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Will Chicago's "AAA-Rating" on Its Sales Tax Securitization Corp. Hold During Bankruptcy?

The City of Chicago's new debt transaction, secured by sales-tax revenues, emerges as the epitome of financial engineering and ingenuity of a bond transaction structuring.

The city, with its own financial challenges and mounting pension obligation, is going to be selling debt instruments under a newly created company secured by a first lien position pledge on the city's sales-tax revenues; these debt instruments are being labeled as secure as U.S. Treasuries with a AAA credit rating. In the municipal debt markets, every local government strives to earn the best possible rating on their debt issuance to bring the cost as low as possible, as high ratings directly correlate to positive outlook and low coupons for the debt instruments.

In this article, we will take a closer look at the debt structuring of Chicago's Sales-tax debt, the rating criteria and the potential impacts during a financial downturn.

Obtaining "AAA-rating" With Relatively Low General Obligation Ratings

A low general obligation rating can substantially restrict a municipality's access to capital markets or make it substantially more expensive to issue debt. In the City of Chicago's case, their general obligation debt ratings vary from strong investment-grade to junk status, which has essentially restricted their access to capital through debt financing.

Recently, with the help of well-known investment banks, Chicago has ventured into issuing revenue-backed debt by creating a new corporation and using it to issue new bonds while assuring investors have first claim on the city's sales tax revenues. This transaction has already earned an AAA-rating by a couple of the rating agencies and a positive outlook on the city's sales tax revenue streams.

However, this presents its own dilemmas in the event of financial insolvency of the municipality; as in, whether the debt holders will continue to get their coupon payments or, if instead, the city will be required to meet its other obligations to its pensioners, local government employees and funding critical city-wide programs.

The Case of Sales Tax Revenue Pledged Debt for Puerto Rico

For many investors, Chicago's sales tax backed debt seems very relatable to Puerto Rico's COFINA debt, which was backed by the first pledge on the sales tax revenue streams. Throughout the financial restructuring of Puerto Rican debt, there has been the emergence of two primary disputes between GO and revenue-backed debt.

Many investors assume, rightfully so, that revenue-backed debt is a relatively safer investment option and consider its position to be higher than general obligation debt due to the specific revenue streams that are typically collateralized to make payment on these bonds. However, this assumption can be severely challenged in the event of local government insolvency or restructuring efforts. This conundrum has caused quite a stir among Puerto Rico's GO and COFINA debt holders. GO bondholders and their legal representatives have brought forward lawsuits claiming that their debt obligations must be met by the island's government before COFINAs are paid, irrespective of any revenue pledges, liens or secured debt. Several references and interpretations have been made toward the GO debt structures, and the island's Constitution states that GO debt must be paid before other expenses. The legal teams in favor of GO bonds have argued that the COFINA structure is invalid and violates the island's Constitution because Puerto Rico cannot continue to pay its sales tax bonds while skipping GO payments, especially when GO debt structure entails a claim on any "available resources" of the Commonwealth, including sales tax revenues.

On the other hand, COFINA debt holders have filed their own lawsuits claiming that their debt indentures allow them to have the first claim on any revenues generated through sales tax, and that these revenues are not part of the general revenue to pay GO debt obligations prior to revenue debt. In addition, they have also claimed the invalidity of GO debt, since any GO debt issued after 2011 has been over the Constitutional limit and, according to the lawsuit, should be rendered invalid. COFINA holders also say that since the sales tax revenue is specifically pledged for payment of revenue-backed debt, it doesn't constitute "available resources" and cannot be mingled into the general fund.

As if this feud wasn't enough to keep investors occupied, there have been internal legal disputes between senior and subordinate COFINA debt holders. As in many local U.S. governments, revenue debt is typically issued depending on the timing and the capital needs of the municipality and can often be structured with senior and subordinate lien positions on the pledged revenues. As the sales tax revenues are also on a decline for the Commonwealth, COFINA holders are scrambling to get clarity on their positioning to claim those sales tax revenues. In obvious terms, senior debt holders claim that their debt service obligations must be met before any junior or subordinate lien positions are paid; senior lien holders would like this to be true for both semi-annual debt payments (such as interest and principal payments) or full payment on senior holdings prior to subordinate debt in the event of bankruptcy. Subordinate debt holders disagree with these terms and would like to have a claim on the sales tax revenues equal to that of the senior debt holders.

Investors and the municipal markets have shown similar concerns on the AAA-rating for the City of Chicago's revenue-backed debt and the validity of these ratings during a financial distress similar to Puerto Rico.

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