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Illinois Pension Defeat Seen Heightening State's Downgrade Risk

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(Bloomberg) -- Illinois, already tagged with the lowest credit rating among U.S. states, is at risk of downgrades and higher borrowing costs after lawmakers' fix for its $111 billion pension shortfall was struck down in court.

Yields on an index of Illinois bonds jumped to the highest since December after the state Supreme Court on Friday said the 2013 pension revamp violated the state constitution's ban on reducing worker retirement benefits. The decision has implications for localities statewide as Illinois may have less money to distribute.

Illinois, which is grappling with $7 billion in unpaid bills, is graded four steps above junk by the three biggest rating companies. A cut would give it the lowest standing for a U.S. state since 2010. Standard & Poor's on Friday put the state on "CreditWatch with negative implications," saying it expects to decide on the rating within three months.

"I wouldn't be surprised to see downgrades at the state level," said **Neil Klein**, senior managing director and principal in New York at Carret Asset Management, which oversees $750 million of munis. "There will be some ripple effects within the state."

Bill Inflation

After years of skipped contributions, Illinois in 2013 had just 39.3 percent of assets needed to meet promises to retirees, the worst ratio among states, according to data compiled by Bloomberg. The law overturned last week sought cuts in cost-of- living increases and a higher retirement age.

Friday's ruling adds $1 billion to its pension bill for the fiscal year starting July 1, according to the Civic Federation, a Chicago-based nonprofit research group that follows the city's finances.

Republican Governor Bruce Rauner, who took office in January, already faces a projected $6.2 billion budget gap for next fiscal year after lawmakers let a 2011 income-tax increase expire Jan. 1 without reducing spending.

Laurence Msall, president of the Civic Federation, Paul Mansour, head of municipal research at Hartford, Connecticut- based Conning, and Molly Shellhorn, a senior research analyst at Nuveen Asset Management in Chicago, all said the court's decision raises the risk of a rating cut.

Moody's Investors Service grades the state A3, while S&P and Fitch Ratings assess it at A-. Moody's and Fitch give it negative outlooks. No state has been lower since California in April 2010.

S&P said the ruling “underscores the profound credit challenges facing the state from a budget and liability standpoint.” Fitch said its rating didn’t assume the law could survive. Moody’s said the decision increases pressure on the state to come up with ways to pay for the liabilities.

Higher Yields

Trading in Illinois bonds reflects the heightened risk. Yields on 30-year, tax-exempt debt rose to a five-month high of 4.73 percent Friday, data compiled by Bloomberg show. The spread of about 1.5 percentage points above benchmark debt is the widest since January.

In comparison, a Bank of America Merrill Lynch index of general-obligations rated BBB has an effective yield of about 4.6 percent.

“It’s going to mean higher borrowing costs for all Illinois political subdivisions across the board,” said Mansour at Conning, which oversees $11 billion in munis. “It increases the risk of a downgrade for the state of Illinois, but the rating agencies will be waiting for the response of the state to this news before they make any decision.”

Rauner said that he wasn’t surprised by the decision and that his plan wouldn’t reduce currently promised benefits.

He said at an appearance in Chicago on Friday that his recommended fix is “fundamentally different” from the one proposed by his predecessor, Pat Quinn.

The ruling “was certainly not a confidence booster for state of Illinois bonds,” said Richard Ciccarone, Chicago-based chief executive officer of Merritt Research Services LLC, which analyzes municipal finance. “It’s perhaps another step of uncertainty along the path here of getting this eventually resolved.”

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