Municipal Market Comments

Ascent Investment Partners

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from Montage Investments

Voter Reject Michigan's Emergency Manager Law

On November 6, voters in Michigan overturned the state's Public Act 4, which allowed the state to appoint an emergency manager for fiscally stressed municipalities. Michigan's Act 4, passed in 2011, permitted the governor to appoint a manager with powers over all aspects of local government, including the powers to alter budgets, sell assets and void existing labor contracts. Act 4 was opposed by local government officials and public employee unions that claimed the law took too much power from elected officials and placed it in the hands of a single manager accountable to no one except the Governor. Champions of Act 4 pointed to the ability of the state to step in and manage municipalities that were failing under local leadership and avoid defaults or Chapter 9 bankruptcy filings that occur in other states. The bond market was generally supportive of Act 4, viewing it as an important tool for managers to ensure that issuers' obligations were met regardless of the steps needed to ensure payment.

Prior to the election, Michigan (current ratings Aa2/AA-/AA-) had five cities and three school districts operating under emergency managers: the cities of Flint, Benton Harbor, Pontiac, Ecorse and Allen Park; and school districts in Detroit, Highland Park and Muskegon Heights. With the rejection of Act 4, the state appears to fall back on an earlier emergency financial manager law (Public Act 72) that still permits the governor to appoint a financial manager, but without the sweeping powers to control all local government actions. Act 72 is also facing legal challenge, by the same groups that led the fight against Act 4. At this point, it remains unclear how the state will manage financially troubled local governments going forward.

According to figures reported by Bloomberg News, Michigan bonds generally have seen an increase in yield levels (drop in price) since Election Day due to market concerns that the state now has less power to step in to help its financially troubled local governments. The fear is that this lack of strong control could lead to an increase in defaults or bankruptcies down the road. Some commentators have gone so far as to speculate that Michigan could be hit with a wave of municipal bankruptcies as a result of the rejection of Act 4, painting the state as "the next California". ***We do not view the defeat of Act 4 as a significant negative development for investors in Michigan municipal bonds generally, and***

we would view general weakening in Michigan bonds as an opportunity to search for high quality issuers at attractive yield levels.

Even without Act 4, Michigan has many controls in place to ensure that local governments meet their obligations. Through the Michigan School Bond Qualification and Loan Fund, which provides credit enhancement for the majority of local school district bonds issued in Michigan, the state has a strong position from which to oversee local school districts' financial health and budget management. The State also extends loans through the program to help financially pressured districts.

Michigan also has a very strong state policy on Chapter 9 bankruptcy. Local governments may only seek protection under Chapter 9 if permitted under state law. Currently, approximately three dozen states have laws permitting political subdivisions to seek municipal bankruptcy. Michigan is one of the states that permits Chapter 9, but the path to bankruptcy in Michigan is one of the toughest among the states. Unlike California, local governments in Michigan must seek the approval of the Governor in order to pursue Chapter 9. The current Governor has stated that he will never approve a bankruptcy filing by a municipality in the state. While that position could soften over time or with a change of administration, Michigan has in place multiple levels of state oversight and assistance that could be applied long before the situation reaches the point of insolvency.

While it is certainly possible that it could now be much harder to effectively manage financially troubled municipalities onto a path to recovery, we do not expect a broad increase in credit risk in Michigan following the election outcome. Ascent continues to invest in municipal bonds in Michigan – as in all states – on a credit-by-credit basis. By doing so, we can select issuers that demonstrate strong financial management and solid underlying credit characteristics, and take advantage of any weakening in the market based on hasty generalizations and overreaction to headline risk.

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