

## **Questions Regarding the Journal/Sentinel Article from April 6, 2008 on School District Investments**

The Sunday, April 6, 2008, edition of the Milwaukee Journal/Sentinel Newspaper included an article regarding post retirement benefit funding in several school districts, including Whitefish Bay. Unfortunately, the article failed to provide a full context and explanation of the Whitefish Bay School District's efforts to plan for and fund post retirement benefits.

The Whitefish Bay School District has been a leader in recognizing its post retirement benefit liability and establishing funding strategies to avoid a future funding crisis. The post retirement trust referenced in the Journal/Sentinel article is one of two major funding strategies established by the Whitefish Bay Schools. The first trust, established in 2005, involves purchased life insurance policies on employee volunteers that generate revenue in the short term and will provide significant benefits to fund post retirement obligations in the long term. The second trust fund, discussed in the Journal/Sentinel article, involves AA rated, collateralized corporate debt involving some of the strongest companies in the world.

Both trusts are performing well and are generating revenue that already is reducing the school district's long term financial obligations for post retirement benefits. In fact, combined the trusts generated \$56,966 this past quarter. Further, as detailed below, the trusts involve conservative investments, comply with all state requirements for public fund investments and present very little risk to the public funds involved.

Predictably, when the economy improves so will the revenue generated by these investments. In the longer term, the post retirement benefit trusts will place the school district in an excellent position to meet its post retirement benefit obligations without heavy dependence on local property taxpayers or the state government.

Meanwhile, adjustments have been made to school district labor contracts to minimize future post retirement obligations. For example, the length of years of service necessary for employees to qualify for post retirement benefits has increased, and in some cases doubled. Consequently, those retirees who qualify will have spent most of their careers working in the Whitefish Bay School District.

Following are a number of questions related to the April 6<sup>th</sup> Journal/Sentinel article and clarifying responses to assist in understanding the investment picture related to the post retirement trust discussed in the newspaper article.

- 1. What is the investment vehicle the Whitefish Bay School District is using to partially fund post retirement benefits?**

*The district's trust is using two different vehicles to fund part of its post employment benefits.*

*In January 2005 the Trust, with voluntary employee consent, purchased life insurance policies on current employees who are entitled to receive the future benefits represented by the other post employment benefits (OPEB) liability. The Trust's investment in life insurance provides a long-term asset to match the long-term nature of the liability. The insurance premiums are paid by the Trust from funds deposited by the district and/or proceeds of the Trust Obligations. Note: these Trust Obligations issued to facilitate the funding of the Trust are not a direct debt obligation of the district.*

*In December 2006 the Trust issued additional debt obligations to purchase a fixed income collateralized debt obligation (CDO) of investment grade corporations. This investment provided locked interest rates: the district borrowed at the London Interbank Offering Rate (LIBOR) plus .18 and invested at LIBOR plus 1.00. The district also provided a moral obligation to maintain the trust valuation at or above 101%. The investment is a seven year note and is diversified among 140 investment grade companies. The investment portfolio is AA rated.*

**2. Has the Whitefish Bay School District been told that it needs to come up with \$3.8 million to avoid the risk of default of its investments?**

*No, it has not. The school district's indentured trustee (Wells Fargo) is required to notify the district anytime the collateralization falls below 101% and request re-collateralization. We have received a notice that the asset ratio is below that level. The asset/collateralization rate determines the trust debt interest rate -- if the collateralization drops, the trust debt interest rate would increase. However, at no time would the interest rate be greater than the trust investment yield. The lender has not instructed the trustee to accelerate the debt (make debt due and payable in other words) as a result of this ratio change.*

**3. Is the school district generating revenue on the collateralized debt obligation investment?**

*Yes, the trust has been generating quarterly interest revenue. The quarterly surplus generated by a positive interest spread has been \$25,203 for the CDO investment only.*

**4. How big is the risk of default?**

*The investment is rated AA (which is the second highest rating) and, according to the collateral manager, the credit rating currently is the same or better than when we executed the transaction. The current portfolio also has a trading reserve of \$2,000,000.*

*Further, the district's total investment was \$10,000,000. This \$10,000,000 is split among 140 companies equally. The risk associated with this investment is that companies in our portfolio would default (bankruptcy). We only hold debt from investment grade companies which are the biggest and some of the strongest companies in the world. It is very unlikely that we will see default on the scale to cause loss in principal....that's why it carries an AA rating.*

**5. How does the risk of this investment compare to other investments school districts make?**

*It is important to note that these investments comply with the older more stringent Wisconsin statutory investment guidelines. The investment is AA rated, fixed income, seven year note.*

*The following are lawful investments for Wisconsin county, city, village, town, school district, drainage district, or technical colleges under the prudent State of Wisconsin guidelines. These options were available prior to the state modifications outlined in Act 99:*

- Commercial paper having a rating which is the highest or 2nd highest rating category assigned by a nationally recognized rating agency;
- Commercial paper insured by an insurer having a claims paying rating which is the highest or 2nd highest rating category assigned by a nationally recognized rating agency;
- A certificate of deposit that matures in not more than three years and is issued by a credit union, bank, savings bank, trust company, or savings and loan association which is authorized to transact business in the State of Wisconsin;
- A certificate of deposit that matures in not more than seven years and is insured by an insurer having a claims paying rating which is the highest or 2nd highest rating category assigned by a nationally recognized rating agency;
- A corporate bond that matures in not more than seven years and has a rating which is the highest or 2nd highest rating category assigned by a nationally recognized rating agency; and
- A corporate bond that matures in not more than seven years and is insured by an insurer having a claims paying rating which is the highest or 2nd highest rating category assigned by a nationally recognized rating agency.

*This investment compares favorably to all of our other investments. The investment is in a portfolio of corporate bonds with AA credit risk and is further secured through diversification among over one hundred investment grade corporations. We also use a collateral manager to manage the investment portfolio and reduce risk. The investment is structured so that the district receives protection even if several companies default.*

**6. If there is a significant default in the investment, will taxpayers be asked to replace the funds?**

*Trust Obligations were issued to facilitate the funding of the Trust. These obligations are not a direct obligation of the district. Under the moral obligation of the district the trustee would request that the board consider payment but have no legal authority to require such payment. However, a significant number of corporations would have to default before this would ever happen. Consequently, the probability of default is very small and there is no legal requirement for the school district and its taxpayers to replace the funds.*

**7. How solid are the companies included in the investment portfolio?**

*Again, the overall portfolio is rated AA. These are not small companies and they employ tens of thousands of employees. It would be extremely unusual to see multiple defaults.*

**8. How many companies would have to fail for the investment to be at risk?**

*The Royal Bank of Canada (RBC) who was the broker on the Corporate Bonds provided the district an updated estimate of our risk assessment. In order for the principal investment to become at risk more than eight corporate credit defaults would need to occur within our portfolio. The estimate used a projected recovery rate of 40%...we have not had any.*

**9. Are sub-prime mortgages involved in the investment?**

*The district does not have any direct exposure to sub-prime mortgages. We have purchased collateralized debt of investment grade companies. The portfolio carries an AA rating. The only exposure to sub-prime would be if we are holding a company's debt and they have sub-prime*

*exposure. It would not be unexpected to see the financial sector companies have some exposure to sub-prime although the majority of the big banks have already disclosed the write-downs of those securities.*

**10. The Journal/Sentinel article references talks underway with the bank involved in the investment. What is the nature of these talks and has there been an outcome?**

*I'm not familiar with the Journal/Sentinel's reference to "any talks underway." Our legal counsel has ongoing discussions with the bank's legal counsel regarding these transactions.*

**11. Will the investment pay the total amount promised if the corporate debt obligations are held to maturity in five years?**

*The answer is yes... they will. The Journal Sentinel failed to make this point clear. The investment matures after five years at par or the amount promised at purchase (we are two years into the seven year transaction). These investments are not like securities that vary with the market. The investment is in fixed rate corporate debt which matures at par. The risk we have is only associated with corporate credit default.*

**12. How much has the school district paid in fees to establish and maintain the investment?**

*Whitefish Bay Schools will have paid a total of \$111,500 over the period of the seven year investment for establishing and maintaining the investment. This figure includes the legal fees associated with the transaction.*

**13. What is the risk of doing nothing to manage OPEB liability?**

*In 2006 the Governmental Accounting Standard Board passed a rule that was aimed at making governments (schools) pay for various retirement benefits in the same way that pensions are funded. As a result of this rule, the school district is required to calculate and disclose the cost of promised non-pension retirement benefits – retirees' health care, for instance – and the money needed to pay them annually.*

*While the rule makes governments determine and report those numbers, it does not require the schools to budget money to pay for them. However, even if they do not, the accumulated underfunding must be reported as a liability on the balance sheet – something that could quickly wipe out all accounting reserves. The School District of Whitefish Bay has been very proactive in negotiating changes to reduce post employment collective bargaining benefits and generating revenue outside of the tax levy. Doing nothing to manage this liability would be irresponsible and cause the district to make reductions to educational programs in order to fund retiree benefits.*

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