FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Chicago, IL's IDR at 'BBB-'; Outlook Revised to Negative

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Fitch Ratings - New York - 28 Oct 2020: Fitch Ratings has affirmed the 'BBB-' rating on the Issuer Default Rating (IDR) and outstanding general obligation (GO) bonds of the city of Chicago, Illinois.

The Rating Outlook is revised to Negative from Stable.

Fitch also affirms the 'AA-' rating and revises the Rating Outlook to Negative from Stable on the Chicago Sales Tax Securitization Corporation (STSC) outstanding sales tax securitization bonds and second lien sales tax securitization bonds. The outlook revision on the STSC bonds is based on the outlook revision on Chicago's IDR, as the bankruptcy-remote, statutorily defined nature of the STSC and a bond structure involving a true sale of the pledged sales tax revenues lead Fitch to assign a bond rating at the maximum permitted by criteria of six notches above the city's IDR.

SECURITY

The GO bonds are payable from the city's full faith and credit and its ad valorem tax, without limitation as to rate or amount.

Feedback

ANALYTICAL CONCLUSION

The 'BBB-' IDR and GO rating recognize the city's role as an economic hub for the Midwestern region of the U.S., supporting solid revenue growth prospects in the post-pandemic period, as well as the city's unlimited independent legal authority to raise revenues which supports a midrange level of inherent budget flexibility. The rating also considers the city's high and growing long-term liability burden, constrained expenditure flexibility, high revenue volatility, and improving financial profile and solid reserve cushion.

The Negative Outlook reflects credit pressure associated with significant budget gaps totaling $798 million in fiscal 2020 and $1.2 billion in fiscal 2021 against a corporate fund budget of roughly $4.0 billion. The city proposes to close the budget gaps through a combination of debt refunding and restructuring targeting budget relief of up to $450 million in 2020 and $501 million in 2021, property tax and other revenue increases, and personnel reductions, among other measures. Fitch believes that the city's fiscal plan entails some degree of execution risk, and is sensitivity to the unpredictable nature of the current economic and revenue environment. The effectiveness of recurring budget measures is critical to the rating outlook and the city's prospects for returning to structural balance in the post-pandemic period. The budget proposal does not assume additional federal stimulus, relies on modest use of corporate fund reserves, and continues to fund the pension ramp-up for municipal employees and laborers and the full actuarially-based pension contribution for police and fire.

ECONOMIC RESOURCE BASE

Chicago serves as the economic and cultural center for the Midwestern region of the U.S. The city has a population of 2.7 million (equivalent to 21% of the state population) which has experienced modest declines in recent years. Socioeconomic indicators are mixed with elevated individual poverty rates but income levels that exceed the state and nation and strong educational attainment levels. Common of many densely populated urban U.S. cities Chicago has experienced a high number of coronavirus-related cases, business closures, job loss, and declining consumer activity, all of which have had significant adverse effects on revenue and pressure the city's operating budget.

KEY RATING DRIVERS

Revenue Framework: 'aa'

Fitch expects slow, steady economic expansion to lead to continued solid revenue growth, excluding the effect of new or raised taxes and fees. The city's home rule status affords it access to a wide variety of revenue-raising options, many of which are legally unlimited.

Expenditure Framework: 'bb'

Carrying costs for debt service and retiree benefits equal a substantial portion of operating resources. Public safety, which is fairly inflexible as a practical matter, comprises a majority of general fund spending, further constraining expenditure flexibility. Rising pension costs will continue to drive expenditures to grow at a much faster natural pace than revenues, likely necessitating ongoing revenue-raising measures and careful expenditure control.

Long-Term Liability Burden: 'bbb'

The long-term liability burden is high relative to the resource base at 37% of personal income, and expected to climb further even as the city phases into actuarial funding of pension contributions.

Operating Performance: 'a'

The city's ability to close recessionary revenue gaps is strong and is a function of the city's high revenue raising flexibility and long-term reserves that are available to offset the expected level of revenue volatility in a downturn.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to positive rating action/upgrade:

--Budgetary solutions to the current fiscal stress that preserve the city's 'a' level of financial resilience and sustain the city's progress toward structural budgetary balance, including actuarially-sustainable pension contributions, in the post-pandemic period.

--A quick recovery in the city's economy resulting in lower than expected near-term revenue declines and greater than expected revenue recovery in the post-pandemic period.

--Further timely and substantial federal action that offsets the likely deep economic and revenue declines the city will face over the next few months. This could take the form of significant direct aid for revenue losses or sufficient economic stimulus that supports a rapid rebound in economic activity.

--For the STSC bonds, positive rating action on the city's IDR, in conjunction with the quick stabilization of the pledged revenue stream and expectation for it to return to pre-virus growth levels in the post-pandemic period.

Factors that could, individually or collectively, lead to negative rating action/downgrade:

--The city does not present a comprehensive and plausible path to unwind non-structural fiscal measures and avoid a material erosion of reserves and financial resilience or exacerbation of an already stressed long-term liability burden.

--Sustained and deep revenue declines that compromise the city's ability to institute fiscal policies sufficient to address resultant budgetary gaps or that fundamentally weakens the ability of the resource base to meet its long-term financial obligations.

--For the STSC bonds, negative rating action on the city's IDR and/or severe declines in pledged revenues that exceed Fitch's coronavirus scenarios and that weakens our view of the dedicated tax bond structure's financial resilience.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit [https://www.fitchratings.com/site/re/10111579].

Feedback

CURRENT DEVELOPMENTS

The outbreak of coronavirus and related government containment measures worldwide has created an uncertain global environment for U.S. state and local governments and related entities. Fitch's ratings are forward-looking in nature, and Fitch will monitor the severity and duration of the budgetary impact on state and local governments and incorporate revised expectations for future performance and assessment of key risks.

While the initial phase of economic recovery has been faster than expected, GDP in the U.S. is projected to remain below its 4Q19 level until at least 4Q21. In its baseline scenario, Fitch assumes continued strong GDP growth in 3Q20 followed by a slower recovery trajectory from 4Q20 onward amid persisting social distancing behavior and restrictions, high unemployment and a further pullback in private-sector investment. Additional details, including key assumptions and implications of the baseline scenario and a downside scenario, are described in the report titled, "Fitch Ratings Coronavirus Scenarios: Baseline and Downside Cases - Update", published on Sept. 8, 2020, and "Fitch Ratings Updates Coronavirus Scenarios for U.S. States and Local Tax-Supported Issuers", published on Oct. 1, 2020 on www.fitchratings.com.

Economic implications of the pandemic and related public health measures remain significant for Chicago as is the case across many high-density U.S. cities. The pandemic and related public health measures have significantly affected the city's economy, which had posted relatively modest job growth relative to the U.S. in the years preceding the outbreak. August 2020 employment was 12.2% below the same month level in 2019 (compared to -6.9% for the U.S. non-seasonally adjusted) notwithstanding the phased reopening of the economy. The city's September unemployment rate registered a still high 13.8%, down from a peak of 18.7% in April (unemployment dipped to a low of 12.6% in January 2010 during the Great Recession). Chicago's daily coronavirus case rate has spiked to levels last seen in late April. In response, Governor Pritzker ordered a ban on indoor bar and restaurant service and a limit on group gatherings commencing October 30 until positivity rates improve. Fitch expects economic and employment data to remain volatile and difficult to forecast until an effective vaccine or treatment are widely available, reinforcing Fitch's concerns over the ability of the city to meet its near-term revenue forecasts.

Chicago Financial Update

Entering fiscal 2020 (Dec. 31 YE) Chicago's operating performance was trending upward, reflecting improved fiscal management, progress toward eliminating a structural gap in the corporate fund budget and stable reserve levels exceeding $1 billion (inclusive of balances stemming from prior assets sales/leases) or 25% of spending at fiscal YE 2019.

Chicago adopted a $4.5 billion corporate fund budget for fiscal 2020, closing an original budget gap of $838 million with a variety of one-time measures (including $210 million in refunding savings), $226 million in structural revenue enhancements, and $289 million in recurring efficiencies and expenditure reductions (including $121 million in departmental cuts and a $60 million increase in pension contributions from Chicago Public Schools). The downturn in economic activity following the outbreak of the coronavirus opened a significant revenue gap of $886 million in fiscal 2020 (about 20% of the budget) since reduced by $88 million via departmental cost savings. If not for the pandemic-related revenue loss the city estimates it would have generated a surplus of $88 million on the year. The city's revenue loss closely approximates the decline indicated by the Fitch Analytical Stress Test (FAST) model, which relates the city's historical general fund revenue volatility to GDP to support the assessment of operating performance under Fitch's criteria. FAST has been adjusted to reflect GDP parameters consistent with Fitch's global coronavirus forecast assumptions.

To close the gap the city plans to use $350 million of the $470 million in Coronavirus Relief Funds (CRF) received to cover eligible virus response costs, and the issuance of up to $1.7 billion of GO and STSC bonds to refund and restructure outstanding GO bonds for approximately $450 million in budgetary savings. The debt restructuring also targets $501 million in budget relief in fiscal 2021. The city reports a fiscal 2021 gap of $1.2 billion, based on a continuation of restrictions on economic activity until the second half of 2021 and total corporate fund revenue of $3.64 billion - essentially in line with fiscal 2020 estimates or a nearly 18% decline from the fiscal 2020 budget. The fiscal 2021 budget proposal reflects the use of $30 million in corporate fund reserves, $30 million in TIF surplus, and $30 million from fund sweeps/asset sales.

Fitch views the city's planned debt restructuring and use of other one-shots as forms of deficit financing, a fiscal tool that has been explored more frequently by U.S. state and local governments, particularly those that are lower-rated, to help mitigate the severe revenue stress associated with the coronavirus pandemic. The restructuring inherently increases the sensitivity of the rating to the timing and strength of revenue recovery in the post-pandemic period. The debt restructuring adds significant costs over time, but Fitch believes their implication for the city's near-term fiscal recovery are more neutral.

The city proposes to balance these one-time options against $562 million in structural measures to close the fiscal 2021 budget gap. Fitch views the city's focus on recurring fiscal solutions as critical to returning the budget to structural balance over the next several years. The 2021 budget proposal recommends a $94 million increase in the property tax levy and an inflationary increase to the levy beginning in 2021. Roughly $91 million in additional new revenue is proposed including an increase to the personal property lease tax and vehicle fuel tax rates. Fitch expects these revenue actions to be subject to scrutiny during budget hearings given the economic climate. That said, these proposals highlight the broad revenue flexibility of the city, which we view as an important fiscal tool and a strength of the credit.

A total of $106 million in personnel savings from the reduction of 1,921 corporate fund positions (about 7.6% of the workforce) and $89 million in non-personnel cuts have also been proposed. The city is not anticipating additional federal stimulus funds, the prospect for which varies depending on the outcome of the upcoming November elections. The budget proposal funds a $135 million increase in pension contributions, reaching $1.8 billion in total to the city's four pension funds, and includes the full actuarially-based pension contribution (albeit with a 90% funding target) for the city's police and fire pension plan for a second consecutive year. The city is expected to complete the five-year ramp up to actuarial funding of the municipal employees and laborers pension plans in fiscal 2022, which will contribute to a steep increase in pension payments to $2.25 billion.

STSC Overview

The bankruptcy-remote, statutorily defined nature of the STSC and a bond structure involving a true sale of the pledged sales tax revenues are key credit strengths that lead Fitch to assign a bond rating at the maximum permitted by criteria of six notches above the IDR of the city of Chicago. The city has sold all right, title and interest in the pledged revenues to the corporation, a limited purpose entity. The state directs all pledged sales tax revenues to the trustee for the benefit of bondholders and the residual flows to the city for any lawful purpose.

Pledged revenues include the portions of the city's home rule sales taxes that are collected by the state as well as its local share of state sales taxes. The Illinois Use Tax and Illinois Service Use Tax are both subject to appropriation by the Illinois General Assembly. These revenues, which represent about 15% of fiscal 2019 pledged revenues, are excluded from Fitch's dedicated tax analysis because their value is limited to one notch below the state's IDR (BBB-/Negative).

STSC Resilience Analysis

Fitch's current resilience assessment for the senior and subordinate structures is 'aaa' and 'aa', respectively. The resilience assessments are based on the maximum annual debt service (MADS) level permissible under the senior and subordinate ABTs, which require a minimum MADS coverage ratio of 4.0x and 1.75x, respectively. The exclusion of pledged revenues subject to state appropriation in Fitch's dedicated tax analysis yields an effective MADS coverage ratio of 3.4x senior and 1.5x subordinate based on the minimum coverage requirement under the ABTs.

Fitch-adjusted pledged revenues could decline 71% to 1.0x senior MADS or 33% to 1.0x all-in MADS. The coverage cushions are considered in the context of the FAST model, which yields a 4.2% decline in the -1% U.S. GDP scenario, and the largest decline in Fitch-adjusted pledged revenues over the period covered by the revenue sensitivity analysis, or an 11.2% drop from fiscal 2007-2009.

To evaluate the sensitivity of the dedicated tax bond structure in the current environment, Fitch also applies a revenue stress of 34% (annualized) to the latest audited annual totals, based on Fitch's nationwide assumption of declines in retail sales, and compares that against annual debt service scheduled over the next three years. Fitch estimates senior lien coverage remaining solid at a minimum of 2.3x and all-in coverage at 1.7x (subordinate lien debt service does not commence until fiscal 2022). In both cases, the coronavirus stress results exclude the pledged revenue subject to state appropriation.

By way of comparison, the city is forecasting a nearly 12% decline in pledged revenues in fiscal 2020 based on YTD collections, followed by growth of 9% in fiscal 2021 and 8% in fiscal 2022 under its base case forecast. Fitch could revise its resilience assessments downward, which could result in negative rating action on the bonds, if the decline in pledged revenue through fiscal 2021 is equal to or greater than Fitch's coronavirus stress absent conclusive evidence of a near-term stabilization and resumption of growth.

CREDIT PROFILE

Chicago spans 228 square miles with a population of nearly 2.7 million people, is a "home rule" unit of government under Illinois law. The city has a mayor-council form of government, wherein the mayor function as the chief executive officer. The city provides a full range of municipal services including police and fire, economic, cultural and community development, and water and wastewater, among other services. Chicago also operates O'Hare and Midway international airports.

In addition to the sources of information identified in Fitch's applicable criteria specified below, this action was informed by information from Lumesis.

REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

ESG CONSIDERATIONS

Unless otherwise disclosed in this section, the highest level of ESG credit relevance is a score of '3'. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

Feedback

RATING ACTIONS

ENTITY/DEBT	RATING	PRIOR

ENTITY/DEBT	RATING			PRIOR
Chicago Sales Tax Securitization Corporation (IL)				
• Chicago Sales Tax Securitization Corporation (IL) /Sales Tax Revenues - Second Lien/1 LT	LT	AA- Rating Outlook Negative	Affirmed	AA- Rating Outlook Stable
• Chicago Sales Tax S...	LT	AA- Rating Outlook Negative	Affirmed	AA- Rating O...

VIEW ADDITIONAL RATING DETAILS

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Additional information is available on www.fitchratings.com

APPLICABLE CRITERIA

U.S. Public Finance Tax-Supported Rating Criteria (pub. 27 Mar 2020) (including rating assumption sensitivity)

APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

FAST States & Locals - Fitch Analytical Stress Test Model, v2.4.0 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

ENDORSEMENT STATUS

Chicago (IL)	EU Endorsed
Chicago Sales Tax Securitization Corporation (IL)	EU Endorsed

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