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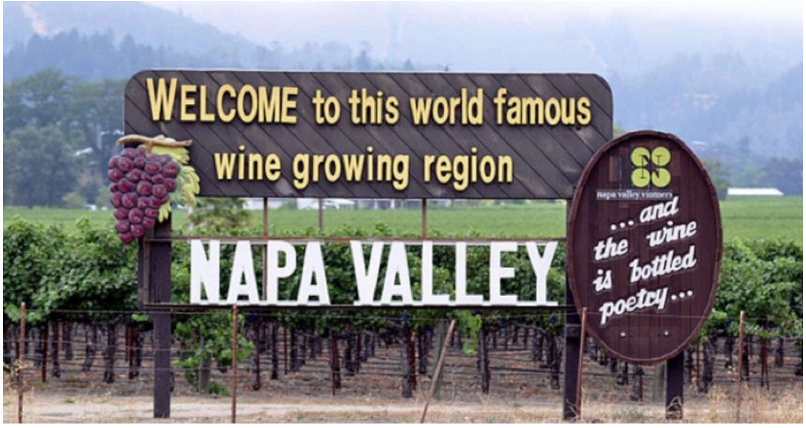
Capital Appreciation Bonds: Delaying the Inevitable



An action that California's Napa Valley Unified School District took in 2009 is just now getting exposure, and at least one board member said that if it had been a private deal (not a taxpayer-backed one), he would be running for cover. Jose Hurtado, a NVUSD board member, said he stands by the deal he voted for — to borrow $29 million and put off paying it back until 2049 — but if it were a traditional mortgage, he "would run" away from it.

Back in 2006, the board made promises it couldn't keep, and when it ran out of money it found a "workaround" to push the problem into the future. It promised taxpayers a new high school in 2006, and it authorized $183 million to build it. But the Great Recession shrank tax revenues to the point where the school couldn't be completed without more borrowing. However, the board also promised taxpayers that it wouldn't raise tax assessments above the current $36 per $100,000 of assessed valuations.

Enter KNN Public Finance, which, in return for a small fee — $156,000 to be exact — introduced the board members to a new concept: capital appreciation bonds (CAB). By recommending that the board issue CABs to complete the high school, payments on the new debt wouldn't start until the year 2049. Voila! Problem solved: new high school, no new taxes to pay for it.

The trick to CABs is something called compound interest. Since no payments are needed for 40 years, the principal owed accrues interest which, over time, accrues additional interest on itself. It is sometimes called a "zero coupon bond" or a "payday loan" or a "balloon payment" loan. Others refer to CABs as "surprise" loans in that the amount due can be many times the size of the original loan. In the Napa Valley case, it's $182 million, or more than six times the original loan amount.

Taxpayers in Alvord Unified School District in Riverside, California, also wanted a new high school and were delighted to learn that they could have one without paying for it, using CABs. Herb Calderon, assistant superintendent for the district, said: "They wanted a beautiful high school and we gave them a beautiful high school [but] if they knew how much it cost, I'm sure we'd get some flak." The school cost $110 million to build, but by the time the CABs come due, the real bill will approach half a billion dollars.

California Treasurer Bill Lockyer isn't at all happy about it. More than 400 school districts and other agencies have racked up $9 billion in CAB debt and, by his calculations, the total when the "surprise loans" come due will be $36 billion. It's easy for the school board members to be fooled, as the concept can be complicated to understand, sometimes deliberately so, but it's also dressed up as a solution to today's problem with the consequences so far in the future that no one on the board cares, or may even be alive, when the bill comes due. Said Lockyer in an interview,

> The average tenure of a school superintendent is about three and a half years, so they're aren't going to be around in most instances to worry about paying that off.

Nor will the voters, probably, who enacted it in the first place.

The irony is that it will be the children of the voters, attending the new schools, who will wind up paying for it, or defaulting on the debt used to pay for it.

Neither Napa nor Alvord has gone to the excesses that Poway United School District did in 2011 when it used CABs to borrow $105 million, which will balloon to $982 million when it's due, a payback rate of more than nine times the original loan. Not be outdone, the Santee School District borrowed a paltry $3.5 million, which will balloon to just under $60 million, or more than 16 times the original loan.

The lion was unleashed in 2009 when California passed AB 1388 eliminating the debt-ceiling requirement on long-term debt for school districts. The bill, proposed and promoted by the lenders lobbying group The California Public Securities Association, made CABs legal and invited the torrent of debt that followed.

There are so many assumptions built into CABs that their default is nearly certain. Estimates about future real estate valuations and the related tax revenues it would generate, assumptions about interest rates (some include inflation escalators), along with caps on real estate taxes per $100,000 of assessed valuations, all combine to make up a toxic brew that will likely explode long before the surprise loans come due.

The biggest surprises are likely to be felt by the bond holders who at present are persuaded that their loans are safe and, if they become unsafe, they'll be able to unload them onto unsuspecting souls unfamiliar with the deals. After all, the CABs were designed by some of the biggest banks and financial institutions in the country, including Piper Jaffray and Goldman Sachs.

Underlying all of these assumptions — some call them "straight line thinking in a curvilinear world" — is this one certainty: compound interest. When it is allowed to work for an investor, the power of compound interest can make him wealthy. But from the other side, it can, and likely will, spell disaster on a mammoth scale for those owing the money. As Albert Einstein once said, "Compound interest is the eighth wonder of the world. He who understands it earns it. He who doesn't, pays it."

Capital appreciation bonds are about to teach an important economic and political lesson: Borrowing is dangerous. It is especially dangerous when combined with economic ignorance and political expediency.

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