TEXAS PUBLIC POLICY FOUNDATION
Testimony

March 20, 2013
Center for Fiscal Policy

On Prohibiting the Issuance of Capital Appreciation Bonds

Testimony to the Senate Committee on Intergovernmental Relations

by Chuck DeVore, Vice President of Policy

Chairman Hinojosa and Members of the Committee:

My name is Chuck DeVore, and I am the Vice President of Policy at the Texas Public Policy Foundation, a nonprofit, non-partisan free market think tank based here in Austin. Thank you for taking the time today to discuss Senate Bill 449, a bill to prohibit the issuance of capital appreciation bonds (CABs).

To be clear, the Foundation supports SB 449, believing it necessary to ban this exotic public financing tool so as to preserve future generations of taxpayers from an inordinate amount of local debt. This is not meant to be hyperbole but rather a sober assessment of the situation if CABs are not restricted.

Background

For those unfamiliar with CABs, the Legislative Budget Board (LBB) defines them as:

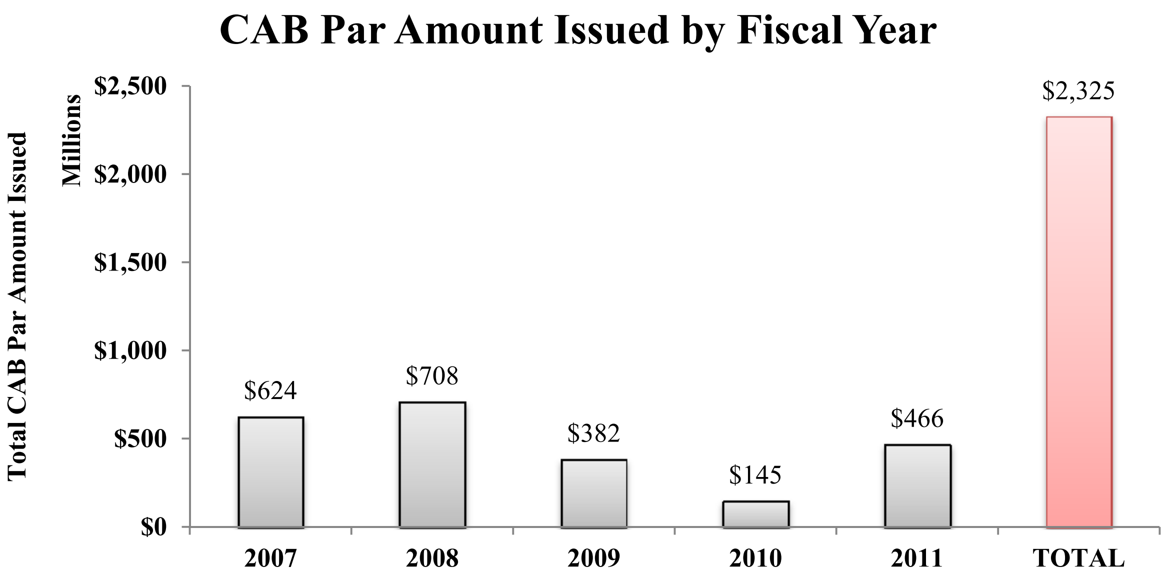
> …a type of municipal bond that defers the payment of principal and interest until the bond matures, typically many years (as many as 40) after the issuance of the bond.
>
> CABs are typically used by school districts where immediate development is needed due to a rapidly expanding population, but where there are limited financing options. The assumption is that the number of taxpayers will increase and the anticipated tax base growth will enable repayment of the obligation. These bonds are increasingly used in districts in California, Florida, and Texas, where the school-aged population is expanding faster than the current tax base can support.
>
> CABs provide a financing option for municipalities that would otherwise have to forgo critical development due to lack of funds, impose unreasonable or impermissible tax levies on a current population in order to support a larger future population, or default on existing obligations that the municipality is unable to repay without the CAB funds.
>
> **The buy-now, pay-later approach often results in crippling repayment obligations, with the repayment costs being greater than the benefits derived from the bond.**[1] [emphasis mine]

The LBB's point about "crippling repayment obligations" merits further emphasis.

The overall repayment ratio for a traditional bond is commonly in the range of 3-to-1. With capital appreciation bonds, however, borrowers can expect the repayment ratio to be much higher given the structure of the bond. In some cases, there is evidence to suggest that the total repayment ratio is as high as 10-to-1.

In other words, the existence of capital appreciation bonds has made it possible for a local governmental entity in Texas to borrow $1 million, forgo any payment on principal or interest for decades, and, once current officeholders have long vacated their positions, be required to pay back as much as $10 million once the bond matures. This has obvious financial and economic implications for future Texas taxpayers, many of whom have not even been born, and, worse yet, this is an issue that is growing more severe.

continued on back



Source: Bond Review Board

CABs: A Growing Problem in Texas

As I noted in the *Austin American-Statesman* late last year, "Texas has increasingly turned to appreciation bonds in recent years."[2]

From 2007 to 2011, the Texas Bond Review Board estimates that local governments in Texas issued more than $2.3 billion in CAB debt in more than 700 separate borrowings.[3] The height of this borrowing came in fiscal year 2008 when, presumably, cash-strapped local governments anxious about their finances assumed more than $700 million in this kind of buy-now, pay-later debt. Repayment on this debt could eventually cost taxpayers pay more than $20 billion, a payback of 9-to-1.

A separate analysis from California Watch, an independent, nonpartisan watchdog group, suggests that Texas has issued more CABs than any other state over the last several years. From the article:

> In Texas, 590 districts and other government entities have issued these bonds over the past six years—**more than any other state,** according to a California Watch review of a database maintained by the Municipal Securities Rulemaking Board, a federal regulatory agency that oversees the municipal bond market. California was second, with 404, followed by Ohio, with 202.[4] [emphasis mine]

The evidence suggests that Texas' local governments have significantly increased their exposure to CABs over the years to an extent far greater than any other state. While much of the financial burden will not be felt by future taxpayers for many years to come, there are some immediate consequences to be had, as Leander ISD has learned.

Case Study: Leander ISD

An example of how rapidly things can go wrong can be found in Leander Independent School District (ISD). Leander ISD found itself grappling with a burgeoning student population, with expectations that the housing stock would soar 50 percent by 2021 from a base of about 58,000. The school board borrowed heavily to finance school construction.

When the recession hit, Leander ISD faced two problems: it borrowed too much and it paid too much to build schools; so, to get out of their current crisis, they set up a future crisis by delaying bond payments for decades by refinancing their debt, borrowing about $389 million in Capital Appreciation Bonds.

But, such buy-today, pay-tomorrow borrowing is not without consequence. Fitch, a bond ratings firm, downgraded Leander ISD's debt last May, observing, "The downgrade applies to approximately $1.3 billion ...[of debt]... secured by an unlimited ad valorem tax pledge levied against all taxable property," with further restructurings likely at very high debt levels, with slow amortization of principal due to the "... extensive use of capital appreciation bonds to minimize tax rate impacts and shift the debt burden to future taxpayers."[5]

This is as close to a morality play as can be found in the dry language of Wall Street—an intergenerational theft of taxpayers not yet born.

This $1.3 billion in outstanding bonds amounts to $11,000 per capita (every person in the taxing district, so a family of four would have $44,000 of Leander debt that they were carrying).

CABs in Other States

Texas is not the only state where capital appreciation bonds are an issue. Other large states, like Michigan and California, have taken steps to either curtail or prohibit CABs, recognizing their toxic nature.

In California, the Legislature is currently considering AB 182, a measure to enact certain restrictions on the issuance of capital appreciation bonds, such as limiting the repayment ratio to no more than 4-to-1 and more explicitly state the overall cost of the bond.

In Michigan, the Legislature, seeing no redeeming value in the existence of CABs, banned their issuance outright in 1994.

Recommendation

In short, the Foundation urges the committee to pass SB 449 to prohibit the issuance of CABs and protect future generations of taxpayers from the burden of excessive local debt.

Thank you for your time. I look forward to answering any questions that you may have. ✯

[1] Legislative Budget Board, *Bill Analysis for Senate Bill 449* (4 Mar. 2013).

[2] DeVore, Chuck, "Devore: "CAB rides can be extremely costly," *Austin American-Statesman* (11 Sept. 2012).

[3] Texas Bond Review Board, *2011 Local Government Annual Report* (May 2012) 10.

[4] California Watch "Controversial school bonds create 'debt for the next generation,'" (31 Jan. 2013).

[5] "Fitch Downgrades Leander ISD, TX's ULT Bonds to 'AA-'; Outlook Revised to Stable," *Business Wire* (18 May 2012).

Texas Public Policy
FOUNDATION

900 Congress Ave., Ste. 400 Austin, Texas 78701 | (512) 472-2700 ph. (512) 472-2728 fax | www.TexasPolicy.com