Chicago Board of Education is running out of time and money

By Gunjan Banerji
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Chicago Board of Education is in a bind with both the teachers' union and the Illinois legislature.

Chicago Board of Education (CBOE)'s split rating sugarcoats a souring financial condition, said Triet Nguyen, a managing director at NewOak Capital.

The district is trying to keep schools open in September with short-term debt and hopes the state legislature allows it to delay a USD 634m pension payment due on 30 June. The district authorized USD 1bn of Tax Revenue Anticipation Notes (TRANs) last Wednesday (24 June) at a school board meeting.

TRANs are not a real solution and are costly for the already distressed district, market participants said. When a school district is healthy, TRANS can be helpful to enhance liquidity early in the year, prior to receiving tax collections or state aid, one of the analysts said.

But in a crisis situation where a government got into an unanticipated bind, such as the case with CBOE, it can be very worrisome, said Donald Boyd of the Rockefeller Institute. The TRANs can help them get through the immediate cash crunch but if they need to borrow again to replace the notes, they are persistently at the mercy of financial markets, Boyd said.

Obtaining financing with your back against the wall will be very expensive, Nguyen said. If investors doubt their ability to repay notes and meet other obligations, they could pay exorbitant rates when they need to borrow again, or even risk loss of market access, Boyd said.

Straddling the ratings spectrum

Any credit that has reached a liquidity crisis of this level is probably not deserving of an investment grade, Nguyen said. The Board of Education's liquidity crisis was evident with its most recent USD 500m bond issuance, as the market rejected part of its proposed debt structure.

Since then, Moody's downgraded the credit to junk in May, Illinois Governor Bruce Rauner said that bankruptcy is a solution for the district, and CBOE ran out of money to pay for a USD 634m pension payment due by the end of June.

The credit still holds an investment grade rating by two ratings agencies: Standard & Poor's pegs it at A- with a negative outlook, and Kroll grades it at BBB+ with a stable outlook. Moody's has it at the junk rating of Ba3 with a negative outlook and Fitch has it at BBB- with a negative outlook.

"I think that spreads would indicate that a number of analysts believe that CBOE is of below investment grade," said Neene Jenkins, vice president of municipal credit research at AllianceBernstein.

A tranche of USD 97m Series 2010F general obligation bonds last traded on 29 June 2015 at 90.5 yielding 5.9%, according to Electronic Municipal Market Access.

“We continue to monitor the credit and will take into consideration how the budget gap for FY16 is resolved” said Kate Hackett of Kroll Bond Ratings Agency. The pledge of state aid revenues on debt service is a significant factor in assignment of a stable outlook, Hackett said.

“Standard & Poor's Ratings Services is closely monitoring the impact on the Chicago Board of Education (CBOE; A-/Negative) of a recent downgrade of its debt to noninvestment grade by another rating agency,” according to a report published by the agency 2 June 2015.

Series of short-term fixes

The district has unsuccessfully attempted to secure an extension from the Illinois legislature on making a USD 634m pension payments due 30 June. It failed to attain a three-fifths majority required by the House last week. CBOE might get a second chance this week if the House votes on Senate Bill 437, which would allow CBOE to delay the USD 634m payment to the Chicago Teachers Pension Fund.

Mayor Rahm Emanuel was reported to reject Governor Bruce Rauner’s offer to advance USD 450m in state funds to help the schools make the pension payment.

“One ball that has fallen positively for them is that the governor signed a general state aid bill,” said John Schomberg, a senior counsel at law firm Clark Hill. Schomberg was general counsel to former Illinois Governor Pat Quinn from 2010 to 2015.

Rauner signed House Bill 3763 on 24 June, which allows the state to provide funding to public school districts, even though the rest of the budget is at a standstill. While the district is making its plea on the 11th hour to delay its pension payment, it does so with the wind at its back thanks to Rauner’s funding relief, Schomberg said.

Nevertheless, the Chicago Teachers Pension Fund has repeatedly stated that it expects full payment. Unfortunately, Mayor Rahm Emanuel at a hearing for the pension extension was not able to provide a good answer about a partial payment, let alone a full payment, said House Representative Joe Sosnowski, R-6th District.

“It always worries me when at the last minute they decide that they need a decision and they have no plan to present. It’s either poor management, or poor planning, or they are trying to hide something,” Sosnowski said.
However, the district seems committed to making the payment because of the ratings reactions that may ensue if it doesn’t, Schomberg said.

Charles Burbridge of the Chicago Teachers Pension Fund expressed disappointment regarding the proposed delay but stressed the importance of a full payment to the fund in an emailed statement.

Dry pockets

Chicago may not be Detroit, but CBOE may be Detroit Public Schools. Theories such as the creation of a separate School Financing Authority to manage the district’s finances and issue debt on its behalf have emerged, as previously reported.

While there may not be much political appetite for Chapter 9 bankruptcy in Illinois, you don't have to have a Chapter 9 to have a bond default, Stern said. Investors don't like to think about this, Stern said.

It's a bad sign if annual debt service and pension costs are near 25% of total revenues, Nguyen said. It does not mean that the district will default, but it should not be investment grade, Nguyen said. The district's financials have been artificially boosted by one-shot deals.

The district's FY14 debt service and pension costs were 20% of FY14 revenues, and poised to encroach upon more of the district's revenues as pension costs grow. A USD 500m issuance will also cause debt service to rise.

"Nobody saw through that. The underlying structural trends were not positive," Nguyen said.

If the district runs out of money, it could find other ways to say that there is no more money, Stern said. CBOE's request to delay the pension payment is one example of officials saying that they cannot abide by the rules that were set up, Stern said.

It is not improper or illegal for someone who owes money to another and cannot pay it to negotiate an extension of the timing of the payment, a change in the amount of the payment, or negotiate an exchange of the defaulted (or soon to be defaulted) security for another security with more lenient terms, said Mark Berman, a bankruptcy attorney and partner at Nixon Peabody's financial restructuring and bankruptcy practice group.

CBOE's could reach the point where it cannot make debt service payments; however, the credit is of such high visibility that it would try to negotiate the debt first and bring bondholders to the table before simply defaulting, Nguyen said.

A CBOE spokesperson did not return requests for comment.