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from Montage Investments

Detroit Files Largest-Ever Municipal Bankruptcy

On July 18th, the city of Detroit filed a petition for Chapter 9 bankruptcy, making it the largest U.S. municipality to ever seek bankruptcy protection. Detroit, the 18th largest city in the U.S., displaces Jefferson County, Alabama as the largest-ever Chapter 9 filing. Detroit's move comes after the city was unable to negotiate a restructuring with creditors of roughly $19 billion of debt and other liabilities.

Ascent holds no Detroit bonds of any type, though Detroit general obligation bonds and pension funding certificates are widely held by mutual funds and other large institutional investors. The impact of the bankruptcy on market values of Detroit's securities will vary depending on the specific security structure. Some market analysts expect that bonds from all issuers in Michigan could demand a yield premium (lower prices) as investors weigh the relative investment risk in Michigan municipal bonds. We do not believe that Detroit's filing necessarily suggests an increase in credit risk for Michigan municipalities as a whole, and we continue to seek value opportunities in high quality Michigan municipal bonds with very strong credit protections.

Summary of Detroit's Outstanding Liabilities

	Estimated Amount Outstanding ($)
Unsecured Obligations	
Unlimited tax general obligation bonds and notes	$650,000,000
Pension funding certificates of participation	1,400,000,000
Unfunded OPEB liabilities*	5,700,000,000
Unfunded pension liabilities	3,500,000,000
Other Liabilities	300,000,000
Total Unsecured Obligations:	**$11,550,000,000**
Secured Obligations	
Sewer revenue bonds	$3,400,000,000
Water revenue bonds	2,600,000,000
State-aid secured limited tax general obligation bonds	450,000,000
Swap liabilities	890,000,000
Other	100,000,000
Total Secured Obligations:	**$7,440,000,000**
Total Outstanding Obligations:	**$ 18,990,000,000**

* Other Post-Employment Benefits (OPEBs) include retiree health care benefits, survivor benefits and other non-pension retiree obligations.

Source: City of Detroit

Detroit now faces a long and expensive legal process to restructure its finances and rebuild a stable long-term foundation. The city's state-appointed emergency manager predicts that Detroit could emerge from Chapter 9 in late 2014. We believe the process is likely to take at least two to three years and could stretch beyond that. Creditors are lining up to challenge the city's bankruptcy filing - the city's two retiree pension funds sued on July 17th to prevent Detroit from seeking bankruptcy protection. If the city's filing is approved (and we expect it to be), only then will the bankruptcy process begin in earnest.

Michigan has a long history of actively supporting struggling municipalities through strong state oversight and programs to provide interim funding to struggling cities and school districts. Michigan's governor had taken a hard line against municipal bankruptcy, stating that he would never approve a filing by a Michigan municipality, but the size and depth of Detroit's problems appear to have overwhelmed the state's willingness to help. In an abrupt about face from earlier this year, Governor Rick Snyder not only approved the city's filing, but stated that bankruptcy appeared to be the only way "to radically restructure the city and allow it to reinvent itself without the burden of impossible obligations."

We do not believe that Detroit signifies a higher overall level of credit risk for municipal investors. Rather we view Detroit as a unique situation and one that was readily apparent to investors who paid attention to the warning signs. As we discussed in the July 2 Municipal Market Comments, Detroit's difficulties have been apparent for a long time. While the full depths of the city's financial problems might not have been understood before the emergency manager's workout proposal was released in June, the forces pushing the city toward insolvency were clear:

- Detroit's demographics have been deteriorating for more than 50 years. The city's population has declined from 1.9 million in 1950 to approximately 700,000 in 2010. From 2000 to 2010, Detroit's population dropped by 25%. Detroit's tax base has been steadily shrinking and the city reportedly has more vacant properties than any other large U.S. city (both by number and by % of total tax parcels). The city's unemployment rate is twice the national and state average while per capita income levels are only half the Michigan average level.
- Detroit's finances have been on an unsustainable path since the late 1990s and were made worse by the financial crisis and recession. Detroit has run a governmental funds deficit of roughly $100 million annually since 2007, against a total budget of approximately $2 billion. The accumulated deficit in all governmental funds at the end of fiscal year 2012 was $1.55 billion. The city has only been able to operate by borrowing against future revenues.
- Since the mid-2000s, the city has been unable to issue new G.O. bonds without providing the additional security of a state pledge to intercept aid payments to the city in a first-dollar, lock-box security structure. The unlimited-tax G.O. bonds issued since 2000 have all carried municipal bond insurance.
- In response to a significant pension funding shortfall in the mid-2000s, Detroit issued pension funding certificates totaling more than $1.5 billion. These bonds have locked up the city's casino revenues while at the same time pension liabilities demanded an ever-growing portion of the city's shrinking general revenues.

We will continue to monitor Detroit's bankruptcy proceedings very closely. The city's emergency manager has proposed paying off "unsecured" claims, including unlimited tax general obligation bonds at approximately 20 cents on the dollar or less. How the bankruptcy court proceeds with balancing bondholder claims, retirement fund claims and other creditors could set significant precedents regarding the security of municipal bond legal structures in bankruptcy going forward.

In the coming weeks, we will publish additional comments discussing the potential implications of Detroit's case on tax-backed general obligation bonds. We will also highlight how Ascent's approach to credit selection and portfolio structuring minimizes investors' risk of impairment regardless of how the bankruptcy court ultimately treats bond investors' claims.

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