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Chicago Water Bond Deal Washes Off Taint of Interest Rate Bets.

Chicago removed the stain of ill-timed bets on derivatives as it sold more than half a billion dollars of debt for its water system.

The nation's third-largest city sold about $505 million of securities on Wednesday to buy back the last of its variable-rate debt and help cover about $102 million of fees to Royal Bank of Canada and Barclays Plc to break off interest-rate swaps.

The offering concludes a refinancing wave by Chicago since its credit rating was cut to junk by Moody's Investors Service a year ago, which gave banks the right to force it to pay off debt early and terminate related swap contracts. Chicago has already paid about $260 million to cancel derivative trades over the past 12 months, foisting added costs on a city already contending with soaring bills to a retirement system that it owes $20 billion.

"It's a smart defensive move to do this, and I think the market will view it positively," said Paul Mansour, head of municipal research at Conning, which oversees $11 billion of state and local debt, including Chicago securities, and is considering buying in the latest deal. "It represents good financial stewardship to remove derivative products from the balance sheet as it reduces financial risk."

Securities due in 2031 sold for 3.08 percent, according to three people with knowledge of the deal who requested anonymity before the final prices were released. The top yield is about 1.1 percentage points more than benchmark municipal debt that matures in 15 years, data compiled by Bloomberg show.

"Investors responded quickly and favorably to the second lien water revenue bonds demonstrating the financial community's ongoing support for the Mayor's plan to repair city finances," Carole Brown, Chicago's chief financial officer, said in an e-mailed statement after the sale.

Even before the Moody's downgrade, Mayor Rahm Emanuel had been planning to cut the city's exposure to floating-rate bonds and derivatives, a financing technique that was popular with states and cities until the financial crisis of 2008 hit them with spiraling bills. Such deals have since cost governments billions and helped to push Jefferson County, Alabama, into a record-setting bankruptcy.

Chicago has sold about $2.8 billion of debt in the past 12 months, according to Bloomberg data. It last issued $500 million of tax-exempt general-obligation bonds in January for top yields of 4.9 percent, about 2.3 percentage points more than benchmark securities.

The city's latest may benefit from an influx of cash into municipal-bond funds that are hunting for higher returns as yields hover near a 50-year low. Investors added $710 million to such funds in the week ended May 4, marking 31 weeks of inflows, according to Lipper US Fund Flows data.

Chicago's water bonds carry higher credit ratings than its other securities, thanks to the revenue reaped from rate increases in the past three years and a customer base split between the city and its suburbs. S&P Global Ratings on April 26 boosted the second-lien water bonds to A, five levels above junk and two steps higher than the city's general-obligation debt, citing the benefits from getting rid of the derivative deals. Moody's, which didn't rate Wednesday's deal, grades Chicago's second-lien water debt Baa2, two steps above junk.

Beyond Names

"It has the name Chicago in it so some investors look at it kind of negatively, but if you look at the underlying credit it's a strong credit," said Brian Steeves, a portfolio manager in Rye Brook, New York, at Belle Haven Investments, which oversees $4 billion of munis and is considering buying the new bonds. "It will definitely be well-subscribed."

In a sign of such demand, the water-system debt trades for lower yields than the city's general obligations, indicating that investors perceive less risk. A portion of the securities due in 2025 traded Tuesday for an average yield of 3.3 percent, according to data compiled by Bloomberg. That compares with 5.1 percent for general obligations.

Even so, Chicago's still struggling with ballooning retirement costs and the political paralysis that's left the state without a budget.

"There still is that broader cloud of the pension and the lack of a state budget that overshadow some of these positive fundamental trends for some of the specific issuers in the Chicagoland complex," said Gabe Diederich, a Menomonee Falls, Wisconsin-based portfolio manager at Wells Fargo Asset Management, which manages about $39 billion of munis, including various Chicago bonds.

Emanuel has yet to lay out how Chicago will shore up its pension funds after the state supreme court threw out his plan to reduce benefits and require workers and the city to boost their contributions. A record property-tax hike will provide funds for the police and fire pensions, but without changes, the other two retirement funds will run out of money in 10 to 13 years.

"Once you have a distressed obligor, in this case, the city, it's best to just avoid everything given the uncertainty of just what tools it'll use to kind of repair its own general operating budget," said Tom Schuette, co-head of credit research and portfolio management at Solana Beach, California-based Gurtin Fixed Income Management LLC, which doesn't hold Chicago debt among its $10.1 billion of assets. "Once you're in a distressed situation, we think all bets are off."

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