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Fitch: Illinois Legislation Gives Chicago New Financing Tool.

Fitch Ratings-New York-19 July 2017: An amendment to the Illinois Municipal Code (65 ILCS 5) included in the state's fiscal 2018 budget agreement provides a structure by which Chicago and other home rule entities in the state can create entities to issue debt that would not be constrained by the Issuer Default Rating (IDR) assigned to the local government by Fitch Ratings. If properly applied by a home rule entity, the structure could result in ratings higher than and without regard to the IDR.

This type of structure has significant precedent including a number of New York state financings. The structure could not be employed directly by the Chicago Board of Education, whose IDR is 'B+'/Outlook Negative, as it is a non-home rule entity.

Separation from Local Governments' Operating Risk
The legislation allows for the establishment of a limited purpose entity to issue obligations for the benefit of the transferring unit (a home rule unit such as the city of Chicago). The entity could then issue bonds secured by revenues received from a state entity that have been conveyed by the transferring unit under an assignment agreement. The revenues would then become property of the issuing entity rather than the transferring unit. Fitch would look for any bond documents prepared for such financing to make clear that the assignment is irrevocable and that the transferring unit gives up its right, title and interest in or to the transferred receipts needed to repay the issuing entity's obligations.

Since operating risk resides with the transferring unit rather than the issuing entity, the issuing entity debt would be rated without consideration of operating risk, as represented by the IDR. The legislation's provision that the assignment agreement may provide for the transfer of receipts after payment of debt to the transferring unit does not alter Fitch's view of the separation of operating risk from the issuing entity. This is consistent with Fitch's general treatment of dedicated tax securities in cases in which the issuer has no meaningful operations.

The statutory lien provisions of the legislation provide additional protection to bondholders by eliminating the incentive to challenge the ownership of the revenues in a bankruptcy of the transferring unit, as the bankruptcy code provides that bondholders would have a right to the continuation of the lien in a bankruptcy.

Separation from State Credit Risk
The legislation includes non-impairment language related to the state's obligations that Fitch views as important to reducing the impact of the state's credit quality on the debt. The state pledges not to alter the power of the State Comptroller, Treasurer or Department of Revenue to transfer receipts to the issuing entity. The state also pledges not to change the basis on which the pledged revenues are derived.

To separate the bonds' rating from the state's, the transfer of the revenues must be outside the state's discretion. Therefore they cannot be subject to state appropriation. In Illinois, pledged sales tax revenues could be rated above the state's IDR since they are not subject to state appropriation,

but pledged motor fuel tax revenues, which are subject to state appropriation, would be capped at the state's appropriation rating (currently 'BBB-'/Outlook Negative).

Different from Special Revenue Analysis
In contrast, when issued directly by a local government, sales tax revenue bonds are capped at the entity's IDR because Fitch does not believe pledged sales taxes would be considered pledged 'special revenues' under the definitions in section 902(2) of the U.S. bankruptcy code. Fuel tax revenue bonds are not capped by the issuer's IDR, since Fitch believes fuel taxes clearly fit the definition of special revenues described in section 902(2)(B) of the code.

Chicago's dedicated tax ratings provide an illustration of Fitch's rating methodology for different types of pledged revenues. Fitch rates the city's sales tax revenue bonds 'BBB-'/Outlook Stable, reflecting the city's IDR cap. The city's motor fuel tax bonds are rated 'BBB-'/Outlook Negative, equal to the state's current appropriation rating, one notch below its IDR of 'BBB'/Outlook Negative. The motor fuel tax bond rating would not be capped by the city's IDR if it were lower than the state's appropriation rating.

Similar to New York Structures
Fitch views this structure as similar to those of several authorities created by New York state to allow for debt issuance by state-created authorities for the benefit of cities and counties throughout the state. These include the New York City Transitional Finance Authority, the Nassau County Interim Finance Authority, The Buffalo Fiscal Stability Authority, and the Erie County Fiscal Stability Authority, all rated 'AAA'/Outlook Stable by Fitch. The ratings are without regard to the benefiting governments' IDRs. The enabling legislation for each of the New York authorities creates a bankruptcy-remote entity with a first perfected security interest in the pledged revenues and includes covenants prohibiting action that would impair bondholders. Pledged revenues are remitted to the state comptroller, who remits them directly to the issuers.

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