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School Bond Credit Enhancement Program Q & A on the Guaranty Fee

What is the guaranty?

Thru the “Credit Enhancement Program”, the Public School Endowment Fund pledges to loan the State Treasurer funds to make payments on a bond issue if a district or the Treasurer is unable to, ensuring the bond does not default. The endowment guaranty is only used if the Treasurer’s intercept of State payments to the district are insufficient and the State does not have sales tax funds available to make the payment. The State’s pledge results in an “AA” bond rating while the endowment’s “Credit Enhancement” boosts the rating one more notch to “AAA”.

How much is the guaranty fee?

2 basis points (0.0002 or 0.02%) times the “total debt service” of a bond (original principal plus expected interest). For example, a \$20 million bond with a 15-year term would have a fee of \$6,000 (\$20 million of principal plus \$10 million of interest paid times 0.02%).

How much does the “Credit Enhancement” guaranty save school districts?

Improving a bond’s rating to “AAA” from “AA” reduces its interest rate (and ultimately reduces property taxes). The lower interest rate results in up-front savings of 20-50 basis points of debt service or \$60,000-\$150,000 for a \$20 million, 15-year bond.

Why is there a fee? Why not provide the service for free?

The trustees overseeing the Public School Endowment Fund (the Endowment Fund Investment Board and the Land Board) have a strict, legal, fiduciary obligation to the beneficiaries of the Fund to ensure the Fund has the highest return at an appropriate level of risk. The trustees are prohibited from considering factors other than the benefit to the fund when considering a guaranty. This means that no guaranty can be made unless the trustees believe it is in the best interest of the fund to do so.

The 0.02% guaranty fee compensates the Public School Endowment Fund for risk of loss of capital and for investment restrictions. It also provides a fair way to share the benefit of the guaranty with all beneficiaries of the Fund.

The Fund's guaranty to provide back-stop liquidity to make bond payments is a contingent claim against the Fund. Providers of guaranties (e.g. banks) almost always charge a fee for pledging availability of future borrowing capacity. The trustees of the Fund must take the level of guaranties into account in setting asset mix and determining the level of liquidity to hold in the fund. The higher the level of guaranties, the more cash, or cash-like instruments that must be held and these have a lower long-term expected return than other potential investments.

Who sets the fee?

The fee is set by the Endowment Fund Investment Board as part of the state's Administrative Rules process. The legislature has the authority to disapprove any Administrative Rule.

Where does the money from the fee go?

The fee is deposited in the Public School Endowment Fund (Earnings Reserve section), from which distributions to beneficiaries (Public Schools) are made based on an annual amount set by the Land Board and allocated according to a formula established by the Board of Education. Therefore, all beneficiaries in the fund eventually benefit from the guaranty fees.

Why was 2 basis points chosen as the fee?

In setting the fee for the investment in the guaranty, both the cost to the Fund and market rates for similar guaranties were considered.

Until 2008, there were insurance companies who would take on the risk of guaranteeing a school bond for a fee. The lowest historical rate we are aware of to boost an AA rating to AAA was 10 basis points. However, in today's economic environment, no firms are offering a cost-effective guaranty.

In examining the actual cost of the guaranty to the Public School Endowment Fund, Investment Board staff recommended a fee less than 10 basis points for two reasons:

- After consulting with the State Department of Education, the State Treasurer and school district financial experts, staff concluded that the risk of permanent loss of any funds loaned to districts is low, since the districts can levy taxes to repay the loan.
- Having the school bond guaranty in place does limit the Fund's ability to take on some attractive investments, especially investments in other guaranties, but the current negative impact is small.