

**UPDATE SCHOOL BOND LOAN  
PROGRAM FINANCING**

**House Bill 5832 as enrolled  
Public Act 245 of 2000  
Second Analysis (1-25-01)**

**Sponsor: Rep. Ron Jelinek  
House Committee: Education  
Senate Committee: Education**

***THE APPARENT PROBLEM:***

Since 1961 when the state created the Michigan School Bond Loan Fund, school districts have been able to receive the state's guarantee of their bond issues. The benefit to the districts is that when they sell their debt on Wall Street, they are able to use the state's credit rating (now AA+). School districts also can borrow from the loan program, which many do in order to level out their millage rate over the life of the bonds' repayment. (See *BACKGROUND INFORMATION*, below.)

Since the enabling act was adopted nearly 40 years ago, there have been changes in financial practices, and in addition, there are many new financial instruments available to investors. In order to authorize these new kinds of investments, as well as to modernize the investment practices and standards that guide the state treasurer when he manages the School Bond Loan Fund, legislation has been proposed to update the act.

***THE CONTENT OF THE BILL:***

House Bill 5832 would amend Public Act 112 of 1961, the School Bond Loan Fund Financing Act, which provides for the financing of the School Bond Loan Fund through the issuance of bonds and notes, to include commercial paper as a financing instrument available to the State Administrative Board for making loans to school districts. The bill also would authorize the board to issue bonds, notes, or commercial paper in order to refund bonds, notes, or commercial paper issued under the act. In addition it would require the state treasurer, instead of the superintendent of public instruction, to certify an amount needed to provide funds for loans to school districts.

In addition, House Bill 5832 would permit the State Administrative Board to authorize and approve insurance contracts; agreements for lines of credit; letters of credit; commitments to purchase bonds, notes,

or commercial paper; and, any other transaction to assure timely payment or purchase of any bonds, notes or commercial paper under the act. The board also could authorize and approve an interest rate exchange or swap, hedge, or similar agreement in connection with the issuance of bonds, notes, or commercial paper or in connection with outstanding bonds, notes, commercial paper, or other obligations.

House Bill 5832 also would permit the board to authorize the state treasurer to sell, deliver, and receive payment for bonds, notes, or commercial paper issued under the act; deliver these financial instruments partly to refund bonds, notes, or commercial paper and partly for other authorized purposes; select which outstanding bonds, notes, or commercial paper would be refunded; buy bonds, notes, or commercial paper issued under the act; approve interest rates or methods of determining interest rates, prices, discounts, maturities, and the like; execute, deliver, and pay the cost of remarketing agreements, insurance contracts, agreements for lines of credit, and the like, and any other transaction to assure timely payments or purchase on bonds, notes, or commercial paper issued under the act; and, determine the details of, execute, and pay the cost of an interest rate exchange, swap, hedge, or similar agreement.

MCL 388.981 and 388.982

***BACKGROUND INFORMATION:***

The School Bond Loan Program. In an explanation given to the Education Committee, the Department of Treasury included a program overview of the Michigan School Bond Loan (SBL) program. According to the overview, the program provides a state-sponsored credit enhancement and loan mechanism for K-12 public school district unlimited tax bond issues. The bonds must be *qualified* by the state treasurer to participate in the program. Bond proceeds must be

used for capital purposes as authorized by applicable state law (primarily the Revised School Code).

Participation in the SBL program benefits a school district in two ways: 1) Qualified bonds receive a rating equal to the state's credit rating, usually resulting in a lower interest rate and cost than a school district can achieve on its own. The state guarantees to pay debt service (i.e., to make an immediate loan to a district) whenever there is risk of default. Approximately 400 districts (about 80 percent of all districts) have qualified bonds outstanding. 2) A district may borrow on an ongoing basis from the state an amount sufficient to assist the district to pay principal and interest requirements on its outstanding qualified bonds. Borrowing from the SBL fund levels the ordinarily fluctuating debt millage that would have to be levied over the life of the bond issue (typically, 20 to 30 years). Approximately 111 school districts (about 20 percent of all districts) currently borrow from the SBL fund to augment their debt service payment.

The Department of Treasury explains the bond issue qualification process, as follows. A school district that seeks to issue qualified bonds must receive preliminary qualification of the proposed bond issue from the Department of Treasury before calling for a local election. The criteria for authorizing preliminary qualification are based on the proposal's compliance with requirements regarding the maturity structure of the bond issue, and the school district's demonstration both that the cost of project is "reasonable", and that it is needed, in order to adequately address current and probable future enrollment. After preliminary qualification, the school district holds an election. If a majority of the district's voters vote in favor of the proposal, the district may apply for final qualification. Upon approval of final qualification, a Certificate of Qualification is issued, and the district may proceed to sell the bonds to prospective investors with the credit enhancement that state qualification provides.

Further, the department explains borrowing from the School Bond Loan Fund, as follows. If a local debt levy of at least seven mills does not raise sufficient funds to pay the full annual debt service on the school district's bonds, the district may elect to borrow the additional necessary funds from the SBL fund. Loans are made to districts on a semi-annual basis. The loan approval process involves submitting an application to the SBL program, which includes information pertinent to qualified bonds outstanding, debt service obligations, state equalized valuation, debt mills, tax collections, and the district's loan needs. School districts repay loans, plus accrued interest, when local

debt levies yield more revenue than the annual debt service on the bonds. The school district continues to levy debt millage until the SBL loan plus SBL accrued interest is repaid. Since 1991, districts must levy at least seven mills or a high "computed" millage sufficient to repay the school bond loan funds within 60 months of the final bond maturity date. However, this repayment requirement is, in effect, extended if a school district issues a subsequent bond issue, and borrows from the SBL fund.

The Department of Treasury notes that with regard to state funding for the School Bond Loan Fund, Article IX, Section 16 of the constitution grants the state authority to issue general obligation debt without voter approval, to provide the funds necessary to issue loans. This is the only non-voted general obligation debt the state of Michigan may issue. The interest charged to school districts with outstanding loans is based on the interest cost to the state for these general obligation debts.

School Bond Debt Levels Increasing. According to testimony before the Education Committee, the recent surge in Michigan school district debt and the parallel increase in borrowing from the state's School Bond Loan Fund (SBLF) have left the state vulnerable to significant future financial liabilities. The Department of Treasury reports that when the state last sold debt on Wall Street to finance environmental clean-up projects, Moody's Investor Services, the national credit rating agency, specifically expressed concern regarding the growth in the state's contingent, qualified school debt. When Michigan's SBLF program debt is included in debt ratios (that is, "gross" state debt versus net tax-supported state debt), Michigan's debt burden triples.

Since 1994, the treasury department says state-qualified debt held by school districts has doubled to more than \$8.8 billion. Debt service owed by school districts' fiscal year 1998-99 debt service payments totaled approximately \$710 million. Borrowing from the SBL fund has also increased. In 1994, a total of 42 school districts borrowed from the fund to support their debt service on local bonds; today the SBL program loans funds to 111 school districts (about 20 percent of all districts). The total outstanding direct loans owed by districts to the fund increased from \$58 million in fiscal year 1993-94 to \$327 million in fiscal year 1998-99.

The Department of Treasury has expressed concern about this level of borrowing. For example, twenty participating school districts have been borrowing from the fund over 20 years, and five districts for more than 30 years. Further, 22 districts have recently issued new

bonds without repaying outstanding SBL fund loans, and without a millage increase. Instead, they borrow from the SBL fund and defer loan repayment, and accumulate interest costs on new loans.

Bonding and borrowing under the SBL fund program may be initially attractive to district school boards and their taxpayers, since annual debt millages are lower. However, by exchanging bonded debt for a school bond loan, total interest costs for the issue rise significantly. For example, a school district that issues bonds with no borrowing from the school bond loan fund might spend \$1 in interest costs over the life of the debt for every \$1 in bond proceeds. However, a school district that issues bonds that are partially financed by borrowing from the school bond loan fund might expend \$1.50 in interest costs for every \$1 in bond proceeds. What's more, a school that is already borrowing from the fund for previously issued bonds and is then proposing to issue yet additional bonds financed by borrowing from the fund will pay significantly more. Indeed, the Department of Treasury reports that recent proposals submitted by some school districts for review have indicated interest costs of \$2 to \$4.80 for each \$1 of bond proceeds. Estimates indicate that the potential SBL fund borrowings of existing participants in the program could reach \$1.2 billion in additional interest costs for these districts. It then follows that when funds are used for these higher interest payments, they are not available for capital projects.

In order to protect against fiscally irresponsible school bond issues, the state treasurer took action on July 22, 1999. At that time the department issued five parameters that evaluators follow when they review applications in order to give a district's bond proposal its preliminary qualification. (A preliminary qualification precedes a vote of the district's taxpayers, after which final qualification is given, and bonds are issued.) The five parameters require that preliminary qualification be contingent on several limiting conditions: *the financial impact of the bond issue* (including among other things a millage increase for current school bond loan fund borrowers, and an interest cost- to- bond ratio no higher than 1.5 to 1); *construction costs* (limits on costs per square foot, depending on region); *utilization of teaching station capacity* (a district-wide utilization rate of 85 percent); *amortization of bonds for a period not greater than the useful life of the assets*; and *new construction in combination with discontinued use* (demonstrated through a well-documented physical plant study that illustrates cost savings of abandonment and new construction).

### **FISCAL IMPLICATIONS:**

The House Fiscal Agency notes that the bill has no fiscal impact on the state or on local units of government. (1-24-01)

### **ARGUMENTS:**

#### **For:**

The bill would update the authorization language of the School Bond Loan Fund to enable the state treasurer who administers the fund to make a wider array of investments. The new investment flexibility will enable the state treasurer to provide higher yield investment services to the local school districts who borrow through the fund.

#### **Against:**

School bond debt has increased substantially during the past decade, and more effort should be made to curb the increase, especially in school districts that do not pay off their bonded indebtedness before incurring yet additional debt. Since the Department of Treasury put parameters in place last year to make borrowing more difficult for schools, some school districts have argued that the state treasurer does not have the authority to administer the program following the new rules. (See *BACKGROUND INFORMATION*, above.) Consequently, a companion bill, House Bill 5833, would have strengthened the state treasurer's authority to limit districts' borrowing and to deal with districts whose loans are in default. However House Bill 5833, though enacted as Public Act 290 of 2000, did not take effect due to the governor's veto of a key provision of the school aid budget, to which House Bill 5833 was tie-barred. Thus, the two-bill package is incomplete and does not effectively deal with the issues it was intended to address.

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