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Chicago's Gamble on Disclosure.

CHICAGO – Chicago took a gamble by voluntarily laying out in stark terms the fiscal threats that could lead to further credit erosion and the impact on its swap and liquidity contracts, market participants said.

Mayor Rahm Emanuel's administration won praise for its openness, but the sobering information could also contribute to market jitters over the city's battered credit ratings, which have driven up interest rates on Chicago debt.

The voluntary disclosure March 6 that accompanied the city's reporting of its latest downgrade from Moody's Investors Service's offered investors information on swap terminations triggered by the latest action and the proximity of other contracts to triggers.

"There's an evolving disclosure standard and we've tried to be a case study in best practices," chief financial officer Lois Scott said in an interview after release of the filing to the Municipal Securities Rulemaking Board's EMMA site. "We haven't been in the bond market for some time and we felt there was a consistent pattern of questions as we talked to rating agencies, investors, and banks so we wanted to make sure that we were communicating the same information to all parties."

Moody's Feb. 27 downgrade to Baa2 triggered termination events on four interest rate swap contracts, exposing the city to payments totaling $60 million if demanded by the counterparties. The city has renegotiated the terms of one of the swaps, avoiding a potential $20 million payment, and negotiations continue on the others.

The disclosure offers the city protection against accusations that it withheld material financial information as regulators scrutinize disclosure practices, market participants said.

Some investors said it compliments city strides in building better investor relationships through improved access, expanded disclosure, and annual investor conferences.

On the other hand, some market participants said the information underscores the pressures on the city's balance sheet.

"We think that knowledgeable municipal investors should find the disclosure disturbing," said Michael Johnson, managing partner and head of research at Gurtin Fixed Income Management LLC.

"Once a termination has occurred, the city is at the mercy of the counterparty bank," he said. "This loss of control is a hallmark of a distressed credit." The firm shed its Chicago bonds prior to 2013 over credit concerns.

Brian Battle, director of trading at Performance Trust Capital Partners, called the voluntary disclosure "shrewd and prudent" and "the right thing to do."

The city's chief financial officer "has been around a long time," Battle said, previously working as a banker and financial advisor, and "what's she done is met a disclosure burden that might not have been a regulatory mandate but was a market mandate."

Market concerns will remain heightened until the city solves its pension woes, Battle said, which is unlikely to happen soon amid state-level inaction and a Chicago mayoral runoff April 7 pitting Emanuel against challenger Jesus "Chuy" Garcia.

Garcia has not said how he would address a looming $550 million annual spike in the city's public safety pension contributions, and Emanuel continues to count on so far nonexistent action by state lawmakers to enact benefit reforms and allow the city to phase the higher contribution levels in.

Institutional investors welcome information that's useful, so any details on that front are welcome, said Ernie Lanza, a partner at Greenberg Traurig and former MSRB deputy executive director. "By and large more information is better," he said, unless there's some error in the content. "In principle everybody should have the same information," he said.

Duane Morris LLP attorney Steven Gray is the city's lead disclosure counsel. The firm and Cotillas & Associates were co-disclosure counsel on a September offering statement that offered expanded disclosure on the impact of Chicago's credit rating deterioration.

The latest GO downgrade escalates the pressures posed by the city's floating-rate portfolio – inherited by the Emanuel administration – and leaves the city open to "more exposure to banks than is ideal" between the letter of credit support behind the deals and the swap counterparties, city officials said.

The city's 24 swaps tied to $2.4 billion of floating-rate general obligation and revenue-backed paper were almost $400 million underwater based on market valuations at the close of 2014.

The city has renegotiated terms with BMO Harris Bank on a $66.8 million floating-to-fixed-rate swap that was part of a $223 million 2005 floating rate GO issue.

It avoided a $20 million payment based on current valuations. The threshold was moved to the level under Baa2.

Wells Fargo has notified the city it reserves its right to designate an early termination date on the three swaps in which terminations were triggered by the downgrade. "The city is in ongoing discussions with Wells Fargo regarding the swaps," the disclosure says.

The city reported posting as collateral a letter of credit issued by PNC Bank in connection with a sale/leaseback transaction the city entered into in 2005 on the city-owned portion of the Orange Line rail transit route to Midway Airport. The lease deal expires in 2031.

The downgrade requires the city "to use reasonable efforts" to replace the PNC letter of credit with other collateral by March 29.

The administration's financial team has tinkered with its derivative portfolio, tightening up mismatches in basis trades and maturity dates, winning changes in rating thresholds, and terminating its swap options and other swaps in deals converting the underlying debt to a fixed-rate structure.

The city has terminated seven swap or swap options on $1 billion of floating-rate debt and struck more favorable terms on termination triggers on 12 derivatives tied to $1.3 billion of debt since 2011.

While the city has not entered into any new swaps, it did strike amendments last year on some forward starting swaps in which it captured up-front payments based on market conditions at the time.

On its LOCs, the city has sought to diversify its bank exposure and struck more favorable rating terms on new LOCs in an effort to reduce exposure on the city's weaker credits, like its GO bonds, so banks are not "in the driver's seat," administration officials said.

City officials stress that the cash flows under the swap terms are not pressuring its balance sheet but rather the termination triggers based on its credit ratings.

When the credit thresholds were set, the city's credit was stable, and even on the upswing following its establishment of a permanent $500 million reserve with proceeds of its Chicago Skyway toll bridge lease in 2005.

Two additional swaps face termination triggers if the city's GO rating is lowered one notch.

The first is one of four floating-to-fixed swaps tied to a $202.5 million 2004 GO issue. The swap is with Bank of New York Mellon for $136 million. It expires in 2019 and is negatively valued at $4.1 million. Amendments were struck on the contract in 2014.

The other swap that could see a termination triggered by another downgrade from Moody's is tied to a $117 million sales tax issue from 2002. The floating-to-fixed swap is with JPMorgan for $111.7 million. The swap expires in 2034 and is negatively valued at $29 million. The city's sales tax rating is tied to its GO level.

In addition to Chicago's GO bond swaps, it has swaps tied to its Midway Airport, water and wastewater enterprise revenue credits with rating triggers in the triple-B category.

Three second-lien water swaps have triggers at below the Baa1 level. Moody's recently affirmed the credit's A3 rating.

Three second-lien wastewater swaps are tied a $332 million issue from 2008, including two with triggers below the Baa1 level. Moody's recently downgraded the second lien wastewater credit to Baa1 level, meaning another downgrade would trigger the termination events for those Bank of America and JPMorgan derivatives. Each of the two is for $49.8 million. They expire in 2039 and are each negatively valued at about $11 million.

The city bears no collateral posting obligations on any of its swaps.

The city has 26 liquidity support, letter of credit, and direct purchase facilities on more than $2 billion of floating rate bonds from issues between 2002 and 2014 sold under its GO credit, Midway Airport second lien, O'Hare International Airport third lien, water, wastewater, sale tax credit, and tax-increment financing bonds.

The rating thresholds for events of default on most are triggered at a speculative grade rating, with the exception of four totaling $372 million that are tied to the city's wastewater credit and O'Hare International Airport, which have a threshold below the BBB level.

The city's lowest wastewater bond rating is A3 from Moody's on junior-lien revenue bonds. Its lowest underlying rating for third-tier O'Hare airport revenue bonds is A-minus from Fitch Ratings.

A default under the city's revolving lines of credit at a speculative grade rating would allow the termination of its credit facilities, requiring the city to immediately pay all outstanding amounts. The city currently has $294 million outstanding under its short term borrowing program which has a capacity of $900 million.

The filing also highlights Standard & Poor's affirmation of the city's A-plus rating and negative outlook on Feb. 27 and Fitch Ratings' Feb. 24 affirmation of the city's A-minus rating and negative outlook. The Moody's downgrade impacted $8.38 billion of general obligation debt, $542 million of sales tax bonds, and $268 million of motor fuel bonds, and $1.5 billion of wastewater debt.

THE BOND BUYER

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