

## U.S. STATE AND LOCAL GOVERNMENT SECTORS

# Enhanced Ratings: The Pennsylvania School District Intercept Program

### An Update

It took 266 days for Pennsylvania lawmakers to settle on a 2015–16 spending plan. During the impasse, Pennsylvania school districts faced eight months of uncertainty, with many resorting to cash-flow quick fixes. Rating agencies were forced to react to the indecision, and one even discontinued its pre-default and post-default enhanced ratings. However, a plus for bondholders is that lawmakers learned from the experience and delivered a new law in the summer of 2016. Pennsylvania’s Act 85 of 2016 strengthened the Pennsylvania school district intercept mechanism.

### Pennsylvania’s Post-default and Pre-default Intercept Mechanisms

The Pennsylvania intercept statutes provide the legal ability to divert (or intercept) funds the commonwealth is obligated to pay school districts. The intercept provisions of the Pennsylvania School Code establish the process by which school district debt service payments may be intercepted. The School Code sets forth that upon notice the Pennsylvania Secretary of Education or the Department of Education will withhold state aid payments if a school district fails to make a debt service payment. This is how state aid is intercepted if necessary, sent to the paying agent, and paid to bondholders. The principal Pennsylvania school district mechanism is the post-default (PA Act 150) intercept. It covers all Pennsylvania school districts unless they participate in or have structured a pre-default intercept. The two pre-default intercepts are the State Public School Building Authority Lease Intercept (SPSBAL) [Sect 7-785(b) of the School Code] and the School District Fiscal Agent Agreement Intercept (Sect 633 of the School Code).

### Rating Agency Treatment of PA’s School District Intercept Program

The past few years have been a roller coaster ride for those following the Commonwealth of Pennsylvania’s credit and school district intercept enhancement. Many observers and participants closely watched the Pennsylvania budget delay in the second half of 2015 and into the first quarter of 2016. The rating agencies tried to patiently let the budget negotiations work the issues out. But by September 2015 they could no longer wait.

### Moody’s Investor Service Enhanced Ratings Review

- On September 10, 2015, Moody’s downgraded the pre-default ratings from A1 to A2 and lowered the post-default enhanced rating ceiling from A2 to A3.
- A few months later, on December 22, 2015, Moody’s (for pre-default and post-default) notched the enhanced rating off the underlying and lowered the rating ceiling to Baa1, with a floor of a B1.

### Current Enhanced Ratings Summary, PA Intercept Program for School Districts

Program	Type	Moody’s	S&P	Fitch
State Public School Building Authority Lease Intercept (SPSBAL) [Sect 7-785(b)]	Pre-Default	A2	Discontinued	A+
Fiscal Agent Option (Sect 633)	Pre-Default	A2	Discontinued	A+
Pennsylvania Act 150	Post-Default	2 notches up from underlying, A3 Ceiling & B1 floor	Discontinued	Not Rated

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*Pennsylvania’s Act 85 of 2016 strengthened the Pennsylvania school district intercept mechanism.*

- After the FY 2016 Pennsylvania budget impasse concluded on March 23, 2016,<sup>1</sup> the A2 across the board for pre-default credits was reinstated and the ceiling for the post-default ratings was raised back to A2 from Baa1 in August 2016, thanks partially to PA's Act 85 of 2016.

*On September 4, 2015, Standard & Poor's (S&P) put the PA intercept program on "CreditWatch with negative implications" due to the budget impasse.*

### Standard and Poor's Global Enhanced Ratings Review

- On September 4, 2015, Standard & Poor's (S&P) put the PA intercept program on "CreditWatch with negative implications" due to the budget impasse. The rating agency noted it expected to resolve the CreditWatch within 90 days.
- S&P then withdrew its pre-default and post-default ratings on December 11, 2015. Additional details of why the enhanced program ratings were withdrawn were expanded upon in a December 14, 2015 report.<sup>2</sup> A December 29 report acknowledged Pennsylvania Governor Tom Wolf's line-item veto but resulted in no rating action(s).
- After the fiscal 2016 budget impasse ended, S&P published a clarifying report. In this April 26, 2016 (and another on May 19, 2016) report S&P noted:
 

"Following the withdrawal of our rating on the Pennsylvania credit enhancement program on December 11, 2015, and our subsequent report indicating our expectation of the unlikelihood of the rating being reinstated, we have discontinued the underlying rating for credit programs on Pennsylvania's school districts."<sup>3</sup>
- S&P has still not reinstated an enhanced pre-default or post-default rating for the Pennsylvania school district intercept program.

*S&P then withdrew its pre-default and post-default ratings on December 11, 2015.*

### Fitch Ratings Service Enhanced Ratings Review

Fitch published reports on August 20, 2015, and January 11, 2016, but did not see the budget impasse as a tremendous threat to Pennsylvania's or the intercept's credit quality. Fitch's pre-default ratings remained at A+. The rating agency does not have a post-default enhanced rating.

### Pennsylvania's Act 85 of 2016

In summer 2016 lawmakers strengthened the Pennsylvania school district intercept program. If anything good came out of Pennsylvania's fiscal 2016 budget impasse it was Pennsylvania's Act 85 of 2016,<sup>4</sup> signed into law on July 13, 2016, by Governor Wolf. The new law allows the Pennsylvania Department of Education, if needed in the event of a state budget impasse, to request available Pennsylvania General Fund money to make a debt service payment. This became a concern last year when Pennsylvania school districts were not receiving state aid payments during an extended budget delay. Since the impasse was before Act 85, the circumstances reduced the value of the state's enhancement program for school districts because there was no state aid to intercept.

It is important to understand that while the new provisions strengthen the PA intercept mechanism, they do not guarantee debt service payments will be paid. There are limitations.

- Payments cannot exceed 50% of a school district's annual general fund subsidy.
- Funds are limited to available cash balances at the time of the intercept.
- The Commonwealth is restricted from issuing tax anticipation notes or entering into a loan agreement with the PA Treasury for liquidity to provide intercept payments.
- A 10-day period giving the chair and the minority chair of the appropriations committee of the PA House time to "review and comment" on the request is required.

*If anything good came out of Pennsylvania's fiscal 2016 budget impasse it was Pennsylvania's Act 85 of 2016.*

<sup>1</sup> For more on the conclusion of the FY16 Pennsylvania budget impasse please see our commentary titled [PA Budget Becomes Law on Day 266](#), published March 23, 2016.

<sup>2</sup> Please see "Standard & Poor's Analysis of Credit Enhancement Programs Is More Than a Mechanical Exercise," by S&P, December 14, 2015.

<sup>3</sup> Pennsylvania School District Underlying Rating for Credit Programs Discontinued, S&P, April 26, 2016.

<sup>4</sup> Please see [Pennsylvania Act 85 of 2016, HB1605 pp. 103-106](#).

## Municipal Credit Rating Scale and Definitions

	Rating Agency			Rating Definition
	Moody's	S&P	Fitch	
Investment Grade	Aaa	AAA	AAA	Exceptionally strong credit quality, subject to the lowest level of credit risk
	Aa1	AA+	AA+	Very strong investment grade credit quality, subject to very low credit risk
	Aa2	AA	AA	
	Aa3	AA-	AA-	
	A1	A+	A+	High investment grade credit quality, subject to low credit risk
	A2	A	A	
	A3	A-	A-	
	Baa1	BBB+	BBB+	Good investment grade credit quality, subject to moderate credit risk; profiles could contain some speculative characteristics
	Baa2	BBB	BBB	
	Baa3	BBB-	BBB-	
Non-Investment (Speculative) Grade	Ba1	BB+	BB+	Weak credit quality, judged to be speculative, subject to substantial credit risk
	Ba2	BB	BB	
	Ba3	BB-	BB-	
	B1	B+	B+	Very weak credit quality, judged to be highly speculative and subject to a high level of credit risk
	B2	B	B	
	B3	B-	B-	
	Caa1	CCC+	CCC+	Extremely weak credit quality, judged to be highly speculative, subject to a very high level of credit risk; default is possible
	Caa2	CCC+	CCC+	
	Caa3	CCC-	CCC-	
	Ca	CC	CC+	Extremely speculative credit quality, in or near default, some prospect of recovery
		CC		
		CC-		
		C+	Default appears imminent or inevitable	
		C		
		C-		
	C	D	D	Lowest rating, typically in default, little prospect for recovery of principal or interest

Source: Moody's, S&P, Fitch, PNC Capital Markets

## PNC Pennsylvania School District Reports

Date	Name of Report	Summary
3/20/2017	Enhanced Ratings: The Pennsylvania School District Intercept Program	An Update
8/16/2016	Moody's Upgrades Pennsylvania's School District Enhancement Programs	Changes by Moody's after PA Act 85 of 2016
8/11/2016	State Enhancement Programs for School Districts	Nation-wide summary
6/8/2016	Rating Agencies Overhaul Treatment of PA School District Enhanced Ratings	Changes by Moody's, S&P
9/14/2015	Pennsylvania State Aid Intercept Program for School Districts—A Summary	Closer look of pre-default and post-default mechanisms and examples

Source: PNC Capital Markets

## PNC Capital Markets School District Financings

Date	Issuer Description	Amount (millions)	Bid Type	Date	Issuer Description	Amount (millions)	Bid Type
2/14/2017	Sharpsville Area SD	\$8.72	Comp	10/19/2015	Harrisburg SD	9.96	Negt
2/13/2017	West Allegheny SD	5.27	Negt	10/1/2015	Southern York Co SD	4.23	Comp
1/18/2017	Northampton Area SD	18.53	Comp	9/7/2015	Delaware Vly SD	9.95	Negt
1/9/2017	South Park SD	7.33	Negt	9/7/2015	Penn Hills SD	19.97	Negt
12/12/2016	Canon-McMillan SD	24.83	Negt	8/24/2015	Phoenixville Area SD	7.73	Comp
11/30/2016	West Chester Area SD	8.50	Comp	8/17/2015	North Allegheny Sch Dist	34.77	Negt
11/29/2016	Springfield Twp SD	10.00	Comp	8/11/2015	Waynesboro Area SD	10.00	Comp
11/28/2016	Burrell SD	8.47	Negt	7/27/2015	Dallas School District	5.98	Negt
11/28/2016	Scranton SD	30.05	Negt	7/27/2015	Girard SD	7.60	Negt
11/21/2016	Lenanon SD	9.90	Comp	7/20/2015	Gtr Nanticoke Area SD	8.10	Negt
11/21/2016	Hermitage SD	9.73	Negt	7/13/2015	Bedford Area Sch Dist	4.22	Negt
11/14/2016	Indiana Area Sch Dist	9.93	Comp	6/22/2015	Bedford ASD	8.30	Negt
11/14/2016	Girard SD	6.60	Negt	6/22/2015	Montrose Area SD	5.18	Negt
11/7/2016	Wilkes Barre Area SD	35.08	Negt	6/15/2015	Curwensville Area SD	9.90	Comp
10/24/2016	Clearfield ASD	9.47	Comp	6/11/2015	Shikellamy SD	7.04	Comp
10/3/2016	North Hills SD	32.19	Negt	5/25/2015	Pine-Richland SD	9.52	Negt
8/22/2016	South Park SD	9.53	Negt	5/18/2015	Hermitage SD	4.73	Negt
7/18/2016	West Allegheny SD	9.96	Negt	5/18/2015	Huntingdon Area SD	10.00	Negt
7/11/2016	Centennial Sch Dist	43.49	Negt	5/18/2015	South Park SD	10.00	Negt
7/6/2016	Northern Bedford Co SD	7.50	Comp	5/11/2015	Conewago Vly SD	8.94	Comp
5/16/2016	Bethel Park SD	69.85	Negt	5/7/2015	Greencastle-Antrim SD	9.88	Comp
5/9/2016	Norristown ASD	41.94	Negt	5/4/2015	Penn-Trafford SD	4.45	Negt
4/21/2016	Phoenixville Area SD	9.50	Comp	5/4/2015	Pine-Richland SD	9.94	Negt
3/21/2016	Scranton Sch Dist	8.46	Negt	4/27/2015	Avonworth SD	18.58	Negt
3/14/2016	Pine-Richland SD	6.59	Negt	4/20/2015	Tulpehocken ASD	8.80	Negt
3/7/2016	Fort Leboeuf SD	5.93	Negt	4/13/2015	Whitehall-Coplay SD	9.17	Comp
2/29/2016	Dallas SD	13.43	Negt	3/24/2015	Central Fulton SD	9.65	Comp
2/16/2016	Lower Merion SD	55.67	Comp	3/23/2015	Philadelphia Sch Dist	91.34	Negt
2/8/2016	Harrisburg SD	10.00	Negt	3/2/2015	West Allegheny Sch Dist	9.01	Negt
1/12/2016	Northampton ASD	9.88	Comp	2/16/2015	NW Area Sch Dist	4.93	Negt
12/21/2015	Scranton SD	40.51	Negt	2/16/2015	Titusville Area SD	8.46	Negt
12/7/2015	Abington SD	4.55	Comp	2/9/2015	Conneaut SD	9.69	Negt
12/7/2015	South Park SD	3.56	Negt	2/2/2015	South Middleton SD	10.00	Comp
11/30/2015	Wyoming Area School Dist	9.20	Negt	1/12/2015	Abington Heights SD	6.86	Negt
11/16/2015	Brentwood Boro SD	8.03	Negt		Total Negotiated	779.99	
11/9/2015	Greater Nanticoke ASD	9.73	Negt		Total Competitive	248.65	
11/2/2015	Wyoming Area SD	10.00	Negt		Grand Total	\$621.83	

Source: Bloomberg L.P., PNC Capital Markets

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CIB CMG PDF 0615-0135-194401