Illinois

# Illinois is on a straight path to junk credit at the end of June

US state has more than $14.5bn of past-due bills from suppliers, writes John Dizard

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AN HOUR AGO by: **John Dizard**

People are talking about a looming governance crisis in Washington, but that moment has already arrived for the state of Illinois. Thanks to the inability of the state legislature and the governor to agree a budget over the past two years, Illinois is on a straight path to becoming junk credit at the end of this month.

The consequences will be felt across the country. Apart from the higher costs for Illinois state borrowers, the budget crisis has opened a range of legal and even constitutional issues over the conflicting claims that pensions, debt service, social benefits and essential state services have on limited government resources.

That is not some general topic for think-tank seminars or newspaper leaders. It is now possible that many primary schools in Illinois will be unable to open on time for the autumn term come August or September. In February, in Marion County, Illinois, the mother of Kobe, a one year old boy with a breathing disability, opened her door to find sheriff's deputies and a representative of her son's oxygen bottle supplier demanding the return of their equipment. The state government, for which the mother works, had not paid her insurance benefits. The boy was allowed to keep his oxygen, for now.

In addition to the invoice for Kobe's breathing apparatus, the state of Illinois has more than $14.5bn of past-due bills from suppliers, about double the level of a year ago. This is in addition to its total bonded debt of about $27bn, and estimated unfunded pension liabilities of $130bn. The state government is bringing in annual revenues of about $30bn.

The state has not issued a general obligation bond since November. Last week, Illinois GO bonds traded at a record 335 basis points over the MMD index of AAA municipal bonds. If, as muni bond people expect, the state is downgraded to junk next month by at least two rating agencies, the spread it pays on swaps contracts will rise from 345bp to 645bp.

Earlier this year proposals were drawn up for a large new taxable GO bond issue, perhaps for $7bn with a five-year maturity, which could pay down the state's past due bills. The Republican governor, Bruce Rauner, and the Republican president of the state senate insisted that such a bond had to be part of a "grand bargain". This would include, among other measures, a consolidation of state agencies, reform of the workers' compensation system, a freeze on property taxes, term limits for elected officials and some state contributions to the city of Chicago's pension funds.

The Democratic speaker of the state house of representatives, Michael Madigan, a public sector union ally who has held his position for 32 of the past 34 years, resisted Mr Rauner's package deal. Earlier this year there was some hope of a compromise between the two sides. In recent months, though, as the state's fiscal position has worsened, the governor and the state Democrats hardened their positions. This partly reflects an urban/rural divide between Chicago-area liberals and downstate conservatives.

As if this mutual loathing and intransigence were not enough, last week Judge Joan Lefkow of the Federal District Court in Chicago ordered the state government to make contractual payments for its Medicaid obligations to managed-care organisations. The language the judge used in her order sent a shockwave through the municipal bond market.

As she pointed out, the state comptroller "is funding the state payroll as well as debt service at 100 per cent . . . Although the court means no disrespect to the comptroller, who faces an unenviable situation, it finds that minimally funding the [Medicaid] obligations of the decree, while fully funding other obligations fails to comply not only with the consent decrees, but also with this court's previous orders."

Professional muni investors read and re-read the order. On its face, as one portfolio manager says, "she is starting the process of reprioritizing the primacy of debt service under state law and the state constitution. That would be game over."

The judge asked the state and Medicaid advocates to try and work out a compromise by next week, but the point was made. Bondholders do not have priority over social welfare recipients. Whether that position is morally correct or not, it certainly will make it more difficult and expensive to sell Illinois bonds in the future, if the state wants to fund pension obligations or fix its highways.

One of the key questions to ask about distressed sovereign credits is whether the paper is owned by locals. Even during Nigeria's time of troubles in the 1970s and 1980s, the central bank continued to pay its promissory notes, even as its bank loans went into default. Nigerian officials owned some of the notes.

And while interest income from Illinois GO bonds is exempt from federal income tax, it is not exempt from the state income tax on Illinois residents. So Illinois bond investors are spread around the entire country, lessening the local pain of downgrades or defaults.

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