Impact of Detroit Bankruptcy on the Municipal Bond Market

Detroit, the cradle of the automobile assembly line and a symbol of industrial might, filed the largest U.S. municipal bankruptcy after decades of decline left it too poor to pay billions of dollars owed bondholders, retired officers, and current city workers. The City filed for bankruptcy after asking creditors owed more than $11 billion to accept just $2 billion in new notes in exchange for canceling their debt. That debt includes $2 billion in unsecured bonds and billions more in pension, health-care, and other obligations owed to current and former city workers.

Detroit's historic bankruptcy filing could raise anxiety levels and interest rates for cities that depend on the nearly $4 trillion municipal bond market to fund critical projects. Detroit owes creditors almost $19 billion, and its bankruptcy could make investors more hesitant to put money in municipal bonds. However, Detroit has been under distress for quite some time, and its credit condition has been well understood by the municipal market. We expect the effect will be fairly muted and that Detroit's problems are specific to the City and unlikely to spread.

The bankruptcy filing could lead to short-term gains for the City, but medium- and long-term pain is probable. While under court protection, Detroit can stop paying some debts, is temporarily immune from most lawsuits, and may be able to ask a judge to cancel contracts, including union agreements. However, this development will also raise borrowing costs for the City of Detroit and other municipalities in the State of Michigan over an extended period because investors will perceive Michigan local government bonds as considerably less secure going forward.

Detroit’s general retirement system, its largest unsecured creditor, is estimated to be owed $2.04 billion in unfunded liabilities. A pension plan for retired police and firefighters is owed an additional $1.44 billion, court records show. Detroit has 20,100 retirees, about twice the number of active employees. Among the biggest drains on the City’s general fund, which pays for police, fire and other basic services, are health benefits paid to retired city workers, mostly former police and firefighters.

Under Chapter 9 of the U.S. Bankruptcy Code, the first step is likely to be a court fight over whether the City was entitled to bankruptcy protection, a challenge that would ask if the City was truly insolvent and it had no alternative to filing. The City asked a judge to appoint an official committee to represent the City’s municipal retirees in the bankruptcy case. Unions and associations that have offered to represent retirees possess no legal authority to bind those retirees to restructure their pensions and health benefits, the City said in court papers. The City cannot successfully restructure unless it addresses its crippling unfunded retirement benefit obligations.

Detroit's population, which peaked at 1.85 million in 1950, has declined to 700,000, according to U.S. Census data. Manufacturing jobs fell from 296,000 in 1950 to fewer than 27,000 in 2011. About 60,000 properties in the City, or 15 percent of all parcels, were barren and at least 78,000 buildings were vacant, including 38,000 deemed potentially dangerous. Median household income was less than $28,000, compared with $49,000 statewide, and more than 36 percent of residents lived in poverty, 2011 Census data show. The median home value of $71,000 was barely half the $137,000 value statewide. Income tax receipts alone had declined a whopping 40% just since 2000.

Detroit is the home of General Motors Co., while Ford Motor Co. is in nearby Dearborn and Chrysler Group LLC is based in suburban Auburn Hills. GM and Chrysler both went through their own bankruptcies in 2009 and are thriving again. Job losses at U.S. automakers intensified a decline that began in the 1950s, when white homeowners began moving to the suburbs. As the tax base eroded, basic city services eroded, also. Detroit is too big geographically – 140 square miles - for its dwindling and impoverished tax base to support.

Chapter 9 will give Detroit an advantage over companies that use Chapter 11. Unlike companies, municipalities do not need to ask the bankruptcy court for permission to pay any bills they ran up before filing for court protection, including wages, utilities and rents. That means creditors cannot put as much pressure on a city over its spending habits, as sometimes happens in Chapter 11. Chapter 9 creditors also cannot offer their own reorganization plan and are not entitled to form an official committee with legal fees paid by the municipality. Unsecured creditors typically have those rights under Chapter 11, which companies use to try to stay in business and reorganize.

To get a court to approve a restructuring, the emergency manager must show that the plan is fair and equitable. This will draw much litigation, since bonds and retiree liabilities have never been reduced. Issues include how high tax levies must be and whether assets such as an art collection should be sold or preserved to draw tourists.

While Detroit's bankruptcy filing last Thursday was not unexpected, it is the largest of its kind and unique in other ways as well, making its impact difficult to gauge. The way the bankruptcy is handled could have a lasting effect on the municipal bond market.

MTAM is concerned about how Detroit's general obligation bonds will fare in bankruptcy proceedings. Generally, unlimited tax general obligations bonds are the most senior of a city's obligations, backed by the full faith and credit of the taxing power. Investors expect that, as usually provided in bond indentures, principal and interest on general obligation bonds will be paid before other expenses and that taxes will be increased to pay debt service if necessary. The treatment of those bonds by the bankruptcy court could impact how investors' view those types of securities issued by all Michigan municipalities and potentially could have nationwide implications.