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Detroit Bankruptcy Update: New Plan Would Pay G.O. Bondholders 74%

Under a new proposal released April 9th, holders of Detroit's unlimited tax general obligation (G.O.) bonds would receive 74% of the pledged tax revenues, with the remaining 26% diverted to the benefit of Detroit's pension obligations. Prior to this agreement, Detroit's emergency manager had proposed paying G.O. bondholders only 15% to 20% of their outstanding claims. While bondholders are likely to be paid in full from the bond insurance that guarantees Detroit's G.O. debt, the agreement represents a significant shift in how the emergency manager proposes to treat G.O. bonds in bankruptcy.

The G.O. settlement plan was crafted by court-appointed mediators working to reach agreement between the city and the municipal bond insurers that guarantee all of Detroit's G.O. bonds. By reaching agreement through mediation, both sides avoid the looming prospect of the bankruptcy court choosing an "all-or-none" solution that would either approve the city's 15% proposal, or provide secured status with 100% payback to the bond insurers. This new plan must still be approved by the bankruptcy court.

The original restructuring proposal from the emergency manager classified G.O. bonds as unsecured obligations, even though they are backed by the unlimited property tax pledge of the city. The original plan stated that the city could not raise the levy sufficiently to pay off bonds in full because that would drive businesses and residents out of the city, further eroding the property tax base and tax revenues. In mediation, the bond insurers (representing G.O. bondholders) argued that since property taxes are pledged to make bond payments, if they were not being used to pay bonds they could not be collected by the city. The mediated settlement plan doesn't stipulate that G.O. bonds are secured debts, but it does appear to implicitly recognize that argument by taking the property tax revenue stream and breaking it into two separate cash flows: 76% legally pledged to support new state bonds that will repay the existing Detroit G.O. bondholders and 24% legally pledged to flow into funds to pay city retirees.

Since the emergency manager's original proposal, which assigned unsecured status to G.O. bonds and a recovery of less than 25%, there has been a great deal of concern in the municipal marketplace over the security of the general obligation pledge. Many market participants believe that the value of G.O. pledges generally would be undermined and the value of G.O. bonds generally would be diminished relative to other security structures. The new proposal wouldn't legally settle the issue, though we believe it would alleviate some amount of investors' concern. The proposal doesn't explicitly establish G.O. bonds as secured obligations, though it does appear to recognize that there is a strong argument for that status. If approved by the court, the plan would represent a negotiated settlement rather than a precedent-setting court decision. As such, it would leave the question open for future cases.

We will continue to closely follow Detroit's bankruptcy and its potential impacts on the municipal market. We continue to believe that high quality municipal bonds with strong credit ratings and solid structural protections present very little credit risk for investors. Consequently, we continue to purchase and hold both G.O. and revenue bonds, and do not view one structure as inherently "safer" than another. At Ascent, our approach is to utilize careful credit selection, and avoid holding bonds which are more likely to develop into problem credits. Through careful screening and ongoing surveillance, we believe investors can significantly limit the majority of credit risks.



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