The Institute for Illinois' Fiscal Sustainability

AT THE CIVIC FEDERATION

COST OF THE CRISIS:

An Analysis of the Additional Bond Costs Paid by the State of Illinois Due to the State's Ongoing Fiscal Crisis

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EXECUTIVE SUMMARY

It is widely understood that individuals, corporations or governments with lower credit ratings are typically charged higher rates to borrow funds from banks and investors than those with better credit ratings. The following analysis presents an estimate of the additional cost the State of Illinois has paid for its 12 most recent bond issuances. Even as its credit ranking has fallen and financial outlook has remained negative, the State has issued capital purpose General Obligation Bonds (GO Bonds), Pension Obligation Bonds (POBs), revenue bonds and refunding bonds totaling $9.6 billion between September 16, 2009 and July 14, 2010. Illinois' credit worthiness is currently ranked as one of the two lowest states, along with California, by all three major rating agencies.

This analysis estimates the cost of the bonds sold by Illinois based on yields and compares it to other municipal issuers with higher credit ratings that sold bonds under similar market conditions. By applying the yields charged to governments with better ratings to the same principal and maturity schedule as the Illinois issuances, a reasonable estimate can be made of the additional long-term cost the State has been charged for access to the credit market.

This analysis presents the following findings:

- It is estimated that the State of Illinois will pay 20.9% more than better rated municipal issuers for the most recent $9.6 billion in bonds sold by the State;

- After accounting for the Build America Bond (BAB) subsidies, the State will pay an estimated $551.3 million in additional interest cost above what comparable issuers may have been charged after accounting the for the expected 35% reimbursement pledged by the federal government;

- The majority of the additional borrowing costs charged to Illinois will be paid in the early years of the bonds as the State struggles to cope with its ongoing budget deficit and can expect only modest economic recovery; and

- Due to the structures of the bonds, the State will pay $72.9 million of the $551.3 million in net additional cost in 2011. Over the next five years the State will pay 54.6% of the total additional cost, or $301.2 million.

Although Illinois' overall cost to issue debt has been lower due to dramatically lower interest rates in the credit markets, the State has been charged more than other municipal issuers to access the credit markets. This means that any government services or capital improvements paid for with these bonds are costing Illinois' taxpayers considerably more due to additional interest costs than governments that have maintained better credit ratings despite the economic downturn.

COMPARISON AND ANALYSIS

Credit Ratings and Bond Costs

As of June 17, 2010, the State of Illinois was tied with California for the lowest credit rating of any state from Moody's Investor Services. The General Obligation Bonds (GO Bonds) of both states are currently rated A1 by Moody's. Fitch Ratings and Standard & Poor's (S&P) still consider Illinois' debt slightly more attractive than California bonds and rate Illinois' debt A and A+ respectively. However, S&P has Illinois listed as a negative watch, indicating the possibility of a further reduction. The following chart shows the comparison between the ratings of Illinois and California GO Bonds:

General Obligation Bond Ratings for Illinois		
	Illinois	California
Moody's	A1	A1
S&P	A+	A-
Fitch	A	A-

Source: State of California, State Treasurer, Public Finance Division, Current Credit Ratings, at http://www.treasurer.ca.gov/ratings/current.asp. Source: Commission on Government Forecasting and Accountability, Monthly Briefing June 2010, p. 16-17.

All other states are currently rated AA or better and 13 states currently are rated AAA from at least one agency.[1] Illinois GO bonds were similarly rated AA as recently as December 2008 but have been reduced four times by Fitch in the last 18 months and three times by Moody's and S&P.[2] Despite multiple reductions, all of Illinois' bonds are still considered investment grade assets and not speculative investments. However, Illinois' lower ratings indicate to investors that the State's poor fiscal health makes it more susceptible to adverse economic conditions in a time of continued global financial stress.[3]

Similar negative budgetary factors were noted by each of the rating agencies in the press releases and analyses that accompanied the downgrades, including:[4]

- Increasing levels of unfunded pension liabilities in the State's retirement funds;
- High levels of accrued liabilities and increasing accounts payable;
- Ongoing and increasing budget deficits;
- State source revenue shortfalls; and
- Increasing GO debt and growing debt per capita.

The rating assigned to municipal debt is often the starting point in determining how much an issuer will end up paying to access the credit markets. Municipal bonds sold by domestic entities

[1] Municipal bonds sold by Washington D.C. are listed among state debt by Moody's, S&P and Fitch and currently rated Aa2, A+ and A+ respectively.
[2] Due to a recalibration of the ratings scales by Moody's and Fitch in April and March 2010, both raised Illinois ratings one level. This is not considered an upgrade. Fitch subsequently reduced Illinois' rating in June 2010 one level for its fourth downgrade in 18 months.
[3] http://www.standardandpoors.com/ratings/definitions-and-faqs/en/us
[4] Commission on Government Forecasting and Accountability, June Briefing, p. 16. http://www.ilga.gov/commission/cgfa2006/Upload/0610revenue.pdf (last accessed July 14, 2010).

are usually considered conservative investments, typically paying out lower interest than corporate debt. Favorably low interest rates are charged to many governments because of their ability to levy taxes and fees to support their pledges of full faith and credit to bond holders.

Market conditions are also taken into consideration during the sale of municipal bonds, such as other issuers in the market, the amount of outstanding bonds still available from previous sales and the prospects for a bond issuer's future fiscal health compared to other issuers. The more negative the state's overall financial picture, including what can be gleaned from the ratings issued by Fitch, Moody's and S&P, the higher the interest rates that the market demands for the sale of bonds.

However, it is also common for investors to disagree with rating agencies and steer away from an issuance that their own internal market analysis deems more risky or take a more favorable view than the analysis provided by the rating agencies. This often leads to similarly rated municipal bonds receiving different prices from investors even when offered under similar market conditions.

Recent Market Conditions and Interest Costs

Despite downgrades and negative analysis from the rating agencies over the past year and a half the State of Illinois, like other municipal issuers, has actually been able to lower total interest costs for its bonds compared to bonds sold prior to December 2008. This apparent contradiction is primarily the result of a lower federal funds rate, which is the rate at which banks lend cash to other banks and financial institutions overnight through the Federal Reserve Bank. The target federal funds rate is widely used as the basis for other debt issued by both public and private entities. The target rate set by the Federal Open Market Committee was reduced to between 0.0% and 0.25% in December 2008.[5] The federal government dropped the rate, which had been as high as 3.5% earlier that same year, as a reaction to the tightening of the global credit markets.[6] The federal funds rate currently remains at this level. The federal funds rate directly affects the overall cost of credit but does not control pricing in the municipal market. Investors primarily use benchmark scales known as the Municipal Market Data (MMD), a subscription service maintained by Thomson Reuters, for comparative data such as the 30-year AAA rated GO bond scales that help determine and track pricing in the municipal bond market. These municipal bond scales have followed the federal funds trend, setting record lows over the past year and a half.

Although bonds are currently less expensive overall for Illinois to sell due to market factors, the State is still paying a higher premium to access credit markets than it would have had it maintained a better credit rating. At the same time that Illinois bonds are suffering historically low ratings, Illinois also has sold the second largest amount of debt in a 12-month period in State history. Illinois sold $9.6 billion of GO Bonds, GO Refunding Bonds[7] and Build Illinois Bonds combined between September 16, 2009 and July 14, 2010. This is second only to 2003 when the State sold $10 billion of Pension Obligation Bonds, a special type of GO Bond used in part to pay down the unfunded liabilities of its retirement systems.

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[5] Board of Governors of the Federal Reserve System, Federal Open Market Committee, http://www.federalreserve.gov/monetarypolicy/fomc.htm (last accessed July 14, 2010).

[6] Ibid., Intended federal funds rate, Change (basis points) and Level (last accessed July 14, 2010).

[7] State of Illinois Constitution, Article IX, section 9(e), the State of Illinois may from time to time issue bonds to pay off existing debt and capture lower interest rates, known as refunding bonds.

Cost Comparison Using Yield

To calculate the additional cost Illinois has paid for access to the credit markets attributable to dwindling credit scores and negative budgetary factors over the last 12 months, the yield of the bonds sold by the State can be compared to the yields of other better rated municipal bonds sold at relatively the same time.

Yield is the ratio of the actual price paid for bonds compared to the periodic interest owed to the bondholder or lender. It is calculated from the actual cost the issuer pays on the loan as opposed to the interest rate, which is simply the ratio of interest to principal of the loan. Calculating yield also takes into account any discount or premiums that may arise in the market at the time of the bond sale. Frequently a seller may give a quantity discount or lower the price of a bond to earn a better interest rate on a particular series of bond notes or pay a higher rate of interest if the lender pays more than the coupon price for a bond. **Thus, yield captures discounts and premiums that may occur in the actual sale of a bond and ultimately the actual total cost an issuer pays.**[8] By applying yields of bonds sold in the same market conditions and with the same structures as the bonds sold by Illinois but from issuers with credit ratings more similar to the State's AA rating prior to its downgrades, a reasonable estimate of the additional cost that the State was charged by investors can be calculated.

Calculating the potential interest costs using yields from the comparable bonds in this analysis is not an absolute determination of the exact rates that would have been earned in the market. The municipal issuers used for this comparison are different types of governments with different underlying financial structures.[9] The comparable issuances were chosen first by date to best preserve the market conditions in which the Illinois sales took place. Comparable issuances were then sorted by rating. When available, comparable bonds with ratings similar to Illinois' rating in December 2008 were used. In some cases due to the term of the comparison bonds used, several issuances were needed to provide yields for the entire term of the Illinois bonds. The investment proceeds of some municipal bonds are exempt from federal taxation and treated differently in the market, so the tax status of each of the bonds was also matched. **This analysis aims to provide a rough estimate of how much more the State may have paid than other municipal issuers whose bonds have been sold under a more positive rating and financial outlook but with the same market conditions as Illinois' issuances.** At the time of bond sales investors take into account many factors and undergo a lengthy process of assessing the appropriate price of municipal bonds, which cannot be directly quantified in this type of comparative analysis. The market may also treat different types of governments differently depending on their size and debt profile.

According to the total cost comparison calculations included in Table 2 of this analysis, Illinois was charged approximately $701.8 million more for its bonds than it would have been charged if the State had maintained its credit rating as it stood in December 2008.[10] However, this calculation only shows the gross cost for the bonds at the time of sale and does not take into account the federal subsidy provided under the Build America Bond (BAB) program. As part of the American Recovery and Reinvestment Act of 2009, the federal government pledged to pay

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[8] Vogt, John A., *Capital Budgeting and Finance*, Chapter 10: Interest Rates, Yields, and Pricing for Local Government debt, p. 175.

[9] See Table 1: Comparison Bonds, p. 7.

[10] See Table 2: Total Cost Comparison (Gross), p. 8.

35% of the total interest cost of qualified capital purpose bonds sold through December 31, 2010. Five of Illinois' recent bond issuances have qualified for the federal reimbursement. Although the bonds are taxable, which can lead to higher market costs, the subsidy keeps the total cost to the issuer much lower than it would be otherwise. **After reducing the cost of the bonds by the BAB subsidy, the total additional cost of Illinois' $9.6 billion in debt sold of the past year drops to $551.3 million, or 20.9%, above the cost issuers with better ratings may have paid.**[11]

Additional Cost Per Year

The additional costs calculated using yields in this report are based on the total estimated interest cost for the entire life of all of the bonds sold through 2035. However, because of the structure of Illinois' bonds, the majority of the additional cost will be paid in the early years of the State's debt payments. The annual portions of the additional cost calculated for this analysis are shown in Graphs 1 and 2 on pages 10 and 11 of this report by issuance. Graph 1 shows the gross annual payments as set forth in the bond sale documents and calculated from the published yields. The second graph shows the annual payments net of the federally pledged interest subsidies, expected to cover 35% of the total cost for the five qualified BAB issuances.

These graphs illustrate how the additional interest charged to Illinois is not equally distributed over the next 25 years. **Instead, the majority of the additional borrowing cost will be paid in the early years of the bonds when Illinois can expect only modest economic recovery and continuing financial stress.** In the first year alone, Illinois is estimated to pay $72.9 million or 13.2% of the total additional cost over comparable AA issuances, after accounting for BAB subsidies. This report estimates the State will pay 54.6%, or $301.2 million, of the total estimated additional cost, less the federal BAB subsidies, between 2011 and 2015 and $133.6 million between 2016 and 2020.

Included in this early term cost is the additional interest estimated for the POBs sold in FY2010, which are five-year notes and will be completely repaid by the end of 2015. These POBs make up 18.4% of the additional interest cost paid in the next five years or a total of $101.3 million.

Conclusion

Although Illinois' overall cost to issue debt has been lower due to dramatically lower interest rates in the credit markets, the State has been charged more than other municipal issuers have to access the credit markets. This means that any government services or capital improvements paid for with these bonds are costing Illinois taxpayers considerably more due to higher interest costs than governments that have maintained better credit ratings despite the economic downturn. As part of Illinois' FY2011 operating and capital budget, the State already plans to sell nearly as much debt as it has over the previous 12 months. If the State does not make progress on stabilizing its financial standing, it will continue to pay similar increased borrowing costs over other governments. This extra borrowing cost will continue to stress future budgets with increased debt service costs and a higher cost of government for the taxpayers of Illinois.

[11] See Table 3: Total Cost Comparison (Less BAB Subsidy), p. 9.

TABLES & GRAPHS

Table 1: Comparison Bonds

The following chart shows bond issuances of municipal governments that have maintained better ratings than the State of Illinois and were used as comparisons for this analysis. The comparison bonds were chosen first by date of the sale to represent yields earned in market conditions most similar to the dates of the Illinois bonds sales. The bonds were then chosen by rating and type of issuance.

Bond Issuances and Yields Used to Calculate Total Bond Cost Comparison

Municipal Issuer	Total Sale (in $ millions)	Date	Comp Rating (Moody's/S&P/Fitch)	Yield Range	Tax Status
Meriden, CT	$ 22.3	7/13/2010	NR/AA-/NR	1.0% - 5.75%	Taxable
Kyrene Elementary, AZ	$ 22.4	7/15/2010	Aa1/AA/NR	3.0% - 5.875%	Taxable
School District 2, DuPage County, IL	$ 191.6	7/13/2010	Aaa/AAA/AAA	6.18% - 6.28%	Taxable
Rock Island Mass Transit, IL	$ 10.3	6/17/10	Aa2/NR/NR	2.25% - 6.15%	Taxable
AZ Board of Regents	$ 147.5	6/23/10	Aa3/AA-	3.31% - 6.643%	Taxable
City of Dallas, TX	$ 295.9	6/15/10	Aa1/AAA/NR	0.35% - 4.41%	Exempt
Clean Water Services, Washington Co., OR	$ 90.3	4/28/10	Aa3/AA/NR	3.97% - 5.801%	Exempt
Oregon Board of Higher Education	$ 73.5	4/21/10	Aa1/AA+/AA	1.24%-4.961	Taxable
Housing Authority of Baltimore City	$ 53.0	4/15/10	NR/AA-/NR	3.66% - 6.56%	Taxable
State of Texas	$ 75.0	2/17/10	AA1/AA+/NR	0.5% - 3.69%	Exempt
Milwaukee, WI	$ 16.2	2/2/10	Aa2/AA/AA+	0.75% - 5.35%	Taxable
Alderwood Water District, WA	$ 49.3	1/27/10	Aa3/AA+/NR	2.0% - 5.55%	Taxable
Community Unit School District 4, Champaign Co., IL	$ 86.8	2/4/10	NR/AA/NR	6.05% - 6.30%	Taxable
Daviess County, KY	$ 21.7	1/12/10	Aa3/NR/NR	1.25% - 3.3%	Exempt
Wake County, NC	$ 148.9	12/10/09	Aa1/AA+/AA+	1.24 - 4.30%	Exempt
Fort Worth, TX	$ 41.2	9/22/09	NR/AA+/AA	0.77% - 4.4%	Exempt

Source: Municipal Securities Rule Making Board, Electronic Municipal Market Access, Various Official Statements, http://emma.msrb.org/default.aspx, last accessed July 22, 2010.

Table 2: Total Cost Comparison (Gross)

The following chart estimates total comparison interest cost based on yields applied to the $9.6 billion of bonds sold between September 16, 2009 and July 14, 2010 by Illinois.

State of Illinois Bond Interest Comparison Calculated from Yield (in $ millions)								
Type of Issuance/Date	**Amount**	**IL Rating (Moody's/S&P/Fitch)[1]**	**Comparison Issuance(s)**	**Date**	**Comp Rating (Moody's/S&P/Fitch)[1]**	**Total IL Interest**	**Comp Interest**	**Total Difference**
GO Build America Bonds 7/14/2010	$ 900.0	A1/A+/A	Meriden, CT Kyrene Elementary, AZ School District 2, DuPage County, IL	7/13/2010 7/15/2010 7/13/2010	NR/NR/AA- Aa1/AA/NR NR/AA/NR	$ 819.7	$ 648.3	**$ 171.4**
GO Build America Bonds 6/17/2010[2]	$ 300.0	A1/A+/A	Rock Island Mass Transit, IL AZ Board of Regents	6/17/10 6/15/10	Aa2/NR/NR Aa3/AA-/NR	$ 260.3	$ 228.4	**$ 31.9**
Build Illinois Bonds 6/15/2010	$ 455.1	NR/AAA/AA+	Dallas, TX Water Clean Water Services Washington Co., OR	6/16/10	Aa1/AAA/NR Aa3/AA/NR	$ 85.8	$ 66.0	**$ 19.9**
GO Build America Bonds 4/20/2010	$ 700.0	Aa3/A+/A+	Oregon Board of Higher Ed Washington County Sewer District, OR	4/14/10 4/21/10	Aa3/AA/AA Aa1/AA+/AA	$ 577.9	$ 480.7	**$ 97.2**
GO Build America Bonds 4/6/2010[3]	$ 300.0	Aa2/A+/A+	Baltimore Housing	4/15/10	NR/AA-/NR	$ 246.2	$ 238.8	**$ 7.4**
GO Build America Bonds 4/6/2010[3]	$ 56.0	Aa2/A+/A+	Baltimore Housing	4/15/10	NR/AA-/NR	$ 46.0	$ 44.6	**$ 1.4**
GO Refunding Bonds 2/19/2010	$ 1,501.3	A2/A+/A	Texas Veteran Housing	2/17/10	AA1/AA+/NR	$ 417.4	$ 326.7	**$ 90.7**
GO Build America Bonds 1/28/2010	$ 1,000.0	A2/A+/A	Milwaukee, WI Alderwood Water District, WA CUSD 4, Champaign, IL	2/2/10 1/27/10 2/4/10	Aa2/AA/AA+ Aa3/AA+/NR NR/AA/NR	$ 808.4	$ 686.3	**$ 122.1**
GO Bonds 1/7/2010	$ 3,466.0	A2/A+/A	Daviess County, KY	1/12/10	Aa3/NR/NR	$ 386.2	$ 284.9	**$ 101.3**
GO Bonds 12/16/2009	$ 375.0	A2/AAA/AA	Wake County, NC	12/10/09	Aa1/AA+/AA+	$ 207.6	$ 170.7	**$ 36.9**
Build Illinois Bonds 12/10/2009	$ 154.9	A2/AAA/AA	Wake County, NC	12/10/09	Aa1/AA+/AA+	$ 84.2	$ 70.6	**$ 13.6**
Build Illinois Bonds 9/16/2009	$ 400.0	A1/AA-/A	Fort Worth, TX	9/22/09	NR/AA+/AA	$ 204.8	$ 196.7	**$ 8.1**
Total	**$ 9,608.3**					**$ 4,144.5**	**$ 3,442.7**	**$ 701.8**

Source: Municipal Securities Rule Making Board, Electronic Municipal Market Access, Various Official Statements, http://emma.msrb.org/default.aspx, last accessed July 22, 2010.

1. Not Rated (NR): Some municipal bonds are not submitted by issuers to all three agencies.

2. No comparable bonds included maturities in 2011, so no potential savings were calculated for bonds maturing in that year for the bonds sold on 6/17/2010.

3. No comparable bonds included maturities in years 2011-2013 or 2033-2035, so no potential savings were calculated for bonds due in those years for the bonds sold on 4/6/2010.

Table 3: Total Cost Comparison (Less BAB Subsidy)

The following chart estimates total comparison cost based on the yields applied to the total $9.6 billion of bonds sold between September 16, 2009 and July 14, 2010 by Illinois, less the 35% interest subsidy for Build America Bonds.

State of Illinois Bond Interest Comparison Less Federal Build America Bond Subsidy
Calculated from Yield (in $ millions)

Type of Issuance/Date	Amount	IL Rating (Moody's/S&P/Fitch)[1]	Comparison Issuance(s)	Date	Comp Rating (Moody's/S&P/Fitch)[1]	Total IL Interest	Comp Interest	Total Difference
GO Build America Bonds 7/14/2010	$ 900.0	A1/A+/A	Meriden, CT Kyrene Elementary, AZ School District 2, DuPage County, IL	7/13/2010 7/15/2010 7/13/2010	NR/NR/AA- Aa1/AA/NR NR/AA/NR	$ 532.8	$ 421.4	**$ 111.4**
GO Build America Bonds 6/17/2010[2]	$ 300.0	A1/A+/A	Rock Island Mass Transit, IL AZ Board of Regents	6/17/10 6/15/10	Aa2/NR/NR Aa3/AA-/NR	$ 169.2	$ 148.4	**$ 20.8**
Build Illinois Bonds 6/15/2010	$ 455.1	NR/AAA/AA+	Dallas, TX Water Clean Water Services Washington Co., OR	6/16/10	Aa1/AAA/NR Aa3/AA/NR	$ 85.8	$ 66.0	**$ 19.9**
GO Build America Bonds 4/20/2010	$ 700.0	Aa3/A+/A+	Oregon Board of Higher Ed Washington County Sewer District, OR	4/14/10 4/21/10	Aa3/AA/AA Aa1/AA+/AA	$ 375.7	$ 312.5	**$ 63.2**
GO Build America Bonds 4/6/2010[3]	$ 300.0	Aa2/A+/A+	Baltimore Housing	4/15/10	NR/AA-/NR	$ 160.0	$ 155.2	**$ 4.8**
GO Build America Bonds 4/6/2010[3]	$ 56.0	Aa2/A+/A+	Baltimore Housing	4/15/10	NR/AA-/NR	$ 29.9	$ 29.0	**$ 0.9**
GO Refunding Bonds 2/19/2010	$ 1,501.3	A2/A+/A	Texas Veteran Housing	2/17/10	AA1/AA+/NR	$ 417.4	$ 326.7	**$ 90.7**
GO Build America Bonds 1/28/2010	$ 1,000.0	A2/A+/A	Milwaukee, WI Alderwood Water District, WA CUSD 4, Champaign, IL	2/2/10 1/27/10 2/4/10	Aa2/AA/AA+ Aa3/AA+/NR NR/AA/NR	$ 525.5	$ 446.1	**$ 79.4**
GO Bonds 1/7/2010	$ 3,466.0	A2/A+/A	Daviess County, KY	1/12/10	Aa3/NR/NR	$ 386.2	$ 284.9	**$ 101.3**
GO Bonds 12/16/2009	$ 375.0	A2/AAA/AA	Wake County, NC	12/10/09	Aa1/AA+/AA+	$ 207.6	$ 170.7	**$ 36.9**
Build Illinois Bonds 12/10/2009	$ 154.9	A2/AAA/AA	Wake County, NC	12/10/09	Aa1/AA+/AA+	$ 84.2	$ 70.6	**$ 13.6**
Build Illinois Bonds 9/16/2009	$ 400.0	A1/AA-/A	Fort Worth, TX	9/22/09	NR/AA+/AA	$ 204.8	$ 196.7	**$ 8.1**
Total	**$ 9,608.3**					**$ 3,179.0**	**$ 2,628.2**	**$ 550.8**

Source: Municipal Securities Rule Making Board, Electronic Municipal Market Access, Various Official Statements, http://emma.msrb.org/default.aspx, last accessed July 22, 2010.

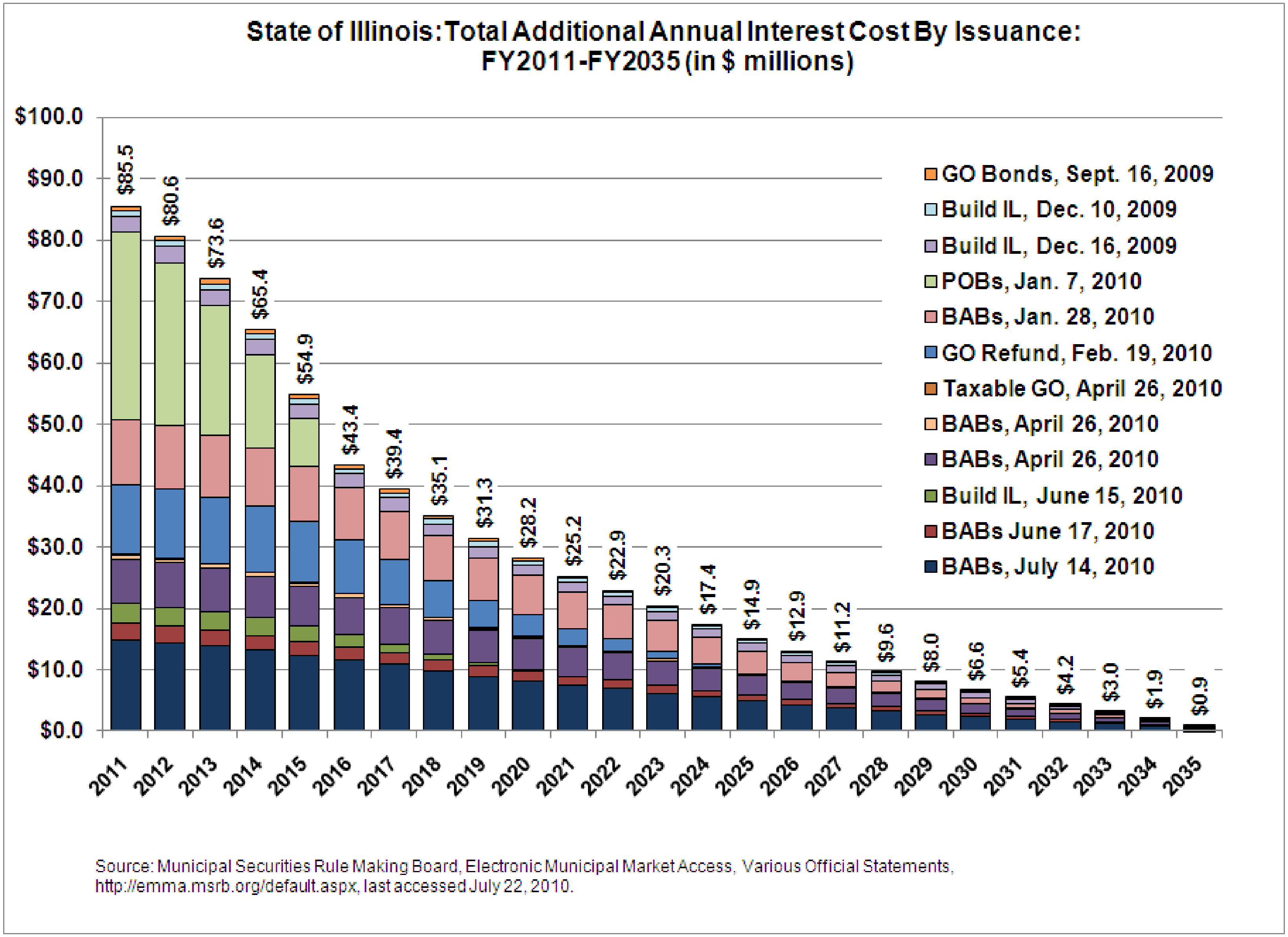
1. Not Rated (NR): Some municipal bonds are not submitted by issuers to all three agencies.

2. No comparable bonds included maturities in 2011, so no potential savings were calculated for bonds maturing in that year for the bonds sold on 6/17/2010.

3. No comparable bonds included maturities in years 2011-2013 or 2033-2035, so no potential savings were calculated for bonds due in those years for the bonds sold on 4/6/2010.

Graph 1: Annual Additional Bond Cost (Gross)

The following graph shows the estimated gross additional cost charged for Illinois' bonds over the comparison bonds as calculated by year and issuance for the entire life of the debt.



Graph 2: Annual Additional Bond Cost (Less Federal BAB Subsidy)

The following graph shows the estimated additional annual cost charged for Illinois' bonds over the comparison bonds minus the 35% federal interest cost subsidy for the Build America Bond included in the total calculation.