Bond Financing Options Explained to Parents and Taxpayers

by Hari Titan, Candidate for PUSD School Board 2014

Since 2000, our school district has identified a number of buildings needing renovation, for seismic safety and/or for modernization. In 2006 Piedmont voters approved a massive bond program to pay for seismic safety improvements (information is available at http://pusdbond.org). That program is now complete, but the School Board still has a long list of modernization measures it would like to complete.

The School Board is currently looking at another ballot measure next year, seeking voter approval to issue additional bonds to finance the renovation of the Alan Harvey Theater at Piedmont High School. The Board seems close to settling on a budget of $14.5 million, but has not settled on the types of bonds – its choice will make significant differences in how much Piedmont homeowners pay, and when. I do my best to explain these differences below.

Creative financing options have been put forward by bond industry with the stated purpose to help pass the bond measure with taxpayers.

These options would allow the School Board to eliminate tax increases until after older bonds mature in 2018 and 2020... but with higher long-term costs to homeowners.

In one of these options, the **Capital Appreciation Bond (CAB)**, no taxes are collected and no payments are made to bond holders for a number of years. Interest charges accumulate and are added to the principal borrowed which becomes a problem for taxpayers in the future.

Delaying tax payments hides higher taxes in the future due to compounded accrued interest payments. This increases the principal amount owed, described as "capital appreciation".

CABs share this trait of "negative amortization" with balloon mortgages and reverse mortgages.

Total taxes paid during the life of the bond eventually have to recapture the costs of the tax/payment holiday and compound interest effects. One way to think about this is called the "repayment ratio", which describes how many dollars are eventually repaid for every dollar of the bond amount.

From the repayment ratios suggested, a CAB bond cost between 3 to 4 times as much as a **traditional Current Interest bond (CIB)**.

The bond industry assumes (on faith) that the tax holiday of a CAB will be easier to sell to current taxpayers than a traditional Current Interest bond.

In Aug 2013, the School Board issued a CAB with no payments (and therefore no tax collection) for 14 years (until 2027) without consent of the majority of taxpayers.

Why should taxpayers in 14 years be liable for our expensive our CABs? California State Bill AB 182 explains that School Districts feel property valuations would be higher many years into the future and that higher taxes will become legal under Prop 39.

CABs have came under heavy taxpayer revolt which resulted in new legislation to require their disclosure to the public (effective 2014) in a ballot measure.

However the mere disclosure of CABs does not inform the public about its financial consequences. PUSD board members referred to AB 182's new legal maximum repayment ratio of 4 as a reason for the public to no longer be alarmed. The table below demonstrates whether a repayment multiplier of 4 looks like a good deal compared to a traditional Current Interest Bond (CIB).

Sum of Assessed Property Values (AV) for Piedmont 2013/14: $3,382,469,394

The new Bond Amount we are seeking is: $14,500,000

		Bond Type	
	Current Interest		**Capital Appreciation**
Yield (%) [level debt-service; level principal]	3.40%		7.00%
Yield Premium for the privilege of deferred payments	---		3.60%
Duration of Bond (years)	25		25
First year of taxation	1		15
District Total Tax Collected for duration of bond			
Repayment Ratio (Total Tax / Bond Amount)	1.5		4
Total Tax	$21,750,000		$58,000,000
Bond holder Interest Portion of these Taxes	$7,250,000		$43,500,000
Comparable Interest Rate (%)	3.40%		15.53%
Total Tax by assessed home value over life of bond			
Per $100,000 assessed value	$643.02		$1,714.72
Person A: $500,000 assessed home value	$3,215.11		$8,573.62
Person B: $1,500,000 assessed home value	$9,645.32		$25,720.85
Tax liability for Person B - tax liability for Person A	$6,430.21		$17,147.24
For average assessed value	$5,282.21		$14,085.89
Average Annual Bond tax	*All years*	*Years 1-14*	*Years 15-25*
Per $100,000 assessed value	$25.72	$0.00	$155.88
Person A: $500,000 assessed home value	$128.60	$0.00	$779.42
Person B: $1,500,000 assessed home value	$385.81	$0.00	$2,338.26
For average assessed value	$211.29	$0.00	$1,280.54

[The yellow areas are inputs for the calculations]

If we look at Total taxes (in green), traditional Current Interest bonds are way more appealing. If we are against any noticeable “tax increase” (in blue), then CABs are the winner.

The public should be given this explanation and choice.

Go to http://HariTitan.com/bond-tax-comparison.htm for an online version of this table that allows you to enter your home valuation and customize the effect to your tax liability.

Person B is paying more tax than Person A for either bond type. However this differential magnifies for CABs (see red). Folks who moved to Piedmont recently, bought near the 2006 peak or bought bigger homes would be more harmed by a CAB than a CIB in the long run.

The Board used a report from KNN (a "bond expert" and bank subsidiary) that did not try to inform these consequences to taxpayers.

The public needs to be fully informed along the lines of my table of pros and cons.

This function should not be outsourced to "bond experts" or the bond industry.

Fitch Ratings state that CABs harm tax rate capacity to meet subsequent needs for capital expenditures:

> "The higher yield, coupled with the longer repayment period, results in higher total debt costs for every dollar generated for projects compared to current interest bonds. As a result of these drawbacks, some issuers may find their tax rate capacity insufficient to meet subsequent capital demands."

San Mateo County (along with 2 other California counties) formed a Grand Jury to investigate CABs. One of their findings was:

> "Moreover, CABs create a disconnect between when borrowed money is spent and when (and by whom) it is paid back. The taxpayers who approve these loans are presenting the tab to their children and grandchildren."

The same report quotes California State Treasurer Bill Lockyer as stating:

> "The only people these deals benefit are the financial advisers, who have collected millions of dollars helping school districts sell capital appreciation bonds."

The California Association of County Treasurers and Tax Collectors has called for an "outright ban" on contributions by brokers, dealers and MUNI professionals to bond ballot measures. I would add this ban should also apply to funding for School Board elections.

California Governor Jerry Brown questioned the legality of "cash-out" nature of these bonds and the reporter suggests the property value increase assumptions are wild:

> "Moreover, the property taxes that will be needed to pay off the debt is based on wild assumptions that property values will increase exponentially."

This situation underlines the need for a School Board member who can craft accessible and comprehensive presentations and can help design and facilitate an electronic Town Hall that can reach greater numbers of engaged citizens on all subjects including matters of financial importance.

Hari Titan for the P.U.S.D. School Board 2014
Modernize access and decision making with an electronic Town Hall

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