FOR CHICAGO, BANKRUPTCY IS NOT THE ANSWER

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Chicago's financial problems have recently received a great deal of attention, and some observers believe that the city is now financially insolvent. However, this is a cursory and simplistic analysis.

The real issue is whether total debt service including pension payments (as a percentage of annual revenues) have crowded out spending on essential government services and rendered Chicago "service insolvent."

Chicago's debts (including pension liabilities) are manageable so long as debt service does not exceed 20% of total revenue (a municipal rule of thumb). Once debt service rises above this level, it begins crowding out funding for necessary government services such as safety, sanitation, public transportation, and education. Citizens no longer receive high-quality services in exchange for high taxes. Once this "crowding out" begins, citizens begin to leave for other cities where taxes support a high-quality urban standard of living. In Chicago, debt service and pension expenses are approximately 25% of total revenues. Chicago's general obligation debt is still rated BBB+ (revenue bonds are rated A), but is on watch for potential downgrade, which could lead Chicago's debt being downgraded to "junk" if current trends continue. In contrast, Detroit's general obligation debt was restored last year to an investment-grade rating with a positive outlook for its future.

As the taxpayer population begins to shrink, cities often try to replace the resulting lost revenues with higher taxes on the remaining population and by borrowing. It would be otherwise too painful to keep spending in line with revenues and restore service quality by reducing expenses, given the bulk of municipal spending is represented by current and retired employees. Chicago is in the early stages of this "hollowing out," as it has already seen hundreds of thousands of its citizens emigrate over the past ten years. The city could end up resembling Detroit, which saw its population decline from 1.2 million in 1980 to 700,000 in 2012. However, Chicago still has time to voluntarily address its financial issues before ultimately defaulting on its debt, which led to Detroit filing for bankruptcy in 2013.

What are some of the objectives for a successful restructuring of Chicago's obligations? A successful restructuring should restore "service solvency" and lead to population growth, GDP growth, and – most importantly – per capita after-tax income growth. This will require substantial investment by Chicago in restoring essential city services, which is revenue otherwise allocated to pension and debt payments. Only after this analysis has been performed can Chicago determine how much can be paid to pensioners and creditors.

It will take years for the benefits of restoring service solvency to be realized. The near-term objective is measurable by reduced emigration. The case of Detroit, where Miller Buckfire, a Stifel Company, acted as the financial advisor to the State of Michigan and city, designing and executing the restructuring plan, is instructive. Since emerging from bankruptcy in 2014 (now over ten years ago), the population has been stable and has started growing. So, restoring service solvency does have immediate tangible benefits.

One might ask, why hasn't Detroit done better, and what does this mean for Chicago? Despite the dramatic reduction in Detroit's financial burden –

debt service costs declined from 40% to 11% of total revenues, and total debt declined by 70% from $10.5 billion to $3.3 billion because of the bankruptcy – Detroit has failed to execute a coherent development strategy to create jobs and increase economic activity. Chicago can learn a lot from the example of Detroit by continuing to focus on economic development.

Although unions and creditors are not to blame for the problems of Chicago, it is inevitable that both groups will have to accept reduced future payments for the obligations of which Chicago can no longer afford. Instead, Chicago should make the interests of the current and future citizens of Chicago its priority and central in planning a successful financial restructuring. Who speaks for them? The unions and creditors are fully capable of taking care of themselves.

Detroit was able to use Chapter 9 to solve its problems. We designed and executed a restructuring strategy which included raising the first ever municipal DIP financing, allocating $1.5 billion to restore city services and eliminate blight, creating a regional water authority, and saved the Detroit Institute of Arts from having to sell its collection. This was possible because Michigan State law allowed cities to file for Chapter 9 Bankruptcy and Detroit was found eligible for bankruptcy protection.

However, Chicago cannot address its financial problems in bankruptcy because Illinois State law does not permit its cities to file for Chapter 9 protection. Even if Chicago could file for bankruptcy, it is doubtful that it would be found eligible and in any case $21 billion of its funded debt are revenue bonds ($6 billion are general obligation bonds) – which are rarely compromised in bankruptcy. A consensual out-of-court restructuring of Chicago's pension obligations and general obligation debt is the most practical strategy.

Fortunately for Chicago and its citizens, the financial technology required to execute a comprehensive non-bankruptcy restructuring is well-developed and understood.

About Kenneth Buckfire

Kenneth Buckfire is Co-Founder & President of Miller Buckfire, a Stifel Company. Over the course of his career, he has advised clients in a broad range of industries and has won numerous awards for his achievements in the restructuring community, which have included The City of Detroit (Distinguished Service Medal of the Foreign Policy Association), the Harvey R. Miller Leadership Award, General Growth Properties (Mega Turnaround of 2010), and Calpine Corporation (Most Outstanding Mega Turnaround of 2008). Prior to founding Miller Buckfire, Kenneth was a Managing Director at Wasserstein Perella & Co. and served as co-head of the financial restructuring group. Before joining Wasserstein Perella, Kenneth was a Senior Vice President at Lehman Brothers. Kenneth is a Visiting Professor at Columbia Business School, where he teaches a course in corporate and government restructuring. Kenneth received his MBA from Columbia University and his B.A. in Economics and Philosophy from The University of Michigan. Read his full bio **here**.

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