John Keel, CPA
State Auditor

An Audit Report on

Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2007

April 25, 2008

Members of the Legislative Audit Committee:

The State Auditor's Office certifies that, for the fiscal year ended August 31, 2007, the amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program (Program) was within the two limits applicable to the Program. One limit, prescribed by Sections 45.053(a) and (d) of the Texas Education Code, protects the Fund by minimizing the risk of loss to the Fund. The other limit, which was established by an Internal Revenue Service (IRS) letter ruling, is intended to prevent reductions in federal tax receipts due to bond arbitrage (issuing tax-exempt bonds for the purpose of investing the proceeds at higher rates than the tax-exempt bonds).

As of August 31, 2007, the bond guarantee capacity of the Fund was $52.9 billion. The total principal of the debt guaranteed by the Program on 2,518 outstanding bond issues was $44.9 billion. The guarantee saves school districts money by enhancing their bond ratings to the highest possible rating. Without the guarantee of this Program, school districts would need to (1) purchase private bond insurance or (2) pay higher interest rates on the bonds they sell.

The guarantee approval process complies with state laws.

The bond guarantee approval process is adequately designed and operates effectively to comply with state laws and regulations. Before a guarantee application is recommended for approval, personnel within the Texas Education Agency's (Agency) Bond Guarantee Program review several sources to determine whether the school district is financially sound. They then use a database to verify guarantee eligibility and prioritize applications according to rules in Title 19, Texas Administrative Code, Section 33.65 (19 TAC 33.65).

Objective, Scope, and Methodology

The objective of this audit was to determine whether the total amount of school district bonds guaranteed by the Permanent School Fund Bond Guarantee Program is within the limits established by state statute.

The scope of this audit covered the Permanent School Fund's (Fund) valuation, all bonds guaranteed by the Fund during fiscal year 2007, and the controls related to the guarantee and recording processes.

The audit methodology included analyzing investment data obtained from the Texas Education Agency and data originating at the Municipal Advisory Council, as well as information gathered during interviews.

Audit fieldwork was conducted from February 2008 through April 2008. We conducted this performance audit in accordance with generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives. The following staff of the State Auditor's Office performed the audit:

- Roger Ferris, CPA (Project Manager)
- Cindy Haley, CPA
- Worth Ferguson, CPA (Quality Control Reviewer)
- Sandra Vice, CIA, CGAP, CISA (Assistant State Auditor)

SAO Report No. 08-031

Each month, Fund personnel calculate the remaining capacity of the Program. Program personnel then ensure that applications recommended for approval will not cause the Program to exceed the amount of available capacity. To help ensure that the Fund accurately reports the amount of guaranteed bonds outstanding, Fund personnel semiannually reconcile Program records to the Municipal Advisory Council's records of guaranteed bonds. Auditors identified potential improvements in Program procedures for processing guarantee applications and communicated those issues, which were not significant to the objectives of the audit, in writing to Program management.

Recent changes have been made to Program statutes and rules.

The 80th Legislature amended the Texas Education Code to permit the State Board of Education (Board) to increase the multiplier used to calculate the Program's statutory capacity limit. Previously, the statutory limit was calculated as 2.5 times the lower of the Fund's cost or market value, which was the same method used to calculate the IRS limit. The new law gives the Board the authority to increase the multiplier to as much as 5 times the Fund's cost value, and the requirement to compare the cost and market values was eliminated. However, the law permits the Board to increase the multiplier to above 2.5 only if "the increased limit is consistent with federal law and regulations and does not prevent the bonds to be guaranteed from receiving the highest available credit rating, as determined by the board."

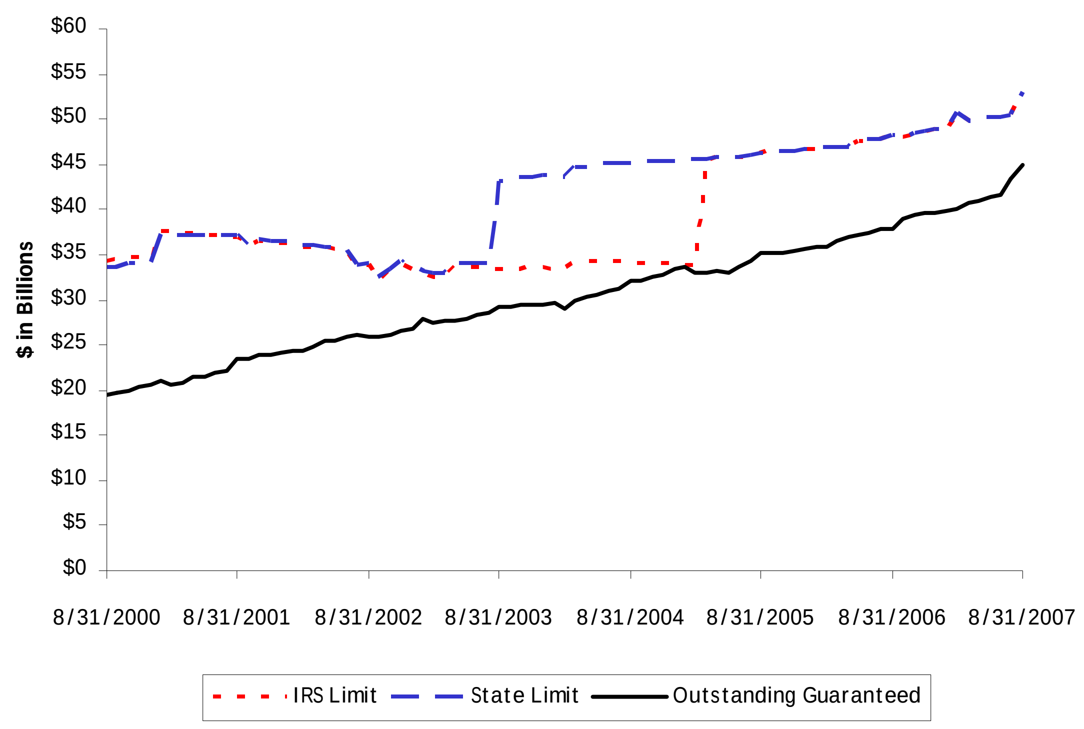
At its July 20, 2007, meeting, the Board directed Agency staff to investigate the effect on the Program's credit rating of increasing the multiplier to 3. In addition, the Agency has initiated efforts to obtain the IRS's agreement to modify its rules. The IRS has not yet agreed to change its rules. Therefore, despite the change in state law, the Program's capacity limit continues to be measured as 2.5 times the lower of the Fund's cost or market value in order to comply with the IRS's existing limit.

In recent years, the Board also has added application prioritization requirements and eligibility restrictions to the Program to extend its ability to guarantee bonds. Guarantees now are limited to school districts with less than $1,250 of annual debt service per student in average daily attendance at the time of the guarantee application. This limitation does not apply to school districts that have enrollments that are 25 percent higher than their enrollments reported five years earlier or to bonds for which the election authorizing the issuance of bonds was called on or before July 15, 2004.

In December 2005, the Board revised 19 TAC 33.65 to clarify the types of new and refunded bond issues eligible for a guarantee. The revisions also required that no less than 5 percent of the Fund's guarantee capacity be held in reserve. This reserve helps ensure that the Fund does not exceed its guarantee capacity and that additional capacity is available for an emergency situation. Figure 1 on the next page shows the amounts of outstanding bonds guaranteed and the two guarantee limits from August 31, 2000, through August 31, 2007.

Figure 1

Amount of Outstanding Bonds Guaranteed Compared with Statutory and IRS Limits
August 31, 2000, through August 31, 2007



Source: Data provided by the Texas Education Agency.

The Program's remaining capacity was $8.06 billion at the end of fiscal year 2007.

The attachment to this letter provides additional information on the Program's fiscal year 2007 activity. As of August 31, 2007, the Program could guarantee an additional $8.06 billion in bonds before reaching the Texas Education Code and IRS capacity limits. This represents a decline of $2.49 billion from the capacity remaining at the end of fiscal year 2006. If there is no change to current Program rules, the Fund's management estimates that the Program's ability to guarantee school district bonds will be exhausted during fiscal year 2010 based on the trends in bond guarantee growth observed in prior years. (The Board's lower limit, resulting from its 5 percent reserve requirement, would be reached during fiscal year 2009.) If requests for new bond guarantees increase at a rate higher than the average in prior years, the guarantee capacity could be exhausted sooner.

The Fund's management estimates that if the state and IRS limits were increased to 3 times the lower of cost or market value of the Fund, the guarantee capacity would be reached during fiscal year 2014 (the Board's lower limit would be reached during fiscal year 2013). If the limit was increased to 5 times the cost or market value of the Fund, capacity would be reached during fiscal year 2031 (the Board's lower limit would be reached during fiscal year 2028).

We appreciate the Agency's cooperation during this audit. If you have any questions, please contact Sandra Vice, Assistant State Auditor, or me at (512) 936-9500.

Sincerely,

John Keel, CPA
State Auditor

Attachment

cc: Members of the State Board of Education
Dr. Don McLeroy, Chair
Mr. David Bradley, Vice Chair
Mr. Rick Agosto, Secretary
Mr. Lawrence A. Allen, Jr.
Ms. Mary Helen Berlanga
Ms. Barbara Cargill
Mr. Bob Craig
Ms. Cynthia Noland Dunbar
Ms. Patricia Hardy
Ms. Mavis B. Knight
Ms. Terri Leo
Ms. Gail Lowe
Mr. Ken Mercer
Ms. Geraldine Miller
Mr. Rene Nuñez
Mr. Robert Scott, Commissioner of Education, Texas Education Agency
Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Texas Permanent School Fund
Ms. Catherine A. Civiletto, CPA, Deputy Executive Administrator, Texas Permanent School Fund
Ms. Cassie Huggins, CPA, Bond Guarantee Program Director

Attachment

Bond Guarantee Program Summary

The following tables provide a summary of fiscal year 2007 activity for the Permanent School Fund's Bond Guarantee Program (Program). Tables 1 and 2 show the changes in the number and amount of outstanding bonds guaranteed by the Program.

Table 1

Number of Guaranteed Bonds Outstanding	
Category	**Number of Issues**
Balance on September 1, 2006	2,265
Issued during fiscal year 2007	384
Refunded or matured during fiscal year 2007	(131)
Balance on August 31, 2007	**2,518**

Source: Permanent School Fund's Bond Guarantee Program Fiscal Year-end Summary.

Table 2

Amount of Guaranteed Bonds Outstanding	
Category	**Amount of Issues**
Balance on September 1, 2006	$ 37,793,429,328
Issued during fiscal year 2007	12,322,538,228
Issues that matured during fiscal year 2007	(1,268,579,772)
Issues refunded during fiscal year 2007	(3,972,028,015)
Issues with sinking payments during fiscal year 2007	(18,560,337)
Other adjustments	(178,014)
Balance on August 31, 2007	**$ 44,856,621,419**

Source: Permanent School Fund's Bond Guarantee Program Fiscal Year-end Summary.

Table 3 lists the school districts whose fiscal year 2007 applications for bond guarantees were denied. This list excludes school districts that, subsequent to their initial denial, submitted additional information resulting in their applications for the guarantee being approved.

Table 3

School Districts Whose Fiscal Year 2007 Bond Guarantee Applications Were Denied	
District	**Reason Application Denied**
DeSoto Independent School District	Not eligible [a]
Humble Independent School District	Not eligible [a]
Lewisville Independent School District	Not eligible [a]
Rankin Independent School District	Not eligible [a]
San Marcos Independent School District	Not eligible [a]
Tatum Independent School District	Not eligible [a]
Terrell County Independent School District	Not eligible [a]
Port Arthur Independent School District	Not considered financially sound

[a] These school districts were not eligible for the guarantee because their annual debt service per student in average daily attendance exceeded $1,250.

Source: Data provided by the Texas Education Agency.