



**Testimony of Pennsylvania School Boards Association
Interest Rate Swaps
Presented to the Senate Finance Committee
Harrisburg, Pennsylvania
Wednesday, May 5, 2010
by
Dr. David Davare, Director of Research Services**

Good morning, Chairmen Browne and Ferlo and members of the Senate Finance Committee. My name is Dr. David Davare and I am the Director of Research Services at the Pennsylvania School Boards Association. I am by joined by Patrick Cusatis, Ph.D., CFA, the association's consultant on this issue.

PSBA is appreciative that you called this hearing to discuss school districts' use of interest rate swaps to manage their debt obligations and investment returns. We also 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 that some financial advisors may be less than independent and as a result school directors may not be receiving full disclosure of the risks and the straightforward information that they need to employ. Additionally, we are concerned that frequent monitoring of these agreements from impartial financial consultants seems to have been ignored to the detriment of school districts.

PSBA has worked to inform its membership base about this issue. It has published the three attached articles in October 2008. Additionally, we expect to undertake web-based trainings, an easy reader on questions that board members should ask on SWAPs, and provide other learning opportunities for our school board directors.

Although PSBA did not advocate for the statutory changes embodied in Act 23 of 2003, it would suggest a different approach than that of the General's recommendation of a complete ban on these transactions and immediate disentanglement. Our recommendations are based, in part, on a survey of our members, but also after having consulted with Dr. Cusatis to assist our association meet our school boards' need for a more thorough understanding of interest rate swaps and potential investment limitations. With regard to the former, we recently completed a survey of the districts listed by DCED as having filed documentation pertaining to SWAPs. We spoke with 61 of the 110

districts on the list. Only 37 had SWAPS, 24 filed the documentation, but did not complete the transaction. Currently, 23 districts are breaking even or making money on the SWAPS. Ten districts terminated the SWAPS with a positive gain, 3 reported a loss, one was unsure of the position.

We also inquired about their training. Where districts did receive additional training, 10 reported making or having made money, and one reported losing money. Where training was only by the financial advisor, 19 did or were making money and 4 are losing or lost money.

At this point, PSBA suggests the following general principles to ensure that school districts and their taxpayers receive adequate protections:

1. Disclosure:
 - a. All fees including spread fees must be disclosed in advance of execution of a swap document and disclosed in the swap document in dollars not merely in basis points or the present value of basis points.
 - b. All risks must be disclosed including best case and worst case scenarios, equivalent to the official statement in a bond issue to investors.
2. Cooling off period: Legislation must provide for a minimum 10 day cooling off period before the execution of a swap agreement by a school district.
3. Independence and monitoring: School districts entering into swap transaction should consult with an independent financial advisor and ensure that they retain an independent monitor/evaluator to conduct periodic evaluation of the swap over the length of the swap who must be separate from the swap provider.
4. Competitive selection: School districts should engage in a competitive selection process like other professional service contracts prior to entering into a swap agreement.
5. Disengagement of current agreements: No school district should be required to engage in immediate withdrawal or termination from current swap agreements, but should consult an independent financial agent or monitor to discuss agreement terms.

At this point, let me introduce our consultant who will discuss this issue in greater detail. Dr. Cusatis is an Assistant Professor of Finance at Penn State Harrisburg. Prior to joining Penn State, Dr. Cusatis was a Senior Vice President in charge of municipal derivatives and municipal remarketing at

Tucker-Anthony. He also was employed as Director at CoreStates Bank and First Union National Bank, where he managed an investment portfolio in excess of \$3 billion. Dr. Cusatis also specialized in municipal new product development at Lehman Brothers in New York.

Dr. Cusatis is the author of numerous articles published in books and academic journals such as the Journal of Financial Economics, the Journal of Futures Markets and the Journal of Applied Corporate Finance. His research has been highlighted extensively the financial press, including *The New York Times*, *The Wall Street Journal*, *Barron's*, *Fortune*, *Forbes*, *CNN*, *CNBC* and *Business Week*. He also co-authored two books on common stock valuation and two books on derivative securities. We would be happy to entertain your questions after a review of Dr. Cusatis' PowerPoint presentation.