



John Keel, CPA
State Auditor

An Audit Report on
**Certification of the Permanent School Fund's
Bond Guarantee Program for Fiscal Year 2008**

June 5, 2009

Members of the Legislative Audit Committee:

The State Auditor's Office certifies that, for the fiscal year ended August 31, 2008, 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, 2008, the bond guarantee capacity of the Fund was \$57.3 billion. The total principal of the debt guaranteed by the Program on 2,596 outstanding bond issues was \$49.9 billion (see the attachment to this letter). 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 verify guarantee eligibility and prioritize applications according to rules in Title 19, Texas Administrative Code, Section 33.65 (19 TAC 33.65).

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.

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's (Fund) Bond Guarantee Program is within the limits established by state statute.

The scope of this audit covered the Fund's valuation, all bonds guaranteed by the Fund during fiscal year 2008, and the controls related to the guarantee and recording processes.

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

Audit fieldwork was conducted from April 2009 through May 2009. 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:

- Anthony W. Rose, MPA, CPA, CGFM (Project Manager)
- Frances Anne Hoel, CGAP, CIA
- Jaime J. Navarro
- J. Scott Killingsworth, CGAP, CGFM, CIA (Quality Control Reviewer)
- Nicole Guerrero, MBA, CIA, CGAP, CICA (Audit Manager)

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Recent changes have been made to Program statutes and rules.

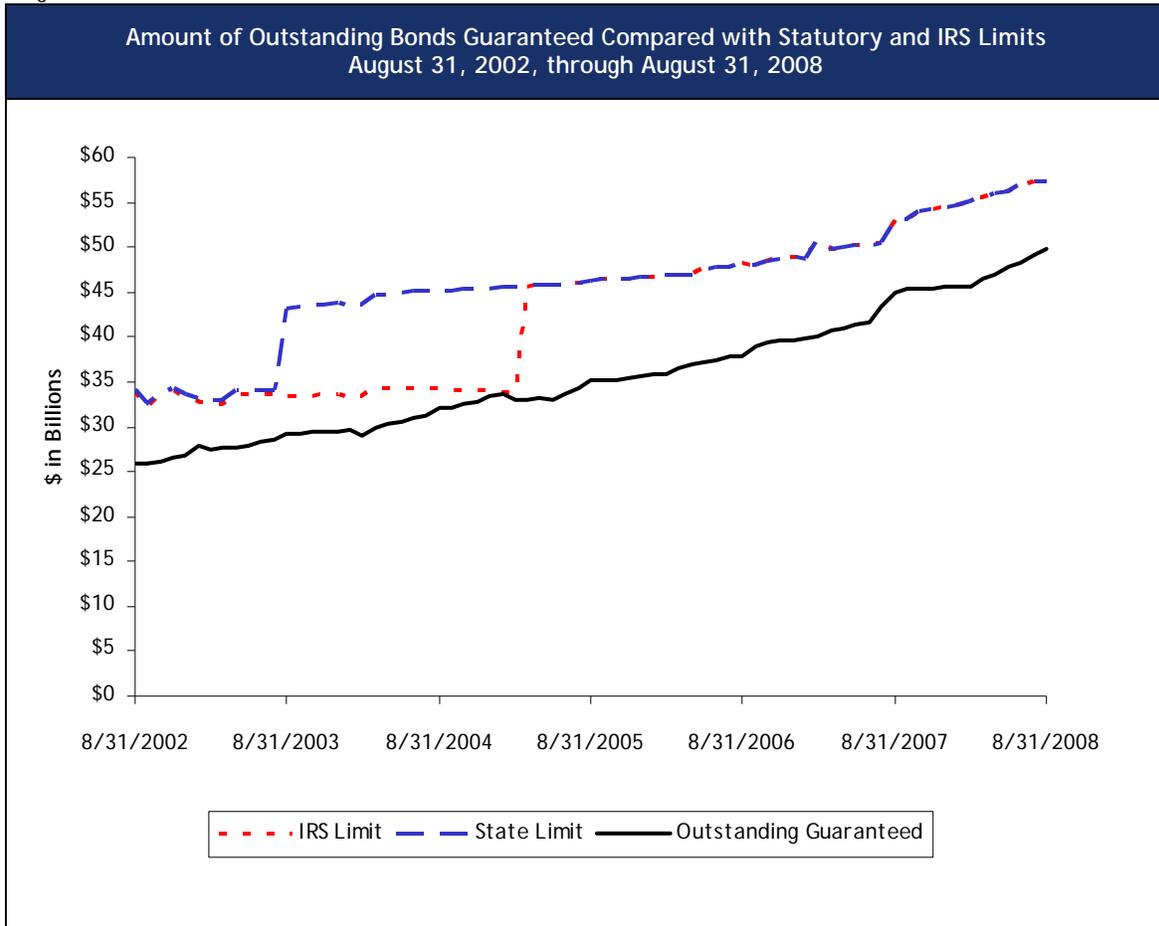
The 80th Legislature amended the Texas Education Code to permit the State Board of Education (Board) to increase the multiplier used to calculate the Program's statutory capacity limit. Previously, the statutory limit was calculated as 2.5 times the lower of the Fund's cost or market value, which was the same method used to calculate the IRS limit. The new law gave 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 more than 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."

The Agency has requested that the IRS modify its rules to allow the Program to increase the multiplier, but the IRS has not yet acted upon this request. 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, 2002, through August 31, 2008.

Figure 1



Source: Data provided by the Texas Education Agency.

The Program's remaining capacity was \$7.49 billion at the end of fiscal year 2008.

The attachment to this letter provides additional information on the Program's fiscal year 2008 activity. As of August 31, 2008, the Program could guarantee an additional \$7.49 billion in bonds before reaching the Texas Education Code and IRS capacity limits. This represents a decline of \$0.58 billion from the capacity remaining at the end of fiscal year 2007.

Management has reported that, in the first eight months of fiscal year 2009, the Fund's market value decreased significantly due to the global financial crisis, approaching and ultimately temporarily falling below its cost value. The Program approved school district applications in September and October 2008, but the Program placed all subsequent applications in a pending status. After all the bond issues related to the approved applications were sold, the Program was temporarily closed on March 6, 2009. To provide better protection from future investment declines, in late March 2009, the State Board of Education approved increasing the Program's reserve from 5 percent to 8 percent. The Agency is continuing to monitor the Fund's market value and the Program's available capacity to determine when the Program can be reopened.

Members of the Legislative Audit Committee

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We appreciate the Agency's cooperation during this audit. If you have any questions, please contact Nicole Guerrero, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA

State Auditor

Attachment

cc: Members of the State Board of Education

Mr. Lawrence A. Allen, Jr., Vice Chair

Ms. Terri Leo, Secretary

Mr. Rick Agosto

Ms. Mary Helen Berlanga

Mr. David Bradley

Ms. Barbara Cargill

Mr. Bob Craig

Ms. Cynthia Noland Dunbar

Ms. Patricia Hardy

Ms. Mavis B. Knight

Ms. Gail Lowe

Dr. Don McLeroy

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



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Attachment

Bond Guarantee Program Summary

The following tables provide a summary of fiscal year 2008 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, 2007	2,518
Issued during fiscal year 2008	226
Issues that matured during fiscal year 2008	(118)
Issues refunded during fiscal year 2008	<u>(30)</u>
Balance on August 31, 2008	2,596

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, 2007	\$ 44,856,621,419
Issued during fiscal year 2008	7,582,194,413
Issues that matured during fiscal year 2008	(1,434,362,939)
Issues refunded during fiscal year 2008	(1,112,952,327)
Issues with sinking payments during fiscal year 2008	(30,928,541)
Other adjustments	<u>0</u>
Balance on August 31, 2008	\$ 49,860,572,025

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

Table 3 lists the school districts whose fiscal year 2008 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 2008 Bond Guarantee Applications Were Denied	
District	Reason Application Denied
Baird Independent School District	Not considered financially sound
Bastrop Independent School District	Not eligible ^a
Canadian Independent School District	Not eligible ^a
Crandall Independent School District	Not eligible ^a
Deer Park Independent School District	Not eligible ^a
Elgin Independent School District	Not eligible ^a
Fairfield Independent School District	Not eligible ^a
Frenship Independent School District	Not eligible ^a
Judson Independent School District	Not eligible ^a
Krum Independent School District	Not eligible ^a
La Porte Independent School District	Not eligible ^a
Millsap Independent School District	Not eligible ^a
New Braunfels Independent School District	Not eligible ^a
Port Arthur Independent School District	Not eligible ^a
Round Rock Independent School District	Not eligible ^a
Santa Maria 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.