CITY OF CHICAGO

COUNCIL OFFICE ON FINANCIAL ANALYSIS (COFA)

January 24, 2020

The Honorable Alderman Pat Dowell
Chair, Committee on Budget and Government Operations
121 N LaSalle St, Room 200
Chicago, IL 60602

Chairman Dowell:

Per Alderman Ervin's request, this is COFA's analysis of the City of Chicago's recent issue of new Sales Tax Securitization Corporation (STSC) and General Obligation (GO) debt to refund various existing. The transaction was authorized by O2019-8927, and anticipated debt service savings from the transaction were included in the City's 2020 Appropriation Ordinance.

COFA finds that the transaction succeeded in generating savings which exceeded the CFO's projections. The decision to front-load the savings in the first two years of the twenty-two year loans could be debated.

Outline of Concept:

CFO Bennett and her staff compared the transaction to a homeowner taking out a home equity loan during a time of low interest rates, and using the proceeds to payoff existing higher-interest credit card debt. The home equity loan offers lower interest rates, because it is secured by a specific, tangible asset with stable values.

In COFA's view, the analogy is apt. Most of the borrowing in the recent transaction was through the STSC. The City is able to borrow money through the STSC at lower rates than available through GO bonds because the debt is repaid with future sales tax revenue.

Investors became warier of municipal special revenue bonds following a March, 2019 court ruling that Puerto Rico was not required to make payments on its revenue bonds while it is in a state of bankruptcy.[1] The STSC is designed to be "Bankruptcy Remote," because the future sales tax revenue required for its debt service is actually sold to the STSC. Thus, theoretically, the City could not withhold sales tax revenue from STSC debt service, even if the City were in a state of bankruptcy.

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[1] "Court ruling in Puerto Rico bankruptcy fans revenue bond fears," by Karen Pierog, *Reuters*, March 28, 2019 https://www.reuters.com/article/us-usa-puertorico-bonds/court-ruling-in-puerto-rico-bankruptcy-fans-revenue-bond-fears-idUSKCN1R92MF

For that reason, rating agencies continue to rate the STSC well above the City's GO rating, although they express concern that its bankruptcy remoteness has not been tested in court.[2]

Assuming that the STSC is in fact bankruptcy remote, STSC debt will be considered very low risk so long as total sales tax revenue remains comfortably above debt service. Thus, sales tax revenue will put an upper limit on the STSC's low-interest borrowing.

Expected outcome as presented in the proposed budget and amended budget

Mayor Lightfoot's initial 2020 Budget Recommendations assumed that the refunding transactions would save the City $200 million. The estimated savings were increased to $210 million as part of the "Plan B" budget amendment (SO2019-8825), which was passed after the General Assembly failed to authorize graduated real estate transfer taxes.

The budget assumed that the STSC would structure the new debt in such a way that the City would take 100% of the savings in the form of lower 2020 debt payments, and all of those savings would be applied to the 2020 budget. The estimated savings were net payment reductions after financing all transaction costs (such as commissions and legal fees) out of the proceeds of the new debt. In addition, the CFO and her staff stated that the transaction would be structured so that future year payments for the new debt would not exceed what the payments for refunded debt otherwise would have been, and final repayment of the new debt would be in the same year or earlier than final repayment of the refunded debt otherwise would have been.

Actual Outcome

The final prices for the refunded bonds were set on January 16, 2020. The City exercised $1.47 billion of the $1.5 billion refunding authorized by the City Council. The table below shows the debt service required for the new debt, the debt service which would have been required under the refunded debt, and the difference between the two for each year.

Due to the exceptionally low municipal bond rates at the time it came to market, the City was able to structure the transaction in such a way as to achieve $101 million in 2021 savings in addition to the $210 million savings budgeted for 2020. The transaction also resulted in very modest savings in each year from 2022 through 2042, while having no effect after 2042.

The City asked the rating agencies to rate the transaction based on 1.75 debt coverage (i.e., that 2019 sales tax revenue would be at least 1.75 times service for all STSC debt- old and new- in the highest debt service year). Final numbers after the bond sale shows that the STSC maintains a 2.55 debt coverage ratio. So, the STSC has capacity for additional borrowing at the same rating level, although the amount of additional borrowing it is capable of will depend on interest rates and sales tax growth.

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[2] "Fitch tax-supported criteria revision drives cuts to Chicago securitization credits," by Yvette Shields, *Bond Buyer*, January 15, 2020
https://www.bondbuyer.com/news/fitch-tax-supported-criteria-revision-drives-cut-to-chicago-securitization-credits

Budget Year	Debt Service Which Would Have Been Due on Refunded Debt	STSC Debt Service	GO Debt Service	Budget Impact
2020	(210,028,010)	-	-	(210,028,010)
2021	(101,421,142)	-	-	(101,421,142)
2022	(86,525,884)	64,024,347	22,481,750	(19,788)
2023	(155,109,764)	92,010,008	63,081,750	(18,006)
2024	(163,708,343)	92,012,761	71,676,750	(18,832)
2025	(193,830,489)	92,011,828	101,810,500	(8,161)
2026	(183,526,974)	92,014,078	91,494,500	(18,396)
2027	(193,758,093)	92,011,078	101,729,500	(17,515)
2028	(181,402,929)	92,011,078	89,373,250	(18,601)
2029	(108,786,758)	92,011,578	16,760,000	(15,180)
2030	(94,248,718)	89,784,828	4,452,000	(11,889)
2031	(62,741,245)	62,724,499	-	(16,746)
2032	(58,555,349)	58,541,470	-	(13,879)
2033	(67,887,491)	67,867,775	-	(19,716)
2034	(61,751,669)	61,735,275	-	(16,394)
2035	(54,218,021)	54,208,023	-	(9,999)
2036	(51,603,492)	51,596,523	-	(6,970)
2037	(52,232,012)	52,217,273	-	(14,739)
2038	(32,982,775)	32,969,473	-	(13,302)
2039	(62,401,093)	62,387,073	-	(14,020)
2040	(62,402,480)	62,386,943	-	(15,537)
2041	(29,013,579)	28,996,167	-	(17,412)
2042	(29,007,775)	28,991,274	-	(16,501)
	$(2,297,144,085)	**$1,422,513,352**	**$ 562,860,000**	**$ (311,770,735)**

Issues

- Under certain circumstances, STSC borrowing could reduce the City's General Obligation credit worthiness, because the STSC "skims the cream" by taking a very reliable revenue source to pay its own debt. However, that is not an issue in this case, because the revenue no longer available to pay GO bonds has been more than offset by reduced GO bond payments.

- The STSC has additional capacity to borrow at the same level of creditworthiness, but it is not unlimited. Therefore, this refunding is a one-time measure. That said, the use of STSC debt to reduce total debt service undeniably improves the City's overall fiscal position.

- It is impossible to be certain whether this is the ideal time to undertake this refinancing. It is *possible* that interest rates may be even lower at some time in the near future. In that case the City could refinance again. But, each refinancing comes with significant costs. In addition to the legal fees, commissions, marketing costs, etc. involved in the transactions, bonds generally contain a "Call Provision." Call Provisions require the City to pay a premium to bond holders if the City repays the debt early, somewhat like a mortgage prepayment penalty. That said, the refunding is taking place as municipal bond rates are at their lowest point in at least sixty-seven years,[3] so there seems little danger that rates would fall much further in the near-term future.

[3] Based on Benchmark 10-year and 30-year municipal bond rates from January 23, 2016 to present, as reported by Bloomberg Financial (https://www.bloomberg.com/quote/BVMB30Y:IND and https://www.bloomberg.com/quote/BVMB10Y:IND); and *Bond Buyer Go 20-Bond Municipal Bond Index* rates from January, 1953 through October, 2014, as reported by the Federal Reserve Bank of St. Louis (https://fred.stlouisfed.org/graph/?g=OYk).

- The most challenging issue is the best way to time the savings over the life of the refunded bonds.[4] Although the refunded bonds would have been payable over the next twenty-three years, the City opted to apply 67% of the savings to the 2020 budget and 33% to the 2021 budget.

    - The Government Finance Officers Association's (GFOA) *Refunding Municipal Bonds* Best Practice recommends establishing general policies on the timing of savings. The City of Chicago does not currently have such a policy. GFOA states,

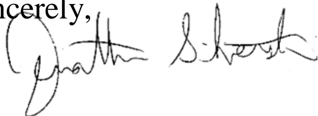
        > *The most common, known as "uniform savings," realizes savings in approximately equal annual amounts over the life of the refunding bonds. Another similar savings structure is known as "proportionate savings" and realizes savings in amounts approximately proportionate to the debt service on the refunded bonds. Alternatively, at times an issuer might wish to "accelerate" the available savings to provide greater near-term debt service relief. When savings are accelerated, or front-loaded, care should be taken to ensure that the debt service on later maturities is no greater than that of the refunded bonds.*[5]

        In this case, the City did meet the recommendation to ensure that the debt service on later maturities is no greater than that of the refunded bonds.

    - Arguably, the City should have applied all of the savings to 2020, because the 2020 budget depends on $143 million in additional Medicaid ambulance billing. As of this writing, the City awaits federal approval of the billing changes.

    - Conversely, it could be argued that the City ought to have spread the savings out over a longer time period, because it faces significant budgetary challenges in the coming years. 40% of the forecast for 2020 deficit ($338 million) was eliminated with one-time measures, so that amount will have to be re-addressed in future years. In addition, the City's required pension contributions will increase by $400 million in 2021, and by another $950 million in 2022, and will continue to rise modestly thereafter.[6]

Sincerely,



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[4] Under the City of Chicago's modified accrual basis of accounting, the City he City accounts for revenues as soon as the revenues are both measurable and available. Such revenues are used to pay liabilities from the current accounting period. However, the savings from the refunding are not revenue. Rather, they are a reduction in expenditures. Expenditures are generally recorded when an event or transaction occurs. So, the debt savings must be applied to the budget(s) of the year(s) in which the debt service is reduced. City of Chicago, *2020 Budget Overview*, p. 173

[5] https://www.gfoa.org/refunding-municipal-bonds

[6] As projected by the *Actuarial Valuation Reports* of the City's four pension funds.