SUBJECT: Equalizing treatment of underwriting commissions on bond sales

COMMITTEE: Financial Institutions — favorable, without amendment

VOTE: 6 ayes — Solomons, Christian, Gutierrez, Flynn, Hopson, Paxton

0 nays

1 absent — Wise

SENATE VOTE: On final passage, April 8 — voice vote

WITNESSES: For — *(Registered, but did not testify):* Tom Oppenheim, Morgan Keegan; Lou Spiegel, Mansfield school District

Against — None

BACKGROUND: Government Code, ch. 1201, is the Public Security Procedures Act. It governs the issuance of bonds, certificates, and notes by subdivisions of state government, such as school districts and cities. The 76th Legislature in 1999 enacted SB 1091 by Duncan, amending Government Code, sec. 45.001 to specify that school districts may sell bonds either through a competitive sale (publicly), or through a negotiated sale (privately).

DIGEST: SB 876 would add Section 1201.029 to the Government Code to specify that a premium above the principal amount in a public or private bond issuance would not be considered proceeds from the bond, for purposes of determining whether the bonds issued exceeded the limit approved by voters, if the premium was used to pay the underwriter's commission.

The bill would take effect September 1, 2003, and would apply to bonds approved by voters before the effective date if issued on or after the effective date of the bill.

SUPPORTERS SAY: SB 876 would make it easier for school districts and bond issuers to choose the bond-selling method most favorable to their taxpayers, regardless of whether the underwriter's commission was paid up front or over time through higher interest rates.

In a competitive bid, the issuer announces the amount and structure of the bond issuance, and companies bid on underwriting the bonds. The company with the lowest interest rate wins the bid, but firms inflate the interest rate on at least part of the bond offering to make a profit from the transaction. The issuer then receives 100 percent of the amount issued, yet voters pay the firm's commission over the life of the bonds through the higher interest rate.

In a negotiated transaction, the issuer publishes a request for proposal to select an underwriter based, among other things, on the firm's experience and expertise and the issuer's needs. The issuer and the chosen company then negotiate an interest rate for the bond issuance, and the underwriter's commission is treated more like a line-item within the overall bond issuance. Instead of being spread over the life of the bonds, the commission is paid up front on negotiated bonds.

The attorney general (AG) has established that the underwriter's commission counts against the voter-approved limit for negotiated bonds, but not for competitive sales. For example, if a school district issued $200 million in bonds for a project, it might pay $1 million to an underwriter in a negotiated sale, leaving $199 million for the project, meaning that the project would not have the full amount of funds voters approved for it. If the bonds were sold competitively, the issuer would not have to pay the underwriter $1 million, but voters might end up paying more than $1 million in higher interest rates for 30 years. However, under the law, these interest rates would not be considered in determining whether the bond issuance exceeded voter-approved limits.

The result is that bond issuers currently have the incentive to use competitive rather than negotiated transactions in order to receive the full amount that voters approved for the project in question. In today's market, however, it usually is more favorable to issue negotiated bonds. The Texas Bond Review Board's 2002 Annual Report states that the average premium on negotiated bonds was $5.56 per $1,000 compared to $8.09 per $1,000 for competitively bid bonds. The AG's interpretation of current law thus actually encourages bond issuers to choose a route that is more expensive to taxpayers, simply because it does not account for the commission as an up-front cost.

A year from now, competitively bid bonds might be more favorable to bond issuers than negotiated bonds. Regardless, from a policy perspective, it would be better to level the playing field between the two types of bond issuances so that issuers could use the type of sale best suited to the project and the voters without worrying about how the payment to the bond underwriter would appear. SB 876 would clarify the statute to do just that. The bill also might help bond issuers reduce the cost of debt to voters through lowering underwriting commissions and interest rates.

Some suggest that the costs of bond issuance, such as legal and financial fees, fees to rating agencies, and bond insurance, also should be excluded in determining whether the bonds exceeded voter-approved limits. However, issuers regularly recover these costs with interest earnings accumulated between the time bond sale proceeds are received by the issuer and the time the funds are needed to pay for the project.

OPPONENTS SAY:

This bill is a good start, but incomplete. It also should exclude the costs of bond issuance in determining whether the amount of a bond exceeded the amount approved by voters. Issuance costs reduce the amount of bond proceeds available for the voter-approved purpose and should be treated no differently than underwriter commissions.