Lease Purchase: The Gateway to Win Win Relations With Public Education

By Dennis R. Balodis, President, The Apris Group, Ltd.

The largest percentage of the municipal tax dollar funds public education. To the banking community, a school district represents excellent account opportunities. However, getting a foot in a district's door to gain and hold the business that a board of education offers is often elusive to classically trained commercial bankers. Learning how to respond to the tax-exempt lease purchase needs of a school district can be the gateway to establishing and maintaining a successful banking relationship.

It is astounding to what ends bankers go in their attempts to win the favor of school business officials in order to acquire their coveted account relationships. It is equally amazing that when a school district wants to borrow in the form of a tax-exempt lease purchase, many bankers haven't a clue. This says to the school business official that the bankers who have been calling for such a long time do not understand the basic finance needs of their district. This can effectively nullify the credibility that took so long to establish.

Lease purchase financing is ubiquitous in school districts. School buses, computers, software, textbooks, infrastructure wiring, telephone systems, copiers, or any equipment that is essential to the operation of a district can be (and, more often than not, is) financed through lease purchase. A typical school district is involved in two to five leases at any given time.

Local banks, unfamiliar with the competitive bidding process, normally may not even realize that a district in their service area is seeking financing. This has long been the purview of vendor-sponsored, captive-leasing programs. Sale oriented, these vendor programs make it convenient for the company making the sale of its equipment to control the transaction and aid in closing the sale for the vendor. While the school district does obtain the equipment it needs, this limiting transaction structure more often benefits the vendor and is detrimental to the district's efficacious use of tax dollars.

Opening the Gate

School districts are mandated to purchase goods, equipment, and projects through competitive bidding. Historically, the business administrator or purchasing agent added a line or two on to the bid for equipment requesting that the vendor provide a lease purchase proposal that would allow the district to pay for the equipment over time. While simple and straightforward, these proposals were only valid for the equipment that the vendor bid. The vendor then took on the role of lender for the school district. By linking the financing to the equipment purchase, the school district limited its choice of equipment suppliers to those with both fair prices and fair lease purchase rates. If a vendor bid a lower cost of equipment at a higher a rate of interest, it stood the chance of losing the bid.

Tax-exempt lease purchase financing for equipment is not regulated by the Municipal Securities Rulemaking Board (MSRB), SEC, or other oversight bodies. Rather, the market functions from the IRS Code, with limitations placed on it by the specific statutes of individual states. This type of environment is ripe for aggressive equipment vendors to join forces with equally aggressive brokers and financial institutions to develop truly creative vendor financing programs, to the detriment of the school district. Often these programs permit the vendor bidding the equipment to couple with a lessor who bought down or otherwise disguised the actual interest rate. The true rates in these transactions are often not even picked up by the district's auditors. The smaller, sale-oriented, vendor lease purchase depends on one type of equipment for its collateral value. The perceived lack of collateral balance, smaller transaction size, and additional costs incurred through local solicitor's review of each transaction drive up the net cost to the district. The convenience of financing through the vendor unfortunately results in the least efficient use of tax dollars. The purchasing power of the school tax dollar gets diverted to fees and interest payments rather than into the classroom, while simultaneously limiting the school business administrator's ability to effectively bid for the best cost of equipment.

Financial advisors working with school districts in New Jersey have helped the schools take control of the lease purchase by maximizing the competitive bidding process. The financial advisors and the district aggregate all of the potential lease purchases contemplated for an entire fiscal year. This is win number one: permitting the district to bid its equipment needs on a stand-alone basis. By bidding the equipment alone, the district has the ability to better select on the merits of the equipment and price, while eliminating the obfuscation caused when a vendor acts as a lender. Both the district and the vendor win. The best price is obtained from the broadest number of potential bidders where the features of the equipment are allowed to come to the forefront, rather than the confusing selection criteria when cost of equipment is combined with interest rates and payments.

The Benefits of Aggregation: Bigger Is Better.

Aggregating the district's lease purchases for the fiscal year into one transaction generates benefits for school districts and lenders. From the district's viewpoint, the interest rate obtainable for one larger lease is lower than what it would obtain on a series of smaller issues, and the costs associated with counsel's review of the transaction is only incurred once. Costs associated with the internal processing of a multitude of small leases with differing monthly payments is brought down to one or two checks per year.

From a lender's perspective, there are also advantages to the economy of scale associated with aggregating the lease purchase. The cost of booking a transaction is the same whether it is for $50,000, $500,000, or $1 million dollars. Additionally, the collateral balance of the whole transaction can be viewed, rather than relying on the individual equipment components, thereby enhancing the overall credit picture. This feature alone broadens competition, driving down rates for the traditional bidders of lease purchases across the nation. While this is a clear win for the tax dollar earmarked for education, there is a component missing—the local bank.

Understanding the True Risks

In the past, financial advisors originated and discounted lease purchases to those few lenders across the country who understood and could take advantage of the tax-exemptability of these transactions. Attempts were made to discount these lease purchase transactions to local banks, but the offers were rou-

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Vocational Programs

In addition to their ability to apply for general funding under this Act, vocational school districts may apply for matching grants up to $500,000. These grants are to be used for the funding of health and safety rehabilitation of school facilities. It should be noted that the Act provides that any public vocational school district that receives grant money is not eligible for any other aid under the Act for five years.

In short, this landmark legislation is by far the most comprehensive school construction financing program ever enacted. We look forward to providing you with follow-up articles in the near future addressing the intricacies of the Act and any questions that may arise concerning its implementation.

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tinely declined. Bankers schooled in commercial credit looked at their worst-case scenarios. “Repossesing little Johnny’s computer from his school does not look good for our bank.” This was an actual response a senior credit officer gave to his president as the reason that their bank should not enter into a transaction. The bank had a deposit relationship with the district, and its headquarters were in the same town as the district requesting the lease purchase. The bank was unable to understand the infinitesimal risk associated with the transaction, and eventually lost the banking relationship.

Education has become necessary to help local banks understand the credit risks of lease purchase transactions for public entities. Local bankers need to step out of the box to learn how to handle the tax-exempt issue to their benefit. Government banking calling officers need to work with lending officers to capitalize on the opportunity afforded to them by these transactions. The purpose of educating local banks is obvious, to keep local tax dollars, and hopefully the banking services, in the community.

In 1998, the Association for Governmental Leasing & Finance conducted the AGL&F Nonappropriation and Default Survey and delivered its results to its members and the financial community in The Bond Buyer, November 1998. The purpose of this survey was to quantify the risks associated with lease purchase and the government issuers. The total number of lease transactions represented in the survey was 78,176. The total dollar volume represented was $12,770,890,000. The result in percent of nonappropriations by dollar volume was 0.06%. The percent of nonappropriations by number of transactions was 0.03%. The percent of defaults by dollar volume was 0.12%. The percent of defaults by number of transactions was 0.01%. Will a banker be forced to take little Johnny’s computer from his classroom? Statistically, the answer is no. Not understanding that the credit risks are minimal in this type of transaction keeps bankers from competing in this market.

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School districts and financial advisors have been encouraging local banks to bid on these transactions with some success. Over the last five years the average lease purchase bid has grown from three hundred thousand, to over one million dollars. The financial advisors have worked informally with a number of local banks, educating them in order to induce them to bid. Some are now expanding their advisory service to include bank training programs designed to help bankers recognize the benefits and opportunities presented by responding to a lease purchase bid request.

Prior disclosure of financial information has further broadened completive bidding. Lease purchase bids have historically not offered any credit information to the potential bidders. Some districts have recognized this need and have worked with their financial advisors to put their bids on CD-ROM. The CDs include the bid documents, the last three years audited statements for the district, the current budget, equipment descriptions, the district's Web page, and other information pertinent to the transaction being bid.

The CD-ROM bid has broadened the pool of potential bidders and accelerated the closing process. Some bidders are preapproving the transaction prior to submission of a bid. If they are successful, the documents for the transaction are prepared and sent out the next day. Broadening the bidding of lease purchase from the traditional vendor driven financing accommodation to a banking product that attracts direct lenders has an added benefit of driving the interest rates even further down.

Winning for All

The bidding process has afforded new opportunities for bankers who take advantage of the competition to win a lease purchase bid. What level of interest in their client does a bank exhibit when they don't even bid? What does it say to the school administration and the board of education members when they hear the results of the bid and award the financing? By not bidding, a bank is rejecting an opportunity to be of service to that board of education; people who live and work in the community and ultimately approve the selection of banking services for the district. Responding to the bid is just the first step.

Properly structuring, positioning, and bidding of these larger lease purchases evolve into more than just obtaining a lower interest rate. Pricing a lease purchase now takes into consideration the total value of a school district's business. The bid of a lease purchase transaction is now a gateway, functioning as a lightening rod for banks to make a statement of their intent to earn a school district's banking business. As competition for deposit dollars becomes fiercer and the banking industry changes, success will be measured by those institutions that understand and can meet the needs of their clients.