Implications of the Near Junk Level Ratings Downgrade of Illinois

On June 1st, 2017, the State of Illinois experienced another credit rating downgrade, now the lowest U.S. State credit rating on record. The downgrades by Moody's and S&P place Illinois to their lowest investment grade ratings (Baa3 & BBB- respectively). Illinois is going on its third year without a budget as politicians endlessly debate ways to address the deficit, and the lack of a budget has investors and the rating agencies worried. Illinois's deficit is about $5 billion or roughly 15% of their general fund revenue. When a budget isn't in place, bills can't be paid without emergency measures which has resulted in Illinois accumulating about $15 billion of unpaid bills. On top of that, Illinois has severely unfunded pension liabilities which need to be addressed. All of these factors have added pressure to the situation making it extremely difficult for the Illinois legislature to agree on ways to cut the deficit. States do not have the ability to file for bankruptcy, so Illinois is going to have to find a way to meet all of their obligations. If/when they are able to pass a budget, the immediate pressure will be lessened as there will be money budgeted to pay bills currently due, but the underlying problem of the budget deficit needs to be fixed. We could continue to see this legislative disagreement and all of the uncertainty surrounding it as long as there are difficult decisions to be made regarding cuts to expenses.

The problems we see at the state level could directly impact local municipalities depending on how much they rely on state funding. When the state doesn't pass a budget, state funding to local municipalities is essentially cut off until a budget is passed. If a municipality has a large state aid dependence ratio (a large percentage of their total revenue in the form of state aid), then that municipality would experience a large decline in revenues if a budget isn't passed. For example, some colleges in Illinois use the revenue they normally get from the state to pay operational expenses like teachers' salaries and might not have spare revenue from other sources as a backup. This has resulted in short-term borrowing by those colleges just to make ends meet until the state funding is approved. On the other hand, many municipalities don't rely on funding from the state and those municipalities would primarily only experience indirect consequences of the state financial issues such as declining population, and increased funding costs. More importantly, bond holders should thoroughly review the stability of the pledged revenue source on the bonds in question. Whether it's a General Obligation bond backed by property taxes or an Essential Service Revenue bond backed by utility payments, investors must review the strength of the revenue source used to satisfy the issuer's debt service requirements.

The pension issues the state is experiencing could also flow to local municipalities if they participate in one of the state-sponsored plans that are highly underfunded. Some municipalities do not participate in those plans and may have a financial condition strong enough to offset any pension concerns. This is why it is imperative that investors consider all available information when making investment decisions. The credit analysis process should include a review of both the reliance on state aid as well as any exposure to unfunded pension liabilities. This is true everywhere, but it is particularly important for municipalities in Illinois given the financial condition of the state.

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