Article Title: Criteria | Governments | U.S. Public Finance: Securitization Of U.S. Federal Impact Aid Revenues To School Districts Data: (EDITOR'S NOTE: —On Sept. 14, 2022, we republished this criteria article to make nonmaterial changes. See the "Revisions And Updates" section for details.) Federal Impact Aid (FIA) to school districts, when pledged as security for revenue bonds, can provide the basis for investment-grade bond ratings, provided certain characteristics and features are present. As with securitization of other federal programs--such as the HUD Capital Fund Financing Program (Quality Housing & Work Responsibility Act of 1998), and Federal Highway Aid (National Highway Designation Act of 1995)--credit concerns related to FIA (currently authorized under Title VII of the Every Student Succeeds Act), include program, appropriation, and eligibility risks. FIA program payments are also subject to changes in the distribution formulas. Ratings may vary by state, student type, coverage levels, term, and by differing legal structures. The Federal Impact Aid Program and Appropriation Trends Federal Impact Aid was originally passed as PL 81-874 and PL 81-815 by the U.S. Congress in 1950, and signed into law by President Truman. The program represented the first federal commitment to public school education. FIA is paid to school districts that are "impacted" by association with the federal government. This impaction can result from federal ownership of land, which is generally tax-exempt property, and from the presence of federal students, such as students living on Indian Trust or Treaty lands, military bases, and in low-rent housing, or students whose parents live or work on federal land, including large civil-service complexes. Conceptually, due to federal impaction, the affected school districts may have limited ability to raise revenues (due to tax exemptions caused by the federal government) and/or have additional students enrolled as a result of federal activity. The federal aid offsets this impact. To qualify and receive FIA, school districts must also submit an application annually, and meet certain federal impaction thresholds of either 400 or more federal students, or a 3% ratio of federal students accounting for average daily attendance (ADA). In order to qualify to receive payment for civilian dependent children, a district must enroll 1,000 or more of these students, or they must represent at least 10% of the district's total enrollment. FIA is currently covered by five separate line items corresponding to different types of payments. These payment types include: Sec 7002: Property Payments (in districts where the federal government owns significant amounts of land acquired since 1938); Sec 7003 (b): Basic Support Payments (in districts where federal students are being educated); Sec 7003 (d): Disability Payments (for special-education costs of federal students); Sec 7007: Construction Payments (to meet construction needs linked to federal students); and Sec 7008: Facilities Payments (for upkeep and repair of schools owned by the U.S. Department of Education that are used by local school districts). Basic Support Payments typically represent the bulk of appropriations and are distributed to impacted schools with no strings attached. Payments under the various sections are eligible for debt service, except for section 7003 (d) funds, which are restricted to use for special education. Aid distributed pursuant to the other sections is eligible for payment of debt service, although S&P; Global Ratings has determined that Basic Support Payments carry the greatest weight in its rating analysis. Amounts distributed to individual school districts are governed by a strict formula that provides little bureaucratic discretion on the part of the Department of Education, which administers the program. In the event of a delay in the enactment of the federal budget, passage of a continuing resolution would enable the Department of Education to distribute a substantial amount of aid to eligible districts based on prior year distributions, and once the federal budget is passed, the remaining percentage of FIA outstanding would flow to the eligible school districts. Federal Impact Aid Distribution Formulas FIA Basic Support Payments are derived from a formula that takes into account weighted enrollment, the average cost of education, and need. The product of a school district's weighted ADA, its per-pupil dollar entitlement, and its need-based percentage (called a Learning Opportunity, or LOT Payment) determines that district's potential aid distribution. Full payment of entitlements are made to certain districts, but have not been made to all districts because the aggregate amount of FIA appropriated is also a factor, and the program has not been fully funded since 1968. The distribution formula is determined by federal statutes, and is therefore subject to change. Weight FIA is distributed to the affected districts on a weighted average basis. Students living on Indian lands are weighted at 125%, following the notion of higher costs of education associated with educating students living on Indian lands due to the remoteness of school sites and the provision for teacher housing. Military students living on federal land, and other students living on federal land whose parents work on federal land are weighted at 100% of the ADA, while military students, students living in low-rent housing projects, and civilian students whose parents work on federal land receive a weighting of 20% or less. Per-Pupil Aid Since FIA is designed to replace revenues for school districts that, due to federal action, have a reduced ability to raise revenue, payments are based on 50% of the average cost of education, as calculated by the Department of Education. A district's local contribution rate per student will be the greater of 50% of the national or state per-pupil average cost. Need As less than the full formula entitlement for the program has been appropriated since 1968, the shortfall causes allocations to be made. Since there is not enough money to fund the Basic Support Payments, these payments are reduced on a needs basis, and are not simply prorated. In this way, more funds are allocated to districts that are more financially dependent upon FIA. Need is computed by adding together the percentage of federal students in a district compared to total enrollment and the percentage of the operating budget that the calculated maximum Basic Support Payments represent compared to the total budget. The per-pupil Basic Support Payment is multiplied by the sum of these two percentages, and the product is known as the Learning Opportunity Threshold, or LOT modifier. To Summarize Thus Far In the absence of full funding of the program, distributions are prioritized to districts ranked by LOT percentage, with districts with LOT percentages of 100% or more given the highest priority. Federal dollars from the program are allocated to all districts in the amount of their LOT percentage times their calculated Basic Support Payment. Only after all districts with a 100% LOT percentage are paid in full would a district whose LOT percentage was below 100% receive additional funding. Timing From a timing standpoint, eligible school districts conduct a student count in the first month of the school year, and submit an application to the Department of Education by January of the same school year. The department performs the necessary calculations, and performs occasional audits for each school district, and determines LOT percentages for each recipient. Federal budget enactment, which would typically occur in the fall of the subsequent school year, will prompt the flow of federal dollars to the school districts. The department is required by law to notify districts that fail to file by Jan. 31 of each year of such delinquency, and subject to receipt of an application within 60 days of such notification, will withhold 10% of the entitlement as penalty for late filing. Distributions may also be delayed to school districts located in states that do not submit average cost of education data that is crucial to the department's formula calculations. Restrictions on Use of Funds and Equalization FIA is one of the only federal education programs in which funds are sent directly to school districts, thus evading state bureaucracy and regulations. Most FIA funds are general funds, with no strings attached, and may be used for any legal purpose under the relevant state's law. Construction and special-education funds are restricted to those purposes; however, construction funds may be used to pay debt service on bonds that financed construction projects. School districts using the Indian lands basis for their FIA eligibility are required to have "Indian policies and procedures" in place to qualify for FIA. These essentially ensure that Indian children are not discriminated against, and that students' parents and the tribe have input in planning and developing programs. States, which are typically a huge source of operating revenue for school districts, may not consider FIA receipts in formulas related to state aid for education, unless that state is determined to be "equalized." An equalization determination can only occur if a state demonstrates that for 90% of the students in the state, the amount of spending per student does not vary by more than 25%. If this disparity is less than 25%, then that state is allowed to reduce state aid to districts receiving FIA. While FIA would not be reduced in an equalized state, a district would experience reduced operating flexibility if state aid were reduced, which could negatively affect factors such as enrollment, and, therefore, FIA amounts. Credit Risks and Other Credit Characteristics Key risk factors at the federal level include failure on the part of the federal government to reauthorize the program, reduced federal appropriations, delays in enactment of the federal budget, and changes in the distribution formula. Local risk factors include enrollment declines, loss of eligibility, failure to file a timely application, audit findings by the department of education indicating that a district owes a refund of past FIA payment, and failure on the part of a state government to forward necessary data. While some of these risks may be mitigated by a bond's legal structure, the lower range of potential ratings for transactions that are deemed to be investment grade takes all risks into account. S&P; Global Ratings will examine several other factors that are also important components of an investment-grade determination. Since enrollment is an important factor in determining the amount of FIA distributed to a school district, a review of the enrollment trends of a particular district should not give rise to any credit concerns, such as an expectation of a declining trend in FIA. In this regard, economic factors such as employment levels and trends are weighed. Likewise, individual districts' historical FIA revenue is analyzed. Credit distinctions in terms of expected long-term enrollment stability can be made based on an FIA recipient's classification. As with any bond rating, financial stability and good financial management improve an issuer's credit profile, implying that future FIA receipts are contingent upon the recipient remaining a viable operating entity able to attract and retain students. The extent to which a school district also faces strong competing alternatives for enrolled students, such as nearby independent (private), charter, or traditional schools, can also play a role in determining credit quality. Other factors that can cause favorable rating variations include: A high ratio of federal-to-total students, which contributes to a high LOT factor and places a district higher in the pecking order in the likely event that the FIA program is not fully funded; Students of a type carrying a high weight, such as the category Indian lands students, which is weighted at 125%; A demonstration that historical annual surplus revenue has been allocated to capital projects or accumulated, indicating that allocating future FIA for debt service does not crowd out other operating and maintenance expenditures; Strong coverage of maximum annual debt service based on historical and projected FIA receipts; A shorter maturity schedule: while investment-grade ratings are not limited to bonds that mature within the current program authorization, bondholder risk is increased as the final maturity is extended; Strong state statutory framework of a state. For example, Arizona statutes limit debt issuance, and annual debt service to some factor of historical FIA; Whether the school district is subject to state equalization, with nonequalization viewed more favorably; and Strong legal protections and bond covenants (see section below). Legal Documentation and Transaction Structure Legal documentation and transaction structure must also contain sufficient bondholder protections. The pledge of FIA for the repayment of debt service must be a valid, legal, and binding obligation of the district. Federal statutes permit most FIA revenues to be used for debt service, with only certain classifications prohibited--such as funds earmarked for education of students with disabilities. It is critical that the distribution of FIA be made to the paying agent or trustee, with the district receiving residual annual payments only after debt service accounts are filled. Bond documents should require timely independent monitoring of the district's application process to ensure eligibility. Debt service due dates should also occur later in the year, due to the potential for delayed payment caused by either federal, state, or local inaction. Nevertheless, a debt service reserve equal to the maximum amount permitted under tax law is mandatory from S&P; Global Ratings' perspective. Given the potential for fluctuation of FIA receipts, transactions pledging FIA should contain a strong additional bonds test for subsequent parity bond issuance to limit dilution of bondholder security. Frequently Asked Questions What is the interplay between the "Securitization Of U.S. Federal Impact Aid Revenues To School Districts" criteria and the "U.S. Federal Future Flow Securitization Methodology", published March 12, 2012? We take a two-step approach to analyze school district debt supported by FIA. First, we apply the "U.S. Federal Future Flow Securitization Methodology" (FFF criteria) in order to set the maximum rating. Second, we apply the "Securitization Of U.S. Federal Impact Aid Revenues To School Districts" criteria to address transaction-specific issues. For school district bonds with FIA pledged as security, the first step (i.e., the application of the FFF criteria) establishes a cap, or the highest rating that the issue can receive (see table 1 of the FFF criteria and an application example in Appendix 1). As a result, the rating determined through the application of the second step of the analysis can be the same or lower than that indicated by the FFF criteria. Revisions And Updates This article was originally published on April 17, 2002. Changes introduced after original publication: Following our periodic review completed on Sept. 28, 2016, we updated the contact information, deleted or updated commentary, and added the "Related Criteria And Research" section. We also added a section titled "Frequently Asked Questions" on Oct. 20, 2016. Following our periodic review completed on Sept. 20, 2017, we deleted outdated commentary and updated the information on various payment types that cover the Federal Impact Aid. Following our periodic review completed on Sept. 7, 2018, we updated the contact information and deleted a chart that presented outdated information on historical Federal Impact Aid flows. On Sept. 14, 2022, we republished this criteria article to make nonmaterial changes. We updated the information in paragraph 1 to reflect updated legislation. We also deleted aged commentary in the section "The Federal Impact Aid Program and Appropriation Trends," a reference to military base closures in the second paragraph within the "Credit Risks and Other Credit Characteristics" section, and a text box with aged commentary related to Arizona issuers and FIA revenue bonds. In addition, we updated contact information. Related Criteria And Research Related Criteria U.S. Federal Future Flow Securitization Methodology, March 12, 2012 Principles Of Credit Ratings, Feb. 16, 2011