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Chicago Eyes Issuing Costly Capital Appreciation Bonds.

The latest general obligation bond proposal from Chicago Mayor Rahm Emanuel could have the cash-strapped city selling up to $500 million of capital appreciation bonds (CABs), a form of debt that government finance experts say could be costly and risky.

CABs are municipal debt for which payments are deferred until the bonds' maturity while interest compounds. Emanuel's administration on Wednesday proposed a refunding of outstanding GO bonds that would give the city the flexibility to issue CABs or the more commonly used current interest bonds for which interest is paid on a periodic basis.

A spokeswoman for Chicago's finance department said the city has not sold CABs since 2009 and expects to issue current interest bonds for the refunding.

Still, the fact that CABs are listed as an option raised concerns as Chicago struggles with low credit ratings, growing budget deficits and already high borrowing costs.

Richard Ciccarone, president and CEO of Merritt Research Services, said Thursday the move would allow the city to "kick the can down the road" by deferring debt service payments for as long as 40 years.

Laurence Msall, president of the Chicago-based Civic Federation, a government finance watchdog group, called CABs "an extraordinarily expensive form of borrowing."

"Going into the market and asking creditors to wait 10, 20, 40 years before receiving any payment carries a very stiff premium," he said.

Emanuel in April announced a plan to clean up the city's debt practices, including converting variable-rate bonds to fixed-rate and eliminating related interest-rate swaps – a move the Civic Federation applauded, according to Msall.

That plan got fast-tracked after Moody's Investors Service downgraded Chicago to junk in May triggering $2.2 billion in accelerated debt and fee payments by the city.

A $1.08 billion GO bond sale earlier this month resulted in higher borrowing costs for Chicago than most issuers in the U.S. municipal bond market.

The city, the third largest in the United States by population, is struggling with a projected $430 million fiscal 2016 budget gap. The deficit is due in part to escalating pension payments that include a looming $550 million contribution increase to its public safety workers' retirement funds.

Msall said he hoped the city council and its new financial analysis office head will take a close look at the bond proposal.

CABs have proved controversial in the past. California in 2013 enacted a law limiting total debt service on the bonds to four times the principal and maturities to a maximum of 25 years. The law also requires CAB deals to allow early repayment of the debt when maturities are longer than 10 years.

The law was sparked in part by reports that a San Diego-area school district’s $105 million of CABs would end up costing nearly $1 billion.

More recently, Puerto Rico’s financially troubled public utility PREPA rejected an offer by bondholders to restructure some of its debt into CABs.

REUTERS

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