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Illinois Forces Towns to Either Eat Higher Costs or Avoid Market.

Illinois's budget stalemate is leading investors to demand higher yields to lend to its towns and villages, causing bond sales to tumble while borrowers outside the state rush to capture the lowest interest rates in a generation.

The drop in issuance this year stands in contrast to the rest of the $3.6 trillion U.S. municipal market, where bond offerings are on pace to reach the highest level since at least 2002, according to data compiled by Bloomberg. Illinois is one of only five states where they've fallen: issuers have sold $8.4 billion of debt through Sept. 11, down from $9.9 billion a year earlier. It's the biggest decline nationwide.

When municipalities do borrow, investors are requiring higher yields because of the association with the state, said Tim McGregor, head of municipals at Northern Trust Corp. in Chicago.

Illinois, with the lowest credit rating of any state, has been without a budget since the year began on July 1 because of a political standoff. That's forcing Illinois to leave some bills unpaid and casting doubt over how it will close a $6.2 billion shortfall.

"You're definitely getting a little extra yield as an investor, even in credits that may not have a direct link to the state," said McGregor, who oversees $27 billion of state and local government securities.

The financial pressure on the local governments has been underscored by Chicago, whose credit rating was cut to junk by Moody's Investors Service in May because of the soaring bills the city faces from its underfunded employee pension funds. It isn't alone: Half of the state's local retirement systems have less than 60 percent of the assets needed to cover all the benefits due as workers retire, according to a commission created by the legislature.

Bond buyers will have their choice of two large deals from the state this week. The Metropolitan Pier and Exposition Authority, which runs Chicago's convention center, is selling $223 million of bonds Wednesday.

OSF Healthcare System, a hospital operator, plans to offer $368 million of tax-free debt through the Illinois Finance Authority on Thursday.

McGregor said Illinois hospitals are being penalized for the state's crisis.

"Health-care bonds in Illinois are probably trading 25 to 50 basis points cheaper, just because of the situation in Illinois, than they would be otherwise," said McGregor.

There's no sign of a resolution to the budget impasse, which has lasted longer than any in the state's history, according to the Civic Federation, a Chicago-based research group. Republican Governor Bruce Rauner and the Democrat-led legislature can't agree on how to fix a deficit left after temporary tax increases expired.

Illinois's bills are piling up without a budget, with the unpaid tab set to reach $8.5 billion by the end of the year from $5.5 billion in August, state comptroller Leslie Geissler Munger said last week. The state is paying about 90 percent of what it owes even during the standoff, she said.

The budget delay has already dealt a blow to the Metropolitan Pier and Exposition Authority, which was unable to make a deposit into its debt-payment fund in July because lawmakers hadn't appropriated the money.

While lawmakers approved the funds last month, the lapse caused Standard & Poor's to lower the authority's rating seven steps from AAA to BBB+, three ranks above junk.

OSF, which operates 10 Illinois hospitals, hasn't felt a direct impact yet, said Dan Baker, its executive director of Treasury services. Proceeds from its sale will be used in part to finance construction and renovation at medical centers in Bloomington, Peoria and Rockford, offering documents show.

"Most of the investors we talk to understand the situation," said Baker. "There's been a little delay in payment at times, though it's not too far behind right now — although it may be without the budget being approved."

Catherine Kelly, a spokeswoman for Rauner, declined to comment on the increasing borrowing costs for Illinois agencies and municipalities. She said on Sept. 2 that the state was "being cautious about bond sales" and plans to issue some debt this year, though it hasn't announced any details. Illinois 10-year general obligations yield 1.94 percentage points more than benchmark munis, near the most since late 2013, Bloomberg data show.

Investors penalized local borrowers even before the new fiscal year began as Illinois lawmakers dueled over the budget deficit. A school district in Rockford, 88 miles (142 kilometers) west of Chicago, issued $40 million of debt in February, with 20-year bonds priced to yield 4.17 percent, Bloomberg data show. That compared with a 3.21 percent rate on an index of similarly rated AA bonds.

Lake County, which borders Chicago's home county to the north, sold $90 million of top-rated general obligations in June. The portion due in about 30 years priced to yield 4.05 percent, compared with 3.43 percent for an index of top-rated municipals.

"Some of their headlines have caused Illinois spreads outside of the state and Chicago to widen out, and there are a lot of very strong municipalities within the state of Illinois," said Rick Taormina, head of municipal strategies at J.P. Morgan Asset Management, which oversees $56 billion in state and local debt.

"We're looking to take advantage of that widening if it occurs."

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