



New Issue: MOODY'S LOWERS STATE OF ILLINOIS' G.O. RATING TO A2 FROM A1, ASSIGNS A2 RATING TO PLANNED \$800 MILLION ISSUANCE

Global Credit Research - 06 Jan 2012

OUTLOOK REVISED TO STABLE; \$32 BILLION OF OUTSTANDING STATE DEBT AFFECTED

ILLINOIS (STATE OF)
State Governments (including Puerto Rico and US Territories)
IL

Moody's Rating

ISSUE	RATING
General Obligation Bonds, Taxable Series B of January, 2012	A2
Sale Amount	\$275,000,000
Expected Sale Date	01/11/12
Rating Description	General Obligation
General Obligation Bonds, Series A of January, 2012	A2
Sale Amount	\$525,000,000
Expected Sale Date	01/11/12
Rating Description	General Obligation

Moody's Outlook STA

Opinion

NEW YORK, January 06, 2012 --Moody's Investors Service has lowered the State of Illinois' general obligation bond rating to A2 from A1 and revised the state's outlook to stable from negative. The A2 rating has also been assigned to \$800 million general obligation January 2012 Series A and Taxable Series B bonds that the state has scheduled to price on January 11. Proceeds will finance school, transportation and other capital projects. We have also downgraded to A2 from A1 the rated portion of the state's \$2.47 billion of outstanding Build Illinois sales tax revenue bonds, and to A3 from A2 \$2.48 billion of Metropolitan Pier and Exposition Authority and \$73 million of Civic Center Program bonds.

SUMMARY RATING RATIONALE

The downgrade of the state's long-term debt follows a legislative session in which the state took no steps to implement lasting solutions to its severe pension under-funding or to its chronic bill payment delays. Failure to address these challenges undermines near- to intermediate-term prospects for fiscal recovery. It remains to be seen whether the state has the political willingness to impose durable policies leading to fiscal strength, though in the recent past it has reached consensus on difficult decisions, such as temporary income tax increases enacted last year that stabilized state finances and reduced the state's need for non-recurring budgetary measures. Illinois retains the sovereign revenue and spending powers common to all U.S. state governments. These powers, along with Illinois' legal provisions giving G.O. debt

service priority over other state spending, support the move to a stable outlook.

STRENGTHS

- Sovereign powers over revenue and spending
- Statutory provisions giving priority to debt-service over other state expenditures

CHALLENGES

- Severe pension funding shortfall
- Chronic use of payment deferrals to manage operating fund cash
- Weak management practices reflected in pension under-funding and payment delays

DETAILED CREDIT DISCUSSION

PENSION UNDERFUNDING WAS CAUSED BY SERIES OF LEGISLATIVE ACTIONS

Illinois has the weakest aggregate funded ratio of the 50 states. Combined, the state's five major plans had an actuarial accrued liability (AAL) of \$146.5 billion as of June 30, 2011. Assets of the plans on that date amounted to only \$63.4 billion, leaving an unfunded actuarial accrued liability (UAAL) of \$83 billion (as reported in the retirement plan valuations). Contribution shortfalls have been the main cause of deteriorating funded status since 1996. In fiscal 2011, for example, the state contributed 73% of the actuarially determined annual required contribution (ARC). The ARC is defined as the amount needed to amortize unfunded actuarial accrued liabilities and to cover the normal cost (i.e., future benefits accrued in the year) of current employees. Under-funding has resulted from legislative actions over the years, including a 1994 law originally intended as a solution to the retiree benefits problem. This law, which established a plan to accumulate assets equal to 90% of the pension plans' AAL over 50 years, effectively provided for annual employer contributions below the actuarial ARC, particularly during its first 15 years. Moreover, even though the law required contributions below the actuarial ARCs, the state has softened its requirements further in certain years. In 2005, the state suspended fiscal 2006 and 2007 contribution requirements for fiscal relief.

MAGNITUDE OF PENSION UNDER-FUNDING IS A DRIVER OF CREDIT WEAKNESS

Illinois' G.O. rating was lowered in December 2009 and again in June 2010. Those downgrades resulted partly from the magnitude of the state's pension funding challenges. The 2010 downgrade occurred several months after the state enacted a law creating a second pension tier, with higher minimum retirement ages and other more stringent conditions. The reforms were applicable only to employees joining the public workforce as of January 1, 2011. These prospective pension changes, despite likely long-term benefits, did not affect accrued liabilities captured in the state's UAAL, although they did become the basis for cuts in near-term statutory contributions. In their 2011 session, lawmakers did not act on a bill reining in liabilities at the expense of current pension participants. Although failure to pay the full pension ARC is in keeping with Illinois' pension funding law, we view it as akin to borrowing for operating needs.

STATE FACES UNSUSTAINABLE ASCENT IN PENSION CONTRIBUTIONS COINCIDING WITH SUNSET OF INCOME TAX INCREASE

State pension contribution requirements under existing statute are expected to rise in the next few years, to \$5.9 billion in 2015 from \$4.1 billion in 2012. The \$1.8 billion increase would raise pension contributions as a share of state operating resources to approximately 18% from 12%, based on the state's multi-year projection. Under current statute, the state's individual income tax rate falls to 3.75% from 5% in calendar 2015, and the corporate income tax declines to 5.25% from 7%. The state in January 2011 raised its

individual income tax rate to 5% from 3% and its corporate income tax rate to 7% from 4.8%, to generate an estimated \$7 billion of additional annual revenue. These tax increases ended a practice of borrowing to cover state pension contributions, as the state did in fiscal 2010 and 2011.

CONSTITUTION'S PENSION CLAUSE MAY BAR REFORMS APPLICABLE TO CURRENT EMPLOYEES

Lack of progress toward significant pension reforms underscores not only the magnitude of the state's pension funding shortfall, but also legal challenges that may block such policies. The state's constitution includes a clause (Article XIII, Section 5) ratified by voters in 1970 that specifically protects public pension benefits from reduction or impairment. This language casts doubt on the state's ability to modify even the unearned benefits of current employees. A bill (SB 512) is pending in the state's House of Representatives that would create a defined-contribution benefit tier and require pension plan participants to choose from one of three tiers: the existing plan, the plan as amended by the 2010 reforms or a defined contribution plan. Those choosing to stay in the first tier would be subject to substantial employee contribution increases. Those opting for the post-2010 reform tier would face less dramatic employee contribution hikes, and participants in the defined contribution plan would receive annual state deposits equal to 6% of salary and be able to contribute additional amounts as desired. No estimate of the budget impact of these reforms has been provided, but we believe the state's near- and long-term savings would be substantial. Even if such proposals are enacted in the legislative session starting January 31, they probably will trigger lengthy litigation, the outcome of which is uncertain.

PAYMENT DELAYS WILL PERSIST, DESPITE INCREASED INCOME TAX REVENUE

Illinois has long relied on deferrals of Medicaid and other payments to manage operating fund liquidity pressure. In recent years, the state's backlog of unpaid vouchers has become more general, affecting public universities, transit systems, school districts, public pensions and vendors of goods and services. The practice has several negative consequences, including adverse economic effects. Entities awaiting payment reportedly have been forced to fire employees or cease operations as they awaited payment of past-due bills. The current backlog is estimated at \$8 billion, including past-due corporate tax refunds and employee health plan contributions. Though revenue from the 2011 tax increases may reduce the backlog, it is unlikely to eliminate it, and the state has not adopted a comprehensive plan to address this issue. One effect of the backlog's growth has been to widen the state's GAAP-basis negative year-end fund balances. Illinois' available operating fund balances as of June 30, 2010 (the most recent year for which data are available), were the largest as a percent of operating revenue of any U.S. state, at 44%, compared with California's 25%. These ratios, respectively reflecting negative balances of \$9.3 billion and \$20.9 billion for the two states, are important indicators of financial strength and the relative priority that the governments assign to maintaining strong financial profiles. The severity of Illinois' reported negative available operating fund balance relative to revenues in recent years is consistent with a credit rating lower than all other U.S. states.

DEFERRED PAYMENTS CONSTITUTE STRUCTURAL OPERATING BUDGET DEFICIT

Payment deferrals represent the rolling of obligations from one fiscal year to the next, and in recent years, the amount has significantly increased. The practice sustains a structural budget gap by using portions of each year's revenues to cover prior-year expenses. For each of the past two fiscal years (2010 and 2011), the state extended the so-called lapse period to December 31 from August 31. The lapse period is the time in which the state is authorized to pay off the immediately preceding fiscal year's expenses using current revenue. The extensions have let the state pay prior-year expenses with revenue received six months into the current and preceding fiscal years. For the lapse period attributable to fiscal 2010, the state used one-shot measures to help cover prior-year bills, including \$1.25 billion from the sale of tobacco settlement bonds and \$717 million from a tax amnesty program. In addition, the state in July 2010 issued \$1.3 billion of cash-flow notes that matured late in fiscal 2011, and it borrowed \$496 million from non-operating sources. Tax increases enacted in January 2011 allowed the state to avoid similar measures for fiscal 2011 lapse-period spending. Fiscal 2012 expenses covered by lapse-period revenue

probably will be increased because of an expected lengthening of the state's Medicaid provider payment cycle. How much lapse-period spending this will require and whether a third lapse-period extension will be implemented are unclear.

BOND PROPOSALS FOR ACCOUNTS PAYABLE HAVE NOT DRAWN BROAD LEGISLATIVE SUPPORT

The governor has advocated issuing long-term debt to address the state's payment backlog. The fiscal 2012 executive budget called for \$8.75 billion of new G.O. debt authorization to pay past-due bills, with \$5.75 billion issued in the spring of 2011 and \$3 billion early in calendar 2012. The governor's proposal would have dedicated half a percentage point of last year's 2 percentage point income tax increase to cover debt-service on the accounts-payable bonds. Lawmakers to date have not broadly supported such plans. Financing the backlog clearly would benefit entities awaiting payment, but without necessarily preventing future accounts payable accumulations, and it would accelerate growth in the state's bonded debt.

DEBT BURDEN HAS INCREASED, REFLECTING BORROWING FOR PENSION CONTRIBUTIONS

Illinois' bonded debt has grown in recent years, primarily as a result of borrowing for pensions. Of the approximately \$33.2 billion of rated bond principal outstanding after the current issues, 49% will correspond to pension financings. The state's fiscal 2010 and 2011 pension funding bonds - \$3.5 billion and \$3.7 billion, respectively - were long-term G.O.'s that financed statutorily required annual contributions. Illinois' outstanding debt as a percentage of income rose to 5.7% in Moody's 2011 State Debt Medians report, from 4.4% the prior year and compared with a national median of 2.8%. Debt per capita amounted to \$2,383, compared with a \$1,066 median. Debt burden is high relative to other states, but remains manageable, in Moody's view. However, if the pension UAAL is included, the state's debt burden is one of the heaviest among the 50 states. Debt and pension UAAL amount to about 18% of GDP, based on 2010 figures. The state's pension ARC, 2010 debt service payments and payments made for other post-employment benefits (OPEB) totaled about \$7.5 billion, or 15% of the state's total revenues from all governmental funds.

DRIVE TO IMPROVE GOVERNANCE FOLLOWS WEAK FINANCIAL CONDITIONS THAT HAVE PERSISTED FOR MANY YEARS

The state's pension funding gap and payment backlogs underscore the weak financial conditions that have persisted and deteriorated over many years. The state is taking steps now to strengthen its management and governance. The state last year, for example, passed a law intended to encourage more timely publication of its GAAP-basis comprehensive annual financial report. The Illinois General Assembly's House of Representatives passed a resolution that any revenue exceeding the budgetary forecast must first be applied to payment of pending vouchers (past-due bills). The 2011 tax increases allowed more balanced financial operations and compliance with pension funding requirements. It remains to be seen how the state will address the scheduled sunset of these tax increases, which begins in 2015.

Outlook

The state's stable outlook reflects its sovereign powers over revenue and spending, as well as statutory provisions establishing priority of payment for G.O. debt service. Although the likelihood of effective, proactive movement on major challenges appears minimal at present, the state's stable outlook also relies on a demonstrated ability to make politically difficult choices as the need arises.

WHAT COULD MAKE THE RATING GO UP

- Adoption of a credible, comprehensive long-term pension funding plan
- Substantial progress in reducing payment backlog, and legal framework or plan to prevent renewed buildup of late bills

WHAT COULD MAKE THE RATING GO DOWN

- Early phase-out of 2011 tax increases without offsetting binding expenditure actions, increasing the structural gap
- Further deterioration in pension funded status or failure to make legally required contributions

PRINCIPAL RATING METHODOLOGY

The principal methodology used in this rating was Moody's State Rating Methodology published in November 2004. Please see the Credit Policy page on www.moody.com for a copy of this methodology.

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Analysts

Edward Hampton
Lead Analyst
Public Finance Group
Moody's Investors Service

Marcia Van Wagner
Backup Analyst
Public Finance Group
Moody's Investors Service

Contacts

Journalists: (212) 553-0376
Research Clients: (212) 553-1653

Moody's Investors Service, Inc.
250 Greenwich Street
New York, NY 10007
USA



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