Bondholders Fret as Alchemy Turns Chicago's Junk to Gold.

- **Chicago sales-tax securitization may herald trend for cities**
- **With money siphoned away, other bondholders left less secure**

Chicago's public pension debt is $36 billion and growing, it's facing $550 million in budget deficits over the next three years and this summer the state had to bail out a school system that was flirting with insolvency.

Yet next month, the nation's third-largest city — whose bonds were downgraded to junk by Moody's Investors Service two years ago — will start selling as much as $3 billion of debt that another rating company considers as safe as U.S. Treasuries.

That's because Chicago is selling off its right to receive sales-tax revenue from Illinois to a separate public corporation, which will issue new bonds backed by those funds, a structure called securitization. Because bondholders will be insulated from the city's finances and have a legal claim to the sales-tax money, Fitch Ratings deems the bonds AAA.

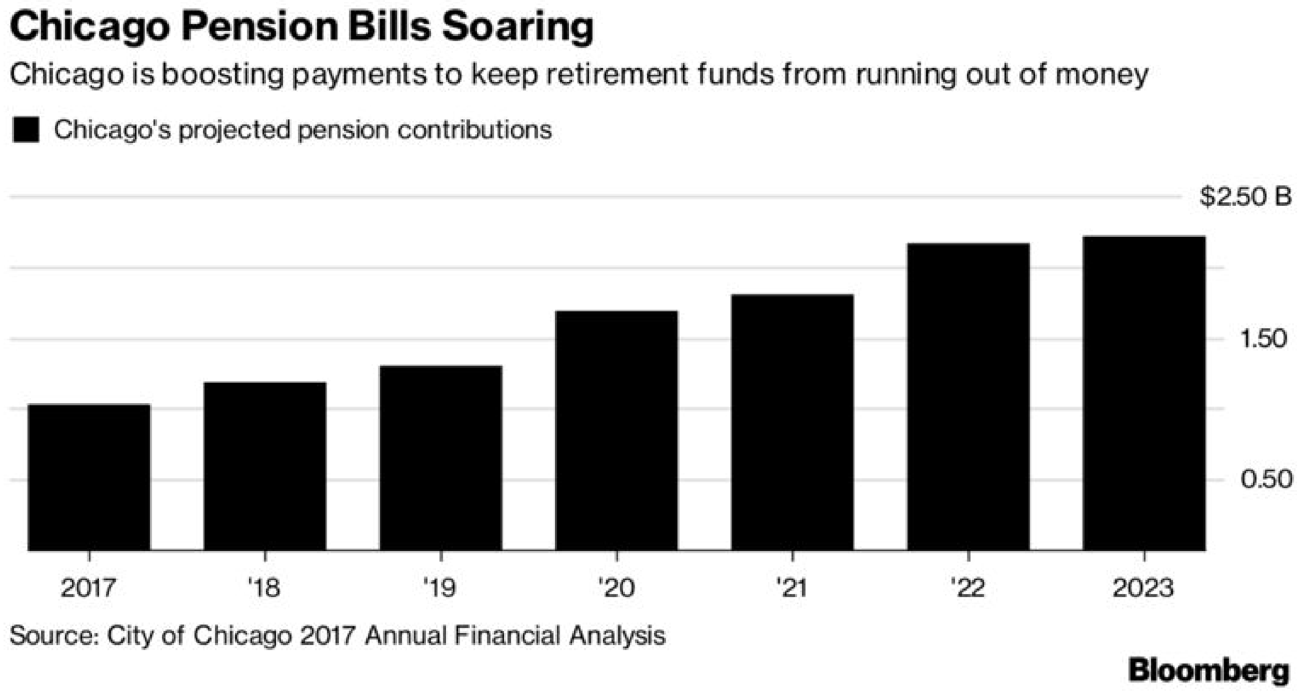
Some investors fear Chicago's approach may kick off a wave of securitizations by fiscally stressed municipalities that would increase their risk by siphoning away cash that backs bonds secured only by a promise to repay. Last month, Connecticut, which had a $3.5 billion two-year deficit, approved a budget that authorizes new debt backed by state income tax so it could receive a higher rating than the state's A+ general-obligation bonds.

"You are, through a process of alchemy creating AAA rated debt," said Christopher Dillon, a municipal bond portfolio specialist at T. Rowe Price Group Inc. "They've lowered their borrowing cost in the near term, but long term, it's just a continued degradation of the full faith and credit at the general-obligation level."

Detroit Casts Shadow

Since Detroit's bankruptcy four years ago, investors in the $3.8 trillion municipal market have given greater scrutiny to securities backed by a government's good word instead of a secure revenue stream. When that city emerged from court, holders of "limited" general-obligation bonds received 42 cents on the dollar for their investments, compared with 100 cents for owners of Detroit's water and sewer debt.

Institutional Investors from Pacific Investment Management Co. to Standish Mellon Asset Management Co. have said they favor revenue bonds, which don't compete for resources with public pensions, over general-obligation debt.



Creating separate entities to issue higher-rated debt isn't a new phenomenon. New York City, Philadelphia, Washington, Nassau County and Buffalo, New York, have all issued higher-rated dedicated-tax bonds to save money. But Chicago's sale comes as many cities face pressure from deeply underfunded pensions and opting for bankruptcy has lost some of its taint after a handful of governments did so after last decade's recession, though Illinois municipalities aren't allowed to take that step.

Chicago was extended the power to securitize its sales-tax payment by Illinois lawmakers this year. Paying off higher cost debt by issuing the new bonds will save Chicago almost $100 million in 2018.

Chicago's new bondholders will have a first claim to more than 90 percent of the approximately $715 million of sales-tax revenue collected each year, according to a presentation to Chicago's aldermen. The state, which collects sales taxes, will send the revenue directly to the bond trustee. Any excess revenue will go to the city.

"It just reeks of having your cake and eating it too," said Triet Nguyen, managing director at NewOak Capital. "You can prioritize certain revenue but the general obligation-bonds are actually fine."

The lower rating on Chicago's general-obligation bonds reflects all its debt, including securitizations and dedicated-tax bonds, and the government's ability to repay it, said Amy Laskey, a managing director at Fitch. The new bond issue hasn't affected that rating because the city is refinancing at a lower cost, not increasing its overall debt.

"The real sea change would be if they decided for some reason to issue a whole ton of debt that they hadn't planned to before," Laskey said. "I haven't heard any indication from them that's the case."

S&P Global Ratings grades the sales-tax securities slightly lower than Fitch at AA, the third-highest grade. They aren't rated by Moody's.

Puerto Rico Fight

Some investors say the legal battle now being waged in federal court between Puerto Rico's general-obligation debt owners and sales-tax bondholders shows that legal structures like the one set up in Chicago are no guaranty when a borrower goes bankrupt or encounters severe financial distress.

In 2006, Puerto Rico passed a law creating a separate entity to issue sales-tax backed bonds with a legal structure similar to Chicago. The commonwealth approved a 5.5 percent sales tax and sent a portion to an entity known as Cofina. The new tax-backed bonds issued by the agency had a bigger margin of safety to pay debt service and garnered A+ ratings, five levels higher than Puerto Rico's general-obligation bonds at the time.

This year, Puerto Rico entered into a form of bankruptcy and Cofina bondholders discovered the debt might not be so secure.

In June, the island said it may need more than $400 million in sales-tax revenue held by Cofina's bond trustee for government operations. Cofina bondholders are fighting the move in bankruptcy court. General-obligation bondholders assert the money belongs to them, arguing that the territory's constitution guarantees them a first claim on the government's resources.

"We're seeing these structures don't always stand up the way they were designed to in bankruptcy," said Tamara Lowin, director of research at Belle Haven Investments. "The market's not putting as much faith in them as they have in the past."

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By Martin Z Braun

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— With assistance by Elizabeth Campbell