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Fitch Affirms Chicago, IL IDR and GO Bonds at 'BBB-'; Outlook Stable.

Fitch Ratings-New York-28 February 2018: Fitch Ratings has affirmed the following Chicago, Illinois ratings:

–Approximately $8.8 billion outstanding unlimited tax general obligation bonds at ‘BBB-‘;
–Long-term Issuer Default Rating (IDR) at ‘BBB-‘.

The Rating Outlook is Stable.

SECURITY
The bonds are payable from the city’s full faith and credit and its ad valorem tax, without limitation as to rate or amount.

ANALYTICAL CONCLUSION

The ‘BBB-‘ IDR and GO ratings and Stable Outlook recognize the city’s role as an economic hub for the Midwestern region of the United States, supporting solid revenue growth prospects, as well as the city’s unlimited independent legal authority to raise revenues. The ratings also consider the city’s high and growing long-term liability burden, constrained expenditure flexibility and improving financial profile. The city’s reserve cushion provides solid capacity to address cyclical downturns, given expected revenue volatility.

Economic Resource Base
Chicago serves as the economic and cultural center for the Midwestern region of the United States. The city’s population totaled 2.7 million in 2016 up 0.3% from the 2010 census, and accounts for 21% of the state’s population. Socioeconomic indicators are mixed with elevated individual poverty rates but above average per capita income levels and strong educational attainment levels.

KEY RATING DRIVERS

Revenue Framework: ‘aa’
Fitch expects slow, steady economic recovery to lead to continued solid revenue growth, excluding the effect of new or raised taxes and fees. The city’s home rule status affords it access to a wide variety of revenue-raising options, many of which are legally unlimited.

Expenditure Framework: ‘bb’
Carrying costs for debt service and retiree benefits equal a substantial portion of operating resources. Public safety, which is fairly inflexible as a practical matter, comprises a majority of general fund spending, further constraining expenditure flexibility. Rising pension costs will continue to drive expenditures to grow at a much faster natural pace than revenues, likely necessitating ongoing revenue-raising measures and careful expenditure control.

Long-Term Liability Burden: ‘bbb’

The long-term liability burden is high relative to the resource base at 41% of personal income, and expected to rise as the city phases into actuarial funding of pension contributions.

Operating Performance: 'a'
The city's ability to close recessionary revenue gaps is strong. This is a function of the city's strong revenue raising flexibility and long-term reserves available to offset the expected level of revenue volatility in a downturn.

RATING SENSITIVITIES
Continued Pension Pressure: The 'BBB-' rating recognizes the improved pension funding framework the city recently implemented as well as the continued challenges associated with stabilizing or decreasing adjusted net pension liabilities. Upward rating momentum is unlikely until annual contributions are sufficient to accomplish this stabilization, but failure to show progress according to the city's plan could put negative pressure on the rating.

Structural Balance: The Stable Outlook incorporates Fitch's expectation that the city will continue to make progress toward structural balance according to its announced plan and maintain reserves commensurate with the rating throughout the economic cycle. A reversal of this trend could lead to negative rating action.

CREDIT PROFILE

Chicago acts as the economic engine for the Midwestern region of the United States and offers abundant and diverse employment opportunities. The city also benefits from an extensive infrastructure network, including a vast rail system, which supports continued economic growth. The employment base is represented by all major sectors including wholesale trade, professional and business services and financial sectors, with no one sector dominating. Socioeconomic indicators are mixed as is typical for an urbanized area, with above-average per capita income and educational levels but also elevated individual poverty rates.

Revenue Framework
Operating revenues are diverse, with the largest source, state and local sales tax, comprising 18% of general fund revenues. Other large sources include the transaction tax, utility tax, and income tax which account for 13%, 12%, and 11% respectively. Notably, property taxes do not fund general fund operations, but are directed to other funds in support of debt service, pensions and a small amount of library contributions.

Growth prospects for revenue are solid. Fitch believes that natural revenue growth, without taking into account planned rate increases, will continue to exceed the rate of inflation, but fall short of national GDP. After a long period without major revenue-raising policy action, the city has raised a variety of taxes and fees to provide funding for dramatically increased pension funding.

The city is a home-rule unit of government, and as such, enjoys the ability to raise or impose a wide variety of taxes and fees, many of which are legally unlimited.

Expenditure Framework
The city devotes 63% of the general fund budget to public safety and 29% for general government.

Fitch expects the natural pace of spending growth to be well above that of revenues, requiring careful budget management. The fastest growing expenditure item will be pension contributions as the city ramps up from statutory to actuarially-based contributions over the next several years. The city has identified revenue sources for much of these in the near-term, and intends to continue

raising revenues to offset these rising costs in the out years.

Expenditure flexibility is constrained, given the large proportion of the budget devoted to public safety, which may be difficult to cut as a practical matter, and very high fixed carrying costs. The carrying costs for debt service, actuarially-required pension contributions and other post-employment benefit (OPEB) actual payments, account for 46% of governmental fund spending, or approximately 43% when taking into account enterprise fund support. That percentage may decline somewhat in the near term, as overall spending rises due to ramped up pension payments that are closer to the actuarially determined contribution, but will still comprise an outsized proportion of the budget for the foreseeable future.

The city contributes to four single employee plans covering municipal employees, laborers, police and firefighters. Annual funding contributions had reflected calculations pursuant to state statute, leading to severe underfunding and further raising the actuarial contributions necessary to prefund the plans. Contribution levels have been rising given recent policy changes that are devoting various new revenue streams toward contributions for each of the four plans. As of 2016 the city paid only $590 million in pension contributions, compared to $2.2 billion in actuarially-determined contributions (ADC). Even if the city meets its target contributions for all four plans, which is expected in 2022, they will still fall short of the ADC, reaching an amount sufficient to provide a 90% funding ratio, rather than full prefunding. This ratio is expected to be achieved in 2055 for the police and fire plans and 2057 for the municipal and labor plans.

Actuarial assumptions include a 30-year open amortization, among other factors that are likely to produce little funding progress absent the plans' consistently exceeding their 7.25% to 7.5% investment return targets, which Fitch views as unlikely. Fitch calculates that the annual cost to amortize the Fitch-adjusted NPLs over 20 years with a 5% interest rate would equal $3.7 billion, or 1.7x the ADC.

Long-Term Liability Burden

The long-term liability burden for total debt (direct and overlapping) and adjusted net pension liability (NPL) is high, at 41% of personal income. Sixty-three percent of the liability relates to net pension liability; Fitch leaves the NPL of three of the city's four single-employer plans unadjusted given their use of blended discount rates below Fitch's 6% target for measuring liabilities; all four plans report depletion dates. The 2016 total adjusted NPL measures $38 billion, and assets covered a scant 20% of adjusted liabilities, which had raised the real risk of plan depletion before the recent contribution increases.

For the city's public safety plans, a 2016 state law requires a five-year ramp up to an actuarial contribution, by 2020. The city council passed a multi-year property tax increase to accommodate the resulting steep increase in contributions. For the laborers' plan, a 911 cell phone fee will support increased contributions, while the municipal employees' plan will receive revenue from a tax on water and sewer charges. Together, pension contributions for the four plans are slated to increase from approximately $1.2 billion in 2018 to $2.2 billion in 2022.

Amortization of GO, motor fuel and Sales Tax Securitization Corporation (STSC) debt is slow with about 30% scheduled for retirement in 10 years. STSC, a separate legal entity, has issued bonds to refund the city's outstanding sales tax bonds as well as some city GO debt. While these refundings extend maturities in some cases, the overall amortization rate is relatively unchanged.

Operating Performance

Reserve levels have stabilized over the last several years, standing at 24% of spending in fiscal 2016. The city relies on a variety of revenue sources to fund operations, some of which are economically sensitive. During a normal downturn Fitch estimates revenues are at risk of a slightly elevated rate of decline, leaving the city with a fairly substantial shortfall to address. This would present a

challenge to the city's financial operations in a downturn but financial flexibility would likely be recovered as conditions improve. Recent extensive revenue-raising measures make it unlikely the city would rely solely on its revenue-raising authority to close such a recessionary gap. Similarly, the constrained expenditure flexibility makes it unlikely that the city could make meaningful spending cuts to address the gap. As such, Fitch believes that while the city may take some revenue- or expenditure-side policy action to address a revenue decline, reserve levels would bear the brunt of the shortfall but would remain at levels consistent with the rating throughout the economic cycle.

Chicago's budget management at times of economic recovery has improved markedly in recent years, although full structural balance remains a challenge even well into the economic recovery. Management has made significant progress toward matching ongoing revenues with annual expenditures. Fitch considers sustainable, affordable, actuarially-based pension funding a critical component of structural balance. Successful execution of the city's plan toward financially sustainable practices would be considered a positive rating factor over time. Remaining plan elements include the elimination of scoop-and-toss refundings by 2019, elimination of the use of current funds to pay routine legal settlements or judgments, and growth of the 'rainy day fund.'

The 2017 general fund budget was balanced with a reduced but still significant amount of one-time measures, including scoop-and-toss refunding and a small amount of appropriated reserves ($53 million) and also included funding for 1,000 new police officers. The $3.6 billion general fund budget closed the previously identified budget gap of $137.6 million through a variety of recurring and one-time measures and no appropriation of general fund balance. The year ended with a $54.4 million net general fund operating surplus (1.5%).

The 2018 general fund budget is balanced with reliance upon approximately $120 million of tax increment surplus and debt service savings from refunding (including principal deferrals), $50 million in expected growth in revenues, $39 million in revenue adjustments, $20 million in spending cuts, $11 million in improved enforcement and debt collection, and $37 million (less than 1% of spending) of appropriated unassigned general fund balance. As it has in recent years, the budget includes a $5 million deposit into its rainy day fund.

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In addition to the sources of information identified in Fitch's applicable criteria specified below, this

action was informed by information from Lumesis and InvestorTools.

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