

FITCH AFFIRMS ILLINOIS' GO BONDS AT 'A'; OUTLOOK STABLE

Fitch Ratings-New York-05 January 2012: Fitch Ratings has assigned an 'A' rating to the following general obligation (GO) bonds of the State of Illinois:

- \$525 million GO bonds, series A of January 2012;
- \$275 million GO bonds, taxable series B of January 2012.

Fitch has also affirmed the rating on approximately \$27.4 billion of outstanding GO bonds of the State of Illinois. In addition, the ratings related to the state based on its appropriation are affirmed at 'A-' as noted at the end of this release.

The Rating Outlook is Stable.

The bonds are expected to sell via competitive bid on Jan. 11, 2012.

SECURITY:

Direct general obligation, full faith and credit of the state of Illinois

KEY RATING DRIVERS

BUDGET STABILIZED WITH TAX INCREASE: Following several years during which the state was unwilling to take action to restructure its budget to achieve balance and increasing reliance on borrowing to close budget gaps, the temporary increases in the personal and corporate income taxes that became effective Jan. 1, 2011 and enacted spending limits closed a significant portion of the structural gap in the state's budget through fiscal 2014.

NEED FOR LONG-TERM SOLUTION REMAINS: Due to the temporary nature of the enacted tax increases, there is still no sustainable plan to resolve the mismatch between spending and revenues. Further, despite the significant increase in tax revenues, the fiscal 2012 budget is not balanced.

CONTINUED RELIANCE ON DEFERRING PAYMENTS: The state still has a significant accounts payable backlog, which totaled \$5.2 billion at the end of fiscal year 2011, equal to 17% of general fund resources. Although the balance was reduced during fiscal 2011 as tax revenues increased, it is expected to increase again during the current fiscal year.

LONG TERM LIABILITIES HIGH: The state's debt burden is above average and has risen over the past few years with issuance for operational purposes. Further, there is a large unfunded pension liability, despite the issuance of pension obligation bonds. The state passed bipartisan comprehensive pension reform (March 2010) that will lower its future pension liability but will not have a significant near-term affect on financial operations.

ECONOMY A CREDIT STRENGTH BUT RECOVERY IS SLOW: The state benefits from a large, diverse economy centered on the Chicago metropolitan area, which is the nation's third largest and is a nationally important business and transportation center.

WHAT COULD TRIGGER A RATING ACTION

TRIGGER FOR NEGATIVE RATING ACTION: Deterioration in the state's financial position, as evidenced by excessive use of non-recurring revenues or additional payment deferrals in the budget, could lead to negative rating action. Also, pushing up against the expiration of temporary tax increases in fiscal 2015 without a solution in place would put extreme pressure on the budget and likely lead to a rating action.

TRIGGER FOR POSITIVE RATING ACTION: A return to balanced general fund operations with limited use of non-recurring budget solutions and implementation of a comprehensive approach to reducing the accounts payable backlog that does not significantly exacerbate the state's already high debt position.

CREDIT PROFILE

The 'A' rating reflects challenges faced by the state of Illinois in achieving budget balance despite the significant revenue raising action taken last year to realign its financial operations. It also reflects the significant unfunded pension liabilities that are placing increasing pressure on the state's operations. The increase in tax revenue, in conjunction with enacted hard spending limits, provide a means for the state to return to budgetary balance for three fiscal years, beginning in the current year, fiscal 2012. However, challenges remain, including addressing increasing spending demands in the general fund from Medicaid and rising pension costs, enacting a plan to reduce the outstanding accounts payable balance, and maintaining budgetary balance in light of the temporary nature of the tax increases.

The state's actions last year followed several years during which it had been unwilling to take action to restructure its budget either through revenue raising or spending reductions. During this time, the state instead relied on borrowing to close budget gaps and increasingly delayed payments to service providers, vendors, and local governments, resulting in an accumulation of over \$6.2 billion in accounts payable, as of June 30, 2010, equal to 23% of state resources. The tax increase that became effective Jan. 1, 2011 allowed the state to reduce this balance by \$1 billion, to \$5.2 billion (17% of state resources) as of the end of fiscal 2011; however, the state expects to increase accounts payable again in fiscal 2012 to balance the budget.

The temporary tax changes are generating approximately \$6.5 billion annually, a 25% increase in ongoing revenue, which largely closes the operating deficit. The tax increases have been coupled with new spending limits which dictate hard dollar caps on spending for operations. Although the enacted budget actually appropriated at a level below the hard cap for fiscal 2012, the budget was not balanced and the state is now expecting to operate with a \$508 million deficit. While the actions taken were positive, significant challenges remain. The tax increases are temporary and will begin to phase out in 2015. Even if the state has achieved budget balance by that point, it will once again be faced with a significant budget balancing decision to make severe expense reductions that it has been unwilling to make up to this point, identify new revenues, or make permanent the tax increases. In addition, there is limited ability within the existing budgetary framework to reduce the accounts payable backlog in a meaningful way without reliance on debt issuance, which has yet to be authorized.

Illinois entered the recession with little financial flexibility having not taken actions to build its reserves or restructure its finances as the economy grew over the five years leading into the downturn. While the extent of the financial problem was clear midway through fiscal year 2009 as revenue estimates were downsized, comprehensive solutions were repeatedly delayed. Faced with reduced revenues and an aversion to broad based tax increases, the fiscal 2010 and 2011 budgets relied heavily on non-recurring revenues, particularly the use of debt to finance operations. The budgetary deficit peaked at \$6.2 billion in fiscal 2010, 22% of general fund resources.

The fiscal 2011 budget continued to push solutions out to the future and relied heavily on borrowing and payment deferrals. While the enacted budget for FY 2011 did include \$1 billion in spending cuts, it left a \$5.9 billion funding gap (21.3% of FY 2011 expected revenues) that was closed by issuing bonds to fund the annual pension payment, interfund transfers, and securitization of tobacco settlement revenues, and carried over \$5 billion in accounts payable through another fiscal year. Tax revenues increased approximately \$2.7 billion fiscal 2011, in large part due to the tax increase, allowing the state to improve its perennially weak cash position, reduce its use of interfund borrowing, and begin to pay down the accounts payable backlog.

In preparing the fiscal 2013 budget, the state is facing growing pension payments that are likely to absorb moderate revenue growth and crowd out other expenditure growth. Pension payments will increase \$1.1 billion to \$5.25 billion in 2013, an increase of 27%, primarily due to the use of more conservative investment return assumptions included in the most recent pension valuation. Increasing funding requirements for Medicaid, a program that was not fully funded in fiscal 2012, and maintaining education spending will place additional pressure on the budget and likely require cuts in other areas.

The state's net tax-supported debt, at 6.2% of 2010 personal income, is moderate but above average,

and debt levels have increased with the state's issuance of GO bonds for operational purposes in fiscal years 2010 and 2011. Debt amortization is average at 51.4% in 10 years, reflecting the heavily back-loaded structure of the pension obligation bonds issued in 2003 balanced by the rapid amortization of the recent bonds issued for pension payments. Illinois provides a strong GO bond pledge, including an irrevocable and continuing appropriation for all GO debt service, and continuing authority and direction to the state Treasurer and Comptroller to make all necessary transfers from any and all revenues and funds of the state. The state funds debt service one year ahead on a rolling 12 month basis.

Other long-term liabilities, particularly pension liabilities, are very high, and the state faces continued significant growth in funding requirements to address the pension systems' large unfunded liabilities. As of June 30, 2011, the unfunded accrued actuarial liability was reported at \$82.9 billion, resulting in a 43.4% funded ratio, a level which reflects the use of five-year smoothing. It is expected that the passage of comprehensive pension reform, in March 2010, which established a two-tier pension system for public employees, raised the retirement age, and scaled back growth in benefits, will reduce the state's future liabilities. However, in the near term, pension funding requirements will increase significantly. Additional reform of the pension system is under discussion.

The Illinois economy is centered on the Chicago metropolitan area, which is the nation's third largest MSA and a nationally important business and transportation center. Illinois' economy has gradually shifted, similarly to the U.S. in general, away from manufacturing to professional and business services. The remaining manufacturing sector includes more resilient non-durables, and is less concentrated in the auto sector than are surrounding states (Indiana, Michigan, and Ohio). While the state economy was not as negatively affected by the recent recession as some of these neighboring Midwestern states, it did contract faster than the national economy. Total non-farm employment declined 4.9% in 2009, versus the national rate of 4.4% and matched the U.S. rate of 0.8% in 2010. Modest growth has resumed with year-over-year job gains of 1% as of November 2011, slightly below the national rate of 1.2%. While the unemployment rate dipped below the national rate in the fall of 2010, it has since increased and is now 116% of the national rate at 10% as of November. Wealth levels remain above average. Per capita income is 105% of the national average, sixteenth among the states.

Fitch affirms the following bonds, which are based on the state's appropriation commitment, at 'A-' with a Stable Outlook:

- Illinois Sports Facilities Authority, sports facilities bonds (state tax supported) series 2001;
- Chicago motor fuel tax revenue bonds, series 2003A, series 2008A, series 2008B.

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Additional information is available at 'www.fitchratings.com'. The ratings above were solicited by, or on behalf of, the issuer, and therefore, Fitch has been compensated for the provision of the ratings.

Applicable Criteria and Related Research:

--'Tax-Supported Rating Criteria', dated Aug. 15, 2011.

--'U.S. State Government Tax-Supported Rating Criteria', dated Aug. 15, 2011.

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Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648898

U.S. State Government Tax-Supported Rating Criteria

http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=648897

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