



John Keel, CPA
State Auditor

An Audit Report on

Certification of the Permanent School Fund's Bond Guarantee Program for Fiscal Year 2010

May 27, 2011

Members of the Legislative Audit Committee:

The State Auditor's Office certifies that, for the fiscal year ended August 31, 2010, the amount of school district bonds guaranteed by the Permanent School Fund's (Fund) Bond Guarantee Program (Program) was within all three limits applicable to the Program. As of August 31, 2010, the total principal of the 2,452 outstanding bond issues guaranteed by the Program was \$49.3 billion (see the attachment to this letter for a summary of the Program's activity during fiscal year 2010). Also as of that date, the bond guarantee capacity of the Program under the state limit was \$71.0 billion, and the State Board of Education (Board) held in reserve \$3.5 billion of that capacity. The bond guarantee capacity under the Internal Revenue Service (IRS) limit was \$117.3 billion.

The statutory limit prescribed by Texas Education Code, Sections 45.053(a) and (d), protects the Fund by minimizing the risk of loss to the Fund. The Board's rules set another limit by allowing the Board to hold guarantee capacity in reserve, as permitted by Texas Education Code, Section 45.0531(a), which the Board may use to award guarantees to school districts with emergencies that require renovation or replacement of school facilities. IRS Notice 2010-5, issued on December 16, 2009, establishes a third limit, which 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 rates paid on tax-exempt bonds).

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 Program

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 applicable limits.

The scope of this audit covered the Fund's valuation, all bonds guaranteed by the Fund during fiscal year 2010, 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 March 2011 through April 2011. 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)
- Michelle DeFrance, MACy, CPA
- Leslie Ashton, CPA (Quality Control Reviewer)
- Verma Elliott, MBA, CPA, CIA, CGAP (Audit Manager)

SAO Report No. 11-031

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 regularly reconcile Program activity to the Municipal Advisory Council's records of guaranteed bonds.

Recent changes have been made to Program statutes and rules.

The 80th Legislature amended the Texas Education Code to permit the 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 five times the Fund's cost value and eliminated the requirement to compare the cost and market values. 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 Texas Education Agency requested that the IRS modify its rules to allow the Program to increase the multiplier. On December 16, 2009, the IRS published Notice 2010-5, which specified that, until the effective date of any future IRS regulations or other public administrative guidance related to the Program, the Program may rely on a new IRS limit of 500 percent of the total cost of the assets that the Fund held on December 16, 2009. In contrast to the statutory limit, which will change over time based on the Fund's total cost value on each measurement date, the new IRS limit established a fixed upper limit because it specified a single measurement date (December 16, 2009) for the Fund's cost value.

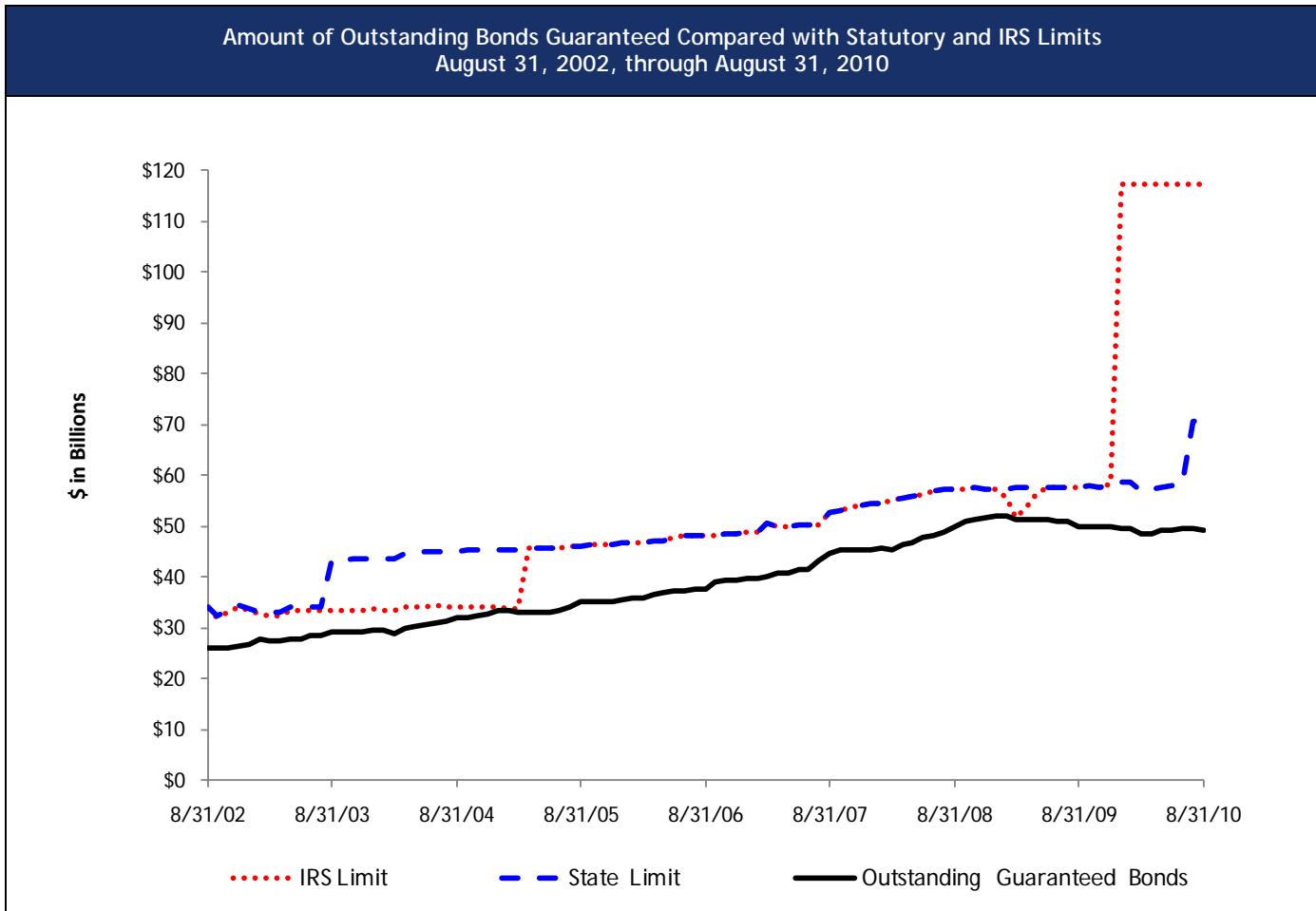
In May 2010, the Board approved an increase in the multiplier used to calculate the Program's statutory capacity limit to three times the Fund's cost value after it had received confirmation from major bond rating agencies that the increased limit would not reduce the credit rating for the bonds to be guaranteed. The multiplier increase became effective in July 2010.

In recent years, the Board also has added application prioritization requirements and eligibility restrictions to the Program to extend its ability to guarantee bonds. At the beginning of fiscal year 2010, guarantees were limited to school districts with less than \$1,650 of annual debt service per student in average daily attendance (ADA) at the time of the guarantee application. Effective July 2010, the Board changed this limitation to permit guarantee awards to a school district whose annual debt service or total debt service per ADA at the time of the guarantee application is within the 90th percentile of the annual or total debt service per ADA of all school districts. The commissioner of education annually determines the 90th percentile of the annual and total debt service per ADA of all school districts. 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.

Effective December 2004, the Board revised 19 TAC 33.65 to impose a reserve and limited the amount of guarantees it would award to 98 percent of the statutory limit then in effect. The Board has since revised the reserve percentage several times. During fiscal year 2010, the Board reduced its reserve from 8 percent to 5

percent, effective in March 2010. Figure 1 shows the amounts of outstanding bonds guaranteed and the statutory and IRS guarantee limits from August 31, 2002, through August 31, 2010. The Board's additional reserve is not presented in the graph.

Figure 1



The Program reopened during fiscal year 2010, and its remaining statutory capacity, net of the Board's \$3.5 billion reserve, was \$18.1 billion at the end of fiscal year 2010.

The Board temporarily closed the Program to new guarantees on March 6, 2009, after significant declines in the Fund's market value during the global financial crisis resulted in the Program's outstanding guaranteed bonds approaching the IRS limit. The issuance of IRS Notice 2010-5 on December 16, 2009, which substantially increased the IRS limit, allowed the Program to reopen and begin accepting applications in December 2009. The Texas Education Agency issued the first round of approval letters in February 2010.

The attachment to this letter provides additional information on the Program's fiscal year 2010 activity. As of August 31, 2010, the Program could guarantee an additional \$18.1 billion in bonds before reaching the limit imposed by the Board's reserve of 5 percent of the Program's total statutory limit. This represents an increase of \$15.0 billion from the net capacity remaining at the end of fiscal year 2009, when the Board's reserve was 8 percent of the statutory limit.

Members of the Legislative Audit Committee

May 27, 2011

Page 4

Auditors communicated less significant issues to Program management separately in writing. We appreciate the Texas Education Agency's cooperation during this audit. If you have any questions, please contact Verma Elliott, Audit Manager, or me at (512) 936-9500.

Sincerely,

John Keel, CPA

State Auditor

Attachment

cc: Members of the State Board of Education

Mrs. Gail Lowe, Chair

Mr. Bob Craig, Vice Chair

Mrs. Mary Helen Berlanga, Secretary

Mr. Lawrence A. Allen, Jr.

Mr. David Bradley

Mrs. Barbara Cargill

Mr. George Clayton

Dr. Marcia Farney

Mr. Charlie Garza

Ms. Pat Hardy

Mrs. Mavis B. Knight

Ms. Terri Leo

Mr. Ken Mercer

Mr. Thomas Ratliff

Dr. Michael Soto

Texas Education Agency

Mr. Robert Scott, Commissioner of Education

Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Permanent School Fund



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Attachment

Bond Guarantee Program Summary

The following tables provide a summary of fiscal year 2010 activity for the Permanent School Fund's Bond Guarantee Program (Program). Tables 1 and 2 show the changes in the number and dollar amount of outstanding bonds guaranteed by the Program.

Table 1

Number of Guaranteed Bonds Outstanding	
Category	Number of Issues
Balance on August 31, 2009	2,531
Issued during fiscal year 2010	192
Issues that matured during fiscal year 2010	(164)
Issues that refunded during fiscal year 2010	(107)
Balance on August 31, 2010	2,452

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

Table 2

Dollar Amount of Guaranteed Bonds Outstanding	
Category	Dollar Amount of Issues
Balance on August 31, 2009	\$ 50,032,724,439
Issued during fiscal year 2010	2,995,779,016
Issues that matured during fiscal year 2010	(1,644,361,846)
Issues that refunded during fiscal year 2010	(2,064,813,271)
Other adjustments	(17,645,000)
Balance on August 31, 2010	\$ 49,301,683,338

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

Table 3 lists the school districts whose fiscal year 2010 applications for bond guarantees were denied.

Table 3

School Districts Whose Fiscal Year 2010 Bond Guarantee Applications Were Denied	
School District	Reason Application Denied
Clyde Consolidated Independent School District	Debt Service Per ADA ^a
Dew Independent School District	Financial Status ^b
Lefors Independent School District	Debt Service Per ADA ^a
Leon Independent School District	Debt Service Per ADA ^a
Port Arthur Independent School District	Debt Service Per ADA ^a
Rio Vista Independent School District	Financial Status ^b

^a The school district's annual debt service per average daily attendance (ADA) exceeded the limit of \$1,650. All of these school districts were denied prior to the State Board of Education's new rules for debt service per ADA, which took effect in July 2010.

^b These school districts did not meet the required criteria to be considered financially sound due to their negative general fund balances and other financial-related issues.

Source: Data provided by the Texas Education Agency.