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CPS Buys Short-Term Relief with Bonds that will Carry Costs for Decades.

Chicago Public Schools' latest long-term borrowing deal will buy the district a bit of financial breathing room through 2019 but comes at an immense cost to future generations.

By the time the $500 million loan is paid off, children now entering kindergarten will be in their mid-30s and the school district will have spent $850 million in interest costs alone — making the total expense of the bond issue a whopping $1.35 billion.

And only a small fraction of the money from the long-term bonds issued in July will be used for school construction or classroom improvements, which budget experts say should be the primary use for long-term debt. CPS is using the biggest chunk of the loan to reimburse itself for failed bond market deals the district previously covered with cash. Another large portion will be used to shave a few hundred million dollars off old debts — even as it extends those debts as much as 25 years.

In addition, the deal commits an enormous sum of state aid to bondholders through 2046, even as state funding remains at the center of an ongoing battle in Springfield. If state aid is ever not enough to cover bond payments, CPS has pledged to turn to property taxes to pay for the loan.

The loan adds to the mountain of interest costs CPS has taken on to deal with its ongoing cash crisis and lack of adequate reserves. The bonds were issued not long after the district took out short-term loans to cover delayed state grants that the Tribune reported cost CPS $70,000 a day in interest and cannot be repaid until the end of September at the earliest.

The district will pay what are high interest rates for a government bond of 6.75 to 7 percent. The deal is structured in a way that allows the district to avoid any significant principal payments on its new debt for the first 20 years. That exacerbates the cost of an already expensive financial maneuver.

Bobby Otter, budget director for the Center for Tax and Budget Accountability a nonprofit government research organization, said the district's continued use of debt to cover short-term budget gaps indicates the severity of the system's financial predicament.

Otter said his organization considers the CPS' recent borrowing "bad public policy and bad public finance."

"They are not getting the benefit of what you normally would when you bond out something," he said. "A new school building is probably the best example. You bond it out, but then the school is there for decades, and students and families are able to use it for that time. So the public good is there for a long time. In this, the public good is really only being used for a year."

Otter explained that as the payments on the bonds kick in, more money will be required to pay for these long-term debt costs soaking up resources from the classroom. Although CPS is granted a bit of breathing room, eventually the district will have to come up with more funds from the state and local taxpayers to afford the payments on the debt, he said.

An accounting loophole allows CPS to use $229 million from the long-term bond proceeds to recoup bond market losses paid for in previous years. In addition, the district will reimburse itself for $31 million in capital expenses previously paid for out of cash accounts. Finally, the loan will cover $200 million in old debt costs that date back as far as 1996.

Paying off the cost of old bonds by issuing new debt that extends the life of the old debt and increases long-term costs is a practice referred to as “scoop and toss.” The method has long been used by various Chicago governments to cover up operating deficits.

Another expense of the borrowing are upfront discounts to initial buyers totaling $33 million, typically handed out to help increase demand for what the market considers risky bonds. The district also paid $6.7 million to consultants, bankers and lawyers.

Civic Federation President Laurence Msall described the costs of the district’s bonds as “frightening,” while comparing the district’s financial tactics to easing “a portion of the credit card bill by taking out a second or third equity loan on the home.”

“It’s an enormously expensive way of operating,” Msall said.

“The district has few options, if it is going to continue to operate and open the schools in September, than to seek creative borrowing techniques,” he said. “But that doesn’t mean there should not be the articulation of both a Plan A and a Plan B. … CPS desperately needs a long-term financial strategy.”

Responding to questions about the district’s borrowing practices, CPS replied with a statement saying it “will continue investing in students’ education, because these students only get one chance at a good education.”

“Along with downstate and suburban superintendents, we’re supporting historic reform that will remove the stain of Illinois’ worst-in-the-nation school funding system and put hundreds of districts on a stronger path in the future,” CPS spokeswoman Emily Bittner said.

The district did not respond to questions about fiscal plans for the coming years outside of its support for a new state funding formula that includes payments similar to other districts to cover its burgeoning pension costs.

Bittner confirmed the future interest payments totaled $850 million but noted that, “dollar tomorrow is worth less than a dollar today,” and that the inflation-adjusted cost of the interest on the loan was $405 million “on a present value basis.”

The long-term loan comes at a pivotal time for CPS. District principals received budget plans last week that count on money from a state education funding bill that Republican Gov. Bruce Rauner has promised to veto and amend in a way that the administration says would reduce state funding to CPS by $145 million. Amid that uncertainty, district officials need to come up with an overall operating budget by the end of August.

Laurel Patrick, a spokeswoman for the governor’s office, told the Tribune in an emailed statement that the governor understands that CPS pays for its teacher pensions while other school districts do not, but said Rauner does not believe state taxpayers should pay for legacy pension issues that occurred because of past CPS financial mismanagement.

“This is not about ‘the governor versus Chicago,'” Patrick wrote in the statement. “Illinois is close to making historic change that will help poor children in Chicago and throughout the entire state of Illinois."

Rauner's threat to veto additional funding for CPS comes as the district is looking at another big budget hole.

Documents from the $500 million bond sale that closed July 13 told investors the district faces a deficit of $544 million. CPS also disclosed it expects to pay $99 million in "net salary and benefit increases" compared to its recently completed budget year. Members of the Chicago Teachers Union are set to receive a 2 percent across-the-board pay bump as part of their latest contract. Another $45 million in additional expected costs are related to health care, transportation and energy costs, and non-CTU salary increases.

To pay for these cost increases and to finance its ongoing budget deficits, the district continues to use debt practices that Mayor Rahm Emanuel has pledged to wring out of the city's budget.

Since 2012 the city has undertaken a plan to phase out the use of "scoop and toss" refinancing and to end its reliance on debt to pay its annual operating costs. However, no such reforms have taken hold at CPS.

Otter said the only way out of the cycle of borrowing to make ends meet seems to be more money from the state. But there remain questions as to whether the proposed long-term funding mechanisms in Springfield will be put into place.

Given that, Chicago's school leaders are digging deeper into more expensive sources of emergency cash.

Bad bets on toxic debt wiped out the last of the district's reserves nearly three years ago. With its latest bond issuance, CPS is using federal accounting rules to repay itself for losses from the termination of those deals in 2015 and 2016.

The bets CPS made were in the form of swap contracts. Swaps are agreements between the bond issuers, in this case CPS, and banks where each party makes a bet that various market indexes will go lower or higher than the amounts it has already pledged to pay to bondholders. The district, which bet mostly on higher interest rate environments than occurred, was on the losing side of these agreements. When the district's bond ratings dropped to junk status, it was disqualified from the deals. Based on the terms of the deals, CPS had to pay the negative value of the swaps contracts — $233 million — once they were terminated by the banks.

The termination payments sapped the remaining reserve funds after the district used nearly $1 billion from those funds in previous years to balance its budgets. Since then, school leaders have had to rely on costly short-term loans to paper over its budget gaps from year to year and cover periods before property tax payments are received.

By using bond proceeds to recover its losses, the deal triples the already eye-popping tab of the district's swaps losses. The district will not make any principal payments on the loan for 25 years while racking up interest costs of roughly $449 million by the time the debt is retired in 2046. Once the loan is paid off, the total cost of the bad swaps bets to the district, including interest and termination payments, will total $682 million.

The bond deal also finances a continuing "scoop and toss" strategy by using more borrowed money to repay $200 million in current loans and interest, stretching the life of those debts for decades. This will free up just under $100 million immediately, with the remaining savings coming through

2019. Again, these debt-based budget methods come at a huge cost. The scoop and toss adds nearly $300 million in interest through 2042 to debts and interest that would otherwise have been retired by 2020.

Some of the bonds costs being scooped and tossed are from debt originally issued in 1996 as part of a major school construction initiative undertaken shortly after CPS saw its ratings increase to triple-A that year. Those bonds were extended through scoop and toss loans in 2008, 2010 and 2016. Adding another layer of refinancing this year leads to a dizzying cycle of interest compounding on interest at an even higher rate.

The school district is currently rated as a junk credit at the bottom of the “B” level by all three major bond rating houses.

Msall repeated, the district has turned to the capital markets because of its own unwillingness to focus on its existing revenue plus instability at the state level.

“As the debate continues in Springfield as to whether there will be a rewriting of the school aid formula or whether the schools will receive their state appropriations this year, the immediate issues, which this borrowing demonstrates, is that CPS is paying an enormous penalty — an enormous cost for not having a long-range plan, for not having a plan that ratings agencies, borrowers or the general public can rely on as to what the Chicago Public Schools will do next,” he said.

That raises the prospect, he said, of determining whether CPS should again fall under state financial oversight, referring to the Chicago School Finance Authority that was established when the district lost access to the capital markets during its 1980 fiscal crisis. However, despite the current bleak outlook, the school district says it expects to continue borrowing — albeit at an exorbitant price.

The district acknowledged its plight in a disclosure to investors associated with the deal.

“Although the Board believes that it has the capacity to borrow both in the short-term and the long-term credit markets, there can be no assurance as to the terms on which the Board will continue to be able to procure such funding, whether the Board’s existing statutory borrowing authority will provide sufficient borrowing capacity, or if market access will continue to be available to the Board,” the district said in bond documents.

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July 31, 2017

Chicago Tribune

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