

# IS NOW THE TIME FOR SCHOOL DISTRICTS TO GET THEIR FIX?

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In the mid 1990's many California school districts issued variable rate Certificates of Participation ("COPs"), utilizing weekly resets of interest rates ("Variable Rate Debt"). One of the purposes of this activity was to allow the financing of school facilities in advance of receiving State funding. When issuing the Variable Rate Debt, many school districts expected that when State funds were received those funds would be used to retire all or a portion of the outstanding Variable Rate Debt. However, in many cases the State funds, when received, were used to fund additional school facilities rather than retire the Variable Rate Debt.

There are a number of reasons why this change of plans occurred. First, for many school districts, student population projections reflecting increased building permit activity indicated the immediate need for additional school facilities. Rather than having to issue new debt for facilities later, many school districts opted to utilize the State funds received in order to build facilities immediately. In addition to the projected immediate need for school facilities, variable interest rates were at then historic lows within a relatively stable bond market. For school districts, these circumstances translated into a lower debt service on the Variable Rate Debt and a comfort level that the costs would remain low while providing the ability to provide facilities needed by a growing population.

Beginning in 2006, the housing market began to slow down and by 2008 building activity had virtually come to a halt. For many school districts the actual student population growth did not equal the projections. Additionally, even though the credit markets remained liquid, there were signs that trouble was looming. Banking institutions started reevaluating balance sheet exposure and lending criteria became increasingly more stringent. The federal government began to intervene to help some of the largest financial institutions in the country remain solvent.

On September 15, 2009, Lehman Brothers declared bankruptcy and credit markets > virtually shut down. Combined with other distressed economic news and events, > the Lehman bankruptcy sent shockwaves throughout credit and debt markets. For all intent and purposes, the credit markets were frozen and lending significantly curtailed. Many investors who had historically bought weekly reset school district Variable Rate Debt backed away from that market. Virtually overnight, some of these investors, in a flight to quality, shifted their money from Variable Rate Debt to U.S. Treasuries. This sudden turn caused Variable Rate Debt resets to spike, debt service to increase and the comfort of low costs in a stable market to evaporate. In spite of the fact of reduced news of economic catastrophe, federal bailouts and fewer headlines of financial institutions failing, over the last 14 months interest rates have remained quite unpredictable. The weekly reset interest rates on a sample of school district Variable Rate Debt have been as low as 0.48% and as high as 12.00%. While liquidity in the markets have improved and reset rates greatly moderated off the spike, investors remain wary and the illusion of a stable market has been unmasked.

Finally, when variable rate debt is issued, a liquidity provider is required. The role of the liquidity provider is to provide funds to purchase the variable rate debt when investors are not available. This is essential to COP holders because they know that if there is no investor willing to purchase the Variable Rate Debt, the liquidity provider will. In the past, there were many banks with good credit ratings that investors trusted to provide the liquidity. However, most of these banks have been downgraded and investors are less sure that these institutions will be able to provide liquidity to variable rate securities. Many of the institutions that would have provided the credit support for Variable Rate Debt have left the business. In many cases school districts are getting notification that their current liquidity provider no longer will provide credit support for Variable Rate Debt.

We think there is a window of opportunity to refund at low fixed rates. When the economy improves, we expect that municipal rates will also increase. If you would like to discuss this in more detail please call Adam Bauer at (949) 660-7303. ♦

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