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Fitch Downgrades Illinois Ratings to 'BBB'; Negative Rating Watch Maintained.

Fitch Ratings-New York-01 February 2017: Fitch Ratings has downgraded the following ratings of the state of Illinois:

- Issuer Default Rating (IDR) to 'BBB' from 'BBB+;
- \$25.9 billion in outstanding general obligation (GO) bonds to 'BBB' from 'BBB+';
- \$431 million Illinois Sports Facilities Authority sports facilities bonds (state tax supported) to 'BBB-' from 'BBB';
- \$2.6 billion Metropolitan Pier and Exposition Authority McCormick Place expansion project bonds to 'BBB-' from 'BBB';
- \$267.8 million city of Chicago motor fuel tax revenue bonds to 'BBB-' from 'BBB'.

The Rating Watch Negative is maintained.

SECURITY

GO bonds are general obligations, full faith and credit of the state of Illinois.

State statutory mechanisms include an irrevocable and continuing appropriation for all GO debt service, and continuing authority and direction to the state treasurer and comptroller to make all necessary transfers from any and all revenues and funds of the state. The state funds debt service in advance by setting aside 1/12 of principal and 1/6 of interest every month for payments due in the ensuing 12 months.

The Sports Facilities Authority, Metropolitan Pier and Exposition Authority, and motor fuel tax bonds require state appropriation for the payment of debt service, resulting in a rating one notch below the state's IDR.

KEY RATING DRIVERS

The downgrade of Illinois's IDR and related ratings reflects the unprecedented failure of the state to enact a full budget for two consecutive years and the financial implications of spending far in excess of available revenues, which has resulted in increased accumulated liabilities and reduced financial flexibility. Even if the current attempts at a resolution to the extended impasse prove successful, Fitch believes that the failure to act to date has fundamentally weakened the state's financial profile.

The Negative Watch reflects Fitch's expectation that the state's implementation of a solution, whether temporary or permanent, will be a challenge in the current political environment and that in the interim the state will continue to delay and defer payments in lieu of balancing the budget. While Fitch acknowledges that there is a plan being developed in the state Senate that contains elements that could ultimately resolve the impasse, its passage is uncertain and the timing of implementing solutions is unknown. Fitch expects to resolve the Rating Watch within the next six months based on an assessment of the state's fiscal trajectory as it starts fiscal 2018. If the state continues on the current path, a further downgrade would be warranted.

Illinois has failed to capitalize on the economic growth of recent years to bolster its financial position. Rather, the decision to allow temporary tax increases to expire and the subsequent failure to develop a budget that aligns revenues with expenditures have resulted in a marked deterioration in the state's finances during this time of recovery. Once again, the state has displayed an unwillingness to utilize its extensive control over revenues and spending to address numerous fiscal challenges.

The 'BBB' rating continues to reflect the strengths inherent in a state's independent ability to control its budget, which remain substantial in Illinois despite policy decisions over a long period that have reduced expenditure flexibility. The rating also incorporates the state's elevated but still moderate liability burden, even considering its accumulated budgetary liabilities. These factors are offset by a history of notable fiscal management weakness that manifests itself in weak operating performance throughout the economic cycle.

Economic Resource Base

The state benefits from a large, diverse economy centered on the Chicago metropolitan area, which is the nation's third largest and is a nationally important business and transportation center. Economic growth through the current expansion has lagged that of the U.S. as a whole.

Revenue Framework: 'aa' factor assessment

Illinois' broad revenue base, primarily income and sales taxes, captures the diversity in its economy and has shown modest growth since the end of the recession. Fitch expects revenue performance to continue to track slow economic growth. The state has unlimited legal ability to raise revenues.

Expenditure Framework: 'a' factor assessment

Illinois has adequate expenditure flexibility despite elevated carrying costs for debt service and retiree benefits, with much of the broad expense-cutting ability common to most U.S. states. However, it is unlikely that reductions in state spending alone would be sufficient to achieve budgetary balance given the magnitude of the current budget gap. Funding demands associated with retiree benefits will continue to be a pressure, as these benefits are constitutionally protected.

Long-Term Liability Burden: 'a' factor assessment

Liabilities are an elevated but still moderate burden on Illinois' resource base, even when considering the large and growing accounts payable backlog that the state has accumulated. The state has very limited flexibility with regard to pension obligations following a May 2015 Illinois Supreme Court decision that found 2013 pension reform unconstitutional.

Operating Performance: 'bbb' factor assessment

Illinois' operating performance, both during the great recession and in this subsequent period of economic growth, has been very weak. The failure to address a long-standing structural budget gap with permanent and comprehensive solutions, whether revenue or expenditure, has left the state with an gaping hole in its operating budget and increasing budgetary liabilities.

RATING SENSITIVITIES

BUDGET SOLUTIONS: Failure to enact a balanced budget for fiscal 2018 would result in a further downgrade. Successful implementation of measures to enact a structurally balanced budget and reduce accumulated budget liabilities would stabilize the credit.

LIQUIDITY: The rating is sensitive to a material reduction in the state's ability to manage within available revenues through discretionary payment deferrals. Furthermore, failure of the state to make its statutorily required debt service transfers as scheduled, 12 months in advance on a rolling basis, would result in an immediate downgrade of the rating to below investment grade because it

would suggest that the state's liquidity pressures are presenting a risk to bondholder interests that has not been evidenced to date.

CREDIT PROFILE

Illinois is a large, wealthy state at the center of the Great Lakes region. It benefits from a diverse economy centered on the Chicago metropolitan area. Illinois' economy has gradually shifted, similarly to the U.S. in general, away from manufacturing to professional business services. The remaining manufacturing sector does include more resilient non-durables, and is less concentrated in the auto sector than surrounding states, but remains vulnerable to cyclical downturn. By most measures the economy has grown slower than the nation for many years and population levels have been stagnant to declining.

Revenue Framework

Illinois has a reasonably diversified revenue base. It relies most heavily on personal income taxes (close to half of general fund revenues) and sales tax. The balance consists of corporate income tax, lottery and gaming revenues, and a variety of other smaller taxes and transfers. The state has a flat personal income tax rate of 3.75%, which was temporarily increased to 5% between 2011 and 2015 from the prior flat rate of 3% to close post-recession budget gaps and reduce accumulated liabilities.

Historical revenue growth, adjusted for the estimated impact of policy changes, has been slightly above inflation but has somewhat lagged national economic growth. With Illinois' economic performance also lagging national growth, Fitch expects a continuation of this trend of flat-to-modest real revenue growth.

Illinois has no legal limitations on its ability to raise revenues through base broadenings, rate increases, or the assessment of new taxes or fees.

Expenditure Framework

As with most states, Illinois' spending is largely for social services and education, although its carrying costs for debt service and pension payments are comparatively high.

Spending growth, absent policy actions, is likely to be higher than revenue growth, driven mainly by increasing pension costs. Illinois has chronically underfunded its pension system based on a statutory formula that permitted a slow incremental build-up to higher pension funding and targeting only 90% of full actuarial funding. Pension costs are unusually large and continuing to grow, crowding out other spending. As with most states, other spending drivers include Medicaid and education.

The fiscal challenge of Medicaid is common to all U.S. states. Federal action to revise Medicaid's programmatic and financial structure appears likely, although the magnitude and timing of changes for state budgets remain unknown. Both the new presidential administration and congressional leadership support significant Medicaid policy shifts. As one of the largest parts of state budgets and by far the biggest source of federal funding to the states, federal decisions could have significant implications for states' ability to manage this key budget item.

Despite carrying costs that are among the highest of the states, Fitch believes that Illinois retains adequate expenditure flexibility that could be used in the budget process. Illinois funds a broad range of services for its citizens and did not significantly reduce spending during the recession. This leaves the state with ongoing capacity to make spending reductions. However, Illinois has no ability to unilaterally modify retiree benefits following the May 2015 Illinois Supreme Court decision that found 2013 pension reforms unconstitutional.

During the current budget impasse, almost 90% of spending continued to be funded in fiscal 2016 at the 2015 rate, based on continuing appropriations, consent decrees, and court orders, as well as the enacted education budget. A similar partial general funds budget was enacted for fiscal 2017, including full-year appropriations for K-12 education and other state and federal funds; however, the partial budget expired Jan. 1, 2017 and the state is again operating without a full budget in place. There is little flexibility to control spending outside of the budget process in part because the governor cannot unilaterally make many changes without legislative participation.

Long-Term Liability Burden

Illinois' long-term liabilities, particularly pension liabilities, are very high for a U.S. state. Illinois is the weakest of the states in terms of its ratio of debt and unfunded pension liabilities to personal income, at 23% as of 2016, well above the 5.1% median for states. The state's three largest pension systems, covering teachers, universities, and state employees, have low funded ratios driven by a history of weak contribution practices.

In addition to its long-term liabilities, the state has a sizeable accounts payable balance that has accumulated through multiple years of operating at a deficit. As of the end of fiscal 2016, the accounts payable balance totaled \$7.6 billion and it has increased since with the ongoing budget impasse. If the senate proposal to issue bonds to reduce or eliminate this budgetary liability proceeds, Illinois' debt levels would be further elevated but would remain within the moderate range.

Short-term borrowing is allowed, subject to a limitation of 5% of appropriations for revenue anticipation purposes, which must be repaid by the close of the fiscal year, and 15% to meet revenue failure, which must be repaid within one year. The state has no short-term borrowing currently outstanding or planned, although notes were issued during the downturn.

Operating Performance

Illinois is poorly positioned to address a future economic downturn. While it has substantial theoretical capacity to weather a downturn, in terms of both revenue-raising potential and spending flexibility, it has not demonstrated the political capacity to achieve a long-term solution to its chronic budget deficits. During the great recession, the state largely maintained spending but delayed payments to address lower revenues. It accrued, as a result, an accounts payable balance that at its peak, reached 20% of the operating budget. In the absence of a change in management's approach to state finances, it is Fitch's expectation that future deficits would also be addressed by deferring state payments and increasing accumulated liabilities, although this approach is made more challenging by the state's already significant and growing deferrals during this period of economic growth.

Illinois' budget management during the current period of expansion has been especially weak. Temporary increases in personal and corporate income tax rates in place for four years, from Jan. 1, 2011 through Dec. 31, 2014, closed or partially closed the budget gap across five fiscal years. However, with their expiration, and the failure to enact a spending plan within expected revenues, the budget gap has ballooned. As a result, the state finds itself with a current operating deficit, structural budget deficit, cash crunch, and accumulation of accounts payable that will surpass its highest level at the depth of the recession.

The governor and state legislature could not come to agreement on a realistic spending and revenue plan for either the fiscal year that ended June 30, 2016 or the current fiscal year. With spending that far exceeded available revenues in fiscal 2016, the state's accounts payable balance grew to an estimated \$7.9 billion at year-end, a significant portion of which was for the state employee health insurance plan. Similarly unable to enact a full-year balanced budget for fiscal 2017, the governor

proposed, and the legislature enacted, a partial budget to fund operations while continuing negotiations over the budget and the governor's proposed reform agenda, which addresses issues separate from the budget. The partial budget has now expired, and if spending continues in the current year without approval of new revenues or the enacting of severe budget reductions, which seem unlikely, the state is on course to once again run a sizeable deficit that would flow through to the accounts payable bottom line.

The state Senate has put forth a series of bills that have the potential to lead to a compromise that will resolve the impasse. The Senate bills include raising the state income tax and other revenue measures, debt issuance to reduce accumulated budgetary liabilities, pension reforms, aid to Chicago public schools, and non-budgetary reforms sought by the governor, including a freeze on property taxes, workers compensation reform, and some form of term limits. These proposals, if they proceed through the full legislature and are signed by the governor, have the potential to meet the requirements to stabilize the Illinois IDR and related ratings. However, their passage is uncertain as is the timing of the implementation of any solutions.

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