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Chicago and Illinois to push back on Treasury's aid guidance

By

Yvette Shields

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Chicago and Illinois will make their case with the Treasury Department to alter American Rescue Plan guidance that in its current form would scuttle plans to repay COVID-19 related borrowing with the aid.

The Treasury's eagerly awaited guidance lays out in 151 pages how local and state and tribal governments can use their share of the $350 billion of ARP funds.

While it offers wide latitude to cover pandemic-related revenue hits, the guidance prohibits using funds to put toward pension contributions for the purpose of reducing an accrued, unfunded liability; fund tax cuts; and make reserve deposits' or repay principal and interest. Governments can tap the funds for water, sewer and broadband, but not general infrastructure.

"Look the federal government's sending dollars and then telling us that we can't then send those dollars back to the federal government to pay for the borrowing that we took out last year, clearly doesn't make a lot of sense. And so we've talked to the Treasury Department about that," Gov. J.B. Pritzker said Wednesday.

“I think Illinois has some work to do to convince the federal government that paying off the MLF will fit into guidance,” said Eric Kim, head of U.S. state ratings for Fitch Ratings.

Chicago intended to use its $1.9 billion first to repay $465 million of borrowing on a one-year line taken out in December to help manage the $800 million pandemic-related revenue blow to tax collections last year.

Illinois planned first to repay about $2.175 billion that’s still outstanding from two financings totaling $3.2 billion through the Federal Reserve’s Municipal Liquidity Facility from its total of $8.1 billion of ARP funds along with overdue bills and possibly interfund borrowing.

Plans to pay off the COVID borrowing were welcomed by market participants worried that the two fiscally strapped governments with weak ratings, structural budget gaps and chronic pension woes would loosen the purse strings, but those plans now run afoul of the rules laid out in the “Interim Final Rule.”

The city and state aren’t ready to shift gears given the 60-day window from Monday’s publication date to submit comments that could result in changes.

"The Treasury guidance represents interim rules that have been put out for comment, and the city plans to seek clarification on the guidance as well as provide comment,” Mayor Lori Lightfoot’s office said in a statement Tuesday.

The quagmire raised over use of funds provides more of a planning headache for the state as it's scheduled to pass a budget by May 31 for the fiscal year that begins July 1. The city operates on a calendar year and while the short-term borrowing can be paid off early in June it doesn't come due until December. The city and state have several years to use the funds.

"The rules are still being worked on in Washington … and we are in daily communication with the offices at the Treasury Department that are deciding about those rules," Pritzker said Wednesday when asked about the issue at a news conference. "They put out a preliminary rule … and so we're following that trail to make sure that we get everything done that we need to, so we can use those."

"The Dept. of the Treasury said it welcomes feedback to the interim guidance on permitted uses of the stimulus funds. GOMB and our office will be seeking to clarify" the rules, Illinois Comptroller Susana Mendoza said in a statement.

"Illinois was out there with a very clear proposal but that seems to be outside of the guidance. I think Illinois has some work to do to convince the federal government that paying off the MLF will fit into guidance," said Eric Kim, head of U.S. state ratings for Fitch Ratings.

"There does seem to be some opening for government to make the case to make debt repayment allowable. The Treasury is saying we want feedback, we specifically want feedback on this point." The rules take effect immediately but could be revised.

The guidance may get in the way of city and state plans, at least temporarily, and could force them to eventually to shift gears but it's still a sizeable amount of money that will bolster the fiscal house of both and benefit their credit profiles as long as they primarily stick to using it for non-recurring expenses.

The city and state didn't bank on the federal government restricting repayment of direct COVID-related debt. Illinois — the only state to tap the MLF set up by the Federal Reserve in response to market turmoil early in the pandemic — borrowed $1.2 billion of one-year notes in June 2020 at a 3.82% rate based on an MLF pricing chart. It returned to borrow $2 billion in December at a rate of 3.42% with a three-year repayment term.

"In its current form, the rule looks like it would complicate the state's efforts to do some of the things it said it wanted to," said Ted Hampton, lead Illinois analyst at Moody's Investor Service. "Whatever the strings attached wind up being this aid is substantial and will have a positive and stabilizing" impact on state finances.

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While Moody's doesn't tell governments how they should use their money "to the extent that these funds which will not recur can be matched with expenses that are non-recurring because of the pandemic or loss of revenue — that would be more positive," Hampton said. Moody's revised its outlook to stable from negative earlier this year.

Fitch maintains a negative outlook on the state and is watching closely how the state uses the ARP funds before returning the outlook to stable. "State budgets are large and complex and there are broad uses that are allowable" under the guidance, but meeting all the rules can be tricky, Kim said.

Guidance

The overarching purpose of the funding is "to provide fiscal relief that will permit state, local, and tribal governments to continue to respond to the COVID-19 public health emergency" and so the "eligible use category would not include payment of interest or principal on outstanding debt instruments, including, for example, short-term revenue or tax anticipation notes, or other debt service costs."

Such expenses don’t fall under the category “government services” as they don’t directly provide services or aid to citizens.

“Payments from the Fiscal Recovery Funds are intended to be used prospectively and the Interim Final Rule precludes use of these funds to cover the costs of debt incurred prior to March 3, 2021,” it continues. “Fees or issuance costs associated with the issuance of new debt would also not be covered using payments from the Fiscal Recovery Funds because such costs would not themselves have been incurred to address the needs of pandemic response or its negative economic impacts.”

But the Treasury poses a series of direct questions to stakeholders including one on the debt rule: “In the Interim Final Rule, paying interest or principal on government debt is not considered provision of a government service. Discuss the advantages and disadvantages of this approach, including circumstances in which paying interest or principal on government debt could be considered provision of a government service?”

The city, state and others planning to repay COVID-related debt with the funds can argue that it was direct loss of tax revenue and their aim to avoid layoffs or service cuts — which can be restored with ARP funds — that drove the borrowing in the first place and should be eligible for repayment.

The guidance lays out a methodology to calculate the reduction in revenue caused by the pandemic by comparing actual revenue to an alternative representing what could have been expected to occur in the absence of the pandemic. “Importantly, once a shortfall in revenue is identified, recipients will have broad latitude to use this funding to support government services, up to this amount of lost revenue,” the guidance says.

The guidance more easily clears a path to restore services or jobs, but Lighftoot and Pritzker avoided deep cuts with the borrowing arguing they would further damage the recovery. They banked on the prospects that with more federal aid they could repay the debt.

Illinois' rating remains one cut away from junk over its chronic $141 billion pension liability and structural imbalance but Moody’s and S&P Global Ratings recently moved their near-term outlook back to stable from negative as pandemic pressures have eased thanks to federal relief and revenue collections that have turned out less bleak than first expected.

The state owes $1.043 billion borrowed from non-general funds, $400 million using the State Treasurer's Office's investment tool and $2.175 billion in MLF loans — all debts along with the current $4 billion backlog that Pritzker and Mendoza hoped to pay down with ARP funds.

Chicago incorporated $465 million of scoop-and-toss debt restructuring to help deal with an $800 million COVID-tax loss in 2020 and $500 million to cover another $800 million blow this year in its budget package approved last November.

The city opted to use a short-term line to raise the 2020 funds with plans to either retire it with federal aid or to roll it into a long-term debt restructuring later this year along with the $500 million in the absence of a federal relief package.

Lightfoot and her Chief Financial Officer Jennie Huang Bennett told the buy side last week they were putting repayment of the $465 million at the front of the line once federal funds were in and would also cancel the $500 million restructuring. The latter is not impacted by the guidance.

The city's GOs carry a BBB-minus from Fitch Ratings, an A from Kroll Bond Rating Agency, a junk level rating of Ba1 from Moody's Investors Service, and BBB-plus from S&P Global Ratings, all with negative outlooks.

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