Chicago Schools Haunted by Bankruptcy Chatter Ahead of Bond Sale.

The Chicago Board of Education can't catch a break as it borrows to pay for upgrades to the third-largest U.S. school system.

First, Moody's Investors Service and Fitch Ratings cut it to one step above junk last month, delaying a planned $372 million bond sale. Then last week, before a pared-down $296 million version of the deal, set for Tuesday, Governor Bruce Rauner said the system may need bankruptcy protection, an option that's not legally open to it.

There's little prospect that the backdrop will brighten. The system faces a projected $1.1 billion budget gap next fiscal year as retirement costs climb. Its relative borrowing costs are close to a two-year high. And with negative outlooks from Moody's and Fitch, a downgrade to junk may chase off investors.

"There are a lot of balls in the air when it comes to our outlook," said John Miller, co-head of fixed income in Chicago at Nuveen Asset Management, which oversees about $100 billion of municipal debt. Nuveen may buy the new bonds for its high-yield fund, he said. "They might have to entice people with more spread, particularly with headline risk like this."

Pension Strain

The fiscal strains are an amplified version of the city's struggle to stave off insolvency. Chicago, with $20 billion of unfunded pension liabilities, has the lowest general-obligation grade among the 90 most-populous cities, apart from Detroit.

Michael Passman, a schools spokesman, said the bond sale is going forward as planned.

"The governor's suggestion is not a viable option to remedy CPS's financial difficulties," he said via e-mail. "The solution to CPS's financial situation lies in Springfield with legislators" who can help alleviate its budget deficit.

Tuesday's offer includes a portion maturing in December 2039 that is being marketed at a preliminary yield of 5.63 percent, according to three people familiar with the sale who requested anonymity because the deal isn't final. That's about 2.7 percentage points more than benchmark municipal debt, data compiled by Bloomberg show.

At that level, the deal offers extra yield relative to previous bonds from the school board. Debt maturing in December 2042 traded Tuesday at an average yield of about 5.3 percent, or 2.3 percentage points above benchmark munis, Bloomberg data show. That's close to the widest in at least two years, and up from 1.8 percentage points before Moody's March 6 downgrade.

The securities were part of the last fixed-rate offering from the schools in 2012, when they priced to yield 0.89 percentage point above benchmark munis.

Bankruptcy Specter

Moody's rates the school board Baa3, the lowest investment grade and equivalent to Fitch's BBB-. Standard & Poor's ranks it A-, three steps higher. All consider it riskier than Chicago. Mayor Rahm Emanuel effectively runs the schools, appointing the seven-member board.

Given the system's more than $9 billion in unfunded pension obligations and growing deficit, Rauner, a first-term Republican, raised the specter of bankruptcy April 14 at an education forum in Chicago. The governor, who supports giving Illinois localities authority to file for Chapter 9 reorganization, repeated his claim that union contracts are putting local governments in financial peril.

Default Doubts

The mayor dismissed the suggestion in a press conference the following day, saying it's better to focus on areas such as curbing pension costs. Chapter 9 isn't even an option at this point: While lawmakers have introduced a bill in the Illinois House to allow municipal bankruptcy filings, the measure remains in committee.

The school bonds have "minimal payment default risk" and investors seeking extra yield should consider purchasing the debt, according to a report Monday from research firm Municipal Market Analytics in Concord, Massachusetts.

In the latest hurdle for the system, Chief Executive Officer Barbara Byrd-Bennett took leave April 17 after the board was served with federal grand jury subpoenas seeking records about contracts, according to updated bond documents.

The district, which educates about 400,000 students, has $6.3 billion of Moody's-rated general obligations.
Perhaps most troubling for the board's path to solvency is that it has nowhere to turn for help, said Bill Black at Invesco Ltd., which handles $22.8 billion of munis.

"There may be more bumps in the road ahead — there's no one out there to spare money for the school district," Black said from Downers Grove, Illinois. "The city has its own issues, and so does the state."

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