[Bond Case Briefs]

Municipal Finance Law Since 1971

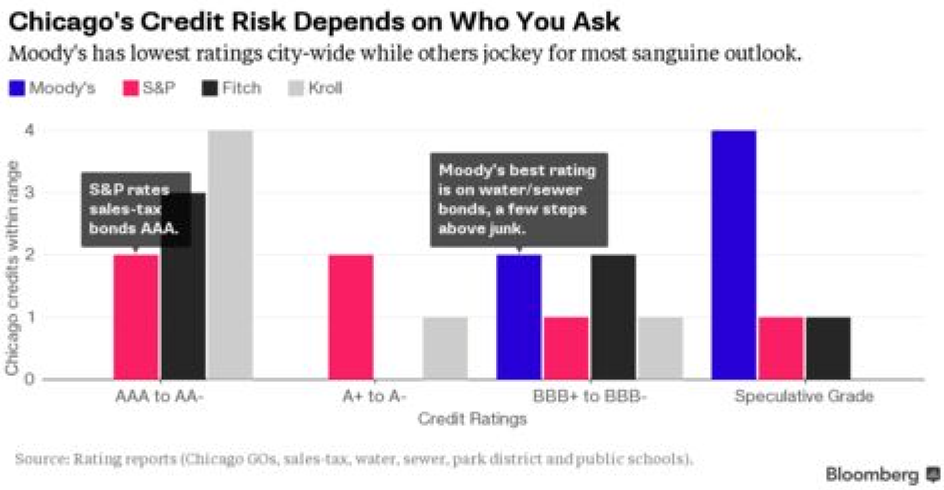
[Junk or AAA? Rating Split Plagues Chicago as It Borrows Billions.]

What's Chicago's risk to municipal-bond investors? It depends on which credit-rating company you ask.

In the eyes of Moody's Investors Service, most of the $20 billion of bonds tied to Chicago are junk, as speculative as a charter school or regional hospital that could shut down. To Standard & Poor's, the city's park district is as credit-worthy as the U.S. government, and its sales-tax-backed debt is even safer. Only Kroll Bond Rating Agency deems the public schools worthy of an investment grade.

No U.S. city has caused a larger difference of opinion in the municipal-bond market than Chicago, which is being squeezed by soaring bills to its underfunded retirement system. The city's sales-tax, motor-fuel-tax, water, sewer and park bonds all have at least a six-level gap between the lowest and highest ratings, data compiled by Bloomberg show. The discrepancy has led investors to err on the side of caution by demanding higher yields, threatening to saddle Chicago with added costs as it prepares to issue about $3 billion of debt.

"The dispersion in ratings just doesn't make sense," said Mikhail Foux, head of municipal research at Barclays Plc in New York. "Moody's is too conservative and S&P is too relaxed about this. The truth is probably somewhere in the middle."



Chicago illustrates a rift in the approaches that rating companies use to assess municipalities, whose securities are backed by varying revenue sources and legal safeguards. Those can leave some bondholders sheltered if a city faces a budget shortfall or collapses into bankruptcy, as Detroit did two years ago.

The views on Chicago have become more divergent since May, when Moody's lowered its general obligations to Ba1, one step below investment grade. While S&P and Fitch Ratings followed with their own downgrades to those securities, the companies have been at odds over how to gauge the rest of the city's bonds.

Moody’s was the only one to downgrade all of Chicago’s other major securities: It reduced the park, sales-tax and motor-fuel-tax debt to the same level as the city, while the water and sewer bonds were cut to the lowest investment-grade tier. S&P and Fitch left some of those ratings unchanged, despite their more dour assessment of the city’s finances.

Buying Opportunity

The inconsistency has created pockets of value, Foux said. In particular, water and sewer bonds are trading at higher yields than they should, he said. The city plans to sell $439 million of the securities this month, the latest in a wave of offerings from Chicago.

“The market really does trade a lot of times to the worse-case scenario,” said Dan Solender, who oversees $17 billion, including Chicago debt, as head of munis at Lord Abbett & Co. in Jersey City, New Jersey. “Most of the market isn’t really looking at the higher rating anymore.”

Moody’s analyst Rachel Cortez said its Chicago ratings are so closely aligned because the securities draw from the same tax base or aren’t separated sufficiently from the city’s grasp to warrant a higher grade.
S&P said in a Sept. 24 report that a Chicago agency won’t be penalized just because of the pressure on the budget, given that some bonds are sheltered from those strains. Jane Ridley, the analyst who wrote the report, said sales-tax bonds have the first claim on that money, which gives them less risk that general obligations.

Karen Daly, a senior managing director at Kroll, said the rating differences can be explained by the separate security pledges backing Chicago’s bonds.

The analysis has been complicated by the risk of bankruptcy, a tool that Republican Governor Bruce Rauner has so far unsuccessfully sought to extend to Illinois municipalities. Were Chicago able to write down its debts in court, water and sewer bondholders wouldn’t stand to lose as much as owners of other securities, Fitch analyst Amy Laskey wrote in a Sept. 22 report. Hence the higher rating.

“All the different operating entities have differing bankruptcy risks,” Laskey said in an interview. Though Illinois currently doesn’t allow it, she said, “we always believe that if there were an entity that was in need of filing, that the state would find a way to allow them to.”

Market’s View

Trading in Chicago bonds shows the market is siding with Moody’s, which assigned the lowest ratings, said Justin Land, who oversees $4 billion of munis as director of tax-exempt management at Wasmer Schroeder & Co. in Naples, Florida.

The most-traded Chicago sales-tax bonds changed hands Thursday at an average yield of 4.6 percent, compared with 3 percent for munis with a similar 23-year maturity and the same top grade from S&P, data compiled by Bloomberg show.

Park district debt due in 2024 traded last week at an average 3.86 percent, compared with about 2.1 percent for AAA munis, Bloomberg data show. Sewer bonds due in 2021 changed hands last week at a yield of 3.2 percent, or 1.58 percentage points above the benchmark, while water bonds maturing in 2032 traded at 4.5 percent, a difference of 1.75 percentage points.

“Typically we’ll be on the side of caution and kind of lean our viewpoint toward the weaker credit rating,” said Dan Heckman, senior fixed-income strategist in Kansas City, Missouri, at U.S. Bank

Wealth Management, which oversees about $127 billion. “People are very well aware of the issues, and they want to have substantial compensation.”

Bloomberg News

by Brian Chappatta and Elizabeth Campbell

September 30, 2015 — 9:01 PM PDT Updated on October 1, 2015 — 12:08 PM PDT