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Here's One Record Illinois Doesn't Want to Attain: QuickTake Q&A

Illinois may soon become the first state on record to have its bond rating cut to junk. Behind that financial trouble is an intractable political impasse and drama that's been building for more than two years as Republican Governor Bruce Rauner and the Democrat-led legislature battle over how to close the state's chronic budget deficits. Illinois is on track this fiscal year to spend over \$6 billion more than it brings in, and public universities are reeling from the loss of state aid. On June 1, S&P Global Ratings warned that the loss of its investment-grade rating is likely unless action comes soon.

1. Can Illinois go bankrupt?

No. States aren't eligible to petition U.S. courts to escape from their debts, the way cities such as Detroit have. While Congress amended the law to allow for Puerto Rico to do so, any effort to extend that to states is extremely unlikely, would face intense opposition and may not pass constitutional muster. When the idea was raised in Congress after the last big recession, it was roundly opposed by governors and U.S. lawmakers from both parties who said it would rattle the bond market and punish even financially prudent governments. Some saw it as a tool to gut the pensions of public employees.

2. Is Illinois the next Puerto Rico?

Its fiscal squeeze isn't nearly as bad as the one gripping Puerto Rico, which in May agreed to use bankruptcy-like proceedings to slash its debt. A U.S. territory, Puerto Rico is contending with a shrinking economy, years of deficit borrowing and a declining population. It owes more than twice as much to investors as Illinois, a state with a larger, wealthier pool of residents and an expanding economy that's vastly bigger. While Illinois's financial challenges are significant, the crisis is largely politically self-inflicted.

3. What are the politicians fighting about?

Rauner and Democrats who control the legislature can't agree on how to eliminate budget shortfalls that persisted after a temporary tax hike expired in January 2015, just as the governor took office. Rauner has pushed for any fiscal fix to include key elements of his agenda, such as property-tax curbs, an overhaul of the workers' compensation insurance system to cut costs and legislative term limits. Democrats say they've passed compromise measures that incorporate some of his goals, but Rauner says they don't go far enough to enact real change.

4. What will happen once Illinois is cut to junk?

The downgrade will likely force Illinois to pay higher interest rates whenever it needs to raise money in the financial markets. Mutual funds that are only allowed to own investment-grade securities would be unable to purchase its bonds, leaving it potentially more dependent on non-traditional buyers such as high-yield and hedge funds. That's what happened after Puerto Rico was cut to junk

in 2014. The stigma could also scare off some individual investors, who hold more than 40 percent of all municipal securities directly in their portfolios. Individual investors are sometimes prone to react to negative news reports, a phenomena municipal analysts refer to as “headline risk.”

5. Will there be a big selloff of Illinois bonds?

Probably not. Some of the biggest money-management firms that own Illinois bonds have said they could continue to hold them if the rating is cut. Matt Fabian, a partner at Municipal Market Analytics, said that funds that would have to sell their bonds have likely already done so, given that the downgrade is widely expected and was telegraphed in advance. Prices have already declined considerably since the last downgrades on June 1. The yields on Illinois 10-year bonds have jumped nearly half a percentage point to around 4.8 percent, some 3 full percentage points more than those on top-rated securities, according to data compiled by Bloomberg.

6. Is Illinois going to default?

Putting the state’s bonds just one step below investment grade indicates that’s a fairly distant possibility. S&P says that a BB rated borrower is “less vulnerable to nonpayment than other speculative issues,” though it faces major ongoing uncertainties that could undermine its capacity to make good on its debts. Despite the lack of a budget, debt service has continued to be paid and Illinois can draw on any unrestricted funds to ensure that it is. No state has defaulted since Arkansas did in the Great Depression.

7. Will this pressure Illinois into passing a budget?

Possibly. Rauner on June 15 called lawmakers back to Springfield to act on a Republican compromise plan before the new fiscal year begins on July 1. But a string of previous ratings downgrades didn’t break the logjam. Democrats and Republicans have each blamed the other side for the paralysis, leading to speculation that their impasse will continue through the 2018 elections, when Rauner can seek a second term.

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