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Credit Rating Superdowngrades Only Confuse Investors.

What does it mean that S&P lowered Illinois sales-tax bonds five steps in one shot?

Coming into this week, Illinois's $2.5 billion in sales-tax bonds carried an AA- grade from S&P Global Ratings, the fourth-most pristine rank. By the firm's own system, that signified "very strong" financial security characteristics differing only slightly from those rated higher.

In one fell swoop on Tuesday, S&P slashed those bonds by five steps. At BBB, just two levels above junk, that same debt suddenly has merely "adequate" protections that could be threatened by an economic downturn.

I have colloquially referred to this type of large rating cut as a "superdowngrade" in the past. Usually it happens to smaller borrowers facing some unexpected and specific source of financial stress. In the case of Illinois, though, S&P simply revised its criteria for priority-lien tax revenue debt and ratcheted the ranking lower accordingly.

For the moment, set aside the question of which rating is more justified. This sudden and drastic action does nothing but create confusion for bond investors. It reinforces how rating companies still struggle to properly grade municipal debt, which can be backed by various revenue streams and have different levels of legal protection from state to state. S&P's move isn't exactly a ringing endorsement for its judgment when looking to buy bonds in Illinois.

This is hardly the first such instance of credit ratings in Illinois that jolt the $3.8 trillion municipal market. In fact, those same Build Illinois bonds were downgraded five levels in May by Fitch Ratings, which also cited revised criteria that required it to give greater consideration to the state's general credit quality. In 2015, I wrote about how Chicago's sales-tax debt was rated AAA by S&P but considered junk by Moody's Investors Service because of differences in how the two firms evaluated such securities. Investors had trouble figuring out the right price.

Speaking of Chicago, this shake-up comes at an awkward time for the Windy City, which was supposed to be in the market this week selling $1.3 billion of debt through its recently established Sales Tax Securitization Corp. It postponed the deal because of what a Chicago spokeswoman called "recent market fluctuations," though some investors speculated that S&P's move rattled the market. Bloomberg News's Elizabeth Campbell reported that debt due in 2053 was being offered for a top yield of 4.37 percent. For Chicago, that's quite cheap borrowing if it can still get it.

But back to the Illinois bonds. S&P's report says they have a "strong credit structure that we believe largely insulates bondholders from economic and revenue volatility." That sounds about right for the previous AA- rating. But then it goes on to say this:

> "To date, the Build Illinois bond program's authorizing legislation has restricted its use to financing capital and infrastructure projects. While this remained the case even throughout the state's two-year budget impasse, future legislatures could enact laws

> broadening the program's allowable uses … in a scenario of severe fiscal distress, which we believe the state is susceptible to experiencing, a legislative expansion of the Build Illinois bond program's authorized uses is conceivable."

Those are two radically different views of the perceived safety of Illinois's sales-tax bonds. On the one hand, investors are well-protected from any economic downturn or revenue shortfall. But also, everything could change, particularly in the not-that-improbable case of severe fiscal distress. Talk about whiplash — which is it?

In truth, the new BBB rating is probably the right one, and anyone buying bonds tied to Illinois (with a BBB- grade overall) probably knows it. But that still doesn't excuse that it took so long to happen. Credit-rating firms suffered serious blows to their reputations during the financial crisis. Moody's, S&P and Fitch also settled claims in 2011 that they unfairly gave lower grades to public bonds than they should have. Altering their criteria to better reflect creditworthiness is necessary, of course, but when it happens regularly and involves a massive shift up or down the ratings scale, it's fair to question why the old model was so off-base.

Muni mutual-fund managers will say that they do their own analysis rather than rely on ratings. The mom-and-pop investors who frequent the tax-exempt bond market don't all have the same luxury. Sure, these grades aren't a perfect science. But considering all three firms both trace their roots back more than a century, you'd think there'd be just a bit more consistency.

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