Payden&Rygel
Research

ON THE BRINK: A Look Into States' Dance with Downgrades

July 2017

ILLINOIS: THE DUBIOUS DISTINCTION OF BEING FIRST TO WORST

The political and fiscal brinkmanship exhibited by Illinois' leadership over the last month has been one for the history books. Though the state has struggled with a budget impasse since 2015, the month of June was particularly exciting as municipal market participants got to observe what can only be described as a high stakes game of "chicken" between state legislators and rating agencies. After receiving a downgrade from S&P and Moody's to one level above junk (Baa3/BBB-) and being placed on negative credit watch, the next thirty days proved to be quite tumultuous. Shortly after, the state received a second blow in the form of a fiscally ruinous court order requiring it to accelerate Medicaid provider payments and to make their recipients whole in the current fiscal year. The compound effect of facing a first-ever state level junk rating and extreme liquidity pressure mobilized the Democrat-led legislature to take unilateral action to pass its first budget in two years, overriding the governor's veto.

We have avoided issuing a comment on the state's affairs over the last month due to the fast- paced nature of developments and the uncertainty around legislative action (or inaction) in response to the mounting pressure. Even though the epic standoff has ended in a long-awaited budget, we remain hesitant to upgrade our "negative" outlook on the state or any of its general fund related obligations. Our view is informed by a number of credit risks that we believe remain outstanding and, frankly, may be insurmountable in the foreseeable future. What features most prominently in our analysis, and is perhaps the most destabilizing credit element, is the state's propensity for political theater and the use of the budget as a weapon of war in partisan conflict. Furthermore, we do not think the budget that the legislature did manage to pass addressed the state's short or long-term needs effectively[1] and, had it not come on the heels of a record-long impasse, would have received poor marks from rating agencies and market participants under more "normal" circumstances. It certainly would not usher in a market rally in the state's debt, which we have seen over the last few days, and would almost certainly result in a downgrade of the general obligation credit.

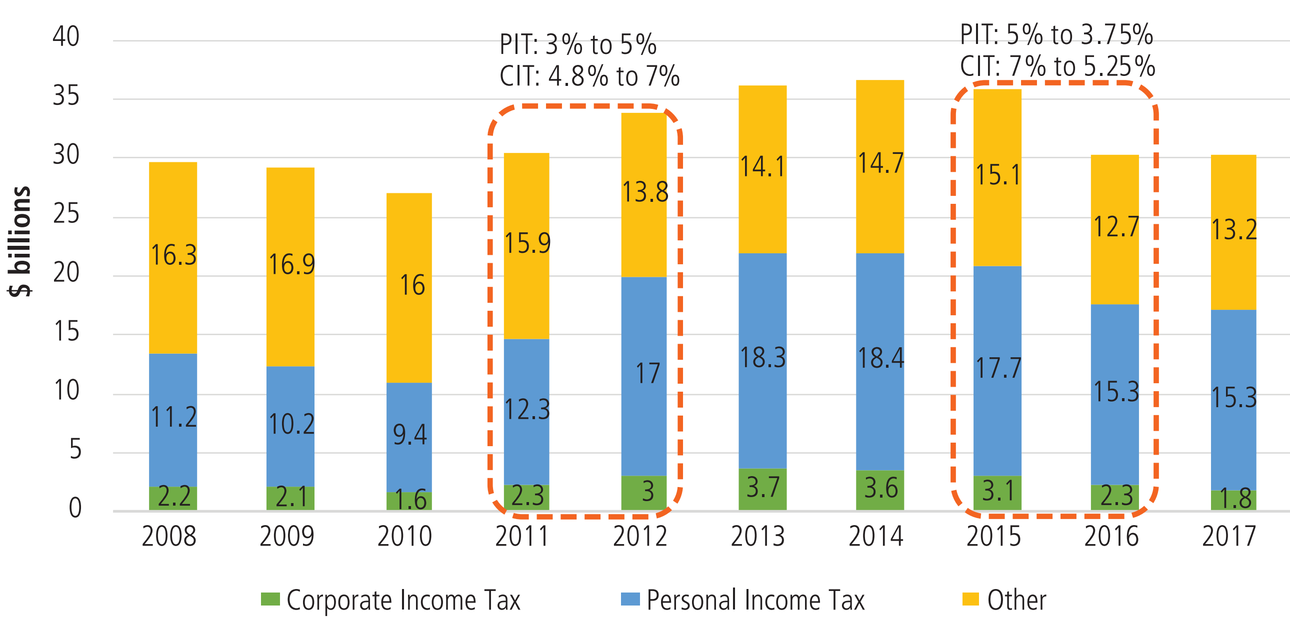
It is evident that the fiscal realities of the state are difficult to comport with budget sustainability even in the short term. Although the FY2018 budget succeeds in reverting to a more sustainable tax regime – making permanent rates initially implemented in FY2011-2012 – it is now on a narrower tax base. The state has lost roughly 1% of its population, one of the only major states to experience population loss in the last five years. Thus, the budget assumption that the higher tax rates will yield the same amount in revenue as they did five years ago is overly optimistic (*Exhibit 1*).

The case for budget stabilization and improving long-term outlook becomes even shakier when one considers the liabilities side of the equation. Even before the state began counting pension obligations as long term debt,[2] we see a growth pattern in liabilities that is not consistent with population trends, which have been negative in recent years, and faltering revenue trends (*Exhibit 2*). More often than not, we see the state adhering to a "kick the can down the road" fiscal policy approach by either identifying one-time transfers to pay for multi-year spending mandates or by not identifying any revenues at all. The staggering growth in unpaid bills over the last two years as a result of the impasse ($15 billion or nearly 40% of general fund expenditures), including payments to vendors and various state agencies and funds, is an example of how a lack of consensus on policy and funding priorities compromises the state's most fundamental credit indicator: its claims-paying ability. The most recent budget seeks to address this debt problem by issuing more debt - $6 billion in GO bonds – to lower the elevated interest rates being charged to the state. The choice to issue bonds to pay down bills instead of leveraging federal funds against Medicaid obligations is the same as borrowing for operating expenses – not considered to be a prudent budget practice. Tragically, even this effort at indemnifying its debts may be too little too late for the myriad local agencies and service providers whose institutions and beneficiaries have suffered irreversible damage as a result of having to scale down or permanently shutter vital programs and operations. Some social service networks and educational systems, especially colleges and universities, have experienced service delivery insolvency, which not only represents a public policy crisis but also leads to greater population and capacity loss. This is often followed by a negative feedback loop of further economic weakening and missed budget projections given a shrinking revenue base.

The palliative consideration for any state going through budget stress is rooted in its budgetary sovereignty from the federal government and a good degree of control over its own fiscal destiny. States have wide latitude for raising revenues, cutting expenditures and driving their own policy priorities. Illinois now faces a real threat to this important credit element. The court-mandated Medicaid reimbursement ($3.3 billion) suggests compromised liquidity and a pending loss of discretion over the allocation of its cash resources. To a point, the state's practice of deferring payment on some of its obligations represents an exercise of sovereign authority that allows it to focus resources on core priority commitments such as bond payments.[3] However, this practice has limitations, and resources ultimately become too stretched to triage effectively and ultimately *all* obligations become subject to political risk. In these instances, as we have observed in other high profile bankruptcy scenarios, even core priority payments, and the constitutionally enshrined procedures that protect them, can be abandoned by the obligor.

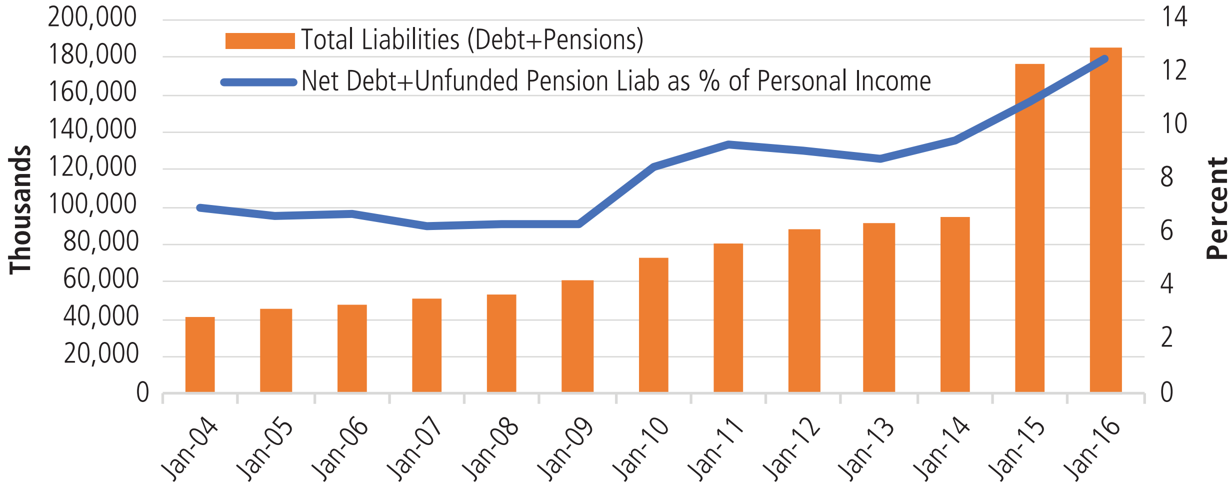
Given its status as a sovereign, the precise boundary of this limitation for Illinois is unknown. At the state level, Illinois provides a strong general obligation bond pledge, including an irrevocable and continuing appropriation for all general obligation debt service. At this time, our outlook is mainly colored by the fact that the state's cash management has become subject to material reprioritization by the courts as a result of the budget impasse, which means that it has relinquished key aspects of its fiscal discretion to a non-legislative body.[4] This is exacerbated by the presence of competing – and strongly protected – pension claims on revenues, and the deeply entrenched resistance to any kind of pension reform in the legislative apparatus. This will continue to weigh heavily on our assessment of the creditworthiness of the state, its agencies and local subdivisions in the near term.

Exhibit 1: Illinois Revenue Trends in Major Categories



Source: Illinois State CAFR 2016, BAML Global Research

Exhibit 2: The Tax Burden Imposed by State Liabilities on Taxpayers Is Growing Exponentially



Source: Merritt Research Services, Payden & Rygel Research

BIRDS OF A FEATHER DON'T STICK TOGETHER: States Marching to Different Drumbeats on Budget Practices

For the most part, Illinois' fiscal deterioration stands in contrast to the experience of other states. For one, it unfolded and accelerated amid a broader economic expansion. States revenues are pro-cyclical in nature, exhibiting behavior consistent with macroeconomic trends. Illinois saw falling revenues, a widening structural budget deficit, depletion of its budget reserves, and dramatic growth in its short and long-term liabilities during a period of economic growth. Most states' budgets were lifted by the rising tides of the growing economy over the last eight years. However, in some cases, growing liabilities and expenditure pressure caught up and surpassed the surplus gains made over the last few years. In other cases, as with the oil producers, regional economic problems lay at the core of steep budgeting problems. Budget problems stemming from pensions and entitlements are largely the result of promises made in the last century under a set of expectations for economic growth and demographic trends that did not materialize in this century. We can expect to revisit these problems on an annual basis in the foreseeable future.[5]

Recent analysis published by the Mercatus Center at GMU[6] that looked at short-term indicators like cash and budget solvency across states, found that basic capacity for funding current government operations is compromised in a number of states besides Illinois (*Exhibit 3*). Conversely,

Exhibit 3: States' Fiscal Conditions Move Further Apart

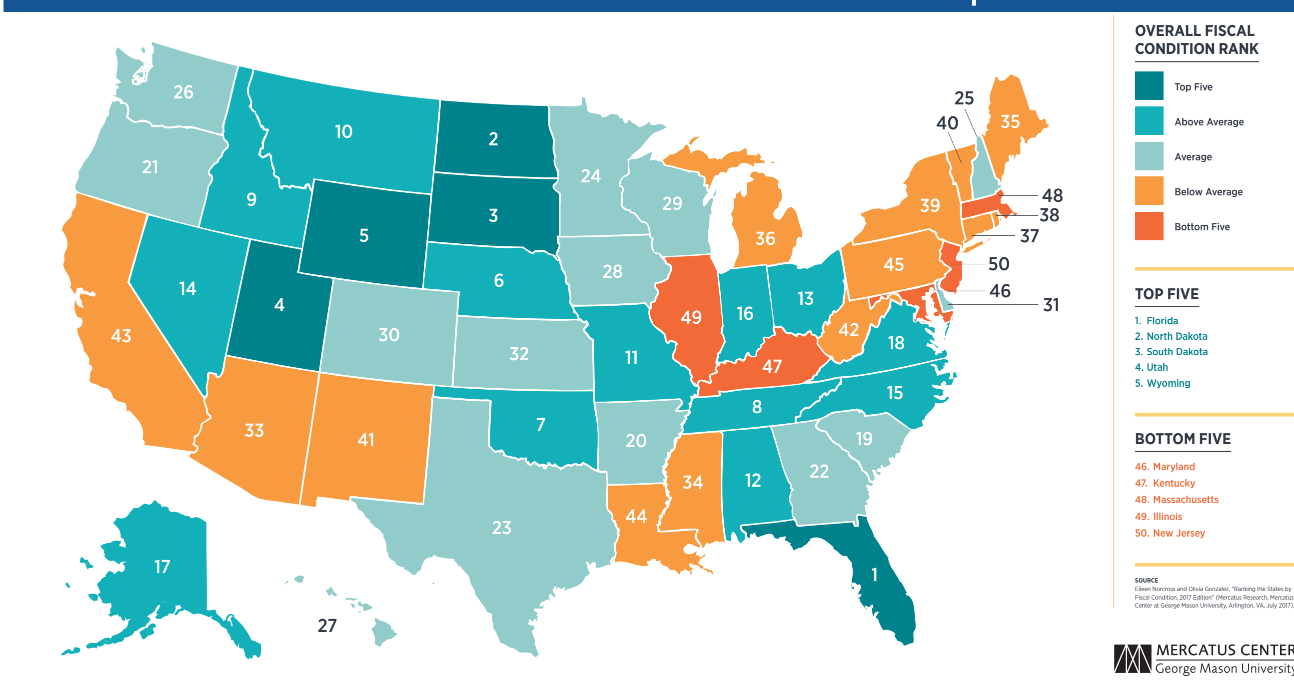


Exhibit 4: More States Are Moving Down the Credit Stack

State	Moody's	S&P	Fitch	Reason
Alaska	Aa3 ↓	AA+	AA+	Ongoing structural budget issues that stem from a limited economic base concentrated in energy production; weak liability profile, and heavy pension burdens.
Connecticut	A1 ↓	A+ ↓	A+	Worsening budget issues due to high fixed costs and state economic weakness, despite national economic growth.
Illinois	Baa3 ↓	BBB- ↓	BBB ↓	Growing pension deficit and backlog of unpaid bills, exacerbated by prolonged political gridlock.
Kansas*	Aa2	AA- ↓	NR	Structural budget issues arising from income tax cuts coupled with weaker than expected economic growth.
Kentucky*	Aa2	A+ ●	AA-	Pension plan funding levels at risk of significantly deteriorating; continuing growth in fixed costs which may affect budget strength.
Louisiana	Aa3	AA- ↓	AA-	Lower than expected tax collections precipitated by a contraction in the oil and gas industry.
Massachusetts	Aa1	AA ↓	AA+	Failure to rebuild the state's reserves pursuant to its own fiscal policies, to offset volatile revenue streams and elevated debt levels.
Mississippi	Aa2	AA	AA ↓	Weaker than expected operating performance from soft economy leading to reserve drawdowns.
New Jersey	A3 ↓	A-	A	Growing debt burden led by considerable unfunded pension liabilities; persistent structural imbalance and weak fund balances.
New Mexico	Aa1 ↓	AA ↓	NR	A large shortfall in tax revenues from falling energy prices has depleted reserves and weakened liquidity profile.
Oklahoma	Aa2	AA ↓	AA ↓	Weaker tax revenue collections deteriorating liquidity and creating vulnerability in the case of economic weakness.
West Virginia	Aa2 ↓	AA-	AA	Revenues have lagged projected estimates creating a structural imbalance; unfunded pension liabilities are higher than average.
Wyoming*	NR	AA+ ↓	NR	Low pension funding levels and budget stress arising from decline in energy prices.

* "Implied state rating" as no GO debt outstanding

● Outlook was moved to negative, but rating not downgraded.

the study also found that several states are in excellent financial shape and command substantial budget reserves and have benefitted not only from strong economic performance but from prudent and foresighted budgetary practices.

The Mercatus study notwithstanding, we are observing some key changes and shifting tides in States' fiscal health, and median quality of the state general obligation sector. Though more states are receiving downgrades – often for similar reasons - this change is not unlike what happens in other credit markets, when an expansionary business cycle ends and stricter and more conservative reporting practices are standardized. (*Exhibit 4*). The fiscal health map is starting to look much more colorful, and states are beginning to differentiate themselves as good actors, bad actors, and "worried" actors.

We see some states that exhibit consistently good judgement when it comes to their budget, some that exhibit consistently bad judgment, and others that are in the process of figuring out which of the two clubs they want membership to. We see a lot of changes to how states report and comply with industry accounting standards, even when the results are not in their favor. We see that drivers of strong fiscal performance remain the same: fiscal discipline in the form of having strong reserve practices, reliable revenues from a stable base, and keeping debt levels low relative to resident income. And last but not least, we see that ratings of state obligations do not adequately capture the qualitative elements of risk such as political entrenchment, or the "willingness" component of the "willingness and ability" to repay. Ratings distribution notwithstanding, we now see more quality dispersion and fundamental differentiation that is long overdue and well-warranted, with state level general obligation no longer being the monolith of credit strength it was in years past.

1 The $36.1bn fiscal spending plan includes a 10% cut to the state's higher education institutions and 5% across-the-board cuts to state agencies, totaling some $2.5bn in cuts, as well as permanent personal income tax and corporate income tax increases (to 4.95% and 7%, respectively), which are estimated to generate $5bn in additional revenue. The plan also solidifies Chicago's reforms to its municipal and laborer plans, but does nothing to address the State's severely underfunded pension plans. Given the negative trajectory of revenue collections in the State and the reliance on $6bn in additional borrowing to pay down a huge backlog of bills, the plan has substantial implementation risk.

2 See GASB 68 Accounting and Financial Reporting for Pensions

3 S&P Global Ratings: Illinois. July 12th and June 1st, 2017

4 Ibid

5 Bank of America Merrill Lynch Global Research, July 7th, 2017.

6 Mercatus Research: https://www.mercatus.org/system/files/norcross-fiscalrankings-2017-mercatus-v1.pdf. Financial Health of States was ranked according to basic financial statistics on revenues, expenditures, cash, assets, liabilities, and debt, states may be ranked according to how easily they will be able to cover short-term and long-term bills, including pension obligations. Fiscal solvency was assessed based on five separate categories; cash solvency, budget solvency, long-run solvency, service-level solvency, and trust fund solvency (pensions).