

# STATE CREDIT ENHANCEMENT

JANNEY FIXED INCOME RESEARCH

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## STATE CREDIT ENHANCEMENT PROGRAMS

- Credit enhancement programs of various states add a strong layer of security to many local municipal issues, especially those issued for public school districts.
- At least 24 states offer these credit enhancement arrangements, but the details and mechanics vary between programs.
- Investors seeking diversification beyond state of residence should consider the credit benefits of these "double barreled" local government obligations.
- Although most programs are structured to "intercept" state aid, a few with permanent fund structures are among the strongest enhancement programs in the nation.

About 24 states have programs to add credit enhancement to bonds of local issuers, primarily school districts. The application of these enhancements allows local government units to incur lower interest costs when accessing credit markets. Enhancement types come in four basic varieties: (1) direct state guarantee of local bond issues; (2) issues backed directly by state appropriations; (3) permanent fund backing, from the state's establishment of dedicated financial resources to back qualified debt; and (4) intercept programs, whereby state aid due the issuer is redirected to the paying agent for the benefit of bondholders. Our focus is on permanent fund and state aid intercept programs.

Bondholders benefit from this double barreled type of security feature, with the first line of defense being the creditworthiness of the local issuer including factors such as tax base, state support, quality of management and other traditional metrics and indicators. The state programs, rarely invoked, provide a secondary backstop for bondholders.

## FOCUS ON SCHOOL DISTRICTS

Although certain programs support city and town issuers as well as public universities, the majority of enhanced bonds are issued to support public school districts. A primary function of state government is support of public elementary and secondary education, with a series of court cases enforcing state responsibility to offer educational opportunities to all children. States provide this support primarily through payments to local school districts, essentially redistributing state level revenue such as sales and income taxes. These enhancement programs offer an indirect benefit in the form of lower borrowing costs.

Most state credit enhancement programs contain provisions to intercept and redirect state aid to bondholders should the issuing school district fail to meet a scheduled debt service payment. Although details of individual programs vary both among and within states, there are a few key points to consider.

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### Selected State Enhancement Programs

State Rating	Coverage	Program Rating	Comments	Program Type
Colorado Aa1/AA-/NR	Public Schools Higher Education	Aa2/AA/AA	Strong intercept mechanism. Upon notification, state treasurer makes up debt service deficiency, even if amount needed is above appropriated state aid amount.	Intercept Unlimited Advance
Georgia Aaa/AAA/AAA	Public Schools	Aa1/AA+/AA+	If DS payment not paid, state will remit appropriations due the SD directly to paying agent.	Intercept Current Year
Kentucky Aa2/AA-/NR	Public Schools	Aa3/A+/AA-	Pre-default - If DS payment not paid, state will remit appropriations due the SD directly to paying agent within 5 days.	Intercept Unlimited Advance
Kentucky Aa2/AA-/NR	Public Higher Education	Aa3/A+/AA-	If DS payment not paid, state will remit appropriations due the SD directly to paying agent.	Intercept Current Year
Massachusetts Aa1/AA+/AA+	Public Schools Municipalities	Aa2/AA-?NR	Direct Pay - State remits DS to paying agent and then recovers from state aid.	Direct Pay
New Jersey Aa3/AA-/AA-	Public Schools Municipalities	A1/A+/A+	If DS payment not paid, state will remit appropriations due the SD or municipality directly to paying agent.	Intercept Current Year
New Jersey Aa3/AA-/AA-	Public Schools	Aa2/AA-/AA-	Bond Reserve Program (Chap 72) established fund with assets equal to 1% of total school district debt in state - 1.5% for debt issued after Jul 2003. State applies money from fund to pay interest and purchase maturing principal if needed. Appropriations are required to replenish as needed.	Permanent Fund
New Jersey Aa3/AA-/AA-	Community Colleges	A1/A+/NR	State commits to appropriate and transmit to paying agent amounts needed to cover debt service.	Appropriation
New York Aa2/AA/AA	Public Schools	A1/A/NR	If DS payment not paid, state will remit appropriations due the SD directly to paying agent.	Intercept Current Year
Ohio Aa1/AA+/AA+	Public Schools	Aa2/AA/AA	Pre-default. If prior to bond payment date SD has not remitted funds sufficient for DS, state will remit amounts necessary from appropriations due.	Intercept Current Year
Pennsylvania Aa1/AA/AA+	Public Schools	Aa3/A/NR	If DS payment not paid, state will remit appropriations due the SD directly to paying agent.	Intercept Current Year
Pennsylvania Aa1/AA/AA+	Public Schools	Aa2/A+/AA	Pre-default. If DS payment will be missed (15 days before payment due) state will remit appropriations due the SD to paying agent.	Intercept Current Year
Pennsylvania Aa1/AA/AA+	Public Schools	Aa2/NR/AA	For certain issues through St Pub Sch Bldg Auth, SD can elect to have payments made by state directly to paying agent.	Direct Pay Current Year
Pennsylvania Aa1/AA/AA+	Community Colleges	NR/A/NR	If DS payment not paid, state will remit appropriations due the SD directly to paying agent.	Intercept Current Year
Texas Aaa/AA+/AAA	Public Schools	Aaa/AAA/AAA	Likely strongest program in nation. \$24 bln assets and \$49 bln of guarantees for 2x leverage with a 3x leverage cap. Upon notification of DS shortfall PSF remits funds directly to paying agent.	Permanent Fund

Intercept mechanisms are usually triggered when an issuer fails to send a debt service payment to the paying agent.

Source: Moody's, S&P, Fitch, Official Statements and Janney Fixed Income Strategy

### CONSIDERATIONS

- Intercept mechanisms are usually triggered when an issuer fails to send a debt service payment to the paying agent. The notification processes differ, but once the state, usually through its department of education, is notified of the missed or deficient payment, the state "intercepts" upcoming aid payments, which would go to the school district in the normal course of events, and redirects them to the paying agent for bondholder benefit.
- There may be a timing delay, so it is possible that the paying agent receives funds from the state days after the bond interest and/or principal due date, causing a delay in payment. A few stronger programs include a pre-default provision, creating a notification system that assures the state's payment is received by the paying agent on or before payment date.
- Most programs can apply only state aid resources appropriated for the current fiscal year, although a few such as Colorado's and Kentucky's can tap resources not yet appropriated.

New Jersey and Texas both offer segregated funds with assets dedicated to backing school district issues, establishing them as among the strongest programs in the country.

- Before assigning a rating based on the enhancement, rating agencies consider the effectiveness of the mechanics underlying the program, and require that state aid revenues be sufficient to cover debt service payments if needed.
- Typically the communities and districts most in need of credit enhancement receive higher levels of state aid than less needy borrowers. Wealthier communities and school districts may carry underlying ratings as high or higher than the enhanced rating. For example Lower Merion School District in Pennsylvania, with an underlying rating of Aaa, gains little benefit from the enhancement program. On a per pupil basis it receives fewer state aid dollars than less wealthy school districts. By contrast, Philadelphia School District, which is rated Ba1, receives enough state aid from Pennsylvania to cover its debt service obligations by nearly six times. The state intercept program enables the school district to borrow at interest rates appropriate for Aa2 issuers.
- The enhancement rating is usually separate from the underlying rating. In some instances, where a bond is covered by bond insurance, three separate ratings are possible - the basic underlying rating, the rating based on state enhancement and the rating based on the insurance.

### CONCLUSION

Although intercept is the primary enhancement mechanism, some programs involve a direct payment from the state, eliminating any timing delay. New Jersey and Texas both offer segregated funds with assets dedicated to backing school district issues, establishing them as among the strongest programs in the country.

State credit enhancement programs offer bondholder security beyond that available from the underlying credit metrics of the issuer. Investors seeking to diversify into issuers beyond their state of residence should consider bonds enhanced by programs from other states.

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