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Moral Obligation and Charter School Financing

1. Background and Definitions

Background

The use of the moral obligation financing began in New York state in the early 1970's to support debt of the New York Housing Finance Agency. Where a moral obligation pledge once was used primarily by states to support housing agency debt, increasingly states and localities are using a moral obligation pledge to reduce capital costs for a variety of purposes, including economic development, environmental remediation, and social service delivery.[1] Another familiar example of moral obligation financing was used in Illinois for the Illinois Medical District Commission. See Illinois Medical District Commission – link to example: http://emma.msrb.org/MS243857-MS219165-MD426422.pdf

Definition

According to the Municipal Services Rulemaking Board**,** *the term "moral obligation bond" refers to a bond, usually issued by a state or agency, that is secured by a non-binding covenant that any amount necessary to make up any deficiency in pledged revenues available for debt service will be included in the budget recommendation made to the state legislature or other legislative body, which may appropriate funds to make up the shortfall. The legislature or other legislative body, however, is not legally obligated to make such an appropriation. Unlike a general obligation pledge, the moral obligation bond does not require voter approval and does not have the state's official pledge of its full faith and credit*.[2]

Variations on the above definition include reference to where and to what extent debt service reserve requirements must be maintained in conjunction with issuance, who issues the debt, and the mechanism involved in covering any shortfall.

In bond documents, the moral obligation pledge is commonly referred to as "Debt Service Reserve Fund deficiency make up provision." The moral obligation is always the secondary, rather than primary, security feature; for charter schools, primary security would be general revenue pledge along with first mortgage lien on real property and improvements

In order to trigger action anticipated under the typical moral obligation pledge, the conduit issuer, trustee, or other entity independent of the borrower must determine that there are either insufficient

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[1] http://www.cdfa.net/cdfa/cdfaweb.nsf/ordredirect.html?open&id=sep2003tlc.html

[2] http://www.msrb.org/EducationCenter/Municipal-Market/About/Overview/Sources-of-Repayment.aspx

monies to pay principal and/or interest on the bonds due during the next state/city fiscal year, or there has been a withdrawal of funds from the Debt Service Reserve Fund to pay principal or interest on the Bonds. Upon such determination, a certification is made to the chief executive officer, i.e. governor or mayor, of the amount required to meet debt service on the Bonds, or to restore the level of funding in the Debt Service Reserve Fund to the level required under the Indenture. The governor/mayor is then required to submit the appropriation request to the legislative body as expeditiously as possible. Any appropriation requested is subject to approval by the legislature, which is not required to appropriate. That said, the combination of experience and conventional wisdom holds that legislative bodies are very likely to do so – as discussed recently in Rhode Island https://www.bloomberg.com/view/articles/2012-06-27/curt-schilling-s-moral-obligations-and-rhode-island-s

2. Moral Obligation and Charter Schools

Colorado and Utah are the only states with active Moral Obligation (MO) programs for charter schools. Indiana initially authorized use of the State of Indiana's and the City of Indianapolis' MO pledge for charter schools though the statute has not been actively implemented on behalf of the state's charters.[3]

Colorado

Colorado pioneered the use of moral obligation financing for charter schools in 2002, authorizing $200 million of charter school debt that could be issued and backed with the state's moral obligation.[4] Colorado charter schools must be rated as "investment grade" to be eligible for state MO backing. Schools providing a "credit assessment" from a rating agency finding investment grade credit worthiness may move forward with moral obligation prior to receiving the formal credit rating.

Colorado's initial 2002 cap of $200 million to be issued under the moral obligation pledge was reached in less than two years (by August 2005), leading to 2006 legislation increasing the fund to $400 million. Subsequent 2014 legislation added an additional $100 million.

2003 and 2004 saw considerable MO financing activity, mostly attributable to schools refinancing prior bond transactions. Since then, however, the pace has slowed – after getting to the first $200 million in just three years, it took another ten years (June 2015) before the outstanding par amount of bonds issued under the moral obligation program reached $400.5 million.[5] Since 2002 there have been 56 moral obligation transactions totaling $699.7 million, with a current debt totaling $400.5 million for 32 schools. The Official Statement of a Colorado MO enhanced bond transaction appears here http://emma.msrb.org/ER977085-ER764592-ER1166015.pdf

Utah

Utah's MO program began in late 2012 when Ogden Preparatory Academy borrowed $17.8 million to construct a new school facility. Since then, there have been 13 additional Utah MO transactions (just one in 2016) totaling $228.5 million. Because Utah's credit profile is at the very

[3] http://www.lisc.org/media/filer_public/59/38/5938b90b-07cc-411c-845f-431f50a4682e/2014csflandscape.pdf
[4] http://www2.ed.gov/admins/comm/choice/charterfacilities/report_pg15.html
[5] https://www.colorado.gov/pacific/treasury/charter-school-intercept-and-moral-obligation

highest triple-A level, its MO pledge raised the S&P rating for these enhanced bonds to the double-A level from the unenhanced "BBB-" category. [6]

See the following link to the OS of a MO enhanced Utah transaction. http://emma.msrb.org/ES761492-ES597801-ES993565.pdf

3. Moral Obligation Components

Moral obligation legislation involves various elements. These are listed below along with Colorado and Utah specifics for reference.

Components	Colorado	Utah
Eligibility		
Minimum Credit Quality	Investment grade rating required for MO enhancement.	State Authority established criteria including: (a) Whether the school has an investment grade rating; and (b) As allowed under statute has added eligibility criteria.
Tax-exempt bonds	Effectively, yes	Yes, in Authority regulations
Issuer		
	The Colorado Educational and Cultural Facilities Authority (CECFA) is Colorado's single statewide conduit issuer for all charter school bond transactions – including those MO enhanced	State Charter School Finance Authority – staffed by State Treasurer's staff and overseen by three-person board including treasurer.
Oversight and Monitoring		
	Colorado's legislation assigns different roles to both CECFA and the State Treasurer for overall management of the state's moral obligation program. Generally speaking, CECFA is more involved at issuance (i.e. gatekeeper) while the Treasurer's office manages the reserve fund and would presumably be more active in the event of default.	The entirety of the MO process "housed" in and under the Treasurer's watch – there is no other agency with a key role in the process. The Treasurer's role as state fiduciary and intimate involvement with MO transactions provides concentrated and experienced security.
Amount Authorized		
	Colorado began with a cap of $200 million that could be issued with state MO backing and subsequently raised that limit in two stages to $500 million. Over $150 million was issued in the program's first year.	Utah uses a convoluted formula that 1) Establishes a cap; 2) With some facial comparability to state support for district bond guarantees.

[6] http://www.lisc.org/media/filer_public/59/38/5938b90b-07cc-411c-845f-431f50a4682e/2014csflandscape.pdf

	Colorado's initial debt cap was somewhat arbitrary though reflected an amount that didn't sound too high while still allowing a healthy amount of business under that initial $200 million.	The cap is currently just under $390 million.
Credit Support		
School Level	School level debt service reserve fund required for access to MO program (minimum one year's debt service to be used to keep payments regular)	School Debt Service Reserve Fund requirement as set by authority – same one-year debt service coverage.
State Level	State debt reserve fund used to replenish school debt service reserve funds if needed Initially funded with $1 million plus percent of savings from all charter deals benefitting from MO to accrue over time. Additional $6.5 added to fund in 2014 Colorado did not have a lot of money available to seed the initial reserve fund. Use of the $1 million and accrual method was designed to help sell the program at first – knowing that the state reserve fund was inadequate to cover any real shortfall	State maintains a Charter School Reserve Account funded with initial ($3 million) appropriation and annual contributions from participating schools. The current balance is $7.5 million.
Role of Authorizer		
	Colorado does not assign a role for charter authorizers beyond CECFA asking for a letter of good standing.	Authorizers are notified of pending financing.

4. Moral Obligation Benefit

Charter School Experience

Based on the 56 transactions since 2003 Colorado's moral obligation pledge predictably raises a low investment grade rated school to an "A" mid-range investment grade category.[7] For more information on credit ratings categories see attachment B.

Based on the experience of 14 Utah MO transactions, the same low investment grade rated school sees their rating improved to the "AA" level due to Utah's state credit rating being at the highest AAA level.[8]

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[7] http://www.lisc.org/media/filer_public/59/38/5938b90b-07cc-411c-845f-431f50a4682e/2014csflandscape.pdf
[8] http://www.lisc.org/media/filer_public/59/38/5938b90b-07cc-411c-845f-431f50a4682e/2014csflandscape.pdf

The combined experience of Colorado and Utah suggests a general MO ratings bump from the bottom of the investment grade range to one in the mid to higher investment grade range. The underlying credit rating of the "pledging" jurisdiction has the greatest impact on the resulting credit rating of the enhanced transaction.

	Initial rating	Unenhanced School Rating	MO Enhanced
Utah	AAA	BBB-	AA
Colorado	AA	BBB-	A

5. Replicability

Other states that are interested in pursuing a moral obligation in their state should review the moral obligation components table above. In addition, a state should:

a. **Review Existing Debt**: Determine the existing tax-exempt debt of charter schools noting the number of transactions, the par amount, and the concentration of borrowers.

   Depending on the terms of their current bond issuances, schools with existing debt and investment grade ratings might see substantial debt service savings if refinanced under a moral obligation pledge. Assuming some cap on MO financing (perhaps using CO and UT caps as illustrative), those best positioned to benefit from MO financing could consume a large percentage of available financing and minimize access for new borrowers. On the other hand, those schools' participation could help promote MO legislation on the front end and help stabilize the reserve fund to the benefit of the overall charter community.

b. Project the Pipeline of Charter School Debt: Determine the number of charter schools and the amount of debt they need to secure future sites. This will help size the need for a moral obligation. The Colorado cap is currently $500 million and the Utah cap is $390 million. The cap can be set for the near-term demand with the intent of raising it as the market matures and as the state gains experience with this financing mechanism.

c. **Investigate Use of Available Funding**: Determine the potential to tap A state's Capital Budget to seed a Moral Obligation reserve fund. This would improve the odds of legislative success by creating an initial reserve fund to protect against loss. A capitalized reserve fund that can be tapped in the event of an MO default clearly increases the comfort level for policy makers contemplating MO enhancement. Experience suggests the amount involved does not need to be large to increase that comfort level - Colorado started with a minimal $1 million contribution (since increased) and Utah began with $3 million. As noted below both states' reserve funds are also supplemented with school contributions from those issuing under the MO.

d. **Plan for School Contributions**: Both Colorado and Utah supplement their state reserve fund with school contributions tied to the finance savings realized by schools benefitting from MO enhanced financing. While this adds funds to the safety net of a reserve fund, that accumulation is fairly gradual, meaning the primary benefit (at least in the near term) is the appearance of beneficiary schools contributing to the cause.

The author, Jim Griffin, acknowledges the assistance of the Local Initiative Support Corp, Wendy Berry, the Utah State Treasurer's Office, and Robert Cane among others for their input. This paper was commissioned by Building Hope through the Charter School Facility Research Hub, a collaborative effort of charter school facility support organizations. The Hub is dedicated to conducting and applying research to create a positive environment for charter school facility projects. For those interested in exploring a moral obligation in their state, please contact Jim Griffin at Momentum Research or Mark Medema at Building Hope.

Attachment A - Illustrations

Please see Table 1 for an illustration of potential costs, savings, and reserve accumulation using various interest rates at an assumed $20 million average issuance. The cumulative numbers assume 3 issuances per year for the first ten years (and then no more) for a cumulative of $600MM.

Table 2 below presents two Colorado transactions issued a month apart –one with the MO enhancement and the other without— and shows the considerable difference in overall debt service paid by the schools.

Table 1 – Sample Benefit to a New State Factor	Low Interest Rate Environment	Medium Interest Rate Environment	High Interest Rate Environment
Unenhanced Rating	BBB	BBB	BBB
Unenhanced Interest Rate	4.00%	6.00%	7.0%
Annual Debt Service (a)	$1,156,602	$1,452,978	$1,611,728
Total 30 Year Debt Service (b)	$34,698,059	$43,589,347	$48,351,842
Enhanced Rating	A	A	A
Enhanced Interest Rate	3.40%	4.50%	5.25%
Annual Debt Service (c)	$1,087,427	$1,227,831	$1,338,339
Total 30 Year Debt Service (d)	$32,622,799	$36,834,926	$40,150,160
Annual Transaction Savings (a-c)	$69,175	$225,147	$273,389
Cumulative Transaction Savings (b-d)	$2,075,261	$6,754,421	$8,201,682
Annual Deposit to M.O. Reserve Fund/School	$6,918	$22,515	$27,339
Total Annual Savings (3 bonds per year)	$207,526	$675,442	$820,168
Total Cumulative Savings (30 years with 3 bonds per year for first 10 years)	$52,919,143	$172,237,739	$209,142,891
Final MO Reserve Fund Balance at 30 yrs	$5,291,914	$17,223,774	$20,914,289

Table 2 – Comparison of similar issuances Examples:	Unenhanced Rate Assumption	Enhanced Rate Assumption	Basis Point Difference
Global Village Academy ($6.58 million sold non-rated on 6/22/16)	5.869%		
Excel Academy (sold with Colorado MO with enhanced rating of 'A' on 7/22/16)		3.16%	271

Attachment B – Credit Rating Definitions

Moody's		S&P		Fitch		
Long term	**Short term**	**Long term**	**Short terme**	**Long term**	**Short term**	
Aaa	**P-1**	**AAA**	**A-1+**	**AAA**	**A1+**	**Prime**
Aa1		**AA+**		**AA+**		**High Grade**
Aa2		**AA**		**AA**		
Aa3		**AA-**		**AA-**		
A1		**A+**	**A-1**	**A+**	**A1**	**Upper Medium Grade**
A2		**A**		**A**		
A3	**P-2**	**A-**	**A-2**	**A-**	**A2**	
Baa1		**BBB+**		**BBB+**		**Lower Medium Grade**
Baa2	**P-3**	**BBB**	**A-3**	**BBB**	**A3**	
Baa3		**BBB-**		**BBB-**		
Ba1	Not Prime	BB+	B	BB+	B	Non Investment Grade Speculative
Ba2		BB		BB		
Ba3		BB-		BB-		
B1		B+		B+		Highly speculative
B2		B		B		
B3		B-		B-		
Caa		CCC+	C	CCC	C	Substantial risks
Ca		CCC				Extremely speculative
C		CCC-				In default, with little prospect for recovery
/		D	/	DDD	/	In default
/				DD		
/				D		