



An Audit Report on Certification of the Permanent School Fund's Bond Guarantee Program

April 28, 2003

Members of the Legislative Audit Committee:

We certify that the amount of bonds guaranteed by the Permanent School Fund's (PSF) Bond Guarantee Program (Program) is within the limit prescribed by Section 45.053(a) of the Texas Education Code. However, the Program is approaching its guarantee capacity limit. The Program's remaining guarantee capacity of \$8.0 billion at August 31, 2002 is a decrease of \$5.5 billion from August 31, 2001.

As of August 31, 2002, the bonds guaranteed by the Program totaled \$26.0 billion, an increase of \$2.4 billion from August 31, 2001. The limit set forth in the Texas Education Code was \$34.1 billion, a decrease of about \$3 billion from August 31, 2001. The Internal Revenue Service (IRS) limit for the maximum amount allowable for guarantee was \$33.9 billion, also a decrease of about \$3 billion from August 31, 2001. The total amount guaranteed has reached approximately 76.5 percent of the more restrictive IRS limit, compared with 63.6 percent at August 31, 2001. The amount of bonds guaranteed and the limitations exclude any interest accretion on bonds.

Although the total amount of bonds guaranteed by the Program is within the limits prescribed by the Texas Education Code and the IRS, we previously identified three related issues that the PSF is addressing to ensure that it continues to comply with these limits, make adequate disclosure, and manage Program risk. We commend the actions that PSF has taken to resolve the issues related to accounting for bond accretion and extending the capacity of the Program. Details are provided in the attachment.

This certification is required by Section 45.053(b) of the Texas Education Code. The Program was created as a way for school districts to improve the credit rating and marketability of their bonds. When the Program guarantees school district bonds, the bond ratings are enhanced to the highest possible rating. The Program especially helps poorer school districts that have relatively low bond ratings. Without the Program, school districts would have to pay for private bond guarantee coverage or pay higher interest rates.

There are two limits for the total amount of bonds the Program can guarantee:

- The Texas Education Code sets the limit at two times the cost or market value of the PSF (whichever is lower), excluding real estate.

Program Savings to School Districts

The Program is saving school districts millions of dollars in interest and bond guarantee premium costs annually by enhancing school district bond ratings to the highest possible rating. Without this Program, school districts could improve the credit rating and marketability of their bonds only by paying private bond guarantors a fee to guarantee their bonds.

On average, having its bonds guaranteed by the Program saves a district private guarantee fees ranging from about 0.22 to 0.40 percent of principal and total interest depending on market conditions and the underlying bond rating of the school district. For example, a 5 percent, 30 year, \$20 million bond issue would cost about \$85,000 to \$155,000 in up-front fees for a private bond guarantee.

Bond Accretion

Some of the bonds guaranteed by the Program are deeply discounted bonds that "accrete" interest until maturity. Accretion is the accumulation of interest over the life of the bond. The issuer promises to pay the principal and interest in the future at maturity.

PSF excludes accretion with regard to the amount of bonds guaranteed and statutory limitations.

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- A 1991 IRS Letter Ruling sets a limit of 250 percent (or two and a half times) of the amortized cost or market value of the PSF (whichever is lower), adjusted for new deposits to the fund after May 14, 1989. Noncompliance with the IRS limit may result in school district bonds becoming taxable or in school districts having to pay a rebate to the IRS.

The Texas Education Agency (TEA), which approves bonds guaranteed by the PSF, generally agrees with our observations, and its responses are included in the attachment. We appreciate TEA's cooperation during this audit. If you have any questions, please contact Carol Smith, CPA, Audit Manager, at (512) 936-9500.

Sincerely,

Lawrence F. Alwin, CPA
State Auditor

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Attachment

cc: Members of the State Board of Education
Dr. Felipe Alanis, Commissioner of Education, Texas Education Agency
Mr. Holland Timmins, Acting Executive Administrator, Permanent School Fund

Follow-up on Prior Recommendations

Although the total amount of bonds guaranteed by the Permanent School Fund's (PSF) Bond Guarantee Program (Program) is within the limits prescribed by the Texas Education Code and the Internal Revenue Service (IRS), we previously identified three related issues that the PSF is addressing to ensure that it continues to comply with these limits. We provided the Legislative Audit Committee our previous report, *An Audit Report on Certification of the Permanent School Fund's Bond Guarantee Program* (SAO Report No. 02-038, April 2002), regarding three issues relating to the program limitations. The following table summarizes the issues and the implementation status of the recommendations.

Status of Recommendations from April 2002 SAO Report 02-038		
Recommendation	Status	Comments
<p>Section 1 - PSF should:</p> <ul style="list-style-type: none"> ▪ Complete its planning and set a target date for systematic accounting for capital appreciation bond (CAB) accretion. After PSF quantifies outstanding accretion, it should disclose the amount in the notes to its financial statements. ▪ Obtain an opinion from the Office of the Attorney General to validate PSF's interpretation that CAB accretion can be excluded from the calculation of total bonds guaranteed. 	Partially Implemented	<ul style="list-style-type: none"> ▪ PSF is in the process of loading more detailed Program data into a new investment accounting system portfolio sufficient to calculate bond accretion and reconciling the new portfolio with its old portfolio summary amounts. PSF has a goal of reporting the amount of accretion on bonds guaranteed by August 31, 2003. However, it cautions that budget cutbacks may prevent the hiring of temporary help to accomplish the work on a timely basis. ▪ PSF consulted its bond counsel and does not believe an Attorney General opinion is needed. PSF will disclose, but does not intend to include, the amount of accretion in the amount of bonds guaranteed based on industry practice and the absence of a specific legal requirement. We believe the disclosure of bond accretion will be sufficient to resolve this issue.
<p>Section 2 - PSF should discuss an appropriate limit for the Program with bond rating agencies and submit draft legislation to the Legislature to increase the statutory limit for the Program.</p>	Partially Implemented	<p>The Texas Education Agency (TEA) coordinated with the Program bond counsel, rating agencies, and legislative representatives regarding raising the Texas Education Code limits. Representative Hochberg introduced legislation to raise the limit to 2.5 times the cost or market value of the PSF, whichever is lower. We believe this increase will resolve the issue and will not endanger the PSF, as explained in our previous report.</p>
<p>Section 3 - PSF should, in conjunction with the Legislature, informally discuss with appropriate parties the applicability of the arbitrage tax laws to the Program and determine whether the IRS limit can be reevaluated.</p>	Partially Implemented	<p>TEA coordinated with its bond counsel for the Program and requested a reevaluation of the General Land Office (GLO) deposit reduction factor used in the Program limitation calculation. IRS advised that TEA must apply for a new letter ruling to obtain an IRS determination. TEA is considering waiting until the fall of 2003 to request the letter ruling so that it may combine its request with any other questions that may result from any new school finance initiatives enacted during the current legislative session. TEA also committed to addressing the issue with the Texas Office of State-Federal Relations to ask that office to consider federal legislation to raise or eliminate the federal restriction on the Program.</p>

Summary of Information Technology Review

Overall, the Texas Education Agency's (TEA) information systems that support the Program appeared to be working properly and enabled the PSF to report Bond Guarantee Program amounts and limitations accurately. PSF is currently in the process of loading more detailed Program bond data by individual maturity date into a new investment accounting system portfolio to provide the amount of interest accretion on the Program. PSF is also reconciling its old portfolio summary Program bond issue amounts with its new detailed portfolio Program amounts. Our tests of reconciliations and financial transactions processed by the information systems for fiscal year 2002 indicated that the reported Program amounts and limitations were accurate. As part of obtaining an understanding of internal control relevant to the audit of the fiscal year 2002 Program, we performed the following information technology-related procedures:

- Performed general and application control review procedures for the PSF's major investment information systems and analyzed the investment trading system
- Determined whether the PSF had properly deactivated access to automated investment accounting and trading systems for terminated employees
- Analyzed reviews of information systems conducted by other parties, such as the Department of Information Resources

Management's Responses



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Felipe T. Alanis
Commissioner of Education

April 17, 2003

Mr. Ron Zinsitz
Project Manager
Texas State Auditor's Office
1501 N. Congress Avenue
Austin, Texas 78701

Dear Mr. Zinsitz:

We are in receipt of your draft audit report on the certification of the Permanent School Fund's Bond Guarantee Program. I would like to thank you for the professionalism with which your office has conducted this audit. We appreciate the efforts of the State Auditor's Office to identify and resolve issues within the program and to improve and protect a program that, as your report states, is saving Texas school districts "millions of dollars in interest and bond guarantee premium costs."

We agree with your observations regarding the maximum amount allowable for guarantee and also regarding the total amount guaranteed under the program.

As you indicate in your follow-up on prior recommendations, the Texas Education Agency (TEA) has coordinated with bond counsel, rating agencies and legislative representatives regarding legislation to increase the statutory limits. TEA also plans to seek Internal Revenue Service (IRS) approval for proposed changes in the limitation calculations as well as any other initiatives enacted during the current legislative process.

If you have any questions, please contact Holland Timmins, Acting Executive Administrator of the Texas Permanent School Fund at 512-463-9169. Thank you.

Sincerely yours,

Felipe Alanis
Commissioner of Education

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Fulfilling the Promise for All Texas Children

Summary of Objective, Scope, and Methodology

Our objective was to determine whether the total amount of school district bonds guaranteed by the Program exceeded the limits established by state statute and the IRS and to follow-up on prior year related issues. We limited the scope to the amount of outstanding guaranteed bonds as of August 31, 2002.

To analyze bond information, we:

- Gained an understanding of governing statutes and business processes.
- Interviewed Program personnel.
- Compared bond information with external sources including independent audit reports of certain school districts.

This audit was conducted in accordance with generally accepted government auditing standards.