

# **Bond Case Briefs**

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## **Market Spreads Side with Moody's as Chicago Picks a Fight.**

CHICAGO – Chicago Mayor Rahm Emanuel isn't happy with Moody's Investors Service, so he's trying to make the rating agency go away.

Emanuel's administration disclosed Tuesday that the mayor formally asked Moody's to withdraw all of the city ratings. The disclosure came ahead of investor meetings set for this week.

Moody's declined, according to a city official.

Moody's downgraded the city's GO bonds to junk-level Ba1 in May 2015. The rating remains there today, with a negative outlook.

Three other rating agencies assign Chicago ratings in the lowest investment-grade tier of triple-B.

In a stinging letter dated Dec. 8 to Moody's president and chief executive officer Raymond W. McDaniel Jr., Emanuel accused the rating agency of failing to recognize the city's strides on factors identified by Moody's as needed to win an upgrade. The city cited factors such as raising its pension payments to actuarially required contributions and increasing revenue to fund pension obligations.

"With each rating action or market comment, Moody's instead introduces new and sometimes unrelated factors to justify its negative view of the city's credit," Emanuel wrote. "All the while, measurable progress by the city to confront the fiscal challenges do nothing to impact our rating or our outlook.

"It has become increasingly clear that Moody's rating methodology and agenda are far from objective and independent...your current rating does not accurately reflect the city's credit or our ability to pay debt service when due," the letter continued.

If Moody's does not grant Emanuel's request, the mayor said it should be made clear that any opinions from Moody's are based solely on publicly available information.

The city has not sought Moody's ratings on new issues for more than two years.

Moody's rates the city's general obligation, sales tax and motor fuel bonds at Ba1 with a negative outlook. The city's GOs were already trading at speculative-grade levels before Moody's downgraded them to junk in 2015. Moody's rates the city water and wastewater debt in the lowest investment grade Baa tier and airport debt in the single-A category.

The city's 10-year GOs have traded in recent months at the junk-level spread of 250 to 300 basis points to the Municipal Market Data's top-rated benchmark, and its yields on tax-exempt sales over the last year and half have landed within that range. The BBB benchmark on Tuesday was at 3.17%, a 95 basis point spread to the AAA rate. The city carries ratings of BBB-minus and BBB-plus from the three other rating agencies.

The spread on its 10-year paper hitting 200 basis points in November 2014, six months before the

Moody's downgrade, dropping some and then rising to 250 basis points in April, a month before the downgrade. After the downgrade, spreads steadily climbed upward, hitting 300 basis points. That marked a doubling of the 145 basis point spread on its 10-year in a primary market outing in March 2014.

A speculative grade spread is a moving target, said one market participant. Currently, a weak investment grade name should price in the mid-to-high 100s, one market participant said. Anything at 225 basis points is considered high yield, another trader said. Another said anything over 200 falls into the high yield category.

"This shows that the market is appropriately skeptical about the other three 'investment grade ratings,' since much of Chicago's near-term outlook still hinges on what happens in Springfield. It's certainly outrageous for Mayor Emanuel to try to bully Moody's into withdrawing its rating and kudos to Moody's for sticking to its 'process,'" said Triet Nguyen, head of public finance credit at NewOak Fundamental Credit. "We believe there's no imminent risk of default at this time, just 'spread risk' or underperformance risk."

Market participants have said the city could see yield penalties narrow a bit if it loses its junk status, but they may not reach investment grade levels. One participant suggested it's more about the city shedding the taint of the label or the risk of further negative headlines from a possible downgrade.

Moody's spokesman David Jacobson said in response to a request for comment that "Moody's has a process for handling requests from issuers to withdraw their ratings and follows that process when such requests are made" and it does not comment on potential future rating actions.

City finance spokeswoman Molly Poppe said Moody's declined to withdraw the ratings.

The timing of the letter last month was aimed at staving off potential negative commentary or action ahead of the city's \$1.16 billion GO sale next week, even though Moody's was not asked to rate the bonds.

"The point here is that the mayor is taking steps to protect taxpayers. As you know, investors do their own analysis on whether they are going to buy the city's bonds, but they rely on rating agencies to extract yield," Poppe said.

Moody's in recent reports has made clear that Chicago's path to investment grade requires improved pension funding status. "The city's unfunded pension liability would need to begin to stabilize and decline. The actions the city has taken to date have only enabled their pension problem to get worse at a slower pace," Moody's has said.

The city has put tax-supported funding streams in place to raise contributions to its four pension plans that carry \$33.8 billion of net pension liabilities, but payments based on actuarial requirements don't kick in until 2021 and improved funded status is a long way off.

In a November report, Moody's listed factors that could lead to an upgrade including: rapid economic and revenue growth; further budgetary adjustments that accommodate pension contributions sufficient to stop growth in unfunded pension liabilities; and operational stability and improved liquidity at Chicago Public Schools. None has occurred.

When it downgraded Chicago to junk, Moody's described as factors that could lead to an upgrade or stable outlook city or state actions that halt the growth of the city's unfunded pension liabilities and revenue growth and/or reductions in other operating expenditures that enable the city to accommodate increased pension costs into annual operating budgets. The city would argue that it

has met the second criteria.

Jacobson countered the city's assessment that the rating agency had wavered.

"We do not advise any issuer on how to improve their credit rating. In our November 7 report affirming Chicago's Ba1 rating and negative outlook, we did note the 2016 pension reforms will help increase pension contributions and the city's economy and liquidity remained strong. However, we also noted the unfunded pension liabilities will continue to increase for several more years, and the deteriorating credit of the Chicago Public Schools (B3/negative) now poses new risks to the city that did not exist earlier."

Moody's dropped the city's rating to junk after the Illinois Supreme Court struck down state pension reforms. The opinion made clear the difficult path ahead for the city to solve its pension crisis. It marked a hard and steady fall from the Aa3 rating Emanuel inherited in 2011 after Moody's began giving greater weight to pension status.

The city faced further ratings fallout from other rating agencies because the drop to speculative grade triggered defaults and termination events on bank products. Still, the city held on to its other investment-grade ratings.

The ratings discrepancies sparked a spirited market debate over the role of rating agencies and how closely they represent investor sentiment.

"No local government's split credit ratings have—in recent memory—spurred as passionate of a debate as Chicago's," Municipal Market Analytics partner Matt Fabian wrote in mid-2015. "It strikes us that underlying this debate may be a discrepancy between what ratings are and what the industry ideally wants them to be."

After the downgrade, Emanuel delivered a stinging rebuke, highlighting the disparity in ratings, calling Moody's out of step and accusing it of trying to force the city's hand on increasing property tax rates.

Market chatter over the downgrade was underscored by Moody's release six days later of a special report to address "questions we are receiving concerning last week's downgrade." Moody's senior analyst Rachel Cortez then took center stage at a long-scheduled discussion of city finances hosted by the City Club of Chicago.

"To us it was pretty clear that benefit reductions under any circumstances are impermissible and in violation of the Illinois constitution," Cortez said. The rating agency turned out to be right as pending city pension reforms were also later shot down.

Some believed Moody's acted too swiftly while others said the market already perceived the credit as junk. The junk-level downgrade also shone a light on default risks. Moody's sought to tamp down concerns, highlighting its analysis that Ba-level credits show just a 5% likelihood of default in the coming years.

## **The Bond Buyer**

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