

ANALYSIS

The Illinois ‘Financial Condition Penalty’ Continues to Grow: An Analysis of Illinois’ June 2016 Bond Sale

Martin J. Luby, *DePaul University and the University of Illinois Institute of Government and Public Affairs*

Background

On June 16, 2016, the state of Illinois sold \$550 million in General Obligation Bonds (referred to here as the “June 2016 Bonds”). This was the first bond issue since the state’s recent credit rating downgrades by Moody’s and Standard and Poor’s and while the state is still without a budget. Just as for consumers, the state’s credit ratings affect its borrowing costs.

So just how much of a “financial condition penalty” did Illinois pay on this month’s bond sale?

Methodology

To answer this question, I made two analyses. For the first analysis, I assumed that the state sold its June 2016 Bonds at the relative prices it received on bonds it sold 10 years ago when the state’s credit ratings were much higher.¹ I then compared these counterfactual prices to the actual prices Illinois received on its June 2016 bonds. The difference between the counterfactual and actual bond prices is the financial condition penalty paid on the June 2016 bond sale compared to its bonds 10 years ago.²

In the second analysis, I assume that the state sold its June 2016 Bonds at the relative prices it received on bonds sold in January 2016 (referred to here as the “January 2016 Bonds”) before the recent credit rating downgrade and current budget impasse. I then compare these counterfactual prices to the actual prices Illinois received on its June 2016 bonds. The difference between the counterfactual and actual bond prices is the financial condition penalty paid on the June 2016 bond sale compared to its bonds sold less than six months ago.

Findings

- The total dollars the state actually received for the June 2016 Bonds was approximately **\$575,965,500**. The total dollars the state would have received if the June 2016 Bonds carried the relative prices on Illinois bonds 10 years ago (i.e., the 2006 relative prices) is estimated to be **\$645,511,680**.³ The aggregate difference between the actual and counterfactual bond prices was **\$69,546,180** which is the financial condition penalty.

¹ The “relative prices” used in this analysis are based on the state’s bond yields relative to the benchmark MMD AAA bond index as published daily by Thomson Reuters

² The price a government receives for its bonds is the present value of all the principal and interest payments on the bonds discounted at the investor’s required rate of return (i.e., from the government’s perspective, its borrowing cost). All else equal, the higher the price a government receives for its bonds, the lower its total borrowing cost. In this sense, the difference between the counterfactual and actual prices represent the present value of the additional borrowing costs by selling the bonds at the actual (rather than counterfactual) prices.

³ For illustrative purposes, the June 2016 bond maturing in ten years carried an interest cost 1.85 percentage points higher than AAA MMD bond index. The 2006 bond maturing in ten years carried an interest cost 0.18 percentage points higher than AAA MMD bond index. This represents a 1.67 percentage point increase in relative borrowing cost for the state between 2006 and June 2016 for this bond.

This nearly \$70 million financial condition penalty is an estimate of the cost to the state on the June 2016 Bonds as a result of the deterioration in its financial condition over the last 10 years.

- The total dollars the state would have received if the June 2016 Bonds carried the relative prices on Illinois bonds less than six months ago (i.e., the January 2016 Bonds relative prices) is estimated to be **\$587,581,281**.⁴ The aggregate difference between the actual and counterfactual bond prices was **\$11,615,780**, which is the financial condition penalty. **This nearly \$12 million financial condition penalty is an estimate of the cost to the state on the June 2016 Bonds as a result of the deterioration in its financial condition just over the last six months.**
- Due to a decline in overall market interest rates and favorable conditions in the municipal market at the time of the bond sale, the state realized a historically low overall borrowing cost on the June 2016 bond sale from an absolute interest rate level perspective.⁵ However, on a relative basis, the state could have realized significantly higher prices (i.e., paid lower borrowing costs) for its June 2016 Bonds if its credit had not deteriorated over the last 10 years or even over the last six months.

Future Policy Implications

- The \$70 and \$12 million financial condition penalty estimates only relate to the June 2016 Bonds. Assuming that future debt sales will be at typical levels of about \$1 billion each year, this financial condition penalty will be much larger.
- Furthermore, based on recent analyses, the state will need to issue much more annual debt than in the past to address its growing infrastructure needs. A recent estimate of the annual bond amount needed to address these needs is \$4 billion. **At this \$4 billion annual bond level, the financial condition penalty estimate will be in the hundreds of millions based on 2006 relative pricing levels and tens of millions of dollars based on the state's relative bond prices only six months ago.**

⁴ For illustrative purposes, the June 2016 bond maturing in ten years carried an interest cost 1.85 percentage points higher than AAA MMD bond index. The January 2016 bond maturing in ten years carried an interest cost 1.55 percentage points higher than AAA MMD bond index. This represents a 0.30 percentage point increase in relative borrowing cost for the state between January 2016 and June 2016 for this bond.

⁵ The true interest cost of the June 2016 bonds was 3.7425% which was lower than the true interest cost on the state's January 2016 bond sale of 3.9989%. However, as evidenced in this research, the state would have realized a significantly lower borrowing cost if it sold its June 2016 bonds at the relative prices it received in the past.