FCMAT

FISCAL CRISIS & MANAGEMENT ASSISTANCE TEAM

Fiscal Alert

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Interfund Borrowing Using Bond Proceeds

This Fiscal Alert addresses the practice of interfund borrowing using voter-approved and restricted general obligation bond proceeds. This guidance is provided in response to questions from county offices and school districts throughout California, and was recently addressed by the California Debt and Investment Advisory Commission (CDIAC) in an article titled "California School Finance: The Practice of Borrowing from Bond Proceeds." What follows is a summation of the guidance provided by CDIAC. This Fiscal Alert should be considered as analysis and not legal advice.

Background

Borrowing from other funds to satisfy temporary shortfalls in operating cash is common among California school districts. Education Code Section 42603 allows the governing board of a school district to temporarily transfer monies held in a fund of the school district to pay obligations in another fund. The provision does not limit this authority to particular funds, and includes no specific exclusions for funds holding restricted dollars.

Traditionally, the purpose of interfund borrowing has been to finance temporary cash shortfalls that occur before property taxes are received. The most common reason for interfund borrowing is the disharmony between the timing of revenues and expenditures. With the receipt of property taxes occurring at two main intervals during the fiscal year, the use of interfund borrowing has allowed districts to mitigate the associated cash flow implications and meet current financial obligations, including expenses related to personnel. Moreover, following the Great Recession, state-apportionment deferrals greatly increased the need to use available cash in other funds to temporarily support the general fund.

Districts that have funds available often prefer to borrow internally rather than from a financial institution since the practice is generally faster and less costly. To accomplish this, a district must prepare an annual resolution for governing board approval before moving the cash between district funds.

School districts must use borrowed funds to pay off existing obligations and cannot appropriate the funds for other uses. Section 42603 limits districts from transferring between funds if the receiving account will not accumulate sufficient income in the current fiscal year to repay the borrowed funds. Generally, transferred funds must be repaid within the same fiscal year, or in the following fiscal year if borrowed within the last 120 days of the current fiscal year.

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Relevant Issues

The benefit of these borrowings may be overshadowed by the risks a district assumes when it transfers voter-approved and restricted general obligation bond proceeds to satisfy temporary shortfalls in operating funds. Any district seeking to use bond proceeds for temporary borrowing should carefully consider these risks.

1. Loss of Tax-Exempt Status for Bonds
   Bonds that have been issued as tax-exempt investments may lose the preferable tax status if the proceeds are not spent in accordance with U.S. Treasury regulations, which include restrictions on tax-exempt general obligation proceeds for short-term "working capital" purposes. A loss of tax-exempt status can affect both the price and marketability of the bonds, can have an adverse impact to investors who purchased bonds expecting to shelter their interest income from taxes, and may require an issuer to pay more for future tax-exempt borrowings.

2. Loss of Direct Subsidy
   In the case of Qualified School Construction Bonds (QSCBs) and Build America Bonds (BABs), interfund borrowing may result in the loss of the direct subsidy payments. The provisions governing the use of these proceeds require them to be used for a designated project, such as "construction, rehabilitation, or repair of a public school facility or for the acquisition of land on which such a facility is to be constructed." Loss of the subsidy can affect the underlying value and credit quality of the bonds and require the issuer to meet debt service obligations using other funds.

3. Legal Considerations
   The use of bond proceeds outside of their intended capital purpose may violate state law. School districts may issue general obligation bonds under the authority of Proposition 39, which requires that an issuer specify the purposes of general obligation bond proceeds and may not spend the proceeds "for any other purpose, including teacher and administrator salaries and other school operating expenses." Districts issuing bonds pursuant to Proposition 46 are required to use the proceeds for "real property and improvements." In both cases, using the funds as working capital, even temporarily, fails to fulfill these obligations. As well, Education Code Section 15100 establishes permitted purposes for proceeds including construction, repair, restoration, furnishment, and equipment. Section 15146 prohibits the use of proceeds for purposes other than those specified at the bond's issuance. Therefore, interfund borrowing involving a transfer of general obligation bond proceeds to funds with expenditures outside of the designated capital project for which the bonds were issued may violate these sections of the Education Code.

   While Education Code Section 42603 broadly allows for the temporary transfer of funds in any fund or account for payment of obligations, this section may be contradicted by the restrictions imposed by sections 15100 and 15146. Section 42603 may also be in conflict with the California Constitution, Article XIII A, if an interfund borrowing involves general obligation bond proceeds transferred to a general operating account that pays teacher and administrator salaries or other operating expenses. Based on principles of statutory construction, which include specific language that overrides potentially contradictory general language in the same or a different statute, the authority provided districts by Section 42603 to conduct interfund borrowing may be preempted and inapplicable to the extent that it conflicts with federal law or the California Constitution.

4. Disclosure Violations

   Federal regulations impose specific disclosure and anti-fraud requirements on certain municipal market participants. Failure to annually disclose operating information and audited financial statements violates Securities and Exchange Commission (SEC) Rule 15c2-12. Additionally, if a municipal entity does not disclose the full amount or effect of material information, such as a transfer of bond proceeds, in bond offering documents it may also constitute a material misrepresentation or omission. If the SEC deems these omissions to be a failure to disclose material facts, it may initiate an enforcement action against the district.

   Defending against such actions may cause substantial financial and organizational risk.

Apart from legal and regulatory requirements, interfund borrowing may hinder a district's access to the capital markets and the community's support of its educational and facility goals. In various ratings reports, the rating agencies cited significant or increased reliance on interfund borrowing as an indicator of the issuer's weakened financial position and used this fact, in part, to justify a ratings downgrade.

FCMAT also considers interfund borrowing when analyzing a district's fiscal condition since this may be an indicator of existing or emerging financial problems. Poorly timed transfers from bond funds can cause delays to projects funded by bond proceeds and may ultimately result in additional costs either from project financing or penalties for failing to meet project deadlines.

Borrowing from a bond fund may also erode the public's trust in the school district, and could affect the district's ability to seek voter approval for future issuances. Despite the temporary nature of the loan, the public may question the district's use of the proceeds and its ability to repay the loan fully and timely.

Districts have several alternatives that are preferable to borrowing from bond proceeds.

1. Tax Revenue Anticipation Note (TRAN)

   The most common method to mitigate a cash shortfall is a TRAN, a short-term note that may be issued by the district or the county board of supervisors, on its behalf, and secured by anticipated tax revenues to be collected in the same fiscal year. TRAN funds, typically held in a "proceeds" account, may be used for any purpose, including current expenses, capital expenditures, repayment of indebtedness, and investment.

2. The County Superintendent of Schools
   A district may borrow from the county superintendent of schools, with the approval of the county board of education. Funds are issued at the county office's discretion and are subject to availability. Funds must be repaid within the same fiscal year.
3. The County Treasurer
   School districts may also seek to borrow against future payments to carry out facilities repairs. To do so, the district must submit a resolution to the county board of supervisors requesting a loan. Following the board's approval, the county treasurer's office disburses the funds to the district. The amount disbursed is limited to 85% of what the district accrues in the current fiscal year.
   Districts may also address cash shortfalls by undertaking a constitutional advance of property tax revenues. The governing board of a school district may submit a resolution to the county treasurer requesting an advance on tax revenues. Repayment of the advance is made from tax revenues accruing to the district later in the fiscal year. The advance may not exceed 85% of the district's anticipated property tax revenues for the forthcoming fiscal year.

Conclusion

While recognizing that interfund borrowing can be useful for school districts to remedy cash flow shortfalls, borrowing from bond proceeds poses a substantial risk to issuers and districts alike. With other options available to mitigate a temporary cash shortage, districts should use alternative means to meet general obligations and avoid using bond proceeds for temporary borrowing.