

# State School District Credit Enhancement Programs

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## 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, as of February 2, 2021.

### 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      |
| Washington State School Bond Guarantee                            | Aaa / AA+ / AA+   | Aaa / AA+ / AA+      |
| Oregon School Bond Guaranty                                       | Aa1 / AA+ / AA+   | Aa1 / AA+ / AA+      |
| Idaho School Bond Credit Enhancement                              | Aa1 / AA+ / NR    | 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) | A3[-] / BBB+ / NR | A3[-] / BBB+ / A-[-] |

[-] Negative Outlook; [+] Positive Outlook; NR = Not Rated  
 Source: Moody’s Investors Service, S&P Global Ratings, Fitch Ratings, FCM, as of February 2, 2021.

## 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      | Aa2 / AAA[-] / AA+ | Aa1 / 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, as of February 2, 2021.

## 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+ / AA+       |
| Massachusetts Qualified Bond                                       | Aa2 / AA / 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         |
| Mississippi School District Debt Enhancement                       | NR / AA- / NR           | Aa2 / AA / AA         |
| New Mexico School District Intercept                               | Aa3 / NR / NR           | Aa2 / AA[-] / NR      |
| Dormitory Authority of State of New York School District Intercept | Aa3 / NR / AA-[-]       | 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  | Baa1[-] / BBB / BBB+[-] | A3[-] / BBB+ / A-[-]  |

[-] Negative Outlook; [+] Positive Outlook; NR = Not Rated

Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM, as of February 2, 2021.

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          |
| 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+          |
| Idaho School Bond Credit Enhancement                               | Aa1 / AA+ / NR          | Aa1 / AA+ / AA+          |
| Minnesota School District Credit Enhancement                       | Aa2 / AAA[-] / AA+      | Aa1 / AAA[-] / AAA       |
| 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+ / AA+          |
| Massachusetts Qualified Bond                                       | Aa2 / AA / 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            |
| Mississippi School District Debt Enhancement                       | NR / AA- / NR           | Aa2 / AA / AA            |
| New Mexico School District Intercept                               | Aa3 / NR / NR           | Aa2 / AA[-] / NR         |
| West Virginia Municipal Bond Commission                            | NR / AA- / NR           | Aa2 / AA- / AA           |
| Dormitory Authority of State of New York School District Intercept | Aa3 / NR / AA[-]        | 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)  | A3[-] / BBB+ / NR       | A3[-] / BBB+ / A-[-]     |
| New Jersey Qualified Bond  | Baa1[-] / BBB / BBB+[-] | A3[-] / BBB+ / A-[-]     |

[-] Negative Outlook; [+] Positive Outlook; NR = Not Rated

Source: Moody's Investors Service, S&P Global Ratings, Fitch Ratings, FCM, as of February 2, 2021.



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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