Detroit to Default with Potential Bankruptcy Around the Corner (6/17/2013)

"The Coffers are Bare"

The City of Detroit is insolvent. The state appointed emergency manager has proposed defaulting on $11.4 billion of unsecured debt. The city will not make payments on such debt. Negotiations with all creditors, including bondholders and pensioners, will conclude by July 12th. Subsequent to the conclusion of the negotiations, a bankruptcy declaration could be forthcoming.

Potential Impact on Detroit Bondholders:

- Approximately 80% of such obligations carry municipal bond insurer guarantees. Therefore, we anticipate that bondholders will continue to receive timely interest and principal payments from the various insurance companies.
- Detroit is proposing a settlement that would give unsecured bondholders (those bonds that are not insured) and the bond insurance companies approximately 10 cents on the dollar.

Potential Fallout for the Municipal Market:

- The city is defining $530 million of general obligation full faith and credit bonds as "unsecured". That implies that such bonds are to be treated no differently from the approximate $1.4 billion of pension certificates that do not carry this stronger security pledge. It is uncertain if a bankruptcy judge will agree with this distinction.
- To date, various municipal market participants expressed strong opinions regarding the failure of the plan to differentiate between the stronger full faith and credit pledge inherent in general obligation security, and the weaker appropriation pledge underlying the pension certificates.
- In short, we do not see this as an issue for the "overall" municipal market.
- The Detroit tax base, economy, population and fiscal operations have eroded for decades. Credit ratings have also fallen in step.
- Credit ratings, by definition, essentially measure proximity to a potential default. While municipal defaults are exceedingly rare, and will continue to be so, Detroit's slippery slope has been almost 50 years in the making.

- Therefore, we do not see this as a “willingness to pay issue” or as an event with broader municipal market implications, as in this specific case, the “coffers are truly bare”.
- The Detroit fiscal pie has shrunk dramatically. Ultimately, the heavy loss will be shared by all participants: bondholders, employees and pensioners. It is up to the negotiators, or potentially a bankruptcy judge, to decide how to divvy up the pennies on the dollar that will ultimately remain.
- Finally, in this case, we do not expect general obligation bondholders to be treated as a favored class.

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