Municipal Market Comments

Ascent Investment Partners

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Detroit's Bankruptcy Offers Muni Investors Some Lessons for the Future

On December 10, Detroit emerged from its 18-month municipal bankruptcy. Detroit's final plan of restructuring allows the city to shed $7 billion of bond and pension obligations. Under what is being called the Grand Bargain, the city's unlimited tax general obligation (G.O.) bonds will be repaid at approximately 76% of their par value. However, because all of the city's unlimited tax G.O. bonds carry bond insurance, investors will actually be repaid by those policies in full. The value of some city pensions (i.e., police and firefighters) will be slightly modified, while general city employees stand to lose approximately 25% of the value of their long-term pensions.

As the dust begins to settle, we believe that municipal bond investors would be wise to consider the lessons the Detroit bankruptcy may provide for future municipal workouts. Among the key takeaways are:

- **Municipal bankruptcy is a very political process.** Investors need to acknowledge that municipalities are political entities, managed by elected officials that may consider investor interests to be subordinate to the interests of taxpayers or to strategic political considerations. Investors should not expect to be treated "fairly" if their interests are not aligned with the larger political interests of the municipality and the state in which it resides.
- **Bankruptcy is a long and expensive process.** Although it took a year and a half, Detroit's Chapter 9 filing actually proceeded much faster than most municipal bankruptcies. However, Detroit was only able to expedite the process because it had the full support of Michigan's governor and local business leaders. Even so, the costs to the city for filing bankruptcy (primarily legal and consulting fees) are estimated to be as much as $200 million. For investors, bonds from bankrupt municipalities may experience long payment delays that can erode their values even if they ultimately repay full principal.
- **There is very little legal precedent in municipal bankruptcy.** Even though there have been a number of high profile Chapter 9 filings in recent years (Detroit, Jefferson County (AL), Stockton and San Bernardino (CA)), the majority of completed restructurings have resulted from negotiated settlements rather than litigated cases. To date, each case has been unique, and investors have no reason to believe that the path and outcome in Detroit will provide a meaningful guide to how any other municipality's Chapter 9 filing might be resolved.

- **General Obligation bonds may not be the safest structure.** In Detroit's case, the ultimate settlement of unlimited tax G.O. bonds resulted from negotiations. Consequently, the security status of G.O. debt under federal bankruptcy law remains unclear.
- **It is not clear that revenue bonds are much safer.** Detroit's emergency manager also proposed a haircut to the value of the city's outstanding water and sewer revenue bond, even though those securities are explicitly secured by a pledged revenue stream. Many investors rely on such security pledges for protection in fiscally distressed situations, but we believe that in a bankruptcy, municipalities could be more than willing to try to force concessions from "secured" revenue bond holders as well.
- **Bondholders need to have advocates with deep pockets.** In Detroit, the city initially proposed repaying G.O. bonds at approximately 15 to 20 cents on the dollar. Only the strong legal challenges by the municipal bond insurers forced the city to negotiate a much higher settlement value. If individual investors are left to fight for their own interests, we believe they are likely to be overwhelmed by the larger, better resourced creditors and issuers.
- **Bond insurance provides significant value in bankruptcy – if your insurer is able to pay the claims.** Holders of insured Detroit bonds of all types will receive the full principal and interest payments on their bonds because the insurers are able to pay those claims. While bond insurance can provide protection in the short-run, the health of the insurance companies themselves is subject to a significant degree of credit and market risk. Given our experience through the financial crisis and collapse of the bond insurance industry in 2008 and 2009, we do not view bond insurance as dependable long-term credit support.

In our view, the overriding lesson of Detroit is that conservative investors can avoid the market and credit risk inherent in these situations through careful credit selection. Detroit's Chapter 9 filing did not happen overnight – the city was a distressed credit for many years before it tipped into bankruptcy. Investors doing reasonable surveillance on their portfolios should have seen the warning signs in Detroit, allowing them to make better informed risk/reward decisions about their holdings. Ascent has successfully avoided municipal defaults and impairments to date. We believe that this is because we perform careful credit evaluation prior to purchase and perform active surveillance of all of the bonds that we hold.

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