Stoever Glass & Co
30 Wall Street, New York, NY10005

CAN ILLINOIS SUFFER ANOTHER ROUND OF DOWNGRADES? YES!

What Would It Take for Illinois State Ratings to Drop to "Junk Bond Status"?

June 14, 2016

Dick Larkin
Director of Credit Analysis
Stoever Glass & Co., Inc.
P: (862) 432-8818
E: dlarkin@stoeverglass.com

On June 9, 2016, Standard & Poor's became the third rating agency to downgrade Illinois' general obligation bonds to the Baa/BBB category. Not counting Puerto Rico (which is not a state, but a territory with less sovereign power than a state), Illinois is one of only a handful of states that have seen their bond ratings drop to that level in modern rating agency history since 1960.

Using Standard & Poor's History of U.S. State Ratings as a guide, Illinois became the fourth state to see its rating drop to levels that are barely investment grade, following Louisiana in 1988, Massachusetts in 1989, and California in 2003. At one point, three of these states had ratings as high as "AAA" (California, Massachusetts, and even Illinois), whereas Louisiana has had ratings as high as "AA".

What does this rating history tell us? It says that all of these four bond issuers have or had credit rating fundamentals (economic/tax base, administrative and legal factors, and reasonable debt levels) that warranted higher ratings. So, what is the common cause?

It can best be said that the downgrades of these are "self-inflicted wounds", the results of man-made disasters from poor fiscal management or lack of regard for basic accepted budgetary management. It also shows us that the bond ratings of issuers like Illinois can be reversed and followed with upgraded ratings, as has been the case for the other three once-poorly rated states.

Is There a Floor Beneath State Ratings?

Putting it another way, are there no circumstances under which a state will see their rating fall into non-investment grade ("junk") status? Last week, Moody's responded emphatically that they had no floor for state ratings. They did point out that most state ratings fall into the "Aaa" to "Aa" categories, primarily because of the built-in economic diversity of these relatively large units, a near monopoly over their ability to govern taxation, expenditures and the timing of their receipts and disbursements. In Illinois, that state's saving grace is that they have honored a dedication of required revenue into a special designated debt payment fund. While many vendors are not being paid, this is one of a state's sovereign powers to manage its cash flow, and state accounts payable are rising to record levels (estimated at $10 billion by both S&P and Moody's). The state still has not adopted a budget for their fiscal year which ends in 2 weeks, and of course there would be no movement to set an adopted budget for the next year which starts on July 1.

If this were a city or a county, this kind of fiscal performance would have resulted in junk ratings years ago. The only reason that has not occurred is because states have "sovereign power" over their financial affairs. Other than spending federal grants for purposes required by the terms of the grant, states like Illinois are beholden to no one for their financial affairs. Which gets us to today's sorry state of affairs for Illinois.

In 2010, the state passed temporary personal and corporate income tax increases to fund deficits earlier in this decade. On December 31, 2014, those new taxes were allowed to lapse. Personal income tax rates dropped from 5% to 3.5%, and corporate income tax rates dropped from 7% to 5.25%. There is no, and never was, a "Plan B" to deal with the substantial reduction of state revenue, estimated at $4 to $5 billion annually.

Illinois' budgetary management has virtually no precedent. There are only 2 weeks left in fiscal year 2016, which ends on June 30, and there still is no adopted budget between the Governor and the Legislature. Given that fact, it is academic to discuss the 2017 State budget, which starts on July 1. The rating downgrades are more a reflection of poor financial management than they are the risk of default. The root cause of Illinois' poor budget management does not lay blame to either the Governor or the legislature. The downgrades do lay blame collectively, however, at the feet of both the Governor & legislature. Allowing the state to go 11+ months without an adopted budget is not only poor financial management. It is shameful.

Will Illinois Follow Puerto Rico Into Junk Bond Rating Territory?

The answer is an unequivocal "NO" from this analyst. Illinois has too many things in its favor, if it would only follow prudent and consistent financial management:

1. A moderate debt burden, that is rapidly repaid (over 54% in 10 years);
2. A diversified and growing economy, marked by higher than average per capita income and gross domestic product;
3. A reasonable tax burden, which if raised could permit new spending or deficit reduction;
4. Illinois does not rely on short-term cash flow debt, which is issued in the beginning of the budget year and repaid at the end of the budget year.

This last point is very important: an issuer that relies on notes of one year or less to pay bills early in the year are particularly at risk if there is a sudden drop in revenue, or if revenue forecasts were optimistic. This scenario was important in Massachusetts' & California's ratings of BBB in the early 1990s, because the debts in billions of dollars were coming due when state tax revenues were falling short by billions of dollars.

Illinois does not use short-term notes for cash flow management; instead, they have used delays & prioritization of cash payments to vendors not included in legislatively approved stop-gap spending approvals. Moody's & S&P estimate that Illinois has between $9-$10 billion of bills waiting to be paid for lack of legal budgetary appropriation authority. At some point, using delayed vendor repayments has to stop, or essential state services will be affected.

One Last Comment on the State of Illinois' Pension Funding: Underfunding Does Not Mean Insolvency

It's common knowledge that Illinois has one of the worst pension funding levels in the U.S., estimated at 40% of what will be needed over the long haul to meet the retirement needs of its past and current employees. The next two states, Kentucky & Connecticut, have funded ratios of 45% and 50%. And yet, both of these states still enjoy significantly higher bond ratings in the "AA" to "A+" categories.

Like individuals, States like Illinois should be "squirreling" away assets to meet substantial financial retirement obligations as they come due. But that does not necessarily mean that states must be at a 100% actuarially funded level. In general, higher levels of pension funding reduce the money needed to cover future retirement costs.

The chart below might put things in perspective. I took Illinois historical pension receipts/disbursements from 2011-2015, and then made projections for 2016-2025 based on certain assumptions, some of which may be controversial.

ILLINOIS ACTUAL AND PROJECTED PENSION FUND BALANCES USING AN AVERAGE INVESTMENT RETURN RATE OF 7%															
	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	2025
BEGINNING BALANCE	$53.2	$63.4	$61.9	$68.0	$78.6	$80.0	$83.8	$87.6	$91.3	$94.7	$97.8	$100.7	$103.4	$105.9	$108.3
State Payments	$4.3	$5.0	$5.9	$6.9	$7.0	$7.5	$7.9	$8.0	$8.1	$8.1	$8.3	$8.5	$8.7	$8.9	$9.1
Employee Payments	$1.4	$1.5	$1.4	$1.5	$1.5	$1.6	$1.6	$1.7	$1.8	$1.8	$1.9	$2.0	$2.1	$2.1	$2.2
Investment Income	$12.1	$0.2	$7.8	$11.7	$3.0	$5.5	$5.7	$6.0	$6.2	$6.4	$6.6	$6.8	$7.0	$7.1	$7.2
TOTAL INCOME	$17.8	$6.70	$15.1	$20.1	$11.5	$14.5	$15.3	$15.7	$16.1	$16.4	$16.8	$17.3	$17.7	$18.1	$18.6
Benefits Paid	$7.6	$8.2	$9.0	$9.5	$10.1	$10.8	$11.4	$12.0	$12.7	$13.3	$13.9	$14.6	$15.2	$15.8	$16.4
TOTAL EXPENSES	$7.6	$8.2	$9.0	$9.5	$10.1	$10.8	$11.4	$12.0	$12.7	$13.3	$13.9	$14.6	$15.2	$15.8	$16.4
Net Change in Assets	$10.2	-$1.5	$6.1	$10.6	$1.4	$3.8	$3.9	$3.7	$3.4	$3.1	$2.9	$2.7	$2.5	$2.3	$2.1
ENDING BALANCES	$63.4	$61.9	$68.0	$78.6	$80.0	$83.8	$87.6	$91.3	$94.7	$97.8	$100.7	$103.4	$105.9	$108.3	$110.4

This is, by far, not an actuarial projection; rather, it is a rough approximation of where Illinois' pension fund balances will be using what I believe to be reasonable assumptions:

1. State payments are made according to an already-agreed upon schedule of increases through 2025 and beyond;
2. Employment contributions grow the same as at past rates, with a built-in growth factor of 4% annually
3. Pension disbursements rise at the same growth rate as 2011 through 2015; and
4. Pension Fund balances can be invested at an average rate of return of 7% annually.
5. This last assumption is controversial, as state and local governments are being pressured to use forecasts of about 4% annually (reflecting a rate of return on risk-free Treasury bonds). Most pension funds, both public and private, allocate 50% or more of their investments into stocks, where long term performance has far exceeded the rate of return on Treasury bonds, notes or corporate debt.

Of course there will be years where investment returns will be below 7%. These will be offset by years where investment returns far exceed 7%. The Stern School of Business for NYU shows that since 2006 (which included the crash of 2008), the average mathematical rate of return on a barrel of S&P 500 stocks was 9.03%.

Using these assumptions through 2025, the chart demonstrates that through the next 10 years, Illinois' pension balances continue to grow, and that annual benefit payments are met with a cushion for future years. Again, these projections are no more than that- mathematical projections using simple assumptions for revenue and expense data beyond 2015. It is my belief, however, that the projections are useful; if they come close to reality over the next 10 years, Illinois' pension fund assets would still be in a position to pay at least 5 more years of benefits, even if the state stops payments completely, or receives no income or gains on its investment portfolio, scenarios which I believe are possible but remote.

About the Author

RICHARD P. LARKIN, Stoever Glass & Co., Inc.

Richard Larkin is the Director of Credit Analysis specializing in municipal bonds, joining Stoever Glass in April 2016. Earlier in his career Dick spent 8 years at HJ Sims, where his first assignment was to testify before the House of Representatives on the Bond Insurance Crisis. Dick worked at J.B. Hanauer from 2003-2008, performing high-yield municipal bond analysis. Dick was also a Managing Director in Fitch's public finance group as the Co-chairman of its Public Finance Criteria Committee. He covered high-profile tax-supported and revenue bond credits and had supervisory responsibility for credit surveillance and the development of public finance staff. Prior to joining Fitch in 1998, Dick was a Managing Director and Chief Municipal Rating Officer at Standard & Poor's, responsible for municipal rating policies, practices, governance and criteria. Following twenty-one years at S&P, Dick worked as a financial advisor at Fairmount Capital Advisors where he developed credit enhancement programs for public pension funds. Later, he helped found Reliance SRL, a rating agency that performed local credit ratings in Uruguay.

From 1988-1992, Dick was a charter member of the Anthony Commission on Public Finance, created to protect federal tax law on the ability of state and local governments to carry out their responsibilities to their citizens at the lowest possible cost. From 1995-1998, Dick also served on the National Advisory Council on State & Local Budgeting (NACSLB). This industry task force, comprised of representatives from the private sector and officials from all levels of local government, identified and fostered 60 of the best budgeting practices that have been implemented by our best-run state and local governments. Dick earned his BA in economics from Iona College and a Masters in economics from Fordham. In 1999-2000, he was a key participant in the implementation of Fitch's Default Study and revision of its criteria and ratings. During the same period, he authored the definitive study on the impact of municipal government's management practices on credit ratings, defining for issuers a rating agency's relative evaluation of best management practices. Dick has had hands-on rating experience in 42 states, at all levels of state and local government covering virtually every type of debt structure and security pledge. He has been a frequent speaker at state and national Government Finance Officers' Association (GFOA) conferences, and has articles published in national media and public finance textbooks.

Dick has appeared frequently on CNBC, Bloomberg Television and Fox Business News, and has been widely quoted in the Wall Street Journal, BusinessWeek, the Bond Buyer and Bloomberg reports, as well as many other media outlets. Dick serves on the Policy Committee for the Securities Industry and Financial Markets Association (SIFMA), serves on the Governmental Advisory Standards Advisory Council (GASAC), is a member of Municipal Bonds For America (MBFA), a public/private group charged with educating government officials about the benefits of tax-exemption for municipal bonds for government issuers as well as the investment market. He was also awarded the National Federation of Municipal Analysts' Award for Excellence in 1996, and from 2008 through 2015 was elected as an "All-Star" Special Revenue Bond Analyst by Smith's Research & Gradings.

Disclosures:

This report is published by Stoever Glass & Co. This publication is for your information only and is not intended as an offer, or a solicitation of an offer, to buy or sell any investment or other specific product. The analysis contained herein does not constitute a personal recommendation or take into account the particular investment objectives, investment strategies, financial situation and needs of any specific recipient. It is based on numerous assumptions. Different assumptions could result in materially different results. We recommend that you obtain financial and/or tax advice as to the implications (including tax) of investing in the manner described or in any of the products mentioned herein. Certain services and products are subject to legal restrictions and cannot be offered worldwide on an unrestricted basis and/or may not be eligible for sale to all investors. All information and opinions expressed in this document were obtained from sources believed to be reliable and in good faith, but no representation or warranty, express or implied, is made as to its accuracy or completeness (other than disclosures relating to Stoever Glass & Co). All information and opinions as well as any prices indicated are current only as of the date of this report, and are subject to change without notice. Opinions expressed herein may differ or be contrary to those expressed by other business areas or divisions of Stoever Glass & Co. as a result of using different assumptions and/or criteria. At any time, investment decisions (including whether to buy, sell or hold securities) made by Stoever Glass & Co. , its affiliates and employees may differ from or be contrary to the opinions expressed in Stoever Glass & Co. research publications. Some investments may not be readily realizable since the market in the securities is illiquid and therefore valuing the investment and identifying the risk to which you are exposed may be difficult to quantify.

Past performance of an investment is no guarantee for its future performance. Some investments may be subject to sudden and large falls in value and on realization you may receive back less than you invested or may be required to pay more. This report is for distribution only under such circumstances as may be permitted by applicable law.

The contents of this report have not been and will not be approved by any securities or investment authority in the United States or elsewhere. Stoever Glass & Co. is not acting as a municipal advisor to any municipal entity or obligated person within the meaning of Section 15B of the Securities Exchange Act (the "Municipal Advisor Rule") and the opinions or views contained herein are not intended to be, and do not constitute, advice within the meaning of the Municipal Advisor Rule.