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Testimony of Kurt Phillips, PRSBA
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Good morning. My name is Kurt Phillips. I am the Director of Business Affairs for Cornwall-Lebanon School District, a public school district located in Lebanon County with approximately 4,700 pupils and an annual budget of approximately $60 million.

Thank you for the opportunity to present our viewpoints regarding the utilization of "Qualified Interest Rate Management Agreements" by public institutions and HB 1905 (Scavello), legislation which would ban school districts from entering into such agreements. While these financial instruments do merit a concerted fiscal review by the public entity engaging in the transaction, I believe the characterizations of these instruments to be exaggerated and in some cases unfounded.

My testimony will begin by reviewing my consideration of these instruments relative to the Auditor General's report and subsequently move into a discussion of my District's analysis of these products and its use of the instruments.

The characterization of the use of swaps as "gambling with public funds" or "betting on interest rate movements" is inaccurate if the instruments are understood and properly used. I would submit that such descriptions could be loosely applied to almost any financing activity including inactions by a public entity when conducting its financial affairs. I would also like to offer that the Auditor General's observation that these instruments are improperly subscribed to by "unsophisticated public officials", while consistent with the gambling observation included in the report, is generally demeaning and I believe off-base. Furthermore, one of the most difficult aspects of public entity officials is to not fall prey to deceptive marketing of any products or services, and interest rate management contracts would simply be one more item on the list of things that need to be fully understood prior to purchase or commitment.

Every public entity that either issues debt or invests funds is faced with recurring decisions regarding the cost or price of funds. Decisions about fixed versus variable rates and length of committed funds, whether borrowed or invested, must be considered at each of these junctures. Accordingly, if an "unsophisticated public official" is involved in any of these transactions, the entity could be placed at risk of loss of funds, loss of revenue, or an above-normal cost of purchased funds. Interest rate contracts may be used to displace some of this risk. I will explain this more thoroughly in a minute.

The Auditor General's report also pinpointed inappropriate fee and cost structures associated with interest rate contracts. I agree it is absolutely critical that this portion of the agreement be thoroughly understood. Nonetheless, this consideration is really no different than it would be for any other financial transaction that an entity enters into. All pertinent fees and costs, whether paid directly or netted through the transaction must be understood and analyzed by the paying institution.

Another critical component is the counterparty to the swap transaction. Again, this element is no different than the process that should be used by the public entity when entering into an agreement with a financial entity for routine banking services. Significant sums of money are dependent on the financial soundness of the financial institution(s) with which balances are held every day and it is critical that the entity is comfortable with such financial institutions. The review process used for these institutions should mimic the process used to evaluate the interest rate swap counterparty.

Let me now take a moment and explain to you how our District analyzed and ultimately utilized an interest rate management agreement. The type of agreement entered into by the District is called a "Constant Maturity Interest Rate Swap". In this transaction the District has agreed to swap the interest payment on approximately $16 million of bonds outstanding on the District's books. The $16 million of bonds is used only as a notional value and none of this amount is at risk for the District. In this District's swap agreement, it has agreed to pay a short-term interest rate, in this case 1 month London Interbank Offered Rate (LIBOR), and to receive from the counterparty a long-term interest rate, in this transaction, it is the 10 year LIBOR rate less 56.3 basis points. The logic to the transaction was (and remains) that the District has an average investable funds balance of approximately $14 million. Left naked, the return from these investable funds could be as high as $1 million in a given year and as low as $100,000 in another year. To this district that disparity is 2 ½ mills that are at risk in a given fiscal year. Due to the flow of funds in a school district, it is nearly impossible to alter the term of invested balances for the purpose of enhancing yield or return. Accordingly, the District has always been subject to a significant downturn or (equally disruptive) upturn in return from these funds. By entering into the swap transaction, the District has mitigated a significant portion of the risk of these interest rate movements, over which the District otherwise had no control.

Extensive education was performed with the Board at origination and is repeated on an annual basis as long as the swap remains on the District's books. The Board originally was provided with all of the information relative to how the swap works. Ongoing, the Board is updated monthly on the performance of the swap and the associated termination and market value. This information is also included in the monthly information that is distributed to the public. I informed the Board that if they were in any way uncomfortable they should not vote to enter into the transaction, and indeed a single Board member did not vote in favor for that very reason. It is also important for the Board to understand that it is not necessarily a bad thing if payments are made on the swap, as this would be the offset to an upward spike in short-term interest rates and therefore our interest earnings on invested balances have increased as an offset. In addition to this understanding, the District budgeted for and established an interest rate stabilization fund to minimize potential future negative performance of the swap.

In conclusion, there absolutely are risks associated with the interest rate management agreements. However, properly managed and understood, I believe that these transactions can provide an important financial option to public entities.

Thank you, again, for the opportunity to present our viewpoints. I am glad to answer any questions or address any comments the committee may have.

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