

March 11, 2013

from  Montage Investments

State Credit Enhancement Programs for Local School Bonds

School district credit enhancement programs allow states to provide credit support for local school district bond issues, providing lower borrowing costs for school districts. Under these programs, states will direct certain revenues under state control to pay debt service for local school bond issues, if needed, and provide financial oversight of local school districts. Currently, 27 states provide some type of enhancement program to strengthen the credit quality of local school district bonds, with some states having multiple programs. Enhancement programs allow school districts to receive higher credit ratings for bond issues than they might otherwise receive on the basis of their own credit. Improved credit quality and consistency of credit structure across many issuers' offerings provide greater investor appetite for issues at lower interest rates.

Ascent views state credit enhancement programs as an important tool for enhancing portfolio credit quality. We do not buy bonds solely on the strength of the enhancement, even for 'AAA' programs like the Texas PSF or the Utah state guarantee. We always look beneath the state program to ensure that the issuing school district is a strong credit in its own right. By doing so, we are also able to find relative value among issues with similar state program ratings, choosing the underlying issuers that provide the best combination of high credit quality and yield.

State enhancement programs carry a wide range of ratings, from 'A' up to 'AAA.' The credit quality of a particular program is a function of the type of program and also of the specific mechanics of the program. The types of program structures currently in use are:

- **Permanent Fund:** The state pledges permanent, nonexpendable trust funds to guarantee debt service on local school bonds. These trust funds consist of assets derived from natural resource sales, royalties, and related activities. Leverage ratios cap the amount of guaranteed debt that may be outstanding at any given time. Permanent funds represent the highest quality enhancement programs; the four permanent fund programs in operation are each rated 'AAA.'
- **State Guarantee:** The state guarantees the full and timely payment of local school bonds with its own G.O. pledge. The credit ratings and outlooks for these programs are the same as the states' G.O. ratings. State guarantees are second only to permanent funds in credit quality.

- **State Appropriation:** The state commits to appropriate funds for local school bond debt service from its own general fund or other state resources. Program ratings will depend on the state's general credit quality and strength of the specific state funding commitment, with higher ratings typically assigned if the debt service commitment comes from the state's General Fund. State appropriation programs generally offer very high credit quality, typically only one notch below the state's own G.O. rating.
- **Unlimited Advance State Aid Intercept:** The state pledges to make payments for debt service from the local district's annual state aid allocation directly to the bond trustee or paying agent. The state will advance whatever amount is needed to ensure bonds are paid on time, regardless of how much aid the local district is due, then reimburse itself out of current and (if necessary) future educational aid due to the district. Unlimited advance programs generally reflect the credit quality of the state, but are less strong than an explicit state appropriation pledge.
- **Classic State Aid Intercept:** The most commonly used structure, this type of program requires the state to forward local district aid already earmarked for the district in the current year directly to the trustee or paying agent for the bonds. The state will only transfer an amount up to the remainder of the district's current-year aid. The ratings on classic intercept programs are constrained by the limit of having only the remaining balance of a local district's current-year state aid available for the state to intercept for the benefit of bondholders. Classic intercept programs can be enhanced by requiring a higher ratio of interceptable state aid – to – debt service and more stringent oversight and reporting requirements. The ratings for classic intercept programs range widely. Enhanced intercept structures can receive very strong ratings, while intercepts with more limited requirements typically fall in the 'A' category.

A program's ratings are determined by the specific mechanisms used to ensure payment of the local district's scheduled debt service. Beyond the broad structure of the program, factors that influence the credit ratings on enhanced bonds include: the level of oversight the state maintains over local school district finances and debt payments; timing of notification of deficiency in debt service accounts; timing of flows of state funds to paying agents; limitations on the amount of state payments; participation requirements; state programs' ability to identify problem school districts before a default occurs; and remedies for nonpaying school districts after a payment is missed.

The table on the following pages outlines the programs currently being used by states to enhance the local school district bond issues. The final column identifies whether changes in the state's own general credit ratings will cause equivalent adjustments to the enhancement program ratings. For example, Moody's recent outlook change for the state of Missouri, to negative from stable, resulted in a negative outlook also being assigned to bonds enhanced through the Missouri Direct Deposit Intercept Program.

State School Bond Credit Enhancement Programs (Ratings as of 03/11/13)

State	State Ratings	Program	Program Ratings ¹	Program Structure	Ratings Move in Tandem?
Arkansas	Aa1 / AA	Arkansas School District Enhancement Program	Aa3 / nr	Unlimited advance intercept	Yes
Colorado ²	Aa1 / AA	Colorado State Aid Intercept Program	Aa2 / AA-	Unlimited advance intercept	Yes
Georgia	Aaa / AAA	Georgia State Aid Intercept Program	A1 / A	Classic intercept	No
		Enhanced Georgia State Aid Intercept Program	Aa1 / AA+	Enhanced classic intercept	No
Idaho ²	Aa1 / AA+	Idaho School Bond Guaranty Program	Aa1 / AA+	State guarantee	Yes
		Credit Enhancement Program for Local School Bonds	Aaa / AAA	Sales tax revenue pledge	No
Indiana ²	Aaa / AAA	Indiana State Aid Intercept Program	A1 / A	Classic intercept	No
		Enhanced Indiana State Aid Intercept Program	Aa2 / AA+	Enhanced classic intercept	Yes
Kentucky ²	Aa2 / AA-	Kentucky State Aid Intercept Program	Aa3 / A+	Unlimited advance intercept	Yes
Massachusetts	Aa1 / AA+	Massachusetts Qualified Bond Act	AA2 / AA	Classic intercept	Yes
Michigan	Aa2 / AA-	Michigan School Bond Loan Fund	Aa2 / AA-	State guarantee	Yes
Minnesota	Aa1 / AA+	Minnesota standing appropriation for schools	Aa2 / AA+	State standing appropriation	Yes
Mississippi	Aa2 / AA	Mississippi State Aid Capital Improvement program	nr / AA-	Classic intercept	Yes
Missouri	Aaa / AAA	Missouri Direct Deposit Intercept Program	Aa1 / AA+	Classic intercept	Yes
Nevada	Aa2 / AA	Nevada Permanent School Fund	Aaa / AAA	Permanent fund	No
New Jersey	Aa3 / AA-	New Jersey Qualified Bond Program	A1 / A+	Classic intercept	Yes
		New Jersey Chapter 12 program	A1 / A+	State appropriation	Yes
		New Jersey Fund for Support of Free Public Schools (Ch. 72)	Aa3 / AA-	State appropriation	Yes
New Mexico	Aaa / AA+	New Mexico State Aid Intercept Program	Aa1 / nr	Classic intercept	Yes
New York	Aa2 / AA	New York State Aid Intercept Program	A2 / A	Classic intercept	No
Ohio	Aa1 / AA+	Ohio State Intercept Program (new)	Aa2 / AA	Classic intercept	Yes
Oklahoma	Aa2 / AA+	Oklahoma Permanent Fund	Aaa / AAA	Permanent fund	No
Oregon	Aa1 / AA+	Oregon School Bond Guarantee Program	Aa1 / AA+	State guarantee	Yes

State	State Ratings	Program	Program Ratings ¹	Program Structure	Ratings Move in Tandem?
Pennsylvania	Aa2 / AA	Pennsylvania State Aid Intercept Program	A1 / A	Classic intercept	No
		Enhanced Pennsylvania State Aid Intercept Program	Aa3 / A+	Enhanced classic intercept	No
South Carolina	Aaa / AA+	South Carolina Education Finance Program	Aa1 / AA	State appropriation	Yes
South Dakota ²	Aa2 / AA+	South Dakota State Aid Intercept Program	nr / A	Classic intercept	No
Texas	Aaa / AA+	Texas Permanent School Fund	Aaa / AAA	Permanent fund	No
Utah	Aaa / AAA	Utah School Bond Guarantee Program	Aaa / AAA	State guarantee	Yes
Virginia	Aaa / AAA	Virginia State Aid Intercept Program	Aa3 / A	Classic intercept	No
		Virginia State Appropriation	Aa1 / AA+	State appropriation	Yes
Washington	Aa1 / AA+	Washington School Bond Guarantee Program	Aa1 / AA+	State Guarantee	Yes
West Virginia	Aa1 / AA	West Virginia Municipal Bond Commission program	nr / AA	State appropriation	Yes
Wyoming ²	nr / AAA	Wyoming Permanent Fund	Aaa / AAA	Permanent fund	No

¹ Long-term debt ratings from Moody's and S&P

² No GO debt outstanding. Listed ratings and outlooks reflect the highest issuer rating or state supported appropriation debt rating.

Sources: Moody's; S&P; Fitch



Brian Tournier
 Director of Research
 Ascent Investment Partners

Disclosure: This newsletter is limited to the dissemination of general information pertaining to Ascent Investment Partners, LLC's ("Ascent Investment Partners") investment advisory services and general economic market conditions. The information contained herein should not be construed as personalized investment advice, and should not be considered as a solicitation to buy or sell any security or engage in a particular investment strategy. The views expressed are for commentary purposes only and do not take into account any individual personal, financial or tax considerations. There is no guarantee that any claims made will come to pass. The opinions and forecasts are based on information and sources of information deemed to be reliable, but Ascent Investment Partners does not warrant the accuracy of the information that this opinion and forecast is based upon. Opinions expressed are subject to change without notice and are not intended as investment advice or to predict future performance. Consult your financial professional before making any investment decision. Past performance does not guarantee future results.

Ascent Investment Partners is an SEC registered investment adviser with its principal place of business in the State of Missouri. Ascent Investment Partners and its representatives are in compliance with the current registration and notice filing requirements imposed upon registered investment advisers by those states in which such registration or notice filing is required. Ascent Investment Partners may only transact business in those states in which it is noticed filed, or qualifies for an exemption or exclusion from notice filing requirements. Any subsequent, direct communication by Ascent Investment Partners with a prospective client shall be conducted by a representative that is either registered or qualifies for an exemption or exclusion from registration in the state where the prospective client resides. For information pertaining to the registration status of Ascent Investment Partners, please contact Ascent Investment Partners or refer to the Investment Adviser Public Disclosure web site (www.adviserinfo.sec.gov). For additional information about Ascent Investment Partners, including fees and services, send for our Disclosure Brochure using the contact information herein.