LOWERING THE COST OF CAPITAL FOR PUBLIC CHARTER SCHOOLS:

A CLOSER LOOK AT MORAL OBLIGATION BONDS

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OVERVIEW

As the public charter school sector continues to mature, more schools than ever are accessing the bond market to finance their next school building. As they do so, the interest they pay is funded by a school's operating costs (which are provided through taxpayer dollars), meaning every extra basis point in interest represents fewer dollars available for textbooks, teacher salaries, and field trips. As states seek to use their education budgets more efficiently, moral obligation bonds are an attractive option to lower interest rates without overburdening the state's balance sheet.

Moral obligation bonds—revenue bonds backed by the pledge (though not the legal obligation) for the state to make up for missed payments with funds appropriated through the budgeting process—have been used for housing and other projects since the 1970s. A state that fails to honor its pledge to backstop payments would risk a downgrade to its credit rating, which would trigger increased borrowing costs across the board for the state. As a result, states take the moral obligation pledge seriously—as does the bond market, yielding higher ratings for bonds supported by a moral obligation and thus lower interest rates.

WHAT ARE MORAL OBLIGATION BONDS?

Moral obligation bonds were first used by the State of New York to support the construction of housing in the early 1970s. Since that time, moral obligation bonds have been used to finance housing, higher education facilities, hospitals, corrections facilities, and more. Moral obligation programs vary in their details, but typically the state holds a funded reserve that can be drawn on in the case of default and pledges that it will appropriate funds to recapitalize the reserve if it is depleted. This pledge is not a binding legal obligation, giving rise to the "moral obligation" label. Moral obligation bonds often receive a credit rating one step below the state's credit rating. Alternatively, general obligation bonds, which the state is legally bound to support, have ratings equal to the state's rating. The advantages of moral obligation bonds are that they are not hard liabilities on the state's balance sheet and do not count toward constitutional limits on debt. Because of these advantages, states turn to them to reduce borrowing costs without increasing state debt.

HOW ARE MORAL OBLIGATION BONDS USED BY STATES?

Moral obligations are utilized by various state government agencies for a wide range of purposes. Virginia is perhaps the most prolific user of the moral obligation, with a total of $3.8 billion outstanding. The Virginia Resource Authority (VRA) issues moral obligation bonds to provide low-cost financing to localities for water, wastewater, public safety, transportation and other authorized projects. VRA had $928 million of moral obligation bonds outstanding as of June 2018 and has sustained a record of no payment defaults. Virginia also has moral obligations issued under the Virginia Public School Authority in the amount of $2.9 billion, though that authority is not expected to issue additional moral obligation debt.

The table below provides a sampling of the many agencies that authorize moral obligation bonds.

TABLE 1

STATE	AGENCY
Alaska	▸ Alaska Municipal Bond Bank ▸ Alaska Energy Authority ▸ Alaska Student Loan Corporation
Colorado	▸ Colorado Educational and Cultural Facilities Authority
Delaware	▸ State Housing Authority
Maine	▸ Finance Authority of Maine ▸ Maine Educational Loan Authority ▸ Maine Health and Higher Education Facilities Authority ▸ Maine State Housing Authority ▸ Maine Affordable Housing Coalition
Michigan	▸ Michigan State Housing Development Authority
New Jersey	▸ New Jersey Housing and Mortgage Finance Agency ▸ South Jersey Port Corporation ▸ Higher Education Student Assistance Authority
New York	▸ New York State Housing Finance Agency
Utah	▸ The State Board of Regents ▸ Charter School Finance Authority
Vermont	▸ Vermont Municipal Bond Bank ▸ Vermont Economic Development Authority ▸ Vermont Housing Finance Authority ▸ Vermont Student Assistance Corporation
Virginia	▸ Virginia Resources Authority ▸ Virginia Public School Authority

Rarely has a state ever had to step in and act on the moral obligation. Two notable instances where a revenue deficiency occurred are as follows:

- **New Jersey, South Jersey Port Corporation:** The state has regularly provided funds to replenish its debt service reserve, effectively making this moral obligation an ongoing state subsidy for the benefit of the Port Corporation. In 2017, the state issued $225 million and anticipates replenishing the reserve again in 2020.
- **Rhode Island, 38 Studios:** The state pledged $75 million toward 38 Studios, a video game company, as an economic development effort. When the company filed for bankruptcy, the state appropriated the funds necessary to avoid defaulting on the bonds. If the state had not acted on its moral obligation, its overall credit rating would have been severely affected.

The examples above illustrate the risk associated with using the moral obligation to support economic development projects, which rating agencies consider to be less essential to the state—and therefore riskier—than other uses, such as healthcare or educational facilities. Rhode Island's ill-fated 38 Studios bond was viewed widely as a high-risk venture and proved to be just that.

Both of these projects are notable because they are economic development projects (and a video gaming company is a bit of a stretch at that). These types of projects often carry additional risk compared to essential government services such as health, education, and housing.

WHERE ARE MORAL OBLIGATION BONDS HELPING CHARTER SCHOOLS?

Despite their widespread use across a variety of other sectors, Colorado and Utah are the only states currently using moral obligation bonds for charter schools. Jim Griffin, who played an integral role in the creation of Colorado's program in 2003 as then-president of the Colorado League of Charter Schools, says that the program has achieved the benefits that were hoped for without some of the downsides that were expected. "A lot of the discussion at the time the legislation passed centered on protecting the state. Now, more than 15 years into the program, two things have strengthened the state's position: no defaults and the 'safety net' reserve fund has grown significantly from where it began," Griffin says.

In Colorado, schools are required to have an investment grade credit rating (which means the school poses a low risk of default) of their own in order to access the moral obligation. In addition to the investment grade credit rating, Utah also looks at a school's financial strength, its operating history, and its location to determine if it qualifies for the moral obligation program. The use of this program in Utah typically results in interest savings of 30 to 40 basis points (which translates to a 0.3% to 0.4% difference in interest rates). The 19 bonds issued through Utah's program to date are expected to realize interest savings of more than $90 million over the life of the bonds. These savings represent taxpayer money that can be spent in the classroom on teaching children instead of paying interest to a bank.

NEW LEGISLATION

In Idaho, where legislation in support of moral obligation bonds for charter schools was just signed into law, there will be no investment grade credit requirement. As a result, Idaho's program should boost interest savings for schools even further, as the moral obligation could be the support needed for a school to go from a speculative credit rating to a high investment grade rating. According to Jim Blandford, managing director in Baird Public Finance group in Colorado, the use of the moral obligation in Idaho could result in a difference of 125 basis points. That means that on a single $10 million bond, a moral obligation could save a school—and the taxpayers funding it—$2.9 million in interest over 30 years. Applying the same savings to a pool of $500 million in bonds translates to school and taxpayer savings of more than $143 million over 30 years.

Other states have considered moral obligation bonds. In Florida, educators have been advocating for increasing the state's financial support of capital projects for schools. However, budgeted capital outlay funds (known as PECO funds) for charter schools, traditional public schools, and state colleges and universities are expected to decrease next year by nearly $100 million to $280 million. Lawmakers have been reluctant to utilize general obligation bonds as a replacement for decreasing PECO funds. The need for new funding solutions could be an opportunity to revisit moral obligation bonds.

SUMMARY

Though the use of moral obligations in the charter school sector is relatively new, the outcomes are similar to those in the many sectors that have made use of the financing tool for decades—significant interest savings for taxpayers, without the addition of hard debt to a state's balance sheet. Given the benefits of the moral obligation programs for asset classes like housing and hospitals, and the success that moral obligation programs for charter schools have experienced in Colorado and Utah, other states should consider legislation for moral obligation programs. That would be a positive development for state budgets and the taxpayers that support them, all while providing much-needed facility financing to benefit charter schools and the children they serve.

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