U.S. Municipal Bond Market

The Texas PSF is Up Against a Federally Allocated Cap

- The Texas Permanent School Fund (Aaa/AAA/AAA) is very close to reaching a federal allocated cap.
- The potential for extension by the federal government and what that timing could look like is currently unknown. It is not a certainty that the capacity will be increased.
- We are currently not expecting credit or rating pressure on bond issues already enhanced by the Texas Permanent School Fund. We are also not currently expecting credit or rating pressure to underlying ratings as a direct result of the cap expiration.

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School Enhancement Programs

U.S. state enhancement programs for school districts can be broken down into four general categories. The four we most commonly see used are state guarantees, state appropriation pledges, intercept mechanisms and permanent funds. State permanent school funds are established under a state's constitution, but there is not a direct connection between the credit quality of the state, and there is no direct link to a state's underlying state rating. The credit quality of a particular permanent school fund is derived from features such as a fund's investment holdings, asset-liability metrics, and investing guidelines, policies and performance.

We are currently not expecting credit or rating pressure on bond issues already enhanced by the Texas Permanent School Fund.

The Texas Permanent School Fund

The Texas Permanent School Fund (TX PSF) serves Texas residents by guaranteeing debt issued by qualified school districts and charter schools. The TX PSF began in 1845 and currently guarantees $95 billion of outstanding bonds with $55.6 billion of assets (as of August 2021). Moody's, S&P Global, and Fitch assigned their highest rating to the TX PSF—the program's ratings are Aaa/AAA/AAA.

Texas Permanent School Fund Top Ten Exposures

TX School District	Moody's Rating (Outlook)	SP Global Rating (Outlook)	PSF Guaranteed Debt ($ in millions)	Interceptable State Aid (FY21) as % of Gen. Fund Revenues	% of Total PSF Guarantee
Cypress-Fairbanks ISD	Aa1 (stable)	AA (stable)	3,104	41.2%	3.2%
Dallas ISD	Aa1 (stable)	AA+ (stable)	2,986	12.0%	3.1%
Northside ISD	Aa1 (stable)	AA (stable)	2,237	32.2%	2.3%
Frisco ISD	Aa1 (stable)	AA+ (stable)	2,135	21.4%	2.2%
Houston ISD	Aaa (stable)	AA+ (stable)	2,045	13.5%	2.1%
Katy ISD	Aa1 (stable)	AA (stable)	1,774	44.3%	1.8%
Fort Bend ISD	Not rating	AA+ (stable)	1,403	40.1%	1.5%
Lamar CISD	Aa2 (Negative)	AA (stable)	1,338	44.9%	1.4%
Conroe ISD	Aa1 (stable)	AA+ (stable)	1,334	31.0%	1.4%
North East ISD	Aa1 (stable)	AA- (stable)	1,291	27.7%	1.3%

Source: TX PSF annual statements, Moody's, SP Global, and HilltopSecurities

Recent Press Attention

Articles in the press this week brought additional attention to the fact that the debt limit of the TX PSF under federal law is close to its capacity. We saw an article in the Texas Tribune and an article in The Bond Buyer and both addressed this reality.

Data published on the Texas Education Agency's website shows that the available capacity of the program is now down to only $652.6 million as of Oct. 31, 2022.

What We Know

The allowable capacity for the TX PSF under federal law is currently $117 billion. Data published on the Texas Education Agency's website shows that the available capacity of the program is now down to only $652.6 million as of Oct. 31, 2022. A significant and expected decrease in the allowable capacity recently occurred as a result of the voter-approved referendums that occurred during recent elections.

The TX PSF's federal cap was last extended back in 2009. However, we are not certain that the $117 billion cap will be increased again. If the program's capacity is increased, we do not know when precisely that decision is likely to occur. We are not able to tie this process to policy items being considered during the lame duck Congress for example. Nor are we able to tie a potential increase to legislative agenda items that are likely to be considered in the beginning of 2023. Therefore, we are uncertain if or when the TX PFS capacity is going to be increased.

If the program runs out of remaining capacity, Texas school districts and charter schools will need to rely on their underlying ratings when they access the capital markets during debt financings.

Will Likely Increase Issuer Debt Service Costs If Capacity is Not Increased

If the program runs out of remaining capacity, Texas school districts and charter schools will need to rely on their underlying ratings when they access the capital markets during debt financings. This reality, all things being equal, will likely increase debt service costs for Texas school districts and charter schools. It is difficult to generalize what the increases would look like because there are several factors that go into deciding pricing levels. But, in most cases we are expecting that debt service costs for new issues will be higher without the TX PSF pledge.

Do Not Expect Credit Deterioration

We are not expecting any credit deterioration or negative ratings pressure to any current TX PSF issues in front of or after (if) the federal capacity is reached at least in the near-term. This could change if the program liquidity or other factors change, but we are not anticipating any weakening at this time.

We are not expecting any credit deterioration or negative ratings pressure to any current TX PSF issues in front of or after (if) the federal capacity is reached at least in the near-term.

Under a scenario where capacity on the program is reached, we are not anticipating credit deterioration or negative ratings pressure to school or charter school participants that sell debt outside of the TX PSF. This could also change depending on macro-economic circumstances and as individual credit situations evolve, but we do not anticipate pressures developing as a result of current conditions.

Recent HilltopSecurities Municipal Commentary

- State Credit Mainly Improved & Most Positioned to Withstand a Recession, Dec. 6, 2022
- Anticipating Municipal Issuance Will Remain Challenged Again in 2023: Our Forecast, Nov. 1, 2022
- Our 2022 Mid-Term Election Preview, Oct. 20, 2022
- Another Prime Chance to Swing At - and connect with - U.S. Municipal Bonds, Sept. 26, 2022

Readers may view all of the HilltopSecurities Municipal Commentary here.