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After Moody's Bombshell, What Will Other Ratings Agencies Say?

When Moody's Investors Service downgraded Chicago debt to junk status, it did more than tick off City Hall with its timing. It ramped up pressure on other rating agencies, giving them something else to ponder in deciding how soon to act.

Moody's announcement on May 12 preceded—and threatened to short-circuit—city efforts to refinance $900 million in variable-rate debt and borrow $200 million to pay off interest-rate swaps and avoid termination fees and other financial penalties associated with a lower credit rating.

"The fact is, the risk has escalated because of Moody's actions," said Richard Ciccarone, the Chicago-based CEO of Merritt Research Services. "They've become part of the problem."

While Moody's has dropped the city's debt rating by seven notches, to Ba1, one level below investment grade, since mid-2013, Standard & Poor's Rating Services has maintained an A-plus rating—five rings from the top—for more than four years.

The six-notch spread is the widest for any city, creating challenges for debt traders.

"The market is having difficulties on price discovery," John Donaldson, who helps manage about $700 million of munis, including Chicago debt, tells Bloomberg. The director of fixed income at Haverford Trust in Radnor, Pa., adds, "What level should something with that big a gap trade at?"

OTHER DOWNGRADES COMING?

S&P warned last week that it, too, could lower the city's rating by more than one notch. But it gave the city breathing room, indicating that a downgrade would happen only if the city failed to implement a plan by the end of this year to "sustainably fund" its pension contributions, or if it "substantially" draws down its reserves to do so.

Chicago pensions are underfunded by about $20 billion.

After Moody's acted on May 12, Fitch Ratings, which rates Chicago debt A-minus, said it was "in contact with city management and will assess the rating impact of the recent downgrade."

Mike Belsky, a former group manager in public finance for Fitch in Chicago, contends that Moody's acted prematurely, underestimating Chicago's "booming economy" and City Hall measures to work out of its pension mess. He adds, "S&P puts more weight on underlying economics than Moody's."

Mayor Rahm Emanuel termed Moody's decision "irresponsible." Meanwhile, yesterday Moody's downgraded Chicago Public Schools debt to three grades below investment quality and lowered the Chicago Park District's debt rating to match the city's.

The city maintains that its pension situation is different from the state's. It argues that if changes to

Chicago's pension system are overturned, the city won't be on the hook for obligations of municipal and laborers funds. Instead, the city will revert to a multiplier-based funding obligation, it says, "and the funds will go broke in 10 and 13 years, respectively."

Some municipal market veterans expect S&P and Fitch to issue downgrades on Chicago debt soon, but possibly not until after seeing what the Illinois General Assembly does about the pension bomb before adjourning later this spring.

Rating agencies tend to act more in lockstep when upgrading ratings than downgrading them, according to municipal finance officials.

MOODY'S EXPLANATION

Moody's downgrade of city debt came just days after the Illinois Supreme Court on May 8 ruled unconstitutional pension law changes enacted by the Legislature in 2013. The decision wasn't a surprise to Moody's, which said it had anticipated such a result, baking it into a prevailing A3 rating and a negative watch on state debt.

Why, then, did it choose to downgrade Chicago debt, without first putting it into a "rating under review" category that typically opens a 90-day window for rating changes?

"The Supreme Court decision on pension reforms affects both entities, but widens the flexibility difference between them, as the option of reforming pension benefits was relatively more important to the city than the state, in our view," Moody's said. "Among the state's broader set of options are reversing recent income tax cuts, reducing revenue sharing with local governments, and shifting pension costs to school districts and universities."

Last month, preceding a $300 million bond sale, Chicago Public Schools did not seek a rating from Moody's, after the Chicago Park District and the Chicago Transit Authority shunned the agency last year.

That history could have factored into Moody's move this week—but not as payback, according to some municipal market observers.

"A rating agency that did that . . . you'd be out of business," says Bill Morris, a retired investment banker and former state senator. "They might have felt need to give them fair warning before they do anything else. In fact, not hiring them may have precipitated this. All three (rating agencies) evaluate the big issuers whether you use them or not."

City Hall wouldn't say what agencies it approached about pending refinancings. Moody's declined to comment on the matter.

'STREET CRED'

Paul Vallas, a former Chicago budget chief and CEO of CPS, said Moody's move, while "accurate," is striking. "It is bold, but the bottom line is, certainly, anyone who looks at the city's finances should not be surprised. But it's bold that they would do it now . . . just after the mayor's been re-elected."

Others argue that Moody's and its ilk are still compensating for overly rosy ratings that preceded the mortgage-market meltdown.

"All the agencies are trying to re-establish their street cred," says Bill Brandt, a former chairman of the Illinois Finance Authority. "When the pendulum swings, it tends to swing to the extreme."

About $10 million of federally tax-exempt Chicago debt maturing in 2040 changed hands yesterday at an average yield of 5.84 percent, the highest since December 2013, according to data compiled by Bloomberg. By comparison, the yield to maturity on BBB general obligations is 5.2 percent, Bank of America Merrill Lynch data show. It's almost 8 percent for the high-yield muni index.

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