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Moody's Rating Methodology Change

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Moody's New School Rating Methodology Overview

- On January 26, 2021, Moody's Investors Service released a new national credit rating methodology for schools

- Moody's stated goal of the new methodology is to enable it to more uniformly assess credit risk to school districts across the country
  - Essentially Moody's changed its measuring stick
  - Moody's removed and added variables based on their reliability as predictors of credit strength (e.g., absolute size of the school district was eliminated and enrollment was added)

- Along with the new methodology, Moody's prepared a "scorecard" for every school district that it had previously assigned a credit rating

Moody's New School Rating Methodology Overview

- 637 school districts were notified of a potential rating change (79% were unchanged)
  - 236 school districts for a downgrade (14 in Illinois)
  - 304 school districts for an upgrade (eight in Illinois)
  - 97 school districts direction uncertain (one in Illinois)

- In addition, for each financing, Moody's assigns an issuer rating and a rating to the specific financing
  - In Illinois, nearly every time, the issuer rating and the financing (debt instrument) rating will be the same
  - A difference may occur in other states that have financings with the debt service payment being classified as subject to annual appropriation

Moody's New School Rating Methodology Scoring

- Standard Scoring: Economy (30%), Financial Performance (30%), Institutional Framework (10%) and Leverage (30%)
  - The new system also allows for dynamic scoring of the rating categories if a certain variable is too high or low
  - Enrollment is included in the economic score
- Illinois Tier 1 and 2 school districts and Tier 3 and 4 school districts are assigned an Institutional Framework score of "A" and "Aa", respectively.
- Scorecard notching
  - Potential for pension shift (-1)
  - Weak Financial Reporting
    - Cash basis of accounting (-1)
    - Absence of Pension Liability information (-0.5)
    - Absence of information on fixed assets (-0.5)
- Moody's new criteria applies an automatic notching to its <u>scorecard</u> not an automatic notching of the rating. The initial scorecard is often different than the rating outcome.

Credit Rating Scales and Definitions

	Moody's	S&P	Fitch	Kroll	
Investment Grade	Aaa	AAA	AAA	AAA	Extremely strong capacity to meet financial obligations.
	Aa1	AA+	AA+	AA+	
	Aa2	AA	AA	AA	Very strong capacity to meet obligations.
	Aa3	AA-	AA-	AA-	
	A1	A+	A+	A+	
	A2	A	A	A	Strong financial capacity but susceptible to adversity.
	A3	A-	A-	A-	
	Baa1	BBB+	BBB+	BBB+	
	Baa2	BBB	BBB	BBB	Adequate financial capacity but adverse conditions will lead to weakness.
	Baa3	BBB-	BBB-	BBB-	
Non-Investment Grade	Ba1	BB+	BB+	BB+	
	Ba2	BB	BB	BB	Non-Investment Grade Speculative
	Ba3	BB-	BB-	BB-	
	B1	B+	B+	B+	
	B2	B	B	B	Highly Speculative
	B3	B-	B-	B-	
	Caa	CCC+		CCC+	
	Ca	CCC	CCC	CCC	Extremely Speculative
	C	CCC-		CCC-	
			DDD	CC	
			DD	C	
		D	D	D	Default

Rating Surveillance Process

- Once the scorecard was released to each school district under review, the district was given an opportunity to speak with a Moody's analyst and present information that may mitigate a potential downgrade

- Many other IL districts that use cash accounting were not on the list, and in the absence of other negative changes, we expect most of these ratings will remain the same in the future

- For the IL districts that were downgraded, the cash basis of accounting was only one of two or three factors

- One of our clients was on the list for a downgrade and its rating did not change after the further review by Moody's

Take Away from Rating Surveillance

- For districts with large TIF value, provide data on EAV located in TIF districts to increase per capita market value calculations

- Stress that enrollment declines do not reduce State funding

- Provide data on the value of fixed assets if not included in financial statements to eliminate -0.5 notch (data should be in the AFR)

- Provide GASB 68 report from IMRF to eliminate -0.5 notch due to absence of pension liability information

Impact to the District if Downgraded

- A rating change would not impact the interest rate on the current bonds since they are fixed rate

- Consider using S&P on future financings
  - This requires a careful analysis before switching
  - S&P has factors in its analysis that is not favorable to certain IL school districts

- Consider the modified accrual base of accounting after discussing it with your auditor to determine the pros and cons of making a switch
  - In addition to rating agencies, investors prefer accrual accounting

Questions?

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