



## Pennsylvania Association of School Business Officials

Mailing Address:  
P.O. Box 6993  
Harrisburg, PA 17112-0993

Office Location:  
2608 Market Place  
Harrisburg, PA 17110

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Telephone 717-540-9551

[www.pasbo.org](http://www.pasbo.org)

FAX 717-540-1796

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### Comments of the PA Association of School Business Officials on the Auditor General's Special Investigation of the Bethlehem Area School District December 1, 2009

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We have reviewed the report of the Office of the Auditor General following its special investigation of the Bethlehem Area School District (BASD), including the consequences of terminating Qualified Interest Rate Management Agreements (swaps). The PA Association of School Business Officials (PASBO) concurs with many of the Auditor General's concerns regarding the potential risks associated with these very complex financial transactions. We also concur with the report's warnings of the consequences of inadequate discussion and disclosure of risk and excessive reliance on advisors compensated by these products. We also agree with the need for more thorough and understandable disclosure of the associated fees.

The availability of swaps as an interest rate "hedge" has resulted in the increased use of variable rate indebtedness and its associated risks. These risks, such as the lack of bank liquidity required to support variable rate bonds, and the risk of credit rating downgrades, were minimal in the past. Only after the recent financial meltdown have these risks become acute. Extraordinary financial circumstances have forced the early termination of otherwise normally functioning swap transactions. In the current low interest rate environment, these terminations have proven very costly, which was the case with BASD. These termination costs have been successfully avoided in many cases, including some of the swaps held by BASD.

Swaps, associated with fixed rate debt have been used, in many cases, quite successfully as a method of hedging against falling investment earnings. We are aware of several cases where swaps have mitigated plummeting school general fund interest revenues.

Certainly swaps are not appropriate for many school districts and financings. Despite these concerns, and the potential for losses by school districts entering into swaps, we believe the report's recommendations are overly severe and should be reconsidered. A single district's experience (and in fact only two swap transactions by the district were analyzed) as a "case study" for the entire Commonwealth should not be the basis of a sweeping prohibition on these types of financial transactions.

Act 23 of 2003, which amended the Local Government Unit Debt Act, expressly provided swaps as a debt financing mechanism for school districts and municipal governments. It was unanimously passed in both chambers after two sets of amendments were adopted. The legislation (House Bill 1148) was also the subject of a public hearing at which PASBO testified. PASBO endorsed the use of swaps as a financing mechanism that could result in savings on debt required for school construction and capital purchases. We acknowledged that all debt management decisions are "extremely detailed and require knowledgeable public officials" to be effective and efficient stewards of public funds.

We also believe that local decision-makers should be given options for reducing taxpayer burden. Swaps do provide an option but with a different level of risk as the Auditor General's report indicates. However, there are inherent risks in all debt instruments.

School boards and the district's financial team, including superintendents, business administrators, retained financial advisors and bond counsel, make decisions on debt instruments that must consider risk and the potential to reduce costs to taxpayers. A variety of financial tools provides the opportunity for reducing project cost and having a balanced debt portfolio. We encourage members to look at all debt management tools including swaps and to make appropriate decisions after a thorough and exhaustive analysis that evaluates risk.

As the report indicates, since 2003 more than 20% of the school districts in the Commonwealth have elected to use swaps as part of their financing strategies. We believe an examination of additional school district swap transactions would illustrate financial benefits to school districts and their taxpayers. With the correct application of the safeguards contemplated by Act 23, swaps can be a reasonable tool. Swaps have been used for many years in the private sector and are currently used by Commonwealth agencies as well.

In addition to proposing the elimination of the authorizing legislation, the Auditor General's report calls for terminating all existing swaps. Terminating an existing swap unnecessarily in an unfavorable interest rate environment could be a poor and costly financial decision. Early termination, much like the sale of many investments prior to maturity, could result in penalties as well as losses. Sweeping termination of all swaps at this time could cost hundreds of millions of dollars of taxpayer funds.

We have seen financial markets react in unanticipated and unforeseen ways in the past 12 months. As the Auditor General's report states, "the history of these transactions was uneventful until the September 2008 banking crisis and stock market crash, when market conditions favorable to the District ended and turned unfavorable." So absent the drastic upheaval, the swap transactions at BASD could have continued to benefit BASD and its taxpayers.

Clearly the transactions identified in the report entered into by BASD, resulted in significant and unfortunate costs to the district. However, the experience of one entity cannot reasonably be the basis for the repeal of a seven year old law and the termination of hundreds of financial transactions. We are prepared to work with the Auditor General, the General Assembly and other Commonwealth agencies to adopt amendments, regulations or policies to improve the law and enhance the existing safeguards. We are also prepared to assure that our members are fully aware of the risks and benefits of swaps.

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PASBO is a statewide professional association with more than 2,000 active members who are K-12 school employees below the rank of superintendent. PASBO members support classroom learning and student achievement by providing many services required in the day-to-day operations of schools including: finance, accounting, purchasing, facility management, transportation, technology, food service, human resources, safety and communication. For additional information go to: [www.pasbo.org](http://www.pasbo.org)