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 (Program) was within all three limits applicable to the Program. As of August 31, 2011, the total principal of the 2,536 outstanding bond issues guaranteed by the Program was $52.7 billion (see the attachment to this letter for a summary of the Program’s activity during fiscal year 2011). Also as of that date, the bond guarantee capacity of the Program under the State Board of Education (Board) limit was $74.4 billion, and the Board held in reserve $3.7 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 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 82nd Legislature passed Senate Bill 1, which contained a provision that called for the inclusion of charter schools into the Program. That provision went into effect on September 28, 2011. In October 2011, the State of Texas requested an IRS ruling on whether the inclusion of charter schools in the Program might cause the Program to violate current arbitrage laws, which could result in the loss of the Program’s tax-exempt status. The Fund will not make any guarantees for charter schools until the State receives assurance from the IRS that the inclusion of charter schools will not change the Program’s current tax-exempt status.

In addition, Texas Education Code, Section 59.04, stipulates that the State’s commissioner of education may not approve charter district bonds for guarantee if that guarantee would result in a lower bond rating for the Program. Based on this stipulation, the Program has indicated it will get updated rating letters from the bond rating agencies to determine whether the Program will maintain its current bond rating if charter schools are included in the Program.

Figure 1 shows the amounts of outstanding bonds guaranteed and the statutory and IRS guarantee limits from August 31, 2003, through August 31, 2011. The Board’s additional reserve is not presented in the graph.
The Program’s remaining statutory capacity, net of the Board’s $3.7 billion reserve, was $18.0 billion at the end of fiscal year 2011.

The attachment to this letter provides additional information on the Program’s fiscal year 2011 activity. As of August 31, 2011, the Program could guarantee an additional $18.0 billion in bonds before reaching the limit imposed by the Board’s reserve of 5 percent of the Program’s total statutory limit.

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. Barbara Cargill, Chair
    Mr. Bob Craig, Vice Chair
    Mrs. Mary Helen Berlanga, Secretary
    Mr. Lawrence A. Allen, Jr.
    Mr. David Bradley
    Mr. George Clayton
    Ms. Marsha Farney
    Mr. Charlie Garza
    Ms. Patricia Hardy
    Mrs. Mavis B. Knight
    Ms. Terri Leo
    Mrs. Gail Lowe
    Mr. Ken Mercer
    Mr. Thomas Ratliff
    Mr. Michael Soto
Texas Education Agency
    Mr. Robert Scott, Commissioner of Education
    Mr. Holland Timmins, CFA, Executive Administrator and Chief Investment Officer, Permanent School Fund
Bond Guarantee Program Summary

The following tables provide a summary of fiscal year 2011 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

<table>
<thead>
<tr>
<th>Category</th>
<th>Number of Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance on August 31, 2010</td>
<td>2,452</td>
</tr>
<tr>
<td>Issued during fiscal year 2011</td>
<td>344</td>
</tr>
<tr>
<td>Issues that matured during fiscal year 2011</td>
<td>(156)</td>
</tr>
<tr>
<td>Issues that refunded during fiscal year 2011</td>
<td>(104)</td>
</tr>
<tr>
<td><strong>Balance on August 31, 2011</strong></td>
<td><strong>2,536</strong></td>
</tr>
</tbody>
</table>

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

Table 2

<table>
<thead>
<tr>
<th>Category</th>
<th>Dollar Amount of Issues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Balance on August 31, 2010</td>
<td>$ 49,301,683,338</td>
</tr>
<tr>
<td>Issued during fiscal year 2011</td>
<td>7,340,621,873</td>
</tr>
<tr>
<td>Issues that matured during fiscal year 2011</td>
<td>(1,670,893,470)</td>
</tr>
<tr>
<td>Issues that refunded during fiscal year 2011</td>
<td>(2,315,801,196)</td>
</tr>
<tr>
<td>Other adjustments</td>
<td>(1,680,000)</td>
</tr>
<tr>
<td><strong>Balance on August 31, 2011</strong></td>
<td><strong>$ 52,653,930,545</strong></td>
</tr>
</tbody>
</table>

Source: Permanent School Fund’s Bond Guarantee Program Fiscal Year-end Summary.
Table 3 lists the school districts whose fiscal year 2011 applications for bond guarantees were denied.

<table>
<thead>
<tr>
<th>School District</th>
<th>Reason Application Denied</th>
</tr>
</thead>
<tbody>
<tr>
<td>Texhoma Independent School District</td>
<td>Not Allowed $^{a}$ and Financial Status $^{b}$</td>
</tr>
<tr>
<td>Higgins Independent School District</td>
<td>Not Allowed $^{a}$ and Financial Status $^{b}$</td>
</tr>
</tbody>
</table>

$^{a}$ The purpose of the bonds was to build housing to increase available housing for teachers in the school districts. The Texas Constitution allows the Permanent School Fund to guarantee bonds only for the purposes of acquisition, construction, or improvement of instructional facilities.

$^{b}$ These school districts did not meet the required criteria to be considered financially sound due to declining student populations.

Source: Data provided by the Texas Education Agency.