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The Price Illinois Will Pay For its Deepening Debt.

A little-noted but nonetheless important factor in Illinois' long-running fiscal stalemate has been the state's ability to keep borrowing money even as its finances have deteriorated.

Municipal bond markets have served as a pressure release valve, sparing Gov. Bruce Rauner and House Speaker Michael Madigan the full potential consequences of their intransigence and fiscal dereliction. Investors' appetite for Illinois IOUs helps stave off a short-term crisis that might force Rauner and Madigan to compromise.

Bonds finance capital spending, smooth out cash flows and keep \$26 billion in existing Illinois bond debt afloat through refinancing. The state has even propped up its ailing pension funds with money borrowed in bond markets. "It's critical to the state," says Laurence Msall, president of the Civic Federation, a fiscal watchdog group.

And so far, Illinois hasn't lost that critical funding source, despite a credit profile that only a payday lender could love. The state has more than \$7 billion in unpaid bills, a worst-in-the-nation pension funding shortfall of more than \$100 billion, and it's heading into a second straight year without a budget. Yet it floated \$480 million in bonds in January and plans to borrow another \$550 million this week.

All investors have asked in return is a higher interest rate than fiscally responsible states pay on their bonds. Illinois paid about 4 percent on its last issue, compared with a median rate of 2.34 percent for AAA-rated state bonds, according to Richard Ciccione, CEO of Merritt Research Services, a provider of research and data on municipal bonds.

But a couple of developments last week suggest the price of profligacy is about to rise. Credit rating agencies Moody's and Standard & Poor's cut Illinois' ratings again, with Moody's parking the state just two levels above junk status. More ominously, an influential bond investor openly questioned the market's willingness to indulge a borrower incapable of basic fiscal discipline.

RISING PRICE OF ADMISSION

"We as municipal market participants should really be penalizing in some way, by almost not giving them any access to the market," Peter Hayes, who oversees a \$119 billion municipal bond portfolio at investment giant BlackRock, told Bloomberg News last week. "Think about it—they're a state without a budget, they refuse to pass a budget, they have the lowest funded ratio on their pension of any state, and yet they're going to come to market and borrow money."

Hayes' remarks shouldn't be taken as a signal that bond markets are about to slam the door on Illinois. Budget or no, many investors can't resist a 4 percent yield in an era of rock-bottom interest rates. And from a bondholder's perspective, risk of a payment default appears low, explains Moody's senior credit officer Ted Hampton.

Despite its fiscal chaos, Illinois still brings in plenty of revenue to cover debt service on bonds.

What's more, state law gives bondholders first crack at those revenues, meaning they'll likely get paid before any money goes to struggling social services agencies stiffed by the state. "We don't think the state of Illinois is likely to default on its (bond) debt anytime soon," Hampton says.

What Hayes' comments do suggest, however, is that skepticism toward Illinois is growing among bond investors. Ciccarone notes that some have begun to back away from Illinois bonds, relegating the state to a costlier corner of the market. "With conservative investors you're seeing resistance," he says. "The investors that are stretching for yield are interested."

As demand for Illinois paper shrinks, its borrowing costs will rise. How high? Possibly a lot higher, if paralysis endures in Springfield and Illinois' credit rating keeps falling. Moody's has a negative outlook on Illinois, a sign that at least one more downgrade may be coming. A drop into junk territory would be extremely expensive—junk-rated Chicago Public Schools bonds carry a rate of 8.5 percent.

A far-fetched scenario, perhaps, but Illinois' current fiscal predicament seemed unimaginable not so long ago. As Hampton says, "We're sort of in uncharted territory here with Illinois."

CRAIN'S CHICAGO BUSINESS

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