

# Bond Case Briefs

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## Swimming with the Sharks: Goldman Sachs, School Districts, and Capital Appreciation Bonds.

Remember when Goldman Sachs - dubbed by Matt Taibbi the Vampire Squid - sold derivatives to Greece so the government could conceal its debt, then bet against that debt, driving it up? It seems that the ubiquitous investment bank has also put the squeeze on California and its school districts. Not that Goldman was alone in this; but the unscrupulous practices of the bank once called the undisputed king of the municipal bond business epitomize the culture of greed that has ensnared students and future generations in unrepayable debt.

In 2008, after collecting millions of dollars in fees to help California sell its bonds, Goldman urged its bigger clients to place investment bets against those bonds, in order to profit from a financial crisis that was sparked in the first place by irresponsible Wall Street speculation. Alarmed California officials warned that these short sales would jeopardize the state's bond rating and drive up interest rates. But that result also served Goldman, which had sold credit default swaps on the bonds, since the price of the swaps rose along with the risk of default.

In 2009, the lenders' lobbying group then proposed and promoted AB1388, a California bill eliminating the debt ceiling requirement on long-term debt for school districts. After it passed, bankers traveled all over the state pushing something called "capital appreciation bonds" (CABs) as a tool to vault over legal debt limits. (Think Greece again.) Also called payday loans for school districts, CABs have now been issued by more than 400 California districts, some with repayment obligations of up to 20 times the principal advanced (or 2000%).

The controversial bonds came under increased scrutiny in August 2012, following a report that San Diego County's Poway Unified would have to pay \$982 million for a \$105 million CAB it issued. Goldman Sachs made \$1.6 million on a single capital appreciation deal with the San Diego Unified School District.

### **Green Light to Exploit**

In a September 2013 op-ed in SFGate.com called "School Bonds Are a Wall Street Scam," attorney Nanci Nishimura wrote:

". . . AB1388, signed by then-Gov. Arnold Schwarzenegger in 2009, [gave] banks the green light to lure California school boards into issuing bonds to raise quick money to build schools.

Unlike conventional bonds that have to be paid off on a regular basis, the bonds approved in AB1388 relaxed regulatory safeguards and allowed them to be paid back 25 to 40 years in the future. The problem is that from the time the bonds are issued until payment is due, interest accrues and compounds at exorbitant rates, requiring a balloon payment in the millions of dollars. . . .

Wall Street exploited the school boards' lack of business acumen and proposed the bonds as blank checks written against taxpayers' pocketbooks. One school administrator described a Wall Street meeting to discuss the system as like "swimming with the big sharks."

Wall Street has preyed on these school boards because of the millions of dollars in commissions. Banks, financial advisers and credit rating firms have billed California public entities almost \$400 million since 2007. [State Treasurer] Lockyer described this as “part of the ‘new’ Wall Street,” which “has done this kind of thing on the private investor side for years, then the housing market and now its public entities.”

Gullible school districts agreed to these payday-like loans because they needed the facilities, the voters would not agree to higher taxes, and state educational funding was exhausted. School districts wound up sporting shiny new gymnasiums and auditoriums while they were cutting back on teachers and increasing classroom sizes. (AB1388 covers only long-term capital improvements, not daily operating expenses.) The folly of the bonds was reminiscent of those boondoggles pushed on Third World countries by the World Bank and IMF, trapping them under a mountain of debt that continued to compound decades later.

The Federal Reserve could have made virtually-interest-free loans available to local governments, as it did for banks. But the Fed (whose twelve branches are 100% owned by private banks) declined. As noted by Cate Long on Reuters:

The Fed has said that it will not buy muni bonds or lend directly to states or municipal issuers. But be sure if yields rise high enough Merrill Lynch, Goldman Sachs and JP Morgan will be standing ready to “save” these issuers. There is no “lender of last resort” for muniland.

### **Debt for the Next Generation**

Among the hundreds of California school districts signing up for CABs were fifteen in Orange County. The Anaheim-based Savanna School District took on the costliest of these bonds, issuing \$239,721 in CABs in 2009 for which it will have to repay \$3.6 million by the final maturity date in 2034. That works out to \$15 for every \$1 borrowed.

Santa Ana Unified issued \$34.8 million in CABs in 2011. It will have to repay \$305.5 million by the maturity date in 2047, or \$9.76 for every dollar borrowed.

Placentia-Yorba Linda Unified issued \$22.1 million in capital appreciation bonds in 2011. It will have to repay \$281 million by the maturity date in 2049, or \$12.73 for every dollar borrowed.

In 2013, California finally passed a law limiting debt service on CABs to four times principal, and limiting their maturity to a maximum of 25 years. But the bill is not retroactive. In several decades, the 400 cities that have been drawn into these shark-infested waters could be facing municipal bankruptcy - for capital “improvements” that will by then be obsolete and need to be replaced.

Then-State Treasurer Bill Lockyer called the bonds “debt for the next generation.” But some economists argue that it is a transfer of wealth, not between generations, but between classes - from the poor to the rich. Capital investments were once funded with property taxes, particularly those paid by wealthy homeowners and corporations. But California’s property tax receipts were slashed by Proposition 13 and the housing crisis, forcing school costs to be borne by middle-class households and the students themselves.

The same kind of funding shift has occurred in college education nationally. Tuition at public universities and colleges was at one time free. But in successive economic downturns, states have made up for shortfalls in educational budgets by raising tuition. By 2012, tuition was covering 44% of the operating expenses of public higher education. According to a March 2014 report by Demos, 7 out of 10 college seniors now borrow, and their average debt on graduation is over \$29,000. The

result nationally is a student debt that has grown to \$1.5 trillion.

### **The State that Escaped: North Dakota**

According to Demos, per-student funding has been slashed since 2008 in every state but one - the indomitable North Dakota. What is so different about that state? Some commentators credit the oil boom, but other states with oil have not fared so well. And the boom did not actually hit in North Dakota until 2010. The budget of every state but North Dakota had already slipped into the red by the spring of 2009.

One thing that does single the state out is that North Dakota alone has its own depository bank. The state-owned Bank of North Dakota (BND) was making 1% loans to school districts even in December 2014, when global oil prices had dropped by half. That month, the BND granted a \$10 million construction loan to McKenzie County Public School No. 1, at an interest rate of 1% payable over 20 years. Over the life of the loan, that works out to \$.20 in simple interest or \$.22 in compound interest for every \$1 borrowed. Compare that to the \$15 owed for every dollar borrowed by Anaheim's Savanna School District or the \$10 owed for every dollar borrowed by Santa Ana Unified.

How can the BND afford to make these very low interest loans and still turn a profit? The answer is that its costs are very low. It has no exorbitantly-paid executives; pays no bonuses, fees, or commissions; pays no dividends to private shareholders; and has low borrowing costs. It does not need to advertise for depositors (it has a captive deposit base in the state itself) or for borrowers (it is a wholesale bank that partners with local banks, which find the borrowers). The BND also has no losses from derivative trades gone wrong. It engages in old-fashioned conservative banking and does not speculate in derivatives. Unlike the vampire squids of Wall Street, it is not motivated to maximize its bottom line in a predatory way. Its mandate is simply to serve the public interest.

North Dakota currently has a population of about 740,000, or the size of Santa Ana and Anaheim combined. If a coalition of several such cities were to form a municipally-owned bank, they too could have their own low-cost capital funding mechanism, allowing them to escape the budget-sucking tentacles of Wall Street's vampire squids.

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