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Buyer Beware: New PA Law Opens Riskier Investment Options for Local Governments.

HARRISBURG — As anyone with a savings account knows, the money in that account has earned virtually nothing for several years.

It's a lingering effect of the global financial meltdowns that occurred when banks' subprime mortgage pools sank in 2007, causing those same institutions to stop lending one another money the next year, which led to a credit crisis that spiked short-term interest rates. In response, the Federal Reserve has kept interest rates low to spur more borrowing and speed up the economic recovery.

But if the feds aren't raising interest rates, banks aren't either. That's why your savings account is earning far below the 4 to 5 percent it earned before the financial meltdowns.

Well, your local school district, borough and township have the same savings account problem.

In response, the Legislature and Gov. Tom Wolf have given local governments the chance to earn more interest under a new municipal finance law that took effect Tuesday. But with that newfound investment power comes greater risk of financial loss to taxpayers.

The law, known as Act 10, legalizes several short-term financial instruments that had been prohibited for most of the state's 67 counties, 500 school districts, 957 boroughs, 1,454 townships and the quasi-public municipal water and sewer authorities.

Some financial and legal experts are urging local elected officials to use caution and education when listening to salesmen who might tout the investments' benefits while glossing over instruction manuals and repercussions of misuse.

"Some of the investments are far more complicated than what was available previously," said Stuart Knade, chief counsel of the Pennsylvania School Boards Association, which has hosted seminars and delivered a webinar about the new law to its members. "I would hope most school districts would go into this cautiously."

Before the law, most local governments had limited and different investment options compared with their brethren in other states. With the exception of Philadelphia and Pittsburgh, most Pennsylvania local governments were only allowed to invest taxpayer money in financial instruments that were issued and protected by the U.S. Treasury or covered by a bank's collateral.

The new law unifies local government entities under one investment law. The law also opens up investment options, all of which carry varying degrees of default, interest or credit risks.

The options are mortgage-backed securities offered by government-sponsored enterprises such as Fannie Mae and Freddie Mac; corporate capital loans known as commercial paper; non-collateralized negotiable certificates of deposit; collateralized loans known as repurchase agreements; and shares in money market funds operated by investment companies such as

Vanguard and Fidelity.

With the exception of the mortgage-backed securities, all investments have time limits for how long a government can hold them, between 180 days and three years. All the instruments must be highly rated by at least two nationally recognized credit-rating agencies, such as Moody's, Standard & Poor's or Fitch.

Those investment rules also now apply to state-based investment pools such as the Pennsylvania Local Government Investment Trust. Created in 1981, the trust holds more than $3 billion in investments for 2,900 local governmental entities and is managed by one of the state's largest financial investment companies, Public Financial Management.

If used wisely with a diversified investment portfolio, the law should be relatively safe, said Lou Gattis, a finance professor at Penn State University's Smeal College of Business.

"However, more choices does create the possibility of greater confusion and misuse," he said.

The confusion and misuse, he warned, would arise if local officials do not understand what they are buying or try to double down on losses.

"Many colossal losses start with small losses that are hidden, held too long, or made worse by 'doubling down' to recover the losses," Gattis said.

There is no gauge for how many local governments may opt for the new investments, said Chris Cap, executive director of the state Association of Boroughs.

"Yet many are inquiring about their benefits and consulting with their investment advisers on the local level," he said.

In using the new law, local officials should keep in mind the 2007-08 financial crisis, said Anne-Marie Anderson, a professor of finance at Lehigh University in Bethlehem. That crisis was caused by poor risk management by professional financial people who were more interested in turning a profit than in minimizing market exposure, she said.

"If the school board buys what the trader is selling without doing their due diligence or without setting up an oversight committee, they run the risk of buying junk," Anderson said.

But Doug Hill, executive director of the County Commissioners Association of Pennsylvania, sees no downside in the law. It simplifies and unifies the investment rules for all local governments, he said. The law's safeguards, he said, will ensure taxpayers are protected.

The law was needed to level the investment playing field among government units, said Dave Sanko, executive director of the Pennsylvania State Association of Township Supervisors.

"In the period of ongoing low interest rates and rates of return for investments, this provides another tool for communities to earn a little extra interest to avoid property tax [increases]," Sanko said.

The communities that opt to use the law, Sanko added, will only make about two-tenths of a percent more on interest. On a $1 million investment, Sanko said, that equates to about $2,000 in earnings in a climate where every little bit counts to avoid tax increases.

The change in the law was suggested by community bankers and officials at the trust to give local governments more investment options, said Rep. Kate Harper, R-Montgomery, the bill's primary sponsor. Since the market crash in 2007-08, she said, interest rates have been so low, no one, including government, is making enough money on interest to help cover expenses.

"No one's made money since 2008," Harper said. "The idea is to recognize where local governments could invest."

The law also has built-in protections, she said, such as time limits and credit reports of the investments. In addition, she said, the law does not permit all of the investment instruments bankers and the trust wanted, such as derivative swaps.

Swaps, legal under a 2003 law, are layered on top of variable-rate bonds. They are private contracts with investment banks that call for bond issuers and banks to bet on interest rate swings.

Used appropriately, swaps are hedges against potential increases in the interest rate of the underlying bonds. Used inappropriately, swaps become speculative tools that can over-leverage risk, as the Bethlehem Area School District found out when the mortgage and credit crises hit and taxpayers got crushed with skyrocketing interest payments. The district took out 17 swaps — the most of any school district in the state — between 2003 and 2009, and most have since been unwound at significant contract cancellation fees.

Swaps also are used in the banking and corporate finance world for some of the investment instruments listed in Act 10, such as negotiable CDs, bills of exchange and commercial paper.

But there is little chance financial advisers can use the 2003 law to layer a swap onto any of the Act 10 instruments, said Bruce Rader, a Temple University finance professor. The reason, he said, is that most of the Act 10 instruments carry short investment time frames, while swaps are typically put on bonds that have decades-long maturity dates.

Lawrence J. White, a New York University economics professor, agreed. The law seems safe, he said. If taxpayers get fleeced, the problem is not with Act 10, he said, it's with the lack of vigilance of local elected officials.

Local elected officials and their business managers do not have to be financial experts to handle the law, White added. They just have to know how to recognize the good financial experts from the bad ones, and that usually entails a cost, he said.

"Sorry, but expertise requires a price," White said.

And trust is not enough.

"There is a man," White said, "named Bernard Madoff."

And another named John Gardner Black.

Black, a small-time financial adviser, traveled Pennsylvania, from the Lehigh Valley to Lancaster to Butler County, selling school districts a bag of financial goods during Wall Street's technology investment bubble in the 1990s. His sales pitches, short on specifics and long on investment promises, were too good to be true.

In 1997, the Securities and Exchange Commission, during a routine audit, discovered Black was running a Ponzi scheme with $233 million in taxpayer money. The SEC said Black was giving school officials fraudulent invoices and other records that hid $71 million in investment losses and expenses. Black pleaded guilty in 2000 and got three years in prison for what was at the time the largest taxpayer fraud in state history.

Black's crimes went unnoticed for years because school officials did not ask the right questions and trusted his unbelievable claims on return rates, said Knade, of the school boards association. The saga, he said, highlights the need for elected officials to become knowledgeable of the complicated financial instruments they might be asked to consider.

The Black case can serve as a guide, he said, adding, "Someone once told me if someone guarantees you a rate of return, run the other way."

The Morning Call

By Steve Esack

steve.esack@mcall.com

Twitter @sesack

717-783-7305

ACT 10 TIPS

Financial experts caution local governments to proceed carefully with the investment options that became available under a new law Tuesday.

• Diversify holdings across issuers, maturities, industries to ensure risks are not concentrated.

• Don't invest in any security you do not understand, especially if your adviser cannot easily explain the benefits and risks.

• Ensure the security meets investment objectives such as liquidity, income, growth, safety and time frame.

• Beware of securities that look too good.

• Understand that securities that offer high yield have higher risk.

• Communicate risks to stakeholders with periodic risk reports and open discussions.

• Don't hide investment losses or double down on them.

Source: Lou Gattis of Penn State University's Smeal College of Business