Bond Case Briefs

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Have They Got a Bond for You.

Connecticut and Chicago borrow a debt trick from Puerto Rico.

State and local governments pledge their full faith and credit to repay general obligation bonds, but politicians in Chicago and Connecticut realize their word is depreciating in value. Thus they're pitching a debt arbitrage to reduce their borrowing costs.

As part of Illinois's slow-rolling bailout of Chicago, Democrats in Springfield this summer allowed the city to issue bonds securitized with $700 million or so in annual sales tax revenue. Creditors would have a legal lien on the revenues. Chicago plans to start floating the sales-tax bonds next month to refinance existing debt.

The bonds will be cheaper to finance than Chicago's junk-rated GO bonds, which carry a 3.5% premium over top-rated municipal securities. Fitch has rated Chicago's sales tax bonds AAA, which is an insult to every triple-A issuer including the U.S. Treasury. (Fitch still rates Treasurys triple-A, unlike Standard & Poor's.) While the city noted in a recent presentation that "ratings agencies rate bonds issued by special-purpose corporations highly because they are more legally secure than a normal bond," that hasn't historically been the case.

Securitized bonds issued by special public corporations were once considered less safe than GO bonds because their revenue bases are narrower and can shrink over time. Consider the 2011 bankruptcy of Jefferson County, Alabama, which resulted from political corruption at its over-leveraged sewer system.

Detroit's Chapter 9 bankruptcy in 2013 set a precedent by subverting GO bondholders to pay public workers and retirees. Prior to Detroit, creditors considered GO bonds sacrosanct and figured courts would compel local governments to raise taxes or cut pensions to repay them. That assumption proved incorrect. So creditors are now demanding higher yields for GO bonds issued by fiscally irresponsible governments.

Hence, Connecticut lawmakers recently authorized bonds backed by state income taxes as a substitute for GOs. The budget noted that "the new type of borrowing authorized in the bill may be viewed more favorably in bond markets because it is linked directly to a large and relatively stable revenue source." Hmmm.

Income-tax revenues in Connecticut have repeatedly fallen short of estimates due to tepid economic growth. Last year they were off by $530 million. Perhaps Democrats consider this a rounding error on a $3.5 billion deficit. Chicago has reassured investors that the new "corporation would be considered bankruptcy-remote" (our emphasis). However, "in the unlikely event of a municipal bankruptcy, bondholders would still be paid." Not so fast.

Puerto Rico likewise established a special public corporation in 2006 to issue sales-tax "Cofina" bonds, which were billed as more secure than debt paid from the commonwealth's operating fund. And for a time that appeared true as politicians raised the sales tax (which was later converted into a VAT) to repay creditors.

But last year Puerto Rico's governor issued a debt moratorium, which led Congress to impose a fiscal control board and create a quasi-Chapter 9 bankruptcy process. Cofina and GO bondholders are now vying for the same, small pool of money, and both will be lucky to get half of what Detroit bondholders recovered.

Illinois could authorize Chicago to declare bankruptcy in the future, and while states can't declare bankruptcy, Connecticut could try to renegotiate the terms of its debt. In the event of a default, GO bonds in both places would be less secure because of competing creditor claims.

Investors thirsty for yield may take Chicago and Connecticut up on their proposition, but they shouldn't complain later if these bets turn out to be bad political risks. Caveat creditor.

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