Illinois Update: One Year Later, Budget Impasse Continues to Erode Credit Ratings

State of Illinois	
General Obligation bonds	Baa2/BBB+/BBB+
Appropriation bonds	Baa3/BBB/BBB

Sources: Fitch Ratings; Moody's; S&P

On June 8, Moody's downgraded the State of Illinois' general obligation bond (G.O.) rating to Baa2 from Baa1. The following day, S&P downgraded the state's G.O. rating to BBB+ from A-, while Fitch placed its ratings on Rating Watch Negative. Illinois is the lowest rated of the 50 states and is now the only state rated in the "triple-B" category. Over the coming months, Fitch will review its rating in light of the state's ability to pass a structurally balanced budget for the 2017 fiscal year, which runs from July 1, 2016 to June 30, 2017. Should the state fail to pass a budget for the second consecutive year, we believe Fitch will likely downgrade Illinois another notch, to BBB.

Despite Illinois' declining ratings and ongoing budget dysfunction, we continue to view shorter maturity Illinois G.O. bonds as suitable for conservative investors in diversified portfolios. We believe that the state will retain investment-grade G.O. bond ratings. Illinois has the resources and policies in place to ensure that it will make timely payment of principal and interest on its G.O. bonds. We do, however, view appropriation bonds having significantly greater default risk due to the state's inability to effectively manage its budget process. We no longer view Illinois state appropriation debt as being suitable for conservative investors.

We continue to take the view that Illinois' financial problems are, at their core, political problems that can be remedied. Among the factors underpinning our assessment of the state's long-term investment-grade credit quality are:

- Illinois has the sovereign powers to raise revenues, as evidenced by the temporary income tax increase that was in place from 2011 through 2014;
- The state's economy, anchored by Chicago, has performed reasonably well in recent years;
- State statute requires that debt service on state G.O. bonds is paid prior to any other state expenditures; and
- Illinois has adequate inter-fund borrowing capability to ensure that, regardless of liquidity pressures or budget shortfalls in the general fund, the State will have access to sufficient funds to make timely payment on debt.

Illinois' ratings decline over the past seven years is the result of the impacts of the financial crisis and recession, compounded by an ongoing period of legal and political fighting over how to balance the state's budget and manage its long-term public pension liabilities. The state's temporary income tax increase expired on Dec. 31, 2014, creating a significant revenue gap for FY2015 and FY2016, and lawmakers and the governor have been unable to come to an agreement over how to stabilize the state's finances. Fiscal year 2016 will end on June 30 with no budget having been passed. Now, the state heads into its second fiscal year with no budget and little prospect of one being negotiated in the near term.

Even without a budget, approximately 90% of state spending in FY2016 continued at 2015 levels. However, the state's repeated failure to pass a budget that balances revenues and expenditures continues to add to its significant operating deficit. Without a budget, the state also failed to make contributions to its pension plans, making an already-difficult situation substantially worse. Should the situation persist into FY2017, the state's operating shortfall will rise further.

One of the core issues in Illinois remains how to address the state's significant public pension liabilities. At the end of FY2015, Illinois' five public pension funds has an aggregate unfunded liability of approximately $111 billion, reflecting a long-term funding level of 41.9%. Legislation to reform public pensions and reduce future liabilities was ruled unconstitutional by the Illinois Supreme Court in 2015, leaving the governor and lawmakers scrambling for solutions. The statutory requirements to fund pension liabilities place an increasing strain on the state's finances.

Illinois' credit ratings will remain under pressure until the state passes a budget. After that, credit improvement will be a dependent on longer-term progress by the governor and legislature on balancing structural revenues and expenditures while addressing how to close the pension funding gap. We do not envision Illinois will follow a path like Puerto Rico. Whereas Puerto Rico faces economic erosion that ultimately created a financial crisis, Illinois has a robust economic base that continues to perform well. Ultimately, Illinois' credit path will be determined by the ability of elected officials to compromise on measures that stabilize state finances and focus on long-term stability.

Brian Tournier
Director of Research
Ascent Investment Partners