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from  Montage Investments

Pennsylvania Downgrade Affects Local School Bond Ratings

On July 16, 2012, Moody's downgraded the general obligation credit rating of Pennsylvania to Aa2 from Aa1 and assigned a stable outlook at the new rating level. S&P and Fitch recently affirmed Pennsylvania's G.O. ratings at AA/stable and AA+/negative, respectively.

Moody's downgrade was due to the agency's view that the state has a weakened financial position that will be pressured to recover structural balance in a slow-growth economy. Moody's noted its view that Pennsylvania has a large and growing debt burden and pension liability that could challenge the state's ability to achieve balanced budgets going forward. Balancing these credit concerns are a number of fundamental strengths that support the still-strong Aa2 rating and stable outlook. These include:

- Recent strengthening of revenue growth;
- Effective governance and financial management that has achieved two consecutive balanced budgets despite revenue pressures; and,
- A diverse and stable state economy that has been relatively resilient through the recent recession and slow recovery.

In addition to dropping the ratings on state G.O. and appropriation-backed debt, the Moody's downgrade also lowered by one notch the program rating of Pennsylvania's state intercept program for local school districts. The program rating of the Pennsylvania Act 150 School District Intercept Program, the most widely used of the state's intercept programs, dropped to A1 from Aa3. The current program ratings for the Act 150 program are A1 by Moody's, A+ or A by S&P (depending on the specific structural details of the issue), and AA by Fitch.

The Pennsylvania enhancement program ratings are a function of the credit strength of the state and the structural mechanisms put in place to ensure that sufficient funds will be available in time to make scheduled debt payments. Rating factors include the

financial strength of the state, the historical stability of state education funding levels, the local issuer reporting and oversight mechanisms incorporated in the program, and the requirements for size and timing of state aid payments relative to scheduled debt service. The downgrade of the Pennsylvania intercept program lowered ratings on more than 250 local school bond issues, the vast majority to A1 from Aa3. Many other school district bonds participate in the program but have underlying district ratings that are Aa3 or better on their own. These issues were unaffected by the rating change, as Moody's assigns the higher of the state enhancement rating or the issuer's own rating.

Ascent's approach to school district enhancement programs does value the credit support and state oversight offered to local issuers by the states' program structures. In each case, however, we also look through the enhancement program to evaluate the underlying credit of the issuer itself. We will only buy or hold bonds that we believe offer strong credit quality on their own fundamental characteristics, with the state enhancement providing an extra layer of credit protection. Therefore, we do not view the Pennsylvania state program downgrade as a reason to sell enhanced Pennsylvania local school district bonds.

Pennsylvania's School Bond Enhancement Program

The Pennsylvania program is a classic state aid intercept program, the structure most commonly used by states to provide credit enhancement for local issuers. Each school district in Pennsylvania receives distributions of money from the state to support the cost of providing local public education. The intercept program takes advantage of the availability of that state aid, which can be diverted to a paying agent in the event a local government cannot make its full and timely debt service payment.

Pennsylvania's program is governed by Section 633 of the Public School Code. Act 150 created the withholding mechanism by which the Secretary of Education can withhold state aid distributions to ensure the payment of principal and interest on local district general obligation bonds. The program was further enhanced in 1998. Under the basic program, there is no set time period for prior notification of a shortfall in debt service. The withholding provision is triggered only after a district fails to make a required debt service payment. State law requires the Secretary to withhold school aid payments if a school district experiences a debt service shortfall. This program structure is eligible to receive an 'A' rating from S&P.

Under the enhanced structure, the district establishes a debt service sinking fund that must be fully funded 15 days prior to the debt service payment date. If the sinking fund is not fully funded at that time, the Secretary will intercept the district's state aid payments and transfer them to the sinking fund. Alternatively, instead of a sinking fund, the district can agree to have its appropriations paid by the State Treasurer directly to the trustee no later than 15 days before the debt service due date to provide timely payment of debt service. If debt payments are properly structured to match the timing and amounts of state aid payments, the district can achieve an 'A+' from S&P under the enhanced program.



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