State School District Credit Enhancement Programs

March 2023

Executive Summary

The use of state guaranties, state aid intercepts, and other similar programs to enhance the credit ratings of local governments is a common financing structure in U.S. public finance. Many states use such programs to enhance the credit ratings of local school districts. State school district credit enhancement programs generally fit within one of four categories:

- State Permanent Fund
- State Guaranty
- Standing or Annual Appropriation
- State Aid Intercept

The majority of the programs are designed to make funds available for timely debt service payments prior to a default. In fact, all the programs covered here have pre-default timing mechanics for debt service payment recovery. Although a state's program usually extends to all school districts, it is important to note that not all school districts may qualify to participate, and not all the bonds of an issuer may have the enhancement in place to support the ratings. Some states—without the type of explicit school district enhancement programs discussed here—provide other financing vehicles that school districts participate in, such as municipal bond banks or other pooled financings handled through a conduit issuer.

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Program credit ratings and outlooks may not be expressly tied to a state's ratings. The contractual relationship between the state and the program participant determines the extent to which, if at all, the program credit rating or outlook will track the state credit rating. Not all programs fit neatly into the four categories outlined above and are not necessarily affected by state rating changes. While program structure, mechanics, and specific statutory provisions differentiate credit quality, there are at least three features common to all school district credit enhancement programs in general:

- An independent paying agent, notifying the state in the event of a default or a potential default
- A revenue source independent of the school district, sufficient to cure a debt service shortfall
- State oversight of school district participants

State Permanent Fund Programs

State permanent funds are constitutionally created and historically have been funded through natural resource royalties and related activities. The corpus of the fund functions similar to an insurance policy, whereby it is leveraged to guarantee the debt service of school district bonds. Permanent fund program credit ratings are based on the fund's investment policies, liquidity, leverage, and operating guidelines, and are entirely independent of the state's ratings. Table 1 below assesses the credit quality of the two state permanent fund programs based on the following factors: (i) liquidity and leverage, (ii) investment policies, and (iii) operating guidelines.

TABLE 1: State Permanent Fund Programs

Program Name	Program Ratings	State Ratings
Texas Permanent School Fund	Aaa / AAA / AAA	Aaa / AAA / AAA
Nevada Permanent School Fund	Aaa / AAA / NR	Aa1 / AA+ / AA+

[–] Negative Outlook; [+] Positive Outlook; NR = Not Rated
Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM; February 2, 2023.

State Guaranty Programs

Six states have established programs that guarantee the debt service of eligible school district bonds. Under a guaranty program, the state may commit to draw on its general fund, on an alternative liquidity source, or on a special dedicated reserve fund, or to issue general obligation bonds, if necessary, to cure a debt service shortfall of a participating school district. State guaranty program credit ratings tend to be the same as the state's ratings. Table 2 provides an assessment of credit quality of the six state guaranty programs based on the following factors: (i) the state's own credit strength, (ii) the state's level of commitment and mandate to act, and (iii) the degree of institutionalized state oversight.

TABLE 2. State Guaranty Programs

Program Name	Program Ratings	State Ratings
Utah School District Bond Guaranty	Aaa / AAA / AAA	Aaa / AAA / AAA
Idaho School Bond Credit Enhancement	Aaa / AA+ / NR	Aaa / AA+ / AA+
Washington State School Bond Guarantee	Aaa / AA+ / AA+	Aaa / AA+ / AA+
Oregon School Bond Guaranty	Aa1 / AA+ / AA+	Aa1 / AA+ / AA+
Michigan School Bond Qualification and Loan	Aa1 / AA / AA+	Aa1 / AA / AA+
New Jersey School Bond Reserve Act (Fund for Free Public Schools)	A2[+] / A-[+] / NR	A2[+] / A-[+] / A[+]

[–] Negative Outlook; [+] Positive Outlook; NR = Not Rated
Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM; February 2, 2023.

Standing or Annual Appropriation Programs

The principal distinction between state guaranty programs and state appropriation programs is that under appropriation programs, states are not contractually obligated to use all available resources to cover a participating school district's debt service shortfall. Although appropriation programs do not provide an explicit guaranty, they are structured to ensure timely debt service payments in the event of a shortfall, so the risk of nonappropriation by the legislature is very low. These programs reflect each state's constitutional obligation to fund public education. Three states use appropriation programs to enhance the credit quality of school district bonds, and the program credit ratings are typically equivalent to or one notch below the state's general obligation rating. Table 3 provides an assessment of credit quality of the three state appropriation programs based on the following factors: (i) the state's own credit strength, (ii) the state's level of commitment and mandate to act, (iii) the degree of institutionalized state oversight, and (iv) program mechanics.

TABLE 3: State Appropriation Programs

Program Name	Program Ratings	State Ratings
Minnesota School District Credit Enhancement	Aa1 / AAA / AA+	Aaa / AAA / AAA
South Carolina School District Credit Enhancement	Aa1 / AA / AA+	Aaa / AA+ / AAA
West Virginia Municipal Bond Commission	NR / AA– / NR	Aa2 / AA– / AA

[–] Negative Outlook; [+] Positive Outlook; NR = Not Rated
Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM; February 2, 2023.

State Aid Intercept Programs

Intercept programs are designed to divert, or intercept, state aid due a school district in the event of a debt service payment shortfall. The strength of the state's pledge to ensure that any debt service deficiency is cured in a timely manner is driven primarily by the program's mechanics and the availability of state aid. The strongest programs are distinguished by structural features that ensure full and timely payment of debt service from the state in the event of a potential default by a participating school district. Such programs serve to appropriate sufficient amounts regardless of any state aid to the school district that has already been disbursed at the time of intercept—referred to here simply as an unlimited advance. Intercept programs of a weaker strain involve a structure that limits the advance for the payment of debt service to any remaining undisbursed state aid due the district in a given fiscal year, or a limited advance. Still yet weaker structures entail an unclear timing mechanism that may result in a post-default debt service payment recovery. The strength of the program's mechanics drives its credit ratings, which may be multiple notches below the state's general obligation (or equivalent) ratings. Some intercept programs where the timing or the amount of state aid disbursement is unclear may have a ratings ceiling several notches below the state's general obligation ratings, and will not necessarily change when the state's ratings or outlook changes. Table 4 illustrates the credit quality of the 16 state aid intercept programs based on the following factors: (i) timing of disbursement (pre- or post-default), (ii) availability of funds (unlimited or limited advance), (iii) required notification, (iv) the degree of institutionalized state oversight, and (v) the state's own credit strength.

TABLE 4: State Aid Intercept Programs

Program Name	Program Ratings	State Ratings
Missouri School District Direct Deposit	Aa1 / AA+ / AA+	Aaa / AAA / AAA
Georgia School District Intercept	Aa1 / AA+ / AA+	Aaa / AAA / AAA
Indiana School District Enhancement	NR / AA+ / AA+	Aaa / AAA / AAA
Virginia Localities Intercept	Aa1 / NR / NR	Aaa / AAA / AAA
Ohio School District Credit Enhancement	Aa2 / AA / AA+	Aa1 / AA+ / AAA
Massachusetts Qualified Bond	Aa2 / AA[+] / NR	Aa1 / AA[+] / AA+
Dormitory Authority of State of New York School District Intercept	Aa2 / NR / NR	Aa1 / AA+ / AA+
Arkansas School District Intercept	Aa2 / NR / NR	Aa1 / AA / NR
Colorado School District Credit Enhancement	Aa2 / AA– / AA	Aa1 / AA / NR
New Mexico School District Intercept	Aa3 / NR / NR	Aa2 / AA / NR
Mississippi School District Debt Enhancement	NR / AA– / NR	Aa2 / AA / AA
Pennsylvania School District Intercept	A2 / NR / A+[+]	Aa3 / A+ / AA-[+]
Kentucky School District Enhancement	A1 / A-[+] / A+[+]	Aa3 / A[+] / AA-[+]
New Jersey Qualified Bond	A3[+] / BBB+[+] / A-[+]	A2[+] / A-[+] / A[+]

[–] Negative Outlook; [+] Positive Outlook; NR = Not Rated
Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM; February 2, 2023.

A common question concerning state aid intercept programs is in regard to the specific mechanics that apply to the intercept of state aid itself and the required notification necessary to redirect it to bondholders. Is state aid transferred directly to the bond trustee to pay debt service as it comes due, or is debt service paid from district resources and state aid intercepted, or redirected, upon notification in the event of a shortfall? In fact, both processes are used, but the latter is more common. The former is referred to here as a direct advance intercept, with the schedule for the payment of state aid covering debt service established upon bond issuance. For those programs that require notification to cover a shortfall, notice of at least one week prior to the scheduled debt service payment date is considered strong; three days, average; less than three days, weak; and post-default or unclear timing, weakest.

Although the four categories of credit enhancement programs discussed above are presented in the order of their relative strength, specific program mechanics and the credit strength of the state itself can elevate the quality of any one program above another. Table 5 provides an overall assessment of credit quality of school district credit enhancement programs, regardless of their particular category, based on the following factors: (i) the dedication of specific state resources for school district credit enhancement, (ii) the state's level of commitment and mandate to act, (iii) the state's own credit strength, (iv) program mechanics, and (v) the sufficiency of available revenues.

TABLE 5: Relative Ranking of All Programs

Program Name	Program Ratings	State Ratings
Texas Permanent School Fund	Aaa / AAA / AAA	Aaa / AAA / AAA
Nevada Permanent School Fund	Aaa / AAA / NR	Aa1 / AA+ / AA+
Utah School District Bond Guaranty	Aaa / AAA / AAA	Aaa / AAA / AAA
Idaho School Bond Credit Enhancement	Aaa / AA+ / NR	Aaa / AA+ / AA+
Minnesota School District Credit Enhancement	Aa1/ AAA / AA+	Aaa / AAA / AAA
Washington State School Bond Guarantee	Aaa / AA+ / AA+	Aaa / AA+ / AA+
Missouri School District Direct Deposit	Aa1 / AA+ / AA+	Aaa / AAA / AAA
Georgia School District Intercept	Aa1 / AA+ / AA+	Aaa / AAA / AAA
Indiana School District Enhancement	NR / AA+ / AA+	Aaa / AAA / AAA
Virginia Localities Intercept	Aa1 / NR / NR	Aaa / AAA / AAA
Oregon School Bond Guaranty	Aa1 / AA+ / AA+	Aa1 / AA+ / AA+
South Carolina School District Credit Enhancement	Aa1 / AA / AA+	Aaa / AA+ / AAA
Michigan School Bond Qualification and Loan	Aa1 / AA / AA+	Aa1 / AA / AA+
Ohio School District Credit Enhancement	Aa2 / AA / AA+	Aa1 / AA+ / AAA
Massachusetts Qualified Bond	Aa2 / AA[+] / NR	Aa1 / AA[+] / AA+
Dormitory Authority of State of New York School District Intercept	Aa2 / NR / NR	Aa1 / AA+ / AA+
Arkansas School District Intercept	Aa2 / NR / NR	Aa1 / AA / NR
Colorado School District Credit Enhancement	Aa2 / AA– / AA	Aa1 / AA / NR
New Mexico School District Intercept	Aa3 / NR / NR	Aa2 / AA / NR
Mississippi School District Debt Enhancement	NR / AA– / NR	Aa2 / AA / AA
West Virginia Municipal Bond Commission	NR / AA- / NR	Aa2 / AA- / AA
Pennsylvania School District Intercept	A2 / NR / A+[+]	Aa3 / A+ / AA-[+]
Kentucky School District Enhancement	A1 / A-[+] / A+[+]	Aa3 / A[+] / AA–[+]
New Jersey School Bond Reserve Act (Fund for Free Public Schools)	A2[+] / A-[+] / NR	A2[+] / A-[+] / A[+]
New Jersey Qualified Bond	A3[+] / BBB+[+] / A-[+]	A2[+] / A-[+] / A[+]

[–] Negative Outlook; [+] Positive Outlook; NR = Not Rated
Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM; February 2, 2023.

In general, the bond market is volatile, and fixed income securities carry interest rate risk. (As interest rates rise, bond prices usually fall, and vice versa. This effect is usually more pronounced for longer-term securities.) Fixed income securities also carry inflation risk, liquidity risk, call risk, and credit and default risks for both issuers and counterparties. Any fixed income security sold or redeemed prior to maturity may be subject to a substantial gain or loss.

Interest income generated by municipal bonds is generally expected to be exempt from federal income taxes and, if the bonds are held by an investor resident in the state of issuance, from state and local income taxes. Such interest income may be subject to federal and/or state alternative minimum taxes. Investing in municipal bonds for the purpose of generating tax-exempt income may not be appropriate for investors in all tax brackets. Generally, tax-exempt municipal securities are not appropriate holdings for tax-advantaged accounts such as IRAs and 401(k)s.

Interest income generated by Treasury bonds and certain securities issued by U.S. territories, possessions, agencies, and instrumentalities is generally exempt from state income tax but is generally subject to federal income and alternative minimum taxes and may be subject to state alternative minimum taxes.

Short- and long-term capital gains and gains characterized as market discount, recognized when bonds are sold or mature, are generally taxable at both the state and federal levels. Short- and long-term losses recognized when bonds are sold or mature may generally offset capital gains and/or ordinary income at both the state and federal levels.

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