

Bond Case Briefs

Municipal Finance Law Since 1971

Illinois Budget Impasse Drives Borrowing Costs to 17-Month High.

Illinois's Republican governor and Democratic-led legislature are at an impasse over how to fill a \$6.2 billion budget hole, undermining the state's credit in the eyes of investors and driving up borrowing costs.

The extra yield buyers demand on Illinois bonds relative to benchmark debt has climbed to the highest since 2013, according to data compiled by Bloomberg. Asset managers at Conning and Wasmer, Schroeder & Co. say Illinois, already with the lowest credit rating among U.S. states, is at risk of being cut closer to junk.

Challenges have only mounted since voters last year chose Governor Bruce Rauner, a Mr. Fix-it business executive, to repair Illinois's finances. Lawmakers are poised to pass a spending plan that's short by billions of dollars for the second straight year. The state also lacks a solution for the nation's worst-funded pension system after the state Supreme Court this month overturned a 2013 overhaul.

"They haven't been really willing to make tough decisions and get something done politically that everyone can agree upon," said Justin Land, who helps oversee \$4 billion of munis as director of tax-exempt management at Wasmer, Schroeder in Naples, Florida. "The market is telling you that things aren't going to be fixed, at least not in the near-term."

Bill Burden

After meeting with legislative leaders Friday in Springfield, Rauner told reporters his plans for tax and regulatory change have been on the table for months. There's ample time to reach an agreement by Sunday's deadline to pass bills by a simple majority, he said.

"We will know if they are sincere and we have true reform — we'll know by Sunday night," Rauner said outside the Executive Mansion. "Nobody's going to have to say, 'Well, we didn't have enough time to think about it.' That's baloney."

Thirty-two states are confronting budget gaps this year, next year or both, according to Standard & Poor's. Some are reducing services, while others are proposing tax increases, even in Republican-led capitals. Yet the struggles of Illinois, with a backlog of \$4.4 billion of unpaid bills, stand out, partly because the strains have left it ranked four steps above junk.

While Rauner won't agree to new taxes without spending cuts and steps such as letting localities exempt workers from union dues, Democrats demand more revenue, suggesting steeper levies on high earners. The deficit for the fiscal year starting July 1 emerged after an income-tax increase approved in 2011 expired at the start of January.

Investors are penalizing Illinois as the fiscal pressure builds. Yields on the state's 10-year obligations reached a 16-month high of 4.17 percent last week, data compiled by Bloomberg show. The spread

was about 1.8 percentage points above benchmark debt, the widest since December 2013.

Debt from Illinois has lost about 1.3 percent this year, while the entire municipal market is about flat, Barclays Plc data show.

Downgrade Risk

Illinois is graded A3 by Moody's Investors Service and an equivalent A- by S&P. While both give it a negative outlook, S&P put Illinois on review for a rating cut after the court's May 8 ruling, and said it would decide within three months.

"I don't see how this credit does not get downgraded within the next two months," said Paul Mansour, head of municipal research in Hartford, Connecticut at Conning, which oversees \$11 billion in munis for insurance companies.

Trading in Illinois bonds suggests the municipal market is moving in that direction. Federally tax-exempt general obligations maturing in March 2032 traded Thursday for an average yield of about 4.9 percent. In comparison, a Bank of America Merrill Lynch index of BBB general obligations due in about 17 years has an effective yield of 4.85 percent.

Voting Hurdle

Legislators' task is about to get more difficult. After Sunday, a three-fifths vote will be needed to approve a spending plan.

The Democrats "are only interested in maintaining the status quo of broken budgets," Catherine Kelly, a Rauner spokeswoman, said in an e-mail.

Democratic House Speaker Michael Madigan, who controls the legislative agenda, told reporters this week that the \$36.3 billion budget he intends to send to Rauner, a former private-equity executive, is about \$3 billion short. Democrats plan to work with Rauner to raise the money, Madigan said.

Steve Brown, a spokesman for Madigan, said by phone Thursday that Rauner's budget, proposed in February, had "significant" gaps, including more than \$2 billion in unrealized pension savings.

While Illinois voters elected their first Republican governor since 1998 in November, the choice hasn't done much to alter the political balance of power. Democrats held onto super-majorities in the legislature, setting up the potential for bipartisan compromise — or gridlock.

"People were hopeful coming into the session because it was a fresh start," said David Yepsen, director of the Paul Simon Public Policy Institute at Southern Illinois University. "Now it's turned sour."

Bloomberg

by Elizabeth Campbell and Tim Jones

May 28, 2015