Chicago Schools Seen as City's Next Hurdle as Pension Bill Looms.

Chicago's next financial obstacle lies with its school system, which for the first time ever may not have enough cash to make a required payment into its teachers' retirement fund.

As the Chicago Board of Education faces a $634 million pension payment due June 30, yields on some of its bonds are climbing toward records set last month. Officials of the nation's third-largest school district are also struggling to plug a $1.1 billion deficit for the fiscal year starting July 1 and trying to get out of $228 million of termination payments for derivatives that went awry.

Given the demands, the district may fail to make the full pension payment, inflating its retirement-fund shortfall and leaving it vulnerable to more downgrades after its $6.2 billion of debt was cut to junk last month, said Laurence Msall, president of the Civic Federation, a Chicago-based research group that's tracked the city's finances since 1929.

"Of all the Chicago issuers, CPS seems to be the one that's struggling the most," said Adam Stern, director of muni research in Boston at Breckinridge Capital Advisors, which oversees $20 billion in municipal strategies, but holds no Chicago school debt. "I don't think anyone is investing with the thought that the spreads are going to come back in. There are a lot of medium- and long-term structural issues."

'Tough Choices'

Charles A. Burbridge, executive director of the teachers' pension fund, called for the full payment in a statement Wednesday, while noting the "tough choices" confronting the district. Bill McCaffrey, a schools spokesman, didn't respond to e-mail and phone queries Thursday regarding the payment.

Mayor Rahm Emanuel signaled a solution has to come from the state capital. Chicago, with 2.7 million people, gets less pension cash than suburbs and cities downstate, he said.

"Springfield has to step up and help," Emanuel told reporters Wednesday. Kelley Quinn, a city spokeswoman, didn't respond to e-mail and phone messages seeking comment Thursday.

The school system may not get much assistance given Illinois's deteriorating finances. The state doesn't have a spending plan for the year starting July 1, and if a budget isn't passed, schools won't get aid set for distribution Aug. 10.

Junk Move

Moody's Investors Service and Fitch Ratings cut the district, which educates about 400,000 students in more than 600 schools, to one level above junk in March, giving banks the right to demand payments to end interest-rate swaps. Moody's lowered the district again in May to Ba3, three levels below investment grade, citing the strain of pension costs on its "precarious financial position."

Board of Education bonds maturing in December 2039 yielded 2.66 percentage points above benchmark munis Thursday, the widest spread since May 21, according to data compiled by Bloomberg on the most-traded debt of the past week. The data are for trades of more than $1 million, a benchmark for institutional investors.

The securities yielded as high as 6 percent, approaching the record of 6.5 percent set May 14.

Burbridge at the teachers' fund said that to his knowledge the board has never missed a required payment.

The system, which was 51.5 percent funded as of June 30, 2014, has three options, said Msall at the Civic Federation: skip or delay the payment, make budget cuts or seek relief from state lawmakers.

"It would not be surprising to find that the Chicago Public Schools may have difficulty having the cash to make the payment," Msall said.

'Worse Picture'

"Any deferral of the pension contribution could provide short-term budgetary relief, but it would also provide for a much worse picture down the road," Rachel Cortez, a Moody's analyst in Chicago, said by phone.

The board has already cut more than $740 million in non-classroom spending since 2011 and drawn on reserves.
After the mayor-appointed school board closed 50 schools in 2013, saving an estimated $40 million, the move fueled a voter backlash that helped push Emanuel into an unprecedented mayoral runoff election.

"The sad reality is how many schools can you shut down? How many teachers can you lay off?" said Dan Heckman, senior fixed-income strategist at U.S. Bank Wealth Management, which oversees about $127 billion in Kansas City, Missouri. The firm holds no Chicago school debt, because of the rating.

"They're still going to have daunting challenges financially," he said.

Bloomberg

by Elizabeth Campbell & Brian Chappatta

June 18, 2015 — 9:01 PM PDT Updated on June 19, 2015 — 6:10 AM PDT

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