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A Debt-Ratings Rift Rattles Chicago.

The world's two largest ratings firms are divided in their view of Chicago's fiscal health as the city grapples with a $20 billion pension hole, a potential preview of battles expected to break out around the U.S. as retirement obligations mount.

Moody's Investors Service lowered Chicago's bonds to junk status last week while rival Standard & Poor's Ratings Services settled on an investment-grade A-minus rating , a more optimistic view of the nation's third-largest city. As recently as five years ago, both firms gave Chicago the same grade of double-A-minus.

The highly unusual four-notch ratings gap is the result of a change Moody's made two years ago when it decided it would no longer rely on the investing returns targets submitted by cities and states to calculate pension costs. Its own estimates are more conservative, meaning the city's pension problems look worse.

Chicago represents the most prominent example yet of how diverging views of bulging pension obligations can have huge ramifications for financially strapped cities. The split views are befuddling investors and the bearish grades could lead to higher borrowing costs, difficulties refinancing debt and new doubts about navigating the $3.7 trillion municipal-debt market.

"Moody's precipitous downgrading of Chicago's credit should raise questions about the suitability of using ratings to market bonds to retail investors," according to a report Monday by Concord, Mass.-based research firm Municipal Market Analytics.

Mayor Rahm Emanuel called the Moody's downgrade "irresponsible," but the firm defended its more aggressive methodology. "Our adjustments are geared toward improving comparability" of liabilities among pensions, Tom Aaron, an assistant vice president at Moody's, said in an interview.

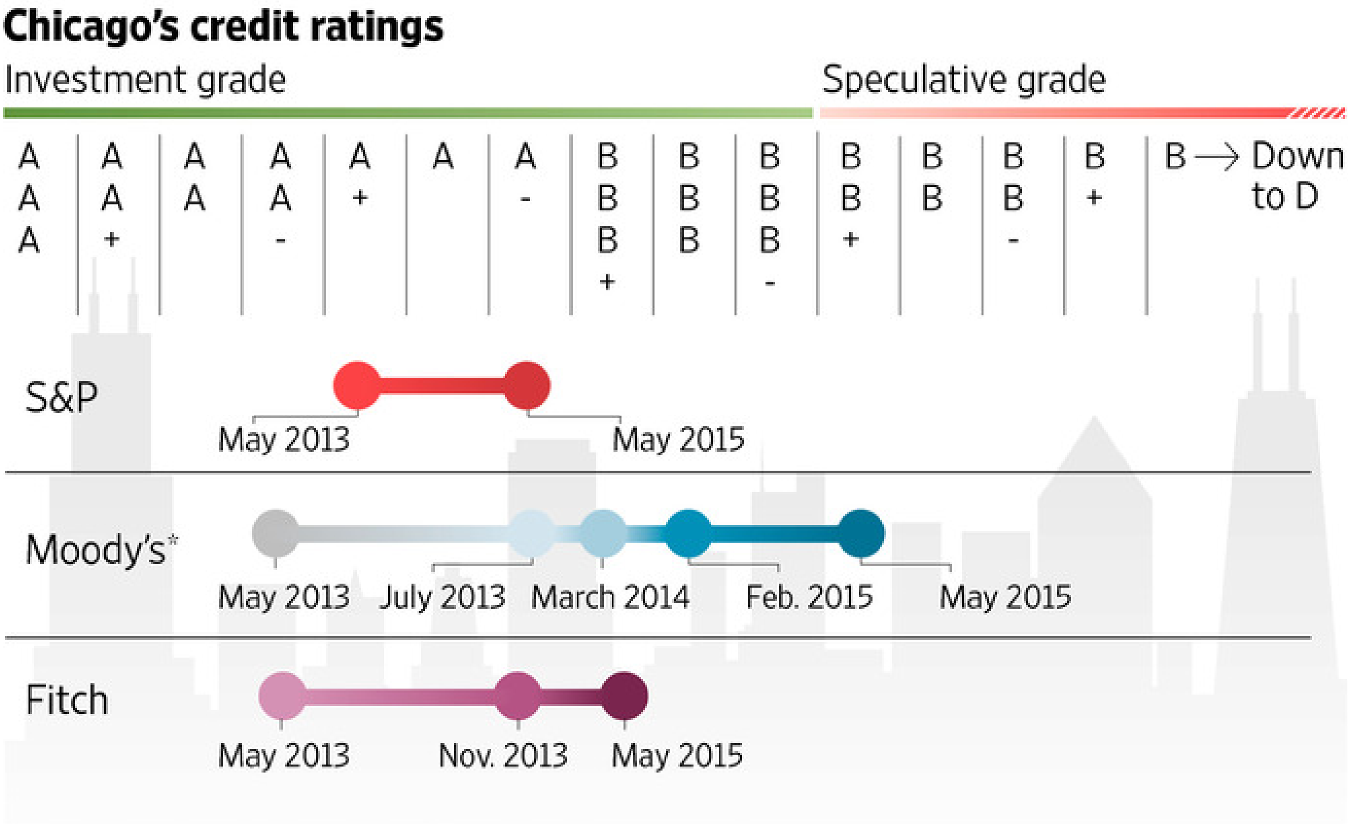
S&P analyst Helen Samuelson, however, said the firm stood by its more optimistic rating. The city still has "options," she said, including increasing taxes to boost revenue.

The changes made by Moody's in 2013 and S&P's tweaks last year have already had a dramatic effect on the direction of municipal-bond ratings. In the first quarter of 2014, S&P said it had upgraded 533 cities and other municipalities due to revised criteria against just 39 downgrades, according to a Janney Capital Markets report published last year. During the same period, Moody's downgrades outnumbered its upgrades.

Janney titled the divergence "The Great Municipal Bond Rating Dislocation."

Credit Chasm

Major credit firms disagree about the fiscal health of the nation's third-largest city.



*Moody's scale of rating differs from the other companies
Source: the companies
THE WALL STREET JOURNAL.

Other cities with big pension problems, such as Atlanta and Pittsburgh, have yet to show sizable grading disparities, but the frequency of ratings rifts could accelerate in coming years as cities wrestle with how to solve a collective $1.2 trillion pension funding shortfall, said Eric Friedland, head of municipal research at Schroders PLC and a former Fitch Ratings analyst.

Projected pension costs can vary greatly based on what state or local governments select as their return assumptions. Public officials are under pressure to keep those targets high as a way of avoiding higher taxes or benefit reductions as they try to recover from heavy investment losses incurred during the 2008 financial crisis.

State and local pension liabilities ballooned at more than twice the rate of their assets in the aftermath of the crisis, according to the National Association of State Retirement Administrators. Public pensions now have about $3.8 trillion in assets versus $5 trillion in liabilities, according to Nasra.

Philadelphia has $5.3 billion in unfunded pension liabilities, while Phoenix has $2.5 billion and Atlanta has $1.5 billion, according to Merritt Research Services LLC, a municipal-bond data provider. Both firms agree on Atlanta at double-A and Phoenix at double-A-plus, but Moody's rates Philadelphia one notch lower than S&P does.

What makes Chicago unique is the magnitude of its retirement shortfall. The city has only half the assets it needs to cover its pension liabilities, or the equivalent of four years of general operating budgets. Mr. Emanuel's cost-cutting pension overhaul looks less likely to win court approval after the Illinois Supreme Court struck down a similar proposed law earlier this month that sought similar benefit cuts.

"As Mayor Emanuel has repeatedly stated, the City of Chicago's financial crisis is real, urgent, and has been decades in the making," said Chicago Deputy Mayor Steve Koch in a statement. "Moody's decision to downgrade the City was driven by the Illinois Supreme Court's reversal of the state pension reform bill and has substantially magnified the City's financial challenges, adding real costs to Chicago's taxpayers.

Moody's chose to prejudge both the outcome of the City's pension reform law that solves half of our unfunded pension liabilities before it is heard in court as well as the active police and fire discussions that would help address the other half of our pension issue, putting them out of step with all the other major ratings agencies."

Last week's Moody's downgrade—the fourth in two years for Chicago—could trigger around $2 billion in accelerated payments by the city, Moody's said.

The sudden four-notch ratings gap in Chicago caught some market participants by surprise and prompted selling from some retail investors, said Daniel Solender, head of municipal-bond management at Lord Abbett & Co., which manages $17 billion. It may also affect the city's effort to refinance about $900 million in bonds in coming weeks, by reducing the number of institutional investors who can buy the debt.

Returns on Chicago general-obligation bonds have fallen about 3.4% since the downgrade, counting price changes and interest payments, according to data from Barclays PLC. Yields rise as prices fall.

If both S&P and Moody's downgrade Chicago to junk status, it could have a wider effect because some big buyers of municipal bonds such as pensions and insurers can only invest in debt that carries an investment-grade rating from the big agencies. Fitch's triple-B-plus rating is notch below S&P's grade.

But some investors are already avoiding Chicago debt. Burton Mulford, portfolio manager at Eagle Asset Management in St. Petersburg, Fla., which oversees about $2.5 billion, is already steering clear of most Chicago debt and may sell bonds from the city's park district, he added.

"Because our client base is very conservative, we'll probably eventually get out of those credits," Mr. Mulford said.

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By TIMOTHY W. MARTIN and AARON KURILOFF

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Write to Timothy W. Martin at timothy.martin@wsj.com and Aaron Kuriloff at AARON.KURILOFF@wsj.com