[Bond Case Briefs]

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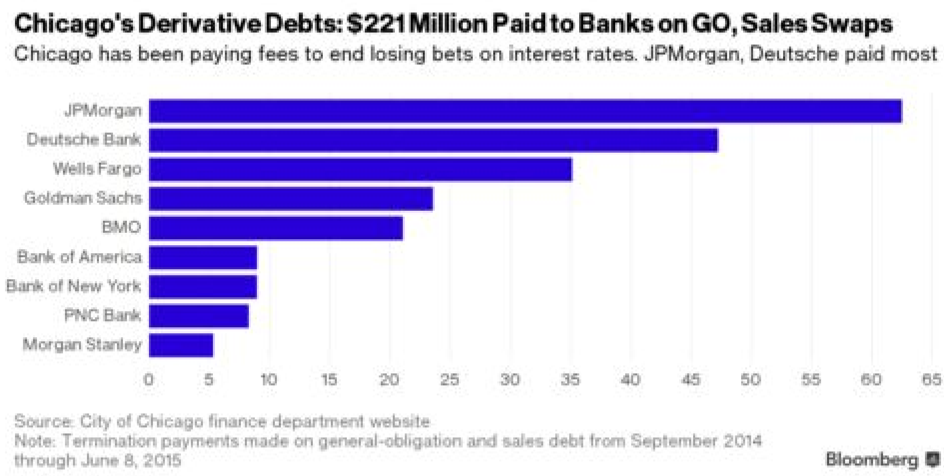
[Chicago Settling $390 Million Tab When City Can Least Afford It.]

Chicago taxpayers, already reeling from a financially strapped school system and mounting pension costs, are looking at a final tab of about $390 million to end ill-timed bets on interest rates.

The city council on Wednesday authorized issuing as much as $200 million of bonds to help pay termination fees, estimated at $100 million, to unwind derivative contracts linked to its water debt, the last of the city's interest-rate swaps. Chicago has already paid about $290 million to exit other swaps, according to city documents. In May, Moody's Investors Service lowered its rating to speculative grade, increasing pressure on the city to restructure the debt.

Chicago and other municipal borrowers made wagers on the future direction of rates using agreements with banks to swap payments in a gamble to squeeze out additional savings. The strategy backfired when the Federal Reserve lowered rates in an attempt to stimulate the economy in the wake of the financial crisis. The result: issuers have paid billions to unravel those agreements.



The swaps "were intended to be defensive in some ways, reduce interest costs, and they've been anything but that," said Richard Ciccarone, the president of Merritt Research Services, which tracks municipal finance. "They've been very costly to the city."

The deals were agreements to trade interest payments based on variable-rate debt and intended to reduce losses for municipalities when interest rates rose. Instead, the Fed kept rates near historic lows, and governments had to pay the market value to break the contracts. To compound the pain, interest rates have declined this year even after the central bank boosted its target rate in December for the first time in almost a decade.

In April, Mayor Rahm Emanuel announced a plan to end the city's interest-rate swaps and convert its variable-rate debt to fixed rate. Less than a month later, Moody's dropped Chicago's rating to Ba1, one step below junk, accelerating the strain on the city by giving banks the right to require it to repay debt early or pay fees to break swap contracts.

Lowest Rated

"We are not out of the woods," Emanuel told reporters at City Hall on Wednesday. "This is another additional step in righting the ship, fixing the fiscal conditions of the city, and making our health of our fiscal picture stronger."

Chicago is the lowest-rated big city in the nation, with the exception of Detroit. Its finances deteriorated as its pension shortfall deepened, reaching $20 billion. That's more than $7,000 per resident. In October, Emanuel made some progress when he pushed through a $543 million property-tax hike, the biggest in city history. Its proceeds will bolster public safety worker pensions. The city's public schools are also grappling with pension debt. The cash-strapped system owes another $676 million to its retirement fund by June 30, and the junk-rated district's deficit is projected to reach $1 billion a year through 2020.

The city has exited all of its interest-rate swaps tied to general-obligation, sales and waste-water debt. Chicago is using the approved borrowing to get out of the water derivatives. There was no public discussion during Wednesday's meeting before aldermen approved issuing the bonds.

"While it's an important step as the city moves forward on refinancing its variable-rate debt and getting out from underneath these swaps, it was disappointing that there weren't more questions over the details that would have reflected a better understanding by the city council members as to what the full cost of the program will be, how it will be impacting them in the future, and how this information will be used going forward to avoid this same cost," said Laurence Msall, president of Civic Federation, which tracks the city's finances.

Necessary Step

While the council's finance committee approved the $200 million deal in January, a full vote got delayed after some members asked for more time to review the issuance. Scott Waguespack, one of the alderman who had asked the administration for more information, agreed that the issuance should move forward after he met with the mayor's staff and finance department. The deal was originally scheduled to price in the first quarter. The city expects the borrowing "in the coming months," according to Molly Poppe, a city spokeswoman.

"There's a little bit of assurance there that the amount of the payoff is not exorbitant," Waguespack said. "We're kind of resigned to relying on what the market is doing for making the payment."

Exiting the swaps is necessary to ensure long-term stability of the water system, said Dennis Derby, an analyst and portfolio manager at Wells Fargo Asset Management, which holds Chicago general obligations and water debt among its $39 billion in assets. The city's water system's security is "fairly strong," he said.

"We look at it from an operating standpoint as certainly a stronger credit than they had been in the past," said Derby, who is based in Menomonee Falls, Wisconsin. "In order to have a strong credit operationally, they need to remove that swap termination risk, which is I think a prudent thing to do."

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