

BOARD FINANCE COMMITTEE MEETING MINUTES

OCTOBER 13, 2008

Members of the Board Finance Committee met on Monday, October 6, 2008, in the Dining Room of the Education Center, at 1516 Sycamore Street, Bethlehem, PA. Mr. McKeon, Chairperson, called the meeting to order at 6:30 p.m. The following school board members were present: Mrs. Michele Cann, Mrs. Judith Dexter, Mrs. Irene Follweiler, Mrs. Loretta Leeson, Mrs. Charlene Koch, Mr. Rosario Amato, Dr. Craig Haytmanek, and Mr. Benjamin Tenaglia. Also in attendance were Dr. Joseph A. Lewis, superintendent of schools; Mr. Stanley J. Majewski, Jr., assistant to the superintendent for finance and administration; Attorney Kevin Reid; Mr. Scott Shearer from Public Financial Management (PFM); Mr. Steve Goldfield from Public Resource Advisory Group, (PRAG), members of the press and other interested citizens.

Mr. McKeon called the meeting to order at 7:00 p.m.

COURTESY OF THE FLOOR – None

Mr. McKeon turned the meeting over to the consultants, Mr. Scott Shearer and Mr. Steve Goldfield.

Mr. Shearer presented a 16 page handout which gave an overview of the district's Swaps and Bonds.

Mr. Goldfield stated that he received questions from the board and would address them in conjunction with Mr. Shearer's presentation.

He explained the differences between Fixed Rate Bonds and Variable Rate or Floating Rate Bonds. With Fixed Rate Bonds, the day that you price them you fix your coupon, your costs; it does not change for the next twenty years you know exactly what your payment is. That market is its own market. It was a very traditional market for school districts.

Having some short term or floating rate debt is not a bad idea. The cost of floating rate debt is cheaper. There is risk with this type of debt because of interest rate risk. Every week there is a seven day floater. Every Wednesday it is reset. When the market is good it means a low interest rate. The district went several years with low interest. One of the risks is that the rate floats up.

Mr. Shearer went on to review the handout regarding the district's bond issues.

Mrs. Leeson asked what a PE percentage and what AR percentage meant.

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Mr. Shearer stated that PE stands for Project Eligibility. This is set when the district goes through the PlanCon Process. AR stands for Aid Ratio. When you multiply the PE percentage and the Aid Ratio you get the state's share reimbursements. Any issue that has a PE percentage gets reimbursement from the state. It changes each year as your Aid Ratio changes each year.

He went on to say, as of now; the total amount of bonds outstanding is roughly \$280,000,000 of principle that is due. Of the \$280,000,000, approximately \$222,000,000 is variable. The majority of the school district's underlying debt is in a variable rate mode. The problem now is the fact that SFMA is much higher than anticipated and the credit issue with FSA, the insurance company that insures the bonds.

Mr. Goldfield explained why this happened to the district, and if it could be worse. He explained that it happened to a lot of municipalities sooner. We have credit markets that are completely dislocated right now. Once the AAA is lost the value of it goes away, and the spread goes up, and costs money. RBC was trying to remarket the bonds but could no longer find buyers at certain rates. They have now put all the bonds back to Dexia. Once they do become bank bonds, rates change, and after a certain point in time, the repayment schedule may change as well.

He stated that they are trying to get detail on some of the repayment schedules. If we would have to repay all of the debt in five years or seven years. That becomes very important. When bonds become bank bonds they can go back to "normal" bonds if Dexia is able to find new buyers. When there are a lot of Bank Bonds the clock starts ticking.

Mrs. Leeson asked if the bank bonds were held for six months, could the payments be accelerated to have the district pay them off in five or seven years.

Mr. Shearer replied that she is correct.

Mrs. Cann asked what made the bonds go to Bank Bonds.

Mr. Goldfield explained RBC was out trying to find investors to buy the paper and was not successful. If the big money market mutual funds that make a market in this, say they do not want FSA/Dexia insured liquidity, and no one will take it, you then have to look for crossover buyers which are people who usually buy taxable bonds. The big question is whether this is a temporary situation.

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Mr. Shearer recapped the presentation for the committee. He stated that the district has seven Bond Issues outstanding. Four are in the Variable Rate mode where the rates are resetting each week. The problem is SIFMA is much higher than anticipated so the debt service is much higher.

The second part of the presentation deals with the district's Swaps. Swaps became prevalent in 2003.

Mrs. Follweiler asked if the intention of the Swaps was to make monies to even out the payments. If the Swap made additional funds, we had additional funds, and we could still pay our bill.

Mr. Shearer replied that he believed it was the intention to lock in a lower fixed rate then could have been done with a traditional bond issue.

Mr. Goldfield stated if the district made a little more one month they would keep it aside if the next month it went the other way. The district could use it at the end of the year.

Mr. Shearer said the main problem is that SIFMA has gone up very high from 2 percent to 8 percent. LIBOR has only gone up 4 percent. There is a major mismatch going on right now.

Mrs. Follweiler asked what is driving LIBOR up.

Mr. Shearer responded that LIBOR is the rate that the banks, worldwide, lend each other overnight. With everything going on in the market, the credit crunch, banks going under, there is no trust between the banks. The overnight lending rate should be around 2 percent right now, due to all the distrusts with all banks, it is increasing the rate. We are hoping that it will come down.

Mr. Goldfield stated what we really need is to have SIFMA come down. LIBOR has gone up a lot because it is the inner bank borrowing rate and the banks in Europe were not loaning to each other.

Mr. Shearer stated if LIBOR comes down it will make this problem worse.

Mrs. Cann questioned the difference in Variable Rate Bonds and Fixed Rate Bonds.

Mr. Goldfield explained that there are risks with both.

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Mrs. Leeson stated that she appreciates the background presented by the consultants.

Dr. Haytmanek stated that he agrees with Mrs. Leeson, he now has a better understanding of the Swaps.

Mr. Shearer focused on the short term options the board has related to the three Constant Maturity Swaps which total approximately \$150,000,000. Due to the volatility that is happening in the market these Swaps are costing the district between \$200,000 and \$250,000 per week if the conditions stay as they are. One choice would be to suspend the contract. There would be no more contracts and it would help stop some of the losses. If all three of the Constant Maturity Swaps are suspended for one year, the district would actually receive some amount of money. If they were completely terminated the district would owe money.

Mr. Amato asked if we suspended the contracts, would the district have to go back to them.

Mr. Shearer responded that if market rebounds the district could terminate the contracts, and either break even, or get out of it for good. Or, let the year go, and once the year ends everything would be as it is today. This stops the bleeding now, but gives flexibility for the future.

Mrs. Koch stated that this seems like a very easy, too good to be true, way of getting out of something. She asked is there not going to be somebody out there who will be very angry at us for doing that.

Mr. Goldfield stated that he would like to lay out the short term options, as well as long term options, and then discuss the risks involved with each.

Mr. Shearer stated that the district has \$222,000,000 of Fixed Payer Swaps. If the market stays as it is it could keep costing the district \$500,000 per month. Relating to the 2003 Notes, the district could amend these swaps to help reduce the mismatch by converting from Libor to SIFMA. This would reduce the mismatch by approximately \$200,000 per month or by half.

Another short term solution would be to change the Re-marketing Agent. This could be done relatively quickly.

Discussion followed regarding Re-Marketing Agents.

Mrs. Dexter asked Mr. Goldfield to outline the pros and cons of changing Re-Marketing Agents. Why would we want to, how would the district benefit.

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She also asked him to make a firm recommendation of what he thought rather than laying out a number of different options.

Mr. Goldfield replied that the pros and cons of changing Re-Marketing Agents change. In this market it would not be worth it. Until the market comes back up, it would not be worth it. If the board decides to keep one or more of the Swaps out in a floating rate, it would be good to look into changing.

He stated that they were not prepared to give a recommendation at this time. They will be ready when they have all of the numbers figured out and the lowest cost to the district.

Mr. Goldfield stated that he would like to see the district get out of the CMS trades. One of the recommendations will be to get out of some of the Swaps and head toward Fixed-Rate. If the board could afford it, the suggestion will be that one, two, three, or all four of the deals get converted to a Fixed-Rate when the time is right. This would get rid of some of the risks.

Mr. Shearer suggested investing in its own bonds, which would offset the high rates we are paying. There are a lot of legal requirements to be worked out. It is another short-term solution.

Discussion ensued on buying the district's own bonds.

Mrs. Dexter asked what the down side is of suspending the Constant Maturity Swaps for a year.

Mr. Shearer responded that the biggest downside is that the district would not be eliminating any of the risks.

Mrs. Dexter asked if the district were to suspend for one year, how tied is the district into that one year mark. If it becomes favorable to the district to lift the suspension in ten months could we do that, or if we prefer to extend the year to fifteen months could we do that.

Mr. Shearer replied that the contracts could always be amended. If you do the suspensions, they have to be watched daily. It is one of the quickest ways, and could be done in a couple of weeks. They would still need to be tracked very closely.

Mrs. Dexter stated that the district paid a fee when the bonds were being remarketed, when the bonds become bank bonds, are there fees associated with the bonds being held by the bank.

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Mr. Shearer stated that Dexia would want there to be. The district would need to get their permission to stop paying the remarketing agent. They do not want them to become bank bonds they want them remarketed back out.

Mr. Tenaglia asked why we would continue to pay the Remarketing Agent if they are not remarking our bonds.

Mr. Shearer responded that we would have to have a Standby Bond Purchase Agreement and the Remarketing Agent Agreement state that if bonds become bank bonds then the Remarketing Agent would not receive their fee for those bonds.

Mr. McKeon adjourned the meeting for a five minute recess...

The meeting reconvened.

Mr. Goldfield discussed Fixed Rate Bonds. One of the things to do in order to get rid of the risks is to Fix-Out your bonds. Floating Rate Bonds allow you 30 days notice to prepay them with no premium. With the district's existing structure, we can issue uninsured Fixed Rate Bonds. No one is buying Municipal Bond Insurance because there is no value in the Fixed Rate Market or the Floating Rate Market.

Another option would be for the district to obtain a Letter of Credit when credit becomes available again. Both consulting firms have solicited for Liquidity and for Letters of Credit.

One of Mr. Goldfield's clients got a Letter of Credit on an insured VRDB with a Swap, exactly what the district has. It started trading right at SIFMA. If you get a good named bank that is welcomed, the funds are dying for that kind of paper. They are trading up to 2 or 2.5 percent below SIFMA. The 4.7 percent could convert down to 2.2 percent.

Under this scenario the Swaps would stay in place and we would still have the Basis Risk. There would still be the Counter Party Risk. The Basis Risk being what if 68 percent of LIBOR does not mimic SIFMA. What if it does not come back, do we want to be in that position. The Fixed Rate eliminates the interest rate risk. With a Letter of Credit the Basis Risk improves. You do not have the FSA/Dexia spread.

Mr. Goldfield stated that the concepts presented are good concepts; however, they can not make a recommendation tonight due to the fact that they do not know what it will look like over the long term or the short term to the Basis point or penny.

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Until they run the actual numbers side by side they can not tell you which is better. They will not recommend one or the other tonight.

Mr. Goldfield went on to discuss, and illustrate comparing long term solutions. He presented a graph showing the millage required for each suggested option.

Mrs. Cann asked if the district could borrow Fixed Rate, is that available.

Mr. Goldfield responded not now, but some day soon, yes. It can not be that municipalities are not going to be able to borrow tax-exempt Fixed Rate Bonds again. It is an unbelievable situation now. No one can tell when it will be fixed. He recommends getting the pieces ready for when the market opens up. The district still has Bank Bonds. The suspension and the conversion can help. It looks like the district will have more each week for now.

Mrs. Leeson asked if the best bet would be to buy back some of the district's Bank Bonds.

Mr. Goldfield replied that in a month or two the district may know more about where FSA is going. If FSA/Dexia does not have the ability to come back the district will have to execute one of the other options.

Short term, if the district has \$20,000,000/\$30,000,000, and it can buy another school district or the districts own bonds and get 7.5 percent it would be good. In the long run either FSA/Dexia will be on the upswing or there will be a continuation of what is going on right now. There are not money market mutual funds that have the desire to own any and will continue to tender and tend and just have all Bank Bonds.

Mrs. Leeson asked if Bank Bonds is the lowest interest rate right now.

Mr. Goldfield replied that they are. It should only be viewed as a six month grace period, and the district will either get out because the market will correct itself, or the district must pursue some of the other long term strategies.

Mrs. Dexter asked what the next step should be.

Mr. Goldfield stated that we should be in the dialogue phase. The board should tell the consultants what options they feel are right for the district. After that, the district needs to start getting ready, presuming there are enough board members that want to do at least one Fixed Rate deal, and want to put out to bid Remarketing Agent and Underwriter RFP's and RFQ's.

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Mrs. Dexter asked if Mr. Shearer agrees with Mr. Goldfield.

Mr. Shearer replied that the board should be working on the short term solutions, and at the same time, working on the long term solutions. Hopefully, the long-term solutions may never need to come to fruition, if everything settles down. For some of the long-term solutions the district should start getting the Official Statement in working order, get things to the credit rating agency to have them do some preliminary work; draft parameter resolutions ready to go for Bond Issues, get resolutions ready for some of the short-term solutions; like suspending the CMS's. There is a lot of work that needs to get done moving both the long-term and short-term plans together.

Mrs. Dexter asked if the consultants have talked with the administration about these plans.

Mr. Goldfield replied that they had not discussed tonight's presentation with the administration because they have not compared notes with each other as they were working up until the last minute.

Mrs. Dexter stated that each consultant is giving information. She would like to know if either of the consultants disagrees with what the other has presented tonight. Either the explanation, or factual information, or recommendations, or what options the board should consider.

Mr. Shearer replied that he does not disagree.

Mr. Goldfield replied that they are both in agreement.

Mrs. Dexter asked if the administration has questions.

Mr. Majewski stated that he did not have questions and was in agreement with what was presented. There is too much dysfunction at this time. Things must be watched closely so that when the time is right the district can act.

Dr. Lewis concurred with Mr. Majewski. He stated that both of the consultants have done a good job explaining what the district's options are. He feels that we have to be able to act. We need to make decisions on how to approach financial advisement and start a more intimate partnership. He feels there should be more discussions on the options.

Mr. Majewski stated he agrees. We need to continue monitoring and looking at the options. Something needs to be on board with the district so if there is an opportunity to be able to unwind something, all or portions, whatever it may be, can happen quickly.

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In the last couple of years we have been monitoring the opportunities to terminate Swaps. By the time it was brought to the board the opportunities disappeared. Knowing that the market is so volatile the opportunities may not last for very long.

We need to be in a position that we know our strategy; what our trigger points are going to be so that we may respond quickly since there is no guarantee that what is here today will be here next week.

Dr. Lewis added that Mr. Majewski provided information, at Mr. Tenaglia request, that shows what our schedule of interest rates are. There is a sizable amount of money. Investing in some of our own money makes a lot of sense. He is also interested in looking into the Constant Maturity Swaps in terms of "stopping the bleeding." Is there a tolerance level that the board wants the administration to move on that? He agrees with Mr. Majewski that we need to have a Financial Advisor in position to make these kinds of moves.

Mr. Majewski stated that he was not convinced on how he feels about suspending some of the Swaps. He would like to take a look at some of the factors used to make those amounts right now. No doubt they will be subject to change, and may be something we should continue to monitor.

Dr. Lewis stated he would like to see additional models. He would like to see how the \$225,000 figure was arrived at.

Much discussion followed on the amounts projected and how they were determined.

Mr. Goldfield stated both firms will give the board more guidelines and details. The presentation given tonight was just an overview. What are the trigger points? At what value to the district does it make sense?

Mr. Shearer stated that it is very important to have the parameter resolutions adopted by the board, saying the board authorizes the team to do \$50,000,000 of the CMS Suspension, assuming these levels are hit. All we need is the board president or the finance chairperson, and the business office on the phone to get it done. Sometimes as little as half an hour is all the time you get. These things move very quickly.

Mrs. Dexter feels we should not be going around discussing what risks, what priorities we should have, or whether we need to take some time to digest what we have heard tonight and get back together again to discuss it. She does not know what the next step is to get to the point where we can draw up a resolution to authorize the consultants to do anything.

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Right now, we do not know which one of us, or both of you, or how that would work. She stated that there are people in the audience who would like to ask questions or make comments.

Mrs. Leeson stated that there are people in the audience who also have financial expertise. Perhaps a task force should be set up. Sometimes digesting the whole thing will take more time. She suggests using some of the expertise from within the community members who are willing to help us.

Dr. Haytmanek stated that both of the consultants did an excellent job. He asked if it is the board's choice to decide if they want both firms or just one firm.

Dr. Shearer stated that it is the board's choice.

Mr. Goldfield commented if the board wants both of the firms to continue as co-financial advisors, it works. If the board desires to choose between the firms, both firms are more than capable of undertaking this engagement. They were asked to work as a team, which they did.

Mrs. Koch responded to Mrs. Leeson's idea of setting up a Task Force. In this instance we have more of a need to come up with ideas and take some action a little faster than Task Forces have.

Mrs. Leeson stated that she thinks it would be faster, as the citizens from the community have a better level of understanding.

Mr. Majewski stated as we are putting together a team it should include members who have an understanding of the legal ramifications involved.

Mrs. Dexter stated she is in favor of a Task Force. It would be another source of information. She would like to hear from the gentlemen in the audience. She asked if the committee has an executive session could the audience participate.

Mr. Amato stated we have been sitting here for four hours and listening to experts tonight. Why in the world would we want a Task Force? This is not the time to get the community involved. We need someone who can get us out of this situation.

Much discussion followed regarding the establishment of a Task Force.

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COURTESY OF THE FLOOR – Albert Gerra 2702 Parkland Drive. Stated he reviewed the two packs from the consultants and suggested the board review them carefully and pick one. One firm should be able to do the job. Just pick which the board thinks is best. The community will listen to common sense.

A lot of what was presented tonight is very complicated. The community would understand paying off the bonds early. Do not dismiss the bank bond idea. He believes we will get through all this.

Dr. Lewis stated that he is not so sure about the bank bonds. He would like assurance that we could take \$20,000,000 and buy our own bonds.

Mr. Amato commented that we all have opinions. He has listened to three experts tonight. It is all someone's opinion on which direction to go based on their experience in the field. We need to give it to someone who will work on it day in and day out and make sure when the time is right they act on it and get us in the right direction. Getting a Task Force would be insane.

Mr. Gerra stated that he thought it was \$10,000 well spent.

Much discussion on whether to buy back bonds followed.

Mr. Tenaglia stated that he would not advise buying back the bonds.

Mr. Majewski stated that this has never been done before in Pennsylvania. Do we want to be a test case and find out it was a mistake.

Mr. Shearer stated that this would be a short-term solution.

Mr. McKeon asked Mr. Kevin Reid from the solicitor's office to address the board.

Attorney Reid stated that there are three levels of the legal analysis we need to go through. He could not address these at this point in time, but stated that those are the layers needed to be investigated by the board. These are all things that need to be explored on the legal side before you can have a legal answer. Part of the answer might be that the guidance is unclear.

Mr. Gerra stated there is a Pennsylvania Intercept Program for school districts in trouble, State Intercept. They pay your bonds for you and take the money out of the state contribution given each year for your budget.

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Mr. Goldfield stated that there is a State Intercept Program. He believes there are other strategies to be used to avoid defaulting on the bonds. Once you do that you would lose access to the capital markets for quite some time. That is the last thing the district needs right now.

Discussion followed regarding which firm would be best to hire.

Mrs. Leeson asked for more background on both firms proposals.

Mr. Shearer reviewed his firm's proposal with the committee. He stated that it is the firm's standard contract for Financial Advisory Services. He also reviewed the proposal for a Swap Advisor. To do a CMS Swap Suspension or a restructuring of an existing Swap would cost approximately \$11,200. To terminate one of the Swaps, based on a competitive process, it is \$12,500, plus a quarter of a basis point. For termination of a negotiated Swap, it would be \$10,000, plus a quarter of a basis point.

Mrs. Leeson asked if this was per annum.

Mr. Shearer responded that it is a one-time fee paid at the termination of the transaction. All the Swap fees are a one-time fee; for putting on a Swap, for taking off a Swap, or restructuring a Swap they are one-time fees. The only on going fee is, if the district wants, evaluation and reporting on an annual basis, the cost would be \$10,000 per year for monitoring.

Discussion followed with regard to the district's need for the evaluating and monitoring portions of the contract.

Mrs. Dexter asked if there was a conflict of interest since Mr. Goldfield had been Bond Counsel in 2003, and now might be the Financial Advisor.

Mr. Goldfield responded the role that he played in the 2003 transactions was drafting of legal documents, resolutions, and proceedings.

Mr. Goldfield reviewed his firm's proposal with the committee. PRAG does not do a lot of school district work. The proposal is pretty straight forward. We are charging an hourly rate for the work we are doing. He has spoken with Steve Eiser, the head of PRAG's Derivative Practice, and the President of the firm. Mr. Eiser has agreed to give a discount of his hourly rate. Mr. Goldfield would do the majority of the work.

Mrs. Leeson asked if all work is to be done on an hourly basis with a \$2,500 retainer fee, would hourly rates be charged against the \$2,500.

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Mr. Goldfield replied yes.

Mrs. Follweiler asked if we hired either of the firms, would there be definitive advice.

Mr. Shearer responded yes.

Mr. Goldfield stated that there are pros and cons to each option. If he was pressed he would give a definitive answer.

Mrs. Dexter asked what he would do if he were the district right now.

Mr. Goldfield stated that right now he would get a Bond Counsel and start moving forward on the Fixed Rate and the Floating Rate Professional RFQ processes. Get people on board and get trigger points laid out.

Mr. Shearer stated a key role is getting Bond Counsel involved in the conversations. There are lots of legal questions. He feels that is a very important step.

Mr. McKeon adjourned the meeting at 11:05 p.m.

Minutes prepared by:

Confidential Secretary to the Assistant to the Superintendent for Finance and Administration