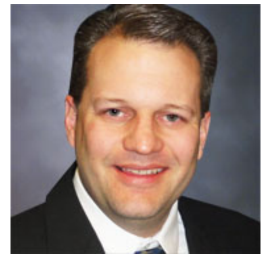
Commentary – Special Topics

August 2013

Detroit Makes History



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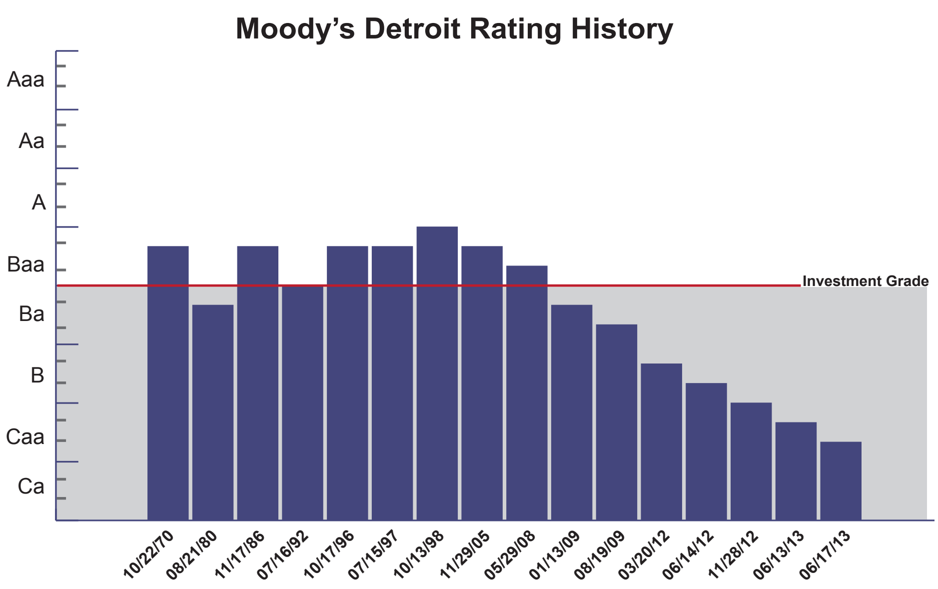
On July 18th, after years of struggling with a weak economy, declining population, financial mismanagement, corruption and political infighting, Detroit has finally filed for bankruptcy. With more than $18 billion in liabilities it is the largest municipal bankruptcy in U.S. history. While the city's bankruptcy filing is a colossal event in the municipal market, its eventuality has been expected by many for some time.

Owning no Detroit debt in our portfolios makes our sideline chair a rather comfortable perch for watching what is sure to be a long-fought legal battle; however, we will be watching the events unfold closely as Detroit's case has the potential to set precedent for others considering filing for municipal bankruptcy, also known as Chapter 9. The fallout from this case could have a broad impact on the way rating agencies and the municipal market overall evaluate municipal debt securities.

A Long Road to Insolvency

Detroit has long been a struggling credit. It was first rated in the junk category by Moody's back in 1980, regained an investment grade rating in 1986 but once again fell to junk levels in 1992, only to reemerge as investment grade in 1996. Detroit made its most recent descent into junk ratings in 2009 and has been declining ever since.



Source: Moody's. For ratings with no numerical modifier assigned, a value of 2 was assigned for the purposes of the graph.

Detroit has had many issues over the years but one of the largest problems has been population decline. The city's infrastructure was built to support a population of more than 1.8 million, but the population has declined in recent

When Moody's assigns a speculative grade rating (ratings of Ba or lower) the rating reflects a much more material risk of default. A bond's idealized loss rate following a default begins to be a consideration in assigning the rating. By assigning Detroit's Unlimited Tax General Obligation bonds a Caa3 rating following the bankruptcy filing, Moody's is implying a loss rate of 15.3 - 42.6%.

Moody's Rating	Implied Expected Loss Rate Range
Ba	1.7 - 6.4 %
B	6.4 - 15.3%
Caa	15.3 - 42.6%
Ca	42.6 - 70.7%
C	70.7 - 99.5%

Source: Moody's

years to less than 700,000. Add in a declining tax base, a struggling economy heavily focused on the auto industry, high tax and crime rates, political infighting, corruption and low wealth indicators and serious financial problems caused by a shrinking population become a ticking time bomb. For years Detroit has been forced to borrow to cover annual operating deficits and the city has had a negative general fund balance since 2005. Earlier in 2013, the situation grew too big for the city to handle and forced Michigan's governor to make use of the state's emergency manager statute, placing the city under the control of an Emergency Manager. To give some perspective to the magnitude of Detroit's problem, Jefferson County Alabama – formerly the largest U.S. municipality to file for Chapter 9 – sought protection from $4.23 billion in liabilities, equating to $6,409 per resident. Detroit's $18 billion filing represents $26,277 per resident.

Tenets of the Emergency Manager Plan

Detroit's Emergency Manager, Kevyn Orr, released a plan on June 14, 2013 and warned creditors that if progress wasn't made in negotiations on debt restructuring the city would file for bankruptcy a minimum of 30 days after the proposal's release. Given the Emergency Manager Plan (the Plan) would pay unsecured creditors less than 20% recovery, it wasn't a surprise that creditors weren't willing to accept the proposal. On July 18th, Orr made good on his ultimatum and filed for bankruptcy.

Detroit's restructuring plan is unique compared to other municipal bankruptcies in that it is specifically focusing on bondholders and pension obligations to solve its fiscal problems. One of the main tenets of the Plan is the categorization of liabilities as either secured or unsecured – that is to say whether the liability is backed by another asset or not.

According to the Plan, $11.55 billion in liabilities are categorized as unsecured. The plan places $650 million of the city's unlimited tax general obligation (UTGO) and general obligation (GO) bonds on par with $5.7 billion in retiree health care benefits, $3.5 billion in unfunded pension liabilities and $1.5 billion in pension certificates as unsecured liabilities. Orr is proposing that all unsecured creditors be treated equally. As part of the restructuring plan, Orr ordered an immediate moratorium on repayment of all unsecured debt, which led to a default on a $39.7 million pension certificate payment that was due June 14th. The next general obligation debt service payments are due in October 2013.

The handling of secured obligations is not expressly delineated in the Plan but Orr has stated they are subject to negotiation. Debt categorized as secured obligations totals approximately $7 billion, including $5.9 billion in water and sewer revenue bonds and $480 million in GO debt (considered secured by a state aid intercept component). It is of interest to note that in the municipal investment community, GO bonds have traditionally been viewed as the strongest security type in the sector because they are backed by the full faith, credit and taxing power of the issuer. In contrast, revenue bonds are backed by a specific source of revenue and repayment is dependent upon that revenue stream. In the case of UTGO bonds, Detroit's stated intention to include them in a repayment moratorium is nearly unprecedented.

General Obligation-Unlimited Tax (UTGO)
UTGO's have a dedicated property tax levy - that is voter approved - for the bonds and the municipality is authorized and required by law to levy and collect ad valorem taxes upon all taxable property in the city, without limitation as to rate or amount, to pay principal and interest on the UTGO bonds when due.

General Obligation-Limited Tax (GO)
Limited Tax GO's do not have a dedicated levy and therefore compete with other general fund expenditures. Michigan state statute says that limited tax GO bonds are payable from any funds available to the city for the purpose as a first budget obligation, including the proceeds of annual ad valorem property tax, subject to certain tax rate limits.

Why This Is Not Just a Large Bankruptcy

Filing for bankruptcy and having debt expunged is a complicated process. Chapter 9 has not been well tested, leaving a lot of uncertainty regarding how various matters will be handled by the courts. In our view, perhaps the most significant question for the courts to decide is whether Michigan state laws that protect pensions and debt obligations take precedence over federal bankruptcy law, or whether the state effectively waived that right by allowing a municipality to participate in a federal bankruptcy proceeding. Legal arguments could center on two provisions of the U.S. Constitution:

- Article 6, which declares federal laws to be supreme
- The 10th Amendment, which reserves for the states all powers not constitutionally delegated to the federal government (e.g., protection of public employee pensions)

Other important issues we believe the court will consider in its upcoming hearings include:

- Municipal pensions enjoy protection under Article IX, Section 24 of the Michigan State Constitution, which states that the contractual obligation "shall not be diminished or impaired"
- Orr's Plan may not have fulfilled the requirement in Michigan Public Act 436 (emergency manager statute) to "provide for payment in full of the scheduled debt service requirements on all bonds, notes and municipal securities of the local government"
- Whether UTGO debt with a dedicated tax levy and voter approval will be classified as secured debt

In the Detroit proceeding, Orr's proposal steps away from the traditional way of handling GO and pension liabilities and ranks them equal in priority of payments with other unsecured liabilities. This is important because it will be the first time a large municipality tries to force large losses on GO debt bondholders through Chapter 9 and it may set a precedent going forward on priority of payment of GO debt vs. unfunded pension obligations.

Will Detroit Spark Additional Bankruptcies?

We do not see a risk of widespread contagion of Chapter 9 bankruptcy filings coming from the Detroit proceeding. Detroit has been struggling for decades and has some unique circumstances that have led to the filing. If Detroit is successful in reducing GO and pension liabilities in bankruptcy, it is possible other seriously distressed credits that have reached the breaking point may attempt to use Chapter 9 as a tool to help them back to stability. However, we feel Chapter 9 will not be a viable option for the majority of municipal issuers for a number of reasons:

- First - A municipality has to be located in a state that permits municipalities to file bankruptcy. Currently only about half the states do.
- Second - A municipality has to pass several tests in order to prove it is eligible for bankruptcy protection, which has historically been a high bar.
- Third - Chapter 9 proceedings are expensive. One estimate predicts the cost of Detroit's bankruptcy could exceed $100 million.
- Fourth - A stigma persists around municipalities filing for bankruptcy, making it more difficult to attract businesses and residents to the community.
- Finally - Chapter 9 is simply not often needed.

The municipal market is a very high-quality market with over 93% of the Moody's universe rated single A or higher in 2012. As a comparison, only 23% of corporate credits rated by Moody's were single A or higher in 2012. Chapter 9 bankruptcy filings are extremely rare. Looking at Chapter 9 filings from 2006 through the first quarter of 2013 – arguably the toughest period in municipal finance since the Great Depression – there were a total of 69 Chapter 9 filings. As a comparison, more than 300,000 businesses filed for bankruptcy in the same period.

	Total Municipal Bankruptcy Filings	Total Business Bankruptcy Filings[1]
2006	5	19,695
2007	6	28,322
2008	4	43,546
2009	12	60,837
2010	7	56,282
2011	13	47,806
2012	20	40,075
2013*	2	8,512
Total	69	305,075

*1st Quater 2013

[1]Business filings - If the debtor is a corporation or partnership, or if debt related to operation of a business predominates, the nature of the debt is business. Total includes business filings under Chapters 7, 11, 12 and 13.

Source: United States Courts

Why the Detroit Case Matters to Munis

The biggest risk we see coming from the Detroit case keys on whether Orr is successful in his plan to classify UTGO debt in the same category as other unsecured debt. If that happens, the rating agencies may potentially revise their methodologies for rating GO debt, leading to possible downgrades on GO credits in Michigan and perhaps nationally. Fitch and Moody's have made comments stating that depending on the federal bankruptcy court's Detroit ruling, they may need to revise their methodologies, but for the time being they are taking a wait-and-see approach.

We anticipate the legalities and sheer number of creditors involved in the Detroit bankruptcy filing will put any final resolution out into the future, possibly by years. While there is the ***potential*** for a sea change in how municipal credits are viewed by the rating agencies and the markets, we believe any performance impact will be more severe for non-investment grade credits. Despite Detroit's bankruptcy filing being a junk bond story, its unique challenges are relevant to the municipal market as a whole. Our portfolio management and credit teams will continue to proactively monitor our universe of investment grade credits for potential impacts as pieces of this interesting case are decided.

(See next page for important disclosure information)

Author's Bio

Tim Rusell, Principal Credit Research Analyst, is responsible for credit research within the sovereign and municipal sectors including: tax back obligations, utilities, transportation, higher education and health care. He also serves on the Tax-Exempt Credit Committee. Tim began working in the financial industry in 1996 when he joined U.S. Bancorp Asset Management. Tim received a B.A. in finance and marketing from the University of St. Thomas. He is a member of the National Federation of Municipal Analysts and the Minnesota Society of Municipal Analysts. Tim also serves as an officer on the Board of Directors of the Minnesota Society of Municipal Analysts.

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