PASSING THE BUCK

How Paul Vallas’s Toxic Deals Wreaked Havoc On Chicago and Philadelphia Schools

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ABOUT ACRE

The **Action Center on Race & the Economy** (ACRE) drives campaigns that fight for structural change. ACRE directly takes on the financial institutions and megacorporations that are responsible for pillaging communities of color, devastating working-class communities, subverting the democratic process, and harming our environment.
Chicago mayoral candidate Paul Vallas touts his record of balancing budgets and fiscal responsibility, but a close look at his financial policies as the Chief Executive Officer of Chicago Public Schools (CPS) and the School District of Philadelphia (SDP) shows a pattern of kicking financial problems down the road and leaving future generations of schoolchildren with the bill.

While Vallas was CEO, CPS:

- Started a pattern of skipping pension payments, which ultimately led the Chicago Teachers’ Pension Fund to go from being fully funded to having a $9.6 billion shortfall;

- Borrowed $666.2 million using “the school district equivalent of a payday loan,” which ultimately cost CPS $1.5 billion in interest; and

- Took out a variable-rate bond, which CPS later had to take out a toxic swap deal to try to manage, ultimately costing taxpayers nearly $32 million.

Under Vallas’s leadership, SDP took out a series of toxic swap deals, which ultimately cost Philadelphia taxpayers more than $161 million.

In each of these cases, Vallas took measures that helped him balance his budgets by pushing his administration’s costs onto future generations of Black and brown schoolchildren, teachers, and taxpayers.

Paul Vallas has a record of kicking financial problems down the road and leaving future generations of schoolchildren with the bill.
Pensions are deferred wages that employers owe workers for the work they have already done. People who work for employers that offer pensions agree to accept lower wages so their employer will put the extra money that otherwise would have been part of their wages into a pension fund. The pension fund then invests those deferred wages and, when workers retire, there is enough money there to pay for their pensions.

When Paul Vallas took over as CEO of Chicago Public Schools, the Chicago Teachers’ Pension Fund (CTPF) was fully funded. This is because CPS had been making its pension contributions on time every year until then. However, Vallas started the dangerous trend of declaring pension holidays in 1999. Because the pensions were so well-funded, he decided to skip pension payments and instead use teachers’ deferred wages to plug holes in other parts of his budget.

Even the conservative-leaning Illinois Policy Institute (which has aligned itself against Vallas’s opponent in the Chicago mayoral race) described the situation thusly: “CPS’ problems began in 1995 when politicians started treating the pension system as a slush fund, draining billions of dollars from teachers’ retirements for political benefit.” Vallas served as CEO of CPS from 1995 through 2001.

Vallas opened the floodgates. CPS declared pension holidays for 13 consecutive years, refusing to put money teachers had already worked for into their pension fund. The pension fund’s losses compounded during this time. Not only was it missing out on the annual pension contributions but it also was unable to invest those contributions and make a return. As a result of these pension holidays and a weak stock market, CTPF had a $9.6 billion shortfall by 2013. The pension contributions required to make up for the payments that were skipped during these pension holidays played a significant role in CPS’s perennial budget crises over much of the past decade.

As of June 2021, CTPF’s funded ratio was still less than 50%, down from 100% in 1999.
VALLAS TOOK OUT PAYDAY LOAN-TYPE DEBT

Vallas literally borrowed against Chicago schoolchildren’s futures when he took out $666 million in capital appreciation bonds, a form of debt in which the borrower pays nothing for several years but then has to pay very large sums to make up for the skipped payments.

A capital appreciation bond (CAB) is a long-term bond with compounding interest on which the borrower is not permitted to make any principal or interest payments for many years. In this way, it is similar to a negative amortization mortgage, in which the outstanding principal actually grows over time because the unpaid interest gets tacked on to the amount owed and compounds. Because of this structure, borrowers often end up paying extraordinarily high interest rates over the life of the bonds. Former California State Treasurer Bill Lockyer called CABs “the school district equivalent of a payday loan.”

Vallas took out three CABs totaling $666 million while he was CEO of CPS. CPS will ultimately pay $1.5 billion in interest on these three bonds, for an effective interest rate of 233% over the life of the bonds. Table 1 details the interest costs of these deals.

Table 1: CPS’s CAPITAL APPRECIATION BONDS UNDER VALLAS

<table>
<thead>
<tr>
<th>Bond</th>
<th>Principal Amount Borrowed</th>
<th>Years Without Any Payments</th>
<th>Total Interest Cost</th>
<th>Interest Rate Over the Life of the Bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997A Bonds</td>
<td>$38.0 million</td>
<td>14 years</td>
<td>$52.5 million</td>
<td>141%</td>
</tr>
<tr>
<td>1998B-1 Bonds</td>
<td>$328.7 million</td>
<td>11 years</td>
<td>$816.8 million</td>
<td>248%</td>
</tr>
<tr>
<td>1999A Bonds</td>
<td>$299.5 million</td>
<td>8 years</td>
<td>$617.3 million</td>
<td>206%</td>
</tr>
<tr>
<td>Total</td>
<td>$666.2 million</td>
<td></td>
<td>$1.5 billion</td>
<td>223%</td>
</tr>
</tbody>
</table>
When school districts and other governmental entities borrow money, they have a choice: they can take out a conventional fixed-rate bond or a variable-rate bond. With a fixed-rate bond, borrowers are able to lock in a set interest rate and payment schedule ahead of time so there are no surprises. A variable-rate bond, on the other hand, is similar to an adjustable-rate mortgage. In the near-term, it may be possible to get a lower interest rate, but because the rate fluctuates over time, there is always the risk that interest payments can skyrocket down the line.

In 2003, the Illinois General Assembly passed a new law that led to the proliferations of variable-rate bonds in the state. This law officially blessed variable-rate bonds and also enabled borrowers to enter into interest rate swaps to help offset the risk of spiking interest rates. Prior to the passage of this law, CPS had relied almost exclusively on fixed-rate bonds for its borrowing.

One notable exception was the 2000B, 2000C, and 2000D General Obligation Bonds that CPS took out under Vallas’s leadership. These bonds consisted of $303 million in debt that could toggle between variable-rate and fixed-rate interest modes. Because variable-rate bonds start with lower interest rates than fixed-rate bonds, public officials looking for ways to save money often turn to them. However, the upfront savings are loaded with a lot of risk down the line. At the time that Vallas took out these bonds, school districts in Illinois were not yet permitted under state law to enter into swaps to offset the variable-rate risk.

By 2007, the 2000C bonds were in variable-rate mode. Vallas’s successor, Arne Duncan, entered into swap deals to mitigate the interest-rate risk of the 2000C bonds. However, this backfired on CPS and ultimately cost the district $31.8 million, as Table 2 shows.

Interest rate swaps are a type of derivative instrument that was often pitched to municipal borrowers as a way to protect against rising interest rates on variable-rate bonds. However, these deals were laden with a whole host of risks. Perhaps the biggest risk was posed by the egregious termination clauses embedded in the toxic swap agreements. Because these clauses are typically triggered when
borrowers fall under financial distress, they serve to compound financial woes by hitting municipalities with stiff penalties when they can least afford them. For example, CPS’s credit rating downgrades in 2015 triggered $240 million in termination penalties on the school district’s toxic swap deals.

School districts and other municipal borrowers that entered into toxic swaps unwittingly took on other risks as well. For example, swaps were supposed to protect against spikes in interest rates, but they backfired when the Federal Reserve slashed interest rates to near zero in response to the 2008 financial crisis. Not only did the net payments on the swaps rise, but many borrowers were unable to take advantage of the low interest rate environment to refinance because they could not get out of their 20- or 30-year swaps without paying penalties. Furthermore, the sharp decline in variable interest rates actually caused the termination penalties on these toxic deals to balloon, so at precisely the time that it would have been most advantageous for borrowers to refinance their bonds, the penalties to get out of the corresponding swap deals were higher than ever before.

As Table 2 shows, CPS lost $15.7 million in net payments on the swap connected with Vallas’s 2000C bonds, but then it had to pay another $16.1 million in termination penalties when it was forced to end the deal early following its credit rating downgrade in 2005.

### Table 2: CPS’S TOXIC SWAPS LINKED TO VALLAS’S BONDS

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Swap Payments</td>
<td>$15.7 million</td>
</tr>
<tr>
<td>Termination Penalties</td>
<td>$16.1 million</td>
</tr>
<tr>
<td>Total Losses on Toxic Swaps</td>
<td>$31.8 million</td>
</tr>
</tbody>
</table>

**VALLAS DRAGGED PHILADELPHIA SCHOOLS INTO TOXIC SWAP DEALS**

As CEO of the School District of Philadelphia (SDP) from 2002 through 2007, Vallas also led SDP into toxic swap deals. In 2004, SDP took out ten interest rate swaps to mitigate the risk of $691 million of underlying variable-rate bonds. These swaps locked SDP into decades-long deals. Six of the swaps were set to expire in 2030 while another four were set to expire in 2021.
After the 2008 financial crisis, the net payments on these swaps skyrocketed. SDP terminated nine of these toxic swaps early in 2010 and 2011, paying $89.6 million in termination penalties. The tenth swap expired in 2011, as originally scheduled. In all, SDP paid $71.9 million in net swap payments on these deals, in addition to the termination penalties, bringing the total costs of Vallas’s toxic swap deals to $161.5 million.

<table>
<thead>
<tr>
<th>Table 3: PHILADELPHIA SCHOOLS’ TOXIC SWAPS DEALS</th>
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<tr>
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VALLAS’S DISEAPPEARING ACT

Chicago mayors like Lori Lightfoot, Rahm Emanuel, and Richard M. Daley have a long history of making short-sighted decisions that helped them fill budget holes but cost taxpayers dearly in the long run. Whether it was the privatization of the city’s parking meters or scoop-and-toss financing schemes, Chicagoans are still paying for their reckless decisions.

Paul Vallas is cut from the same cloth. His record as the head of both the Chicago and Philadelphia school districts shows he repeatedly balanced his budgets by mortgaging the future. Whether it was by skipping payments or entering into risky deals, time and again, Vallas stuck future taxpayers, students, and teachers with the tab in order to save money while he was in office. His financial shenanigans cost the two districts $1.7 billion in predatory debt deals and paved the way for a nearly $10 billion shortfall in the Chicago Teachers’ Pension Fund. Vallas got to take credit for supposedly “fixing” Chicago and Philadelphia schools, but when it came time to pay the bill, he was long gone.
ENDNOTES


2. Ibid, 1.

3. Ibid, 1.

4. Ibid, 3-4.


6. Dabrowski, Ted, John Klingner, and Tait Jensen. 3


15. Analysis of Chicago Public Schools’ interest rate swaps based on the CPS’s Comprehensive Annual Financial Reports (2006-2016), the official statements of the underlying bonds, and historical LIBOR rates.


