Municipal Market Comments

Ascent Investment Partners

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from Montage Investments

State of Illinois Credit Update

S&P Downgrades Illinois to 'A' on Pension and Budget Concerns

On August 29, 2012, S&P downgraded its rating on the State of Illinois to A from A+ and assigned a negative rating outlook. Illinois is now rated A2/A/A with Moody's and Fitch maintaining stable outlooks. In conjunction with the State's upcoming sale of general obligation (G.O.) bonds, Moody's recently reviewed and affirmed its rating and outlook on Illinois, and we expect Fitch to do the same in the near future.

S&P stated in its rating release that "the downgrade reflects the state's weak pension funding levels and lack of action on reform measures intended to improve funding levels and diminish cost pressures associated with annual contributions. The downgrade also reflects continued financial weakness despite significant measures in the past two years to improve structural budget performance." S&P's action follows last week's failure by a special session of the Illinois Legislature to take any concrete action on pension funding reform.

In addition to Illinois's G.O. bonds, S&P also downgraded bonds secured by appropriations from the State Legislature or secured by the State's moral obligation pledge. The State of Illinois's Special Obligation civic center bonds, secured by state appropriation, were lowered to A- from A, with a negative outlook. S&P also downgraded to BBB from BBB+ issues from each of the following issuers that are secured ultimately by the state's "moral obligation pledge," (a pledge that the state intends to provide funds if needed to ensure timely payment of the bonds, but is has no legal obligation and makes no specific pledge to do so):

- Illinois Development Finance Authority
- Illinois Education Facilities Authority
- Upper Illinois River Valley Development Authority
- Illinois Rural Bond Bank
- Southwestern Illinois Development Authority

We anticipated S&P lowering Illinois's rating, and our assessment of the State has not changed. Despite its declining credit quality, we do not believe that there is any realistic potential that Illinois will fail to make timely payment on its general obligation debt. While we do believe that it is possible that the rating agencies could further downgrade the State in the intermediate term (2013-2015), we believe that Illinois will maintain single-A category ratings over the long-term and we continue to maintain positions in Illinois G.O.s.

Unlike the state's G.O. bonds, we do not view Illinois's moral obligation pledge as a secure credit support. In the event of severe budget pressure, we believe it is possible that the state would choose not to provide funds to support one or more of the projects financed through these issuers. As a result, we do not consider the Illinois moral obligation security pledge as suitable for conservative investors.

Our view on the security of Illinois's general obligation debt is supported by a number of factors, including:

1. Illinois has the sovereign powers to raise revenues, as shown by the increase in income tax rates for 2011;

2. Illinois has no statutory or constitutional limitations on its ability to raise taxes or otherwise generate additional revenues for the state;

3. State statute requires that debt service on state G.O. bonds is paid prior to any other state expenditures; and

4. Illinois enhanced its interfund borrowing capability over the past two years 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. As of fiscal year-end 2012 (June 30), Illinois had $9.2 billion of cash balances in other state funds that could be tapped if needed to make debt payments.

The State of Illinois continues to grapple with significant budget pressures that have eroded the state's financial position and credit ratings over the past several years. Like all states, Illinois experienced significant revenue declines from 2008 to 2010 as a result of the financial crisis and national recession. Unlike most other states, however, Illinois was not able to manage its budget in a way that established more structurally sound budget performance. Consequently, Illinois's G.O. credit quality has declined substantially over the past three years. As recently as March 2009, the state was rated Aa3/AA/AA. Now, Illinois is the lowest-rated state by Moody's and tops only California in its S&P and Fitch ratings.

Illinois has made some meaningful changes in the past two years to address its financial challenges. The Governor and Legislature put in place temporary personal income and corporate income tax increases that together are projected to generate an additional $6 billion annually for the state through their sunset on Jan. 1, 2015. Together with spending reductions and caps, the state reduced its budget shortfall in FY2012 and is currently projecting a $1.4 billion year-end surplus for the current fiscal year (FY2013, ending June 30, 2013). Even so, the State will face significant pressure in FY2014 to either extend or make permanent the tax increase or reduce further levels of state expenditures, or both.

Illinois also implemented some limited pension changes in 2010 that are expected to lower future pension funding costs over the long term. However these changes address only future employees and are expected to actually increase budget pension costs in the near term. The Governor proposed a number of more sweeping changes to pension funding for current employees, but no changes have been passed. Illinois remains the worst-funded state in the nation. The five pension funds run by the state for various groups of employees (state teachers outside Chicago, police, state employees, etc.) reported an aggregate funding level of only 43.4% as of fiscal year end 2011. Annual general budget pension expenditures – the costs for past and current employees plus the amounts required to "make up" the underfunding – are projected to grow rapidly in the coming years and will place a severe burden on state budgets unless further structural changes are implemented.

In light of the uptick in municipal bankruptcy filings in recent months, and the periodic musings of various analysts in print and broadcast media from time to time, investors may naturally wonder whether Illinois could face a bankruptcy or default in the coming years. Our view, and that of numerous Chapter 9 bankruptcy lawyers and market participants with whom we have worked over the years, is that states cannot go bankrupt. There are no provisions in federal law allowing states to seek bankruptcy protection. Chapter 9 bankruptcy specifically applies to political subdivisions within states.

States can default, and have at various points in the 19th Century and during the Great Depression. However, in every situation since the late 1800s, tax-secured bond holders have been made whole. Given states' dependence on capital markets for everything from cash flow needs to long-term capital infrastructure finance, we see no real possibility of a state attempting to shed G.O. debt liabilities through a strategic default. Furthermore, the Illinois Constitution requires that the Governor present, and the Legislature enact, a balanced budget. And within that budget, debt service on G.O. bonds is at the front of the line. While a balanced budget requirement is not without its loopholes – and clearly, Illinois has carried budget deficits forward over the past few years using a variety of accounting methods – this will ultimately force the state to take steps to address its structural budget imbalance. Unlike corporations and even some municipalities, there is no way out for the state other than to ultimately make the hard political decisions necessary to regain structural integrity.

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