

# Municipal Credit Update

## The Ripple Effect of State Fiscal Woes on Underlying Governments

November 2015

High-profile state budget impasses have drawn considerable attention this year with Florida, Illinois and Pennsylvania all struggling to find political middle-ground through tenuous budget negotiations.<sup>1</sup> Gurtin Municipal Bond Management, LLC has always closely monitored local government holdings to ensure they remain high quality in spite of any turmoil at the state level, and the growing trend of budgetary stalemates has resulted in revisions to our approved rating thresholds for local governments impacted by potential delays in appropriations. We have also scrutinized any possible impairments to the statutory guarantees that are provided through credit enhancement programs utilized in states affected by budget impasses.

We believe Philadelphia School District's recent predicament illustrates the wisdom of closely monitoring the potential credit ramifications of budget impasses. While we have no exposure to the District, we have followed the situation closely. Philadelphia School District, the largest school district by enrollment in Pennsylvania, issued bonds under a state program that required the Commonwealth of Pennsylvania to pay a portion of the District's state aid directly to the Trustee to cover debt service payments.

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<sup>1</sup> While Florida ultimately resolved its budget impasse after a 19 day special session of its legislature, Illinois and Pennsylvania remain without an approved budget as of publication. Each State's fiscal year began on July 1, 2015.

This direct flow of revenues was seen as a way to insulate bondholders from the risks of the junk-rated District and its serious financial woes. Instead, three months into Pennsylvania's current budget stalemate, with no state aid flowing to school districts or to the Trustee to pay the District's debt, the junk-rated district was forced to bypass the state intercept program, and sell short-term debt to generate the revenues needed to pay its own debt service on bonds. Although investors believed this debt to be of high quality given the State's pledge to pay them with intercepted state aid, ultimately, these bondholders were entirely reliant on a junk-rated school district's ability to access the capital markets to sell short term debt.<sup>2</sup> This is a situation we deem to be highly incongruous with the investment grade ratings these bonds continue to carry even after the nearly missed payment. This event provides insight on the impact that state aid delays can have on underlying municipalities, as well as how state intercept programs and statutory guarantees can fail when there is no state aid to intercept or standing authorization to make payments. Both Pennsylvania and Illinois are now in their fifth month without a budget in place for the new fiscal year, which started on July 1st. As of

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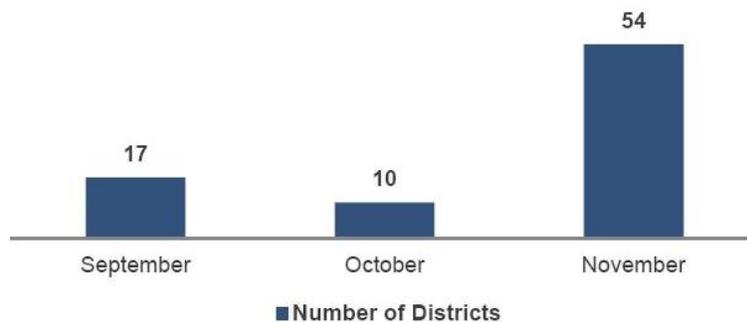
<sup>2</sup> The School District of Philadelphia. Material Event Notice: Failure of Credit Enhancement to Perform. September 17, 2015. Retrieved from: <http://emma.msrb.org/ER016465-ER715987-ER117415.pdf>. Moody's Investors Service. Moody's downgrades Pennsylvania's pre-default intercept programs to A3 from A2. November 5, 2015. Retrieved from <https://www.moody.com> (reporting that the District issued notes to pay the debt service).

publication, both states appear to at long last be making progress towards budget agreements, however, the prolonged stalemate has had a waterfall effect on the school districts, cities, counties, universities, and other government-sponsored programs that rely on state resources to remain operational. The degree to which delays or potential reductions in funding affect these entities varies and, as a result, when events like these unfold, determining the impact to each individual obligor-security is a critical component of our credit analysis.

or delays in statutory support.

With this current budgetary impasse, we took a close look at Pennsylvania schools. Pennsylvania and Illinois have differed in one significant way during this impasse. Illinois passed a temporary budget early on, allowing for aid to continue to flow to its school districts, while Pennsylvania passed no such stopgap budget, leading to threats of districts closing<sup>3</sup> and the need for districts more heavily-dependent on state aid to issue temporary cash flow notes (Figure 1).<sup>4</sup> Given

**Figure 1. Number of Pennsylvania School Districts Cash Flow Borrowing due to Budget Impasse Expected to Increase Significantly in November**



**In the case of state aid delays, we conduct a forward-looking review to evaluate underlying municipalities' ability to withstand stress caused by the state impasse**

We have been following the budget process in both states closely and have continued to review our holdings as the impasses have continued. Not only have we opted to apply more stringent credit guidelines to investment opportunities, but we have also completed a thorough, timely and forward-looking analysis of our existing holdings to measure each entity's ability to grapple with the funding landscape in light of the anticipated reductions

this lack of state funding and the potential distress it could create, we implemented strict credit guidelines for any new purchases of Pennsylvania school districts, and conducted a thorough review of all of our Pennsylvania school holdings, to identify schools with heightened exposure to the delays. Through this review, we found that the vast majority of the districts we hold are well-positioned to withstand the budget

<sup>3</sup> Nicosia, Mareesa. The Tenuous Fate of Pennsylvania's Public Schools. The Atlantic. October 13, 2015. Retrieved from <http://www.theatlantic.com>.

<sup>4</sup> Pennsylvania Auditor General. Auditor General DePasquale Says Borrowing by School Districts, IUs Now at Least \$431 Million Because of State Budget Impasse. October 28, 2015. Retrieved from <http://www.paauditor.gov>.

impasse, generally through access to substantial reserve levels and/or moderate reliance on state funding. We identified a very small number of schools that we believed would be most vulnerable to the impasse and sold out of these holdings. While we may take further rating actions if the budget impasse continues and new disclosure shows additional stress at the local level, we currently believe the Pennsylvania obligors in our clients' portfolios are well-positioned to manage through the current environment.

### **State aid delays call into question the ability for state intercept programs to function when no state aid exists to intercept**

State enhancements that rely on intercepting aid or providing a full, faith and credit guarantee of the state are only as strong as the states themselves, and when a state is functioning without a budget in place or experiencing significant fiscal stress itself, these guarantees start to show their weaknesses. Over half the states have credit enhancement programs that school districts can utilize to access the capital markets or lower their interest rates. These programs typically involve a statutory guarantee that the state will make debt service payments in the event of a deficiency, often through intercepting a district's state aid. Notably, some states have stronger enhancement mechanics that have a separate pool of funds available or also put the state's general obligation pledge behind the enhancement program. In Pennsylvania's case, the lack of a state budget affects a district's ability to access this program and does so at a time when the district may need it most. Ironically, it is due to that same budget impasse that districts find themselves in this precarious position.

The uncertainty of how state intercept programs can function without a budget in place, as exhibited by the failure of the enhancement program to provide state aid for Philadelphia School District's debt, calls for greater scrutiny of this program and programs in other states. Although this event led to a rating downgrade of Pennsylvania's "pre-default" enhancement program by Moody's Investors Service to A3 from A2, we would argue the downgrade is insufficient given bondholders extremely close call with a debt service default and failure of the State's program mechanics. Reliance on statutory guarantees and funding can provide stability to underlying entities when states are fiscally well-positioned, but when that changes, this dependence may only exacerbate fiscal troubles for those reliant on these state funds. For this reason, our credit thresholds are dynamic and move according to each state's fiscal and political landscape. While Pennsylvania and Illinois may be approaching the end of their budget impasses, increasingly entrenched political parties and interests ensure that these will not be the last states operating without a current year budget in place. As the trend of states dealing with budgetary stalemates grows, we will continue to apply forward-looking analysis to ensure our holdings meet stringent credit thresholds.

Please feel free to contact us at [research@gurtin.com](mailto:research@gurtin.com) for additional information.

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