

# **Bond Case Briefs**

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## **How Long Can Illinois Hold Onto Investment Grade Ratings?**

CHICAGO – Illinois' sovereign powers over spending and revenues and its sturdy general obligation repayment statute are being tested as its budget gridlock inches toward the two-year mark.

The two factors have propped up the state's credit profile but as the state's budget deficit, bill backlog, and unfunded pension obligations climb to record levels, some market participants and politicians are questioning how long Illinois can preserve investment-grade status.

They see risk in the state's failure to overcome political gridlock and use its sovereign powers to fix its budget problems, and the threat that liquidity strains could overwhelm the GO repayment provisions.

"Nothing is off the table here," S&P Global Ratings analyst Gabriel Petek, a senior director in the state governments group, said when asked how long the state could hold on to an investment-grade rating while continuing on its current course.

Illinois is the lowest rated state, now at the Baa2/BBB level across the board, only two notches away from speculative grade territory where no state has gone in recent memory

"It's something that we are watching. It's unprecedented for a state to go this long without a budget," Petek said during a panel discussion at the rating agency's state and local government credit forum in Chicago Thursday.

Moody's Investors Service and S&P assign Illinois a negative outlook and Fitch Ratings has the credit on negative watch.

The market already trades Illinois paper at junk level. The state's 10-year GO is trading at a 215 basis point spread to the Municipal Market Data's top-rated benchmark. That's up from a 12-month average of 191 bp and up from 170 bp a year ago.

MMD's BBB in the 10-year range trades at a 97 basis point spread.

"Illinois has a much higher spread than this level," said Thomson Reuters MMD's Daniel Berger. "The market does not consider Illinois GOs as an investment grade."

Spreads hit a peak of 238 basis points at the end of 2016. "Illinois is paying a steep price for going two years without a budget," Triet Nguyen, head of public finance credit at NewOak Fundamental Credit, wrote in a March 6 report looking at Illinois and New Jersey trading levels. "This is an unheard-of spread for a state GO credit and we can only infer that the market is already viewing the Prairie State as below investment grade."

S&P's negative outlook suggests there's at least a one-third probability that the state will see a downgrade over a one- to two-year timeframe. Petek said when looking at the state's \$12 billion backlog of unpaid bills and a pension system funded ratio of just 39.2%, "the trend is not good."

About 90% of state government spending continues based on continuing appropriations and court orders, while higher education and social services, have received just piecemeal appropriations.

A downgrade looms if the state begins fiscal 2018 on July 1 without progress, S&P warned in a report earlier this month after negotiations stalled on a bipartisan Senate budget deal known as the "Grand Bargain."

Entering a third fiscal year without a comprehensive budget "could indicate to us an erosion in political will that renders its credit quality and fundamental fiscal conditions as inconsistent with the state's current rating," the report said.

Fitch also issued a pointed warning in connection with its Feb. 1 downgrade.

"If the state continues on the current path, a further downgrade would be warranted," its analysts wrote.

"We have ample liquidity to make debt service payments and are committed to make all bond payments in full and on time," Gov. Bruce Rauner's administration said in a statement. "Monthly general funds revenue on average are more than 12 times monthly general revenue fund general obligation debt service transfer requirements."

## **GOBRI AND SOVEREIGN POWERS**

The sovereign powers that provide broad authority to manage expenses and taxation are highlighted in all Illinois rating reports as a key rating strength, along with its GO statutory protections and its diverse economy.

At some point, however, "you lose the natural protections" afforded by your sovereign powers, said Richard Ciccarone, president at Merritt Research Services LLC.

"Illinois still has the economic capacity to turn it around," Ciccarone said. "That's a big distinction; we have a political stalemate that puts the state in a credit condition that's not consistent with the economic capacity of the state."

A core strength of the state GO - highlighted in state investor presentations and recognized by market participants as one of the strongest among states - is the irrevocable and continuing appropriation for debt service payment.

Statutes direct the state treasurer and comptroller to make all necessary transfers monthly from any and all revenues and funds of the state to cover 1/12 of principal and 1/6 of interest for payments due in the next 12 months. They flow into the General Obligation Bond Retirement and Interest fund known as GOBRI.

"These features remain integral to the state's investment grade ratings," a recent S&P report said.

Analysts worry that such a prioritization over other state stakeholders starved for their aid or vendor payments is not "sustainable."

"Sometimes those protections can fall away," Petek said, citing challenges posed to debt structures in Detroit, Puerto Rico, and Stockton, Calif. At the end of the day, he said, flow of funds and security features don't make up "for what is fundamental insolvency."

Illinois is nearing a point of "service level insolvency," and "it's problematic," he said.

He's not the only analyst with such concerns.

If basic functions of a state cannot be implemented or carried out or vendors or organizations in dire need take the state to court, "that could force the state to reprioritize" its use of revenues, said Howard Cure, director of municipal research at Evercore Wealth Management LLC.

As the state's bill backlog and other liabilities mount so that liquidity is stretched, "layers of protection that cushion you between default and on time payment are diminished," Ciccarone said.

## **INVESTMENT GRADE**

While it's unheard of for a state to fall to speculative grade status, "it's also unheard of to go two years without a budget," Cure said.

"I think the market is still willing to give them a benefit of the doubt" that leaders can reach a compromise, because it's not an economic issue but political paralysis, Cure said.

A one-notch downgrade would send Illinois' appropriation-backed and moral obligation debt, which is one notch below the GO rating, down to junk.

At risk is the Metropolitan Pier and Exposition Authority's \$2.6 billion of convention center bonds, \$431 million of Illinois Sports Facilities Authority sports facilities bonds and \$267.8 million of Chicago motor fuel tax revenue bonds.

Illinois has \$26 billion of GO debt and \$2.5 billion of sales tax-backed Build Illinois bonds. Moody's links the two ratings. Fitch and S&P assign high-grade ratings to sales tax paper.

No state in recent memory has been rated in speculative territory, according to the three rating agencies.

All three major rating agencies had California in triple-B territory in 2003 and 2004, and Fitch and Moody's also sent California there in 2009 and 2010.

Moody's in 2009, when it rated California Baa1, notched some regional center debt three rating levels off the state credit, which put them at junk.

Market participants are pondering the rating agencies' next steps and the impact on trading values.

NewOak in its report said it sees Illinois as a better relative value than New Jersey because it's already trading at junk levels.

A downside for buyers is the prospect that the "Grand Bargain" dies and no new fix surfaces and the rating agencies junk the rating, Nguyen wrote.

"There might be a short-term market over-reaction, which we would view as a buying opportunity," he wrote. "A more likely scenario would call for other rating agencies to downgrade the state to the lowest investment grade status and just stop there."

Nguyen believes it "will still take a lot" for rating agencies to drop the rating below investment grade.

As the budget gridlock drags on, concerns mount that a resolution might not come before the 2018 election, when Democrats hope to win back the governor's office. Rauner, a Republican, is expected to seek re-election.

Nguyen raises the specter that the state will limp along until the next election. That would result “in short-term market volatility, but investors should be well compensated for that risk at a spread of 240 [bp] or wider.”

The impasse has been driven by Rauner’s refusal to approve a budget with any tax hikes unless lawmakers also pass his policy and governance reforms, which are opposed by the legislature’s Democratic majorities.

Senate President John Cullerton, D-Chicago, a co-author of the “Grand Bargain,” warned against such a position in a recent speech.

“By then, we’ll have been downgraded to junk status and no one will lend us money. The new governor will have that hung around his or her neck,” he said.

“The governor is very concerned about the state’s finances and does not expect the state to be rated below investment grade,” the administration said in a statement. “He is seeking a balanced budget and structural changes to grow the economy and improve the state’s fiscal health.”

## **The Bond Buyer**

By Yvette Shields

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