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How Cash-Strapped Chicago Snagged a Triple-A Rating for Its New Bonds.

Chicago is running a multimillion-dollar deficit and faces a pension-funding crisis that dwarfs many others around the country.

Yet the nation's third-largest city is on the verge of selling as much as $3 billion in bonds at a triple-A rating, the latest twist in the tale of cash-strapped U.S. municipalities adopting Wall Street financial engineering in their struggle to raise money in the market.

Echoing methods adopted by Puerto Rico and New York, Chicago has created a new company to sell debt, offering a tempting pledge to investors: a dedicated first claim to the city's sales-tax revenue.

In theory, that should make the debt as secure as U.S. Treasury bonds. But there is a catch: analysts and investors say in the scenario of a bankruptcy, it is difficult to predict whether owners of the new bonds would get paid back ahead of other creditors, pensioners or even police and emergency services workers.

The deal tests whether years of near-zero interest rates will send yield-starved investors into complex bond structures. And Chicago — with a school system that has teetered near bankruptcy and greater expenses than its revenues — could still face a funding gap down the line even if it manages to lower its borrowing costs, analysts say.

For the $575 million in bonds being priced this week, Jefferies LLC is the underwriter, while Goldman Sachs Group Inc. will lead the next batch, according to city presentations. Carole Brown, chief financial officer of Chicago and a former banker at Barclays PLC, told investors that she devised the plan to create the corporate entity to issue the bonds, according to a person who attended an investor luncheon for the sale.

Through the sale, Chicago is tapping a tool New York's leaders developed in the 1970s as the city faced the specter of a bankruptcy. Back then, Felix Rohatyn, a famed mergers and acquisition banker at Lazard, led an entity called the Municipal Assistance Corp., which allowed New York to borrow money even after major banks had choked off financing.

Puerto Rico sold more than $15 billion in sales tax bonds over the past decade. Rating firms considered the debt to be the island's safest offering, and it was snapped up by investors. Now those bondholders are fighting in court against creditors owning general-obligation bonds, who say their claim on the island's full faith and credit should include sales taxes also. Known by the acronym Cofina, those bonds recently traded at pennies on the dollar.

"Sometimes greed overtakes fear" in the market, said Chris Ryon, a portfolio manager at Thornburg Investment Management, which oversees more than $10 billion in municipal bonds. "It's a function of investors' desire for income."

Earlier this year, Chicago issued more than $1 billion in bonds, with part of the deal yielding 6%, far higher than most tax-exempt municipal credits. The coming deals would allow Chicago to refinance some of its over $9 billion in debt with lower interest costs, city officials have said.

The new debt, the first portion of which has maturities up to 26 years, could save the city more than $90 million in borrowing costs next year, according to the city. Chicago's leaders emphasize in bond filings that the new company, dubbed the Sales Tax Securitization Corp., is separate from the city.

Illinois currently doesn't allow its municipalities to file for bankruptcy, though lawmakers introduced legislation in recent years that cleared the way for Chicago or its school system to file.

Chicago declined to comment on the debt deal. Robert Christmas, a partner at law firm Nixon Peabody, which is advising the city on the sale, said investors shouldn't compare Puerto Rico's sales-tax bonds with Chicago's offering, in part because the city has stronger protections for investors than the island territory had.

Chicago's deal also sheds light on how widely diverging views can emerge from credit-ratings firms in the municipal bond market. Moody's Investors Service has graded the city's debt as junk, but S&P Global Ratings, Fitch Ratings and Kroll Bond Rating Agency have given Chicago investment-grade ratings.

For this latest issuance, Fitch and Kroll gave Chicago's corporate entity an additional boost: a AAA rating, the highest possible grade and equivalent to U.S. Treasurys.

S&P scored it two grades lower, although the firm still rates it five notches higher than other Chicago bonds. S&P also said in November it could change how it evaluates debt like Chicago's latest issuance, meaning investors could end up with bonds that are later downgraded by the firm.

In 2015, two years after it defaulted on its debt, Detroit snagged an investment-grade rating from S&P on new bonds by promising investors they would have first claim on income-tax revenues, although it didn't create a new corporation like Chicago.

Thornburg's Mr. Ryon said Chicago's new entity doesn't deserve separate credit ratings from the city's other debt. "It's a bit of smoke and mirrors," he said.

Moody's, which lowered the city's general-obligation bonds to junk in 2015, doesn't have a rating for the city's new debt. Chicago asked Moody's to withdraw the junk ratings on the general-obligation bonds, the firm said.

Bond ratings are also important because they can dictate money flows. Fund managers are often restricted to buying bonds with certain grades.

Other cities and states will be watching Chicago's bond sales. Illinois passed a special statute allowing the city to issue the bonds, and now other municipalities in the state can do the same.

States including California, Nebraska and Rhode Island have passed laws in recent years aimed at giving bondholders first claims on some taxes even if the issuer is in financial distress. Illinois and Michigan have also proposed similar laws.

Investors say municipalities with weaker financials will continue to try to woo bondholders with proposed safeguards, especially with the market rattled by Puerto Rico's restructuring.

"The idea is to provide a little more reassurance to potential creditors that they've got first crack at the money," said Glenn Weinstein, a Chicago attorney at Pugh, Jones & Johnson P.C., who has advised the city in the past.

At the same time, Mr. Weinstein said, “if you don’t have financial difficulties and your credit is good, you don’t need this.”

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