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[Short on Financial Knowledge, Some School Districts Get Bad Deals on Bonds.]

Districts can fall prey to financial firms that put their own interests first

The state audit of the Fox C-6 School District in the small town of Arnold, Missouri, was brutal.

It revealed a slew of financial missteps: The superintendent and administrators had been giving themselves raises and using school district credit cards to purchase personal items such as shampoo, engraved watches, gift cards and wedding favors. But most costly of all, it argued, were mistakes the school district had made with bonds.

From 2007 to 2013 the district's taxpayers had approved several bonds, totaling more than $46.6 million, to help the district afford new technology, renovations to school buildings and new school buses. [The audit] alleged that the school district got a bad deal — one that may ultimately cost it $5.6 million in unnecessary interest payments.

"What happened in our district should not have happened, but it did," said John Brazeal, who joined the district as its chief financial officer in 2014. "It's not going to happen again on my watch."

John Brazeal, chief financial officer, Fox C-6 School District, Arnold, Missouri

In order to finance large projects, such as the construction of new school buildings or major renovations, school districts generally issue bonds and pay them back, with interest, over several years or decades. To help structure these deals, district administrators and school boards typically turn to outside financial advisers, lawyers and bond underwriters. But that can put school districts in a vulnerable position: They can easily be taken advantage of — urged to issue needless or poorly structured bonds, pushed to accept high interest rates or duped into paying hundreds of thousands in unreasonable fees. State officials and financial experts across the country warn that taxpayers ultimately end up paying millions more each year than necessary, which can lead to new tax hikes or result in less money for classrooms.

Because most bonds are so large, districts face big financial consequences if they don't get the best deal possible, said Mark Robbins, a professor of public policy at the University of Connecticut who has studied municipal bonds. "When you're talking about borrowing tens, even hundreds, of millions of dollars, even a one-hundredth of an interest rate point can be the equivalent of a teacher's salary."

A student is assisted down a staircase at Fox Middle School in Arnold, Missouri. The building is not completely ADA accessible. Whitney Curtis for The Hechinger Report

Most school districts don't have a municipal bond expert on staff or on their board, leaving them at the mercy of financial companies to guide them through the bond issuance process. Federal regulations require that these companies treat municipalities fairly, but the incentives built into the bond issuance process can sometimes pit school districts' interests against those of their financial team.

The advisers are typically paid a fee for their services related to the size of the bond or contingent on it being issued — and that can incentivize them to counsel districts to issue larger or more frequent bonds. Districts also work with underwriters, who purchase the bonds from the district and sell them to investors. The higher the interest rate on a bond, the easier it is for underwriters to sell.

Lori Raineri, president of the Sacramento-based independent public consulting company Government Financial Strategies, says she frequently hears from school district leaders who relied on relationships, referrals or marketing to choose their financial team but lack the quantitative expertise to evaluate the advice they get. (To avoid potential conflict of interests, her firm charges districts a fee based on the work it performs, regardless of whether bonds are sold.)

Raineri says it breaks her heart to see school districts in fiscal distress. She said it begs the question: “Who’s benefiting here?”

When they get a bad deal, school districts can find themselves on the hook for unnecessarily high payments in a variety of ways. Some districts, like Missouri’s Fox C-6, are stuck paying interest rates that are well above market rate. In one extreme case, a California district agreed to pay 12 percent interest on a $16.7 million bond issued in 2005. By the time all the debt is paid off, the district will have spent $34.3 million — almost a million more on interest than on the principal.

The fees that districts pay to financial firms also sometimes reach eyebrow-raising amounts. A study by the Haas Institute for a Fair and Inclusive Society (University of California, Berkeley), identified six California districts that paid more than 8.5 percent of their bond principal in fees, significantly greater than the 1 percent average costs the study found. In a separate case, Kansas City-based George K. Baum & Company, the same financial firm that underwrote the Fox C-6 bonds, was sanctioned by the Financial Industry Regulatory Authority for overcharging a school district in 2011. The company charged $43 per $1,000 bonds issued — far above the typical $7 to $9 for such an offering — for a total fee of $416,173, according to the regulatory authority.

In a memo to the district superintendent, George K. Baum said the fee it charged was appropriate because it had originally anticipated underwriting a larger bond, which failed at the ballot box. The regulator disagreed, noting that the firm “failed to deal fairly with the school district.”

George K. Baum accepted the findings without admitting or denying them, and consented to a censure and fine of $100,000. Jon Baum, the company’s CEO, did not respond to a request for comment.

Lack of competition

Researchers and financial experts, meanwhile, say that school districts also bear some of the responsibility for bad bond deals. Too often, districts don’t shop around for the most favorable deal even though opening the process to competitive bidding can help drive down costs. When schools buy supplies like paper, for instance, they typically request bids and take the best offer they receive. But when it comes to bonds, noncompetitive sales — in which an issuer such as a school district unilaterally chooses an underwriter without comparing multiple options — are common. These negotiated sales make up the bulk of money in municipal bond sales, according to data from the Securities Industry and Financial Markets Association, a trade group for broker-dealers and investment bankers.

There are some circumstances in which a noncompetitive sale is the better option: when a district has a low credit rating and is unlikely to attract any bidders, for example, or when the bond deal is complex. Yet experts say those cases are exceptions.

Mike Parnell, an associate executive director at the Missouri School Board Association, said that noncompetitive sales often make sense because they allow school districts to retain local control of the bond-issuing process rather than leaving it up to the market. “If you’re able to negotiate a more favorable rate for the district, that’s going to be a good thing,” he said. “If you just have to take whatever is out there that day, that may not be in the district’s best interest.”

But Robbins, the University of Connecticut professor, takes a different view: It’s a matter of convenience for school districts that don’t want to put in the time and effort to seek out comparisons. Among researchers who study competitive bidding, there’s widespread agreement that a bidding process yields the best deal, he said: “It is not controversial.”

Some states require that school districts go through a competitive bidding process under at least some circumstances when issuing a bond. But at least 25 states do not.

School districts that forgo competitive bids often make their decisions based on relationships — which financial firms will go to great lengths to forge. The firms will sponsor school board or leadership conferences and take school leaders out to dinner.

Some firms have gotten in trouble for going even further. In 2013, the Financial Industry Regulatory Authority fined a Missouri-based underwriting firm $200,000 for “improperly gifting” more than 2,000 tickets to sporting events. About half the tickets went to school superintendents and one-third to school board members who stopped by its booth at the annual Missouri School Boards’ Association conference and filled out a piece of paper with their contact information.

The association said it was unaware of that incident. “The only giveaways we sanction at our conference are random drawings,” the association said in an email. “We expect vendors in our exhibit hall to comply with all laws and industry standards.”

Community outrage

In the Fox C-6 School district, which serves over 11,000 students in a tight-knit community near the Mississippi River, the state audit led to an outcry against school leaders. In the 109-page report, the school board was singled out for special scorn for allegations that it failed in its duty to vet the district’s spending. After the audit and the resulting public backlash, top administrators left the district. The superintendent took a buyout but admitted no wrongdoing.

In the report, the state also faulted the school district for failing to solicit competitive bids for its bonds, as recommended by state auditors. Brazeal, the Fox C-6 chief financial officer, said he doesn’t agree completely with the auditors’ recommendations on competitive bidding. He sees some downsides to a competitive bid process, and he believes the district owed most of its financial troubles to a different culprit: the terms of the debt.

The bond deal had an interest rate of 4 to 5 percent, at a time when the market rate was closer to 3 percent, according to the audit. Also, the debt was structured so that the district was making interest-only payments until 2026, increasing the overall cost of the loan.

Why the district made these decisions is unclear — curiously, no documentation of the advice that led to these actions could be located by state auditors. The auditors noted that the district failed to seek advice from someone who didn’t stand to make money from the transaction.

“The lack of independent financial advice could result in the Board not being adequately informed of debt issuance options or being unable to adequately evaluate debt proposals,” the state auditors wrote. “The underwriter does not have a fiduciary responsibility to the district.” (The state auditor did not respond to requests for comment for this story.)

A 2013 report from the Missouri state auditor found that the vast majority of the state’s districts and municipalities did not use an independent financial adviser and, therefore received all their financial advice from their underwriting firm. The report estimated that school districts and local governments could have saved up to $43 million between 2008 and 2011 had they gotten more favorable interest rates.

A bill introduced in the Missouri House of Representatives in 2017 and backed by the state auditing agency would have required school districts and other municipal agencies to use an independent financial adviser or go through a competitive bid process when issuing bonds. But the bill died in committee after push back from financial firms and from groups that represent municipal agencies.

The groups said that a competitive bidding process would add bureaucracy and time and wouldn’t end up saving taxpayers money. “We didn’t see any upside to that at all,” said Dirk Burke, executive director of the Missouri Association of Counties, an advocacy group that represents county governments.

But a narrower bill introduced in the state Senate did pass later that year. Under the legislation, Missouri school districts with good credit ratings must hire an independent adviser or sell their bonds competitively when issuing bonds worth more than $12 million.

Parnell, of the state school board association, says that most Missouri school districts still prefer to use negotiated sales for their bonds.

Bad financial decisions can breed distrust in communities, forcing district leaders to spend time and money repairing their reputations and making it more difficult for them to raise money for new projects. This year, for example, the Fox C-6 School District asked voters to approve a $70 million bond to upgrade aging school buildings.

Ahead of the vote, the district’s top administrators — none of whom worked in the district during the previous bond deal — distributed a question-and-answer sheet to residents designed to head off concerns. It addressed comments such as: “How do we know they are going to do what they say with the $70 million?” and “I am not supporting the district because they did not prosecute the former superintendent.”

Brazeal said he felt that the school district had done everything it could to repair the community’s trust.

“It’s sad when money is not benefiting students” he said. “For those of us that are here to carry on, we do what we can to keep it from happening again.”

But the efforts at rebuilding trust seem to have fallen flat. On April 2, voters rejected the district’s plan to issue $70 million in new bonds for building renovation and upkeep. Meanwhile, district staff continue to grapple with buildings in disrepair: Pipes leak sewage, basement classrooms have broken floor tiles and schools are not fully accessible to people with disabilities.

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