WASMER SCHROEDER

Making the Grade: A look at the Credit Quality of California School Districts

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Overview

Demand for in-state municipal bonds in high-tax states has increased significantly following the passage of the Tax Cuts and Jobs Act (TCJA) in 2017, which implemented a $10,000 cap on state and local deductions. In California specifically, which boasts the highest state income rates in the country, a popular source of tax exempt income comes from bonds issued by local school districts. The sector is typically thought of as safe and conservative area for investment, but a handful of recent headlines involving issues such as union strikes, poor budgetary practices and declining enrollment has cast some doubts on the sector overall and prompted questions from Wasmer, Schroeder (WS) clients. In this paper we focus on a lesser known but critical area of credit support for the sector – the unique legal framework in California that provides an additional layer of security for local school districts in the state. Two pieces of legislation in particular, Proposition 98 and Assembly Bill 1200 (AB 1200), provide statutory and constitutional protections that together give CA local school district debt a strong fundamental credit quality.

Background

Proposition 98 was approved by voters in 1988 as a way to increase the overall state funding to schools Proposition 98 put in place the rules and formulas used to calculate a minimum annual funding level for all public education institutions in the state ranging from kindergarten to community college. Effectively, Prop 98 created a funding floor so that school districts, particularly in weaker socio-economic areas of the state, would continue to receive state revenues even in low-growth or down years. It is important to note that during prior periods of weak revenue growth, the state has attempted to alter the funding formula or delay funding to school districts, however, these efforts have been unsuccessful in decreasing state funding. While revenues can still be volatile during recessionary periods, overall per-pupil funding (adjusted for inflation) is at its highest level in more than three decades.

On its own, Proposition 98 did not prevent school districts from becoming financially distressed. After the bankruptcy of Richmond Unified School district in 1991, the State of California passed Assembly Bill 1200, creating a formal process for supporting fiscally distressed school districts and increasing county oversight of all school districts in the state. The bill expanded the role of county education offices in monitoring school districts, mandating that they could intervene under certain circumstances to ensure that districts could continue to meet their financial obligations. AB 1200 also created the Fiscal Crisis and Management Assistance Team (FCMAT) which provides both preventative services and recovery assistance to fiscally distressed school districts. Additionally, the bill developed a framework for fiscally distressed school districts to request emergency general fund loans from the state, if needed.

Demonstrated Success

Since the implementation of AB 1200, no school districts in California have defaulted on their bonds or filed for bankruptcy. Additionally, the state has only provided emergency loans to nine school districts (see table on the following page) since AB 1200's passing 28 years ago, significantly less than the 26 school districts that received loans from the state in the 12 years preceding 1991. Further, five of the districts that requested emergency loans have successfully paid them off and regained fiscal and operational independence from the state. These results demonstrate that the oversight system established in 1991 has had a positive effect on preserving school districts' fiscal health, helping them avoid the need for emergency loans from the state

District Name	Year of loan	Loan From State	Final Pay off Year
Inglewood Unified	2012	$29 million	2033
King City Joint Union High	2009	$13 million	2028
Vallejo City Unified	2004	$60 million	2024
Oakland Unified	2003	$100 million	2023
West Fresno Elementary	2003	$1.3 million	2010
Emery Unified	2001	$1.3 million	2011
Compton Unified	1993	$19.95 million	2001
Coachella Valley Unified	1992	$7.3 million	2001
Richmond Unified	1991	$28.53 million	2012

The strength of the system was heavily tested during the Great Recession, when Proposition 98 guaranteed that school districts continued to receive a base amount of funding from the state despite the economic downturn. It should be noted that this guarantee of state funding is different from traditional state enhancement programs. For example, in Texas, an endowment fund ensures the payment of qualified debt service for state schools, and Michigan provides a direct guarantee from the state. The features of Proposition 98, combined with the additional financial and managerial responsibility required of school districts due to AB 1200, resulted in no districts defaulting on their debt even with the added financial stress brought on by the Great Recession.

Underlying Credit Fundamentals Still Matter

While school districts in California continue to benefit from these legal protections, we still believe that it is important to analyze the district's underlying credit fundamentals. The passing of Proposition 98 and AB 1200 has successfully decreased the number of fiscally distressed or insolvent districts, but it has not completely eliminated the potential for rating volatility due to declining credit quality.

A number of factors can affect the credit quality of an issuer, and an issuer experiencing rating volatility or declining credit quality does not necessarily mean that it is at risk of becoming financially distressed or insolvent. However, rating volatility can be an indicator of future distress. In any case, we emphasize the importance of monitoring and analyzing underlying credit fundamentals to identify and assess these risks on the front end.

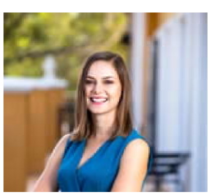
Notably, even with intervention from the state and the county, financially distressed situations oftentimes get worse before they get better. They also can play out over a long time horizon, usually 10-20 years. For example, because of continued operating deficits, both the Oakland and Inglewood Unified School Districts needed additional state grants to supplement the loans they had previously received. These grants were authorized by the passage of Assembly Bill 1840, which also shifted more responsibilities to the county and established a new process for appointing outside administrators.

None of the nine districts that have been taken over by the state have had their General Obligation debt downgraded by the rating agencies to Below Investment Grade (BB+ equivalent and below), underscoring the rating agencies' comfort with the state's support.

Conclusion

The strength of these legal provisions that currently exist only for California school districts, particularly with the passing of AB 1200, is evident in the low number of emergency state loan requests, as well as the fact that no school districts have defaulted on their bonds since the passing of AB 1200 in 1991. Given the significant legal protections provided to California School Districts, we see the likelihood of a school district default or a bankruptcy as very low, however, rating risk is still present due to changes in a district's underlying credit fundamentals. Credit monitoring and analysis continue to be important because of these risks. At WS, our research team benefits from having extensive experience and state-of-the-art technology to actively monitor and identify potentially distressed school districts.

Because we believe that default risk for fiscally distressed school districts in California is low, we consider them to be low-risk investments, and think that they will remain that way for the foreseeable future.



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Emily Perkinson holds the position of Associate Credit Analyst at Wasmer Schroeder (WS). In that role, she is responsible for tax exempt and taxable municipal research. She is also one of the firm's designated Impact Analysts, verifying that a potential investment's use of proceeds will fund a project or service that will have a positive impact on society or the environment.

Emily earned her BS in Finance from Florida Gulf Coast University. She is a member of the National Federation of Municipal Analysts and the Southern Municipal Finance Society.