on changes in taxable values, the issuance of new money bonds or refunding bonds, and other circumstances.
- Require districts to maintain books and records of bond proceeds and make those records available to the department.
- Set a single interest rate on loans issued from the School Bond Loan Fund (under prior law) or the School Loan Revolving Fund.
- Permit the department to pre-qualify a bond issue if there is no "adverse financial impact".
- Permit a district to use residual funds remaining after a project is complete for project enhancements only if the district's bond counsel opines that using the residual funds to make debt service payments or to repay qualified loans would adversely impact the federal tax treatment of interest on the bonds.

A detailed description of each bill follows, and a fiscal analysis begins on page 7.

Senate Bill 770 – School Bond Qualification, Approval, and Loan Act, 2005 PA 92

<u>Computed Millage</u> After a district's bonds are qualified by the department, the district determines the millage rate (i.e., computed millage) required to pay the debt service on all of the district's qualified bonds as well as the debt service required to repay any anticipated qualified loans on such bonds no later than the mandatory final loan repayment date specified in the loan agreement (i.e. no later than 72 months after the final maturity date of all of the qualified bonds.) The computed millage must be between 7 mills (statutory minimum) and 13 mills (constitutional maximum).

The act provides that the computed millage is determined as of the date of the order qualifying the bonds or a later date requested by the district and approved by the department. A district may request an increase in computed millage if the amount of debt service increases for any reason and the computed millage is insufficient to repay outstanding qualified loans by the mandatory final loan repayment date.

Under the bill, the computed millage would be calculated based on the repayment of qualified bonds and loans no later than a newly defined final mandatory repayment date (explained in further detail below). Beginning October 1, 2012, the bill would require the computed millage to be reevaluated, at least annually, based on a variety of changes in circumstances, including the issuance of additional qualified bonds, the refunding (refinancing) of any qualified bonds, changes in loan interest rates, changes in taxable values, and changes in assumptions in the department's program guidelines.

An adjusted computed millage could not exceed the constitutional maximum of 13 mills, could not be lower than the computed millage in the most recent order qualifying bonds, and, could not be lower than the statutory minimum of 7 mills. If the department determined that the district did not accurately reevaluate the computed millage, it could determine the new computed millage to be levied by the district.

<u>Final Mandatory Repayment Date</u> Current law provides for different mandatory final loan repayment dates depending whether a district had outstanding loans at the time PA 92 was enacted:

- For outstanding qualified loans *as of July 20, 2005*, the payment date for all outstanding qualified loans and any additional qualified loans expected to be incurred related to qualified bonds issued prior to July 20, 2005 is not later than 72 months after the final maturity date on the most recent qualified bond issue.

- For qualified loans on qualified bonds issued *after July 20, 2005*, the loans shall be due not later than 72 months after the final maturity date of the qualified bonds.

The bill would codify "final mandatory repayment date" and provide that each of the above mandatory final loan repayment dates would become final mandatory repayment dates. Once a final mandatory repayment date was established it would apply to all of the district's qualified bonds and loans until 30 days after the date the district had no outstanding qualified bond or loans. The department could set a later final mandatory repayment date if the district agreed to increase its existing computed millage, but not to exceed the constitutionally set 13-mill cap.

<u>Application for Prequalification – Debt Service Projections</u> Current law requires the district to have its bond proposal "prequalified" by the department prior to submitting a ballot question to the district electors. Prequalification requires the department to assess the district's facility and financing needs, including projected project costs and debt service requirements, taxable value, projected SLRF loans, enrollment projections, and facility utilization rates.

The application for prequalification must include, among other things, a pro forma debt service projection showing the estimated number of mills the district will levy to pay for the bonds. A district must also provide evidence that it will repay all outstanding qualified loans at the time required. For the purposes of the pro forma debt service projection, districts may assume that taxable values for the first 5 years will grow at the average growth rate for the immediately preceding 5 years. The taxable value growth rate assumed on the remaining duration of the bonds is the lesser of that 5-year average or 3%. While current law states that districts *may* use the assumptions stated in the act for the debt service projections, Rule 2 (R 388.2) of the School Bond Qualification, Approval, and Loan Rules requires that these assumptions *shall* be used.

Under the provisions of the bill, the debt service projection would have to calculate the estimated number of mills required to pay the qualified bonds to be issued, any outstanding qualified bonds, as well as any outstanding or projected qualified loans. Moreover, the bill would require a district to provide evidence that it would repay all outstanding and projected qualified bonds and loans by the final mandatory repayment date.

The bill also would provide that in estimating the taxable value for the first 5 years after the application, districts could calculate the average growth *or decline* rate based on the preceding 5 years, or another period of time if approved by the State Treasurer. For the remaining duration of the qualified bonds, the taxable value would be estimated based on the average growth *or decline* in taxable value for the 20 years immediately preceding the application. However, the annual growth rate could not exceed 3% or be less than 0%.

<u>Prequalification</u> Under the provisions of the bill, prequalification requires the State Treasurer to determine that certain criteria be met. If all criteria are met, the State Treasurer shall prequalify bonds of a district. The following discusses the changes the bill would make to the prequalification requirements.

- <u>Record Keeping</u> The bill would require districts to keep, and provide to the department upon request, books and records detailing the investment and expenditure of the qualified bond proceeds.

- <u>Loan Cap</u> The bill would impose a soft cap on the total amount of qualified loans outstanding at $1.8 billion. If a proposed bond issue was approved by voters after September 30, 2012 and would require additional qualified loans, the bond issue could only be prequalified by the department if the total outstanding qualified loan balance among all districts did not exceed $1.8 billion as of the most recent May 1 or November 1. Since the provision would apply only to prequalification, the department would continue to make additional loans to districts with bonds approved prior to September 30, 2012 on their existing qualified bonds. Also, a district that is able to qualify a bond after the cap is reached by indicating borrowing would not be necessary may be able to borrow from the state if, due unforeseen circumstances at a later date, the taxable value dropped significantly and the district was levying a minimum of 7 mills.

- Additional Bonds Under the bill, prequalification would also require that bonds approved by voters after September 30, 2012 would not have an "adverse financial impact" on the district, the state, or the SLRF. In assessing the financial impact of the bond issue, the department would have to consider, among other things, whether the district's total qualified and non-qualified bonds, including the proposed bond issue, and current outstanding qualified loans would exceed 25% of the taxable value of the district at the time the proposed bonds would be issued.

- Ballot Language Current law requires the *form* of the ballot to conform with the requirements of the act. The bill would require the *language* in addition to the form of the ballot to conform to the requirements of the act.

Final Qualification Upon bond proposal approval by the electors, districts may then file an application for final qualification with the department. The act requires the department to qualify a district's bond if the district complies with a number of requirements. In addition to the current law requirements, the bill would require districts to keep books and records of the bond proceeds and make those records available to the department upon request.

Qualification Fees The act authorizes the department to collect fees for the final qualification of bonds. This fee is to be not less than $3,000 or an amount determined by the department that approximates the department's administrative expenses.

The bill would amend the act to allow the department to charge a prequalification and annual loan activity fee in addition to the qualification fee. The State Treasurer would determine the amounts necessary to cover administrative expenses.

Refunding Bonds Current law permits districts to issue bonds refunding previous qualified bond issues if the refunding bond issue complies with the Revised Municipal Finance Act. The bill would clarify that refunding bonds could be issued to also refund outstanding qualified loans provided certain rules and conditions are met. In addition to the current law requirements, the department would be required to qualify the refunding bonds if the refunding issue would be financially beneficial to the state and the district could show that it could repay all outstanding and proposed qualified bonds and loans no later than the final mandatory repayment date.

Submission of Ballot to Electors Currently, the act requires the ballot language concerning the proposed qualified bond issue to notify electors that if the district receives a qualified loan to pay debt service, the district may be required to levy the millage beyond the maturity date of the bonds in order to repay any loans. This is in addition to Section 24f of the General Property Tax Act, which requires that the ballot language for millage proposals include the millage rate to be authorized, the estimated amount of revenue to be collected in the first year, the duration of the millage, a statement of the purpose of the millage, and a statement as to whether the proposed millage is a new millage or reauthorization of an existing millage.

The bill would amend this section to require the ballot language to notify voters of the estimated amount of principal and interest on any qualified loans, the duration of the millage levy, the computed millage, and that the computed millage is subject to change based on changes in certain circumstances.

<u>Use of the Remaining Proceeds</u> Current law permits districts to use any remaining proceeds from a qualified bond issue after the project has been completed – "residual funds" – to pay for enhancements to the projects described in the ballot question on the qualified bonds, to pay debt service on the qualified bonds, or to repay the state.

The bill would clarify that a district could use the excess proceeds for project enhancements only if, in the opinion of the district's bond counsel, using the excess proceeds to pay debt service or to repay the state would adversely impact the federal tax treatment of interest on the qualified bonds.

<u>Loan Disbursement</u> Current law requires that districts participating in the qualified loan program submit a Draw Request with the department at least 30 days before the debt service payment is needed. The Draw Request includes information on the debt retirement fund balance and the amount of debt service due in the next six months. The filing requirement is imposed on districts irrespective of whether a loan is needed. The act requires that districts not needing a loan submit an Annual Loan Activity Statement that includes the same information as required in the Draw Request.

The bill would simplify the process if a district has sufficient resources to make its debt service payment and does not require a loan. The district would be required to inform the department at least 30 days before the debt service payment is due that it has no need to borrow.

<u>Interest Rates</u> Interest on qualified loans to districts accrues at rates specified in the act:

- For qualified loans incurred on qualified bonds issued under the prior School Bond Loan Act, 1961 PA 108, interest shall be due and payable under any repayment agreement under PA 108 prior to the effective date of PA 92 (July 20, 2005).

- For qualified loans issued after July 20, 2005 bear interest at a rate equal to the greater of 3% or the average cost of funds issued by the MFA to finance the loan program plus 0.125% or, if the MFA has no outstanding debt, the average annual cost of all general obligations issued for the program plus 0.125%.

The bill would require all qualified loans (issued under the prior SBLF program or the current SLRF program) bear interest at a rate equal to the greater of 3% or the average annual cost of bonds or notes used to finance the qualified loans plus 0.125%, but not less than the cost of outstanding bonds or notes issued by the MFA to finance qualified loans. (This provision provides for one interest rate on SBLF loans and SLRF loans.)

Administrative Rules The act requires the department to promulgate administrative rules carrying out the act. The bill instead would permit, rather than require, the department to promulgate rules, and would permit the department to issue bulletins.

Senate Bill 771 – State Loans to School Districts, 1961 PA 112

Currently, the act permits the state to issue debt obligations for the purpose of making loans to districts, as provided for in the State Constitution and 2005 PA 92, and to reimburse the state for any funds advanced or loaned to the SBLF.

The bill would permit the state to issue debt obligations reimbursing the state or the MFA for any funds advanced or loaned to the SBLF or the SLRF. The bill would require proceeds of any bonds, notes, or commercial paper issued under the act for the purpose of reimbursing the state or the MFA to be applied as determined by the State Administrative Board.

Current law requires funds repaid by districts on loans made from the SLRF to be credited to the SLRF. The bill would amend this requirement and allow for repayments to be credited back to state if the loan or repayments on loans made from or payable to the SLRF were assigned to the state (as provided in SB 772).

Senate Bill 772 (H-1) – Shared Credit Rating Act, 1985 PA 227

The bill would amend the act to permit the MFA to assign to the state loans made from or loan repayments made to the SLRF.

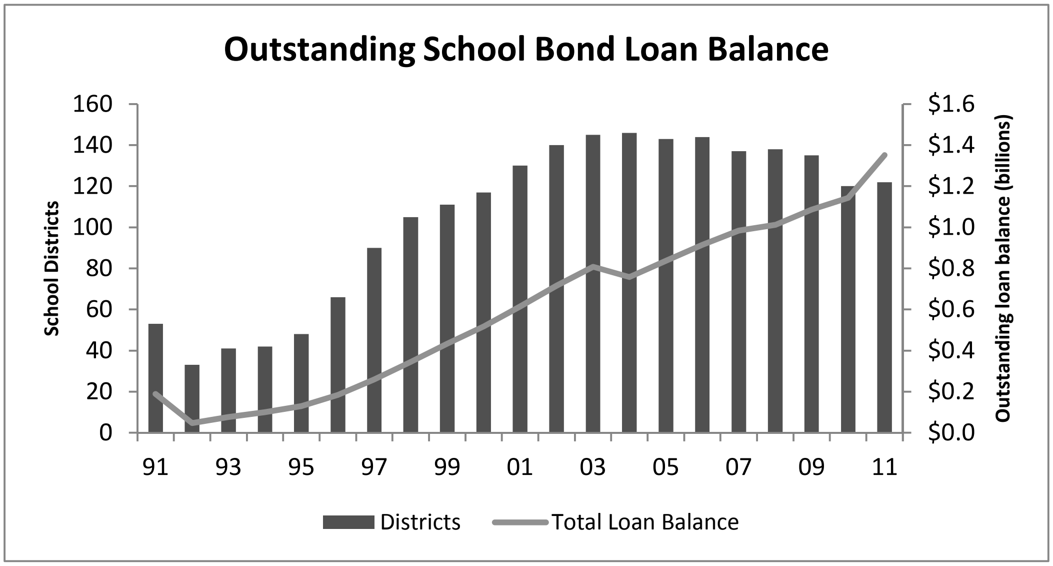
FISCAL IMPACT:

State Fiscal Impact:

Under the SBLP, the state must borrow (issue GO debt) to finance loans to districts, which carries corresponding administrative and debt service costs. The combination of the failure of the SLRF to become a self-sustaining revolving fund due to the dearth of district repayments and a higher demand for qualified loans due to the drop in property tax revenue has caused the state to issue more GO debt, thereby increasing its administrative and debt service costs.

According to the department, as of December 2011, 137 districts participated in the SBLP, including 122 districts with outstanding loan balances. At the end of 1991, 53 districts had a combined outstanding loan balance of $135.9 million ($82.9 million in principal and $53.0 million in interest). By 2011, that number grew to 122 districts with an outstanding loan balance of $1.3 billion ($968.2 million in principal and $261.6

million in interest). Since 2006, the loan balance has grown from $771.1 million to $1.3 billion.



Source: Department of Treasury, *School Bond Qualification and Loan Program 2011 Annual Report*

School Aid Fund (SAF) revenue is used to satisfy the state's steadily increasing GO debt service through an annual appropriation in the School Aid Budget, so any debt service savings estimated under the legislation would be realized by the SAF. The FY 2012-13 appropriation for debt service in the School Aid budget is $120.4 million, and the annual cost is anticipated to grow to as high as $224.6 million in FYs 2030-31 and 2031-32. The proposed package of legislation would make various changes to the SBLP and SLRF that would reduce the state's costs.

First, the legislation would impose a $1.8 billion soft cap on the total amount of outstanding qualified loans, including principal and interest. Once the cap was reached, if a district expected to borrow from the state in order to meet its debt service on a proposed new bond issue, the bond issue could not be pre-qualified (or qualified). By capping the amount of qualified loans outstanding, the state would realize a decrease in future debt service payments as compared to what is anticipated under current law. Under current projections, the $1.8 billion cap would be reached in the first quarter of FY 2014-15. Furthermore, it is projected that the outstanding loan balance would not fall below the $1.8 billion cap until FY 2042-43, thereby eliminating the ability of districts to qualify bonds if they anticipated a need for qualified loans. Districts already participating in the qualified loan program could continue to receive loans.

Second, a district would be required to pay off all qualified bonds and loans by a newly defined final mandatory repayment date. Proposed bond issues (including refunding bonds) and any new qualified loans also would have to be paid by the final mandatory repayment date. This provision would reduce future debt issuance by a district due to the requirement that it pay it off by the existing final mandatory repayment date. The ability to issue further debt or refund existing debt would diminish the closer it got to its final repayment date.

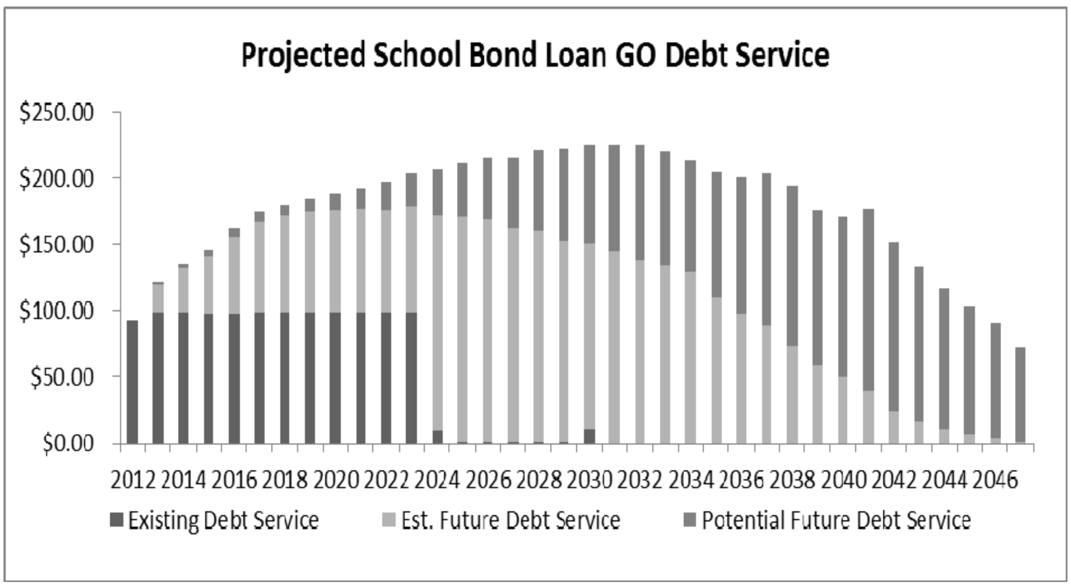
Taken together, the department anticipates that the cap and the new final mandatory repayment date could save the state approximately $2.2 billion over the next 35 years in debt service costs. The chart below shows the state's projected SBLP GO debt service:

- Existing Debt Service shows the known debt service costs, totaling $1.2 billion, based on the current bond obligations.

- Estimated Future Debt Service shows the debt service costs, totaling $2.9 billion, based on current projections of future qualified loans required for existing qualified bonds.

- Potential Future Debt Service shows the projected debt service requirements, totaling an additional $2.2 billion, for additional qualified loans on new qualified bonds issued in the future, if there were no changes in the program.

While these provisions would create significant savings, they would come in the form of future cost avoidance rather than reducing current state debt service costs. The annual savings (represented below in the Potential Future Debt Service) would be small initially, less than $2.0 million in FY 2012-13 and as high as $137.8 million in FY 2040-41.



Source: Department of Treasury (July 2012)

Third, a district would be required to recalculate its computed millage rate at least once annually to ensure the computed millage allowed for repayment of the qualified bonds and loans by the final mandatory repayment date. Annually adjusting the millage rate would reduce the annual loan amounts going out to districts (and thus reduce state debt service payments) because more of the district debt service would be paid through increasing local millages.

There is currently no estimate of the savings attributable to the requirement that a district recalculate its millage annually, but there would be additional savings to the state.

The legislation would lead to more certainty in loan repayments by districts, thereby allowing the SLRF to operate as a revolving fund where district loan repayments support loans to other districts on qualified bonds. Over time the need for the state to issue GO debt to make loans and thus incur debt service payments would be diminished.

Finally, initially the department would realize increased fee revenue under the provisions of the legislation to cover administrative costs in the prequalification, qualification and annual loan activity. However, once the cap was reached, the diminished bond and loan qualifications would reduce administrative costs and overall fee revenue.

Local Fiscal Impact:
The bill restricts access to qualified loans after the outstanding loan balance reaches $1.8 billion. The department projects that the balance will reach this limit in FY 2014-15 and not fall below that level until FY 2042-43. After that point, districts seeking to issue bonds would have to structure the project – in terms of overall cost of the project itself, the structure, timing, and terms of the bond proposal, and the necessary millage rates – so that districts could meet their debt service obligations without resorting to loans from the state. The scope of the project could be more limited, or the millage rates necessary to meet the debt service obligations could be higher than would otherwise be necessary given the lack of access to loans from the state. Today, about 25% of the school districts with qualified bonds participate in the loan program.

Additionally, the annual re-determination of the computed millage rate necessary for districts to meet the debt service requirements on its qualified bonds as well as any outstanding qualified loans, would increase district millage levies above current levels, depending on changes in taxable values, the issuance of any additional bonds for new infrastructure projects, and the issuance of any refunding bonds refinancing existing bonds. Similarly, the single final mandatory repayment date would also require higher millage rates (re-determined annually) if districts with outstanding qualified bonds and loans issue additional bonds and receive additional loans. Although districts issuing additional bonds and loans could have a later final mandatory repayment date if they agree to increase millage rates.

School districts could also see additional costs through the payment of new fees for the prequalification of bonds and annual loan activities, as well as revised fees for the qualification of bonds. Districts would also see additional administrative costs relative the annual re-determination of the computed millage rate and the record retention requirements.

Fiscal Analyst: Ben Gielczyk
Bethany Wicksall
Mark Wolf