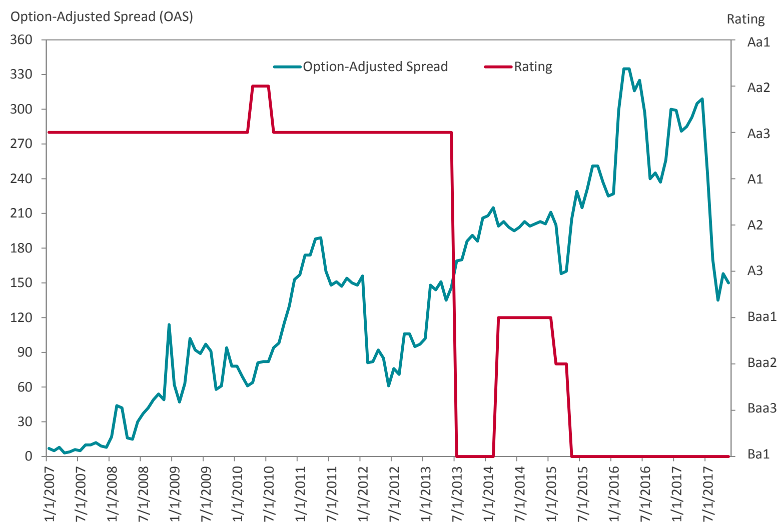
Primed for the Holidays

Ten years ago, investors clamored for high yielding subprime mortgages that proudly displayed their Triple-A credit ratings. Those investors slept comfortably with visions of steadily appreciating home values dancing in their heads. Unfortunately, those dreams turned into nightmares as the Triple-A ratings, along with billions in investor capital, were gone in a flash. Earlier this month, another subprime (non-investment grade) issuer came to market with a twinkling, Triple-A rated bond offering — the City of Chicago. We have heard this story before.

Issuers with challenged fundamentals often employ creative methods to maintain market access at affordable yields. In the old days, all an issuer had to do was offer its general obligation pledge. Backed by an issuer's taxing authority and full faith, the general obligation pledge represented the gold standard of municipal credit for decades. The vanishingly low levels of historical default rates helped reinforce this perception. With their General Obligation (GO) pledges in hand, states and local governments have enjoyed cheap market access while generally avoiding scrutiny. But times are changing.



Source: ICE, BoA Merrill Lynch, Bloomberg, Moodys, and BBH Analysis
Data as of 1/31/07 - 11/30/17

In Chicago, cracks in the GO façade have been developing for years as a result of chronic structural deficits, ballooning pension obligations, and sub-par revenue growth. These issues were exacerbated by the Financial Crisis, deeply entrenched public employee unions, and arguably some of the nation's most robust constitutional pension protections. Chicago's ratings declines have reflected these challenges. Since its downgrade to junk by Moody's in 2015, the City of Chicago has faced much more intense pressure when issuing bonds.

Subject to its own funding pressures and near-junk credit ratings, the State of Illinois passed legislation this summer to help local governments with home-rule authority, such as Chicago, to access the municipal market at a lower cost. The legislation allows a local government to create a special purpose entity (SPE), convey state-collected revenue streams to the SPE, and establish a statutory lien on those revenues. This protects bondholders by preventing the commingling of the pledged revenues with other city funds and thus averting the risk of the pledged revenues becoming a part of the local government's potential bankruptcy proceedings. We should note that, as of this writing, local governments in Illinois have yet to be "enabled" to file for bankruptcy. Nonetheless, these legislative actions have created a practical structure for bonds to be rated higher than the local government's general obligation debt.

Chicago promptly seized this new opportunity by creating an SPE and issuing bonds backed by its state-collected sales tax. This new deal from Chicago was welcomed with open arms. The City only had to offer a paltry 45 basis points[1] of spread to fully place its 10-year maturity. By contrast, the City's GO trades at a spread of 150 basis points. Although some reporters in the press skeptically described the enhanced structure of the Chicago deal as financial alchemy, we view these bonds as legitimately safer than the City's GOs. The fundamental decline and financial stress in Chicago have kept their GOs ineligible for our client portfolios for years. In fact, existing holders of the City's general obligation bonds now have another reason to worry.

Beyond fundamental deterioration, a key concern for creditors is the possibility of a structural weakening of investor rights. This can occur when other creditors are given a more senior lien to one or more revenue streams formerly pledged to others. In our lingo, this is known as becoming structurally subordinated, or simply "getting primed." This is exactly what happened to existing Chicago GO holders when investors in Chicago's new Triple-A bonds were granted a priority lien on the City's state-collected sales tax revenues. Primed for the holidays, indeed.

[1] A unit that is equal to 1/100th of 1% and is used to denote the change in a financial instrument.

Although we see strengths in the City's new dedicated sales tax-backed structure, it is not as strong as it could be because the SPE was created by Chicago and not by Illinois. We only have to look to the Caribbean to see the risk in this. Bondholders of Puerto Rico's sales tax bonds, issued by an SPE known as "COFINA", are currently fighting with Commonwealth GO holders to keep their perceived priority right to sales tax revenues. In Puerto Rico, there was no higher level of government beyond the Commonwealth, itself.

For a contrasting structure, we can examine the New York City Transitional Finance Authority (TFA), a bankruptcy-remote SPE created in 1997 as a public benefit corporation and an instrumentality of the State of New York. Through the TFA, New York City has been able to issue bonds backed by a priority lien on the City's portion of state-collected income and sales tax revenues. In this case, the SPE was established and administered by a higher level of government, unlike Chicago, which was granted the authority by the State of Illinois to establish its own SPE.

Structural analysis is an important consideration when we assess the durability of a credit. We recognize that, as a dearth of municipal bankruptcy case law exists, we cannot solely rely on structural provisions to protect our clients' capital. Because there are no definitive legal precedents that make such structures inviolate, we cannot gain an equivalent level of comfort with Municipal structural protections as we can deduce for the taxable bond sectors. Newfangled bond structures appear with regularity in the bond market. It is our job to understand them and their limitations. With valuations tight, our trading activity might be settling down for a long winter's nap. Keeping our credits money-good in all seasons remains our top priority.

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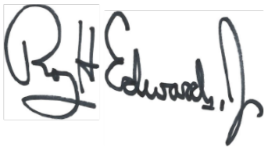

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Risks
Investing in the bond market is subject to certain risks including market, interest-rate, issuer, credit, and inflation risk; investments may be worth more or less than the original cost when redeemed. Income from municipal bonds may be subject to state and local taxes and at times the alternative minimum tax.

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