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Chicago at Brink of Swaps Fee as Bond Ratings Fall: Muni Credit.

Chicago's deteriorating credit quality has pushed taxpayers to the brink of paying almost $400 million to Wall Street banks on derivatives contracts that are backfiring.

The city and Chicago Public Schools, both at risk of rating reductions as pension obligations mount, agreed to interest-rate swaps with companies including Bank of America Corp., Goldman Sachs Group Inc. (GS) and Loop Capital Markets LLC last decade as part of debt sales. The accords were designed to cap expenses in case interest rates rose. The deals went awry as the Federal Reserve cut borrowing costs during the recession.

The issuers' combined bill to exit the deals has reached about $400 million, almost two-thirds more than the metropolis spent on streets and sanitation in 2013. The contracts on the derivatives stipulate that the banks can demand payment when the issuers' credit rating falls to a specified level. For the city, that trigger is one level away on most contracts after Moody's Investors Service cut it to three steps above junk.

"These governments are in a precarious position," said Laurence Msall, president of the Civic Federation, a Chicago watchdog on government finance. "Hundreds of millions of dollars are at stake."

Derivatives Trail

States and cities in the $3.7 trillion municipal market have paid at least $5 billion to banks to end interest-rate swaps, data compiled by Bloomberg show. The contracts contributed to the bankruptcies of Detroit and Jefferson County, Alabama.

In Chicago this week, Alderman Roderick Sawyer introduced a resolution in the city council calling for Mayor Rahm Emanuel to file an arbitration claim with the Financial Industry Regulatory Authority to recover payments the city and school district have made on swaps. That could generate more than $600 million and eliminate the need for termination payments, said Jackson Potter, an official with the Chicago Teachers Union.

"The mayor has made a commitment that the city will not enter into any new debt swaps of this kind and has enacted measures to modify and reduce risk to protect the taxpayers of Chicago," Carl Gutierrez, spokesman for the city's budget office, said in an e-mailed statement.

"We monitor our swap liability carefully and are in continuing conversations with our swap counterparties to manage the risks of our derivative portfolio," Bill McCaffrey, a schools spokesman, said via e-mail.

March Cut

The city had its general-obligation rating lowered to Baa1 in March by Moody's, which cited “massive” pension liabilities. The company also assigned a negative outlook, meaning more cuts are possible. A credit grade one level lower could trigger swaps termination fees of about $173 million, according to documents for a March bond sale.

The school system, the nation’s third-largest, has more breathing room. It needs two rating companies to reach a predetermined rating level for a possible payment of about $224 million. It’s Moody’s rating is two levels from that point.

The potential payments increase pressure on state lawmakers, Governor Pat Quinn and Emanuel to reduce pension obligations, said Richard Ciccarone, Chicago-based president of Merritt Research Services. As the city and school system use reserves to balance budgets, they may have to look for new tax revenue, he said.

“There’s not a lot of room for comfort at the schools or the city,” Ciccarone said. “The parties need to work together to resolve a very pressing issue. Politics will just make it more difficult.”

Illinois Bill

Quinn, a Democrat seeking re-election this year, signed a bill in June that partially addresses Chicago’s $19.2 billion pension shortfall. The law, which cuts benefits and makes employees pay more for retirement, restructures two of the city’s plans, for about 60,000 municipal workers and retirees. The law doesn’t affect the police or firefighter obligations or lower retirement costs for the schools.

While those changes haven’t faced legal challenges, a state judge halted the implementation in May of an overhaul of the state retirement system after unions questioned its constitutionality.

‘Political Mess’

The political calendar may complicate matters.

Emanuel, a first-term Democrat, faces a potential challenge in February elections from Karen Lewis, president of the teachers union. Emanuel closed 49 underperforming elementary schools last year, hurting his approval rating, according to a Chicago Tribune poll released last month. That signals the difficulty he may face in addressing the district’s budget and pension issues.

Duane McAllister, who helps oversee about $5 billion of munis at BMO Asset Management Corp. in Milwaukee, said the pressures are keeping his company from buying.

“Chicago is sort of still mired in the political mess that seems to be Illinois politics,” said McAllister.

Some city debt is gaining in the face of the stress. Bonds maturing in January 2040 traded yesterday at an average yield of 4.72 percent, compared with an average of about 5 percent since March, according to data compiled by Bloomberg. Yesterday’s yield was about 2.6 percentage points above benchmark debt.

Moody’s in August warned of the “narrow distance to rating triggers” for the school system’s swaps. The district has 10 fixed-rate swaps with potential triggers if two of the three biggest rating companies cut the debt to the equivalent of Baa3, which is one step above junk, or lower.

Triggers Below

Moody’s grades it Baa1, two levels above the trigger. Fitch Ratings is at A-, three levels above the trigger, and Standard & Poor’s is at A+, which is five levels above. Moody’s and Fitch both have negative outlooks.

“There will be formidable pressure going forward,” said Mark Lazarus, a Moody’s analyst in Chicago. “It’s something you factor into future ratings.”

Hitting the trigger levels wouldn’t automatically mean the city or school district would have to pay to end the swaps; the banks would have the option to force payment. The companies could also take steps such as having the issuers put up collateral to secure the payments, as banks did to Detroit with taxes on its casinos.

Goldman Sachs declined to comment on the contracts, said Michael DuVally, a spokesman in New York. William Halldin at Charlotte-based Bank of America also declined to comment. James Reynolds, chief executive officer at Chicago-based Loop, didn’t respond to e-mails and a phone call seeking comment.

Reserve Stash

For Chicago, a termination payment would be manageable, said Ty Schoback, a senior analyst in Minneapolis at Columbia Management Advisors, which oversees $30 billion of munis.

“Chicago has got quite a bit of reserves stashed away,” Schoback said.

The city has reserves of about $625 million from leasing a tollway and parking system, according to a February S&P report.

Chicago’s payments for pensions are set to reach $1.1 billion in 2015 from about $478 million in 2014, according to financial documents.

The “aggregate amounts are not catastrophic,” said Arlene Bohner, a senior director at Fitch. Though “it is of concern given the other spending pressures they’re under.”

School Burden

For the school system, a termination payment would be “far more burdensome,” Schoback said.

The district, with about 400,000 students, has tapped reserves to balance its budget as pension costs rose. Swaps payments of $224 million would exceed the $216 million it has in debt-service reserves, according to Moody’s. The system is using about $862 million of budgetary reserves in its fiscal 2015 budget, leaving it with about $300 million, projections show.

Its pension contributions in fiscal 2014 and 2015 tally more than $600 million each year, up from about $200 million the previous three years, according to budget documents.

The city has modified some swaps, according to Bohner and its 2013 financial report, released in June. In March, it reduced the rating at which two of its 11 general-obligation swaps could be triggered, by one level to Baa3, according to the disclosure statement.

The efforts are a “work in progress,” said Fitch’s Bohner. “It’s definitely on their radar screen.”

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