# COMMONWEALTH OF PENNSYLVANIA

**A SPECIAL INVESTIGATION OF THE BETHLEHEM AREA SCHOOL DISTRICT, LEHIGH/NORTHAMPTON COUNTIES**

***A Case Study of***
***The Use of Qualified Interest Rate Management Agreements ("Swaps")***
***By Local Government Units in Pennsylvania,***
***With Recommendations***

**November 2009**

## JACK WAGNER, AUDITOR GENERAL

PENNSYLVANIA DEPARTMENT OF THE AUDITOR GENERAL

November 18, 2009

Loretta M. Leeson
President, Board of School Directors
BETHLEHEM AREA SCHOOL DISTRICT
1516 Sycamore Street
Bethlehem, Pennsylvania 18017-6099

Dear Ms. Leeson:

The Department of the Auditor General ("Department") has conducted a special investigation of the experience of the Bethlehem Area School District ("District") with Qualified Interest Rate Management Agreements ("QIRMAs"). QIRMAs are "swaps" and other types of derivatives that are purportedly designed to manage interest rate risk or interest cost in connection with the issuance of debt. From April 29, 2003 to June 27, 2006, the District entered into 13 different QIRMAs, the most of any school district in the Commonwealth of Pennsylvania. The District's 13 QIRMAs related to $272.9 million in debt.

Our investigation found that the District's use of two QIRMAs associated with its variable-rate "General Obligation Note, Series 2003 - West Cornwall Township Municipal Authority" ("2003 WCTMA Note") cost District taxpayers $10.2 million more than if the District had issued a standard fixed-rate bond or note, and $15.5 million more than if the District had simply paid the interest on the variable-rate note without any QIRMAs at all. The District's losses were largely due to excessive fees and other charges, especially a $12.3 million payment that the District had to pay to the investment bank counterparty to terminate one of the agreements.

The 2003 WCTMA Note was the only one of the District's outstanding debt instruments as to which the ultimate cost to the District could be quantified. Because the District has other QIRMAs still in effect in connection with its other outstanding debt, the ultimate financial impact of the District's use of QIRMAs remains to be determined.

The District appears to have complied with the applicable provisions of LGUDA as amended by Act 23 of 2003. However, we are concerned less by the District's compliance with state law with regard to entering into the QIRMAs at issue than by the propriety of governmental entities risking public funds via QIRMAs in the first place.

It is important to recognize that the Bethlehem Area School District is not alone in its use of QIRMAs. Of the 500 school districts in the Commonwealth, 107 districts entered into at least one QIRMA during the period between October 2003 and June 2009. During the same period, 86 other local government units ("LGUs") entered into at least one QIRMA. According to data from the Pennsylvania Department of Community and Economic Development, there were 626 QIRMA filings made in Pennsylvania between October 2003 and June 2009, which related to $14.9 billion in debt. Therefore, while our investigation focused on the District's experience with QIRMAs, this report is equally applicable to all other school districts and LGUs across the Commonwealth that may have used such instruments.

We have concluded that QIRMAs are highly risky and impenetrably complex transactions that, quite simply, amount to gambling with public money. Moreover, they are susceptible of being marketed deceptively, and they principally benefit the investment banks and the multitude of intermediaries who sell them to relatively unsophisticated public officials. Accordingly, we make the following recommendations:

- The use of QIRMAs and other derivatives by LGUs and municipal authorities should be prohibited by law;
- No LGU or municipal authority in this Commonwealth should enter into or utilize such instruments from this day forward;
- Any LGU or municipal authority in this Commonwealth that is a party to an active QIRMA should immediately terminate it and refinance with conventional debt instruments if necessary; and
- LGUs and municipal authorities should hire their financial advisors through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

The Department will follow up at the appropriate time to determine the status of action on our recommendations.

We are providing copies of this report to various governmental and independent entities that may have an interest in this matter for their review and whatever further action they may deem appropriate. In particular, we encourage the various law enforcement agencies that will receive this report to investigate and prosecute any conflicts of interest that were involved in these transactions. We also encourage them to pursue all available avenues to recover funds for the taxpayers of the District and other LGUs resulting from any and all breaches of fiduciary duty, including equitable relief from existing QIRMA obligations foisted on the LGUs by financial entities and advisors.

We commend the District for its cooperation with this investigation and its positive response to the report. The District's response is included after the appendices, followed by the Department's comments on the response.

This is a public report and its distribution is not limited. Additional copies may be obtained from the Department's website, *www.auditorgen.state.pa.us*.

Sincerely,

**/S/**

**JACK WAGNER**
Auditor General

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# EXECUTIVE SUMMARY

The Department of the Auditor General ("Department") has conducted a special investigation of the use of Qualified Interest Rate Management Agreements ("QIRMAs") by the Bethlehem Area School District ("District"), Lehigh/Northampton Counties, Pennsylvania. QIRMAs are "swaps" and other types of derivatives that are purportedly designed to manage interest rate risk or interest cost in connection with the issuance of debt. From April 29, 2003 to June 27, 2006, the District entered into 13 different QIRMAs, the most of any school district in the Commonwealth of Pennsylvania. The District's 13 QIRMAs related to $272.9 million in debt.

It is important to recognize that the Bethlehem Area School District is not alone in its use of QIRMAs. Of the 500 school districts in the Commonwealth, 107 districts entered into at least one QIRMA during the period between October 2003 and June 2009. During the same period, 86 other local government units ("LGUs") entered into at least one QIRMA. According to data from the Pennsylvania Department of Community and Economic Development, there were 626 QIRMA filings made in Pennsylvania between October 2003 and June 2009, which related to $14.9 billion in debt. Therefore, while our investigation focused on the District's experience with QIRMAs, this report is equally applicable to all other school districts and LGUs across the Commonwealth that may have used such instruments.

**We found the following with regard to the District's use of QIRMAs:**

- The District's use of two QIRMAs associated with its variable-rate "General Obligation Note, Series 2003 - West Cornwall Township Municipal Authority"[1] ("2003 WCTMA Note") cost District taxpayers $10.2 million more than if the District had issued a standard fixed-rate bond or note, and $15.5 million more than if the District had simply paid the interest on the variable-rate note without any QIRMAs at all. The District's losses were largely due to excessive fees and other charges, especially a $12.3 million payment that the District had to pay to the investment bank counterparty to terminate one of the agreements.

We were able to perform our analysis only on the 2003 WCTMA Note because it was the only one of the District's outstanding debt instruments as to which the ultimate cost to the District could be quantified. Because the District has other QIRMAs still in effect in connection with its other outstanding debt, the ultimate financial impact of the District's use of QIRMAs remains to be determined. Depending on future market fluctuations and other risk factors – which are inherently unpredictable -- and the District's reaction to them, the District's active QIRMAs may or may not prove to be financially beneficial to the District. However, the District would need to realize gains of greater than $10.2 million over the terms of all its outstanding

[1] This swap agreement was entered into at a time prior to the enactment of Act 23 of 2003, when the authority for school districts to directly enter into such agreements was unclear. Accordingly, the transaction was routed through the West Cornwall Township Municipal Authority as a conduit.

QIRMAs in order to offset the losses it has experienced in connection with the two QIRMAs associated with the 2003 WCTMA Note.

**The District appears to have complied with the applicable provisions of LGUDA as amended by Act 23 of 2003. However, we are concerned less by the District's compliance with state law with regard to entering into the QIRMAs at issue than by the propriety of governmental entities risking public funds via QIRMAs in the first place.**

QIRMAs are extremely risky financial instruments and require diligent oversight by the LGU issuer. Our investigation revealed a variety of deceptive marketing tactics that can be employed by investment banks, intermediaries, and advisors to sell these highly complex financing deals to relatively unsophisticated public officials:

- Fees that were characterized as being paid by the investment banks were actually ultimately charged to the District;
- The agreements resulted in huge hidden profits for the investment banks that were not required to be, and have not been, disclosed to the District;
- The intermediaries involved in the deals had apparent conflicts of interests as a result of representing the interests of counterparties as well as the District; and
- At least two of the transactions were structured to provide the District with substantial up-front cash payments at the inception of the agreements as an additional inducement, totaling $5.8 million, while failing to disclose to the District that the investment bank was making a huge and immediate profit on the deal that was far in excess of the cash paid to the District.

Furthermore, our review of the state Local Government Unit Debt Act ("LGUDA"), as amended by Act 23 of 2003, which expressly authorized QIRMAs for school districts and other LGUs, reveals a statute written primarily for the benefit and protection of the financial services industry, not the government issuers or the taxpayers. We have reviewed a number of state reform proposals, which, while well-intentioned, are not likely to prevent negative experiences such as occurred at the District from occurring in the future. Most important, none of the reform proposals changes the basic nature of the transactions, which are essentially a form of gambling with public money.

**Therefore, we recommend the following:**

- The General Assembly should immediately repeal Act 23 of 2003;
- The General Assembly should immediately amend LGUDA, the Public School Code of 1949, the various municipal codes, and any other statutes that govern the investments and contracts that LGUs and municipal authorities are authorized to enter into in order to clearly and unequivocally prohibit school districts, other LGUs, and authorities from utilizing QIRMAs or any of the specific devices and techniques encompassed therein currently in existence or yet to be invented in connection with the issuance of public debt;

- Regardless of whether the General Assembly acts upon our recommendations, no LGU or municipal authority in this Commonwealth should enter into or utilize such instruments from this day forward;
- Any LGU or municipal authority in this Commonwealth that is a party to an active QIRMA should immediately terminate it and refinance with conventional debt instruments if necessary; and
- LGUs and municipal authorities should hire their financial advisors through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

**We are also providing copies of this report to the following governmental and independent entities that may have an interest in this matter for their review and whatever further action they may deem appropriate:**

- Pennsylvania Department of Community and Economic Development;
- Pennsylvania Department of Education;
- Pennsylvania Treasury Department;
- Pennsylvania Office of Attorney General;
- Pennsylvania Securities Commission;
- Pennsylvania State Ethics Commission;
- U.S. Department of Justice, Antitrust Division;
- U.S. Department of the Treasury, Office of Domestic Finance;
- U.S. Securities and Exchange Commission;
- U.S. Commodities Futures Trading Commission;
- Federal Bureau of Investigation;
- Federal Reserve Bank of New York;
- Congressional Oversight Panel;
- State and federal legislative committees;
- Municipal Securities Rulemaking Board; and
- Government Finance Officers Association.

In particular, we encourage the various law enforcement agencies who will receive this report to investigate and prosecute any conflicts of interest that were involved in these transactions. We also encourage them to pursue all available avenues to recover funds for the taxpayers of the District and other LGUs resulting from any and all breaches of fiduciary duty, including equitable relief from existing QIRMA obligations foisted on the LGUs by financial entities and advisors.

This is a public report and its distribution is not limited. The District's response to the report is included after the appendices, followed by the Department of the Auditor General's comments on the response. The Department will follow up at the appropriate time to determine the status of action on our recommendations.

***Note*: Appendix D includes a glossary of terms used throughout this report.**

# INTRODUCTION AND BACKGROUND

The Office of Special Investigations ("OSI") of the Department of the Auditor General ("Department") conducted this special investigation into the use of Qualified Interest Rate Management Agreements ("QIRMAs"), commonly referred to as "swaps" or "derivatives," by the Bethlehem Area School District ("District"), Lehigh/Northampton Counties, Pennsylvania. Of the 500 school districts in the Commonwealth, 107 districts entered into at least one QIRMA during the period between October 2003 and June 2009.[2] During the same period, 86 other LGUs entered into at least one QIRMA.[3] According to data from the Pennsylvania Department of Community and Economic Development ("DCED"), there were 626 QIRMA filings made in Pennsylvania between October 2003 and June 2009, which related to $14.9 billion in debt.[4] Because QIRMAs potentially affect all school districts and other types of local government units ("LGUs") in the Commonwealth, this report will consider and address the impact of QIRMAs not only on the District, but also on a broader scale.

This investigation was conducted at the request of State Sen. Lisa M. Boscola, who sought a determination by the Department of whether the transactions entered into by the District complied with applicable law. Sen. Boscola's request referenced a series of investigative reports by *The Morning Call* of Allentown, Pennsylvania, about the District's use of QIRMAs.[5] We commend both Sen. Boscola and the *Morning Call* for their interest in this important issue.

The period under review by OSI was January 1, 2003 to date, unless otherwise noted. Our objectives included the following:

- Identifying the District's overall debt structure and composition for the period January 1, 2003 to date, specifically regarding the use of QIRMAs associated with bonds or notes issued by the District. We focused on the fees and costs associated with the QIRMAs, as well as the various risks associated with QIRMAs and whether the use of QIRMAs by the District has had a positive or negative impact on the District's debt service payments;

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[2] *See* Appendix A of this report for the complete list of school districts that entered into QIRMAs between October 2003 and June 2009. Note that the effective date of Act 23 of 2003, which provided express authority to LGUs to enter into QIRMAs, was September 24, 2003.

[3] *See* Appendix B of this report for the complete list of non-school district LGUs that entered into QIRMAs between October 2003 and June 2009.

[4] DCED's data may include double-counting. The precise number of QIRMAs cannot be determined because filings may include amendments or terminations of previously filed QIRMAs; the precise amount of debt cannot be determined because more than one QIRMA may be used in connection with the same bond or note. DCED's figure of $14.9 billion in debt consists of $10.3 billion by school districts and $4.6 billion by other LGUs.

[5] *See generally www.mcall.com/swaps*. Our investigation did not attempt to duplicate the newspaper's extensive reporting and analysis. Instead, we focused on the District's compliance with state law with regard to entering into the QIRMAs at issue and the propriety of governmental entities risking public funds via QIRMAs in the first place.

- Identifying applicable laws that provided the District with the ability to enter into QIRMAs and reviewing the District's records to determine whether the District, counterparties, and intermediaries complied with such laws;
- Identifying and evaluating proposed legislation that should be considered in order to protect public funds expended by LGUs; and
- Identifying all school districts and other LGUs in the Commonwealth that have entered into QIRMAs.

The field work for this investigation commenced in June 2009 and concluded in August 2009. OSI interviewed the following individuals:

- Dr. Joseph A. Lewis ("Lewis"), the District's Superintendent,[6]
- Stanley J. Majewski, Jr. ("Majewski"), the Assistant to the Superintendent for Finance and Administration,[7]
- Scott Shearer and Andrew McKendrick of Public Financial Management, Inc. ("PFM"), the District's current financial advisor,[8]
- Jens H. Damgaard, Esquire, of the law firm Rhoads & Sinon, LLP, the District's bond counsel,[9]
- William H. Gorman, Jr., CPA, of Gorman & Associates, P.C., the District's independent auditor,[10]
- all available past and present members of the District's Board of School Directors ("Board"), and
- staff of DCED's Office of Chief Counsel.

**The District's former financial advisor, Leslie L. Bear ("Bear") refused to be interviewed.[11] Mr. Bear acted upon the advice of his attorney, who told OSI that he was concerned that any statements made to OSI might be taken out of context by the U.S. Securities and Exchange Commission ("SEC") in an investigation. As discussed at the end of this report, we are sending copies of this report to the SEC and others for their review and whatever further action they deem appropriate.**

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[6] Dr. Joseph A. Lewis, who served as the District's superintendent during the time period under review and during the investigation itself, has retired from the District, effective January 2, 2010. Due to accumulated vacation and sick leave, his last day on the job was September 25, 2009. Unless otherwise noted, references to the "Superintendent" throughout this report refer to Dr. Lewis.

[7] Stanley Majewski, Jr., who served as the Assistant to the Superintendent for Finance and Administration during the time period under review and during the investigation itself, has resigned from the District, effective February 8, 2010. The Board accepted his resignation on September 8, 2009 without comment.

[8] In November 2008, the District ended its relationship with its former financial advisor, Leslie Bear (*see* footnote 11 and accompanying text), and retained Public Financial Management, Inc. of Philadelphia. Shearer, a Senior Managing Consultant in PFM's Pennsylvania Municipal Group, works out of PFM's Harrisburg office.

[9] The law firm is based in Harrisburg. Damgaard is a member of the firm's Municipal Finance Practice Group.

[10] The accounting firm is based in Northampton, Pennsylvania.

[11] Bear was employed by Arthurs, LeStrange & Co., Inc. of Pittsburgh, and then by Ferris, Baker, Watts, Inc. of Baltimore, Maryland, during the period 2003 through March 2008. In March 2008, Ferris, Baker, Watts was acquired by the Royal Bank of Canada of Montreal, Quebec, Canada, and was renamed RBC Wealth Management. As of the date of this report, Bear is employed by Robert W. Baird & Co., Inc. of Milwaukee, Wisconsin. In all of these positions, Bear has worked out of offices in Exton, Pennsylvania.

Additionally, we reviewed various sets of documents and records received from the District and its current financial advisor related to the District's debt financing structure. These documents included confirmation sheets for each QIRMA entered into by the District, bond and note financing entered into by the District, and payment documents relating to principal, interest, "swap interest" paid or received, fees, and costs associated with debt financing and QIRMAs.

## Applicable Law

The widespread use of swaps and other derivatives to hedge against interest rate risk was facilitated by an amendment to the governing federal law known as the Commodity Futures Modernization Act of 2000 ("CFMA").[12] The most significant features of CFMA were (1) to expressly make such transactions (and other over-the-counter derivatives markets) not subject to regulation under the federal Commodity Exchange Act ("CEA"),[13] and (2) to declare that federal law would henceforth "preempt the field" of the regulation of the use of such derivatives. The practical effect of CFMA was to nullify all state laws prohibiting gambling ("bucket shop" laws)[14] to the extent that such laws might apply to such derivatives. This federal preemption prevents state prosecutors from applying state anti-gambling laws to these types of derivatives, which are nothing more than side bets on how interest rates will fluctuate in the future.[15]

Although the federal CFMA removed legal impediments to the use of such derivatives generally, Pennsylvania law contained no express authorization for school districts and other LGUs to use them. This ambiguity was eliminated by an amendment to the state Local

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[12] Act of December 21, 2000, Pub.L. 106-554, § 1(a), 114 Stat. 2763, 2763-A, as amended, 7 U.S.C. § 5 *et seq.* ("Commodity Futures Modernization Act of 2000").

[13] Act of September 21, 1922, c. 369, 42 Stat. 998, as amended, 7 U.S.C. § 1 *et seq.* ("Commodity Exchange Act").

[14] Prior to the Panic of 1907, securities markets were largely unregulated, and it was quite common for speculators to place bets on future fluctuations in the price of a particular stock without actually having any ownership interest in the stock. These bets were placed in gambling parlors known as "bucket shops," which were bookmaking operations having no affiliation with the stock exchanges, brokerage houses, or the actual markets for the trading of such securities. Because the "bucket shops" were deemed to have been a major cause of the Panic of 1907, one of the first initiatives to bring securities transactions under government regulation was the enactment by several states of "bucket shop" laws prohibiting such transactions as illegal gambling. The practical effect of CFMA was to wipe out these early efforts to bring state regulatory oversight to securities markets and also to prevent federal regulatory oversight under the CEA, creating what has been aptly called a "regulatory black hole" in which transactions in these derivatives were permitted to flourish. One such unregulated market, involving credit default swaps, has been identified as one of the principal causes of the recent collapse of the global banking system. "The Bet that Blew Up Wall Street," Steve Kroft on Credit Default Swaps and their Central Role in the Unfolding Economic Crisis," *60 Minutes,* Aug. 30, 2009.

[15] While the federal preemption does not prevent state insurance commissioners from regulating the varieties of these derivatives that function as insurance, few states have attempted to do so. One reason that such transactions have escaped state insurance regulation is the nomenclature used to describe them. Although the use of the term "insurance" is assiduously avoided, some swaps have all of the essential attributes of insurance. For example, so-called "naked swaps," in which speculators who have no ownership interest in the property that underlies the swap are betting that the property will decline in value, are apparently prohibited by state insurance laws because such speculators have no insurable interest in the property. Prof. Michael Greenberger, University of Maryland Law School, "Memorandum on Regulatory Reform of Credit Default Swaps," Jan. 24, 2009, appended to his testimony on Feb. 3, 2009, before the U.S. House of Representatives' Committee on Agriculture regarding the Discussion Draft of The Derivatives Market Transparency and Accountability Act of 2009.

Government Unit Debt Act ("LGUDA") that was written and lobbied for by the financial services industry[16] and passed by the General Assembly in 2003.

**Local Government Unit Debt Act, as amended by Act 23 of 2003**

The express authority to enter into QIRMAs is conferred by the Local Government Unit Debt Act, as amended by Act 23 of 2003.[17] The general purpose of LGUDA is expressed in the first section of the original act as follows: "A local government unit may borrow money on bonds or notes, including tax anticipation notes, only as provided in this [act]. This [act] provides an exclusive and uniform system on the subjects covered by this [act]."[18]

Other pertinent provisions of LGUDA, as amended, are as follows:

- LGUDA applies to all "local government units."[19] The act defines "local government unit" as: "A county, county institution district, city, borough, incorporated town, township, *school district* or any similar, general or limited purpose unit of local government or any unit created by joint action of two or more local government units which is authorized to be created by law."[20]

- With limited exceptions, LGUDA defines "debt" as "[t]he amount of all obligations for the payment of money incurred by the local government unit…."[21]

- Debt is further classified as "electoral debt" (debt that is incurred with the assent of the voters), and "non-electoral debt" (generally, all other debt authorized to be incurred by LGUDA).[22]

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[16] Martin Z. Braun and William Selway, "Hidden Swap Fees by JPMorgan, Morgan Stanley Hit School Boards," *Bloomberg.com,* February 1, 2008, in which a public finance lobbyist is identified as the initial lobbyist for the legislation, and representatives of a derivative advisory firm are identified as having testified in support of the legislation at a hearing in Harrisburg on October 16, 2002. *See also* Genevieve Marshall, "Bethlehem Area closes deal to borrow $110 million at locked rate," *The* (Allentown) *Morning Call,* Dec. 9, 2003, in which an investment advisor from Media, Delaware County, reportedly claimed that he had helped write the bill that became Act 23 of 2003.

[17] Act of December 19, 1996, P.L. 158, No. 177, as amended, 53 Pa.C.S. § 8001 *et seq.,* ("Local Government Unit Debt Act"), which is referred to in this report as "LGUDA." LGUDA was amended by the Act of September 24, 2003, P.L. 110, No. 23 ("Act 23 of 2003" or "Act 23") to include provisions authorizing LGUs to use QIRMAs in connection with the issuance of bonds and notes. Act 23 was introduced on April 11, 2003 as House Bill 1148, sponsored by Rep. Stephen Nickol (R-Adams/York) and 25 other co-sponsors from both parties. It was a bill written by and lobbied for by lobbyists for the financial services industry (*see* footnote 16). It passed the House of Representatives by a vote of 197-0 on June 26, 2003, and the Senate by a vote of 45-0 on September 9, 2003, with no discussion on the floor of either chamber. When two members of the Senate Local Government Committee, one from each party, asked for additional time to review the legislation due to the complex nature of the issue, their request was denied. House Bill 1148 was signed into law by Governor Rendell on September 24, 2003.

[18] 53 Pa.C.S. § 8001(d).

[19] *Id*. § 8001(b).

[20] 53 Pa.C.S. § 8002(c) (emphasis added).

[21] *Id*. § 8002(a).

[22] *Id*.

- Act 23 added to LGUDA the concept of an "independent financial advisor," which is defined as "[a] person or entity experienced in the financial aspects and risks of interest rate management agreements who is retained by [an LGU] to advise the [LGU] with respect to a [QIRMA]. The independent financial advisor may not be the other party or an affiliate or agent of the other party on a [QIRMA] with respect to which the independent financial advisor is advising [an LGU]."

- Act 23 also added to LGUDA the concept of a "qualified interest rate management agreement" (QIRMA), which is defined as "[a]n agreement . . . entered into by [an LGU], which agreement in the judgment of the [LGU] is designed to manage interest rate risk or interest cost of the [LGU] on any debt [an LGU] is authorized to incur, including, but not limited to, swaps, interest rate caps, collars, corridors, ceiling and floor agreements, forward agreements, float agreements, and other similar arrangements which, in the judgment of the [LGU], will assist the [LGU] in managing the interest rate risk or interest cost of the [LGU]."[23]

- Act 23 also added to LGUDA the concept of an "interest rate management plan," which is defined as "[a] written plan prepared or reviewed by an independent financial advisor with respect to a [QIRMA]," and which must include following elements:

    - A schedule listing the amount of debt outstanding for each outstanding debt issue of the LGU and the expected annual debt service on that debt;

    - A schedule listing the notional amounts[24] outstanding of each previous QIRMA which is then in effect;

    - A schedule listing all consulting, advisory, brokerage or similar fees, paid or payable by the LGU in connection with the QIRMA, and a schedule of any finder's fees, consulting fees, or brokerage fees paid or payable by the other party in connection with the QIRMA;

    - A schedule listing the estimated and maximum periodic scheduled payments to be paid by the LGU, and to be received by the LGU from the other party, in each year during the term of the QIRMA;

    - With respect to interest rate risk, basis risk, termination risk, credit risk, market access risk, and other risks of entering into QIRMAs, Act 23 requires the following:

        - An analysis of all such risks with respect to entering into each QIRMA;

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[23] *Id*. § 8002(c).

[24] In the context of an interest rate swap, the "notional amount" is the specified amount on which the exchanged interest payments are based. Each period's rates are multiplied by the notional principal amount to determine how much each "counterparty" (i.e., a party to a swap agreement) must pay to the other counterparty. In a swap, no principal ever actually changes hands between the counterparties.

    - An analysis of all such risks to the LGU of the net payments due for all debt outstanding and all QIRMAs of the LGU; and

    - The LGU's plan to monitor all such risks.[25]

- Act 23 also added termination payments on QIRMAs to the definition of "unfunded debt."[26]

- Any LGU, except those declared "distressed" by DCED, "may negotiate and enter into QIRMAs." Each QIRMA must be authorized and awarded by resolution.[27] The resolution must include a copy of the QIRMA and the interest rate management plan adopted by the LGU.[28] The resolution must be advertised prior to and after enactment.[29] The LGU may purchase insurance to cover the payments required by the QIRMA.[30]

- The LGU must establish a process for selecting and establishing qualifications for counterparties prior to entering into the QIRMA. The QIRMA must be awarded by public sale, private sale by negotiation, or private sale by invitation. The LGU must select the QIRMA that is in its best financial interest as verified by an independent financial advisor.[31]

- A QIRMA must contain the following provisions:

    - The covenant of the LGU to make payments, the notional amount, and the term.

    - The QIRMA is terminated when all debt to which the QIRMA relates is no longer outstanding;

    - The maximum annual interest rate that the LGU may have to pay;

    - The maximum net payments of an LGU must not exceed the maximum interest rate specified in the QIRMA;

    - The source of the payment obligations of the LGU;

    - A provision addressing a change in the credit rating of a counterparty; and

[25] *Id*. § 8002(c).
[26] 53 Pa.C.S. § 8129.
[27] 53 Pa.C.S. § 8281(a)(2).
[28] *Id*. § 8281(b).
[29] 53 Pa.C.S. § 8003(a), (b).
[30] 53 Pa.C.S. § 8281(a)(3).
[31] *Id*. § 8281(e).

- A provision that the payment of principal and interest on the indebtedness and the payments relating to the QIRMA are "senior in right and priority" to termination payments.[32]

- The LGU must include the scheduled amounts payable for each QIRMA in its budget and appropriate the funds from its general or specifically pledged revenues. The LGU may pledge its taxing authority for the amounts due under the QIRMA. The LGU may pledge a security interest for its payment obligations under the agreement.[33]

- The investment bank counterparty may seek remedies in a court of common pleas for failure by an LGU to budget or pay scheduled amounts. In the case of a school district, the counterparty must provide notice of such failure to the Secretary of the Pennsylvania Department of Education ("PDE"), who is then required to notify DCED. If the Secretary of Education finds that the amounts are due and payable, he/she is required to withhold state appropriations from the school district to pay the scheduled amounts.[34]

- The LGU must file certified copies of the resolution authorizing the QIRMA with DCED within 15 days of adopting the resolution. DCED must maintain copies of a QIRMA while it is in effect.[35]

- An LGU that has entered into a QIRMA must include the QIRMA in its annual financial statements in accordance with rules set by the Governmental Accounting Standards Board.[36]

**QIRMAs – What are they and how do they work?**

Interest rate swaps are one of many different types of "derivatives," which are financial instruments or contracts whose value is based on (i.e., "derived" from) other securities or indexes. An interest rate swap is a contractual agreement between a bond issuer (in the case of this report, the District) and an investment bank[37] in which one set of cash flows is exchanged ("swapped") for another set during an agreed-upon term. An LGU is authorized by state law to use interest rate swaps, and a variety of other interest rate-related derivatives,[38] only under the terms and conditions set forth in LGUDA as amended by Act 23 of 2003, which requires the

[32] *Id*. § 8281(c).

[33] 53 Pa.C.S. § 8282.

[34] 53 Pa.C.S. § 8283.

[35] 53 Pa.C.S. § 8284.

[36] 53 Pa.C.S. § 8285.

[37] The bond issuer and the investment bank are referred to generally as the "counterparties" to the agreement. The District used only two counterparties for QIRMAs, the investment banks J.P. Morgan and Morgan Stanley & Co., both of New York.

[38] *See* 53 Pa.C.S. § 8002(c) (defining QIRMA as "including, but not limited to, swaps, interest rate caps, including collars, corridors, ceiling and floor agreements, forward agreements, float agreements and other similar arrangements which, in the judgment of the [LGU], will assist the [LGU] in managing the interest rate risk or interest cost of the [LGU]").

LGU to formally adopt an interest rate management plan and to enter into a formal contract that fulfills all the requirements of what LGUDA calls a "qualified interest rate management agreement." In theory, QIRMAs provide an LGU with a hedge against fluctuations in interest rates in a variety of situations. As with derivatives in general, new variations of QIRMAs are constantly being invented by investment banks.

Generally, a QIRMA is designed to change the interest rate cash flows related to a bond issuer's debt without affecting the debt principal. For example, in the case of an interest rate swap, the parties agree upon the rates that they will pay to each other and the "notional amount" that will be used as the basis to calculate the amounts due. Throughout the period covered by the agreement, principal and interest continue to be paid on the underlying bonds or notes associated with the agreement at the times scheduled pursuant to the terms of the bonds or notes. The fixed interest rate is fixed for the life of the QIRMA, but the variable interest rate floats. The LGU makes fixed interest rate swap payments to the counterparty in exchange for variable-rate interest payments, creating a "synthetic (i.e., artificial) fixed interest rate." The floating rate is typically based on an index such as the London Inter-Bank Offered Rate ("LIBOR") or the Bond Market Association Municipal Swap Index ("BMA").[39] Floating rates may also be calculated on the basis of the difference between two indices. If both parties' payments are due on the same date, actual cash payments may be settled on a net payment basis.

A QIRMA is a contractual obligation of the LGU. It is neither an investment nor debt. The counterparty is compensated by adjusting the fixed rate that it either pays to, or receives from, the LGU. In some transactions, the counterparty may also pay some or all of the transaction costs or provide an up-front cash payment to the LGU. Although QIRMAs, by their very nature, involve interest rate risk, the transactions typically expose the LGU to a multitude of other risks, including credit or counterparty risk, market risk, liquidity risk, termination risk, basis risk, insurance risk, rollover risk, and market-access risk.[40]

## Bethlehem Area School District – A Case Study

The District is the sixth largest school district in the Commonwealth of Pennsylvania. Located in the heart of the Lehigh Valley, it includes five municipalities: the City of Bethlehem is located in both Lehigh and Northampton Counties; the Borough of Fountain Hill is located in Lehigh County; and the Borough of Freemansburg, Bethlehem Township, and Hanover Township are located in Northampton County. The District has 22 schools (16 elementary schools, 4 middle schools, and 2 high schools), 2 academies, 1 pre-kindergarten center, 1 vocational-technical school, 4 auxiliary buildings, and 1 stadium complex.

In 1991, the District embarked on what was to be an approximately 20-year-long construction initiative focused on rehabilitating many of the District's school buildings in phases. The phases of the rehabilitation project included elementary schools first, middle schools second, and high schools third. From 1991 until 2001, the District used conventional fixed-rate bond financing to raise the money needed to pay for the project. However, in 2003, the District issued

[39] The BMA is now known as the Securities Industry and Financial Markets Association ("SIFMA").
[40] *See* glossary in Appendix D of this report for definitions of these various types of risks.

its first variable-rate note and entered into its first interest rate swap agreement on April 29, 2003 with the investment bank of J.P. Morgan. Because this swap agreement was entered into at a time prior to the enactment of Act 23, when the authority for school districts to directly enter into such agreements was unclear, the transaction was routed through the West Cornwall Township Municipal Authority as a conduit.

Between 2003 and 2007, the District issued four more bonds or notes (three variable-rate and one fixed-rate) and entered into 12 more QIRMAs. 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. The District's negative experience with QIRMAs became the focus of public attention in May 2009 when the District was forced to pay the investment bank J.P. Morgan $12.3 million to terminate the QIRMA of April 29, 2003.[41]

On July 30, 2009, OSI interviewed Stanley Majewski, Jr., the District's Assistant to the Superintendent for Finance and Administration, who also served as Board Secretary. He provided the following information regarding the history of the District's renovation and construction projects:

- The construction initiative was started under the Superintendent's predecessor, Thomas Doluisio.
- Many of the school buildings had not been rehabilitated or updated since the 1950s and were in complete disarray.
- The construction initiative was broken down into three phases over an approximately 20-year period in order to not cause huge tax increases for residents of the District.
- One District building, the Nitschmann Middle School, remains to be scheduled for updating and refurbishing. The estimated cost of this project is $55-60 million. The plans to start this renovation are currently on hold.
- Even with all of the construction projects that occurred at the District since 1991, the District's debt service payments never exceeded 10% of its overall budget.

As previously discussed, LGUDA was amended in 2003 to include the provisions of Act 23. At approximately the same time, the District's former financial advisor, Leslie Bear, approached Majewski and proposed a new type of financing structure for the District's debt. This financing structure included refunding some of the District's fixed-rate debt and issuing new variable-rate debt that had QIRMAs attached to the debt.

In the same interview with OSI, Majewski provided the following information about Bear's introduction of this new financing structure at the District:

- In 2003, the U.S. Federal Reserve System lowered interest rates to historically low levels.
- In 2003, Bear proposed a new financing structure for the District's bonds and notes that included variable interest rates and QIRMAs. The timing was right for the District to entertain this financing because it presented an opportunity to take

[41] The details of this series of transactions are set forth in Table 1 at footnotes 47, 51, and 52 and the accompanying text.

advantage of historically low interest rates, which made variable rates more appealing than fixed-rate financing.

- Prior to this proposal by Bear, the District had only used fixed-rate financing.
- In 2003, the historical data indicated that variable rates were less costly than fixed-rate debt, and Majewski believed that he had an obligation to explore this financing structure for the benefit of the District's taxpayers.
- Bear explained to Majewski and the Board that the QIRMAs that would be attached to the underlying debt would create a "synthetic fixed interest rate." Bear gave the impression that the District was actually entering into a safer fixed-rated debt structure that presented less risk. As it turns out, the "synthetic fixed interest rate" created by the QIRMAs was only accurate if several variables in the financial markets behaved appropriately.
- In 2003, when the District first entered into QIRMAs, Majewski's understanding of the "synthetic fixed interest rate" concept was lacking and not nearly as comprehensive as it is now.

The District entered into its first QIRMA relative to its General Obligation Note, Series of 2003 – West Cornwall Township Municipal Authority ("2003 WCTMA Note") debt issuance. This note was issued as a refunding of two of the District's previously issued bonds – General Obligation Bonds, Series of 1998 and General Obligation Bonds, Series A of 2001 – which were both fixed-rate debt. The 2003 WCTMA Note was created by combining the remaining principal left on the two previously issued bonds in order to issue a variable-rate note using West Cornwall Township Municipal Authority as a conduit issuer.[42] The 2003 WCTMA Note was the District's first use of QIRMAs on underlying debt, with two QIRMAs associated with it during the period April 23, 2003 through May 1, 2009.[43]

Table 1 lists all bonds, notes, and QIRMAs entered into by the District between 1998 and 2009. The table references the debt instrument, type of QIRMA, type of underlying debt structure associated with the bond or note, and the notional amount of the bond or note. The information set forth in the table was obtained by OSI from the District's current financial advisor, Public Financial Management, on July 27, 2009. All of the District's QIRMAs were cross-referenced to the bonds and notes disclosed in the annual audit report of the District for the period ending June 30, 2008, which had been prepared by Gorman & Associates, P.C., the District's independent auditor.

[42] As previously explained, BASD used West Cornwall Township Municipal Authority as a conduit issuer for this QIRMA because this transaction was prior to the enactment of Act 23 of 2003, which amended LGUDA and provided school districts with the express authority to enter into QIRMAs on their own. Conduit issuers may also be used by school districts to ensure that principal and interest payments qualify for partial reimbursement through PDE.

[43] These are referred to as QIRMA # 1 and QIRMA # 2 in Table 1 and the finding.

**As demonstrated in Table 1, the District entered into 13 different QIRMAs during the period April 29, 2003 through June 27, 2006,[44] the most of any school district in Pennsylvania.[45] The District did not enter into any QIRMAs before or after this period. The 13 QIRMAs related to $272.9 million in debt. The District also issued 12 different bonds or notes during the period 1998 to 2009.**

[44] We note that it has been reported that the District entered into 17 QIRMAs. *See, e.g.,* Tim Darragh & Steve Esack, "Risky Business: How financial swaps are crippling Bethlehem school taxpayers," *The* (Allentown) *Morning Call*, June 6, 2009. However, the information that we obtained from DCED and PFM supports only 13 QIRMAs with confirmation sheets. If there were any changes/amendments to these QIRMAs, either they were not filed with DCED or PFM does not have the confirmation sheets. The District did not address this discrepancy in its response to the draft report.

[45] Although the Bethlehem Area School District entered into the highest total number of QIRMAs, the Philadelphia School District appears to have the highest total notional amount related to QIRMAs. The Bethlehem Area School District had the second-highest total notional amount.

**TABLE 1**

***District's Bonds, Notes, and QIRMAs, 1998-2009***

***Note**: The shaded blocks in the first column are the District's bonds or notes during this period. The unshaded blocks in the first column are the QIRMAs that were related to those bonds or notes.*

| DEBT INSTRUMENT | UNDERLYING DEBT STRUCTURE | QIRMA # | QIRMA INFORMATION | | PURPOSE OF DEBT ISSUANCE | NOTIONAL AMOUNT |
|---|---|---|---|---|---|---|
| | | | Trade Date | Counterparty | | |
| General Obligation Bonds, Series of 1998 | Fixed Interest Rate | N/A | | | New Money | $35,000,000 |
| Guaranteed Lease Revenue Bonds, Series of 1999 | Fixed Interest Rate | N/A | | | New Money – Bethlehem Area Vocational - Technical School project | $7,796,870 equals the District proportionate share of $12,175,000 |
| General Obligation Bonds, Series A of 2001 | Fixed Interest Rate | N/A | | | Refunding of Series 2000 and New Money | $43,000,000 |
| Guaranteed Lease Revenue Bonds, Refunding Series of 2001[46] | Fixed Interest Rate | N/A | | | Refunding of 1983 Bonds | $9,700,000 |
| Guaranteed Lease Revenue Bonds, Improvement Series of 2001 | Fixed Interest Rate | N/A | | | New Money - Bethlehem Area Vocational-Technical School Project | $322,0000 equals the District proportionate share of $500,000 |
| General Obligation Notes, Series of 2003 West Cornwall Township Municipal Authority | Variable Interest Rate | | | | Advanced Refunding of Series of 1998 and Series A of 2001 | $74,175,000 |

[46] In its response to the draft report, the District stated that this series was "a bond issue of the Bethlehem Vocational-Technical School, not of the District itself. Under the Vo-tech's Articles of Agreement, the District guarantees a portion of the debt that the District is responsible for. These bonds were refinanced in June 2009 with a fixed rate deal done by PFM."

| | | | | | | |
|---|---|---|---|---|---|---|
| Fixed Rate Payer Swap | | 1 | 4/29/03[47] | J.P. Morgan | | $74,175,000 |
| Basis Cap Swap | | 2 | 5/7/04[48] | J.P. Morgan | | $73,845,000 |
| General Obligation Bonds, Series of 2005* | Variable Interest Rate | | | | New Money | $55,000,000 |
| Fixed Rate Payer Swap | | 3 | 12/23/03 | Morgan Stanley | | $55,000,000 |
| Fixed Rate Payer Swap | | 4 | Amended: 11/18/04 | Morgan Stanley | | $55,000,000 |
| Constant Maturity Swap | | 5 | 5/16/05 | Morgan Stanley | | $55,000,000 |
| Constant Maturity Swap | | 6 | Amended: 6/27/06 | Morgan Stanley | | $55,000,000 |
| General Obligation Bonds, Series A of 2007* | Fixed Interest Rate | | | | New Money | $71,215,000 |
| Swaption | | 7[49] | 12/18/03 | Morgan Stanley | | $71,215,000 |
| General Obligation Bonds, Series of 2007* | Variable Interest Rate | | | | New Money | $55,000,000 |
| Fixed Rate Payer Swap | | 8 | 12/18/03 | J.P. Morgan | | $55,000,000 |
| Fixed Rate Payer Swap | | 9 | Amended: 11/18/04 | J.P. Morgan | | $55,000,000 |
| Constant Maturity Swap | | 10 | 5/16/05 | J.P. Morgan | | $55,000,000 |
| Constant Maturity Swap | | 11 | Amended: 6/27/06 | J.P. Morgan | | $55,000,000 |
| General Obligation Note, Series of 2007 – Shippensburg Borough Authority* | Variable Interest Rate | | | | New Money | $40,000,000 |

[47] The District received an up-front payment of $3,465,000 for this QIRMA (referred to as "QIRMA #1" in the finding). QIRMA # 1 was terminated at the request of the District on May 1, 2009, with the proceeds of the General Obligation Bond, Series A and AA of 2009. (The proceeds of General Obligation Bond, Series B of 2009 were completely allocated to a new project.) The District was required to pay the counterparty $12,364,000 to terminate QIRMA #1.

[48] This QIRMA (referred to as "QIRMA #2" in the finding) was terminated at the request of the District on February 27, 2007. Due to market conditions that were favorable to the District at that time, the counterparty was required to pay $509,000 to the District upon the termination of this QIRMA.

[49] The District received an up-front payment of $2,425,000 for this QIRMA (referred to as "QIRMA #7" in the finding). As of the date of this report, the counterparty (Morgan Stanley) has not exercised this QIRMA with the District.

| | | | | | | |
|---|---|---|---|---|---|---|
| Fixed Rate Payer Swap | | 12 | 11/22/05 | J.P. Morgan | | $40,000,000 |
| Constant Maturity Swap | | 13 | 6/27/06 | J.P. Morgan | | $40,000,000 |
| General Obligation Bonds, Series A, AA, and B of 2009[50] | Fixed Interest Rate | N/A | | | Advanced Refunding of Series 2003 West Cornwall Township Note (Series A) New Money (Series AA) and Limited Tax Obligation (Series B) | $95,220,000<br><br>Series A – ($69,710,000)[51]<br><br>Series AA – New Money ($14,410,000)[52]<br><br>Series B – Limited Tax Obligation ($11,100,000) |
| Guaranteed Revenue Lease Bond, Series of 2009 | Fixed interest Rate | N/A | | | Refunding of Guaranteed Lease Revenue Bond, Refunding Series of 2001 and Guaranteed Lease Revenue Bond, Improvement Series of 2001 | $5,790,952 equals District's proportionate share of $9,160,000 principal amount |

***These bonds and notes still have active QIRMAs associated with the underlying debt as of the date of this report.***

Due to multiple practical limitations, Table 1 does not indicate up-front payments, fees, costs, spreads, savings, etc. for all of the District's QIRMAs.[53] Savings, if any, are unknown until the agreements terminate. Spreads are not reported in the confirmation documents. Certain fees are included in the documents, but are not listed in dollars; instead, they are listed as basis points of present value of the notional amount at the time of the agreement. Costs for issuing bonds and notes are constant and do not relate to QIRMAs.

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[50] In its response to the draft report, the District stated that the purpose of Series A and AA of 2009 was to refund the Series of 2003 WCTMA Note and that the purpose of Series B of 2009 was to raise new money.

[51] The proceeds of the issuance of General Obligation Bond, Series A of 2009, totaled $69,710,000. Of this total amount, $10,339,968 was used to pay a portion of the $12,364,000 that the District was required to pay to counterparty J.P. Morgan to terminate QIRMA #1.

[52] The proceeds of the issuance of General Obligation Bond, Series AA of 2009 totaled $14,410,000. Of this total amount, $2,024,031 was used to pay the balance of the $12,364,000 that the District was required to pay to counterparty J.P. Morgan to terminate QIRMA #1.

[53] It is also important to recognize that the QIRMAs in Table 1 have an aggregate notional amount of more than $272.9 million (the total amount of debt on which the QIRMAs were based) because more than one swap may be used in connection with the same bond or note.

The District appears to have complied with all applicable provisions of LGUDA as amended by Act 23. The 13 QIRMAs referenced in Table 1 are documented by confirmation sheets, including amendments. QIRMAs that were amended are referenced by an amended trade date in the table. Our review of DCED records confirmed that all 13 QIRMAs entered into by the District were filed with DCED as required.

Confirmation sheets are an integral part of each QIRMA because the confirmation sheets reference the trade date, the notional amount, the LGU, and the counterparty. Confirmation sheets also include information regarding fees paid by the LGU when a QIRMA is entered into. We noted that some fees listed on the confirmation sheet were not referenced in dollars but as basis points calculated on the present value of the notional amount of the bond or note.

OSI found no instances in which the District or Bear failed to supply DCED with the requisite information when a QIRMA was entered into. In our review of QIRMA documents and associated confirmation sheets supplied to DCED, we found that the different types of risk associated with the use of QIRMAs was disclosed in boilerplate language that varied little from document to document.

**As explained in the finding that follows, we are concerned less by the District's compliance with state law with regard to entering into the QIRMAs at issue than by the propriety of governmental entities risking public funds via QIRMAs in the first place. For that reason, we recommend that the use of QIRMAs and other types of derivatives by LGUs and municipal authorities should be prohibited by law.**

## FINDING AND RECOMMENDATIONS

**FINDING:** **The District's use of two QIRMAs associated with its variable-rate "General Obligation Note, Series 2003 - West Cornwall Township Municipal Authority" cost District taxpayers $10.2 million more than if the District had issued a standard fixed-rate bond or note, and $15.5 million more than if the District had simply paid the interest on the variable-rate note without any QIRMAs at all.**

OSI performed a comparative analysis of the District's 2003 WCTMA Note, which was issued on May 22, 2003, to determine the total cost of this type of financing to the District.[54] This particular note lends itself to such analysis because the debt was refunded on May 1, 2009, and the two QIRMAs associated with the note were terminated on February 27, 2007 and May 1, 2009, respectively. This permits a comparison of the total actual costs expended by the District on this debt over a defined time period with two hypothetical alternatives. The first alternative is the total cost if the District had issued a fixed-rate bond or note on the same date as the issuance of the note and the related QIRMA, and the second is the total cost if the District had not entered into any QIRMAs associated with the variable-rate note that it issued on that date but had merely paid the variable-rate interest pursuant to the terms of the note.[55]

The 2003 WCTMA Note was issued in the amount of $74,175,000 on May 22, 2003, as an advanced refunding of the District's General Obligation Bonds, Series 1998 and 2001A,[56] which were fixed-rate bonds that never had any QIRMAs associated with them. The 2003 WCTMA Note was a variable-rate instrument that, during its life, had two different QIRMAs associated with it. The first ("QIRMA #1") had a trade date of April 29, 2003, and the second ("QIRMA #2") had a trade date of May 7, 2004.

[54] We were unable to perform a comparative analysis on any of the District's other bonds and notes issued from 2003 to 2007, because the bonds and notes issued during that period still had active QIRMAs associated with them during the fieldwork phase of our investigation. Therefore, the costs will continue to fluctuate in the future depending on market conditions.

[55] In its response to the draft report, the District's current financial advisor, PFM, presented a detailed critique of our analysis and proffered an alternative computation that results in total costs to the District that are somewhat lower than we computed. While we do not necessarily agree with all of PFM's proposed revisions, in fairness to the District, and in order to simplify this final public report, we have decided to adopt them in their entirety. Accordingly, Tables 2 through 5 have been revised to include all of the proposed revisions suggested by PFM, the finding and the explanatory text have been changed to incorporate the revised computations, and footnotes have been added where necessary to explain the changes.

[56] *See* Table 1 regarding the original notional amount of bonds that were refunded in order to issue the 2003 WCTMA Note. The refunding of these bonds in 2003 by the District would have included any outstanding principal. The combined outstanding principal of these two bonds was used to determine a new issuance amount on the 2003 WCTMA Note of $74,175,000.

QIRMA #1 was terminated by the District as part of the refunding of the 2003 WCTMA Note on May 1, 2009, and QIRMA #2 was terminated by the District on February 27, 2007. As illustrated in the comparative analysis, the terminations of QIRMA #1 and QIRMA #2 had extremely different financial implications. By terminating QIRMA #1, the District became contractually obligated make a termination payment to the counterparty, J.P. Morgan, in the amount of $12,364,000, because interest rates associated with QIRMA #1 at the time of termination favored the counterparty. However, when the District terminated QIRMA #2, it became entitled to receive a payment from the same counterparty in the amount of $509,000, because interest rates associated with QIRMA #2 at the time of termination favored the District.

Our comparative analysis of the 2003 WCTMA Note is presented in Tables 2, 3, 4, and 5.

**Table 2 indicates what the *estimated* cost of the 2003 WCTMA Note would have been if the District had chosen fixed-rate financing without any associated QIRMAs.** This total cost was calculated over the period from May 22, 2003, the date of the note's actual issuance, through May 1, 2009, the date of the note's refunding and the termination of QIRMA #1. The principal and interest payments and associated fees used in this calculation were estimated using historical data. The fixed interest rate used in the calculation was estimated by the District's current financial advisor to be 4.26%, representing the prevailing fixed rate at the time of issuance. The estimated yearly debt service costs for this example are shown on a calendar year basis.

**TABLE 2**
***Hypothetical Fixed-Rate Issuance of the 2003 WCTMA Note, May 22, 2003-May 1, 2009***

Sold: 4/29/2003
Dated: 5/22/2003
Principal Amount of Issuance: $73,975,000[57]

| Fiscal Year Ending | Estimated Principal Payments | Estimated Interest Payments[58] | Estimated Total Yearly Debt Service Cost |
|---|---|---|---|
| 6/30/2003 | $0.00 | $0.00 | $0.00 |
| 6/30/2004 | 320,000.00 | 2,739,764.25 | 3,059,764.25 |
| 6/30/2005 | 300,000.00 | 3,050,345.50 | 3,350,345.50 |
| 6/30/2006 | 310,000.00 | 3,046,144.50 | 3,356,144.50 |
| 6/30/2007 | 325,000.00 | 3,040,847.25 | 3,365,847.25 |
| 6/30/2008 | 340,000.00 | 3,034,064.00 | 3,374,064.00 |
| 6/30/2009 | 355,000.00 | 3,025,607.00 | 3,380,607.00 |
| **Totals** | **$1,950,000.00** | **$17,936,772.50** | **$19,886,772.50**[59] |

[57] Table 1 shows the principal amount of this note as $74,175,000. However, in order to provide a more valid comparison, PFM's analysis reduces the principal amount by $200,000, because variable-rate bonds and notes historically have higher issuance costs than fixed-rate bonds and notes.

[58] According to PFM, interest rate payment is based on the AAA Municipal Market Data ("MMD") index, as of April 29, 2003 plus 15 basis points (the approximate spread for Pennsylvania financing agreement at the time). The arbitrage yield rate, including basis points, is 4.26%. The AAA MMD index is an index constructed by averaging the primary and secondary trade data available for the highest-grade AAA-rated state general obligations bonds each day.

**Table 3 indicates actual issuance costs and fees paid, as well as principal and interest paid by the District, on the 2003 WCTMA Note for the period May 22, 2003 through May 1, 2009**. This analysis was developed using the District's actual payment records. This analysis shows actual costs paid by the District for issuing the 2003 WCTMA Note without any associated QIRMAs. This analysis can be compared to the hypothetical fixed-rate analysis to show the different costs associated with issuing bonds and notes that have an underlying debt structure of a fixed, as opposed to a variable, rate.

**TABLE 3**
***Actual Variable-Rate Issuance Costs of the 2003 WCTMA Note, May 22, 2003-May 1, 2009***

Sold: 4/29/2003
Dated: 5/22/2003
Principal Amount of Issuance: $74,175,000

| Fiscal Year Ending | Principal Payments | Interest Payments[60] | Estimated Ongoing Administration Costs[61] | Total Yearly Debt Service Cost |
|---|---|---|---|---|
| 6/30/2003 | $0.00 | $60,518.67 | $0.00 | $60,518.67 |
| 6/30/2004 | 330,000.00 | 753,750,09 | 128,448.80 | 1,212,198.89 |
| 6/30/2005 | 310,000.00 | 1,335,015.14 | 149,051.28 | 1,794,066.42 |
| 6/30/2006 | 320,000.00 | 2,154,262.11 | 150,481.02 | 2,624,743.13 |
| 6/30/2007 | 335,000.00 | 2,677,325.89 | 264,090.51 | 3,276,416.40 |
| 6/30/2008 | 350,000.00 | 2,206,759.12 | 240,905.45 | 2,797,664.57 |
| 6/30/2009 | 365,000.00 | 2,207,339.42 | 207,821.95 | 2,780,161.37 |
| **Totals** | **$2,010,000.00** | **$11,394,970.44** | **$1,140,799.01** | **$14,545,769.45** |

**Table 4 indicates the actual issuance costs and fees paid, as well as principal and interest paid by the District, on the note for the period May 22, 2003 through May 1, 2009, plus all disclosed fees and applicable costs associated with the District entering into QIRMA #1 and QIRMA #2.** The "spread fees" paid by the District relative to QIRMA #1 and QIRMA #2 could not be determined because they are not required by law to be disclosed. J.P. Morgan, the counterparty, is the only party[62] associated with the QIRMAs that would know the

[59] This figure represents the estimated total cost to BASD had it issued a fixed-rate note instead of a variable-rate note with a principal amount of $73,975,000 (principal amount reduced by $200,000 to account for lower issuance costs; *see* footnote 57).

[60] The variable interest rate paid by BASD for the period of this note, based on information provided in the District's payments records, fluctuated from a low of 1.5924% to a high of 6.4916%.

[61] The ongoing administration costs include remarketing and liquidity fees paid by the District on the 2003 WCTMA Note. These fees are unique to variable rate financings and are charged by lenders to search for new interest rates, to pay trustees, and to remarket the bonds or notes.

[62] In its response to the draft report, the District presented PFM's suggestion that the swap financial advisor might also know the spread fee paid by the District. However, Leslie Bear, the District's financial advisor at the time of the agreement, refused to be interviewed. Therefore, we were unable to determine whether he knew the spread fee for this agreement.

spread fee,[63] but J.P. Morgan has refused to disclose the fee to the District. Therefore, even the District does not know the total actual costs that it paid regarding QIRMA #1 and QIRMA #2.

## TABLE 4

***Actual Variable-rate Issuance Costs of the 2003 WCTMA Note PLUS QIRMAs, May 22, 2003-May 1, 2009***

Sold: 4/29/2003 QIRMA#1 trade date: 4/29/2003
Settled: 5/22/2003 QIRMA#2 trade date: 5/7/2004
Dated: 5/22/2003
Principal Amount of Issuance: $74,175,000

| Fiscal Year Ending | Total Variable-rate 2003 WCTMA Note Debt Service[64] | Total Net QIRMA Interest Payments by the District[65] | QIRMA #1 Fees Paid by the District[66] | QIRMA #1 Up-front payment Received by the District[67] | QIRMA #1 Termination Payment Paid by the District | QIRMA #2 Fees paid by the District[68] | QIRMA #2 Termination Payment Received by the District | Total Yearly Debt Service Cost: Including QIRMA #1 and QIRMA #2 |
|---|---|---|---|---|---|---|---|---|
| 6/30/2003 | $60,518.67 | $142,372.14 | $327,074 | ($3,465,000) | | | | (2,935,035.19) |
| 6/30/2004 | 1,212,198.89 | 2,232,808.00 | | | | $427,000 | | 3,872,006.89 |
| 6/30/2005 | 1,794,066.42 | 1,567,109.71 | | | | | | 3,361,176.13 |
| 6/30/2006 | 2,624,743.13 | 410,308.92 | | | | | | 3,035,052.06 |
| 6/30/2007 | 3,276,416.40 | (68,345.88) | | | | | ($509,000) | 2,699,070.52 |
| 6/30/2008 | 2,797,664.57 | 610,655.29 | | | | | | 3,408,319.86 |
| 6/30/2009 | 2,780,161.37 | 1,520,494.77 | | | $12,364,000 | | | 16,664,656.14 |
| **Totals** | **$14,545,769.45** | **$6,415,402.95** | **$327,074** | **($3,465,000)** | **$12,364,000** | **$427,000** | **($509,000)** | **$30,105,246.40** |

**Table 5 summarizes the additional costs that the District incurred by choosing the referenced financing type.** The table shows the additional costs incurred as a result of entering

[63] *See* summaries of OSI's interviews of PFM for additional explanation regarding "spread fees."

[64] The figures used in this column are identical to the Total Yearly Debt Service Cost column in Table 3.

[65] This column includes the net total of interest payments received by the District from the counterparty or paid to the counterparty relative to both QIRMAs. The column shows net interest payments made by the District to the counterparty as per QIRMAs. With the exception of the fiscal year ending June 30, 2007, the District paid more interest than it received from the counterparty relative to the QIRMAs. For the 2003 WCTMA Note, these net payments made by the District are an indication of how poorly the QIRMAs performed. The $6,415,402.95 in net QIRMA interest payments made by the District to the counterparty were in addition to the principal and interest payments made on the underlying 2003 WCTMA Note.

[66] This figure does not include "spread fees" paid to the counterparty for entering into QIRMA #1. However, it does include a "swap advisor fee" paid to Bear.

[67] This up-front payment was received upon execution of the QIRMA with the counterparty.

[68] This figure does not include "spread fees" paid to J.P. Morgan, the counterparty, for entering into QIRMA #2. However, it does include a "solicitor fee" in the amount of $20,000 to Sweet, Stevens, Tucker & Katz LLP of New Britain, Pennsylvania (now, Sweet, Stevens, Katz & Williams LLP); a "swap counsel" fee in the amount of $40,000 to Hartman, Underhill, & Brubaker LLP of Lancaster, Pennsylvania; an estimated "financial advisor fee" in the amount of $183,500 to Arthurs, LeStrange & Co., Inc.; and an estimated "structuring agent fee" to ACCESS Financial Markets of Lancaster in the amount of $183,500. The estimates of the "financial advisor" and "structuring agent" fees were calculated by PFM for OSI. PFM could only provide estimates of these fees, because the fees were listed in the confirmation document as basis points of the present value of the notional amount of the QIRMA. Furthermore, a "structuring agent fee" is extremely rare in these types of agreements.

into the two QIRMAs associated with the 2003 WCTMA Note as compared with the costs of the underlying variable-rate note without QIRMAs and the costs of fixed-rate financing.[69]

**TABLE 5**
***Results of Cost Comparison of Financing Types Available to the District, May 22, 2003 through May 1, 2009***

| Comparative Analysis of Financing Type - Description | Total Debt Service Cost for Financing Type | Total Additional Cost to the District Compared with Actual Variable-Rate Issuance Only | Estimated Total Additional Cost to the District Compared to Hypothetical Fixed-Rate Issuance |
|---|---|---|---|
| Hypothetical Fixed- Rate Issuance of 2003 WCTMA Note | $19,886,772.50 | $5,341,003.06 | N/A |
| Actual Variable-Rate Issuance of 2003 WCTMA Note | $14,545,769.45 | N/A | $(5,341,003.06) |
| Actual Variable-Rate Issuance of 2003 WCTMA Note, plus QIRMAs | $30,105,246.40 | $15,559,476.95 | $10,218,473.90 |

**To summarize, the District's use of two QIRMAs associated with the 2003 WCTMA Note proved very costly when compared to fixed-rate and variable-rate financing without the use of QIRMAs.** If the District had entered into straight fixed-rate financing, it could have saved $10.2 million. Ironically, if the District had not entered into any QIRMAs associated with its issuance of the variable-rate 2003 WCTMA Note, it could have saved $15.5 million.[70] We further note that, because the termination payment relative to QIRMA #1 was included in the District's refunding of debt relative to the issuance of the General Obligation Bonds, Series A, AA & B of 2009, the payments relative to the termination payment portion of this bond issuance will be amortized over the life of the bonds, costing the District even more money in additional interest.[71]

[69] Table 5 shows that the interest cost on the variable-rate note, excluding the costs associated with the QIRMAs, was actually $5.3 million lower than the interest cost on the hypothetical fixed-rate bond or note. This is an anomaly that is due to interest rates remaining low far longer than expected, and should not be construed as an indication that the Department has taken the position that variable-rate financing is an acceptable cost-saving strategy for LGUs. To the contrary, the use of variable-rate bonds or notes exposes the issuer to the risk of potentially enormous losses in the event that interest rates rise and is, in that sense, also a form of gambling with public money. The use of variable-rate bonds or notes was, prior to the advent of QIRMAs, very rare because of the recognition that the interest rate risk associated with such instruments was unacceptable. QIRMAs are supposed to hedge that risk, but, as this report makes clear, QIRMAs have built-in risks that are also unacceptable for LGUs.

[70] This illustrates that the use of QIRMAs as a hedging strategy can produce a paradoxical result, in which the cost of the hedge (the QIRMA) can far exceed the risk hedged against (additional interest cost due to a rise in interest rates). As explained in the preceding footnote, this result should not be construed as our condoning the issuance by LGUs of variable-rate bonds or notes.

[71] It has been reported that the District has recently been forced to terminate another QIRMA, at an estimated cost to the District of $3.7 million, because its liquidity provider, Dexia, a European bank, is leaving the liquidity business. *See* Steve Esack, "Bethlehem schools swap out more risky debt," *The* (Allentown) *Morning Call,*

## Interviews of Board Members

OSI interviewed individuals who served on the District's Board at various times during the period 2003 to present in order to obtain responses to the following questions:

- Why did the District enter into QIRMAs?
- What risks were described to the Board prior to entering into the agreements?
- What proposed changes should be made to applicable laws pertaining to school district use of this type of debt financing?

OSI interviewed current Board Member Judith A. Dexter, Esq. on July 10, 2009. She provided the following information:

- She was elected to the Board in 2005 and has served in the capacity of vice president since December 2007.
- She started to pay more attention to QIRMAs in February 2008, when it was brought to her attention that the District was paying enormous fees relative to the QIRMAs.
- Board members did ask questions regarding QIRMAs to the Assistant Superintendent for Finance and Administration, Stanley Majewski, and the District's former financial advisor, Leslie Bear. QIRMAs are not the sole reason that the District is having financial problems. Majewski told the Board that he is conservative and would not recommend something that would harm the District.

OSI interviewed current Board Member Loretta M. Leeson on July 10, 2009. She provided the following information:

- She has been a member of the Board since 1999, and has served as president since December 2007.
- Bear arranged QIRMA #1 in September or October of 2003.[72] Brochures and charts were presented to the Board in order to "sell" the District on the QIRMAs.
- Board members did ask questions about the risks involved with QIRMAs. Answers provided by Majewski and Bear were very brief and described the risks as very low or virtually non-existent. The Board was told that QIRMAs presented a "synthetic fixed rate" for the District's bonds and that a synthetic fixed rate and a fixed rate are virtually the same thing.
- In the spring of 2008, she learned that the District's bonds were actually variable interest rates that were remarketed every week. She also learned that the District had too much risk and exposure by having 75% of its bonds in a variable interest rate structure. Majewski told the Board that the fees that the District was paying for QIRMAs were "market-appropriate."
- After PFM was retained as the District's financial advisor in October 2008, the Board had a New York law firm and its current bond counsel review the QIRMAs to

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September 22, 2009. In its response to the draft report, the District states, "The District has passed parameters resolutions authorizing the termination of a portion or all of the 2005 Fixed Payer (QIRMA #4 [in Table 1]), however no such termination has actually taken place as of [October 28, 2009]." We note that the precise amount of the termination payment with respect to this QIRMA cannot be determined until the termination actually takes place.

[72] QIRMA #1 was actually dated April 29, 2003. *See* Tables 1 and 3.

determine if the District had any legal recourse against the investment banks or anyone else involved in the transactions. Both law firms responded that the District had no legal recourse against anyone because the law permitted the transactions. Current economic conditions in the world financial market adversely affected the District's QIRMAs.

- There is a place for these financial instruments in the municipal market, but greater risk and oversight are needed. The percentage use of these instruments should be limited to 25% of the entities' bond issuance. Additionally, investment banks also need to fully disclose "fees" and "spreads" to the school districts.[73]

OSI interviewed current Board Member Eugene C. McKeon on July 22, 2009. He provided the following information:

- He has been a member of the Board for two years and is currently the chairman of the Board's Finance Committee.
- He described QIRMAs as having a "synthetic fixed rate" and not a variable rate. The QIRMAs were presented by the District's administration and Bear. He believes that, because the District had a longstanding relationship with Bear, someone (he did not say who) benefited from this relationship.
- There was not enough information regarding risks or potential risks related to QIRMAs. The Board was not informed enough to make qualified decisions on QIRMAs or to ask the right questions regarding the use and operation of QIRMAs.
- He believes that the law governing QIRMAs should be changed or repealed.

OSI interviewed former Board Member Joseph L. Craig on July 22, 2009. He provided the following information:

- He was a member of the Board for ten years and served as vice president and president.
- QIRMAs provided the District with an opportunity to lower payments on loans taken out for the construction of its school buildings. The benefits of the QIRMAs were to save the school district money. He fully trusted Majewski and Bear.
- A chart of risks was presented to the Board and the risks were explained as "nothing is guaranteed." He was not misled regarding the District's use of QIRMAs. In retrospect, he believes that it was not a good strategy to enter into QIRMAs because the Board underestimated the impact of the agreements.
- He believes that the law should be changed.

OSI interviewed former Board Member Julie S. Venanzi on July 22, 2009. She provided the following information:

- She was a member of the Board for eight years.
- She understood QIRMAs as being a benefit to the District because they could save money. She trusted the information provided by Majewski and Bear.
- She does not remember any risks being explained; if there were risks associated with the QIRMAs, she would not have voted for them. The Board made a qualified

[73] Dexter, who was interviewed jointly with Leeson, agreed with this statement without further comment.

decision to enter into the QIRMAs after a very lengthy presentation that included a question-and-answer session.
- She did not provide any response when asked whether or not the law should be changed or repealed.

OSI interviewed former Board Member William J. Heske on July 22, 2009. He provided the following information:

- He was a member of the Board for 15 years and served as vice president and president.
- As a member of the Board's Finance Committee, he was given a presentation regarding the District's ability to receive a low interest rate on bonds. The presentation was made by Majewski and Bear. The District entered into QIRMAs because it had an opportunity to borrow money at 2.5% interest for building projects.
- All of the risks were not fully identified relative to QIRMAs. The Board was not informed enough and, therefore, could not ask the right questions. He believes that someone (he did not say who) may have been benefiting from the District's longstanding relationship with Bear.
- He believes that the law governing a school district's ability to enter into QIRMAs should be changed.

OSI interviewed current Board Member Charlene A. Koch on July 23, 2009. She provided the following information:

- She has been a member of the Board for 16 years and served as vice president and as a member of the Finance Committee.
- The QIRMAs were initiated by former superintendent Thomas Doluisio and Bear, who held meetings with small groups of board members. The reason for entering into QIRMAs was that it would reduce interest payments. The information provided regarding QIRMAs was "way over our heads." She could not ask questions about the QIRMAs because she could not understand them.
- No one explained risks relative to QIRMAs.
- She believes that the law should be changed. State legislators are partially responsible for the problems created by using QIRMAs because they allowed school districts to enter into the agreements.

OSI interviewed former Board Member Diane M. Rowe on July 23, 2009. She provided the following information:

- She was a member of the Board from 2003 to 2007 and served as vice president.
- The QIRMAs were presented to the Board by Majewski and Bear. The reasons and benefits for entering into the QIRMAs were so that the District could save money. QIRMAs were explained as "playing the market" by entering into "variable option interest rates."
- The members of the Board had enough information to make the right decisions regarding the use of QIRMAs. The risks were explained by Majewski as being similar to gambling. In retrospect, she believes that it may not have been a good

decision for the District to enter into QIRMAs considering what happened to the financial market.

- She believes that the laws governing a school district's ability to enter into QIRMAs should not be changed or repealed, but the agreement should be modified to provide for a "cushion."

OSI interviewed current Board Member Irene Follweiler on July 23, 2009. She provided the following information:

- She has been a member of the Board member since 2007.
- No QIRMAs have been proposed to the Board since she was elected. In the past, QIRMAs were presented to the Board by Majewski and Bear. The District entered into QIRMAs because the QIRMAs had made money for the District.
- The explanation of fees paid by the District for entering into QIRMAs was a grey area. She believes that she has not been misled by anyone presenting information regarding the QIRMAs and that she is well-enough informed at the present time to decide whether or not the District should enter into QIRMAs. In retrospect, however, she believes that it was not a good decision for the District to enter into risky financial agreements.
- She believes that the law should be repealed and the District should enter into financial agreements that are simple and clear.

OSI interviewed former Board Member Margaret J. Williams on July 23, 2009. She provided the following information:

- She was a member of the Board for 12 years and served as vice president and president.
- The District entered into QIRMAs in order to lower its interest payments, receive up-front cash payments, lengthen the term of its debt, and consolidate its debt. A detailed presentation regarding QIRMAs was given by Majewski and Bear.
- The Board was made aware of the risks, but the risks described did not sound considerable. The Board was given adequate information and opportunity to ask questions before entering into QIRMAs. She was not misled by the District's administration or Bear. In retrospect, she believes that it was not a good decision to enter into the QIRMAs, although it was a good opportunity at the time.
- She did not provide any response when asked whether or not the law should be changed or repealed.

OSI interviewed current Board Member Michele T. Cann, Esquire, on July 23, 2009. She provided the following information:

- She has been a member of the Board member since 2007.
- She explained her knowledge of QIRMAs as receiving up-front monies in exchange for risks associated with a variable interest rate loan. No QIRMAs had been proposed to the Board since she was elected; only a termination of a QIRMA has been proposed.

- The QIRMAs were presented by Majewski and Bear. The District entered into QIRMAs because they would save money.
- There was no explanation of risks, but there was discussion of fees associated with the QIRMAs. Bear indicated that the District would not pay any fees to the investment bank.
- She did not provide any response when asked whether or not the law should be changed or repealed.[74]

OSI interviewed current Board Member Dr. Craig T. Haytmanek on July 27, 2009. He provided the following information:

- He is a current member of the Board and a past president.
- He explained his knowledge of QIRMAs as agreements being placed on top of bonds to take advantage of interest rates. The QIRMAs were presented around 2003 by Majewski and Bear. The District ultimately decided to enter into the QIRMAs because it would be saving and/or making money.
- The members of the Board unanimously voted to enter into QIRMAs after asking many questions. The Board was made aware of the risks associated with QIRMAs after asking questions of Bear. Haytmanek believes that the fees charged to the District for entering into QIRMAs were higher than normal. He stated that the District did not have an exit strategy to terminate the QIRMAs and, therefore, should not have entered into them in the first place.
- The Board was not misled by Majewski or Bear; he does not believe that any collusion existed between the two men.
- School districts should be allowed to enter into QIRMAs and other risky financial agreements with public funds as long as the board members are informed enough to make the right decisions. The law governing a school district's ability to enter into QIRMAs should not be changed or repealed.

OSI interviewed current Board Member Rosario S. Amato on July 28, 2009. He provided the following information:

- He has been a member of the Board for the past 14 years.

[74] In its response to the draft report, the District presented Ms. Cann's request that this final public report include a revised summary of her response to the question of whether or not the law should be changed or repealed. Because the revised summary is not consistent with our contemporaneous records of the interview, we have not changed the summary above. However, to the extent that the revised summary reflects Ms. Cann's current thoughts on the matter, or thoughts not clearly communicated during the interview, we present it here:

> She is of the opinion that the law should be changed to prohibit school districts from entering into QIRMAs. She related that [District] board members spent hours learning about QIRMAs from both PFM and Public Resources Advisory Group (PRAG), another financial advisory firm considered by [the District]. [The District] paid for the time invested by both of these firms in instructing the Board. It is unrealistic to expect that all school boards will have the time and the money to invest in thorough instruction of board members, an investment that will have to be repeated every time a new board member is seated. Without assurance that every board member on every school board will have adequate knowledge of QIRMAs, it is not appropriate to allow school districts to engage in this financing.

- The District entered into QIRMAs because it would receive up-front monies, but risks would be a negative part of the agreements. This would cost the District more money if variable rates went higher, but historical data did not indicate that this would be the case. The information provided by Bear indicated that the District could make a substantial amount of money, which could prevent the District from raising taxes.
- He believes that he was informed enough about the risks involved and would ask questions of Bear. The Board was not misled by the District administration or financial advisors. He needed to do what was best for the taxpayers.
- He believes that the law should not be changed or repealed. The District needs the ability to make investments that provide the most benefits for the District.

OSI interviewed current Board Member Benjamin M. Tenaglia III on July 29, 2009. He provided the following information:

- He was appointed to the Board in March 2008.
- He provided an extensive explanation of QIRMAs and multiple risks associated with this type of financing because he is an investment advisor. In the fall of 2008, world economic events resulted in several unfavorable circumstances that affected the District's QIRMAs. Weekly interest rates associated with the QIRMAs reset and moved from 1.9% to as high as 8.75%. In May or June 2008, Royal Bank of Canada ("RBC"), which acquired Leslie Bear's firm, indicated that the District was being charged a weekly fee of 12 basis points and that the most that RBC would charge was eight basis points. Tenaglia stated that the standard benchmark of debt composition for a school district should be 75% investment in fixed rates and 25% investment in variable interest rates, with or without QIRMAs.
- In retrospect, he believes that the District should not have had the amount of variable interest rate debt it did that would reset weekly.
- Legislation should be proposed that would put a percentage limitation on the amount of variable interest rate debt that a school district can have.

**In summary, OSI conducted interviews of 14 current or former members of the Board. Six of these board members told OSI that the Pennsylvania law allowing school districts to enter into QIRMAs should be changed or repealed.[75] In addition, three of the 14 board members believe that District officials and advisors did not provide them with adequate training and guidance in order for them to make the proper decisions relative to QIRMAs.**

## <u>Interviews of District Administrators</u>

OSI interviewed the District's Superintendent, Dr. Joseph A. Lewis, on July 30, 2009. He provided the following information:

[75] A seventh member of the Board, Michele T. Cann, Esquire, apparently also shares this view. *See* footnote 74.

- He has been employed as the District's Superintendent for the past seven and one half years.
- He will be leaving his position on September 25, 2009.
- When he arrived at the District, it was already involved in an extensive capital improvement plan. The District's elementary schools had already been improved and the District's middle schools were in the process of renovation.
- Upon his arrival to the District, it had a healthy fund balance (described as a "savings account"). However, in order to keep taxes low, the District kept tapping into the fund balance to fund its renovation projects.
- Around 2003, the District needed approximately $90 million dollars to finance the high school renovation projects and $55 million to finance the Broughal Middle School project. This was when Majewski and Bear proposed QIRMAs to the Board. According to Dr. Lewis, the Pennsylvania Turnpike Commission was already using QIRMAs at this time.
- QIRMAs were presented as options to the Board before the change in law that allowed school districts to enter into the agreements (i.e., Act 23 of 2003). Therefore, the District needed to use a third party (West Cornwall Township Municipal Authority) to enter into the agreements.
- All of the data presented to him regarding the performance of QIRMAs over a 20-year period indicated that the District could save money.
- Majewski made a diligent effort to ensure that the Board fully understood the QIRMAs. This was done by holding several breakfast meetings with small groups of board members. However, the fees that the District would have to pay for entering into the QIRMAs were not discussed at the meetings. The board members never requested any additional meetings and never indicated that they did not understand the QIRMAs.
- After PFM was retained as the District's financial advisor in October 2008, the District's use of QIRMAs was reviewed by two different law firms to determine if an illegality existed. Both law firms concluded that the investment banks had not committed any breach of fiduciary responsibility, there were no violation of any laws, and that the fees charged were excessive, but not illegal.
- He was not aware that the District was paying a "structuring agent fee" for entering into QIRMAs.
- He described fees listed in basis points and not dollars as being a "lack of disclosure."
- He agreed with OSI's comparative analysis of the costs relative to the District's issuance of the 2003 WCTMA Note, but, in his opinion, the termination payments relative to the QIRMA associated with this note should not be considered in the loss computation to the District because the termination payments were a cost of refunding the underlying debt.[76]

[76] We disagree with the Superintendent's statement that the termination payment paid by the District regarding QIRMA #1 should not be included in the loss computation. It is appropriate to include the $12.3 million termination payment in the loss computation because, had the District not exposed itself to risk by entering into QIRMA #1, it would not have had to pay to terminate this agreement. PFM has also included the termination payment in its revision of the computation that was presented in the District's response to the draft report. Accordingly, this payment is included in the loss computation. *See* Table 4.

- He had been somewhat skeptical about how counterparties to the QIRMAs would make any money on the agreements. Bear told him that the business that the counterparties generated through QIRMAs was out of the ordinary and the sheer volume of the agreements would make them profitable to the counterparties. It was not until later when he learned the fees or "spreads" charged by the counterparties relative to QIRMAs were buried in the transactions and not disclosed to the District.
- Variable interest rate debt creates an inherent risk that may not have been fully understood by district personnel.
- Based on what he now knows, he would only enter into fixed-rate financing relative to the District's debt.
- The laws governing QIRMAs should be tightened. The SEC should monitor the fees that investment banks charge on QIRMAs. DCED should review all proposed QIRMAs and approve or reject the agreements if risk is too high.
- The use of variable-rate bonds should be limited to 20% of a school district's overall outstanding debt.
- He emphatically stated that he did not receive anything of value or kickbacks from anyone in connection with the District entering into QIRMAs.

OSI interviewed the District's Assistant to the Superintendent for Finance and Administration, Stanley J. Majewski, Jr. on July 30, 2009. He provided the following information:

- He has been employed by the District in his current position since 1994.
- From 2003 to May 2009, the District's financing and debt structure was approximately 75% variable interest rate and 25% fixed interest rate. The Board was aware of this fact and asked questions pertaining to this debt structure.
- Bear told him that the District's debt structure was 70% "synthetic fixed rate" and 30% variable rate, which Majewski later determined as being opposite of the District's debt composition.
- Board members had numerous opportunities to ask questions relative to QIRMAs. He held several meetings with small groups of board members to answer questions. However, he was unsure if they fully understood the answers to the questions they had asked.
- He indicated that he had a "learning curve" relative to variable-rate financing and QIRMAs over the years.
- He believes that he may not have been presented with all of the financial data necessary to make the appropriate decisions regarding the District's use of QIRMAs. This is a function of investment banks and financial advisory firms not providing information to the general public. If he had different financial data, then it would have affected his decisions regarding QIRMAs.
- In February 2007, the District terminated one of its QIRMAs with the investment bank because it was advantageous to do so. Because interest rates favored the District, this termination of QIRMA #2 allowed the District to receive a $509,000 payment from the counterparty. The exact opposite occurred when the District terminated QIRMA #1 in May 2009 at a cost to the District of $12.3 million.

- He wanted to clarify previous statements that he had made to the media regarding the fact that the District received a $1.2 million up-front payment for entering into a QIRMA. He stated that the District did receive two up-front payments from counterparties in the amounts of $3,465,000 (QIRMA #1) and $2,425,000 (QIRMA #7), but not $1,200,000, as he had previously stated.
- He was unaware that the District may have been the only school district in Pennsylvania that paid a "structuring agent fee" when entering into QIRMAs.
- Bear was providing services at the District prior to the commencement of Majewski's employment.[77] Majewski had known Bear since the 1980s, but lost touch with Bear until he became employed at the District. He feels betrayed by Bear and believes that Bear may have taken advantage of their relationship.
- The QIRMAs relative to the District's 2005 and 2007 bonds and notes are currently providing $30,000 to $40,000 per week in positive cash flow. If this trend continues, the District will save approximately $1,000,000 on its debt service payment over the next fiscal year.
- He does not advocate the repeal of Act 23 or LGUDA. LGUDA should allow variable-rate financing, but a ceiling should be placed on the percentage allowable for this type of debt. School districts should be allowed to have up to 30% variable-rate debt, with or without QIRMAs associated to the debt. The remaining debt should be fixed interest rate financing. He is currently moving towards creating this mixture of debt at the District.
- He emphatically stated that he did not receive anything of value or kickbacks from anyone in connection with the District entering into QIRMAs.
- He referred to the termination payments that the District paid on the 2003 WCTMA Note as "regrettable." All of the financing structure related to the 2003 WCTMA Note performed poorly.
- He believes that Bear also betrayed him when the Board passed a resolution in July 2008 that authorized the termination of the 2003 WCTMA Note. Shortly after he presented the resolution to Bear, Bear indicated that "market conditions changed" and that the District could no longer terminate the QIRMA. He believes that Bear was not entirely truthful with him regarding the District's ability to terminate the QIRMA. He believes that Bear could have helped the District avoid paying the $12.3 million termination payment on the QIRMA associated with the 2003 WCTMA Note. If the QIRMA had been terminated in July 2008, it would have cost the District considerably less money.
- He believes that school boards and business managers who do not deal with QIRMAs on a daily basis cannot be expected to make decisions that may cost them a large termination payment in the future.
- He agreed with the numbers presented by OSI referencing a comparison of fixed, variable, and QIRMA financing for the 2003 WCTMA Note. The numbers accurately depict actual data on this note. The hypothetical fixed-rate data for this note was acceptable and accurate. Fees charged in basis points, not dollars, should

[77] Prior to his formal interview, Majewski told OSI that the District had not hired Bear to perform financial advisory services through a competitive selection process. Majewski said that a competitive process was unnecessary because only a few individuals could perform this type of professional service.

have been more clearly stated in the confirmation documents. Furthermore, it would be acceptable to convert basis points fees into dollars by multiplying .0025 (2.5 basis points charged) times the notional amount of the underlying debt in order to obtain an estimate of fees paid.

**Interview of the District's Current Financial Advisor**[78]

On July 24, 2009, OSI interviewed Scott Shearer of PFM. He provided the following information:

- He has been employed by PFM since 1998, and his firm provides investment advisory services to over 100 school districts in Pennsylvania.

- He was engaged to provide services to the District in October 2008.

- PFM Asset Management LLC, an investment advisor registered under the Investment Advisers Act of 1940, has provided advice to the District regarding interest rate swaps (QIRMAs) over that same time period.

- The District had too many underlying bonds and notes structured at variable rates, which significantly affected the District's debt structure and caused the District to enter into QIRMAs. The underlying variable-rate bonds and notes with QIRMAs attached to them held the District captive to the bonds and notes and did not provide a reasonable and cost effective opportunity to terminate the agreements.

- Liquidity providers protect the District, for a hefty fee, in the event that the bonds are not able to be remarketed by the remarketing agent. These providers offer capital and liquidity in order for the District to sell bonds.

- The Dexia Group, a European bank that served as the liquidity provider for the District's 2003 WCTMA Note, did not renew the five-year agreement with the District to provide liquidity services. Very few companies provide these services. This forced the District to terminate QIRMA #1, refinance the note, and pay a large termination payment to the QIRMA counterparty. The termination payment for the QIRMA was high because long-term interest rates were low.

- The 2003 WCTMA Note was used to refund 1998 and 2001A fixed-rate bonds with a variable rate. The issuance of this note and the QIRMAs attached to the issuance were extremely complicated and risky.[79] The structure of this debt was very different

[78] In its response to the draft report, the District presented Mr. Shearer's request that parts of the summaries of his interviews be amended for clarification purposes in this final public report. We have accepted most of his suggestions, but we have indicated with a footnote the few instances where to do so would result in a material change to the statement he gave in the interviews based on our contemporaneous records.

[79] In its response to the draft report, the District presented Mr. Shearer's request that the words "and risky" be deleted.

from what he had ever seen, especially during a time when QIRMAs were in their infancy.

- In his opinion, an appropriate portfolio of debt at a school district should consist of 25-33% of overall debt in variable-rate underlying financing, with or without QIRMAs. The remaining 66-75% should be in fixed-rate debt. Using this ratio allows local government units to leverage debt. More variable rate debt means more risk, especially when QIRMAs are associated with the underlying variable-rate debt.

- The "structuring agent" fees paid by the District for the QIRMAs were "almost unheard of and not normal."[80] The average fee for swap advisory services is difficult to ascertain given limited public disclosure, but in Pennsylvania seems to have averaged about 2.0 basis points per annum on the outstanding notional amount, present valued and paid up-front. Bear was paid a fee of 4.0-6.0 basis points per annum (present valued and paid up-front) for his services, which is relatively high. All of the District's notional amounts were relatively high; therefore, basis points charged should probably have been less than 2.0.

- The counterparty spread fees paid by other Pennsylvania school districts typically averaged between 6-10 basis points for negotiated transactions at that time (though they are typically lower for competitively bid transactions), but the District may have paid as high as 18 basis points. These fees are not required to be disclosed, and only the counterparty and possibly the swap/financial advisor will know the fees. The spreads are not expressed in dollars, but in basis point differences from the mid-market interest rates on the date the QIRMA was entered into. Current law does not require disclosure of spread fees.

- There are no ongoing fees associated with QIRMAs. Reference to commitment fees, remarketing fees, and placement agent fees paid by the District relates to the underlying variable-rate notes or bonds. The District also paid annual rating fees and is paying fees to a trustee on its variable-rate debt.

- The Shippensburg Borough Authority ("SBA") 2007 Series bond issued by the District (see Table 1) was altered on May 1, 2009. The variable-rate bond had an amortization acceleration clause that would require the District to amortize payments over five years rather than 20 years if the bonds were sent to the liquidity facility and could not be remarketed after a certain period of time. This would have significantly increased the District's debt service payments.

- In 2009, the District obtained a line of credit that refinanced the 2007 SBA variable-rate bond with a better variable rate, but only for a two-year period. This "fix" to reduce variable-rate interest risk is just a "band-aid" and will need to be re-evaluated in the future. A QIRMA is still attached to this bond. The SBA 2007, 2005, and

[80] In its response to the draft report, the District presented Mr. Shearer's request that the words "almost unheard of and not normal" be changed to "above average."

2007 bonds with QIRMAs are performing well and are providing positive cash flow to the District. The debt service payments on these bonds are under the budgeted amounts. The termination of the 2003 WCTMA Note with a fixed rate bond issue "helped" the District and reduced the risk in the District's debt portfolio.

- Another of his school district clients has been very successful in its use of QIRMAs. He attributes this to the fact that this district over-budgets debt service for anomalies in the market, has a rainy day fund, and has a very sophisticated school board. He stated that QIRMAs must be properly and actively monitored.

- Providers of QIRMAs often provide a false sense of security by using terms such as "synthetic fixed rate." The rate is only "fixed" if all market conditions behave in a certain way, which does not always happen.

- Yet another of his school district clients has an appropriate mix of variable- and fixed-rate underlying bonds and notes. This district has saved $7-8 million using fixed- and variable-rate bonds without QIRMAs.

- In his opinion, QIRMAs are good tools if they are actively managed by an advisor and the school board, and the QIRMA must be entered into at prudent and suitable levels. Many districts have done very well with them.

On July 27, 2009, OSI contacted Shearer and Andrew McKendrick, of PFM's Swap Group in Philadelphia regarding "spread fees" paid by the District to counterparties. They provided the following information:

- Spreads only relate to the initial pricing of QIRMAs and do not affect the underlying bond or note.

- When a QIRMA is entered into, the only money to change hands is a wire transfer from the counterparty to the District for fees paid to counsel, advisor, etc. The District does not exchange any money with the counterparty and does not know the dollar amount of this spread fee. The counterparty, and possibly the financial advisor, would be the only individuals who would know the spread fees.

- The counterparty spread fee is essentially the commission the counterparty makes by entering into the QIRMA. It is the difference between the mid-market rate (as observed at the time of pricing) and the rate finally agreed to by the counterparty and swap advisor. The difference, in basis points, between the two is what the counterparty earns on a gross basis when it hedges the transaction. The calculations are extremely complex and are based on present values at the exact moment of pricing that include a variety of different moving variables, including capital and credit charges of the bank, hedging costs in the swap market, and profit to the bank for the service, among others. Depending on the QIRMA, spreads may be more valuable or less valuable based on specific provisions or options listed in the QIRMA. This was the case with the 2003 WCTMA Note. They indicated that it was very

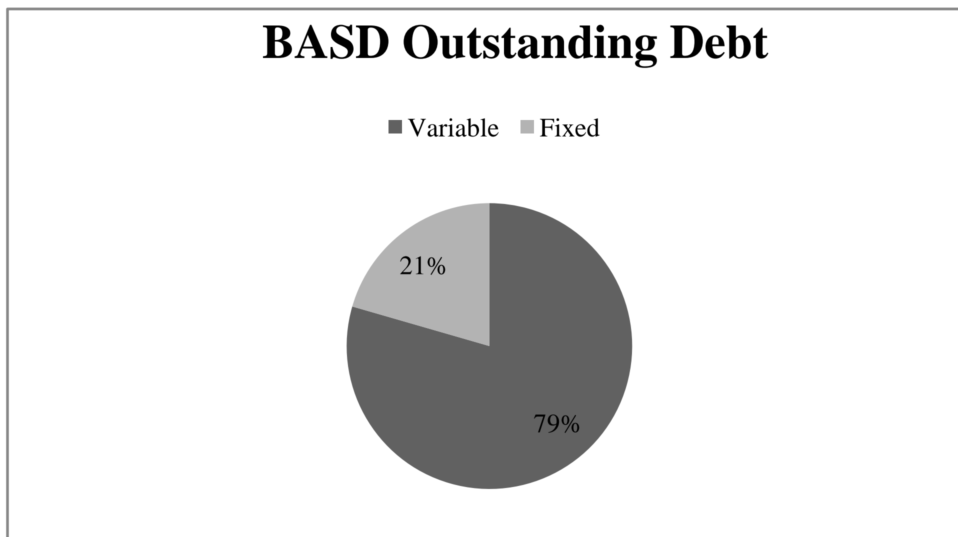
difficult to provide an estimate as to what the dollar value of the spread fees would have been on the two QIRMAs associated with the 2003 WCTMA Note without having been directly involved at time of pricing.[81]

In addition, Shearer provided OSI with a copy of a financial schedule that he created for the Board in a report dated November 14, 2008. This schedule summarizes the interest rate structure of the District's outstanding bonds and notes, as referenced in Table 6.

**TABLE 6**
***PFM's Summary of District Bonds and Notes as of Nov. 14, 2008***

| SERIES | FIXED INTEREST- Amount of Par Outstanding | VARIABLE INTEREST- Amount of Par Outstanding |
|---|---|---|
| | | |
| Series of 1998 | $ 605,000 | |
| Series of 2001 A | 6,030,000 | |
| Series of 2003 –WCTMA Note | | $72,165,000 |
| Series of 2005 | | 54,985,000 |
| Series A of 2007 | 50,745,000 | |
| Series of 2007 | | 54,995,000 |
| Series of 2007- SBA Notes | | 39,995,000 |
| | | |
| **TOTALS** | **$57,380,000** | **$222,140,000** |

The following chart, which depicts the data provided by Shearer in Table 6, shows the variable- and fixed-rate percentages of this debt:




[81] In its response to the draft report, the District presented Mr. Shearer and Mr. McKendrick's request that the following phrase be added to the end of this sentence in this final public report: "though 'post-trade' estimates can be made."

## Interview of the District's Current Bond Counsel[82]

On July 24, 2009, OSI interviewed Jens H. Damgaard, Esquire, of Rhoads & Sinon LLP.[83] He provided the following information:

- He has been employed as bond counsel at Rhoads & Sinon since 1982. He has been counseling the District since November 2008. His law firm has represented approximately 110-120 school districts as bond counsel in Pennsylvania.

- The District's situation regarding the use of QIRMAs is unique due to the total amount of outstanding debt issued by the District (approximately $280 million dollars), the percentage of this outstanding debt that was of variable-rate structure (more than 75% of the District's debt), and the amount of fees paid by the District on QIRMAs (the doubling effect of having a "structuring agent" and "financial advisor" resulted in fees charged that were higher than industry averages.)

- He believes that Bear presented a possible conflict for the District because Bear's firm was an underwriter of bonds and swap advisor.[84]

- LGUDA requires a new filing with DCED every time that a QIRMA is amended, refunded, or terminated. Every time that a QIRMA is amended, a district assumes more risk.

- He agrees with Shearer that the District's financial distress originated more from the District's overall debt structure, and was not necessarily the result of the QIRMAs. The District "crossed any and all normal lines" of debt structure.[85] It had too many underlying bonds and notes structured at variable rates that ultimately broke down

[82] In its response to the draft report, the District presented Mr. Damgaard's request that parts of this summary of his interview be amended for clarification purposes in this final public report. We have accepted most of his suggestions, but we have indicated with a footnote the few instances where to do so would result in a material change to the statement he gave in the interview based on our contemporaneous records.

[83] Rhoads & Sinon LLP of Harrisburg has been the District's bond counsel since November 2008. It is not the District's solicitor. Bond counsel prepares the documents and issues the legal opinions needed to carry out the issuance of debt and entering into legal QIRMAs. It does not advise on the business decisions leading to a transaction. From May 1995 until January 2008, the District's solicitor was Sweet, Stevens, Tucker & Katz LLP of New Britain, Pennsylvania (now, Sweet, Stevens, Katz & Williams LLP). Since January 2008, the District's solicitor has been King, Spry, Herman, Freund, & Faul LLC of Bethlehem.

[84] In its response to the draft report, the District presented Mr. Damgaard's request that this final public report include a revised summary of his response to the question of whether or not Bear had a conflict of interest. Because the revised summary is not consistent with our contemporaneous records of the interview, we have not changed the summary above. However, to the extent that the revised summary reflects Mr. Damgaard's current thoughts on the matter, or thoughts not clearly communicated during the interview, we present it here:

> The duties of a financial advisor, as a fiduciary to the District, are not necessarily consistent with those of an underwriter under the terms of a typical bond purchase agreement. The role and responsibilities of a swap structuring agent are unclear and should be equivalent to that of the financial advisor under the LGUDA.

[85] In its response to the draft report, the District presented Mr. Damgaard's request that this sentence be deleted.

due to the lack of liquidity following the meltdown in the banking industry. The District faced a high degree of risk that was beyond its control.

- With regard to the structure of the District's indebtedness, fixed-rate bondholders assume all risk. With variable-rate bonds and notes, the District assumes not only interest rate risk, but also liquidity and downgrade risk, because bondholders retain the right to give back or "tender" the bonds. The District must then rely on a bank's willingness to lend it the money to do so.

- In general, LGUs, and particularly school districts, run into problems with these complex agreements because they do not always budget or set aside funds for problems that can occur with the financial markets relative to risk exposure. In addition, risks and terms should be explained to the governing body in plain terms because the officials typically are unfamiliar with these financial instruments.

- LGUDA should be strengthened and there should be greater guidance in the creation of interest rate management plans and the permitted use of money received from QIRMAs.

- He had expressed these concerns to DCED's Chief Counsel, Steven Fishman, and advised Fishman that bond counsel need additional guidance on QIRMAs so they can ensure compliance with LGUDA and issue legal opinions on the enforceability of QIRMAs.

- When QIRMAs are entered into, it is usually by telephone conference call. The telephone conversation is recorded and the exact date and time is noted in order to establish the current market rate and mid-market spread. The counterparty and swap advisor always participate in these telephone conversations, plus at least one authorized representative of the school district, such as the business manager or superintendent, who must make an oral acceptance of the agreement.

- The "spread" paid to the counterparty is usually considered a "fee" that is legally required to be disclosed in an interest rate management plan. Not all financial advisors fully disclose the information voluntarily. This information would be easier to comprehend if fees and spreads were required under the LGUDA to be disclosed in actual dollars and not in basis points calculated using a present value of the future QIRMA payments.

- LGUDA should also require a "cooling off period" between the time that the interest rate management plan is presented to the governing board and the date on which the QIRMA is formally approved by the LGU. This will allow for municipal managers and school boards to digest the information. There could also be a public hearing, with questions and answers, offered to the public that solely discusses the proposed QIRMA.

- He agrees with Shearer that the "structuring agent" fees paid by the District for the QIRMAs were "almost unheard of and not normal."[86]

- The vast majority of local governments cannot understand the risks associated with QIRMAs and must rely almost exclusively on their financial advisors for guidance. The financial advisors may have a financial interest in having the transaction approved.

- QIRMAs have received bad press because of the actions of certain financial advisors and counterparties who were "pushing" these agreements on clients that should not have them.[87]

- Counterparties can terminate QIRMAs pursuant to LGUDA when a district's bond rating, liquidity provider rating, or insurer rating is downgraded.

- Currently, the length of an LGU's exposure under QIRMAs can be many years beyond the term of its commitment for liquidity on the underlying variable rate bonds. This and other issues under LGUDA should be examined in light of the recent market turmoil.

**Interview of the District's Current Independent Auditor**

On July 16, 2009, OSI interviewed William H. Gorman, Jr., CPA, of Gorman & Associates, P.C., who provided the following information regarding his independent audit of the District for 2007-08:

- The 2007-08 audit of the District was conducted in the fall of 2008, and this was his first engagement with the District.

- The audit noted there has been an influx of problems with the District's debt service payments due to the global economic climate and credit crunch.

- The District's debt service payments are "through the roof."

- There was nothing abnormal about the fees charged for the QIRMAs because, based on his experience, financial advisors and banks "love" to make large fees on these agreements.

[86] In its response to the draft report, the District presented Mr. Damgaard's request that we delete the words "almost unheard of and."

[87] In its response to the draft report, the District presented Mr. Damgaard's request that we revise this sentence as follows: "QIRMAs have received bad press because of the actions of certain financial advisors and counterparties who were recommending complex agreements for clients that were not financially capable of dealing with resulting problems."

- He audits about 15 school districts. Three school districts that he audits have entered into QIRMAs. One of them has actually made money on the QIRMAs because the agreements were structured well and the agreements used a 10-year LIBOR rate as opposed to a short-term rate.

- In his professional and personal opinion, school districts and other government units should not enter into risky agreements such as QIRMAs. They cannot outsmart large investment banks like J.P. Morgan.

- There are rewards with QIRMAs, but the risks outweigh the rewards. He uses the following analogy when discussing the QIRMAs with auditees. The average person normally enters into a fixed-rate mortgage (as opposed to an adjustable-rate mortgage) unless the person needs a lower payment because he/she is trying to purchase a house that is too costly for his or her income. A school district or other public entity must live within its means just like the average person.

- No government entity should expose the citizens and residents to the risks relating to swap agreements, because public money is involved.

**Interview of DCED Attorneys**

On July 14, 2009, OSI interviewed DCED Chief Counsel Steven J. Fishman and Deputy Chief Counsel Bernadette Barattini. They provided the following information:

- LGUs have employed QIRMAs as provided for under LGUDA for some time.

- No state or federal statute prohibited or restricted the use of QIRMAs.

- Prior to the amendments to LGUDA contained in Act 23, there was a difference of opinion by legal counsel as to whether LGUs had the legal authority to enter into QIRMAs. Some solicitors relied upon the borrowing authority contained in the school and municipal codes. Bond counsel had expressed concern about the legality of QIRMAs prior to Act 23. Act 23 made it legal for LGUs to enter into QIRMAs and established guidelines that are monitored by DCED.

- They did not know how many QIRMAs existed prior to Act 23 because there was no requirement to record them.

- LGUs enter into QIRMAs as a means to keep a portion of their debt portfolio linked to the interest rate market. QIRMAs are attractive to LGUs because they provide money up front to help balance budgets.

- The Municipal Securities Rulemaking Board ("MSRB") is the official repository for all municipal bond disclosure documents and trade data. MSRB is currently promoting the "mark to market" disclosure, which requires assigning a value to an

asset based on the current market price of the asset. QIRMAs are considered assets and not liabilities.

- Act 23 requires LGUs to file all bond transactions with DCED. Prior to filing, the entity must authorize the QIRMA by resolution, show proof of publication, adopt a financial management plan, and disclose termination payments. Fishman opined that LGUs "fall apart" at this level.

- DCED provided the following list of QIRMA providers (i.e., counterparties) doing business with LGUs in Pennsylvania:

  - Bear Stearns
  - Citibank
  - DEPFA Bank
  - Deutsche Bank AG
  - Goldman Sachs
  - J.P. Morgan Chase Bank
  - Lehman Brothers Special Financing
  - Merrill Lynch Capital Services
  - Morgan Stanley
  - PNC Bank NA
  - Royal Bank of Canada
  - USB
  - Wachovia

- QIRMAs are relatively new in Pennsylvania, and their effect could not be quantified because they are attached to liabilities extending 30 or 40 years into the future.

- Fishman recommends that:
  - The level of education and awareness of the decision-makers should be heightened.
  - The independence of the financial advisors assisting the decision makers should be strictly maintained.
  - The law itself is not the problem. It is the decision makers, such as the business managers and the school boards, who are not acting in a conservative manner or making financial decisions in the best interest of the taxpayer or the LGU.

- Fishman favors changes to LGUDA that he believes will address the deficiencies inherent in the law.[88] He also favors guidelines intended to provide guidance for the creation and administration of educational courses on qualified interest rate management agreements pursuant to Section 8281(h) of his proposed amendments to LGUDA.

[88] The amendments to LGUDA favored by Fishman are set forth in Appendix C.

## **CONCLUSIONS AND RECOMMENDATIONS:**

We found that the use of QIRMAs associated with just one of the District's outstanding debt instruments – the variable-rate 2003 WCTMA Note – has cost the District dearly. Our comparative analysis of various forms of financing available to the District at the time shows that the use of two QIRMAs associated with the issuance of the variable-rate 2003 WCTMA Note cost the District $10.2 million more than if the District had issued a standard fixed-rate bond or note at the fixed interest rate prevailing at the time. Furthermore, entering into the series of QIRMAs associated with this note has cost the District $15.5 million more than if it had simply paid the interest pursuant to the terms of the variable-rate note without entering into any QIRMAs.[89]

We were able to perform this analysis only on the 2003 WCTMA Note because it was the only one of the District's outstanding debt instruments as to which the ultimate cost to the District could be quantified. Because the District has other QIRMAs still in effect in connection with its other outstanding debt, the ultimate financial impact of the District's use of QIRMAs remains to be determined. Depending on future market fluctuations and other risk factors – which are inherently unpredictable – and the District's reaction to them, these active QIRMAs may or may not prove to be financially beneficial to the District. However, it is quite obvious that the District would need to realize gains of over $10.2 million, in a best-case scenario, over the terms of all of its outstanding QIRMAs in order to offset the losses that it has experienced in connection with the 2003 WCTMA Note.

The main reason that the District's losses were so great is that the fees and costs incurred by the District on the QIRMAs associated with the 2003 WCTMA Note were excessive, especially a $12.3 million payment that the District had to pay to the investment bank counterparty to terminate one of the agreements. Additionally, all of the investment industry participants we interviewed, who are knowledgeable about how QIRMAs are customarily structured, confirmed that the "structuring agent fee" paid on one of the QIRMAs associated with the 2003 WCTMA Note was particularly excessive. In fact, the District's current financial advisor and its bond counsel both stated that the fees paid by the District on all of its QIRMAs were far in excess of industry averages.

This investigation also revealed the deceptive marketing tactics that can be employed by investment banks, intermediaries, and advisors to sell these highly complex financing deals to relatively unsophisticated public officials. We found that fees that were characterized as being paid by the investment banks were actually ultimately charged to the District. We found that the agreements resulted in huge hidden profits for the investment banks that were not required to be, and have not been, disclosed to the District. We found that the intermediaries involved in the agreements had at least the appearance of conflicts of interests as a result of representing the interests of counterparties as well as the District. Obviously, the huge fees and immediate profits generated by these agreements, in combination with their inherent complexity, present a

[89] As previously explained in footnotes 69 and 70, this is a paradoxical outcome that illustrates the risks inherent in the use of variable-rate bonds and notes with QIRMAs, and should not be construed as our condoning the issuance by LGUs of variable-rate bonds and notes.

powerful temptation to sell them in a fashion that over-emphasizes the financial benefits and minimizes the risks.

Act 23 is deficient in that it does not impose a fiduciary duty on a financial advisor to give advice to the LGU that is not tainted by the fact that the financial advisor's remuneration is coming from an entity whose interest is adverse to the LGU. The District's experience with QIRMAs is an especially egregious example of this. When transactions are structured in a fashion such that the counterparty does not make any profit, and the intermediaries do not receive their fees, unless the deal is consummated, the interests of the counterparty and the intermediaries in receiving payment are inherently in conflict with the interests of the LGU. In such circumstances, the best protection available to an LGU is the impartial advice of a competent and disinterested financial advisor. However, because LGUDA does not impose a fiduciary duty on the financial advisor, and the financial advisor's fee is paid by an entity whose interest is adverse to the LGU, the LGU is left effectively unprotected.

Our interviews of members of the District's school board confirm that they had, at most, an imperfect understanding of the many significant risks involved. We also found that they were under the impression that all of the fees that might be incurred by entering into such transactions were to be paid by the investment banks, when, in fact, all such fees were ultimately paid by the District. At least two of the transactions were structured to provide the District with substantial cash payments at the inception of the deals as an additional inducement, while failing to disclose to the District that the investment bank was making a huge and immediate profit on the deal that was far in excess of the cash paid to the District. In short, these interviews confirm, and we specifically find, that the QIRMAs entered into by the District were sold to the District in an inherently deceptive manner.

Some District officials have contended that the District's losses were caused by the recent unusually severe downturn in the global economy, suggesting that, if conditions were more normal, the losses would not a have occurred. We do not regard this as an acceptable excuse. The possibility of a severe global economic downturn was entirely within the scope of the risk that the District assumed by entering into the QIRMAs. This merely illustrates that the inherent risk factors associated with QIRMAs were not well understood.

There is virtual unanimity that QIRMAs are extremely risky financial instruments and require diligent oversight by the LGU issuer. The District's former financial advisor not only failed to adequately explain the risks involved with QIRMAs, but also failed to provide the necessary oversight to effectively monitor the QIRMAs. QIRMAs, by their very nature, must be actively managed by both the financial advisor and the LGU issuer's governing body. The LGU must not only be adequately educated in all aspects of QIRMAs prior to entering into such agreements, but must also have a financial contingency plan in place to respond to market fluctuations and other risk factors, including rare anomalies such as a global economic downturn.

Our review of LGUDA, as amended by Act 23, moreover, reveals a statute written primarily for the benefit and protection of the financial services industry, which is composed of the investment banks and the intermediaries involved in marketing these derivatives. For example, the counterparties to QIRMAs are empowered to have PDE withhold a school district's state subsidy in the event that the school district fails to make a payment required by a QIRMA.

Furthermore, LGUDA does not require a counterparty to a QIRMA to disclose the "spread fee" that it receives from the deal, and counterparties routinely refuse to disclose such fees. LGUDA also empowers a counterparty to terminate a QIRMA if the bond rating of the LGU issuer is lowered. Whatever safeguards do exist in the law for LGUs are ineffectual.

The District appears to have complied with the applicable provisions of LGUDA as amended by Act 23 of 2003. However, we are concerned less by the District's compliance with state law with regard to entering into the QIRMAs at issue than by the propriety of governmental entities risking public funds via QIRMAs in the first place.

When dealing with public funds, the fundamental guiding principle has always been that preservation of those funds is paramount, i.e., public funds should not be exposed to risk of loss. That is why governmental entities entrusted with custody of public funds have traditionally been restricted to an authorized list of extremely safe investments, such as U.S. Treasury instruments. We find that the entire concept of QIRMAs is tantamount to permitting LGUs to gamble with public money and is, therefore, fundamentally incompatible with traditional restrictions on the use of public funds.

Accordingly, we conclude that QIRMAs are highly risky and impenetrably complex transactions that, quite simply, amount to gambling with public money. Moreover, they are susceptible of being marketed deceptively, and they principally benefit the investment banks and the multitude of intermediaries who sell them to relatively unsophisticated public officials.

Furthermore, the various state reform proposals set forth in the interviews, while imposing additional costly requirements such as mandatory continuing education of public officials, are not likely to prevent negative experiences such as occurred at the District from occurring in the future. Most importantly, none of the reform proposals changes the basic nature of the transactions, which are essentially a form of gambling with public money.

Our recommendation is therefore simple and strong. Because gambling with public money should not be permitted, the use of QIRMAs and other derivatives by LGUs should be prohibited by law.[90]

**We recommend the following:**

- The General Assembly should immediately repeal Act 23 of 2003;
- The General Assembly should immediately amend LGUDA, the Public School Code of 1949, the various municipal codes, and any other statutes that govern the

[90] Note that our recommendation is limited to the transactions that *local government units and municipal authorities* may enter into and is predicated on the traditional restrictions on exposing public funds to risk of loss. Our recommendations are not intended to apply to the transactions and investments of private individuals and entities. We note that legislation is pending in the U.S. Congress to reform the CFMA and subject these types of transactions to more effective regulation, and such efforts are laudable. However, for the reasons stated in this report, we believe that such reform legislation is inadequate to protect public funds from the unacceptable risk of loss posed by such transactions.

investments and contracts that LGUs and municipal authorities[91] are authorized to enter into in order to clearly and unequivocally prohibit school districts, other LGUs, and authorities, from utilizing QIRMAs or any of the specific devices and techniques encompassed therein currently in existence or yet to be invented in connection with the issuance of public debt;

- Regardless of whether the General Assembly acts upon our recommendations, no LGU or municipal authority in this Commonwealth should enter into or utilize such instruments from this day forward;
- Any LGU or municipal authority in this Commonwealth that is a party to an active QIRMA should immediately terminate it and refinance with conventional debt instruments if necessary; [92] and
- LGUs and municipal authorities should hire their financial advisors through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

Unfortunately, nothing can protect school districts, other LGUs, or municipal authorities from the possible adverse effects of the QIRMAs that have already been entered into. Some investment advisors have recommended that entities with active QIRMAs should closely monitor the agreements in consultation with competent and impartial financial advisors, to minimize the risk of further loss of public funds, and to terminate them as soon as reasonably possible. Unfortunately, we cannot concur with such advice, because to do so would be to condone the continued gambling with public funds.

We are providing copies of this report to the following governmental and independent entities that may have an interest in this matter for their review and whatever further action they may deem appropriate:

- Pennsylvania Department of Community and Economic Development;
- Pennsylvania Department of Education;

[91] We have added municipal authorities to the list of public entities that should be prohibited from using QIRMAs because LGUs should not be able to accomplish indirectly, by using a municipal authority as a conduit, what they are prohibited from doing directly. Our intention in making these recommendations is not to merely revert to the state of affairs as it existed prior to the enactment of Act 23 of 2003, when such transactions were structured to use municipal authorities as conduits, as occurred with the 2003 WCTMA Note that we have analyzed in this report. Our intention is to prohibit LGUs from entering into these transactions altogether. In this regard, we note that a recent news article reported that a major element of the District's most recent plan to extricate itself from the QIRMAs associated with one of its bond issues involves the issuance by the District of a new variable-rate bond and the transfer of some of the District's QIRMAs to the Bethlehem Area School District *Authority*. *See* Steve Esack, "Bethlehem schools swap out more risky debt," *The* (Allentown) *Morning Call,* September 22, 2009. We do not know the details of this complex transaction, and we have not analyzed it. However, to the extent that this transaction leaves the District exposed to the risk factors associated with QIRMAs, even if only indirectly, we disapprove.

[92] We also note that the use of variable-rate bonds and notes was apparently very rare prior to the advent of QIRMAs. The use of variable-rate bonds or notes also exposes the LGU issuer to the risk of potentially enormous losses in the event that interest rates rise, which is an inherently unpredictable event. In that sense, the use of such instruments is, in itself, a form of gambling with public money. However, because there may be some limited circumstances in which the issuance of variable-rate bonds or notes – *without* accompanying QIRMAs – may be appropriate (such as if variable-rate financing is the only type of financing available), we are not recommending at this time that the law should be changed to totally prohibit LGUs from using such instruments.

- Pennsylvania Treasury Department;
- Pennsylvania Office of Attorney General;
- Pennsylvania Securities Commission;
- Pennsylvania State Ethics Commission;
- U.S. Department of Justice, Antitrust Division;
- U.S. Department of the Treasury, Office of Domestic Finance;
- U.S. Securities and Exchange Commission;
- U.S. Commodities Futures Trading Commission;
- Federal Bureau of Investigation;
- Federal Reserve Bank of New York;
- Congressional Oversight Panel;
- State and federal legislative committees;
- Municipal Securities Rulemaking Board; and
- Government Finance Officers Association.

In particular, we encourage the various law enforcement agencies that will receive this report to investigate and prosecute any conflicts of interest that were involved in these transactions. We also encourage them to pursue all available avenues to recover funds for the taxpayers of the District and other LGUs resulting from any and all breaches of fiduciary duty, including equitable relief from existing QIRMA obligations foisted on the LGUs by financial entities and advisors.

This is a public report and its distribution is not limited. The Department of the Auditor General will follow up at the appropriate time to determine of the status of action on our recommendations.

## Explanation of Report Appendices

**Appendix A** and **Appendix B** provide information regarding Pennsylvania school districts and other LGUs that have entered into QIRMAs or interest rate swap agreements on bonds or notes issued. Both the school districts and other LGUs are listed in alphabetical order. This information is extracted from documents filed with DCED pursuant to the requirements of LGUDA.

The QIRMAs are required to be filed with DCED pursuant to Section 8284 of LGUDA. This requirement was imposed by Act 23 of 2003. LGUDA requires the local government unit file with DCED certified copies of the resolution authorizing the QIRMA, including any appendix to the resolution, 15 days following the adoption of the resolution. The information[93] included in the appendices was provided by DCED to OSI on July 10, 2009. It should be noted that these appendices do not indicate whether the QIRMA entered into by the LGU had a negative or positive impact financially. Each individual LGU's records would need to be reviewed and examined in order to make those determinations. In addition, the mere filing with DCED does not constitute approval of the agreement by DCED.

**Appendix A** shows that 107 out of 500 Pennsylvania school districts (21.4%) filed QIRMAs with DCED during the period October 2003[94] through June 2009 pursuant to the requirements of LGUDA as amended by Act 23 of 2003. The 107 school districts listed in the appendix encompass 38 of Pennsylvania's 67 counties.

**Appendix B** shows that 86 other types of LGUs in Pennsylvania filed QIRMAs with DCED during the period October 2003 through June 2009 pursuant to the requirements of LGUDA as amended by Act 23 of 2003. The 86 other LGUs listed in the appendix encompass 20 of Pennsylvania's 67 counties.

**Appendix C** contains the amendments to LGUDA that are favored by DCED Chief Counsel Steven J. Fishman.

**Appendix D** is a glossary of terms used throughout this report.

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[93] The information provided by DCED has been slightly modified. Information referencing the general obligation bond/note identification number, DCED comments that reference termination, refunding or amending of bond/note, DCED date received, and bond/note principal or notional dollar amount references were determined not to be pertinent and were therefore deleted.

[94] The effective date of Act 23 of 2003, which provided express authority to LGUs to enter into QIRMAs, was September 24, 2003.

# APPENDIX A

## *School Districts in PA that Entered into QIRMAs under Act 23 of 2003, Listed by Host County*

## *Oct. 2003-June 2009*

| Host County | Local Government Unit with QIRMA(s) |
|---|---|
| Adams | Bermudian Springs School District |
| Allegheny | Allegheny Valley School District |
| Allegheny | East Allegheny School District |
| Allegheny | Hampton Township School District |
| Allegheny | Keystone Oaks School District |
| Allegheny | McKeesport Area School District |
| Allegheny | North Allegheny School District |
| Allegheny | North Hills School District |
| Allegheny | Pine-Richland School District |
| Allegheny | Shaler Area School District |
| Allegheny | South Allegheny School District |
| Allegheny | South Park School District |
| Allegheny | Steel Valley School District |
| Allegheny | Sto-Rox School District |
| Allegheny | West Jefferson Hills School District |
| Bedford | Chestnut Ridge School District |
| Berks | Boyertown Area School District |
| Berks | Conrad Weiser Area School District |
| Berks | Daniel Boone Area School District |
| Berks | Exeter Township School District |
| Berks | Governor Mifflin School District |
| Berks | Hamburg Area School District |
| Berks | Oley Valley School District |
| Berks | Reading School District |
| Blair | Altoona Area School District |
| Bradford | Athens Area School District |
| Bradford | Towanda Area School District |
| Bucks | Neshaminy School District |
| Bucks | New Hope-Solebury School District |

| Host County | Local Government Unit with QIRMA(s) |
|---|---|
| Bucks | North Penn School District |
| Bucks | Pennridge School District |
| Bucks | Pennsbury School District |
| Bucks | Quakertown Community School District |
| Bucks | Souderton Area School District |
| Butler | Butler Area School District |
| Butler | Mars Area School District |
| Butler | South Butler County School District |
| Cambria | Greater Johnstown School District |
| Carbon | Hazleton Area School District |
| Centre | State College Area School District |
| Chester | Downingtown Area School District |
| Chester | Great Valley School District |
| Chester | Octorara Area School District |
| Chester | Owen J. Roberts School District |
| Chester | Oxford Area School District |
| Crawford | Conneaut School District |
| Crawford | Crawford Central School District |
| Crawford | Penncrest School District |
| Dauphin | Central Dauphin School District |
| Dauphin | Derry Township School District |
| Dauphin | Harrisburg City School District |
| Dauphin | Middletown Area School District |
| Dauphin | Steelton-Highspire School District |
| Delaware | Garnet Valley School District |
| Delaware | Haverford Township School District |
| Delaware | Marple Newtown School District |
| Delaware | Ridley School District |
| Delaware | Rose Tree Media School District |
| Delaware | Southeast Delco School District |
| Delaware | Wallingford-Swarthmore School District |
| Erie | Erie City School District |
| Erie | Iroquois School District |
| Fayette | Albert Gallatin Area School District |
| Lackawanna | North Pocono School District |
| Lackawanna | Scranton City School District |
| Lancaster | Lampeter-Strasburg School District |

| Host County | Local Government Unit with QIRMA(s) |
|---|---|
| Lancaster | Manheim Central School District |
| Lancaster | Manheim Township School District |
| Lancaster | Octorara Area School District |
| Lancaster | Penn Manor School District |
| Lancaster | Pequea Valley School District |
| Lancaster | Solanco School District |
| Lawrence | New Castle Area School District |
| Lebanon | Cornwall-Lebanon School District |
| Lehigh | Allentown City School District |
| Lehigh | Bethlehem Area School District |
| Lehigh | Parkland School District |
| Luzerne | Hazleton Area School District |
| Luzerne | Pittston Area School District |
| Lycoming | Loyalsock Township School District |
| Lycoming | South Williamsport Area School District |
| Mercer | West Middlesex Area School District |
| Monroe | Pocono Mountain School District |
| Monroe | Stroudsburg Area School District |
| Montgomery | Lower Merion School District |
| Montgomery | Lower Moreland Township School District |
| Montgomery | North Penn School District |
| Montgomery | Souderton Area School District |
| Montour | Danville Area School District |
| Northampton | Bangor Area School District |
| Northampton | Bethlehem Area School District |
| Northampton | Easton Area School District |
| Northampton | Nazareth Area School District |
| Northumberland | Danville Area School District |
| Perry | Susquenita School District |
| Philadelphia | Philadelphia School District |
| Pike | Wallenpaupack Area School District |
| Schuylkill | Blue Mountain School District |
| Schuylkill | Hazleton Area School District |
| Somerset | Somerset Area School District |
| Tioga | Southern Tioga School District |
| Washington | Bentworth School District |
| Washington | Canon McMillan School District |

| Host County | Local Government Unit with QIRMA(s) |
|---|---|
| Washington | McGuffey School District |
| Washington | Trinity Area School District |
| Wayne | North Pocono School District |
| Wayne | Wallenpaupack Area School District |
| Wayne | Western Wayne School District |
| York | Central York School District |
| York | Dallastown Area School District |
| York | Dover Area School District |
| York | Eastern York School District |
| York | Red Lion Area School District |
| York | Southern York County School District |
| York | Spring Grove Area School District |
| York | York City School District |

***Note**: There are more than 107 entries on this chart due to some school districts being located in more than one county.*

# APPENDIX B

## *Other Local Government Units in PA that Entered into QIRMAs Under Act 23 of 2003, Listed by Host County*

### *Oct. 2003-June 2009*

| Host County | Local Government Unit with QIRMA(s) |
|---|---|
| Adams | Adams County |
| Adams | Oxford Township |
| Allegheny | Allegheny County |
| Allegheny | Bethel Park Municipality |
| Allegheny | McKeesport City |
| Allegheny | Upper St. Clair Township |
| Armstrong | Armstrong County |
| Beaver | Beaver County |
| Berks | Berks County |
| Berks | Exeter Township |
| Berks | Reading City |
| Berks | West Reading Borough |
| Bucks | Bensalem Township |
| Bucks | Bristol Borough |
| Bucks | Buckingham Township |
| Bucks | Bucks County |
| Bucks | Chalfont Borough |
| Bucks | Doylestown Township |
| Bucks | Lower Makefield Township |
| Bucks | New Britain Township |
| Bucks | New Hope Borough |
| Bucks | Penndel Borough |
| Bucks | Perkasie Borough |
| Bucks | Plumstead Township |
| Bucks | Solebury Township |
| Bucks | Upper Southampton Township |
| Chester | Avondale Borough |
| Chester | Chester County |

| Host County | Local Government Unit with QIRMA(s) |
| --- | --- |
| Chester | East Goshen Township |
| Chester | East Nottingham Township |
| Chester | Franklin Township |
| Chester | Highland Township |
| Chester | Kennett Square Borough |
| Chester | London Britain Township |
| Chester | London Grove Township |
| Chester | Lower Oxford Township |
| Chester | New Garden Township |
| Chester | Pennsbury Township |
| Chester | Pocopson Township |
| Chester | Sadsbury Township |
| Chester | South Coventry Township |
| Chester | Uwchlan Township |
| Chester | West Fallowfield Township |
| Chester | West Sadsbury Township |
| Chester | West Vincent Township |
| Dauphin | Dauphin County |
| Dauphin | Derry Township |
| Dauphin | Harrisburg City |
| Delaware | Chadds Ford Township |
| Delaware | Delaware County |
| Delaware | Glenolden Borough |
| Delaware | Lansdowne Borough |
| Delaware | Morton Borough |
| Delaware | Nether Providence Township |
| Delaware | Radnor Township |
| Delaware | Ridley Township |
| Delaware | Swarthmore Borough |
| Delaware | Tinicum Township |
| Delaware | Upper Chichester Township |
| Delaware | Upper Darby Township |
| Erie | Erie City |
| Lackawanna | Lackawanna County |
| Lancaster | Lancaster City |
| Lancaster | Lancaster County |
| Lancaster | Millersville Borough |

| Host County | Local Government Unit with QIRMA(s) |
|---|---|
| Luzerne | Luzerne County |
| Mercer | Mercer County |
| Montgomery | Bridgeport Borough |
| Montgomery | Franconia Township |
| Montgomery | Hatfield Township |
| Montgomery | Lower Providence Township |
| Montgomery | Lower Salford Township |
| Montgomery | Montgomery County |
| Montgomery | Pottstown Borough |
| Montgomery | Rockledge Borough |
| Montgomery | Royersford Borough |
| Montgomery | Upper Dublin Township |
| Montgomery | Upper Hanover Township |
| Montgomery | Upper Pottsgrove Township |
| Montgomery | Upper Salford Township |
| Montgomery | Whitemarsh Township |
| Northampton | Northampton County |
| Somerset | Somerset County |
| Washington | Washington County |
| Westmoreland | Westmoreland County |
| York | York County |

# APPENDIX C

## *Amendments to LGUDA favored by Steven J. Fishman, Chief Counsel of PA Dept. of Community & Economic Development (amendatory language in bold typeface)*

§ 8281. Qualified interest rate management agreements

(a) General rule.—

(1) Except as set forth in paragraphs **(8) and (9)**, notwithstanding any other law to the contrary, a local government unit **in connection with, or incidental to, the issuance or carrying of bonds, but only for the purpose of hedging, or reducing, the amount or duration of payment, interest rate, spread, or similar risk, or to result in a lower cost of borrowing** may negotiate and enter into qualified interest rate management agreements consistent with the provisions of this subchapter.

(2) The local government unit must authorize and award by resolution each qualified interest rate management agreement or any confirmation of a transaction. The resolution is subject to section 8003(a) and (b) (relating to advertisement and effectiveness of ordinances) but may be valid and effective for all purposes immediately upon adoption or as otherwise provided in the resolution.

**(3) Prior to executing and delivering a qualified interest rate management agreement the local government unit must adopt, amend or ratify a qualified interest rate management plan governing entering into and managing qualified interest rate management agreements that addresses authorized purposes, permitted types, creditworthiness of counterparties, interest rate risk, basis risk, termination risk, credit risk, market-access risk, and other risks, liquidity, methods of selection of counterparties, limits concerning awarding a transaction, monitoring, and exposure in accordance with subchapter (b).**

**(4) Prior to executing and delivering a qualified interest rate management agreement the local government unit must adopt, amend, or ratify a debt management plan in accordance with subchapter (c).**

**(5) Prior to executing and delivering a qualified interest rate management agreement the executive officers of the local government unit must be knowledgeable on the benefits and risks involved with such transactions and must meet the educational requirements set forth in subchapter (h).**

**(6) Prior to executing and delivering a qualified interest rate management agreement, the local government unit must complete a Qualified Interest Rate Management Agreement Information Sheet in accordance with subchapter (i) and submit it along with copies of the local government unit's interest rate management plan, debt management plan, and qualified interest rate management agreement to the Department of Community and Economic Development.**

(7) A local government unit has the power to contract for insurance covering the risks of nonpayment of amounts due under qualified interest rate management agreements.

(8) The authority granted in this subchapter shall not apply to any local government unit which has been declared distressed by the Department of Community and Economic Development.

**(9) A local government unit may not enter into any qualified interest rate management agreement for purposes of investment or speculation.**

**(b) Contents of qualified interest rate management plan. – Prior to executing and delivering a qualified interest rate management agreement, the local government unit shall have adopted an interest rate management plan, prepared by integrating the recommended practices published by the Government Finance Officers Association or comparable nationally recognized professional organization and providing guidance with respect to the permitted purposes, authorization process, mitigation of risk factors, ongoing oversight responsibilities, market disclosure, financial strategy, and any other factors in connection with such agreements and shall include:**

**(1) An analysis of the interest rate risk, basis risk, termination risk, credit risk, market-access risk, and other risks to the local government unit entering into qualified interest rate management agreements, including a presentation of detailed scenarios of:**

**(a) the transaction outcome at the maximum rate, representing the upside risk to the public body,**

**(b) the transaction outcome based on the current market, and**

**(c) the anticipated transaction outcome based upon the reasonable current expectations of the public body that are the bases for the decision to enter into the transaction.**

**(2) Estimated and maximum scheduled periodic payments which would be due under the qualified interest rate management agreement**

**(3) The local government unit's procedure for approving and executing qualified interest rate management agreements;**

**(4) The local government unit's plan to monitor interest rate risk, basis risk, termination risk, credit risk, market-access risk, and other risks;**

**(5) The local government unit's procedure for maintaining current records of all qualified interest rate management agreements that have been approved and executed; and**

**(6) Such other provisions as may from time to time be required by the governing body of the local government unit, including but not limited to additional provisions due to changes in market conditions for qualified interest rate management agreements.**

**(7) Demonstration that the CEO and CFO, or equivalent financial officials, of the public body are knowledgeable regarding the market conditions required for, or relevant to, the exchange agreement, and explicit written acknowledgement of the range of potential outcomes as demonstrated in the response to item (1) and the acceptance of the financial risks and adverse potential outcomes presented therein.**

**(a) Representation that legal counsel, the financial advisor or bank**

**representing the public body have explained the legal and financial risks, respectively, of the transaction.**

**(b) Explanation of the sizing of the transaction in relation to rating agency risk evaluation criteria.**

**(8) Demonstration of an expected long-term financial benefit to the public body.**

**(9) Representation by and compensation of financial advisor, if any.**

**(10) Method of selection of counterparty.**

**(11) Anticipated timing of transaction, including the date of execution and date of termination.**

**(12) Evidence that the counterparty is rated in either of the two highest rating categories of a nationally recognized rating agency.**

**(13) A schedule listing all consulting, advisory, brokerage or similar fees, paid or payable by the local government unit in connection with, or costs associated with, the qualified interest rate management agreement, and a schedule of any finder's fees, consulting fees or brokerage fees, paid or payable by the other party in connection with the qualified interest rate management agreement. Including a schedule of all fees paid, by either party, to any natural person, firm, partnership, association or corporation involved in obtaining the qualified interest rate management agreement, including the counterparty's disclosure of any payments the counterparty made to another person to procure the transaction.**

**(14) If a governing body authorizes an interest rate management agreement transaction, the governing body shall designate an officer of the issuer to monitor and report on the transaction. At least annually, the designated officer shall present to the governing body a written report, signed by the designated officer, on all outstanding interest rate management agreement transactions conducted for the issuer. The report must:**

**(1) describe the terms of the transactions;**

**(2) contain a statement:**

**(A) of the fair value of each transaction;**

**(B) of the value of any collateral posted to or by the issuer under the transactions with each counterparty at the year's end; and**

**(C) reviewing the transactions' cash flows;**

**(3) identify with respect to each transaction the counterparty, any guarantor of the counterparty's obligations under the transaction, and the credit ratings of the counterparty and the guarantor; and**

**(4) state whether the continuation of the transactions under the agreement would comply with the issuer's interest rate management agreement policy.**

**(c) Contents of debt management plan – In addition to a qualified interest rate management plan, the local government unit shall have prepared a debt management plan that includes:**

**(1) A schedule listing the amount of debt outstanding for each outstanding debt issue of the local government unit and the expected annual debt service on that debt. In the case of variable-rate debt, the schedule shall set forth the estimated annual debt service**

**thereon and annual debt service on the debt calculated at the maximum rate specified for the variable-rate debt. {53 Pa C.S §8002}**

**(2) A schedule listing the notional amounts outstanding of each previously executed qualified interest rate management agreement which is then in effect. { 53 Pa C.S §8002}**

**(3) Analysis of the effect of rising interest rates on variable-rate holdings of the municipality.**

**(4) Analysis of the risk in maintaining variable risk holdings.**

**(5) Estimated and maximum net payments of total debt service and scheduled periodic net payments, which would be due under all of the qualified interest rate management agreements entered into by the local government unit.{ 53 Pa C.S §8002}**

**(6) A valuation of the market or termination value of all outstanding qualified interest rate management agreements. {53 Pa C.S §8002}**

**(d)** Contents of qualified interest management agreements. -- In addition to other provisions approved by the local government unit, a qualified interest rate management agreement must contain all of the following:

(1) The covenant of the local government unit to make payments required by the qualified interest rate management agreement and the covenants authorized by section 8282 (relating to covenant to pay amounts due under qualified interest rate management agreements).

(2) The notional amount of the qualified interest rate management agreement and the principal amount of bonds or notes or lease rental debt, or portions of the notional or principal amounts, issued or to be issued by the local government unit under this subpart or guaranteed by the local government unit under this subpart, to which the agreement relates.

**(3) Net amount or benefit estimated to be received from the exchange agreement.**

**(4)** The term of any qualified interest rate management agreement, which must not exceed the latest maturity date of the bonds or notes referenced in the qualified interest rate management agreement.

**(5)** A provision requiring the termination of the agreement if all debt to which the qualified interest rate management agreement relates is no longer outstanding.

**(6)** The maximum annual interest rate which the local government unit may pay there under.

**(7)** A provision that the maximum net payments by fiscal year of a local government unit shall not exceed the maximum interest rate specified in the qualified interest rate management agreement for:

(i) periodic scheduled payments, not including any termination payments, due under the qualified interest rate management agreement; and

(ii) the interest on the bonds or notes to which the qualified interest rate management agreement relates.

**(8)** The source of payment of the payment obligations of the local government unit, which must be either general revenues or revenues specifically identified in the agreement.

**(9)** A **provision detailing termination provisions and collateralization or other requirements in event counter-party is downgraded below the two highest rating categories and the source of moneys to fund obligations or purchase price by issuing authority.**

**(10)** A provision that periodic scheduled payments due under the qualified interest rate

management agreement and debt service due on the related bonds or notes or payments due under the related instrument evidencing lease rental debt or guaranty of the local government unit shall be senior in right and priority of payment to termination payments due under the qualified interest rate management agreement.

**(11) A provision stating that any payments shall be payable only in the currency of the United States of America.**

**(12) A provision stating the notional amount of any qualified interest rate management agreement shall not exceed the outstanding principle amount of the debt to which the agreement relates.**

**(13) A provision stating that the local governmental entity's obligations will terminate immediately and absolutely at such time as the funds encumbered for payment by the local governmental entity, pursuant to the terms of the agreement, are no longer available to satisfy such obligations.**

**(14) A provision stating that any qualified interest rate management agreement shall be governed by the laws of the Commonwealth of Pennsylvania, and jurisdiction over the local government unit in any matter concerning a qualified interest rate management agreement shall lie exclusively in the courts of the Commonwealth of Pennsylvania or in the applicable federal court having jurisdiction and located within the Commonwealth of Pennsylvania.**

**(15) A provision stating that no counterparty under any such qualified interest rate management agreement shall ever have the right to compel any exercise of the taxing power of the local government unit to pay any amount due under any such qualified interest rate management agreement, nor to enforce payment thereof against any property of the local government unit, other than the specified revenue source; nor shall any such qualified interest rate management agreement constitute a charge, lien, or encumbrance, legal or equitable, upon any property of the local government unit, other than the specified revenue source.**

**(e)** Other provisions of the qualified interest rate management agreement.-- The qualified interest rate management agreement may include:

(1) A covenant to include any termination payment or similar payment for a qualified interest rate management agreement in its current budget at any time during a fiscal year or in a budget adopted in a future fiscal year.

(2) A provision that the following shall be equally and ratably payable and secured under the applicable covenants authorized in section 8282:

(i) Periodic scheduled payments due under the qualified interest rate management agreement; and

(ii) Any of the following to which the agreement relates:

(A) the debt service due on the bonds or notes;

(B) payment under an instrument evidencing lease rental debt; or

(C) payment under a guaranty of the local government unit.

(3) A provision that the qualified interest rate management agreement may be terminated at the option of the local government unit without cause but that the qualified interest

rate management agreement may not be terminated at the option of the other party to the qualified interest rate management agreement without cause.

**(f)** Award of qualified interest rate management agreements.--

(1) The local government unit shall establish a process for selecting other parties before entering into a qualified interest rate management agreement.

**(2) A counterparty must be a bank, insurance company, or other financial institution duly qualified to do business in the state that either:**

**(A) Has, or whose obligations are guaranteed by an entity that has, at the time of entering into a qualified interest rate management agreement and for the entire term thereof, a long-term unsecured debt rating or financial strength rating in one of the top two ratings categories, without regard to any refinement or gradation of rating category by numerical modifier or otherwise, assigned by any two of the following: Moody's Investors Service, Inc., Standard & Poors Ratings Service, a division of The McGraw-Hill Companies, Inc., Fitch, Inc., or such other nationally recognized ratings service approved by the governing body of the local government unit; or**

**(B) Has collateralized its obligations under a qualified interest rate management agreement in a manner approved by the local government unit.**

(3) A qualified interest rate management agreement must be awarded by public sale, private sale by negotiation or private sale by invitation.

(4) The local government unit shall select the qualified interest rate management agreement which the local government unit determines is in its best financial interest. The qualified interest rate management agreement selected must contain financial terms and conditions which in the opinion of the independent financial advisor to the local government unit are fair and reasonable to the local government unit as of the date of award.

(5) The local government unit may satisfy the requirements of paragraph (4) by obtaining a finding from an independent financial advisor to the public authority that the financial terms and conditions of the agreement are fair and reasonable to the public authority as of the date of the award if all of the following apply:

(i) The local government unit is incurring indebtedness under this chapter which has or will be issued to a public authority.

(ii) In connection with the incurring of debt under subparagraph (i), the local government unit will become obligated for all or a portion of the public authority's costs under an interest rate management agreement.

**(g)** Requirements for resolution. **{Originally §8281(b)}** -- The resolution authorizing and awarding a qualified interest rate management agreement or authorizing a transaction under the agreement must include in the resolution or as an appendix to the resolution all of the following:

(1) A copy of the qualified interest rate management agreement or confirmation of the transaction under the qualified interest rate management agreement in substantially the form to be executed pursuant to the resolution.

(2) A copy of the interest rate management plan adopted by the local government unit.

**(3) A copy of the debt management plan.**

**(4) A copy of the completed Qualified Interest Rate Management Agreement Information Sheet.**

**(5)** A statement of the manner of the award of the qualified interest rate management agreement under subsection (f).

**(h) Educational requirements. – Both the Chief Executive Officer and Chief Financial Officer, of any local government unit proposing to enter into a qualified interest rate management agreement, must attend educational trainings, in conformance with this subsection to executing and delivering a qualified interest rate management agreement:**

**(1) The Chief Executive Officer and Chief Financial Officer must attend educational trainings that have been approved by the department with consultation from the Department of Education, that meet the requirements specified by the department.**

**(2) The minimum training required is six educational hours.**

**(3) The educational trainings must have been attended no more than two years prior to the request.**

**(i) Information sheet. – In addition to a qualified interest rate management plan, debt management plan, and a draft of the qualified interest rate management agreement, described in subchapters (b-d), any local government unit wishing to enter into a qualified interest rate management agreement must also submit to the department a completed Qualified Interest Rate Management Agreement Information Sheet, the form of which will be provided by the department.**

# APPENDIX D

## *Glossary of Terms Used in this Report*[95]

**Bond** – A debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing.

**Commitment Fee** – A fee that lenders charge their borrowers for unused credit or credit that has been promised at a specified future date.

**Counterparty** – A party to an interest rate swap agreement (e.g., the District and J.P. Morgan were the counterparties to QIRMA #1).

**Derivative –** Financial contracts or instruments whose value is derived from the price of other securities or indexes.

**Hedge -** Lessening risk by taking positions that will offset each other.

**Liquidity provider** – An entity that maintains firm bid and offer prices in a given security by standing ready to buy or sell at publicly quoted prices. The entity charges a fee to provide this service, and it specifically relates to variable rate financing.

**Note** – A short-term debt security, usually with a maturity of five years or less.

**Notional Amount** or **Notional Principal Amount** – The specified principal amount on which the exchanged interest payments are based. Each period's rates are multiplied by the notional principal amount to determine how much each counterparty must pay to the other counterparty. In a swap, no principal ever actually changes hands between the counterparties,

**Risk –Varieties:**

> **Basis risk** - The risk that arises when variable interest rates on a QIRMA and an associated bond or other interest-paying financial instrument are based on different indexes. When different indices are used, there is the possibility that the relationship between indices will change such that projected cost savings or synthetic interest rates may not be realized.
>
> **Credit risk or counterparty risk** - The risk to each party of a contract that the counterparty will not live up to its contractual obligations.
>
> **Insurance risk** – The risk that no financial institution will be able to continuously provide insurance to the LGU in order to mitigate the risk of loss from default.

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[95] *See www.investopedia.com for* additional information and explanations regarding terminology used throughout this report.

**Interest Rate Risk** – In the event that absolute interest rates increase without corresponding decrease to the current BMA/LIBOR ratio, the Floating Rate payable by the issuer may exceed the Fixed Rate payable by the counterparty, which would cause the issuer to make net payment to the counterparty, thereby increasing its total debt service obligations as compared with its current obligations.

**Liquidity risk** - The risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss.

**Market-access risk** - The risk that an LGU will not be able to enter credit markets or that credit will become more costly. This type of risk arises when an LGU enters into a QIRMA in anticipation of entering the credit market at a later time but is subsequently prevented from doing so, compromising the objective of the QIRMA.

**Market risk** - The day-to-day potential for an LGU to experience losses from fluctuations in securities prices.

**Rollover risk** - The risk that a derivative associated with an LGU's debt does not extend to the maturity of that debt. In other words, rollover risk arises when the term of the derivative is shorter than the term of the LGU's corresponding debt, thereby creating a gap in the protection otherwise provided by the QIRMA.

**Termination risk** – The risk that the swap will be terminated before maturity and that market conditions at the time of termination will be such that the issuer will be required to make a termination payment to the counterparty.

**Swaption -** Options on interest rate swaps. The buyer of the Swaption has the right to enter into an interest rate swap agreement by a specified future date.

**Synthetic Fixed Income Rate** or **Synthetic Fixed Rate –** A artificial rate created by issuing variable-rate bonds or notes and then entering into a separate variable-to-fixed-rate interest rate swap agreement with a counterparty for all or a portion of the debt.

**Variable Interest Rate -** An interest rate that fluctuates with the market for borrowed funds.

## BETHLEHEM AREA SCHOOL DISTRICT'S RESPONSE TO DRAFT REPORT

### I. <u>EXECUTIVE SUMMARY</u>

The District understands that this Auditor General's report is a case study, and many other districts are in a similar situation. We appreciate that the Auditor General was able to discern the need for LGUs to be dependent upon the quality of the information received through the financial advisor when considering financial transactions. We agree that our former financial advisor "failed to adequately explain the risks involved with QIRMAs" and also "failed to provide the necessary oversight to effectively monitor the QIRMAs." We especially appreciate your specified finding that "the QIRMAs entered into by the District were sold to the District in an inherently deceptive manner."

It has been distressing to learn the lack of protection that is provided to LGUs, and the limited required disclosure that is required by existing Pennsylvania laws regarding financial advisors and transactions as outlined in the Conclusions and Recommendations of the report.

*[**<u>Note from the Department of the Auditor General</u>:** Section II ("Financial Findings") and Section III ("Interview Findings") of the District's response are suggested line-by-line revisions to the text, computations, tables, and interview summaries set forth in the draft of this report that was sent to the District on October 7, 2009 for its review and response. As explained in this final public report, although the Department of the Auditor General does not necessarily agree with all of the suggested revisions set forth in Section II of the District's response, we have decided, in fairness, to adopt and incorporate virtually all of them, with explanatory footnotes where necessary. Furthermore, except as noted in footnotes in the text of the report, we have also decided to adopt and incorporate into the report most of the suggested revisions set forth in Section III of the District's response. Accordingly, as the substance of the District's comments in Sections II and III have already been addressed in the body of this final public report, and in the interest of brevity, we have removed Sections II and III from the District's response presented herein.]*

### IV. <u>AUDITOR GENERAL'S RECOMMENDATIONS</u>

The District has reviewed the Auditor General's recommendations, many of which are directed to the General Assembly. Two specific recommendations are directed to LGUs such as the District.

One recommendation is that LGUs should hire their financial advisors through a competitive selection process. The District first became aware of the extent of its risk exposure in the debt portfolio in mid-2008. The District initiated an approach to unwind itself from the adverse impact that the QIRMAs had on the debt portfolio. At that time, the District determined it needed a different financial adviser, and initiated a competitive selection process. It was October 2008 when PFM was engaged to offer guidance to the District regarding the strategies

and techniques that would be considered in reconstructing a financial plan. The District's financial advisor, PFM, actively monitors the District's debt instruments daily, and provides frequent updates and recommendations, including strategies and timing to minimize the District's risk exposure.

The Auditor General's report also recommends that LGUs immediately terminate any active QIRMAs. The District restructuring program is designed to unwind, restructure and reposition its debt portfolio in a strategic, responsible and prudent fashion. The District has been advised that the alternative of immediate termination of all QIRMAs would be disadvantageous in the current market. The execution of this restructuring program employs a phasing out approach designed to avoid disadvantages inherent in the immediate termination of all of the District's QIRMAs. Termination values, liquidity providers, cash flow, fees, and other factors are all considered by the financial advisor in determining the recommendations. There is frequent communication by PFM with the District regarding the options that exist at a particular time, along with a candid discussion of the risks and benefits to the district. The District believes that the active monitoring and reporting of the debt portfolio and the analysis of the current market impact on the portfolio will assist the District in achieving its goals.

Since the conclusion of OSI's investigation, the Board has continued the process it began in October of 2008 to restructure its existing debt portfolio. On October 26, 2009, the Board voted unanimously to adopt a parameters resolution for the termination of all three of its Constant Maturity Swaps (QIRMAs #6, #11, and #13). On October 27, 2009, with the advice of PFM, the Board officers authorized termination of QIRMAs #11 and #13, whose termination value exceeded the minimum amount set forth in the parameters resolution. QIRMA #11 was terminated for a net payment to the District (after all professional fees) of $1,020,085 and QIRMA #13 was terminated for a net payment to the District of $1,309,750. In addition to termination payments received by the District for terminating QIRMAs #11 and #13, the District has significantly reduced the amount of tax risk related to its existing debt when compared to its debt outstanding (from 101.76% to 69.53%), and has reduced its yield curve risk on its existing debt from 50.88% to 18.65%. PFM is monitoring QIRMA #6 and will terminate if market conditions warrant and the minimum parameters amount is met.

In conclusion, we are appreciative of the opportunity to respond to the Auditor General's Report. In this response, we have corrected some inaccuracies set forth in the report, and have reported the steps that the District has taken over the last year to reduce its risk exposure.

The District supports the efforts to modify laws that pertain to the complicated financing of public debt, and the District further supports the Auditor General and other agencies that may have jurisdiction over the matter of financial institutions and financial advisers to take appropriate action if the deceptive practices noticed in this report have violated existing laws.

## DEPARTMENT OF THE AUDITOR GENERAL'S COMMENTS ON BETHLEHEM AREA SCHOOL DISTRICT'S RESPONSE TO DRAFT REPORT

We appreciate the District's thoughtful and positive response to our draft report.[96] We can sympathize with the distress expressed by the District about the manner in which the QIRMAs were sold to it and the many shortcomings of its former financial advisor, and we commend the District for its diligence in selecting its current financial advisor, PFM, by way of a competitive selection process.

We also commend the District for its determination to extricate itself from its financial predicament. The complex program described in the District's response is evidently designed to minimize the District's exposure to risk, which is a commendable goal. It is also commendable, and very expensive, to engage a financial advisor to design such a comprehensive restructuring program, to monitor the District's debt instruments on a daily basis, and to provide frequent updates and recommendations, including strategies and timing to minimize the District's risk exposure.

However, to the extent that the program continues to subject the District to the multitude of risks associated with QIRMAs, it is tantamount to continuing to gamble with public money. We are not suggesting that the District is merely waiting and hoping that its luck improves sometime in the future. We do not doubt that PFM has the expertise to advise the District on "strategies and timing to minimize the District's risk exposure." Yet we must emphasize that the risk cannot be eliminated and that, if conditions in the future become even more unfavorable, it is the District and the District's taxpayers who will bear the loss, not the financial advisor.

It comes as no surprise that "immediate termination of all QIRMAs would be disadvantageous in the current market," but unless someone is willing guarantee that it will not be even more disadvantageous to the District in the future, and to indemnify the District for any additional losses, we must stand by our recommendation that any LGU in this Commonwealth that is a party to an active QIRMA should immediately terminate it and refinance with conventional debt instruments if necessary. As the District has evidently chosen to continue to expose its taxpayers to such risks, however circumscribed and prudently managed, we can only express our hope that the end result is in the best interest of the taxpayers. Regardless of the fact that the District may have made money on QIRMA #11 and QIRMA #13, the District would need to realize gains of greater than $10.2 million over the terms of all its outstanding QIRMAs in order to offset the losses it has experienced in connection with QIRMA #1 and QIRMA #2.

[96] Although we have not changed any of our recommendations, we made some revisions to this report where appropriate based on the District's response, as we explained in our note presented within the District's response and in footnotes throughout the report. The result is a report that is largely free of disputed facts, that is fair to the District, and that is more understandable to the reader. It is also more concise in that we were able to delete the line-by-line suggested revisions presented in the District's response.

This report is a public document, the distribution of which is not limited. The Department of the Auditor General will follow up at the appropriate time to determine the status of action on our recommendations.

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