



## RATING ACTION COMMENTARY

# Fitch Rates Chicago, IL's GO Bonds 'BBB-' and STSC's Securitization Bonds 'AA-'; Outlook Revised to Stable

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Fitch Ratings - New York - 25 Oct 2021: Fitch Ratings has assigned a rating of 'BBB-' to Chicago's approximately \$215,945,000 general obligation (GO) bonds, series 2021A and \$37,280,000 GO bonds, taxable series 2021C. Fitch also assigns a rating of 'BBB-' to the GO bonds, series 2021B, which are being issued to in exchange for certain outstanding GO bonds of the city, the par amount of which has yet to be determined.

In addition, Fitch has assigned a rating of 'AA-' to the Chicago Sales Tax Securitization Corporation's (STSC) \$263,425,000 second lien sales tax securitization bonds, series 2021A and \$157,060,000 second lien sales tax securitization bonds, taxable series 2021B.

Concurrently, Fitch affirms the 'BBB-' Issuer Default Rating (IDR) on Chicago, the 'BBB-' rating on the city's outstanding GO bonds and the 'AA-' rating on the STSC's outstanding sales tax securitization bonds and second lien sales tax securitization bonds.

The Rating Outlook is revised to Stable from Negative on all ratings.

Proceeds are expected to refund in their entirety the city's outstanding GO bonds, series 2011A, series 2012AC and series 2015B, in addition to the Transportation Infrastructure

Finance and Innovation Act loan, series 2013 (Riverwalk) for debt service savings, the bulk of which are expected to be applied to the 2021 budget.

## **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. The sales tax securitization bonds have a lien on the state-collected portion of the city's home rule sales and use taxes and the local share of the state-wide sales and use taxes; the second lien bonds are secured by a lien that is subject to and subordinate to the first priority lien securing the first lien bonds issued and to be issued by the corporation.

## **ANALYTICAL CONCLUSION**

The Outlook revision to Stable reflects the ongoing revenue recovery across the city and the significant infusion of federal fiscal aid that ease pressure on the city's investment grade standing. Chicago still faces considerable financial challenges and the size of recent years' budget gaps illustrate its sensitivity to economic setbacks. The 'BBB-' IDR and GO ratings reflect this risk, as well as the city's high and growing long-term liability burden and constrained expenditure framework given the heavily unionized nature of the city's workforce and high cost of debt and pension funding.

Rating strengths center on the city's role as the economic hub for the Midwestern region of the United States and commensurate strong recovery prospects, and the city's unlimited independent legal authority to raise revenues (which underpins a midrange level of inherent budget flexibility). The city's commitment to maintaining a sound reserve position is an important credit factor given the precarious nature of its budget and high revenue volatility.

The 'AA-' rating on the STSC bonds reflects the 'aa' growth prospects of the pledged revenue stream and resilience assessments of 'aaa' and 'aa' for the senior and second lien bonds, respectively. 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.

## **Economic Resource Base**

Chicago serves as the economic and cultural center for the Midwestern region of the United States. The city's economy was hard hit by the coronavirus pandemic, particularly the leisure and hospitality sector. Business closures, job losses, and declining consumer activity have had significant adverse effects on revenue and applied pressure to the city's

operating budget. Labor market trends have improved but the city's unemployment rate remains elevated at 9.2% in August (compared to 4.1% in 2019).

## **KEY RATING DRIVERS**

### **Revenue Framework: 'aa'**

Fitch expects slow, steady economic expansion will 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. Pension costs will continue to rise and are subject to volatility inherent in the performance of investment returns and other actuarial assumptions, 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 is 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:

--A period of sustained structural budgetary balance and preservation of reserves that are critical to offset limitations in the city's operating profile, primarily its high cost of funding debt service and retiree benefits;

--Continued economic growth that results in stronger revenue gains and smaller forecasted out-year budget gaps;

--For the STSC bonds, positive rating action on the city's IDR, in conjunction with the continuation of the revenue stream's recovery from pandemic-fueled declines in 2020 and improved stability through future economic cycles.

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

--A reversal in the city's plan to unwind non-structural fiscal measures; an erosion of reserves and financial resilience;

--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 additional large declines in sales tax revenue.

## **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>.

## **CURRENT DEVELOPMENTS**

### **Federal Aid Enhances Near-Term Gap Closing Capacity**

Chicago continues to contend with sizable budget gaps resulting from pandemic-related revenue declines and cost demands associated with the ramp up in pension contributions,

the preservation of service levels and new investments aimed to stimulate economic recovery and provide social support across the city. The estimated budget gap for 2022 is \$733 million, which is down from the \$1.2 billion and \$886 million gaps projected by the city in 2021 and 2020, respectively; however, the gap is still quite elevated in relation to the proposed \$4.9 billion corporate fund spending plan.

Federal stimulus has played a critical role in the city's gap-closing plans, allowing time for revenue recovery while averting more significant cost-cutting measures and/or use of reserves. Chicago received \$470 million in Coronavirus Relief Funds and \$1.9 billion via the American Rescue Plan Act (ARPA). ARPA funds will allow the city to cancel the previously planned scoop and toss restructuring to achieve \$501 million in budget relief for 2021. In addition, the ARPA funds provide a path to repay the \$450 million drawn from a GO line of credit used to close the 2020 budget gap.

Chicago's strong reserve position remains a key credit positive. The city concluded 2020 with unrestricted general fund reserves totaling \$327.7 million or 8.2% of total spending. Fitch's view of the city's financial resilience also considers reserves from prior asset sales/leases totaling \$724.5 million, resulting in a combined available fund balance of \$1.05 billion or 26.3% of spending. Modest fund balance draws are anticipated in 2021 and 2022.

### Improved Revenue Outlook but Structural Risks Persist

Revenue performance has improved throughout 2021. Corporate fund revenues through August are approximately \$224 million ahead of plan and the YE estimate of \$4 billion exceeds 2019 revenue of \$3.9 billion. The city projects that its state income taxes, transaction taxes, service charges and personal property replacement taxes will collectively outpace 2019 revenue by \$327.9 million or 29.8% (some of the growth reflects policy action, including ambulance fee increases in 2020).

Gross STSC sales tax revenues are estimated at \$774.1 million or 6.8% above 2019 revenue. Consistent with many U.S. local governments, the pace of recovery across various tourism and travel related sources has occurred more slowly with transportation taxes, business taxes (including hotels) and recreation taxes forecast to finish about \$244.2 million or 32.8% below 2019 levels on a combined basis.

The proposed 2022 budget totals \$4.88 billion including \$385 million in ARPA funds, \$51.4 million in net current assets and \$35 million in revenue account sweeps. The proposed 2022 budget does not include any new taxes or material fee increases; the property tax levy includes a \$22.9 million CPI increase and \$28.6 million from new development.

Spending growth pressures in 2022 are driven by a \$461.5 million increase in pension contributions and a \$378 million increase to cover retroactive wage increases negotiated with the police officers' union.

Revenue losses stemming from the pandemic have delayed the city's plan to achieve structural balance. The city forecasts use of \$154.2 million in ARPA funds in 2023 but plans to eliminate most other non-structural budget measures by that time. The city reports \$515 million and \$562 million in structural budget measures in 2020 and 2021, respectively, including several revenue enhancements that highlight the broad revenue flexibility of the city. Fitch views this flexibility as an important fiscal tool and a strength of the credit.

The 2022 budget proposes an additional \$149 million in savings and efficiencies including a \$75 million increase in the Chicago Public Schools contribution to the Municipal Employees and Annuity Benefit Fund (MEABF) and \$35 million in health care and contract savings. Meaningful cost-cutting actions will likely become more difficult to achieve over time, emphasizing the importance of Chicago's revenue recovery. Fitch also expects the city will prudently consider decisions to incur ongoing spending commitments of a material nature absent recurring funding sources that would jeopardize advances made toward achieving structural balance, including those associated with the Chicago Recovery Plan, future debt and/or employee wages and benefits.

The Chicago Recovery Plan totals \$1.2 billion in incremental investments centered on affordable housing, family assistance, homelessness support, community development and climate resilience, among other policy initiatives. Funding sources include \$567 million in ARPA money plus proceeds from the \$660 million GO bond issuance. The city reports that the bulk of the plan's spending is expected to be one-time in nature and occur over a multi-year period.

### STSC Analysis

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 city's IDR. 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 20% of 2020 pledged revenues, are excluded from Fitch's dedicated tax analysis because their value is limited to one notch below the state's IDR (BBB-/Positive).

### Sales Tax Rebound Evident

Historical revenue growth has consistently exceeded inflation, supporting the 'aa' growth prospect assessment. The 10-year CAGR has ranged between 2.0% and 3.8% between 2015 and 2019. Annual revenue growth registered 2.1% in 2019 before declining 16.3% in 2020 due to the pandemic.

Vaccine availability combined with the lifting of governmental restrictions have spurred a rapid recovery in STSC revenue, notwithstanding continued pressure on travel-related activities. Gross revenues, including that portion subject to state appropriation and excluded from Fitch's dedicated tax analysis, totaled \$534 million through September 2021, equal to 101% of 2019 collections over the same nine-month period. Growth has accelerated in recent months, boosting the city's YE projection to \$746.4 million in total STSC revenue or 105% of 2019 collections.

### Bond Structures Retain Solid Resilience

Fitch's current resilience assessment for the senior and subordinate structures is 'aaa' and 'aa', respectively. The resilience assessments are based on the minimum MADS coverage ratio of 4.0x for senior bonds and 1.75x for subordinate bonds under the provisions of the respective ABTs. The exclusion of pledged revenues subject to state appropriation in Fitch's dedicated tax analysis yields an effective MADS coverage ratio of 3.2x senior and 1.4x subordinate based on the minimum coverage requirement under the ABTs.

The proposed refunding does not alter the current senior MADS of \$170.7 million. Senior MADS coverage from estimated 2021 STSC revenue on a gross and Fitch-adjusted basis is 4.4x and 3.6x, respectively. Combined senior and subordinate MADS will increase to \$364.5 million after this transaction, yielding a coverage ratio of 2.1x and 1.7x on a gross and Fitch-adjusted basis, respectively.

At the minimum coverage requirement under the ABT, Fitch-adjusted STSC revenues could decline 69% to 1.0x senior MADS or 29% to 1.0x all-in MADS. The coverage cushions are

weighed against the Fitch Analytical Stress Test (FAST) model decline of 7.3% under the standard -1% U.S. GDP scenario and the 16.3% decline in 2020 which represents the largest historical decline dating back to 2000. As a result of the pandemic decline the 29% coverage cushion for the subordinate structure falls below the 'aa' assessment guidance.

However, Fitch believes the 2020 decline overstates the sales tax base's sensitivity to typical economic cyclicalities. Prior to the pandemic, the largest decline in Fitch-adjusted pledged revenues was an 11.2% drop over a multi-year period spanning 2008 and 2009. Future large declines in STSC revenue could alter our fundamental view of the stability of the sales tax base and pressure the rating on the STSC subordinate lien debt.

## **CREDIT PROFILE**

Chicago has a 2020 population of 2.75 million (equivalent to 21% of the state population) which was up a modest 1.9% from 2010. Socioeconomic indicators are mixed, with elevated individual poverty rates but income levels that exceed the state and nation and strong educational attainment levels.

## **Revenue Framework**

Corporate fund revenues are diverse in nature. Transaction taxes on the transfer of real estate, the lease or rental of personal property, and the lease of motor vehicles is the largest single revenue item at about 13% of the proposed 2022 budget (excluding ARPA funds and reserves), followed very closely by residual sales tax from the STSC.

State income taxes, service charges, and revenue from various fines and penalties each represent about 8% of the budget. About 10% of the budget is funded by internal service charges including payments from CPS for their proportion share of the city's contribution to the MEABF. Notably, property taxes fund a small portion of the budget (related to prior year library fund operations), but are directed to other funds in support of debt service and pensions.

Fitch expects longer-term revenue trends to exceed inflation based on Chicago's economic importance to the region, its diverse sector and business representation and the strong characteristics of its workforce.

The city is a home-rule unit of government, and as such enjoys the ability to raise or impose a wide variety of taxes and fees, many of which are legally unlimited.

## **Expenditure Framework**



Common to most U.S. local governments, personnel costs (including salaries and health care) account for the largest share of operating spending at approximately 63% of the proposed 2022 budget with contractual services representing 10%. By function, public safety is the single largest spending category at 50%.

Spending pressures have been headlined by significant increases in the contributions to four single employer pension plans covering municipal employees, laborers, police and firefighters. The proposed 2022 budget includes \$2.3 billion in pension contributions, an increase of \$460.7 million over the 2021 budget and up more than \$1.48 billion since 2016. The pension contributions for all four plans included in the proposed 2022 budget are equal to the actuarially-determined employer contribution. As a result, the city forecasts pension contributions rising at much more favorable pace of roughly \$50 million or less through 2026, subject to investment returns and other key plan assumptions.

Proposed 2022 pension payments are made from a dedicated property tax levy (\$1.4 billion), a water and sewer tax (\$321 million), contributions from enterprise and special revenue funds (\$270 million) and operating resources from the corporate fund (\$329 million). The city also released a request for proposal in April 2021 for the operation of a casino that it estimates would generate \$200 million in annual revenue statutorily dedicated for police and firefighter pension contributions. The casino project is subject to various hurdles and timing uncertainties which keep its financial impact an open question.

Expenditure flexibility is constrained given the large proportion of the budget devoted to public safety (which may be difficult to cut as a practical matter), and very high fixed carrying costs. The carrying costs for debt service, actuarially-required pension contributions and other post-employment benefit actual payments, accounted for 46% of 2020 governmental fund spending.

Pension contributions are far and away the largest component of this metric and expected to remain very high for an extended period of time. The actuarially-calculated pension contributions are based on an amount that targets a 90% funding ratio, rather than full prefunding, by 2058 for all funds. Actuarial assumptions include a 30-year open amortization, one of several factors that are likely to produce little funding progress absent the plans' consistently exceeding their 7.0% to 7.5% investment return targets (which Fitch views as unlikely).

### **Long-Term Liability Burden**

The long-term liability burden for total debt (direct and overlapping) and the Fitch-adjusted NPL is high at 34% of personal income. The NPL is the main driver of the city's long-term

liability burden, representing approximately 20% of personal income. The reported NPL in 2020 was \$33.0 billion or \$36.2 billion based on Fitch's standard 6.0% investment rate of return assumption. The ratio of assets to liabilities was a low 23.5% on a reported basis or 21.8% incorporating the Fitch adjustment.

The depletion dates for the municipal plan was eliminated and the other three plans' depletion dates were extended to 2073 or later as a result of the pension contribution ramp-up. While pension progress has been made (a 2010 actuarial analysis projected all four plans would be insolvent by 2030), the depth of the city's pension liabilities is expected to weigh on its long-term liability burden assessment and overall creditworthiness for an extended period.

Fitch includes both city and STSC debt in Chicago's long-term liability and carrying cost calculations. Outstanding debt amortization is slow with about 30% scheduled for retirement in 10 years. The city's 2021-2025 capital improvement plan totals \$11.2 billion, with proceeds from GO debt, tax increment revenue and other city resources expected to fund about 25% of the total cost (the remainder is largely funded from enterprise revenues plus state and federal funds). As such, Fitch expects the debt-portion of the long-term liability burden to remain fairly steady or climb at a manageable pace in the intermediate term.

## **Operating Performance**

Reserve levels, including those stemming from prior asset sales/leases, have been stable for an extended period of time. The city's high reserves are an important rating consideration, as they represent a cushion against risk to revenue volatility during economic downturns. The FAST model, which provides a relative sense of revenue risk exposure across Fitch's local government portfolio, yields a high 7.7% decline in the standard -1% U.S. GDP scenario.

The 'a' assessment also considers Chicago's midrange inherent budget flexibility assessment (underpinned by its broad revenue-raising authority and ongoing challenges resulting from a strong labor environment), high debt and retiree benefit costs and public service demands particularly with respect to public safety.

Chicago's budget management at times of economic recovery has improved markedly in recent years. Management has made significant progress toward achieving structural balance and federal stimulus has positioned the city to minimize the impact on service delivery and use of one-time measures in response to the large revenue gaps that materialized following the onset of the pandemic.

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](http://www.fitchratings.com/esg).

## RATING ACTIONS

ENTITY/DEBT	RATING			PRIOR
Chicago (IL) [General Government]	LT IDR	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Negative
● Chicago (IL) /General Obligation - Unlimited Tax/1 LT	LT	BBB- Rating Outlook Stable	Affirmed	BBB- Rating Outlook Negative

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**APPLICABLE CRITERIA**

[U.S. Public Finance Tax-Supported Rating Criteria \(pub. 04 May 2021\) \(including rating assumption sensitivity\)](#)

## APPLICABLE MODELS

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

FAST Econometric API - Fitch Analytical Stress Test Model, v3.0.0 ([1](#))

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Chicago (IL)

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