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Fitch Affirms Illinois' IDR at 'BBB'; Outlook Revised to Stable

Fitch Ratings-New York-31 July 2019: Fitch Ratings has affirmed the state of Illinois' Issuer Default Rating (IDR) at 'BBB' and revised the Outlook to Stable from Negative.

Additionally, Fitch has affirmed the 'BBB' ratings on the state's outstanding GO bonds, and the 'A-' ratings on the Build Illinois senior and junior obligation sales tax revenue bonds, which are linked to the state's IDR based on state dedicated tax analysis.

The Rating Outlook for the above bonds has been revised to Stable.

Fitch anticipates reviewing ratings for bonds that may be affected the Outlook revision within the next two weeks. These include Metropolitan Pier and Exposition Authority expansion project bonds (BBB-/Negative Outlook), Illinois Sports Facility Authority sports facilities bonds (state tax-supported) (BBB-/Negative Outlook), and Chicago motor fuel tax revenue bonds (BBB-/Negative Outlook).

SECURITY

GO bonds are general obligations, backed by the full faith and credit of the state of Illinois. State statutory mechanisms include an irrevocable and continuing appropriation for all GO debt service, and continuing authority and direction to the state treasurer and comptroller to make all necessary transfers from any and all revenues and funds of the state. The state funds debt service in advance by setting aside 1/12 of principal and 1/6 of interest every month for payments due in the ensuing 12 months.

Build Illinois bonds have a first and prior claim on the state share of the 6.25% unified sales tax and a first lien on revenues deposited into the Build Illinois Bond Retirement and Interest Fund (BIBRI). Debt service payments on the junior obligation bonds are subordinate to outstanding senior lien debt service; the senior lien is not closed.

ANALYTICAL CONCLUSION

The Outlook revision to Stable reflects key developments over the last three months for the state including an unanticipated revenue surge in April 2019 that positioned the state to resolve a sizable fiscal 2019 mid-year budget gap and enact an on-time fiscal 2020 budget. The positive April revenue surprise seen in Illinois, and other states, supported a significant increase in fiscal 2020 estimated revenues, easing the path to budget adoption and allowing the state to reduce (but not eliminate) reliance on non-recurring measures. The state now has a plausible and achievable 2020 budget plan, leaving the state better positioned from a fiscal perspective, and the potential for a rating downgrade in the near-term has receded. The recent gains, however, are somewhat tenuous and their sustainability hinges on the state's actions over the next several years, particularly around the November 2020 ballot initiative on the graduated individual income tax.

Illinois' 'BBB' IDR and GO ratings continue to reflect an ongoing pattern of weak operating performance and irresolute fiscal decision-making that has produced a credit position well below the level that the state's broad economic base and substantial independent legal ability to control its budget would otherwise support. The state's elevated long-term liability position remains a key credit challenge.

Economic Summary

Illinois benefits from a large, diverse economy centered on the Chicago metropolitan area, which is the nation's third largest and is a nationally important business and transportation center. Economic growth through the current expansion has lagged that of the U.S. as a whole, with population stagnation and labor market weakness.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Illinois' broad revenue base, primarily income and sales taxes, captures the diversity of its economy and has shown modest organic growth since the end of the recession. Fitch expects revenue performance to continue to track its slow economic growth. Significant stalling of economic and revenue growth would be a rating concern as it would weaken the state's revenue framework, and its ability to manage budgetary demands and potentially its long-term liability burden as well. The state has unlimited legal ability to raise revenues.

Expenditure Framework: 'a'

Illinois has adequate expenditure flexibility despite elevated carrying costs for debt service and retiree benefits, with much of the broad expense-cutting ability common to most U.S. states. Contribution demands associated with retiree benefits will continue to be a pressure as these benefits are constitutionally protected.

Long-Term Liability Burden: 'a'

Long-term liabilities are an elevated but still moderate burden on Illinois' significant resource base, even when considering the large accounts payable backlog that the state has accumulated. Illinois has very limited flexibility with regard to modifying existing pension and other post-employment benefit (OPEB) obligations.

Operating Performance: 'bbb'

Illinois' operating performance, both during the Great Recession and the subsequent economic expansion, has been very weak. The state will be challenged to rebuild its financial resilience given the persistence of a structural budget gap and the sizable accounts payable backlog.

RATING SENSITIVITIES

MATERIAL WEAKENING OF FINANCIAL OPERATIONS: Fitch will downgrade the state's IDR if the state exacerbates its structural budget challenges through measures such as materially increasing the burden posed by its accounts payable balance and other liabilities, or otherwise notably increasing the use of non-structural budget maneuvers during a period of ongoing economic and revenue growth.

PENSION OBLIGATION MANAGEMENT: Implementation of proposals to defer or similarly alter annual pension obligations without offsetting measures to reduce long-term costs could also trigger a downgrade. The governor had proposed such a measure in his executive budget that Fitch previously noted as a rating concern, but the enacted budget did not include significant pension changes. Illinois remains very constrained in its ability to revise benefit costs given state

constitutional limitations.

INCOME TAX CHANGES UNCERTAIN: A proposed graduated individual income tax could raise substantial revenue, but faces a long and uncertain path before implementation. The credit implications of the November 2020 vote on the income tax amendment depend on whether Illinois uses any increased revenues to address structural budget challenges, or if the state can adequately adjust its budget to work towards structural balance if the amendment fails.

ONGOING BUDGETARY BALANCE: Upward rating momentum is unlikely until the state more comprehensively addresses its accumulated liabilities including the accounts payable balance.

ECONOMIC RESOURCE BASE

Illinois is a large, wealthy state at the center of the Great Lakes region. It benefits from a diverse economy focused around the Chicago metropolitan area. Illinois' economy has gradually shifted, similarly to the rest of the U.S., away from manufacturing to professional and business services. The remaining manufacturing sector is less concentrated in the auto sector than surrounding states but remains vulnerable to cyclical downturn. By most measures the economy has grown slower than the nation for many years, and population levels have been stagnant, with modest losses in the current decade.

Illinois is one of only three states that the Census Bureau estimates have seen year over year population declines for at least the past five years – Connecticut and West Virginia are the others. While Illinois' total losses are less significant than in those states, Illinois' pace of estimated declines has modestly accelerated each year. Chicago is critical to the state's overall economic trajectory, and the city has also seen modest estimated population losses for the past four years according to the Census Bureau. Despite these trends, the state's economy has continued to grow, as have tax revenues even netting out the estimated effects of the individual income tax (IIT) and corporate income tax rate increase effective on July 1, 2017.

While not anticipated, reversal of currently modest economic growth to outright contraction during a time of national economic growth could weaken Fitch's assessment of the state's revenue framework. This would hamper the state's ability to leverage its robust revenue-raising flexibility to manage its budget.

CREDIT PROFILE

Revenue Framework

Illinois has a diversified revenue base. It relies most heavily on individual income taxes and sales taxes, which combined provide approximately four-fifths of state sources in general funds. The balance consists of corporate income tax, lottery and gaming revenues and a variety of other smaller taxes and transfers. The state raised the individual income tax rate to 4.95% from 3.75% and the corporate income tax rate to 7.0% from 5.25% as part of the fiscal 2018 budget. In 2019, the legislature authorized a ballot question for the November 2020 general election ballot to amend the state constitution and permit a graduated income tax. The legislature and governor also approved a bill that sets new IIT rates and raises the corporate income tax rate effective January 1, 2021 if the amendment passes, which legislative sponsors and the governor estimate could generate \$3.6 billion in new revenues. Some of that revenue will go towards tax relief measures included as part of the legislative package, but the state estimates net new revenues (including both the IIT and corporate income tax increases) would still approximate \$3.5 billion annually (just under 10% of fiscal 2020 state sources in general funds) upon full implementation.

Historical revenue growth, adjusted for the estimated effects of tax policy changes, has generally

been near inflation but has lagged national economic growth. With Illinois' economic performance also lagging national growth, Fitch expects a continuation of this trend of flat to modest real policy-adjusted revenue growth. Unexpectedly weak economic performance could lower Fitch's view of the state's baseline revenue growth prospects.

Illinois has no legal limitations on its ability to raise revenues through base broadenings, rate increases or the assessment of new taxes or fees.

Expenditure Framework

As with most states, Illinois' spending is largely for social services and education. But its carrying costs for debt service and retiree benefits are comparatively high at approximately 19% in fiscal 2017 and retiree benefits have very strong legal protections. Based on the current inadequate 90% statutory funding target and a review of comprehensive annual financial reports (CAFRs) for the states' key pension systems, Fitch estimates carrying costs rose as a share of Illinois' governmental spending in fiscal 2018, and will continue doing so.

Spending growth, absent policy actions, is likely to be higher than revenue growth, driven mainly by increasing pension demands. Pension costs are unusually large and, as noted above, will continue to grow under current law. Illinois has chronically underfunded its pension system based on a statutory formula that targets only 90% of full actuarial funding over the long term.

As with most states, other spending drivers include Medicaid and education. The fiscal challenge of Medicaid is common to all U.S. states and the nature of the program as well as federal government rules limit the states' options in managing the pace of spending growth. Federal action to revise Medicaid's programmatic and financial structure appears less likely in the near term given divided control in Congress.

Despite carrying costs that are among the highest of the states and rising, Fitch believes that Illinois retains adequate expenditure flexibility. Illinois funds a broad range of services for its citizens and did not significantly reduce spending either during or since the Great Recession. The state has ongoing capacity to implement spending reductions via reduced appropriations should it choose to do so.

Importantly, absent a constitutional change, Illinois appears to have no ability to unilaterally modify retiree benefits, including OPEB, for current employees and retirees. In 2014, the Illinois Supreme Court ruled OPEB was covered under the state constitution's pension protection clause and could not be diminished and impaired, invalidating 2012 statutory measures changing OPEB. And the following year, the same court found 2013 pension changes unconstitutional. Given the magnitude of annual pension contributions in particular (more than 10% of spending), this notably constrains the state's expenditure flexibility compared to most other states.

Current annual pay-as-you-go OPEB payments are very modest at less than 1% of total governmental expenditures. But the actuarially calculated annual required contribution is approximately 4% of spending (and about one-third of the pension actuarially determined contribution). As with most states, Fitch anticipates the annual OPEB payments will continue rising given the state's pay-as-you-go funding approach and demographic trends indicating a growing retiree population.

Pension Contributions and Budgetary Relief Measures

Budgetary relief on pension contributions was part of the fiscal 2018 and 2019 enacted budgets, but the actual savings have generally fallen short of expectations. A third tier of pension benefits enacted in the fiscal 2018 budget was projected to save \$500 million that year but appears unlikely to progress with none of the systems taking steps toward implementation due to reported

deficiencies in the enacted legislation.

The fiscal 2019 enacted budget included approximately \$400 million in savings from several changes to the state's pension plans intended to lower liabilities including two buy outs of some portion of current members' future benefits. The pension systems recently reported actual fiscal year 2019 budgetary savings of only \$20 million relative to their previously certified contribution levels.

Under a third change enacted with last year's budget, the state lowered the cap to 3% from 6% on final average salary (FAS) salary increases used to calculate pension benefits for the teachers and state university systems. The state currently bears essentially the full liability for these pension systems. The change required that local employers bear the sole financial responsibility for any salary increases they grant above 3% in the final years of the employee's career.

The 2020 budget extends the two buyouts through fiscal 2024 and reverses the 2019 budget's FAS cap (reverting it back to 6%). Prudently, savings from extension of the buyouts are not incorporated into the budget plan. The administration estimates the FAS reversal will increase state spending modestly, by approximately \$20 million in fiscal 2020, escalating to around \$60 million four years later, and then rising with payroll growth thereafter.

New Labor Agreement Brings Certainty to Expenditures

In conjunction with the enactment of the fiscal 2020 budget, the state also reached an agreement with its primary state employees union, the American Federation of State, County and Municipal Employees Council 31 (AFSCME), running through June 30, 2023 and including the period since June 30, 2015 when the last contract expired. The state also implemented retroactive step-pay increases required following litigation decided last year. The new contract includes one-time stipends for the period without a contract, and annual salary increases ranging from 1.5% to 3.95% beginning in the current year, as well as increases for employee healthcare contributions and co-pays. The state estimates overall healthcare savings could offset the anticipated costs for the contract over the four-year term.

Long-Term Liability Burden

Illinois' long-term liabilities, particularly pension liabilities, are very high for a U.S. state. As of Fitch's December 2018 State Pension Update report, the state's combined debt and pension burden was 29% of personal income, well above the 6% state median and the highest of the states. Based on debt information through March 1, 2019, the long-term liability is approximately 29%. Fitch estimates the state's total long-term liabilities at approximately \$200 billion with pensions accounting for about 80%. This incorporates pension data from fiscal 2017 as the state's 2018 CAFR has not been released. Based on analysis of the most recent state pension system CAFRs, Fitch estimates the state's long-term liability burden based on fiscal 2018 CAFR data will be modestly higher than the current reported level.

The state's three largest pension systems, covering teachers outside of Chicago, public universities, and state employees, have low levels of assets to liabilities driven by a history of weak contribution practices. Net pension liabilities, and related contribution demands, are expected to grow as the state continues to underfund the systems. Based on the Teachers Retirement System (TRS) establishing a 20-year closed amortization period in calculating its actuarially determined contribution (ADC), the state reports the fiscal 2017 pension contribution was approximately 75% of the ADC.

Unfunded OPEB liabilities are sizable at \$38 billion, just ahead of the state's outstanding debt. The OPEB liability represents 6% of personal income and will continue escalating as the state funds its

obligations on a pay-as-you-go basis and is legally constrained from making changes for current employees and retirees.

Fitch's assessment of Illinois' long-term liability burden also reflects a sizable account payable balance accumulated through multiple years of operating deficits, which adds to its ultimate long-term funding demands. Incorporating the full general funds bills backlog of \$7.3 billion (as of June 30 in the state comptroller's monthly debt transparency act report) only increases the more than \$200 billion Fitch-adjusted long-term liability burden modestly, although it poses budgetary challenges and limits the state's financial operating flexibility. The accounts payable balance reached a peak of \$16.7 billion in November 2017 before the state swapped a portion of the payables for GO bonds. The enacted 2020 budget includes authorization for another \$1.2 billion in GO borrowing this year to again replace accounts payable.

Recent Litigation Not Affecting State Ratings

The state is the subject of recent litigation brought by a hedge fund and the CEO of the Illinois Policy Institute (IPI, a fiscal policy advocacy group) claiming the 2017 bill backlog GO bonds and 2003 pension funding GO bonds are unconstitutional and should be invalidated by state courts. Illinois' governor, comptroller, treasurer and attorney general dispute the allegations and in their petition responding to the suit, argued that the bonds fulfill all state constitutional requirements.

As with all state debt, the 2003 and 2017 bonds were approved by the attorney general at the time and bond counsel. Fitch does not consider the filing of this litigation to be a material credit factor but will monitor developments in the case and assess any implications for Illinois' credit profile. The state reports the first hearing on the case (John Tillman and Warlander Asset Management versus the state's governor, treasurer, and comptroller) is scheduled for August 15 in the circuit court for the seventh judicial circuit in Sangamon County.

Operating Performance

Illinois remains comparatively poorly positioned to address a future economic downturn. The states' approach to budgetary gaps has historically been to delay payments, as it did during the Great Recession when it accrued an accounts payable balance that reached 23% of the general funds operating budget in fiscal 2012. The accounts payable balance well exceeded that recessionary peak following the budget inaction between fiscals 2016 and 2017, reaching a level nearly half of fiscal 2018 revenues in November 2017. As noted above the balance has subsequently been reduced to approximately \$7.3 billion as of June 30, 2019 primarily through proceeds from specifically authorized GO bonds and application of federal Medicaid matching funds.

Even with these measures, Illinois continues to carry a sizable accounts payable balance of approximately one-fifth of general funds revenues, well above what Fitch and the state consider normal. Absent robust and sustained budgetary improvement and a commitment to addressing the backlog, Illinois will maintain a similar sizable accounts payable balance into the foreseeable future. Replacing accounts payable with long-term debt has some fiscal benefits given lower interest costs for bonds, but simply shifts, rather than reduces, the overall liability burden.

Fitch anticipates the state would look to address future deficits by again deferring payments. But its ability to do so may be limited by the persistence of the current backlog at a time of economic recovery and payment demands prioritized by court order or other legal requirements, such as for Medicaid and employee salaries, that reduce that flexibility.

Illinois' budget management during the current extended period of expansion has been exceptionally weak. Recent revenue gains stabilized the state's credit profile over the near-term, but long-term

trends remain a significant credit concern.

Temporary increases in individual and corporate income tax rates in place for four years, from Jan. 1, 2011 through Dec. 31, 2014, closed or partially closed budget gaps across five fiscal years. However, with their expiration, and the failure to enact a spending plan within expected revenues, the budget gap ballooned in ensuing fiscal years. Revenues were well below expenditures and accounts payable accumulated at a rapid rate until tax increases were enacted with the fiscal 2018 budget. Although the fiscal 2018 tax increases closed a substantial portion of the shortfall, a significant structural gap remains.

As discussed further below, unanticipated growth in tax collections in fiscal 2019 allowed the state to address a sizable mid-year 2019 gap, and enact a timely 2020 budget that achieves budgetary (but not structural) balance. A gubernatorial proposal for a graduated income tax could generate significant additional revenue to help address the structural gap - but implementation is at least 17 months away and far from certain. The legislature approved moving the proposed amendment to the 2020 ballot, and companion legislation with proposed new tax rates in the 2019 session. But the amendment still requires voter approval at the November 2020 general election and would not be effective until January 1, 2021.

Until the state makes more substantive progress towards ongoing structural balance, either through revenue increases, expenditure reductions, or a combination, Fitch's assessment of Illinois' budget management at times of economic recovery and expansion will likely remain weak.

Current Developments

The state achieved a break in a two-year budgetary impasse with the passage of the fiscal 2018 budget and enacted an on-time budget for fiscal 2019. But neither plan fully addressed the state's ongoing structural challenges. The fiscal 2018 budget included an estimated \$4.5 billion in additional revenues from the increase in individual and corporate income tax rates and limited general funds spending growth, but did not make significant reductions in spending.

Although Illinois avoided another budget impasse for fiscal 2019, the enacted budget (\$38.5 billion in general funds) was reliant on one-time items and policy measures with uncertain fiscal benefits. The budget also failed to make material progress in addressing the state's sizable accounts payable backlog. Recognizing many of the key implementation risks embedded in the budget, the new governor estimated a fiscal 2019 general funds budget deficit of between \$897 million and \$1.3 billion soon after he took office in January 2019.

April Surprise Addresses 2019 and Eases 2020 Process

An unanticipated surge in revenue collections in April 2019 positioned the state to address its fiscal 2019 budget challenges, and also eased the path to enactment of the fiscal 2020 budget. Monthly general funds tax collections increased 32% year over year (yoy) in April 2019 and led the governor's office of management and budget (GOMB) to increase its general funds tax revenue estimate by roughly \$1.5 billion from the governor's executive budget estimate made in February.

Neither the administration nor the legislature's Commission on Government Forecasting and Accountability (COGFA) has reached a definitive conclusion on the basis for the revenue surge. In developing its own revised revenue estimate for fiscal 2019, COGFA noted that most of the increase in revenues came from final extension payments of the individual income tax. COGFA speculated that various factors including taxpayer responses to the 2017 federal tax changes or capital markets activity could have played a role.

The state's enacted fiscal 2020 budget benefited considerably from the robust revenue performance.

Based on these strong collections, the state upped its general fund tax revenue estimates for fiscal 2020 by roughly \$762 million (2%) from the governor's executive budget estimate in February. With the higher revenue base, the enacted budget avoided several one-time measures in the governor's executive proposal (including a pension re-amortization and bonding plan) but does still rely on a non-recurring tax amnesty plan (\$175 million) and \$100 million in interfund borrowing. The budget also includes an estimated \$500 million in new recurring revenues from a healthcare managed care organization (MCO) assessment that will leverage federal matching revenues and support Medicaid spending.

MCO Assessment Requires Federal Approval

The MCO assessment requires approval from the federal government's Centers for Medicare & Medicaid Services (CMS), which has tightened rules around similar taxes over the past several years. To comply with federal rules, Illinois intends to apply the tax to all MCO's in the state (whether they participate in Medicaid or not). Illinois also intends to tier the rates so non-Medicaid plans pay a lower assessment.

CMS recently approved MCO assessments similar to Illinois' proposal for California, Ohio, and Michigan but only Michigan's came under the current administration. Until CMS approved Michigan's assessment in December, it was not clear if the current federal administration would support these plans. Illinois is working with CMS to develop a proposal that meets federal requirements and provides the significant budgetary relief included in the 2020 enacted budget.

The state reports that if an MCO assessment is approved by CMS, it can be levied retroactively for the full fiscal year to generate all budgeted revenues. Outright rejection of Illinois' MCO assessment, or approval at a reduced level could force the state to make mid-year adjustments in 2020.

2020 Budget Includes Education Funding Increases and a Liability Swap

On the spending side, the enacted \$40.1 billion general funds budget for fiscal 2020 includes a roughly \$450 million increase in K-12 funding from the prior year (approximately 5%) with \$389 million flowing through the evidence-based funding formula. The budget also includes funding for the new multi-year labor contract with AFSCME, which represents a significant share of state employees.

While the state forecasts a budgetary surplus of roughly \$150 million in fiscal 2020, Fitch notes this incorporates non-recurring items noted above. Any surplus will pay down a portion of the state's bill backlog. As noted above, the state also authorized issuance of \$1.2 billion in GO bonds to support further pay down but this simply swaps one liability for another.

The 2019 legislative session also included enactment of a \$45 billion capital bill, with \$21 billion expected to come via bonding. Primary revenue sources for the capital bill include increases in the motor fuels tax rate (\$590 million projected by the state in fiscal 2020) and vehicle registration fees (\$475 million annually); and expanded gaming including sports wagering (at least \$350 million annually and more than \$1 billion in one-time licensing fees).

Build Illinois Bonds Rating Details

The 'A-' rating for the Build Illinois senior and junior lien bonds reflects Fitch's linkage of the rating with the state of Illinois' IDR. Structural protections for the bonds warrant a rating no more than two notches above the state's IDR because the bond security includes a statutory pledge of the state share of sales tax revenues (rather than a constitutional or voter-approved pledge), and those revenues flow to state general operations after debt service set-asides. Fitch considers growth prospects for the pledged share of state sales tax revenues to be modest given similar overall expectations for the state's economy. The structure for the bonds, even assuming leverage up to the

full additional bonds test capacity, provides robust resilience through a moderate economic downturn for both senior and junior lien bonds. Fiscal 2018 pledged revenues covered maximum annual debt service on the combined senior and junior liens by a strong nearly 30x.

For additional information on the Build Illinois bonds please see “Fitch Rates \$245MM Build Illinois Bonds ‘A-’; Outlook Negative” published Oct. 1, 2018 on www.fitchratings.com.

Asymmetric Additional Risk Considerations

Illinois has demonstrated a repeated inability to address its structural challenges due to an absence of consensus and resistance among key stakeholders. Despite progress in the most recent legislative session, the track record for the political environment in the state, and its hampering of prudent fiscal policy, remains a negative rating consideration.

Contact:

Primary Analyst

Eric Kim

Senior Director

+1-212-908-0241

Fitch Ratings, Inc.

Secondary Analyst

Karen Krop

Senior Director

+1-212-908-0661

Committee Chairperson

Arlene Bohner

Senior Director

+1-212-908-0554

Media Relations: Sandro Scenga, New York, Tel: +1 212 908 0278, Email: sandro.scenga@thefitchgroup.com

Additional information is available on www.fitchratings.com