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HOUSE OF REPRESENTATIVES
FINANCE
COMMITTEE HEARING

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WEDNESDAY, MARCH 3, 2010
9:30 A.M.

PRESENTATION ON
HOUSE BILL 1905

BEFORE:
HONORABLE DAVID K. LEVDANSKY, MARJORITY CHAIRMAN
HONORABLE RICK MIRABITO
HONORABLE TIM BRIGGS
HONORABLE DAN FRANKEL
HONORABLE JARET GIBBONS
HONORABLE RICK TAYLOR
HONORABLE WILLIAM C. KORTZ II
HONORABLE TIM SEIP
HONORABLE SCOTT W. BOYD, MINORITY VICE CHAIRMAN
HONORABLE JIM COX
HONORABLE GORDON DENLINGER
HONORABLE MICHAEL PEIFER

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JENNY STRATTON
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I N D E X

TESTIFIERS

P R O C E E D I N G S

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CHAIRMAN LEVDANSKY: Good morning. Today's hearing is on House Bill 1905, prime sponsored by Representative Mario Scavello. In essence, this legislation would repeal the amendments made to the local government Unit Debt Act, Act 23 of 2003. Those amendments provided for the use of qualified interest-rate management agreements, more commonly referred to as "swaps." Act 23 is characterized in the conclusions and recommendations section of the Auditor General's report as, quote, A statute written primarily for the benefit and protection of the financial services industry, unquote.

Further, the ramifications of Act 23 were highlighted in an article in the March 2008 addition of the Bloomberg Markets entitled, School Flunks Finance. That article highlighted the financial losses suffered by the Erie and Bethlehem School Districts as well as Beaver County through the use of interest-rate swaps.

We are, indeed, fortunate to have the caliber participants that are here today and I look forward to their testimony and hope to have a better understanding of these financial instruments and if their appropriate for our local government units through this process.

Auditor General, Jack Wagner, who is auditor of the Bethlehem School District and who kind of spurred our focus and interest in this subject, is running a little bit late this morning. So we're going to have a small departure from our agenda. We're going to begin today's hearing with Dr. David Davare, the director of research services for the Pennsylvania School Board Association and Dr. Patrick Cusatis, the assistant professor of finance at Penn State University, Harrisburg, and a consultant to the Pennsylvania School Board Association.

Before we get started, I would like to have the members of the committee introduce themselves. I'm Dave Levdansky, the chairman from Allegheny and Washington Counties.

REPRESENTATIVE SEIP: Tim Seip; representing part of Schuylkill and part of Berks, the Cabela's and Mootz Candy District.

REPRESENTATIVE MIRABITO: Rick Mirabito; Lycoming County.

REPRESENTATIVE BRIGGS: Tim Briggs; Montgomery County.

REPRESENTATIVE FRANKEL: Dan Frankel; Allegheny County.

REPRESENTATIVE DENLINGER: Gordon Denlinger; Lancaster County.

REPRESENTATIVE GIBBONS: Jaret Gibbons; 10th District of Lawrence, Beaver and Butler Counties.

REPRESENTATIVE KORTZ: Good morning. Will Kortz; Allegheny County.

REPRESENTATIVE COX: Jim Cox; Berks County.

REPRESENTATIVE PEIFER: Good morning. Mike Peifer; 139th District, which is Wayne, Pike and Monroe Counties.

REPRESENTATIVE BOYD: Scott Boyd; 43rd District, part of Lancaster County.

CHAIRMAN LEVDANSKY: Thank you. Gentlemen, you may proceed.

DIRECTOR OF RESEARCH SERVICES DAVARE: Good morning, Mr. Chairman, Members of the House Finance Committee. Thank you for the opportunity to be here this morning. My name is Dave Davare. As introduced, I am the director of research services for PSBA. I am joined this morning by Dr. Patrick Cusatis, the association's consultant on this issue.

As a point of reference, we have appended to our testimony, copies of some articles that were published in our bi-monthly magazine, the PSBA Bulletin, on the issue of swaps. We have also appended a copy of

Dr. Cusatis' PowerPoint, which we will be going through in a few minutes.

PSBA is appreciative that you called this hearing to discuss this important issue in the use interest-rate swaps and the obligations and investments of school districts. We want to recognize the value of the Auditor General's efforts for calling attention to the potential problems of interest-rate swaps. Like the Auditor General, we fear some financial advisors may be less than independent in their representation. We're afraid that school districts may not be receiving full disclosure as to some of the risks as well as the benefits.

Although PSBA did not advocate for or against Act 23, we would suggest a different approach from the Auditor General in terms of his recommendation of a complete ban. Our consultant will discuss the issue in a little greater detail during his remarks.

Just a little bit of background, Dr. Cusatis is an assistant professor of finance at Penn State Harrisburg. He joined Penn State full-time in 2002. Prior to joining Penn State, he was senior vice-president in charge of municipal derivatives and municipal remarketing at Tucker-Anthony. He was also employed as director at CoreStates Bank and First Union

National Bank, where he managed investment portfolios in excess of $3 million. Dr. Cusatis is also a specialist in municipal new products development at Lehman Brothers. He and his colleagues pioneered many of the derivative products that are in the municipal market today. Dr. Cusatis is the author of numerous books and academic journals such as the Journal of Financial Economics and Journal of Futures Markets. In addition to some other things, he has also published two books on derivatives and that's one of the reasons why we have been interested in having Dr. Cusatis as a consultant.

To date, PSBA has published three articles, which I have referenced. One was written by Attorney Fishman from DCED. So we have tried to keep our members advised and current on the information. Additionally, we expect to undertake some web-based training as well as having Dr. Cusatis prepare some additional materials that we can educate our board members on this. With that, I will introduce Dr. Cusatis and when he finishes his presentation, we would be happy to entertain your questions. Thank you.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Thank you, Dave, and thank you to the Members of the Committee for having us here today. I would like to begin with a market overview and then talk a little bit about some of the specific structures that are used in the Union Market today. Now, I'm sure you'll see some of this information over and over but I think the more that we're all educated on, what these products are used for, how they're used and correctly used, the better it is for everyone involved.

So just as an overview, the interest-rate swap market is the largest and fastest growing derivative market in the world. Swaps are written on all kinds of different instruments, interest rates, equities, currencies, commodities. As of June 2009, the estimated outstanding volume of interest-rate swaps was a little over 341 trillion. It's probably a little more close to 400 trillion right now. So it's a really large international market.

A plain vanilla swap, a real basic structure in the interest-rate swap market, consists of contracts where two counterparties, a floating-rate payer and a fixed-rate payer agree to exchange net payments at a series of future points in time. A notional principal amount is stated at the time the contract is settled and payments are calculated based on that notional principal amount. No money changes hands when the transaction is entered into. Money changes hands over time.

The fixed swap rate is really the price of the swap and it is set at the date of pricing. And then a floating swap rate is established for the first payment and then changes periodically based on resets and changes in market levels. For a, what's referred to as a plain vanilla swap, a typical swap, that floating rate is based on three-month LIBOR. For other swaps, it can be based on benchmarks including the commercial paper rate, it might be based on a treasury bill rate, a SIFMA, which is a short-term municipal market rate tax exemplary and one-month LIBOR are all examples.

The value of a swap changes like any instrument -- like any fixed income instrument as interest rates change. If you look at this chart, it shows that the value of a swap -- the solid line represents the value to a pay fixed received floating swap and the dotted line represents the value to the opposite, pay floating and received fixed swap. And values change as interest rates change. So as interest rates go up, the value to the party who pays fixed and received floating goes up, and the opposite is true for the party and the other interest rates who have to pay floating and receive fixed. So it's very important to understand that contracts are just like bonds. Swap contracts change in value and interest rates change.

The Union Market: A couple of different

structures are used that could fit into the category similar to the plain vanilla swap. One structure is to use a percentage of LIBOR instead of LIBOR -- like we said, 100 percent of LIBOR -- a percentage of LIBOR because municipal bonds are tax exempt. A percentage of LIBOR would more closely match the cash flows associated with a floating-rate municipal bond and that's done many times because it's more efficient to structure something like the top slide shows than the bottom slide. The bottom slide would be using an actual municipal rate, such as SIFMA. SIFMA is a short-term tax exempt rate and one side receives the fixed rate, the other side pays the fixed rate and receives the floating rate. Typically, for a municipality, the swap is structured so that they are receiving the floating rate and paying the fixed rate.

If we look at the next side, this is the most common structure currently existing for school boards in Pennsylvania and, really, for most municipalities across the country. This is the most common structure that is used. This is called a synthetic fixed rate financing. If you ignore the slot for a minute, look over on the left-hand side, and you'll see that the municipality school district enters into a floating rate structure -- a floating rate bond.

They issue bonds, they receive the proceeds and then over time, they pay the floating rate, which is determined by the market, generally somewhere around the SIFMA rate, which is the short-term floating rate, plus some spread possibly, maybe SIFMA flat, it depends on what kind of school district they are, what their rating is and so on.

At the same time, they enter into an interest-rate swap with a bank, the swap counterparty. Under the terms of the interest-rate swap, they receive the floating rate and they pay a fixed rate. Now, in this example, they could have alternatively issued a fixed-rate bond that would have yielded 5 percent. By issuing a floating-rate bond and swapping it to fixed, they say 50 basis points. So they save one-half of one percent on the entire bond financing over time. And this is the typical use. This is what about 60, 70 percent of the school district swaps that are out there now represent. And it represents real savings, real savings for taxpayers and this is why they're used and the most typical used and one that we think should be allowed.

There are some other structures in the market. One would be a forward-delivery swap. Forward-delivery swap is the same as a regular swap except the payments do not begin until sometime in the future. The swap rate is usually higher if the yield curves are in typical shape or upward sloping. So in that case, the municipality can contract to enter into a swap that begins, say 6 months forward or 9 months forward and nothing happens between now and then. We'll talk more about that in a minute.

Alternatively, you can enter into a swaption. Municipalities can enter into swaptions. A swaption is like a forward-delivery swap except it's an option to enter into a swap at some time in the future. So the swap begins 6 months from now, 9 months, 1 year from now, only if the party, say the school board, decides that they want to enter into the swap. It's like a forward-starting swap, but it doesn't have to start. The municipality pays for that upfront and has the right to enter into it in the future.

If you look at the next slide, there's an example. The municipality potentially needs to borrow $50 million in 6 months, interest rates are currently low and they can lock in the level of current interest rates by using a swaption. And in 6 months, if the bonds are needed, then the municipality orders the swap to begin. When the swap commences, they simultaneously issue floating-rate bonds. When the floating-rate bonds are issued, then the two together, the bonds and the swappers, represent that synthetic fixed-rate financing that we showed as the most common use. So this is a possible structure. If the bond issue is not required, then the municipality lets the swaption expire and the losses and what was paid for the swaption, but nothing more.

Now, there are some structures that we think are not appropriate or represent potential risks to stay in local governments, to school boards, to municipalities. For example, consider the sort of opposite case of the most common use and that is where instead the municipality issues fixed-rate bonds in the same market of five percent and then enters into a swap where they pay the floating-rate and receive the fixed-rate, in this case they received 4 and a half percent and pay SIFMA. What this does is it synthetically creates floating-rate debt.

So this is something to be concerned about because when you create this synthetic floating-rate debt, what you're doing is increasing floating-rate exposure but you have a swap there too. So if interest rates got really high in the floating market, it could cause an unwinding of the swap before the maturity and we think that this structure introduces risk that, and for that reason, should not be used. I think that it's a great use of derivatives and should be avoided.

Another potential risk that we talked about is forward-delivery swap. And the use of a forward-delivery swap as a rate lock, we see as a potential risk. The reason being this, consider this municipality again. It potentially needs $50 million and interest rates are currently low. So they can enter into a forward-delivery swap as opposed to a swaption. If they do that, then, under the terms of the swap, the municipality would pay the fixed-rate and receive the floating-rate and potentially create the same synthetic financing that we showed as the most common use.

The problem is this, if the municipality does not need the swap, if the financing does not occur, then there could be a potential loss because the swap will start because it's a forward-delivery swap and not an option. So this should only be done if the bond issuance has been authorized and is certain to happen and then it's just a delayed version of the synthetic fixed-rate financing.

A little overview of the Pennsylvania's school district swap market, where we stand right now and where we've managed approximately 600 swaps outstanding. Swaps have produced considerable savings for taxpayers over the years primarily because they've been structured as synthetic fixed-rate that we've talked about. There has been very few problems in the municipal swap market as a whole and whether you look throughout the country or throughout the Commonwealth of Pennsylvania or just in the school district market in Pennsylvania relative to the market breadth. There has been some market turbulence that was caused by the credit issues of 2008. It's affected all markets and most of it has settled since 2008. But certainly, there were some problems, but the market, for the most part, has settled out. The problems in the past, as in all derivatives markets, generally, can be very easily identified and avoided in the future.

Some possible risks that we've identified, one is counterparty risk and that's the risk that the swap counterparty, the bank, has difficulties or fails. Only sound counterparties should be used. There's also a possibility of basis risk. Basis risk is a mismatch. For example, if you do a percentage of LIBOR swap and your bonds are actually funded with SIFMA, there could be a little bit of a mismatch there, but that could be avoided or it could be hedged with a basis swap.

Issuance risk: I think we've talked about a forward-delivery swap should only be used if the issuance is certain.

Liquidity risk: The amount of variable-rate bonds associated with swaps should not hinder the liquidity facility. You cannot issue as a -- any issue work with any municipality, any state or local government or school board cannot issue a limitless amount of floating-rate bonds. So there should be some guidelines.

Some recommendations are, one, do not eliminate the use of derivatives for districts as this would be costly and inefficient. Derivatives provide, if correctly used, a very efficient and cost effective way to save money for taxpayers. Do not mandate the unwinding of existing swaps because this would be catastrophic for school districts. Unwinding would cause incredible losses. I showed how swaps change value and how interest rates change. Interest rates are very low right now. Most of the swaps that are on the books right now would require some kind of fee to terminate. They are fine because they have a bond on the other side, but you can't look at one side and not on the other side. So the potential losses would be catastrophic and just not advisable.

Guidelines developed in coordination with market experts and other stakeholders, with respect to liquidity and counterparty choice, will avoid the mistakes of the past. Continual monitoring by outside parties should take place. Financial advisors should be independent parties. And full disclosure of all risks prior to the transaction closing, should be required. An increased education of market participants is recommended. Thank you.

CHAIRMAN LEVDANSKY: Any questions from members? Representative Denlinger.

REPRESENTATIVE DENLINGER: Thank you, Mr. Chairman, and thank you for your testimony, it's appreciated. I want to just go to something quickly, at the conclusion of your testimony, and that was fees to terminate because I think therein lies a lot of the public angst and we are looking at the Bethlehem School District situation particularly.

I'm wondering, in your educated opinion, have these swap agreements been written in such a way that some of these unwind structures are inappropriate? That's kind of a judgment call I realize, but we very much would respect your weighing in on that issue.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I can't comment on issues that I haven't been a part of or seen the structure of, but I can tell you how it typically works in the market. And I am familiar with a lot of municipal swap structures. The graph that I show -- and I'll go back to it -- this graph. You have to look at both sides of the market. So if you enter into a swap, one side is a floating-rate bond and the other side is the interest-rate swap. When interest rates change, the value of the swap changes. Interest rates go down if you're in this swap here that we've talked about. If you're in the swap where you've received floating and pay fixed and interest rates go down, the value of that swap goes down.

I think what's many times characterized as a termination fee is actually what the value of a swap has become. The way it works in the swap market is you don't know what side of the trade you're going to end up being on. If interest rates go up and for some reason you have to take the unwillingness swap, then you'll get a net payment. So what's characterized most of the time as an interest rate fee, I think is actually just a termination value of a swap. The swap value changes when there's changes in interest rates because it's a fixed income instrument. And if it has gone down, well, it's because interest rates have gone down, but you also have a bond against that. So it doesn't really matter, that doesn't really affect you, unless you have to take the swap out.

That's why the real risk here is not the structure as much as making sure you don't have to take the swap off or terminate early and that's where the problems come from. Is that helpful?

REPRESENTATIVE DENLINGER: I think it does help. And then the other thing, there are provisions for not only those who market these products to -- and it is certainly legal, and they do that with districts and municipalities -- but then there are provisions for financial advice or advisors who also weigh in on that process. I would appreciate Dr. Davare and yourself to just share with us as a committee, do you feel that the level of education and advice that's being given to municipalities is adequate?

These are complicated instruments and we're dealing with elected school boards and folks who, many times, do not hail out of the financial community. They're trying to grasp and wrestle with issues that are very complexed in nature, relying on professionals who have a financial stake in this. They are trying to market the product. Do you feel that the level of education is adequate as we currently see it?

DIRECTOR OF RESEARCH SERVICES DAVARE: We have a concern about not only the level of education, and PSBA works continuously to educate it's members, but we also have a concern about the true independence that's called for in the current legislation. The current legislation independence is not defined clearly as to what an independent financial advisor, what connections should or should not exist. So we do have some concern that there is a failure of true independent advice that may be occurring in a few cases. We don't know for certain. We think that some advisors are doing a very good job, but we also know that there may be some advisors out there who are not clearly exposing or providing information on the potential downsides when we're talking about the upsides.

REPRESENTATIVE DENLINGER: How would you like to see independence defined?

DIRECTOR OF RESEARCH SERVICES DAVARE: We would like to see independence defined as a person who is outside the transaction who would work strictly for the governing board, be it, the township supervisors, and not a party to the actual transaction of placing or selling the swaps or buying the swaps. And somebody who would be much like a district solicitor in regard to the financial advice that gets provided.

REPRESENTATIVE DENLINGER: Very good. Thank you. Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Representative

Mirabito.

REPRESENTATIVE MIRABITO: You mentioned that there's a substantial amount of money saved for school districts. Based on what you said, there's also a fair amount of risk. Can you give us an example, a real example, of some school districts that have saved money and also the measured risk?

Anytime you go to see an investment advisor, they always tell you that the level of risk is between a scale of one to five. I would just like to get a handle on what we're looking at because I am following up with the former question, I'm concerned about school boards where some people may not have the education and about this and also I'm thinking about the taxpayers who are thinking I pay money to my school districts to build schools and so forth or pay teachers but not to engage in sophisticated financial transactions. Maybe you can just enlighten me a little.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I can say that there's -- many of the larger school districts have several transactions and I can't quantify for you in dollars right now, but I could look at this and we could measure this. If you look at the larger school districts, generally, savings on a swap are somewhere in the magnitude of 25 to 50 basis points on a particular transaction. So if you compare that to the level of risk -- and that's real savings -- over time, if it's a 20-year issue of any size, it amounts to several million dollars in savings over the life of the issue.

Another question is then, is that worth it given the amount of risk they are taking? For most transactions, I would say that the risk is very small. And the risk is very small because they are solid credits that have entered into this, there's not a lot of chance they will have to exit the swap and then all of the other risk reasons that we've talked about, the counterparties are sound, stable counterparties, the liquidity facilities are in place and there's no issues of those going away.

I guess take into consideration that a number of these transactions that are out there, it's very, very rare that one actually does have to be liquidated or something happens. So the risk and return trade-off, I think, is very good.

DIRECTOR OF RESEARCH SERVICES DAVARE: If I may add to that a couple of examples that have appeared in the paper just before Christmas. The Central Dauphin School District finalized this swap and they made $3 million for it's taxpayers to help support it's construction program.

Chairman Levdansky in his introduction mentioned the article that cited the City of Erie School District problems with swaps. The City of Erie has just recently unwrapped it's swaps and gained $2 million out of it's latest unwrap. There, on the plus side, they lost roughly a million dollars in the first go-around, 2 million on the second go-around, so they're plus a million dollars at this point. So there are districts that are making money just the same as Erie did lose money at one point, Bethlehem, we've all heard the problems about -- concerning Bethlehem and their losses. So we do have districts who are gaining and helping protect their taxpayers.

REPRESENTATIVE MIRABITO: If you look at the swaps that are out there with school districts, are they more at risk from a drop in interest rates or from interest rates going unexpectedly high or is it not either? I guess what I'm thinking about is the housing bubble.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: It shouldn't matter. The structures that are out there create this synthetic fixed rate and where interest rates go, shouldn't affect it at all. So there's really no risk from either.

CHAIRMAN LEVDANSKY: Thank you. Representative Seip.

REPRESENTATIVE SEIP: Thank you, Mr. Chairman. Thank you for your testimony today. I just have a very simple question, I think. I would like to know, in your expert opinion, do you think that there is any higher degree risk for bigger entities? I represent a lot of smaller communities and a lot of smaller school districts, so certainly, any kind of arrangement that the City of Pottsville, one of the smaller third-class cities in the state, or a very small single-A school district would engaged in, would be much different than the City of Erie would engage in.

So if you could just quantify the risk. Is there a very proportional amount of risk or more for the small entities or less for the bigger entities? If you could just quantify that for me, I would appreciate it.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: My wife is from the City of Pottsville. I think that larger entities have more of an ability to enter into these contracts. With that, I guess could go the possibility that they enter into too many of these contracts, whereas, it's less likely for the smaller entities. Some of them will never enter into these contracts. I think that's part of the monitoring that we're talking about, that's part of the guidelines that we're talking about.

It is possible to do too much of this. It is possible to create some exposure that you don't want.

If things are followed the way we see it, if the guidelines are followed in terms of not doing too much so that you don't affect your liquidity facility, maintaining your credit rating. What goes along with all of this is the physical responsibility that keeps credit ratings sound and stable. It keeps the underlined bonds sound and stable. So if all of that's followed, then a larger municipality can have significant savings within their bounds and there can be savings for smaller municipalities as well.

I guess my response is, I could see situations where a larger entity may either be advised to do too much of this or do too much. But I think in most cases, that's something that we can prevent or foresee and yes, you should only do so much. I don't think it's happening right now.

REPRESENTATIVE SEIP: So I think what I got out of what you said is that the risk is about the same; is that right?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Yes, the risk is about the same and I don't think it really changes. I guess you could have a larger issue or go down a path -- the limitation, I guess what I'm trying to get at is that if it's a very small issuer, then it's not likely that someone would even do a swap with them. It may be difficult to have a swap done. If it's a high credit, and some of the real small issuers don't even have credit ratings, so it may be difficult to enter into an interest-rate swap. It's a little easier for the bigger issuers to get into the swaps, so that's maybe where the guidance needs. If they're large enough to enter into a swap, then you're right, the risks are the same.

REPRESENTATIVE SEIP: Okay. Thank you. Thank you, Mr. Chairman.

DIRECTOR OF RESEARCH SERVICES DAVARE: One of the other points that I would to like make on that is -- and we pointed out in some communications with different members of the legislature over the last couple of the years from the PSBA's perspective -- the amount of swaps or the number of swaps in terms of the percentage of its total investment portfolio. The limitation on that, so a district isn't out there doing 100 percent of its available funds and swaps, there should be the balanced portfolio approach. So right now, we haven't taken a position one way or the other, but one of our concerns is how much a school district should be able to invest in swaps.

REPRESENTATIVE SEIP: Thank you. Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Representative Boyd.

REPRESENTATIVE BOYD: Thank you, Mr. Chairman. Dr. Davare, I'm going to ask a number of questions. I'm a pretty simple guy so these are pretty complexed issues and I'm trying to get my head around on how this whole process would work. My first question is, can you just define what the LIBOR index is for us because you referred to it in your testimony?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: LIBOR index is a -- it stands for the London Interbank Offered Rate and it's set every evening by the British Bankers' Association. It kind of represents an international interest rate, but it's U.S. dollar denominated. So for that reason, it's become the benchmark for interest-rate swaps because it's a U.S. dollar denominated interest rate and it represents the interest rate that banks receive if they deposit money overseas.

REPRESENTATIVE BOYD: Does the value of the dollar, internationally against other currencies, affect that rate?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: It might. Generally, it's just a short-term interest rate so there's not a lot of affect to interest rate on it because it's U.S. dollar denominated interest rate so there won't be a lot of affect.

REPRESENTATIVE BOYD: Okay. Thank you. I want to understand the process here and how this evolves. If I'm a business manager for a local school district -- I mean, I'm going to make an assumption. If I'm incorrect, please correct me right away. This is a relatively new phenomenon, these swaps, yes or no? In other words, within say the last three to five years.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: No.

REPRESENTATIVE BOYD: No? This has been going on a long time?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: The interest market really started to grow in the late 80s.

REPRESENTATIVE BOYD: Okay. Thank you. If I'm a business manager for a school and we've entered into data agreements for building projects, does someone knock on my door and make an appointment, an investment advisor or a firm, and come in and say, hey, I've been looking at the construction of your debt and I can save you money? Are there guys out there hawking these instruments? Is that how this process works?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I guess it depends on how the entity does business. I think that most of these entities have bankers that they either deal with regularly and they know these people or they put out an RFP and request some kind of financing, in that case then maybe two or three different alternatives are offered for the issuance. I use to structure municipal bonds. I was an investment banker and we would go in say, here's a couple of solutions for your problems.

REPRESENTATIVE BOYD: As you might have heard, I'm from Lancaster County and unfortunately, some of the red numbers on these swaps are from Lancaster, both the City and the County. So as a taxpayer in those areas -- and I'm going to be very candid with you -- I think of myself as a relatively educated individual but I can't remotely understand and grasp the process by which this unfolds.

The bottom line for me as a taxpayer is I'm looking at you as either a school board member or as a business manager or the controller for the City and I'm saying you have a fiduciary responsibility to handle my tax dollars, don't lose money. If I have my investment portfolio and I meet with my manager, the first thing out of my mouth is, don't lose money.

So my feeling is that there's this really strong responsibility that the risk level should be extremely low in these transactions. And I heard you make an interesting statement. The statement was, what happens with interest rates doesn't matter.

So I guess my question is, if what happens with interest rates doesn't matter, and I believe that the primary responsibility of -- and maybe I'm wrong with this -- but I think they have a fiduciary responsibility to be certain to guard taxpayer dollars with absolute impunity, then why do we see red numbers? My question is, if it should be a no-brainer, then at the worst-case scenario, in my opinion, there should be no net gain, zero or black. But when I see red, it tells me that we're dealing with at least some risk involved and is that an appropriate methodology for managing taxpayer dollars?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Well, first of all, my statement where interest rates go don't matter, that refers to this swap structure that's up on the screen right now because you're creating a synthetic fixed-rate and when you do that, it's insensitive to interest-rate movements. So the savings are there and that's what you have.

Now, in terms of the amount of risk, I

agree. There's a fiduciary responsibility, I agree that the right thing should be done for taxpayers and that has to do with the bond issue and all the financing that is structured all the way down to the level of the bond issue. So the question then is, if there's an opportunity to save money on the bond structure, is it the right thing to do? You're right, it becomes a risk in return question. I guess what I'm saying is that these swaps can be structured and most of them are structured with very little risk.

DIRECTOR OF RESEARCH SERVICES DAVARE: If I might point out, the swaps are part of the Unit Debt Law, separate and distinct from the investment limitations and restrictions on the school district general fund, which is found in 440.1 of the school code and is extremely limited.

So this is a case where districts are looking at some strong restrictions under the school code, but a completely different set of rules related to bond issues and bond financing and that's, I think, where some of the difficulty comes in and the need for more education on the part of the school boards. I believe that the school business officials have continued to run some training for it's membership, the business managers, in swaps and how these work and these kinds of activities which would be part of the school business officials purview.

REPRESENTATIVE BOYD: Okay. It just seems intriguing to me when you did the analysis and you talked about Erie and how, yeah, they lost a million on the first deal and they gained two million on the second deal. And it feels, at least from my standpoint a bit -- not sure the exact word I want to use -- but it just doesn't feel right that that's the right way to, I use the term loosely -- and this is my opinion -- but play with taxpayer dollars.

We're hedging on this issue and we're doing better on that issue and at the end of the day if an individual wants to do that with their personal finances, hey, so be it. If you lose, you lose. That's your problem. But when we start to do that with taxpayer dollars, it starts to feel like, wait a second. You're doing these rather complexed financial transactions with money that's not yours and it just -- I'm not sure if it feels right to me.

I'm just, as I said, not the brightest bulb in the pack when it comes to some of these types of things, and I guess as a policymaker the question for me becomes how strongly do we try and control what's allowed to be certain that we limit the red numbers?

Doctor, you made a comment about under this one model, interest rates don't matter because one of the questions I wanted to ask is, where are interest rates going?

DIRECTOR OF RESEARCH SERVICES: I don't know.

REPRESENTATIVE BOYD: That's the point. And so we're all sitting in this room trying to make decisions for our own personal finances and I'm heavily invested in tips because I think interest rates are going up because the Fed can't indiscriminately print money without driving inflation. So the question becomes, what do we do to limit the downside to this? Do you have a policy recommendation for this committee to consider as to allow this process to unfold but limit or eliminate the red numbers? Is there a way to do that?

DIRECTOR OF RESEARCH SERVICES DAVARE: From PSBA's perspective, and we haven't finalized our full position on it, but there are things like definition of independence, as I mentioned earlier; providing for that independent financial advisor to be required to provide training to the board; having that independent financial advisor periodically review the investments in the swap transactions to keep the school board or the municipal entity well appraised of this status of what's going on in the market. Basically looking at it as representing the board, not representing a specific investment company or an investment firm.

A couple of the other things that we're looking at is the potential for limiting percentage of investments in there. Let me go back to the case of Erie. I wasn't pointing it out to say good or bad, I merely cited Erie to say that here's the districts who've lost money, stayed in the market or went back into the market and made money in the process. So you're right, there is risk. Anytime you're looking for a greater reward, you obviously have some greater risk. That's why we think from a risk perspective to minimize some of the -- or limit the extent to which districts can be involved.

REPRESENTATIVE BOYD: Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Thank you. Representative Peifer.

REPRESENTATIVE PEIFER: Thank you, Mr. Chairman. Dr. Davare, you talk about the need for more training and maybe more of an independent outlook to help the school districts. Isn't that what your bond counsel normally prepares in this type of analysis or is that more of a legal action?

DIRECTOR OF RESEARCH SERVICES DAVARE: Bond counsel is more of a legal action on the side of issuing bonds, not necessarily involved in the swap's transactions itself.

REPRESENTATIVE PEIFER: From the investment side?

DIRECTOR OF RESEARCH SERVICES DAVARE: From the investment side. So that's why bond counsels take a very narrow view in terms of their advice. They're looking primarily at the bond issue and the legalities associated with the bond issue itself.

REPRESENTATIVE PEIFER: But maybe that's what we need. Since we don't have the expertise from the legal side, we actually require bond counsel, maybe we require the same type of investment counsel so we don't win and lose. Clearly, our school boards don't have this area of expertise.

DIRECTOR OF RESEARCH SERVICES DAVARE: And PSBA is supportive of independent financial advice here, again, where the district would be paying a fee directly to the financial advisor to represent it's interest just like they would pay a fee to bond counsel to represent their interest there or to legal counsel to represent their interest in other legal proceedings.

REPRESENTATIVE PEIFER: Do most of your

school boards hire that independent investment authority?

DIRECTOR OF RESEARCH SERVICES DAVARE: We're still looking at it, but it appears that the only person that gets hired is the one who actually ends up placing the transaction.

REPRESENTATIVE PEIFER: Thank you. Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Thank you. I have a few questions. I think I want to start with Dr. Cusatis. On page 15 of your slide presentation, the third bullet, one of your recommendations is, guidelines developed in coordination with market experts and stakeholders with respect to liquidity and counterparty choice will avoid past mistakes, but nowhere in your slide presentation did you go into any detail about the past mistakes.

From your expert opinion, what have been the mistakes that have been made by local taxing bodies, school districts, local municipalities, county governments that have engaged in this financing arrangement?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Well, I don't want to talk about any specifics on the deals that I wasn't involved with, but I will say generally that I think that there have been mistakes with the use of forward-delivery swaps when the transaction was not certain. So you end up with the swap and no bond issue and that's a mistake.

I think that there -- and I don't know if mistake is the right way to classify it -- but I think there have been some issues where we've seen liquidity facilities overextended and there may be some others out there now. So there is this exposure when you issue floating-rate bonds. You have to obtain and maintain a liquidity facility and if that goes away, it could be an issue.

Now, we've had some problems in 2008. 2008 was the perfect storm and it caused a lot of issues for a lot of folks. So I think that so far what we've seen -- when I say mistakes in the past, I don't think they have been bad. I don't think there's been a lot of mistakes by school districts and we haven't seen a lot of fallout by it. But I think going forward we can make sure that some of the risks that I listed earlier are avoided.

CHAIRMAN LEVDANSKY: Just a quick reaction to that. The Bethlehem School District lost 10, 12, 15 million dollars. You don't think that's a mistake?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: No.

I don't think losing 10 or 15 million dollars is a good thing, but I think if you look at what happened in that situation, their liquidity provider, Dexia, just decided not to be a liquidity provider anymore. It sort of falls under the category where we say liquidity providers need to be carefully chosen and you need to know that they're going to be around. But that was a function of the 2008 market conditions where suddenly a large bank who had been doing this for years and years says, we're not going to be doing it anymore. And it wasn't directly -- the loss came because they had to liquidate the swap. But the loss really came because the liquidity provider went away and they had to liquidate the bonds.

CHAIRMAN LEVDANSKY: Dr. Cusatis, one other thing that I want to get your reaction to. In the Auditor General's Report there's a statement by the Bethlehem School District's current independent advisor, Mr. William Gorman. In the Auditor General's report he quoted, "In his professional and personal opinion, school districts and other government units should not enter into risky agreements such as swaps. They cannot outsmart large investment banks like JP Morgan." What is your reaction to his opinion?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I'm not sure what that even means. There's no need to try to outsmart investment banks. These are really large markets. They're set in the market, they're very close and very tight. And I guess that's where some of this confusion is coming from. There's a question of, there's two different things, one is, are these entities playing the market? Are they in some way trying to enter into a derivative contract where they're calling the one side of the market versus the other side; and they're not. That's not what these structures are all about. It's not a matter of trying to outsmart the investment bank or something. I guess I don't know what that statement means. But I would say that these contracts --

CHAIRMAN LEVDANSKY: I think it's pretty obvious what it is. It's about your bet on what future interest rates are going to be.

DIRECTOR OF RESEARCH SERVICES DAVARE: Right, but that's not --

CHAIRMAN LEVDANSKY: Essentially, that's what it boils down to. Who's better at predicting what a future interest rate is going to be? An investment banker or a school board that has somebody that they have returned as a financial advisor or an investment advisor or somebody else that is supposed to be independent and then never had any relationships with the investment bank industry? That's really what it boils down to. Who can best predict what future interest rates are going to be? In terms of state government, who's best to predict next year's revenue? Me and Scott Boyd or Global Financial Services that we contract with, which the State contracts with to make revenue projections based on an econometric model. Do you think he and I can do an econometric modeling better than the professionals or not?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I don't know, but I understand your point.

CHAIRMAN LEVDANSKY: I do know. They're better at it than me and Scott.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Right.

CHAIRMAN LEVDANSKY: Just one final thing. Do you advise school districts?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Do I?

CHAIRMAN LEVDANSKY: Yes.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I have, yes.

CHAIRMAN LEVDANSKY: I mean, I presume that's part of what your work is. So this whole thing of swaps is predicated on who best can understand and predict where some future interest rate is going to be because it's the relationship between the two counterparties.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: No. The prediction of the interest rate part of it is where I don't see the connection. That's where I'm losing you. There's no prediction of interest rates involved here.

CHAIRMAN LEVDANSKY: Not prediction but just not on an absolute level. It's just whether they're going to go up or whether they are going to go down.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: It doesn't matter. There's no play on the level of interest rates here. We're talking about contracts that are established to lock in a fixed rate and if you look at this chart, the municipality is receiving SIFMA plus 20 and it's paying SIFMA plus 20. So that's a pass through. So where the level of interest rates go don't matter. And they pay 4 and a half percent fixed it's as --

CHAIRMAN LEVDANSKY: If interest rate levels don't matter, then why don't we all just do fixed-rate financing?

ASSISTANT PROFESSOR OF FINANCE CUSATIS:

Well, this is a synthetic fixed-rate financing, but it saves money.

CHAIRMAN LEVDANSKY: Okay. My executive director wants to have a follow-up on that.

EXECUTIVE DIRECTOR KASSOWAY: Follow-up to your characterization of Bethlehem. I look at a bond as every year or every six months I have to pay the interest and part of the principal back to the bondholder and that should go for the duration of the bond. Where does the liquidity provider come in? What we haven't been given here is, what happens that causes different things along the trail rather than just having to straight paying out periodically to the bondholder?

What's happening if there's not a play in the market that's causing somebody, a school district, to have to have, quote, a liquidity provider? What's the liquidity provided for? What's happened in the marketplace?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Well, floating-rate bond structures go back a long time, whether there's a swap involved or not a swap. State and local governments have issued floating rate bonds for many years. The liquidity provider exists in order to make the floating-rate bonds money market eligible so that there will be more buyers for them. They don't have anything to do with the swap.

A liquidity provision -- the liquidity provider falls under the rules of 287 in order for the bonds to be eligible for money market funds. They have to have this liquidity facility and they standby to say that we'll make sure that there's a buyer for the bonds. It's a short-term money market requirement.

EXECUTIVE DIRECTOR KASSOWAY: The bonds are already sold. The investment bonds were sold in 2003. What happened in 2008 that they needed liquidity that they couldn't get liquidity from this liquidity provider?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: They needed liquidity right from the very beginning. For floating-rate bonds, in order for them to be money market eligible, the bonds have to be structured with a liquidity facility. A bank stands by as a liquidity facility. And prior to 2008, there were a lot of banks that were willing to be liquidity facilities. In 2008, things changed. Now, they've gotten better since then.

EXECUTIVE DIRECTOR KASSOWAY: I mean, is there a continual offering of these bonds?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Yes -- well, there's a remarketing of the bonds. The rates are --

EXECUTIVE DIRECTOR KASSOWAY: So there's a remarketing of the bonds?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Yes.

EXECUTIVE DIRECTOR KASSOWAY: So that's the difference between the fixed-rate bond and the variable-rate bonds.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Right.

EXECUTIVE DIRECTOR KASSOWAY: If there's a remarketing of the bonds, then I would think that whatever interest rates are going on at the time would make it have an affect.

ASSISTANT PROFESSOR OF FINANCE CUSATIS: If there's no swap, yes.

EXECUTIVE DIRECTOR KASSOWAY: Well, even with a swap, unless it had a --

ASSISTANT PROFESSOR OF FINANCE CUSATIS: No. With the swap, the swap matches the cash flow.

EXECUTIVE DIRECTOR KASSOWAY: So if liquidity providers had sort of withdrawn from the market since 2008, why is it still a safe market to be in if we had this problem with liquidity providers?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: Some have withdrawn, but many have come back into it.

But yes, there was exposure in 2008.

EXECUTIVE DIRECTOR KASSOWAY: What percentage costs are there in the various fees and other payments paid to the investment community by a school district?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I don't know the answer to that. It varies from deal to deal and I just don't know.

EXECUTIVE DIRECTOR KASSOWAY: And why is that cost rarely, if ever, provided in a transparent manner to the school districts or the public?

ASSISTANT PROFESSOR OF FINANCE CUSATIS: I don't know.

EXECUTIVE DIRECTOR KASSOWAY: Thank you.

CHAIRMAN LEVDANSKY: Dr. Davare, I just have one final point in question. Under the recommendation section of the Auditor General's report, criticism is made of Act 23 and they go on and I'm going to quote, a statute written primarily for the benefit and protection of the financial services industry. And it further cites as an example of the power of the counterparties to a swap to have the Department of Education. The statute provides that the Department of Education will withhold a school district state's subsidy in the event that the school district fails to make a payment required by a swap.

So essentially, what we have is the full faith and credit of the taxing part of the school district isn't good enough for the investment bankers and everybody else that proposes these swaps. We have to have state government in our revenue stream served as a backstop to guarantee this transaction, which kind of indicates to me it must be pretty risky. If the full faith and credit of the school district isn't good enough that we've got to backstop it with a revenue stream for their basic subsidy, instead of money going to buy textbooks and pay instructors, we ensure that that money can be taken out of that and applied towards payments for the swap.

Are you aware of any other instances in our funding system at the state level where we allow for the basic education subsidy to serve as a backstop to some other purpose?

DIRECTOR OF RESEARCH SERVICES DAVARE: Representative, that provision was part of the Unit Debt Law prior to the swaps Act in 2003. That had been there as part of the provisions resulting from early years where school districts were choosing not to raise taxes and going into default. That was one of the provisions that went into the Unit Debt Law when it was originally passed. So that's a provision that's been there and that was really intended to help stabilize the credit ratings of school districts back in about 1970 when that law was originally passed because prior to that, and then prior to the 65 consolidation of school districts, a number of districts were going into the stress status every year. A lot of them from not raising taxes and not making bond payments. So that's not a provision expressly tied to the swaps itself.

CHAIRMAN LEVDANSKY: So you're saying that this provision did not come out of Act 23?

DIRECTOR OF RESEARCH SERVICES DAVARE: No, it did not.

CHAIRMAN LEVDANSKY: I'll follow-up with the Auditor General's people relative to that. Just for discussion sake, even if that were the case, would you recommend going back in and changing the Unit Debt Act to remove the backstop so that we can be ensured that the taxing authority of the school district is what's at risk relative to these swaps and not the basic education subsidy to the school district?

DIRECTOR OF RESEARCH SERVICES: I'm not an attorney. It's my belief -- and I request that you respectfully submit this to some legal counsel -- it's my belief that if a district would miss a bond payment and the state would have to exercise that provision, that the district would automatically be subject to the provisions of a distressed school district as they currently exist under the school code. So if the state would take that action they would also then be able to go in and take over the school district under fiscal distress laws that currently exist.

CHAIRMAN LEVDANSKY: In your experience, has it ever happened where the state would forget swaps, just traditional, fixed-rate bond financing for school district improvements, whether or not the school district goes into financial distress or not? Are you aware of any circumstance prior where the subsidy was used to make payments that the school district was obligated to make?

DIRECTOR OF RESEARCH SERVICES DAVARE: Not to my knowledge in the 18 years I have been around it.

CHAIRMAN LEVDANSKY: Okay. With that, I want to thank both of you for your insights and your testimony.

DIRECTOR OF RESEARCH SERVIES DAVARE: Thank you very much for the opportunity to be here.

CHAIRMAN LEVDANSKY: We're going to get back to our set agenda. Auditor General Jack Wagner, the auditor general of the state of Pennsylvania has arrived. Jack, I appreciate your presence here today. I presume you have some of your staff people here with you. If you will be so kind to introduce them?

AUDITOR GENERAL WAGNER: Yes, as a matter of fact, I'll ask two of my staff people to come to the table. My deputy and chief counsel and policy director, Rob Teplitz and my bureau chief of the office of special investigations, Jeff Gribb. Both of which play a very important role in producing the report related to the Bethlehem Area School District.

CHAIRMAN LEVDANSKY: Thank you.

AUDITOR GENERAL WAGNER: May we begin, Mr. Chairman?

CHAIRMAN LEVDANSKY: Yes.

AUDITOR GENERAL WAGNER: Thank you, Mr. Chairman. Chairman Levdansky, Vice Chairman Boyd and Members of the Committee for inviting me here today as Auditor General for the Commonwealth of Pennsylvania, the independent fiscal watchdog of taxpayer dollars.

In my role as Auditor General, we audit all 500 school districts in Pennsylvania, charter schools, cyber charter schools are, obviously, many state agencies and state departments. I also was a member of the Senate, as many of you know, for 10 years and voted for Act 23 of 2003, as I'm sure many members here did and others, but have since seen serious flaws related to it.

Thank you very much for the opportunity to appear before you today to discuss the issue of interest-rate swaps. I would like to commend Representative Scavello for introducing the legislation to repeal the law that allows swaps, along with all the co-sponsors, including Chairman Levdansky. I would also like to commend Senator Lisa Boscola who brought this important issue to our attention last year and who has drafted legislation to address this problem.

Most Pennsylvanians would be upset if members of their school board or municipal governments gambled away their hard earned tax dollars at local slot casinos. They should be just as upset if their school district or counsel has tied up local funds in interest-rate swaps because these exotic financial instruments are tantamount to gambling with public money.

Swaps are best between two parties, say a school district and investment bank on which way interest rates will move. The party that guesses right, wins and gets paid. The party that guesses wrong, loses and must pay the other party. How much is won or lost is determined by how much interest rates fluctuate and other factors. The bigger the swing in interest rates and other factors, the higher the potential losses. When it comes to gambling taxpayer money in swaps, Pennsylvania school districts and municipalities are number one, and I repeat, number one in the nation according to Moody's Investors Service.

A recent investigation by the Pennsylvania Department of Auditor General confirmed Moody's conclusion. Our investigators found that 107 of 500 school districts, a shocking 21 percent, and 86 municipal governments had almost 15 billion, and I repeat, billion in public debt tied to interest-rate swaps with at least 13 investment banks between October 2003 and June 2009.

The Philadelphia School District alone had the most debt tied to swaps contracts, in excess of $1 billion. If interest rates gyrate, if they move dramatically, the Pennsylvania taxpayers would potentially be on the hook for hundreds of millions of dollars or possibly billions of dollars. Our special investigation found that the Bethlehem Area School District lost at least, and I repeat, at least 10.2 million in interest-rate swaps when the banking industry collapsed in the fall of 2008. The district had entered into the most swaps during a three-year period, all total 13 swaps within the Bethlehem Area School District.

We reviewed just two of the district swaps because those were the only two that had concluded by the time of our investigation. The two swaps cost the district taxpayers 10.2 million more than if the district had issued a standard fixed-rate bond or note. Ironically, the swaps cost taxpayers 15.5 million more than if the district had simply paid the interest rate on the variable-rate note without any swaps at all. The districts' losses were largely due to excessive fees and other charges and a termination payment. Because the district has many other swaps still in effect, 11 to be precise, the ultimate financial impact on the taxpayers remains to be seen in the Bethlehem Area School District.

Unfortunately, since the results of our investigation were provided to the public last November, officials of several school districts have defended their use of swaps rather than attempt to disentangle themselves from these risky investments. You may hear some of that here today. Using rhetoric that eerily reflects gamblers at a Las Vegas blackjack table, they have rationalized that their conduct, by saying that there is little risk because they know what they are doing. They try to reassure taxpayers that the school districts and municipal governments that lost their shirts on swaps, simply weren't as savvy as they are.

I wholeheartedly disagree. The truth is this: The Bethlehem Area School District thought it knew what it was doing. After all, it initially profited from its swaps agreements. Before the banking industry collapsed in the fall of 2008. The Delaware River Port Authority claims it earned $40 million on its swaps agreements signed in 2000 and 2001, before they soured. The DRPA is now facing $240 million in liabilities on its swaps contracts.

How risky are interest-rate swaps? Just ask President Obama's White House Economic Advisor, Larry Summers, who was president of Harvard University from 2001 to 2006, approved swaps so toxic that the school recently agreed to pay investment banks a total of almost one billion to terminate those swaps.

As anyone who has ever been to a casino knows, even if you win a couple of bucks early, over the long haul, you never seem to beat the house. The same holds true with swaps. Any Pennsylvania school official or borough manager who thinks that he or she can beat a Wall Street investment banker at a game that is invented by them, is only diluting or fooling himself, herself and also the taxpayers.

As Pennsylvania's independent fiscal watchdog, I have urged the General Assembly to immediately prohibit local governments and municipal authorities from entering into swaps. I also continue to urge school districts and other local governments to take the following actions: Stop using swaps and other types of exotic financial instruments, of which 99 percent of the population doesn't understand; terminate any active swaps and refinance with conventional debt instruments; assess the financial consequences if they were to suffer the same negative experience with their active swaps as discussed in our report; and hire financial advisors through a competitive selection process and periodically evaluate the quality, cost, and independence of the services provided.

I am encouraged by the progress that has been made on the swaps issue in the short amount of time since we released our report. The Delaware River Port Authority, of which I am an ex-official member, unanimously adopted my resolution to prohibit the bi-state agency from entering into future swaps agreements and to begin a process of terminating its current swap agreements. Furthermore, several Pennsylvania school districts, some of which you heard today, including the New Hope-Solebury School District in Bucks County, the Nazareth Area School District in Northampton County, the Central Dauphin School District in Dauphin County, and the Erie School District in Erie County, have recently terminated their swaps, in what I would say, the taxpayers' best interest.

With regard to House Bill 1905, the Department of Auditor General supports the legislation inasmuch as it repeals Act 23 of 2003, which expressly enabled local government units to enter into swap agreements. However, this bill does not address our recommendation regarding the competitive selection and monitoring of financial advisors or our recommendation that municipal authorities should also be prohibited from entering into swaps, which incidentally is what was going on prior to 2003 and the passage of Act 23.

We would suggest an amendment to House Bill 1905 that would, at a minimum, require a local government unit to use a competitive selection process if it feels the need to hire a financial advisor to evaluate the quality, cost, and independence of the financial advisor's performance on a quarterly basis and to report the results of the evaluation to the public or the taxpayers. We would also suggest that the Municipal Authorities Act be amended to expressly prohibit authorities from entering into swaps in connection with their bond issues. Finally, just to be absolutely clear, we would suggest that a similar provision be added to the Local Government Unit Debt Act to expressly prohibit local government units from entering into swaps agreements also.

Exotic investments instruments like swaps may be perfectly acceptable in private sector, I think all of us can understand that, but they should have no role in government. Public debt should be financed with fixed interest rates that are transparent, reliable and easily understood by those voting on those bond issues and more importantly, the public, who is paying for it.

As most homeowners would agree, a fixed-rate mortgage is preferable to a variable-rate mortgage because the monthly payments are stable, making it easier to plan your budget from month to month. The same commonsense rule should apply to school districts and to local governments.

You are here today and you have heard today from proponents of swaps and defenders of the status quo, as well as from those who would argue for a reform of swaps rather than a ban of swaps. I urge you to ask them tough questions, such as the following, and I've heard some of those questions already and commend you for asking them: Do the local elected officials who vote to enter into these transactions really understand, truly understand, what they're voting on? And I would say in the far majority of situations, they do not. None of the other parties involved the financial advisor, the bond counsel, the swaps counsel, the local government solicitor, or the investment banker appear to get paid unless the deal goes through.

Do you believe that local governments are ultimately protected against conflicts of interest involved in these transactions? Do the investment banks or financial advisors involved in swaps ever lose money on these transactions? Very important question.

How much are the fees and commissions? And I just heard a question in regard to that and a I commend you. How much are the fees and commissions to the various parties in the average swap agreement? Very important question to ask. How do the fees and commissions compare to the issuance of standard fixed-rate bond issuance? A vitally important question. Are the fees and losses rolled into refinancing deals and, therefore, not transparent ultimately to the public? Can there ever be enough training, disclosure, or other types of reforms to level the playing field between local officials, Wall Street financial experts, and investment bankers? Quite frankly, I don't think so. Are the benefits to the local government worth exposing taxpayer funds to potentially enormous risk if a swap turns sour?

In closing, I would again like to commend the chairman and the committee members for seeking to ban the use of swaps by public entities. I can assure you-all that the Department of the Auditor General will continue to monitor this issue and again we welcome any questions, thoughts, or ideas on your part. Thank you.

CHAIRMAN LEVDANSKY: Thank you, Mr. Auditor General. Any questions from any of the members? Representative Denlinger.

REPRESENTATIVE DENLINGER: Thank you, Mr. Chairman. Thank you, General, for being here. We appreciate it. We gather that you lean against this; is that fair to say?

AUDITOR GENERAL WAGNER: Well, all of us sometimes in life don't make a sound vote. Act 23 of 2003, I believe, passed unanimously in the House and the Senate. There certainly was not enough discussion in that regard, but we have seen, Representative, that Pennsylvania kind of leads the country here. I would argue that Pennsylvania is at most risk of any state in the country.

REPRESENTATIVE DENLINGER: I'm wondering, in the Bethlehem School District situation, you mentioned they have 11 outstanding swaps agreements in place, you have reviewed two. Will your office do continuing work in the Bethlehem School District?

AUDITOR GENERAL WAGNER: If we are asked to come in and to review the remaining swaps that are in effect, yes, we will do that. It's our hope, based on our office of special investigation report, and some changes that have been made within the Bethlehem Area School District and their desire to terminate, not immediately, but over time, what is in their best financial interest, those 11 remaining swaps, that they will properly and better manage what is left better than the two that have been terminated.

REPRESENTATIVE DENLINGER: And then, a question that I realize is maybe one you wouldn't want to answer correctly, but, as you reviewed those two swaps situations in Bethlehem, do you believe what you have encountered rises beyond poor judgment, and into areas of fraud?

AUDITOR GENERAL WAGNER: In regard to the Bethlehem Area School District, I'm going to let my chief legal counsel and/or my bureau director to handle that one.

CHIEF COUNSEL & POLICY DIRECTOR TEPLITZ: Representative, we didn't say that in the report, but we did find red flags, and we referred the report to numerous other entities that would be better equipped than we would be to route that out. The Securities and Exchange Commission, other entities at the federal level dealing with banking and securities issues, law enforcement at the state level, and the state ethics commission which would also play an important role in this if it chose to, if it thought there was more to investigate. So the report lists, a few times in the report, all of those other entities and we would certainly cooperate with those entities if they needed our assistance to follow-up.

REPRESENTATIVE DENLINGER: And are you aware, did any of those agencies launch investigations or are they still taking a look at the matter?

CHIEF COUNSEL & POLICY DIRECTOR TEPLITZ: We wouldn't necessarily know that, and they wouldn't necessarily tell us that. We do know that the Securities and Exchange Commission, even before the release of the report, was doing a nationwide investigation relating to swaps and we thought that that agency would be particularly interested in our report.

REPRESENTATIVE DENLINGER: Very good. Just as a closing comment, General, I solute your effort.

AUDITOR GENERAL WAGNER: Thank you.

REPRESENTATIVE DENLINGER: I think this is an area of huge question. I think your efforts on behalf of restoring the public trust, which is really what it comes down to at the end of the day, is commendable. So thank you.

AUDITOR GENERAL WAGNER: Thank you, sir.

CHAIRMAN LEVDANSKY: Thank you. Representative Mirabito.

REPRESENTATIVE MIRABITO: Thank you for coming. For the districts and municipalities to disentangle themselves from the swaps, is there going to be more risk of serious loss or is it a situation where, if they don't disentangle themselves, they're exposing themselves to greater loss? I get the sense from your testimony that you think they should terminate the swaps. Even if they are paying a termination penalty; is that correct?

AUDITOR GENERAL WAGNER: Obviously, we have asked that they terminate existing swaps. Initially, we suggested they immediately move in that direction. Some school districts brought to our attention an important point that the cost would be exurbanite to do that immediately. So a planned termination or movement in that direction would be in the best interest of the taxpayers; however, there's a caveat associated with that, which is that if we have another serious downturn in the market, that the risk could be far greater. So we have asked them to aggressivity move in that direction in the best interest of the taxpayers.

REPRESENTATIVE MIRABITO: Do you think that we need legislation to protect the taxpayers in the disentanglement process? I'm not quite sure how we could do it, but do we need -- in other words, from the point of view of the average person sitting out there, they're watching the meltdown and the federal funds being paid to the investment bankers and then they're turning around in their local communities and their watching lots of money being paid to investment bankers.

Do we need legislation that says, look, notwithstanding that this was passed, we need to protect taxpayers so that they're not hurt further in the disentanglement process. And it means the investment bankers may lose some money -- I shouldn't say lose money. They may not make some gains that they thought they were betting on. Do you think we need legislation that way?

AUDITOR GENERAL WAGNER: Well, we definitely need legislation, in our strong opinion, to repeal Act

23 and to move in a direction where local government school districts are not further engaging in swaps. We think that's first and foremost the most important thing we can do, so we limit that exposure going forward.

Do we need legislation to disengage? I'm going to ask one of my two lawyers sitting here today. I think -- and I'll just give my two cents -- it's tough to legislate once you have exposed the taxpayer. But go ahead, Robert, Jeff, please, jump in there.

CHIEF COUNSEL & POLICY DIRECTOR TEPLITZ: I think that relates to the previous question in a sense. There have been other situations where the swap was found to be fraudulent, where law enforcement and any other entities that were involved directed that the transaction be undone in a way so that there was no harm to the taxpayers.

The situation that comes to mind is a recent situation in, I believe, Alabama where the swap was found to be so fraudulent that, I think, what happened was they just tried to turn back the clock as if it never happened.

REPRESENTATIVE MIRABITO: I don't think that's probably going to be the majority of the cases here in Pennsylvania. I guess I'm just concerned that I don't know if we just have to just say once again that the taxpayer has to take it on the chin because of what's happened and whether or not we need to be aggressively trying to find a way to say, notwithstanding, whether there was fraud. I know we don't enter into trying to regulate private party contracts. On the other hand, we have also not seen the depth of devastation that's happened from almost adhesion contracts in some ways.

When you say that 99 percent of the public probably doesn't understand them and the people who entered into them probably didn't understand them, they were contracts that were from the outset, tilted against the parties. And I guess I'm just wondering whether we need to be more assertive to protect the taxpayers. It won't make some people happy. It'll be controversial situation, but, on the other hand, if we don't do it, we may wind up on a local and state level with the same problem that we have on the federal level and a lot of very upset citizens.

AUDITOR GENERAL WAGNER: Well, Representative, you will hear others, as a matter of fact, Central Dauphin School District, who disengaged in swaps, made money in the process. They did it at the right time and under the right situation. We would hope that those engaged would follow in a similar suit, but take serious the disengagement issue that we have suggested in our report and we hope that all of you suggest as a legislative body.

REPRESENTATIVE MIRABITO: Thank you.

CHAIRMAN LEVDANSKY: Thank you. Representative Boyd.

REPRESENTATIVE BOYD: Thank you, Mr. Chairman. Representative Mirabito asked one of my questions. I just want to make sure that we don't statutorily require something that would end up becoming problematic, so that's one. The second one is, I guess, someone from a philosophical standpoint. I understand your version to the current structure, but part of your testimony, there's a portion of it that I do disagree to a degree with you.

Like Representative Denlinger, I do commend your efforts, but there are times when it does make sense to refinance debt, and while I agree with you that fixed-rate interest on a home mortgage is a good idea. My first home mortgage in 1981, my rate was 13 and a half percent, so there was a time when it was wise to get out from underneath that 13 and a half percent and move to a lower percent. So refinancing debt at times does make a lot of sense.

Additionally, depending on where you are, as an example, if you, as an entity, know that you have a subsistent amount of revenue coming in, like selling an asset, and you know the timeframe of that, it may make sense knowing where current interest rates are to take out a low rate with a balloon payment coming, knowing that you're going to have a revenue to pay that. And it's not uncommon for school districts to have assets that they know they're going to sell, like property, that they have that they're no longer going to need to build on. They may sell that asset. While I agree with you in principle, there are times when I can see the ability or the desire to allow school districts the flexibility at the local level to manage their finances.

With all of that said, my question is, do you believe that there is a way that we can allow that flexibility to do some of these transactional swaps and protect the taxpayer at the same time? Do you think that can be accomplished legislatively or do we just have to abandon it altogether and tie their hands and say, this is the way you have to play the game?

AUDITOR GENERAL WAGNER: Well, we have taken a firm position on the risk involved with swaps. And, Representative, if you can figure out how that language should be in terms of minimizing the risk and refinancing, I have supported refinancing of bond issues, but I believe I heard you earlier say, how do you minimize the risk? So with that as being your objective, however, you could achieve that objective legislatively, would be in the best interest of the taxpayer. But, keeping in mind, that there is a tremendous risk here and an unfortunate situation going forward and it's important that we bring that to all of your attention, and the attention of the taxpayers.

REPRESENTATIVE BOYD: So I think if I read between the lines, your answer is no?

AUDITOR GENERAL WAGNER: In fact, your earlier statement that I heard you say is our first responsibility as elected officials is to minimize risks.

REPRESENTATIVE BOYD: Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Representative Seip.

REPRESENTATIVE SEIP: Thank you, Mr. Chairman. Thank you for being here today, General Wagner.

AUDITOR GENERAL WAGNER: Yes, sir.

REPRESENTATIVE SEIP: I want to thank you and certainly your staff for all of your efforts to try and act in the interest of Pennsylvanians on this very, very important matter.

I'm just curious, in your investigation -- and maybe you can't answer this and I'll understand if you can't -- but did you find an entity that was just very overextended, very pressured, very, just desperate to try and remedy some financial situation or did you find an entity that was relatively physically healthy and just ultimately got into a transaction that didn't work out well?

AUDITOR GENERAL WAGNER: Well, Representative, Number 1, we have only investigated the Bethlehem Area School District in terms of their individual swaps. We have looked, though, at the body of public entities involved in swaps. So therefore, we cannot give you an in-depth analysis beyond the Bethlehem Area School District, but it is our firm opinion that the risk exists for all of the entities involved in swaps.

And the tougher questions need to be asked here that haven't been asked: What are the fees and commission? What is the risk to the investment banking entity involved? And we firmly believe that there has not been true transparency involved here, as a matter of fact, a lack of knowledge. And where you have a lack of knowledge and a lack of transparency, you really have a lack of accountability.

It seems as if the people on the opposite side of the table know far more about these transactions than us, who are responsible to the taxpayer, and that's a serious concern.

REPRESENTATIVE SEIP: So looking beyond the Bethlehem School District, and just in general, I guess it's hard to say as to whether some of these entities get into these situations because of a feeling being pressed and very -- I hate to say desperate -- but feeling themselves, their entities, are in a very difficult position and trying to find some remedy to it. I guess it's hard to say whether that's the root of the problem or whether it's just something that they got into and it worked out badly.

AUDITOR GENERAL WAGNER: Well, there is -- and I'm going to ask Jeff Gribb to comment -- to what degree Bethlehem Area School District benefitted upfront. As many of the entities who have become involved in swaps get an upfront payment and that upfront payment initially looks great and it brings additional revenue into the school district or the local government entity. But with that upfront payment is a risk further on down the line. In many instances, including the Delaware River Port Authority that benefited to $40 million upfront, have already lost that

$40 million and have another 200 million, plus, at risk. I'm sure many elected officials at the local level think they're acting in the best interest of their taxpayers, especially if they are getting an upfront payment. Jeff, what did Bethlehem receive?

DIRECTOR GRIBB: I think that Bethlehem was in pretty good shape and now they're not in good shape because of their foray into swaps. Of course, it's always enticing to a public official to get a lower interest rate and I think that's how these things were sold to Bethlehem. They could cut their interest rate a little bit by entering into swaps as opposed to entering into a standard fixed-rate conventional financing and they took the risk. I don't think they realized some of the risks that were involved and that's where they got burned.

Some of these deals were structured to provide them with substantial amounts of money upfront at closing as part of the settlement on the swap. You could argue that that's a form of borrowing that's not authorized by the local government Unit Debt Act. The fact that they enter into this contract and somebody writes them a check for a couple of million dollars, which they then get to use however they want to. That's another enticement that we found.

We just found that in the Bethlehem case that all of the incentives were lined up against the school district getting good independent advice. We found that these deals were sold, basically overemphasizing, exaggerating the benefits, and minimizing the risks because it was in everyone's interest, except the school district, to do so.

REPRESENTATIVE SEIP: Often I think that people look for a very quick solution in many different facets of life and certainly here, even in Harrisburg, I think a lot of times, well, this would probably be a better bill, this would probably be a better idea, but that's going to take too long. We have this bill in front of us, let's just quickly do this. I see how these things happen. People have to really, really think about what we're doing and have the intestinal fortitude to try and act with some foresight.

Thank you very much for your comments today. I appreciate your testimony. Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Thank you. Just a couple of issues I want to explore really quick, Mr. Gribb. Your response to Representative Seip about the school district might get a couple of million dollars upfront and everything looks good. This brings to mind an old saying that I was taught from a gentleman that I knew as an uneducated man who immigrated from Italy. And my pappy always told me, David, you don't get something for nothing in this life.

I have a hard time believing you can get a couple of million dollars upfront and it's not going to cost you somewhere along the line. Where along the line would the person that gave you the $2 million or so, how is it likely to be recouped?

DIRECTOR GRIBB: It would be recouped over the life -- over the term of the swap over years. It's just built into this structure of the deal. And it wasn't something for nothing, it was something that would have to be paid back, but not immediately, over time. Similarly all the fees, commissions and profits are structured into the deal. So in the Bethlehem case, there are I think four or five different advisors and counsel and whatever sitting at their settlement table getting huge checks for fees that were all structured into the deal and would be paid back over time.

So it wasn't like Bethlehem School District had to write a check to their financial advisor for $20,000 or whatever they paid them. That was just a check that came from the proceeds of the settlement of the deal and was financed over the term of the deal. But I think there was -- some of the deals sold to

Bethlehem were basically years away. You can get something that appears like it's for nothing.

CHAIRMAN LEVDANSKY: It's kind of like that mailing that I get telling me that I have been preapproved for a $10,000 credit card. I kind of think that I have $10,000 that I can go out and spend, but then I owe 10,000 plus probably 20 or 25 percent interest over the period of time that it takes for me to pay off. My 18-year-old son who gets these advertisements thinks that it's free money, but it's not really.

Earlier I talked about the state subsidy for school districts serving as a backstop in the case that school districts default on the obligations of swaps. And it was stated that that's basically not set out in Act 23, that that provision was set out in the Unit Debt Act, so that that provision kind of proceeded. That backstop, if you will, existed prior to the legislature's passage of Act 23. Is that your understanding? Is that correct?

CHIEF COUNSEL & POLICY DIRECTOR TEPLITZ: That may be the case, but I think what you hit on in that dialogue before was that that backstop applies because of Act 23. And when Act 23 was passed, that legislation did not exclude Act 23 or exclude swaps from being affected by the preexisting provision in the legislation in the law that existed at the time. So I think it's maybe disingenuous to say that that doesn't imply simply because that wasn't in Act 23. It applies to swaps because of Act 23.

CHAIRMAN LEVDANSKY: So the backstop was there and then we passed Act 23 and the backstop applies to both traditional kind of debt that municipalities and school districts and authorities would incur and now it is also a backstop for this, although, we probably didn't really think about that whenever we passed Act 23. Obviously, there's probably a lot of things that we didn't anticipate when we passed Act 23.

Just one other question. You pointed out, General, that Pennsylvania leads the U.S. in terms of the number of swaps that have been enacted. Do other states have similar legislation to Act 23 that basically serves as an incentive to do swaps or -- I mean, do other states have a similar Act 23 or don't they?

AUDITOR GENERAL WAGNER: Yes. Other states do and there is a movement for more states to move in that direction. But I have to tell you, since our report came out, states are taking a good hard look as to whether or not they should have similar legislation because of the risk associated with it. I don't know the number of states. Jeff, do you know that, or Rob? But, yes, we know other states have similar legislation and many were considering moving in that direction.

DIRECTOR GRIBB: I think it's a relatively small number of states that have legislation specifically authorizing the use of swaps. I don't know how many other states use them even without as an express authorization. They were used in Pennsylvania before Act 23.

CHAIRMAN LEVDANSKY: Right. As a matter of fact, Bethlehem, at the time they enacted their first swaps, they couldn't do it themselves. They had to use a local municipal authority as a conduit for doing that, I understand that.

DIRECTOR GRIBB: That is correct.

CHAIRMAN LEVDANSKY: Just one final thought, Mr. Auditor General. I liked your idea that it would be nice if we could do kind of like an apples to apples comparison on what -- a study to compare how much it costs school districts to do swaps versus conventional financing. And given that, since municipal authorities have been doing swaps prior to Act 23, it seems to me that there would be some body of evidence out there where municipal authorities did do swaps.

Given that experience, how much did it cost the taxpayers, ultimately, with the swap financing from municipal authorities versus conventional financing? Would it be possible to do an apples to apples comparison so we could get really some handle in the aggregate -- we could answer the question in the aggregate: Do taxpayers really benefit from swaps or not? Is that possible?

AUDITOR GENERAL WAGNER: I think it's possible. It's not possible from our department. We would obviously have to do an investigation of every entity that was involved in a swap. But I firmly believe that if that information were available, if any entity would have it, it would be the industry -- it would be the investment banking industry. And as part of that, it would be what the fees, what the commissions are, who has actually gained in this process.

And yes, we keep hearing instances where certain entities have gained. We never seem to know though what the costs are to get there. So you would have to do a complete analysis of what fees, what commissions are, what refinancing deals were involved, what dollars were gained and what dollars were lost. But always out there is the risk. In addition to that whole discussion, is the risk. And that's what we're most concerned about.

CHAIRMAN LEVDANSKY: And you only have jurisdiction insofar as state dollars have been expended?

AUDITOR GENERAL WAGNER: Yes.

CHAIRMAN LEVDANSKY: So which is why you could go in and look at Bethlehem School District and other school districts. But to the extent that municipal authorities engage in swaps, if there's not state dollars involved, you lack the jurisdiction, correct?

AUDITOR GENERAL WAGNER: Yes, Mr. Chairman. You're absolutely right.

CHAIRMAN LEVDANSKY: One day we ought to take a look at expanding your jurisdiction. I get a lot of questions and concerns relative to what goes on in local governments. I mean, it's local taxpayer's dollars, not state taxpayer's dollars and so the Auditor General doesn't have that jurisdiction.

AUDITOR GENERAL WAGNER: We do not.

CHAIRMAN LEVDANSKY: We appreciate your insights and your testimony. Representative Mirabito has one final quick question.

REPRESENTATIVE MIRABITO: Did you find that any public employee, either the school district or in the Delaware case, got a bonus or some recognition for financial -- other than for getting the upfront payment for being successful and getting the $40 million upfront in the school district case? Did anybody get a bonus other than just recognition?

DIRECTOR GRIBB: Not that we've found.

AUDITOR GENERAL WAGNER: Not that we've found, but we always refer our reports where we have questions or concerns to the Ethics Commission or other agencies of government. We did that with the Bethlehem Area School District report.

REPRESENTATIVE MIRABITO: Thank you.

AUDITOR GENERAL WAGNER: Thank you.

CHAIRMAN LEVDANSKY: Thank you all. I appreciate your staff's input as well.

AUDITOR GENERAL WAGNER: Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Next is Mr. Jay Wenger. He's the financial advisor at Susquehanna Advisors here in Harrisburg. Mr. Wenger.

FINANCIAL ADVISOR WENGER: Good morning, Committee Members. I appreciate the opportunity to be here. I'm Jay Wenger. I'm with Susquehanna Group Advisors. We're a Harrisburg-base financial advisory firm. I also serve on the Central Dauphin School Board, so I bring to you two perspectives I think that perhaps will help in your consideration of this matter.

There's been some discussion that overlaps what we presented. I'll try to go through this quickly and then try to address some of the questions you've asked, which I think are very good questions. And frankly, a lot of the same questions are what our clients ask in the process of considering these transactions, so I think it's very appropriate.

Just to be brief, on page 1, we talk about some of the reasons why issuers consider swaps and in some cases enter into swaps. A very common use is the internal revenue code limits issuers to one advance refunding meeting, refinancing a debt issue prior to it's first optional call date. The swap market allows issuers who have already taken that one advance refunding to take advantage of lower interest rates, even though the call date has not come to pass. And that has created economic cash flow that issuers can use either to create cash reserves or finance other capital assets. And I'm not to going to sit here and suggest today that we're the model of best practices, but I think we do some things that I've noticed other financial advisors do, that I think addresses some of the concerns that you have and we insist that issuers do.

Number 1, we don't like issuers taking upfront proceeds from a swap transaction to solve a short-term operating short fall or deficit, really for two reasons. One, as was pointed out, there's a point in time where cash flows might turn negative in these swaps transactions and we strongly encourage and insist that our clients establish what we call an interest rate reserve account that is funded in part from money taken upfront and in part from money taken on a periodic basis. But probably more important, as I sit on a school board this really is an issue that we deal with, which is, if I found money today to cover a budget short-fall this year, I haven't addressed that short-fall budget this year or next year. I've just delayed and hid the problem for one more year. So as a financial advisor, what we don't want to see is that problem fester and compound itself because we've found a one-time solution.

We're very clear with issuers that we would, under no terms, represent that we think that there's another one-time solution next year where we continue to push this problem off until perhaps you think you're not in office or it's not going to matter anymore or somebody is going to bail you out. As a matter of practice, what we like to see is if there's a capital project that they otherwise would have had to finance at four or five percent, whatever it is, that the proceeds go towards that project or they take some of the portion of the proceeds and put it into an interest rate reserve stabilization account or reserve account, whatever you want to call it, so that if the markets go against them for a short period of time, they have the ability to withstand it without going against their operating budget. And for most municipal entities, like Central Dauphin, the last thing that we want to see is where something we did last year or last month becomes a problem next month or next year because we didn't contemplate the risk that was associated with it.

Now, having said that, we go back a year later, two years later and we talk about, okay, what have you done? Well, we had a short-fall last year and we spent that money. That's all we talked about three years ago. There's nothing we can do to control what they do with the money after they've said, yeah, we agree with you. And frankly, if they get into a bind and it helped them out of problem, that probably was a good application. What we like to see is a replenishment of that fund, if and when they actually draw it down for a purpose other than what it is intended.

There has been some discussion about rates going up and rates going down. Why in a residential market you do a fixed rate versus variable rate? In the institutional market or the tax exempt market, I think there is a distinct difference between how municipalities can finance fixed or variable versus how we, as residential mortgage holders, finance our homes. And if you look at, on any given day, residential mortgage rates, a 30-year fixed-rate today is approximately 5 percent. An adjustable rate mortgage is approximately 4 and a quarter to 4 and a half. There's a very small differential between what a residential mortgage holder can achieve by taking on interest-rate risk on a variable-rate market, compared to a fixed-rate, as contrasted to what a municipal issuer can achieve in the, what I'll call the institutional market. It's a much wider spread.

Right now, weekly rate tax exempt bonds are less than a quarter of 1 percent. 30-year fixed-rate bonds are still maybe a little over 4 percent. So it's a much, much wider, what we call spread, or difference in interest-rate in the residential market versus the institutional market. And a lot of our clients ask that very question: Why have a fixed-rate home mortgage? Yeah, you do. And frankly, we would never tell you to go get an adjustable-rate home mortgage when the base-rate is 4 and a half when you look at the conditions, it can go up by 25 or 50 basis points every year for the next 3 years. That's not a fair trade for a residential mortgage holder who thinks they're saving a little bit on a monthly basis for that kind of risk and that kind of pickup. In the tax exempt market, it's a much, much greater difference and when you look at the long-term average of short-term rates, there are reasons why municipal issuers want to have variable rate. There are market conditions that dictate maybe going back to fixed for a short period of time or taking fixed-rate and going variable for a short period of time. The swap market actually provides a very efficient way to do that without incurring, refunding or remarketing and at least get a little technical. But incurring cost of financings and consuming that refunding opportunity that maybe they want to save for sometime down the road.

So it's a little oversimplified to say that I do my home mortgage this way, why doesn't Central Dauphin run their debt the same way? There are differences in the market and distinct differences that would lead me, as a board director, to have a different decision than I would have as a home mortgage -- on my home mortgage.

One of the issues that has occurred recently, as Dr. Cusatis pointed out, is the financial markets and the credit markets collapsed, call it what you want, almost failed to operate at all for a period of if time in the late 2008. In the context of when you sit down with an issuer and you say, here are the potential risks. Prior to the financial collapse of 2008, if we had assigned probabilities to risk, the collapse of the credit markets would have been a much, much lower assignment of risk than some of the other risks that we've vet with the clients. But we've ran into a perfect storm and issuers ran into, Number 1, higher variable-rate cost than they had anticipated for a short period of time, but more importantly, the failure to actually obtain credit in the marketplace for the first time in my career, which is 25, plus, years now.

We've never had a marketplace where you could not access the credit markets. We've never had a marketplace where you could not issue fixed-rate bonds, but for a short period in 2008, those market conditions actually existed. Should we have known that prior to 2008? I don't know of anybody who did. Eyesight is 20/20 and a lot of people would have done things differently, including how we invest pension funds, etcetera, if we hadn't known what was coming.

So the point I'm trying to make is, there are differences in those markets that you can't oversimplify the analysis and say, well, since I do a home mortgage this way, Central Dauphin should conduct itself that way. There are opportunities in the marketplace that afford municipal issuers like Central Dauphin. The opportunity to not only reduce their cost of capital in an efficient way, but also to take advantage of interest rates in the marketplace where, in case, Central Dauphin, knock on wood, but we received a check for almost $3.1 million in a span of a contract that lasted a little less than nine months. And we had spent several meetings, months analyzing a particular transaction, knew that at the time that we were looking at it, it was probably the best market we were going to get, but we had not yet fully vetted all of the issues among 9 more members of business managers, superintendents, etcetera. So by the time we actually reached a decision and decided who the swap provider was going to be, we had missed the best opportunity by probably 2 to 3 weeks.

We still had, what we thought was a very attractive opportunity in the marketplace, entered into what we call a basis swap and that was -- I don't remember if it was late '09 or early 2010 -- but by June of this year, market conditions had changed and we had the opportunity to realize a substantial payment.

In June of this year, the Board adopted a resolution at the full advice of our financial advisor, financial management to establish a termination target of $3 million. One of the questions that you have asked earlier is, who gets paid, is it disclosed, etcetera. There was probably a 3 to 4 to 6 week delay in actually terminating that swap because we were arguing with the swap provider as to what their fee would be on the way out. They wanted to charge X. We thought X was too high. We argued why. It took us the better part of a month to get them to see that our price was the price and if we didn't get our price, they better never show up at the school district again.

So there are a lot of good points raised in this discussion. And I wasn't involved in Bethlehem, so I can't really speak to those specifics. I did read the Auditor General's report. We do have some observations at a fairly high level or a macro level of what happened there that perhaps would help you in your deliberations and consideration, but I really can't speak to the specifics. I don't know the fees exactly, but I will say to you, for our clients and at Central Dauphin, all who is sitting on the board, we didn't just turn our heads to the swap provider and say, oh, that's their fee. I guess we have to live with it.

There is a lot of sound advice being given to clients to dismiss school board members as being ill informed. Central Dauphin is a very, very collection or assemblage of citizens and residents within a community with different professional backgrounds. We have an engineer by training, an accountant, people who work within the government in Harrisburg and we have varied backgrounds. To a person I think they all would say, well, I'm not an expert in this, but I'm going to listen and after I've listened, if I'm not comfortable, I'm going to tell you, I'm not voting for this because I'm not comfortable.

Extending beyond Central Dauphin, I would say that you have all of our clients. And of the 600 swaps that have been done in Pennsylvania, I think was the number quoted, we probably represent a very small percentage of that, so I'm not going to suggest to you that when I say this is what our clients do, that represents 300 of the swaps. It doesn't. We don't allow a client to make a decision on the first presentation. We don't allow them to make it on the second presentation. We want them to hear it; we want them to go home and think about it; we want them to hear it again; we want them to go home and think about it again. We want them to call whoever they want to call. They can call their legislature, they can call their accountant, they can call their financial advisor. We invite bond counsel; we invite the solicitor.

We want to make sure that by the time they have made their decision, yes or no, that they understand the transaction, they understand the risk and they understand their reward. And what we say to those people is, if you go to breakfast Saturday morning and somebody pulls you aside in the restaurant and says, what the heck did you do? You better be able to explain it to them because the greatest embarrassment you can endure is not being able to explain a decision you made last Wednesday. So we take very careful efforts to make sure that they understand the transaction. We try to fully vet the issues.

Now, did we anticipate the credit collapse in 2008? No, we didn't. I'm not going to sit here and tell you that. Has it created some amount of consternation for clients, particularly in the fall of 2008? Yes, it has. Were those transactions structured well enough that by the time we got to 2010 they were back on their feet and the money that had been set aside through various periods of time worked out? Yes, it did. Could the market have completely collapsed and would have gone completely south? That possibility does exist.

We met with a client Monday on an idea and they said, how long do we have? I said, you have as long as it takes you to decide. I can't promise you the market conditions are going to stay the same. I can't promise you that at four months down the road you finally decide the answer is yes, that the numbers still work. Well, we certainly aren't going to tell you that you have to decide today because the numbers were today. This is a decision that you have to understand and you have to feel good about, and when you decide that you come to that conclusion that we can talk about where the market is.

One of the things that we like to see in our clients is that they get to the point where they can ask the questions that you've asked today. Who's getting paid; what are they getting paid; what's the risk; what happens if rates go up; who's the counterparty; what are they worth and what are they getting paid? We want them to ask those questions on their own. If we get to a point where they haven't asked the questions, we feed it to them. Here's what you should have asked us by now.

In a presentation you get a very clear sense if you do this enough times. You know if the client understands. You know by the questions you ask; you know by how engaged they are in the conversation; you know by the look in their eye if, in fact, they're actually following you. And you can tell by the look in their eye if they follow a little bit, if they follow a lot or if they follow all of it. Mr. Boyd has left the room, but I grew up in Lancaster County and we go to meetings in Lancaster County for clients and I would always hear that line, I'm a poor, stupid farmer. Well, I know two things aren't true. You aren't poor, and you're not stupid. The farmer part I can see. A lot of our clients start that way and I know they know. That's the conversation we want to be engaged in.

If somebody sits there and says, if you say it's a good idea, we're doing it. We say, nope, that's not the way this works. We're going to start over. We're going to do it again. You're going to go home and think about it. You're not doing this because we say it works, because the fact of the matter is, the day it doesn't work, you're going to call me and say, it's your fault. And you sit here as an elected official, we're running a non for-profit entity, you're responsible for the decisions you make and you have to live with them.

Our job is to provide advice. We think we do it independently, we think we do it objectively and we think we do it honestly. But at the end of the day, you're responsible to your board, your constituents, and whoever is paying your bills and you're going to have to live with this decision and you're not going to have the opportunity to say, he did it. So there is a very careful process, and I'm not singling us out as doing that.

I can tell you that on the board at Central Dauphin, when a public financial management comes in to talk to us, it's a very fair conversation, it's a very open conversation and if they don't like somebody's idea, they tell us. We had a presentation Monday. I wasn't in the meeting, but I got a report from a swap provider who had made a presentation to the business manager and with our financial advisor in the room, with an idea that was, I think, rejected almost immediately. So to assume that every issuer is being lead down a path because the vendor is very good at what they do, and they are very good at what they do, and when they come in to sell their product, it sounds really good. There's a lot of sizzle in the pan.

But to suggest that clients are ill informed and make poor decisions, I think, is the exception and not the rule. And I'm not going to sit here and tell you that there aren't bad transactions. I'm not going to sit here and tell you that there aren't people getting bad advice and I'm not going to tell you that there aren't clients who don't understand when they say yes or they say no. But I think somebody in this context has used the expression, throwing the baby out with the bath water. I think what's being contemplated is essentially that. I think it is a valuable financed tool that is being used by a non for-profit agency and municipal entities across Pennsylvania.

I think there are some enhancements to Act 23. I think it would give you, as legislatures and representatives of your constituents, comfort that maybe the process has been improved and will work better. Some of those have been outlined by some other presentations today. But markets change, credit markets change, opportunities change, debt profiles change. Somebody asked earlier are large issuers better equipped to do this than smaller issuers? Only because they have more debt and Act 23 ties debt to swaps.

The question was asked earlier, why is the Intercept Program covering swaps? Swaps were intended to be a part of debt instruments, you exchange one interest rate for another. School districts in particular receive reimbursement based on their interest cost. And so in this construction of Act 23, what was intended to come out of this was neither the state or the issuer would be harmed in their debt structure or their reimbursement structure because they did synthetic fixed-rate versus traditional fixed-rate.

There are a lot of reasons why the Intercept Program is in place and the reimbursement program is in place and it's attached to interest-rate swaps. These were not intended to and aren't entered into these kind of willy-nilly transactions where somebody thinks there's a big hit. We at Central Dauphin didn't enter into this 9, 10, 11 months ago with the anticipation that in a short period of time we were going to make $3 million. We expected monthly cash flow for a long period of time and had set up an account to take half of the monthly cash flow, put it into a reserve account to hold for a rainy day when our cash flow was actually negative so that we had some benefit to the operating budget/debt service today, but we're building a reserve for days where it wasn't working as well as it was modeled.

So that's kind of a long-winding tail of where I think the applications are appropriate and where I think clients are being advised appropriately. The kind of irony all of this is it really was the failure of the credit markets that has created the problems, particularly, I think, at Bethlehem. I think I'm correct in saying that. That still doesn't dismiss the fact that there were swaps associated with the termination values. I'm not going to gloss over that and say that it wasn't an incremental cost. It wasn't the swaps, per say, that failed. It was the credit markets that failed.

I'll just flip through this and get passed the structures. There's a page toward the back and I apologize for these not being numbered. I didn't realize that until this morning. We have what we call an SGA practice, Susquehanna Group Advisor practice. We don't meet with board members directly because we think that's an improper way to try to get right information to a client. We meet with either the business manager, the treasurer, the director of finance, whatever their title might be.

If the person who is actually responsible for their operating budget and their debt portfolio, things that is a structure that has merit, then it goes to either the Board of Commissioners or the supervisors or the authority members or the school board members as a full-blown presentation. We don't try to backdoor the administration. We don't try to backdoor the people who are actually running the business on a day-to-day basis and get to somebody who might have some local interest or some political interest or financial interest, perhaps, and having some preferred lender come to the table. We want it to be a very open process, we want to consider more than one lender and we want the governing body to have full access to the information and time to vet the issues.

Again, we don't, after the initial meeting, allow them to make a decision, even if it's a transaction we've done before; even if it's a transaction that is similar to the one that we've done before; even if they just made $5 million terminating the last two or three swaps. We don't let them make a decision on the first pass.

There's always something, there's always some question that hasn't come to mind in the initial meeting. Even sometimes in our mind, as often as we do this. We want to make sure that they've asked, they've considered, and they've made their own conclusion in doing so.

If, after the second meeting, we believe they understand the risk and the reward and the economic benefit and the downside and the associated cost and the fees, then they can schedule a third meeting, at which time we will allow them to actually take action on whatever it is that's being proposed. A good example is back in 2004 or 2005 we did what we call a basis swap back in Adams County. It took four months of meetings to get them to where they felt comfortable to make a decision. Subsequent to that, we did a second transaction that probably took four to five meetings over probably a month to two months. We don't ask people, we don't expect them to do this quickly. We don't expect them to say yes because we said it's a good idea. We don't expect them to say yes because the vendor coming in said it's a great idea and this is a great market opportunity.

We also disclose all of the fees to our clients in dollars, not basis points. You can call almost any of our clients and they could fax or e-mail to you a spreadsheet that shows you our fee, the legal fee, their legal fee and the amount of money that the swap provider that has made us, quote-on-quote, a margin in the transaction. We think it's important that they understand exactly who got paid, how they got paid and why they got paid. If there's some third-party consultant attached to the transaction, we insist that that be disclosed so that everybody knows exactly who is at the table, got to the table.

We think it's important given the size of the transactions and what they're entering into, just as if they were borrowing money, that all the fees at closing are disclosed. We give them an estimate upfront, we monitor that to make sure it doesn't change substantially and when a transaction is completed within an hour or two of execution, they have a spreadsheet that outlines those fees.

So a lot of what you have addressed is, in fact, being practiced in the marketplace and not just by us. I've seen it on Central Dauphin's board, I've seen it when we go other places. I can't think of a client we have where we weren't asked to submit a proposal or interview for the job as their financial advisors/swap advisor. In fact, we probably have lost as many as we've been awarded in that process of submitting qualifications and proposals. So to your point of, is there objectivity or should there be objectivity, we fully support it and think it's being practiced. But again, I can't speak to all 600 transactions and I don't pretend to do that for one minute.

Just quickly, what went wrong at Bethlehem School District, again, a lot of their damage was done by the underlined failure of bond insurers and liquidity providers. That's not an event that we reasonably or even put a low probability of occurring. Except for 20/20 eyesight or revisionist history, other than when they were in a tough spot, there wasn't a lot that we could do. We had other clients who were in that same predicament. We were able to find substitute credit for our clients. Why Bethlehem was unable to, I can't speak to that. But for those clients who sought substitute credit facilities or a change of remarketing agents to get them a more effective weekly remarketing rate, within a matter of weeks or months, we were able to work our way out of the problem and back to the particular transaction, working as it was originally structured to do so.

So second guessing, kind of the whole way around the table, I would suggest that perhaps they were a little quick in acting or reacting to market conditions but I don't know. They might have been in a position where they had a canvas to market in or they were turned down by everybody. I can't speak to that.

What could have helped? I have heard that they terminated 2 in their 11 outstanding. I think one of the issues that comes to our mind is perhaps limits on swaps similar to a school district or a county who can't borrow as much money as they want to. There's a borrowing base limitation on how much they can borrow based on their revenues. I don't have a suggestion for you of what that formula ought to be, but I think some limits on the number of swaps or a layering of swaps probably would be appropriate, so that in the event that the credit markets collapse again and it's not Bethlehem, it's Central Dauphin School District, at least we have a way of limiting the damage and Central Dauphin can't go and curve 13 swaps. And frankly, at Central Dauphin we have pretty close to 150 million in debt. So our opportunity to go create swap transactions is pretty big.

Through the history of school districts being able to enter into swaps, we've entered into one. The school district, prior to my tenure on the board, had considered one, never got to market conditions that it felt were acceptable or appropriate. So it kind of came and passed. But in full disclosure, we're actually considering another one that we think creates value.

As a board member, you sit there and you say, okay, how do I face the taxpayers and say that I'm raising taxes? We look at everything. I frankly go to bed at night with less concern about an interest-rate swap that we might have entered into or considering, than I do about whether or not our self-ensuring of healthcare is going to work as it was modeled and what our pension liability is going to be based on market conditions every year. We balance and juggle a lot of issues. Maybe it's because of what I do for a living on a day-to-day basis. But I will speak to the eight other board members as being very cautious and very bright people. We don't enter into these on whim and we do it in a very limited scope. I think if that were, in some way, a forced application on every issuer, I think the events like Bethlehem would not occur again. But we're talking about a perfect storm in a marketplace and we're talking about an issuer that had leveraged itself pretty highly, the outcome of that is going to be pretty negative when that's what they set out to do.

Again, as I said earlier, we don't allow clients to make a quick decision. I think some kind of cooling off period probably would help in that process, where people would have time to go home and read the Wall Street Journal, read the Newsweek Magazine, read the Patriot news, talk to their personal financial advisor. I think there are a lot of -- there's a lot of benefit to having time to sit on something. Just as if you went to buy a new car and it looked great and they told you that you were getting a great deal. There's a lot of value in shopping, there's a lot of value in going home and reading about what's in the marketplace. So I think limits would probably go a long way and I think a cooling off period where a decision could not be made, regardless of how quickly the market is moving for or against that client, I think probably would be in the best interest of everybody.

Again, I guess it's the second to last page really is what I call the other side, which is my rule as a school board member. I just tried to recap for you the process that we went through there. We made this decision to terminate because the market had moved in our direction. We did not enter into the transaction with that intention, but the economic value of terminating became so compelling that to eliminate the transaction, take the cash, put it in the bank and have a known reserve to apply against interest cost for the next five years, to us, was a very compelling argument. So that's what we did back in June of this year.

Again, in summary, we think that the derivative products that the municipal market has access to have provided a lot of value to a lot of our clients. Dauphin County, for example, has over $5 million of cash flow into swap transactions they have entered into. I heard Mr. Boyd speak of some red numbers in Lancaster County. Theirs were, again, related to the credit markets and being forced to find alternatives outside of the plan that was contemplated.

Suitability is always a big issue. Is a transaction that's appropriate for Central Dauphin appropriate for the City of Harrisburg or is it appropriate for Middletown School District or Steelton Borough? We try to be very careful in any presentation we make to a client and we don't make the same presentation to every client on the same kind of swap transaction because it doesn't fit every client's profile. Certainly, a school district, like Central Dauphin, has a lot of debt and has a lot of opportunity. But we also have a very healthy cash reserve and a cash flow. So we have the ability to endure short periods of market upheaval if we have to. We also, I think, have the discipline to maintain this interest rate reserve account so we're not dipping into operating reserves, which will affect taxpayers. We're dipping into money that was created out of a benefit from a prior transaction or the current transaction.

So again, with all due respect to what's being proposed of the complete elimination of this financed tool to the marketplace, we think revisions are probably more appropriate than abolition.

CHAIRMAN LEVDANSKY: Thank you, Mr. Wenger.

Any members have any questions? Representative Denlinger.

REPRESENTATIVE DENLINGER: Thank you, Mr. Chairman. You're wearing a number of hats today as you present to us and we appreciate that. I'm just trying to get my mind around that. You are obviously a school director --

FINANCIAL ADVISOR WENGER: Yes.

REPRESENTATIVE DENLINGER: -- with your school district. You are also going to other districts representing these swaps?

FINANCIAL ADVISOR WENGER: That is correct.

REPRESENTATIVE DENLINGER: Does Susquehanna Advisors have any relationship to the Susquehanna Bank?

FINANCIAL ADVISOR WENGER: No, we are completely independent.

REPRESENTATIVE DENLINGER: So nothing tied to that another --

FINANCIAL ADVISOR WENGER: No, we have no affiliation with any bank, any financial institution of any kind.

REPRESENTATIVE DENLINGER: You got into a bit of a dialoguer discussion about the perfect storm that happened.

FINANCIAL ADVISOR WENGER: Yes.

REPRESENTATIVE DENTLINGER: I'm wondering, I guess, now, sitting here in 2010, we have realized that that also is a reality of risk and as you made presentations where perhaps in 2006 or 2007, that was not part of the discussion much. How do you help districts to quantify that reality that can happen, that we could have a seise-up of good credit markets and liquidity partners abandoning the market? How do you indicate that?

FINANCIAL ADVISOR WENGER: It's very easy now because of what we've lived through and it's fresh in everybody's mind so it's not like we're trying to get them to remember what happened in 1980 or 1981. Everybody's memory of the early '80s and inflation and I think somebody spoke earlier about their mortgage being 13 and a half percent. That's almost foreign language to most clients today. But what happened a year and a half ago or 2 years ago is still very fresh in their mind. And so that's actually a very easy conversation and that's one of the fist questions that I ask. But your point is well made. Do we discuss it and the answer is yes.

Well, we give them our kind of stress test. If rates go to here, this is what happens and if rates go to this level, here's what happens to you. But you're going to have to be prepared for that if this particular transaction is subject to those kinds of movements.

REPRESENTATIVE DENLINGER: And do you see the boards reacting to that in the form of setting aside additional reserves or making provisions for that ultimate worst-case scenario?

FINANCIAL ADVISOR WENGER: I guess by maybe good luck, more than good foresight, when we started this -- we have worked with non for-profit clients prior to Act 23 being instituted. So we had history prior to the municipal market doing this. But our practice has always been to take a conservative approach to this and try to spread the benefit over a long period of time for a couple of reasons. One, it protects the transaction going forward, but number two, as I said earlier, we really don't want clients burrowing -- hiding an operating problem today. We don't want it hidden, we want it discussed. We want it dealt with.

REPRESENTATIVE DENLINGER: And then there has been a fair amount of discussion today about the fact of estate having ultimate liability. There was an act before, back in 1970 or the early '70s, that kind of hooked the state up to the districts to be the ultimate guarantor of payments. In fairly direct terms, if we were to decouple the state's ultimate guarantee from swap or derivative activity, what would be the practical affect in your estimation on this marketplace?

FINANCIAL ADVISOR WENGER: Well, if you were to take the -- probably the most extreme example would be Philadelphia School District. Philadelphia School District is protected by what the rest of us around the state call the Double Secret Intercept Program. If you were to eliminate the Intercept Program from covering swap payment for Philadelphia School District, you would be hard pressed to find a swap provider willing to do business with them. The other end of the spectrum is Central Dauphin. Our reimbursable percentage is single digits. So the amount that a swap provider will look at is actually coming from the Commonwealth to cover payment at Central Dauphin is slight. Those are the two extremes. In the middle there, some people are going to be in the margin of people who don't want to do business with them or they will. Again, the Intercept Program is intended to cover debt service payments to ensure that every school district across the state essentially has free access to the marketplace because the rating agencies treat every school district as being at least an A-rated credit, and without the Intercept Program, that's not true.

In the marketplace today with the failure of the bond insurers and less credit being available, that underlines credits are far more important than it was 2 years ago, 3 years ago, 10 years ago. So it would have some affect on some issuers' ability to access the swap market. Again, the extreme would be Philadelphia because the intercept is what everybody looks to in Philadelphia. Is the Commonwealth going to bail us out if Philadelphia can't find it's own way through their obligations? At the other end, you have very affluent school districts across the Commonwealth that would be affected almost not at all by that.

REPRESENTATIVE DENLINGER: Final question. Do you think there is some tendency to perhaps not take due diligence as far as deep as could occur because of that ultimate reliance on the state being that guarantor of last resort?

FINANCIAL ADVISOR WENGER: Due diligence by the governing board?

REPRESENTATIVE DENLINGER: Or even those entities, such as yourself, that would enter into the agreements.

FINANCIAL ADVISOR WENGER: No. We don't ever advise a client to look to the state as their source of payment. If you can't carry your own weight, there's another problem.

REPRESENTATIVE DENLINGER: I guess what I'm really asking you is, would you delve deeper into the health, the physical robustness of a given district? Would you go deeper if you knew that the state wasn't the ultimate --

FINANCIAL ADVISOR WENGER: Well, I think it's of a shorter conversation. I think the vendor, the swap provider, what we call the counterparty, would dig deeper earlier -- well, I mean, that's what they look at right away. They look at a school district's financial statement and they look at revenue and they look at expenses and then there is a pretty quick formula that says, how many times does the Intercept Program cover your debt service? And they look to that very quickly. The rating agencies look to it immediately.

I don't know that the process has really changed. I just think some people would not have access to that particular marketplace if that were the case.

REPRESENTATIVE DENLINGER: Very good. Thank you. Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Thank you. My executive director, Mr. Kassoway, has a question.

EXECUTIVE DIRECTOR KASSOWAY: Actually, a couple of quickies and then maybe you can help us understand the whole system. First, what percentage of debt of a taxing authority would you advise be tied to swaps as the maximum?

FINANCIAL ADVISOR WENGER: I can answer that a little differently, faster, I guess. In it's basic form, as Dr. Cusatis pointed out, swaps kind of started out as going from variable to fixed, fixed to variable. We really don't like to see clients go above 50 percent as a maximum variable rate exposure. So that's kind of the starting point. From there, if they're layering some other kind of swap transaction on top of it, then we kind of look at the exposure and say, okay, in the end, what is the real mix of fixed and variable rate debt and how much exposure do we have to changing rates?

What percent of their debt, that's a hard one to answer. Like at Central Dauphin, we have $150 million in debt. We would never suggest a percentage be as high there -- I mean, that's a lot of debt. As a board member, I would cringe if we were contemplating $100 million of swap exposure. But we have clients who are probably at two-thirds of their debt having a swap attached to it. Part of it depends on the profile. If it's a basis swap where we think the risk is very, very manageable and low and they have received very positive cash flow, maybe the percentage goes a little higher.

EXECUTIVE DIRECTOR KASSOWAY: Question, do variable rates come on the horizon at the same time as swaps or did swaps come after variable rates?

FINANCIAL ADVISOR WENGER: Variable rates were created in the early '80s when financing projects were on a long-term debt basis because of how high the rates were just did not work. So variable rate was derived out of a necessity to create a viable way to finance projects. So instead of financing at 18 percent, they were financed at 8 and a half percent.

The municipal markets started using variable rate in the latter part of the 1980s and then more so in the early part of the 1990s when credit became very available and very cheap. So we've kind of gone through now probably the cycle of credit costing almost nothing to it being very expensive, historically, as it is today. The swap market was a little later than -- and the tax exempt came later than the variable-rate market was started and evolved. I would say the swaps probably came more acceptable as variable-rate debt became much more widely applied. It gave issuers a chance if they had borrowed a variable-rate market in a high-rate environment, when rates dropped to fix their debt without entering into a refinancing transaction.

I know it sounds kind of intuitive, but

there are times when the swap market does provide a better interest rate than the traditional bond market does, for reasons that really don't matter today. And so issuers have taken advantage of that when market opportunities has arisen. Swaps kind of followed the variable-rate market, to answer your question.

EXECUTIVE DIRECTOR KASSOWAY: In your remarks, you sort of interchangeably used the term swap advisor and investment advisor. It's been suggested elsewhere that there be a wall between these two, that there should be a separate financial advisor and then the swap advisor also. Would you comment on that?

FINANCIAL ADVISOR WENGER: Well, most municipal entities have -- if they have a financial advisor, that financial advisor really serves a role of monitoring and advising on their debt as well as their investment portfolio. Now, some have split it. In some cases there's a financial advisor and a school district all by itself who manages it's cash portfolio with local providers. I don't see a conflict there in any way. The two are tied and so to kind of act on somebody's debt or to act on their cash portfolio without recognizing the other, I think is probably poor advice being given to the client.

EXECUTIVE DIRECTOR KASSOWAY: When you say swap advisor, are you inferring the swap advisor as the swap issuer or is that a different person?

FINANCIAL ADVISOR WENGER: There are -- in a swap transaction there's a financial/swap advisor and that term gets used interchangeably. I believe that Act 23 actually describes it as an independent financial advisor. It is because in a lot of cases a school district may not have a financial advisor on an ongoing basis. So on a transactional basis, they go hire what they consider to be a swap advisor. There's bond counsel which it is typically the same firm who is there time after time for the school district. They're a legal counsel. And then the swap provider or what we call the counterparty.

EXECUTIVE DIRECTOR KASSOWAY: And then the question, through two presentations, and yours was really excellent, I still don't know. Take us from A to B. You enter into this agreement, what is expected at what -- what can take place to the end of the agreement?

FINANCIAL ADVISOR WENGER: There's an array of swap transactions, so it's difficult to answer A to B in anything close to a short conversation. But in the elevator version, if a school district or the County enters into a swap transaction, it is tied to a piece of debt for some period of time, either for five years, ten years, to determine the debt. In there, all they are doing is exchanging one interest rate for another. Somehow, somewhere they're either going from a short-term variable rate to a long-term fixed or a long-term fixed to a short-term variable, where they are exchanging a taxable index rate for a tax exempt index rate. There are different structures that create different exchanges. But in all cases, you are exchanging one interest rate for another.

It was suggested earlier, and we get this question all of the time, why would I possibly outguess Wachovia Bank or RBC or PNC or JP Morgan or Bank of New York? We're not betting against them. The reality is, if any one of those banks were running truly -- if they were betting on rates, the regulators would shut them down. Their spread in these transactions is, although everybody thinks that the fees are huge in terms of basis points, their spread is relatively small, three, five, seven, ten basis points. That spread by itself, unhedged, would, in no way, allow you -- sitting on a trading desk at any derivative's operation at any bank allow you to have your job past noon today. They are basically buying an interest rate in the marketplace and they sell it to our client at a different rate. They made the spread in between.

The suggestion or the fear that we're betting against them and it's a zero-sum game and we're going to lose because they're smarter, I'd be the first to tell you that they've got a lot of bright guys sitting in their office. They've got PhDs, like Mr. Cusatis, who sit there and run economic models all day long and they've got a room full of those guys. We're not going to try and stand in the ring and slug it out with them nor are they really betting on rates. They would be out of business before they would know what hit them. They're hedging it, they buy a rate, they sell a rate. We have the opportunity because we have a debt portfolio and we're trying to get to some other interest-rate mode than we currently have.

EXECUTIVE PRODUCER KASSOWAY: I guess what I'm saying is, where does money get generated or lost?

FINANCIAL ADVISOR WENGER: Okay. It depends --

EXECUTIVE PRODUCER KASSOWAY: And also talk about remarketing.

FINANCIAL ADVISOR WENGER: It depends. In some transactions, clients take the money upfront. Our preferred model is that they take it over time because taking it over time is the most stable cash flow model for the client. The likelihood that taking it over time turns negative is -- for example, on a basis swap. If your formula structures that you take it as pure cash over time, you can go back a long time. In a number of weeks that they would have had negative cash flow would be a nominal number of weeks. If you take cash upfront, what you're really doing is taking the present value benefit of that cash over time today. And so the cash over time has to go down because you have already taken some of it today.

So taking cash today isn't necessarily paying it back over time. It just increases your risk that you might be negative more often than if you had not taken the cash upfront. But every transaction has anticipated cash flow based on interest rates. And so whether you take it over time for 5 year, 10 years, 20 years, or 30 years, or you take some of it today or all of it today, it's essentially the same cash, all expressed in present value terms. I'm not sure if I answered your question.

EXECUTIVE DIRECTOR KASSOWAY: And the cash is generated from?

FINANCIAL ADVISOR WENGER: Well, in the case of -- first of all, taking cash upfront, you can do it a lot of different ways. In the simple cases, which Dr. Cusatis set forth, where you go from a variable rate to a fixed rate, all you're doing is saying, I had variable rate and I want fixed rate. You're not really expecting a cash benefit in that. You've just expected a certain budget number for your interest cost. If you go from fixed to variable, all you've said is, I think the variable rates is going to be lower than my fixed rate was. So you're not expecting to take cash out per se, you're expecting an interest rate.

There are other transactions where you can generate cash flow, for example, on a basis swap where you receive a percentage of the LIBOR index, a taxable rate, and you pay a tax-exempt rate. You can create a spread in there that you can take on a monthly basis. And to a client it's all presented as over the last 25 years, rates have averaged this. And if that were to hold true, this would be your cash flow model. Over the last 10 years, rates have averaged this. If that holds true, this would be your cash flow model. Based on rates today, this is what your cash flow model would look like. So they get different looks at, different rate environments to try to decide whether or not it makes sense. And there are times where it makes more sense than others just based on market conditions.

EXECUTIVE DIRECTOR KASSOWAY: And they are remarketing?

FINANCIAL ADVISOR WENGER: Well, remarketing deals with variable rate bonds where the bonds have to be sold because -- variable rate means the rate changes every week. So there has to be some mechanism whereby now that rate is reset every week. And as Dr. Cusatis pointed out, they're institutional money funds who buy those bonds. They don't want to buy a rate today at .22 percent and expect it to be that rate every week for the next 10 years. If, as somebody pointed out earlier, we're going to have inflation, that short-term is going to go up. The money fund wants to realize the benefit of that higher rate in a higher rated environment.

The remarketing agents rule is to basically be the clearing agent to make sure that those bonds get sold in the marketplace and they rate every week.

EXECUTIVE DIRECTOR KASSOWAY: And I guess the last final thing. Are you at all concerned with the Fed keeping an artificially low interest rate for an extended period of time that we might not have a good sense of where we are as far as trying to commit to something in the long-term prospect?

FINANCIAL ADVISOR WENGER: It's the same question that every client asks. If I knew that, I wouldn't be sitting here today working for a living, that's the very short answer. Yes, we are concerned.

In these transactions, in any debt portfolio, in any decision the client makes, we try to take into account what could happen, in its worst case how high rates might go. What we try to rely on is historical context of rates.

Again, if you look back over time, variable rate, on average, has outperformed fixed-rate over an extended period of time. You can isolate periods of time where you would have been better off by just saying, I'll borrow a fixed-rate. But depending upon where you can borrow fixed today and where that long-term average is, maybe it makes sense to have some variable rate exposure, maybe you do it in a traditional sense, maybe you don't really have a new money need today but you have an existing debt portfolio and you want part of your portfolio variable.

There are times where market conditions change, interest rates change, but you don't necessarily have a new money project to go borrow it in a variable rate mode. So they go look to change their debt mix or portfolio mix based on market conditions, not based on a new capital project to be financed.

EXECUTIVE DIRECTOR KASSOWAY: Thank you.

CHAIRMAN LEVDANSKY: Representative Mirabito.

REPRESENTATIVE MIRABITO: I feel like we're having two levels of discussions here. I mean, intellectually, swaps for private-sector parties are probably great ways to hedge their bet. But do you think that they are more risky than just a vanilla-rate fixed bond?

FINANCIAL ADVISOR WENGER: The very short answer would be yes because rates can change. We tell clients the day you borrowed fixed-rate, you've taken the risk that rates never drop. Every decision you make has a risk associated with it. You can't say variable rates is the only one with risk associated with it. It has the same risk, but on the opposite side of the spectrum as fixed-rate does. Rates are going to change over time. None of us know where they are going to go. So whether you borrow fixed today at 4 or 5 or 6, and could have borrowed it at .2 or .5 or 1 and a half, you've made a decision today based on your risk reward assessment. That's why a lot of clients have some mix of both because they don't know.

REPRESENTATIVE MIRABITO: You were saying under the federal tax code they are allowed to refinance them once a year?

FINANCIAL ADVISOR WENGER: No. You can refinance prior to what we call the call date. In the tax exempt world, almost every issue is callable at some point in the future. All that means is that's the day you can pay it off without any kind of prepayment penalty.

Unlike your home mortgage where you can refinance at any time, in the municipal market there's kind of a lockout period where you can't do that. So if you do it prior to that first optional call date, it's what the IRS calls an advanced for funding. You get one of those for the life of that bond issue. So the idea is that if you're going to use it, be judicious about it and make sure that it's a good market opportunity.

REPRESENTATIVE MIRABITO: Thank you.

CHAIRMAN LEVDANSKY: Thank you. Mr. Wenger, I appreciate your testimony. It was very educational, very instructive. Given the lateness of the hour, I have some questions, but I'll hold them at this point in time. But I appreciate your testimony.

FINANCIAL ADVISOR WENGER: We're available if you would like to e-mail us. We would be happy to respond to any questions you might have.

CHAIRMAN LEVDANSKY: Perhaps that way would be helpful. Thank you very much.

FINANCIAL ADVISOR WENGER: Thank you. I appreciate your time.

CHAIRMAN LEVDANSKY: We are considerably behind because I think the complexity of this issue and the interest that members have and the questions. But our next panel of testifiers is a board that is put together by the Pennsylvania Association of School Business Officials, Mr. McCullough, Mr. Phillips, and Mr. Damgaard. Gentlemen, just let me give you the option -- I mean, I'll stay here for however long it takes to get all of the testimony today. But I think, given the complexity of this subject, this isn't easy to really understand from a public policy perspective to know exactly what our response to the problems that the Auditor General has pointed out.

Before I would move legislation, I would feel more comfortable if I had another public hearing to continue this discussion and this conversation. So to that extent, just let me ask Mr. McCullough, Mr. Phillips and Mr. Damgaard, would you prefer to testify now or would you rather come back at another date?

DIRECTOR OF ADMINISTRATIVE SERVICES McCULLOUGH: Would you care if we do it now, sir?

CHAIRMAN LEVDANSKY: That's your choice. If each of you would introduce yourselves just for the record.

DIRECTOR OF ADMINISTRATIVE SERVICES McCULLOUGH: I'm Wayne McCullough, director of administrative services and the board secretary of Southern York County School District. I am also president-elect for the Pennsylvania Association of School Business Officials.

DIRECTOR OF BUSINESS AFFAIRS PHILLIPS: I am Kurt Phillips. I am the director of business affairs at Cornwall-Lebanon School District in Lebanon County.

PARTNER DAMGAARD: I am Jens Damgaard. I am an attorney with the Harrisburg law firm of Rhoads & Sinon, a bond lawyer of 26 years and also served as bond counsel to the Bethlehem Area School District as they attempted to deal with the situation they had.

DIRECTOR OF ADMINISTRATIVE SERVICES McCULLOUGH: Good morning. My only concern is whether my parking meter is still okay. Thank you everyone. And as stated, I'm Wayne McCollough, president-elect of Pennsylvania Association of School Business Officials. PASBO is an association of 2,000 members, two-thirds of which are kindergarten through grade 12 non-instructional administrators who provide finance, accounting, operations, facilities, transportation, food service, technology, communication, human resources, purchasing and safety services to support classroom learning for schools in Pennsylvania.

We appreciate the opportunity to speak regarding the use of swaps by Pennsylvania school districts today. In particular, I'll share my experiences at the Southern York County School District that relates to the use of swaps.

Before I discuss the two primary reasons that school districts enter into swap agreements, first I would like to share with you PASBO's position on swaps. PASBO concurs with many of the Auditor General's concerns related to the potential risks associated with these very complex financial transactions. Also, PASBO concurs with the report's warnings of the consequences of inadequate discussion and disclosure of risk and excessive reliance on advisors compensated by these products. PASBO also agrees with the need for more thorough and more thorough understandable disclosure of these associated fees. However, the experience of one entity, such as Bethlehem, cannot reasonably be the basis for the repeal of a seven-year-old law and the termination of hundreds of financial transactions.

Now, I will discuss a little bit about the two primary reasons that school districts enter into swaps agreements. First, swaps are used as an interest rate hedge in the case of variable rate indebtedness and its associated risks. The associated risks, such as, a term that we've heard a lot today, the lack of bank liquidity required to suppose variable rate bonds, and the risk of credit rating downgrades, were, for many years, minimal. Only after the recent global financial meltdown have these risks become heightened. In many cases, extraordinary financial circumstances caused by the financial meltdown have forced the termination of otherwise normally functioning swap transactions. In the current low interest-rate environment, these terminations have proven very costly. In many cases and in "normal" financial environments, however, these terminations have been successfully avoided.

In most cases, when there was a problem, it was not a result of the swap performance, it was a result of the variable rate interest crisis. I think most of us would agree that we should not prohibit school districts from having that variable rate debt as part of their debt portfolio or even variable rate interest rate investment as part of their interest rate portfolio.

Swaps associated with fixed-rate debt have been used quite successfully as a method of hedging against falling interest earnings of school districts. For example, at Southern York our interest earnings from three years ago have gone from three-quarters of a million to less than a 100,000. At Southern York County School District, again, for example, the swap has mitigated plummeting school general fund interest revenues, as noted. From June 2006 to November 2009, Southern York County School District realized a net benefit from our swap of $919,889.55. This included a net cash flow of $168,899.55, a suspension payment of $531,000 and a termination payment of $250,000 minus fees paid.

The Auditor General's report seems to focus on two primary concerns that I believe can and should be addressed. First, there are school districts that lack the internal expertise to understand swaps. I think it is appropriate to require certified professionals for school districts to enter into the swap agreements and to require appropriate reporting and monitoring controls throughout the process. Second, there is the view that school districts paid too much in fees without full knowledge of the fees. Again, I think it is appropriate to address the manner in which these fees are disclosed to school districts.

In the case of Southern York County School District, both of our financial staff and the school board were well informed of the potential gain and risk associated with the swaps transaction. In fact, during this three and a half year process, our professionals made no less than six presentations to our board of education and provided monthly advisement to the district's financial staff.

The point that I would like to make is this: Although swaps are not appropriate for all school districts and financings, I believe the recommendations found in the Auditor General's report are overly severe and should be reconsidered by this committee.

Swaps do provide local school districts an option for reducing taxpayer burden and having a balanced debt portfolio. School districts, like the private sector, should have the opportunity to look at all debt management tools, including swaps.

Finally, the Auditor General's report calls for terminating all existing swaps. Terminating an existing swap in an unfavorable interest-rate environment could be an extremely costly mistake. Early terminations could result in penalties and losses for many school districts throughout the Commonwealth.

I ask you to view the swaps as a credit card. For most, the credit card is a useful and beneficial tool. For some, if it is abused, it will cause financial problems. Eliminating use of credit cards or requiring everyone to terminate their credit cards is not the solution.

PASBO is prepared to work with Representative Scavello and the House Finance Committee to adopt amendments, regulations, or policies to improve the law and enhance the existing safeguards. We believe addressing direct issues, such as disclosure of fees and ensuring proper financial advisement seems much more appropriate instead of not allowing swaps and forcing all school districts to terminate existing swaps.

Again, thank you very much for your time and interest. And I'm certainly happy to answer any questions that you may have.

CHAIRMAN LEVDANSKY: Representative, before we get into questions, let's have all the presentations done first.

DIRECTOR OF BUSINESS AFFAIRS PHILLIPS: Thank you for the opportunity to present my perspectives on the interest-rate swaps situation. I think there is a couple of things in the report that was issued that I would be considering as exaggerated, in some cases unfounded. I would like to address that initially and then go into the way that this particular district used the interest-rate swap.

Troubling, in particular, to me was the

characterization as gambling with public funds or betting on interest-rate movements. That was never part of how we looked at entering into the swap. And I really think you could take that characterization and compare it to almost any financial decision that a public entity makes, whether it be investing of funds or a bond transaction. I think the previous person talked about opting to go into a fixed-rate versus a debt rate. So that kind of financial situation occurs all the time.

Also I was a little uncomfortable with the unsophisticated public officials. I understand how that fits with the gambling observation but I think the characterization is hardly used and not necessarily appropriate. The other part of the report talked about deceptive marketing techniques and we're suspect to that every minute of every day. So this is just another issue that we have to be careful that we don't get burnt by somebody who is coming in to sell us something that's not appropriate for the school districts. So to tie that practice just to interest-rate swaps, I don't think is appropriate as well.

As I mentioned, the fixed versus variable rates is a difficult one for a school district to move through and as investments of funds are made throughout the course of the year, our hands are tied because the cash flows restrict any extension of maturity. So we're always looking at, should we go into a term investment at a higher rate or should we stay in a liquid kind of rate? And here's where I think the interest-rate swap comes in and actually assists the district in what it is trying to accomplish.

Again, before I get to the specifics, another point that was made in the report was inappropriate fee and cost structures. Absolutely they are important, but again, they're no different than if you're doing a banking relationship, doing a bond issue. It's absolutely critical that you understand what those fees and costs are. In our case, we negotiate them every time. Sometimes the other parties don't want to hear that, but we will work until we feel that we're comfortable. The other party deserves to get paid for the work they are doing, but we want to get to the level that we feel is comfortable for the transaction that is happening.

Another important component that we look at is the counterparty to the swap transaction. We need to be comfortable that the other side is financially secure. But, again, no matter what type of financial transaction you're entering into, that counterparty is critical. The most critical to me of a counterparty would be any banking relationship that you have because there are more significant amounts of money that are placed with those financial institutions, that you better fully understand what the strength and the collateralization is of those deposits. So, again, all good points, but it's really, to tie it just to swaps I think is not correct.

I would like to take just a second and talk about the type of agreement that our district entered into. It's one that is called a constant maturity interest-rate swap. The notional amount on this particular transaction was $16 million and, of course, you have to understand the $16 million is not ever at risk. It's just the amount of which the payments are calculated. In our particular agreement, we are paying a short-term interest rate, in this case it's one month LIBOR, and we're receive a ten-year LIBOR rate, less a spread. And the reason this makes sense to us is our average investable balances over the course of the year are approximately $14 million. The $14 million ties to the $16 million.

Now, if I just say I don't want to hear or think about swaps, I've taken a risk because in a given year if interest rates are good, I might be inheriting over $1 million in that $14 million. If interest rates are not so good, like where they are now, it could be $100,000. So I've got a risk there of a pretty substantial amount. In our district's terms, it's about 2 and a half mills. So if that goes away from one year to the next, that's another 2 and a half mills that I would have to assess the local tax base, to make up the difference that I've lost in that revenue by simply ignoring the fact that those interest rates could move.

The education, I think, is absolutely critical. We did extensive education. I think it does need to be done by a financial advisor, third-party, but it also needs to be provided by the administration of the entity, via, the school district or otherwise. I personally took responsibility for that education, a number of sessions with the board upfront. After they agreed to it, I told them if you do not understand, don't go for it. And indeed, one of our nine did not vote against it. They just could not get to the point where they were comfortable understanding the entire transaction.

After that point, we go through a pretty in-depth analysis, again, on an annual basis because boards change, people forget the things that they've heard about. So don't just put in there and say my swap is in place for a couple of years, I'm comfortable with the information that the board has. So we educate on an annual basis in a severe, sincere way and also on a monthly basis share exactly what the performance of the swap has been and what the market value would be in the event that we would want to terminate.

We did share with the board that the concept that after this report came out, it were on the positive side of this swap. Is there any interest to just walk away from this swap, and the answer is no. We understood why we were in the transaction and the transaction is performing exactly the way it was supposed to.

Another important component that I talked to this board about was it's not necessarily a bad thing if we're paying on the swap, if you understand it the way we are, because if you are paying on the swap it means that your interest income is going to have reacted in a different way than what the swap is performing.

In conclusion, absolutely there are risks associated with swaps. They shouldn't be entered into lightly, they should be studied thoroughly. But I believe they are an important and useful instrument and I would ask you to consider very carefully before you take any action to totally say that they cannot be used by public entities. Thank you.

PARTNER DAMGAARD: Good afternoon. Again, I am Jens Damgaard. I've been working as a municipal bond attorney for 26 years. My firm represents about 120 school districts so I've sat through a lot of presentations on bond issues by various financial advisors and I've sat through a lot of presentations regarding swaps by a variety of different financial advisors.

You've heard a lot of good practices today and I think in a lot of those cases those practices are recommended and they're followed, but I can't say that it is in every case. And that certainly was what took place in Bethlehem that these practices were not recommended in many cases and as a result, the district found itself facing a large liability, which is now digging itself out of.

I think it's important to realize that a lot of what we've heard in terms of these practices are involuntary. They're not mandated by the law. One of the jobs we have as bond counsel, we're often asked to give the legal opinions that the swap is legally enforceable. And therefore, as part of that opinion, we have to say that the provisions of the local government Unit Debt Act as they apply to swaps have been adhered to.

In that regard, I have to say that the body of law available to us in given that opinion is just not finished. There are provisions in the Debt Act that are not defined, that are left to be guessed at as to what the intention was, interpretations can be made giving rise, I suppose, to opinion shopping. As you know, some of you who are lawyers, you realize that when you go and you're dealing with a transaction of a client, you know, oftentimes the business terms are not something they really want the lawyer to even comment on. Is it legal and that's pretty much your job. And in many cases, it is legal. Even though you have your opinion on whether this particular provision or that is a wise one.

I guess what I'm asking for, and what I think other bond lawyers are asking for, are more guidance. And I think that guidance can come in the form of regulations. I think, as you can see in my presentations from recommended regulations, I believe that with that type of regulation, we could deal with 90 percent of what we are talking about. Some of the problems with the swaps that we're taking about, in particular ones that really burned the Bethlehem Area School District, could be dealt with if they were limited by regulation. Frankly, some of them, they got in over their head in terms of the amount in dollars of the swaps they undertook and in terms of the length of those swaps.

There really are two kinds of swaps. I know it's complex stuff, but the swaps that got Bethlehem in trouble, I call interest-rate swaps. They're basically the ones we thought of, I think, when the legislation was passed. You have a fixed rate, you really want a variable rate. You have a variable rate, you really want a fixed rate. You trade in those different areas. But what happened was that these type of swaps were sold under the concept of synthetically fixed-rate debt and you heard that and I heard that time and time again. This whole deal, when it's all done, is equivalent to a fixed-rate bond issue but cheaper. When you dig into it and what we learned the hard way really was that the swap -- you had to issue the variable-rate debt and then the swap dealt with the interest rate risk. But because you had to use the variable-rate debt, you had to introduce about three new risks that we really didn't appreciate and really were unable to quantify and I think even more importantly we're really beyond the ability of the district to control.

You heard a story about the liquidity. Well, liquidity is simply a provision in those bonds that save a bond or doesn't want that bond anymore, they can give it back to the school district. Well, the school district doesn't have the money to buy that bond back so they contract with a bank to provide them a loan to buy it back, if they can't find a new buyer. Those banks ran away from those contracts. Those contracts were only 2, 3, 4 years in duration when the bond issue and the swap were 20 years. So you had a long-term obligation on the swap covering a short-term liquidity facility.

In that case, I think that in Bethlehem's case in particular, if those swaps had been limited to the term of the liquidity facility, a lot of that problem would have gone away. And those are recommendations in those regulations that I offer up as suggested.

The swaps that you've heard have made money for districts are what I call cash flow swaps. And what those are used for is really an investment tool, not a debt tool. They're used to make -- to deal with declining interest rate markets. These produce cash when you're losing cash in your general fund, but they're tied to the size of the bond issue. Not just to the size of the general fund balances. So these things can potentially be much bigger than what they would otherwise have to be to deal with that situation. And you're really talking about a 20-year contract to cover a cash flow situation that changes on a year-to-year basis.

I think a lot of this has to do with sizing and length and duration that could be dealt with, I think through, again, regulation and determining what is appropriate sizing. We never got to that ponit. There are no regulations on these laws and I challenge you to figure out where you have a complex financial law that has no regulations behind it.

Now, I see in the A.G.'s report that the attorneys from DCED have suggested regulations and I think that is certainly something that should be given attention. But overall, I think the problems can be addressed. The other one, the fuel for this really is the fees. And the fee disclosure has to be dealt with. The law says you have to disclose all fees. Well, then came the discovery, what are fees? Are the fees what the counterparty gets? Is that a fee? That's not a fee, so we don't have to disclose that. Well, we'll disclose the fee, but we won't tell you what it is in dollars, we'll tell you what it is as a computer formula, and then on and on. So these fees in Bethlehem's case were in the millions over about a 4-year period. And that's what powered the situation where they ended up with more than three-quarters of their debt as variable rate because the overall structure of variable rate with swap is more lucrative than the fixed rate.

Now, there are opportunities for flexibility, I don't question that. But again, it has to be tempered and I think it can be tempered with some approved regulations and I think the people that are available to do that, PASBO, the organization of the Pennsylvania Bond Lawyers, and bankers and the financial community as well.

So that's my point I think. And I'm going to provide a PowerPoint, which gets into this in greater detail.

CHAIRMAN LEVDANSKY: Yes, that would be helpful if you could provide that. Mr. Damgaard, just one quick thing from me. You have mentioned the use of -- traditionally, I would presume that swaps, for the most part, are used to help finance debt and you get that appropriate mix of fixed versus variable interest rate to finance a debt. You need to sell the bonds because you have a building that you need to build or some other physical capital improvement.

But you also just mentioned here about the use of swaps to provide revenue that is then in turn used to make investments to generate cash for the school district. How often does that occur?

PARTNER DAMGAARD: Well, I think that category of swaps you've been hearing most are the ones that generated cash that they received payments to terminate them. They were, by and large, that type of swap whereby two different cash flows that you were locking into, they produced a positive return.

Now, keep in mind that all of this was taking place in an environment where interest rates were low and declining. So that played into the strength of that type of swap and hurt this type of swap where you were locking in a fixed rate, which turned out to be higher than where the market ended up.

When you are looking at these so-called cash flow swaps, you are creating a situation where you are going to receive money largely as interest rates decline or as markets return to their historic norms.

CHAIRMAN LEVDANSKY: Let me rephrase it this way. School districts, counties, municipal entities, should they be prohibited from using swap financing to finance anything outside of capital improvements and capital projects?

PARTNER DAMGAARD: The Debt Act says and Act 23 says that swaps are only to be used to manage interest rate risk and cost. That's all you're suppose to be allowed to use them for. Now, what does that mean? That's another one of those ambiguities that we have been wrestling with for seven years. Our position, as a firm, has said that the money that you receive, whether it's cash flow that you receive periodically or money that you receive in a lump sum, because you terminated it and you were, so-called, in the money at the time of the termination, should be used to pay debt service. Not to plug a hole in the general fund or whatever.

Now, there's different interpretations of that. That's our interpretation. There are other bond counsels who said no, you can use that for a capital project because you will be borrowing money anyway for that. But there are others that say you can use it for whatever you want.

Again, I just highlight that as an example of what we've been wrestling with over the course of the seven years and the things that if we dealt with, if we had said no, they have to be used for interest, either to pay interest now or later, you have to put that into an interest reserve. You've heard that as the best practice, it is a good practice. If you're going to do these, you really should have money set aside, but if they go the wrong way, you can pay for them because, remember, for school districts, these payments are not eligible for the limitations on local tax under Act 1. You may have these exceptions where you can raise taxes, that is not an exception. And likewise, you don't get subsidy payments on swap payments from the state like you do for debt service. So some of the safe guards aren't there. Definitely a good practice is to have that reserve.

Again, limiting it to interest payments or debt service payments now, obviously, it would freeze up your general fund for other things, but using it for now or as a reserve for future debt service is the kind of thing that we could put in place with appropriate regulation.

CHAIRMAN LEVDANSKY: Thank you. Any other questions? Representative Mirabito.

REPRESENTATIVE MIRABITO: I'm following up on what the chairman just said. Mr. Phillips, you talked about saving two and a half mills, but aren't really what you're doing is, by using these to help your cash flow, not sort of confronting whether the budget should be going up two and a half mills?

What really concerns me as a private businessman is that the language being used is language that private parties can use when it's their own money. If I want to hedge bets against interest rates and it's my money. But when public officials are engaging in transactions that reach a point of sophistication, I'm not sure they belong in the public sector.

When you say that you actually were able to save the taxes going two and a half mills, that's a great goal. But are we really not putting out for the public the fact that maybe we're spending too much? And I don't want to sound naive, but at what point do we say, look, enough is enough. We float bonds to build schools, we do this. But we start to have public officials moving into using other people's money in a way that this is what drives taxpayers up the wall because they don't understand it.

You may understand it, and I respect every one of you, everyone who has come before it. There's no doubt in my mind that you-all understand what's going on. But for the average person out there, they don't understand it. All they know is that they write checks for their school board taxes. So I guess I'm asking you, do you think that it's really appropriate for us to be doing this?

DIRECTOR OF BUSINESS AFFAIRS PHILLIPS: I would submit to you that there's quite a few things in the financial affairs of a school district that the general public does not, will not, is not interested in understanding. This is obviously a sophisticated transaction. I think you're right that a lot of them don't understand that. But again, there's a lot of components like that.

What our goal was -- and you have to understand that there are certain times when you wouldn't enter into the transaction because pricing has to be a severe consideration of whether you do these transactions or not.

But the point that I really wanted to make was, that if you just ignore this, I say that you are taking a risk because that part of your revenue stream could just decrease by a substantial amount. And what these transactions do is protect that movement -- as long as you enter it in at the right time -- protect the movement which would decrease your revenues and, there, effect the amount of millage that you have to assess.

CHAIRMAN LEVDANSKY: Representative Denlinger.

REPRESENTATIVE DENLINGER: Thank you, Mr. Chairman. Just to clarify the set of regulations that you proposed for us is the position of PASBO, not necessarily yourself or --

PARTNER DAMGAARD: I would have to characterize that more of my firm. I have not had an opportunity to go in any depth with PASBO. Although, will be discussing that further.

REPRESENTATIVE DENLINGER: And then just a question as we developed a very good conversation here, Mr. Chairman, and I thank you for this opportunity.

When a swap gets into trouble within a district, of those districts that have then gone on to unwind all of their agreements, how much of that activity has been driven by the public relations disaster around the fact that the word swap is toxic in the public mind when it gets to property taxes and school districts and all of that?

Let me put that a little more simply. One swap agreement goes bad. A district has four or five other ones and it might be a very prudent thing to hold on to them, but because there are headlines and there are people threatening to run and all the rest of it for directorships, they suddenly get motivated to unwind everything else and make bad decisions as a result of that.

Can you comment on that? You've seen a lot of districts out there interacting with them. Is some of the amount of the Reading situations or scenarios driven by just the public relations aspect of this?

PARTNER DAMGAARD: Well, I think, certainly, people are getting the message or seeing the headlines or understand what the Auditor General has said. It's hard to terminate these things when you have to write a big check and that is a very difficult public relations problem. It's exacerbated by the fact that there is limited legal ways that you can refund -- pay for that. Now, legally you can under state law include that in another refunding if you're going to take out those bonds, but there are even federal tax laws that come into play. And, again, you're getting into the more complexity of it.

I think that they're doing -- the ones that are writing the checks are doing it for one of two reasons. Either they're just heeding the A.G. report, but I think more likely is because they can't sustain the variable-rate debt that's necessary to support the swap. That's what we're facing at Bethlehem.

The liquidity providers have withdrawn -- we had to find temporary fixes to plug the hole, find someone to provide variable rate loans to replace the variable rate bonds that can't stay in place because the players have gone away, the bond insurers, the bank. So in Bethlehem's case, for example, we have been winding it down for both reasons. Of course, they want to heed the report, the heat that they are taking for it but also because of the fact that they can't find anyone to lend to them on those terms.

REPRESENTATIVE DENLINGER: So to characterize, much more of the case of liquidity partners not being available than public relations and damage control?

PARTNER DAMGAARD: Yes.

REPRESENTATIVE DENLINGER: And then one quick other question for you two, if I may. In each of your respected districts, I'm just curious, how many swap agreements do you have in Southern York and then in Cornwall-Lebanon? And then also, what percentage of your total debt portfolio would these represent?

DIRECTOR OF ADMINISTRATIVE SERVICES McCULLOUGH: We've had one swap agreement, which was a $16 million swap agreement of a $50 million debt portfolio. We've since terminated that, not because of the Auditor General's remarks, but just because the environment was such financially to our advantage and our decision to terminate that swap.

DIRECTOR OF BUSINESS AFFAIRS PHILLIPS: Our numbers are almost identical as far as the size of the swap and the total of debt outstanding. It's the only agreement that we've ever had and we've had discussions about keeping this type of agreement on the books for eternity because of the way it's expected to perform. So we're in one now. It's the only one we've done.

REPRESENTATIVE DENLINGER: Your percentage would be?

DIRECTOR OF BUSINESS AFFAIRS PHILLIPS: It's about 30 percent of the portfolio --

REPRESENTATIVE DENLINGER: And then, Mr. Chairman, one last one here. You mentioned, Mr. Phillips, that the termination fees are -- all things are negotiable in the final analysis, but termination fees certainly would be. Can the two of you share from experience the success that you had negotiating a reduction of those fees as you were getting into the swap arrangement?

DIRECTOR OF ADMINISTRATIVE SERVICES McCULLOUGH: Yes, actually, in one of PASBO's recommendations is that the fee disclosure becomes something that is addressed by this house finance committee and it is something -- I think we've heard that mentioned quite a few times -- but during our termination of our swap, yes, we did have the opportunity to negotiate the termination fee. Not only with our financial advisor and what limits they would accept for that transaction, but also with that third party at that point also. So we established that threshold and we're able to successfully negotiate that.

REPRESENTATIVE DENLINGER: So you broke open an already executed contract and changed the back-end provision, so to speak?

DIRECTOR OF ADMINISTRATIVE SERVICES McCOULLOUGH: Yes.

REPRESENTATIVE DENLINGER: Okay. Very good. Thank you. Thank you, Mr. Chairman.

CHAIRMAN LEVDANSKY: Thank you, Representative Denlinger.

I appreciate all three of your testimonies. You've all given some really good insights. Mr. Damgaard, in particular, I think you have some really good suggestions as to if we're not going to repeal Act 23, some constructive thoughts about changes that need to be made.

I guess just in summing up, there's three options. On the one hand, Representative Scavello's legislation and the Auditor General would recommend that we just repeal Act 23. We figure out a way to phase it out and do as minimal damage as possible. The other option, I guess on the other end of the spectrum is, to do nothing. That these swap financing mechanisms are appropriate for tax bodies and they ought to be and they've been used legitimately in a lot of purposes and so we shouldn't do anything versus we need to make changes. Maybe not so much repeal Act 23, as to amend it and make some substantial changes to it, to make sure that this kind of financing mechanism is, in fact, when it's utilized, is done so in the long-term interest of taxpayers.

This is one of the occasions today I realize that the more that I learn about this subject, the more I realize how much I did not know and how much I need to learn in order to make the best public policy decision. I don't think doing nothing, however, is an option. I think there's enough indications that there are, not just in Bethlehem, but in other areas and likely in many areas that have yet to be investigated and documented, that these kinds of tools are not properly utilized in the public sector.

So I think it does point to the need for us to learn more and then to make some improvements and we will have the discussion about, do we repeal Act 23 or can it be modified and used appropriately? I think that's a discussion that we need to have. But from my perspective, doing nothing isn't a valid choice at this point, given what we've learned.

And finally, let me say one other thing. Mr. Phillip, I appreciate your perspective and I'm sure there are a lot of school board members and other public officials who would agree with you that the Auditor General's characterization of them as unsophisticated public officials, they made mind it demeaning and I understand that. I, for one, don't think that the Auditor General overstated. I don't think he did. As a matter of fact, in my experience in 25 years in public office, that characterization is even too generous in a lot of cases.

If we had, in fact, public officials who treated the taxpayer dollars as their own rather than as other people's money, they would be a lot more judicious and thoughtful in how they vote to spend those dollars. But the public officials are not on the hook. If their decisions relative to financing mechanisms result in a loss in revenue, that doesn't impact them, it impacts the taxpayers. It's the taxpayers that assume all the risk, not the elected public officials.

So we've got to make laws recognizing that. And I can tell you from my experience, especially with school districts and some municipal authorities, they don't really look at -- they are not really that focused on what is in the long-term public interest.

Believe it or not, where I come from, some public officials make decisions based on who got me tickets to the Super Bowl. Some public officials don't exercise their public responsibility to make sure that all the fees are disclosed and that we know how much people are being paid because that person is going to help provide the financing for my next reelection campaign. Those things really are real.

So we've got to seek to make sure that the tools for financing public debt that are made as an option to local elected officials are utilized properly in the long-term interest of the taxpayers. And that doesn't always happen. And I'm speaking from my personal experience as a legislature in my legislative district. I won't speak anywhere else. But I, frankly, at this point in time, don't trust a majority of my local elected officials to have the kind of options that Act 23 gives them right now. I'm fearful, to be honest with you.

It now occurs to me why one of my municipal authorities has been trying to ramrod a municipal agreement down the throat of adjacent municipalities quickly and talking about interest rates are favorable. They must be wanting to use swaps.

I'm telling you this is a -- I can

understand how this could be a legitimate financing tool with public officials that have a long-term public interest at heart, that make sure that they examine all of the options, that all the fees are thoroughly disclosed and everything is vetted. I could understand how this could be a tool that's valuable, but I could also understand how it could be a tool that could be utilized in a manner that does not further and protect the public interest. And that's the perspective from which we have to legislate.

Again, I've learned a lot today. I've also learned enough to know that I've got a lot more that I need to learn before we can make a decision. I think this is a subject that we've just gotten into and we've got a ways to go, I think, before we can figure out exactly where we need to go in terms of public policy on this matter.

But you-all have been helpful as has everybody else, and I appreciate you being here today and everybody's attention and hanging on past the lunch hour right now. But your suggestions and your comments are appreciated and I look forward to continuing the dialogue on this subject in the future.

With that, again, thank you all for being here. This concludes the public hearing on House Bill

1905 of the House Finance Committee.

(The hearing concluded at 1:00 p.m.)

I hereby certify that the proceedings and evidence are contained fully and accurately in the notes taken by me on the within proceedings and that this is a correct transcript of the same.

Kelsey J. Dugo
Notary Public