MORNINGSTAR®

Detroit Bankruptcy Filing: Implications for Investors

Sarah Bush
Senior Fund Analyst

Beth Foos
Municipal Credit Analyst

Jeff Westergaard
Director of Municipal Analytics

Morningstar Special Report
September 16, 2013

State of the City: Detroit Files Bankruptcy

Beth Foos
Jeff Westergaard

The City of Detroit filed for protection under Chapter 9 of the U.S. bankruptcy code on July 18, marking the largest Chapter 9 filing in U.S. history and the first in the State of Michigan. The move came after weeks of negotiations between the city's state-appointed emergency manager and the city's creditors, which resulted in a failure to produce a compromise on the restructuring of Detroit's massive $19 billion of liabilities. Chapter 9 filings are rare, which makes searching for precedent to guide this very complicated case almost futile. However, the events in Detroit unfolding over the next several months and possibly years will force investors to confront some fundamental questions.

We believe this case could have momentous implications for several areas of the municipal market, including the sovereign rights of states versus the power of federal bankruptcy laws over protection of pension benefits, the market's opinion of the fundamental security offered by the unlimited tax general obligation pledge, and the value that bond insurance may provide in the aftermath of the financial crisis. We can't offer the answers to these pressing questions—those will only come with time and court rulings—but we can provide analysis and clarity regarding some of the major issues. In this article, we'll detail the city's liability profile, including bonded debt and unfunded pensions, look at the role of municipal bond insurance for investors holding Detroit debt, and highlight recent trading activity and market reactions to the events to date.

A Brief Recap

Detroit has suffered for decades from a deteriorating economy characterized by rapid population loss, high unemployment rates, and an eroding tax base. Resulting revenue losses coupled with significant mismanagement led to poor delivery of basic city services, huge budget deficits, and a liquidity crisis, which officials say have now rendered the city insolvent. As a result, the state and city went through an extensive exercise of review and negotiations, and in March, the state appointed an emergency manager, Kevyn Orr, to Detroit.

Under Public Act 436, as the emergency manager, Orr has the ability to manage essentially all city affairs. This includes the ability to reject, modify, or terminate terms of existing collective bargaining agreements, control the budget, consolidate and eliminate certain city functions, and file for bankruptcy under Chapter 9 with prior approval by the state. After 18 months, city officials can vote to have the emergency manager removed; then the state can assign a new emergency manager or implement another recovery option under the new law.

Orr, a prominent bankruptcy attorney from Washington, D.C., offered a proposal on June 14 to restructure the city's liabilities, estimated to be $19 billion, owed primarily to retirees, insurers, and bondholders. The plan, which offered pennies on the dollar to retirees and some bondholders, was mostly rejected. After negotiations with major parties broke down, Detroit filed for bankruptcy protection in the U.S. District Court for the Eastern District of Michigan on July 18.

Detroit's Estimated $19 Billion Liability Profile

As illustrated in Exhibit 1, Detroit's liability profile includes a variety of security pledges and promises for repayment, which traditionally carry different risk assumptions for investors. When doing credit analysis and assessing the likelihood of repayment, Morningstar always stresses that understanding the security pledge—how and when that entity has promised to make debt service payments—is extremely important for investors. To that end, we've included brief summaries of the security pledges backing the majority of that profile.

It's important to note that the general obligation unlimited tax pledge is generally considered one of the strongest security pledges offered for bond repayment in the state. General obligation limited tax bonds are first budget obligations of the city, but their levy rates are subject to limitations that introduce more risk of nonpayment. To strengthen certain bonds secured by the GOULT and GOLT pledges of the city and to enhance its access to the markets, Detroit issued GO bonds with an additional pledge of distributable state aid in 2010 and 2012. These DSA bonds provide statutory liens on certain state revenue sharing payments Detroit expects to receive from the State of Michigan under provisions of Act 140 in each city fiscal year to provide more security of payment for investors. A more detailed breakdown of the city's bonds and pension obligation certificates in relation to the specific security pledged for repayment is illustrated in Exhibit 2.

Exhibit 1 Detroit's $19 Billion Liability Profile

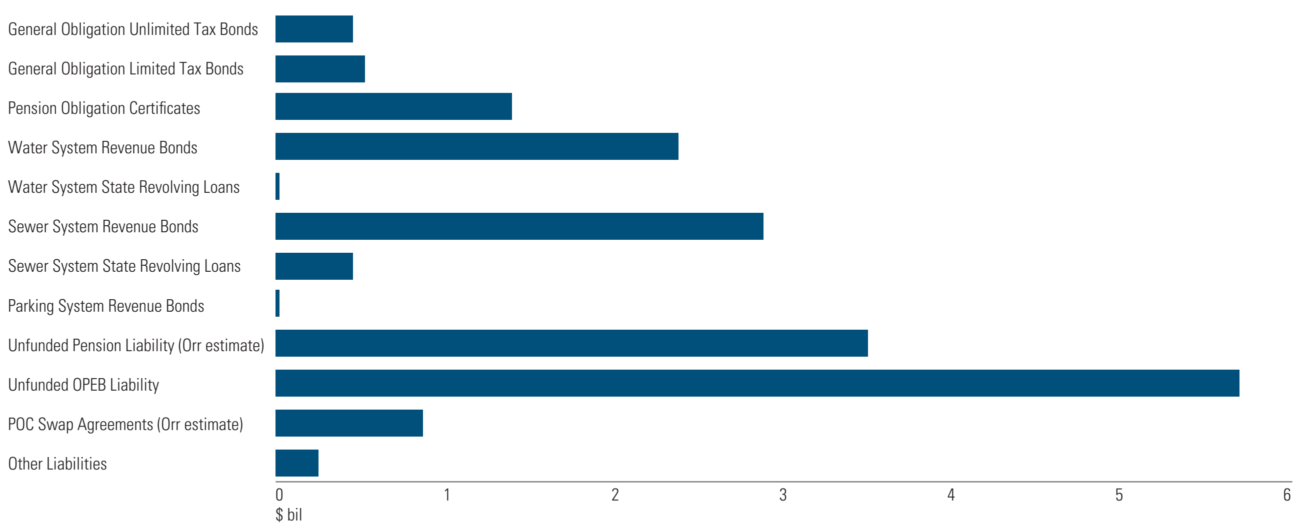
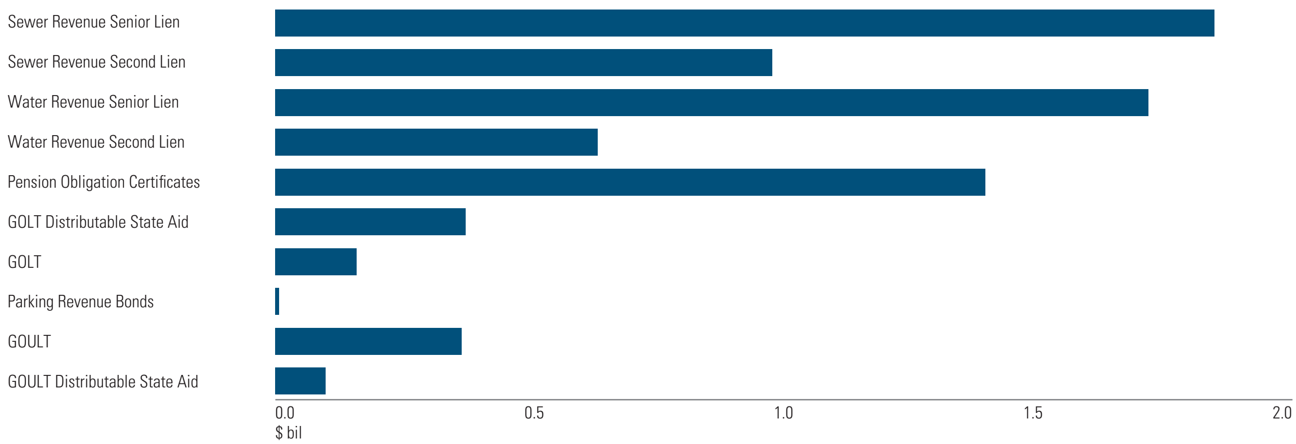


Exhibit 2: Detroit-Bonded Debt Liability Profile



Pension liabilities, although they've become a more recent concern for credit quality, have traditionally been less of a direct focus for bondholders. As we've seen from other recent events and as a result of Orr's proposal for creditors, this is no longer the case in Detroit. Bondholders and retirees have been placed in direct competition with each other for very limited resources under Detroit's restructuring plan.

Security Pledge Summaries

GOULT Bonds: Voter-approved full faith and credit general obligation of the city. The city is authorized and required to levy ad valorem taxes without limitation as to rate or amount upon all taxable property to pay principal and interest on the bonds.

GOLT Bonds: Payable as a first budget obligation from any available funds including any collections from property taxes. Levy rates are subject to constitutional, statutory, and charter limitations.

GOLT and GOULT DSA Bonds: Provides a statutory lien on certain state revenue sharing payments Detroit expects to receive from Michigan under provisions of Act 140 in each city fiscal year.

Pension Obligation Certificates: The city has an unconditional obligation to pay all service payments related to the POCs per contractual agreements with its two retirement service corporations. That obligation is not subject to appropriation.

POC Swap Agreements: Secured claims arising under service agreements related to POC-related interest rate swaps. Detroit directs the revenue received from wagering taxes on a daily basis to a trustee for collateral for the quarterly payment to counterparties.

Water Supply System Revenue and Sewage Disposal System Revenue Bonds and Loans: The city issued bonds and received loans from the State of Michigan's revolving loan funds to finance capital improvements, which are secured by liens on net revenue of each respective system.

Pension Liabilities: Maintains two single-employer pension plans. Michigan's Constitution Section 24 of Article IX states that financial benefits of these plans are contractual obligations and "shall not be diminished or impaired."

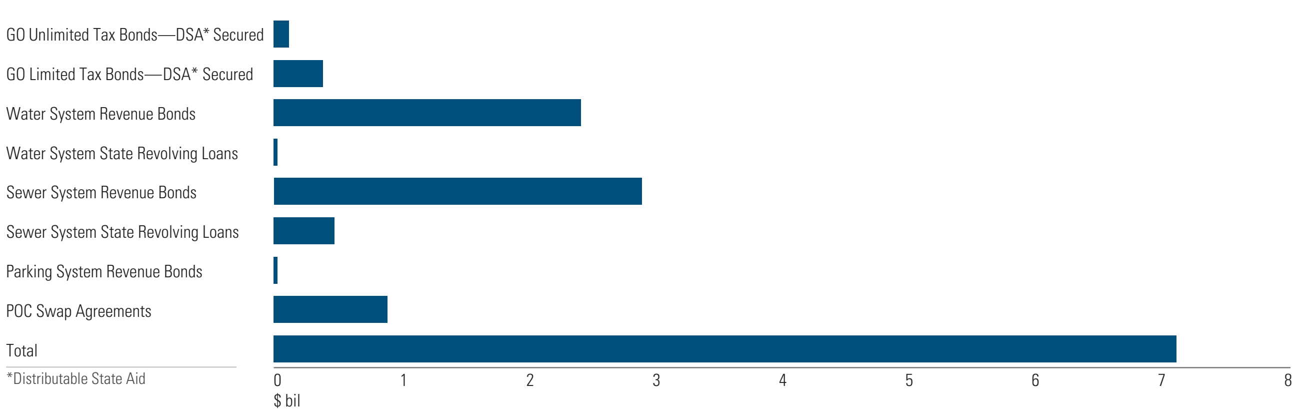
Other Post-Employment Benefits Liabilities: Maintains the Health and Life Insurance Benefit Plan and the Supplemental Death Benefit Plan for retirees. There is no specific article referencing OPEB in Michigan's Constitution lending additional protections in bankruptcy.

Secured vs. Unsecured Liabilities

In the proposal for creditors, Orr outlines Detroit's most pressing liabilities and the city's approach to restructuring them. Importantly for bondholders, under Orr's plan, all of the city's debt is treated as either "secured" or "unsecured". Orr purports that secured debt has a specific asset or revenue stream backing it, such as casino revenue, state aid revenue, or net revenue from an enterprise system. Substantially all of the city's water and sewer revenue bonds, parking revenue bonds, POC-related interest rates swaps (but not the pension certificates themselves), and the GOULT and GOLT DSA bonds that were issued with a backing of state aid are considered a part of the city's estimated $7.2 billion secured debt under the proposal. We expect that the payment of this debt won't be interrupted by the bankruptcy filing and found that the city did make its July 1 payments on certain water and sewer debt service payments. The full repayment of this debt is subject to negotiation with creditors in Orr's restructuring plan.

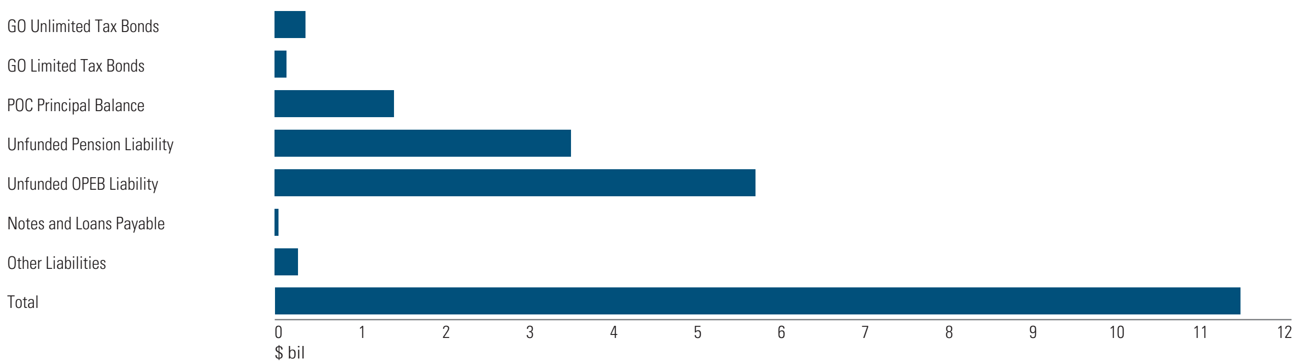
More concerning for some bondholders is what qualifies as unsecured debt in Orr's restructuring plan. Orr categorizes approximately $11.4 billion of the city's general obligation unlimited tax bonds, limited tax bonds, POCs, unfunded pension liabilities and retiree health-care obligations as unsecured liabilities. In using this term, he is indicating that none of the aforementioned have a lien on a specific asset or revenue stream. His proposal exchanges all unsecured debt for a total of $2.0 billion of limited recourse participation notes paid out on a pro rata basis. With this proposal, the city's GO debt is treated the same as

Exhibit 3 Secured Debt Under Orr's Proposal



*Distributable State Aid

Exhibit 4 Unsecured Debt Under Orr's Proposal



pension and OPEB liabilities, which undermines the long-held assumptions about security risk in the municipal market. Traditionally, payments of general obligation debt were believed to take precedent over pension liability payments; however, this plan clearly defies that assumption.

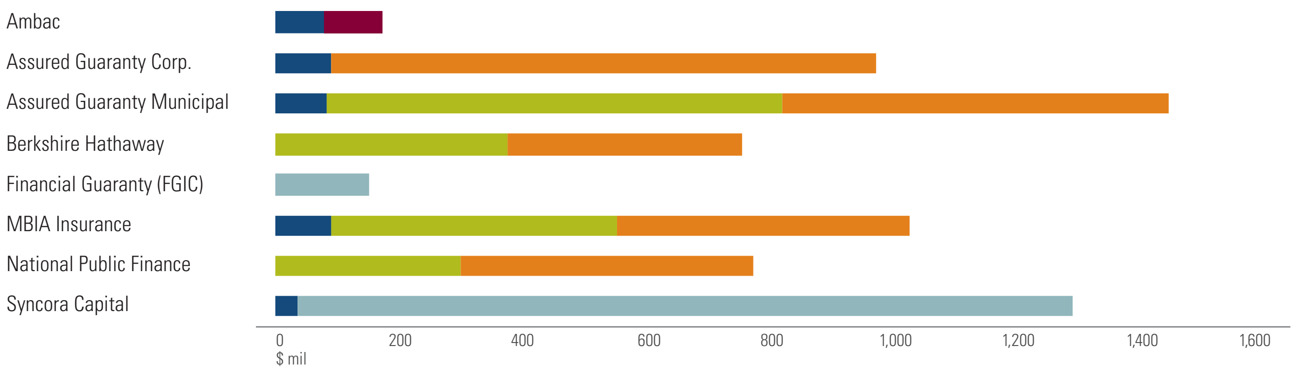
How these issues are resolved could set precedent for how debt and long-term unfunded liabilities are fundamentally viewed by the market and treated by financially stressed municipalities moving forward. Essentially, in this moment of fiscal stress, the state-appointed EM is suggesting that the strong legal security of the GOULT pledge of Michigan localities shouldn't be fully recognized. Investors should take note that moving forward, when it is most likely to be relied upon (during times of financial stress), the strength of the general obligation pledge in this state may not be there.

Municipal Bond Insurance

It's important to note that a significant portion of Detroit's outstanding bonds and pension obligation certificates are also secured by municipal bond insurance. Of the $7.7 billion in bonds and certificates outstanding, more than $6.6 billion (86%) are insured by one of five parent insurance companies. Only $1.1 billion (nearly 14%) of that debt is uninsured. Although these insured bonds no longer carry AAA ratings from the major bond-rating agencies, their policies are still in place, and currently we expect that related bondholders will be paid accordingly.

Shortly after Orr released his debt-restructuring plan, several of the city's insurers, including Syncora Capital Assurance, Ambac Assurance, and Assured Guaranty, issued public statements confirming their commitments to honor the relevant policies. At the same time, they reaffirmed their commitment to pay, Ambac stated it believes Orr's proposal and the failure of the State of Michigan to protect the status of general obligation bonds are harmful to the city and to Michigan taxpayers, and it hired additional advisors to deal with the case. Syncora recently engaged in contentious negotiations in and out of court with the city, as it was forced to cover a nearly $40 million payment due on pension obligation certificates that Detroit officials failed to pay in June.

Exhibit 5 Insurer Exposure by Security Provision



	Syncora Capital	National Public Finance	MBIA Insurance	Financial Guaranty (FGIC)	Berkshire Hathaway	Assured Guaranty Municipal	Assured Guaranty Corp.	Ambac
GO-ULT	34,380,000	—	88,245,000	0	—	81,665,000	87,190,000	77,635,000
GO-LT	—	—	—	0	—	—	—	92,705,000
Water Revenue	—	296,105,000	462,830,000	0	371,705,000	735,555,000	—	—
Sewer Revenue	—	474,215,000	471,160,000	0	381,160,000	622,635,000	879,930,000	—
Pension Certificates	—	—	—	148,540,000	—	—	—	—

Source: Morningstar Municipal Research

Exhibit 6 Ratings for Detroit Insurers

Insurer	Moody's Investor Service	S&P's Ratings Service
Ambac Assurance Corp.	NR	NR
Assured Guaranty Corp.	A3	AA-
Assured Guaranty Municipal Corp.	A2	AA-
Berkshire Hathaway Assurance Corp.	Aa1	AA+
Financial Guaranty Insurance Co.	NR	NR
MBIA Insurance Corp.	Baa1	A
National Public Finance Guarantee Corp.	Baa1	A
Syncora Capital Assurance	Ca	CC

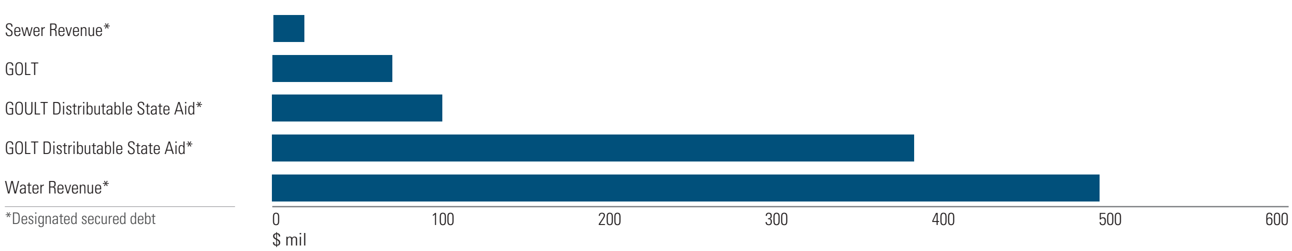
NR=Not Rated

How much comfort municipal bond insurance brings to investors should depend on the overall health of each insurer and how their specific exposure to Detroit bonds will ultimately affect their balance sheets. Exhibit 5 shows that Assured Guaranty Municipal and Syncora Capital have the most exposure to Detroit debt, yet the nature of the securities covered by each are significantly different. The vast majority of the bonds insured by Assured Guaranty is backed by water and sewer revenue and has been deemed secured debt by Detroit officials. This is the debt that we expect Detroit to continue making payments on throughout the bankruptcy filing. The debt insured by Syncora, however, consists mostly of pension obligation certificates, which is considered unsecured debt by the city and for which Detroit has already missed a timely payment. We expect that the city will continue to neglect those payments until a workout plan is negotiated and approved, increasing financial pressure on Syncora. Ambac is the backer of the city's insured GOLT bonds ($92.7 million) which are also at risk for nonpayment by Detroit as they are considered unsecured debt and debt service competes directly with operating revenue under the state's taxing structure.

Uninsured Debt

It is important to note that approximately $1.1 billion of the city's bonded debt does not carry municipal bond insurance, which would traditionally lead to more risk for bondholders, especially in a stressed fiscal situation. However, when reviewing that portion of Detroit's debt profile, we find that a significant portion of the uninsured debt—$985.3 million, or 94%—qualifies as secured debt under Orr's restructuring plan. Again, we expect that Detroit is not likely to interrupt the payment of this secured debt through the bankruptcy petition process, even though it will continue to negotiate with bondholders for restructuring. Therefore, only $69 million GOLT bonds are not covered by insurance and considered unsecured by the city. In our opinion, under Orr's plan and with consideration of insurance coverage, this is the portion of the city's debt that is at most at risk for nonpayment at this time.

Exhibit 7 Uninsured Debt Profile



Pensions and OPEB Liabilities

In addition to the management of GO debt and the impact of municipal bond insurance, how unfunded pension and other post-employment benefit (OPEB) liabilities are treated by Detroit has the potential to set a precedent for other fiscally stressed municipalities. If Detroit is successful in trimming these liabilities, others that cannot afford to support operations, debt payments, and retiree costs at the same time may look to emulate the city's actions. In the Detroit case, key questions regarding these liabilities include what the actual amount of the pension liability is and whether that liability can be impaired even with Michigan's constitutional protections.

What Is Detroit's Pension Liability?

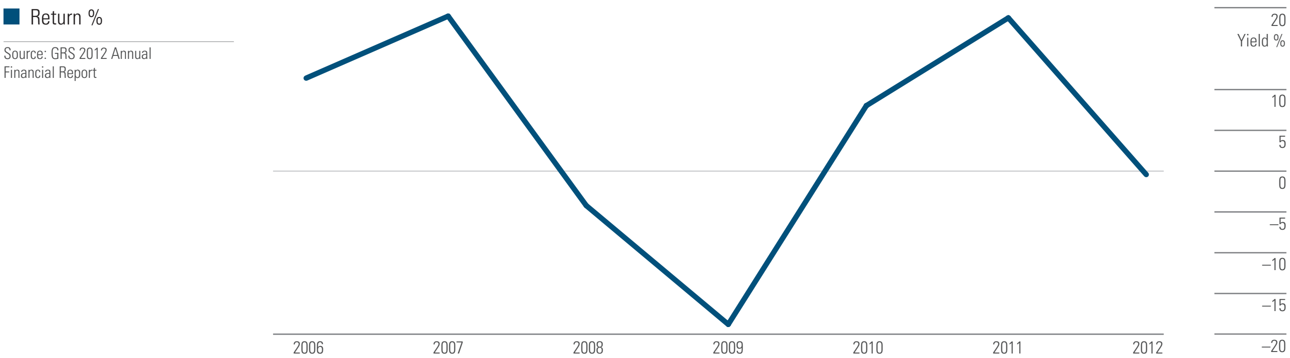
Adding to the city's debt profile are its two pension systems, the General Retirement System (GRS) and the Police and Fire Retirement System, (PFRS) and its OPEB benefits. Each pension system is a single-employer plan composed of a defined benefit and a defined contribution annuity plan. With financing from the offering of the POCs in 2005 and 2006 and other annual payments, the funding ratios as determined by city actuaries for these plans were 83% for the GRS and a strong 99.9% for the PFRS as of June 30, 2011. Together both systems were funded at 91.4% and had a combined unfunded actuarial accrued liability (UAAL) of $644 million. This UAAL is estimated to be $977 million for both systems as of June 30, 2012. Data in Exhibit 8 shows the assumptions and results used by the city's actuaries.

The city also offers OPEB plans consisting of the Health and Life Insurance Benefit Plan and the Supplemental Death Benefit Plan. The OPEB benefits have a total unfunded actuarial accrued liability of $5.7 billion. As the OPEB liability is an undisputed figure, Orr states that the $644 million pension liability is drastically underestimated. Detroit's EM argues that due to aggressive and unrealistic assumed annual rates of return on investments, extended smoothing of funding levels, and its lengthy amortization period, the city's total pension liability will be approximately $3.5 billion as of June 30, 2013.

Exhibit 8 Detroit Pensions Systems

	GRS	PFRS	Total
Amortization period	30 years	30 years	—
Asset valuation method	7-year smoothed market	7-year smoothed market	—
Investment rate of return (net)	7.9%	8.0%	—
Projected salary increases	4.0–8.9%	5.0–9.2%	—
Inflation rate	4.0%	0% for 4 years; 4% thereafter	—
Cost-of-living pension adjustments	2.25%	2.25%	—
Actuarial value of assets	$ 3,080,295,734	$ 3,804,759,868	$6,885,055,602
Actuarial accrued liability	$ 3,720,167,178	$ 3,808,642,553	$7,528,809,731

Exhibit 9 Historical Detroit GRS Investment Returns



Source: GRS 2012 Annual Financial Report

Based on our analysis, we think some of the actuarial assumptions and asset valuation methods that were used to determine the city's UAAL are within industry norms and others are outliers. For example, using a seven-year smoothing period is outside the industry norm of five years. For Detroit, this means that it will be absorbing the large investment losses from 2009 over a longer period. However, the systems outperformed their assumed interest returns significantly in 2007 and 2011, which will help offset that loss. In contrast, using a 30-year amortization period is common when assessing pension obligations, as these are long-term liabilities that will be paid out over time and are consequently amortized in a similar manner.

Investment returns are key assumptions when determining the size of a pension system's unfunded liability, and deciding on a fair rate is difficult. The National Association of State Retirement Administrators (NASRA) tracks investment returns for all state plans, which we believe is a suitable proxy for government pension plans when contemplating this question. Based on NASRA data as of Dec. 31, 2012, the 10-year average rate of return for state pension plans is 7.5%, the 20-year rate is 7.9%, and the 25-year rate is 8.9%. So although we believe that assuming an 8% rate of return is not a conservative practice, it is defensible and within the industry norm.

As displayed in Exhibit 9, actual investment returns for the city have fluctuated greatly over the past few years. We note that these return results are typical for government pension plans during the same period.

Both liabilities, the estimated $3.5 billion of unfunded pension liabilities and the $5.7 billion OPEB liability, are included in the city's $11.4 billion of unsecured liabilities under the emergency manager's plan. With either estimate for the pensions, its unsecured designation pits certain bondholders and insurers against retirees in a fight for the $2 billion limited recourse notes proposed to pay off these liabilities. Of course, with a plan to exchange all of the unsecured debt on a pro rata basis, the use of the higher unfunded pension liability could negatively affect bondholders' rate of recovery.

Can the Pension Liability Be Cut?

It's important to note that the state constitution provides a potential hurdle to the proposed restructuring of the pension liabilities. Like six other states, Michigan has a constitutional provision that expressly prevents it from reducing pension benefits.

Michigan's Constitution Section 24 of Article IX states, "The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions shall be a contractual obligation thereof and shall not be diminished or impaired thereby." OPEB benefits do not benefit from constitutional protection.

Even with that specific constitutional provision, it remains unclear whether that protection must remain in a federal bankruptcy court. Bankruptcy experts have noted that it is possible that a federal court judge could approve a restructuring plan that adjusts the city's debt obligations, including contractual obligations, if specifically authorized by the state. The approval of the governor in Detroit's bankruptcy petition could be interpreted as such state-authorized adjustments. With this, question of the sovereign rights of states versus the power of federal bankruptcy laws over pension benefits will be tested.

Trading Activity and Market Response

While the fact that Detroit was facing severe financial stress was commonly known before the release of Orr's plan, the question remains as to whether this information had been effectively factored into market prices. If that was the case, we would expect to see little change in the trading levels of Detroit obligations relative to the overall municipal market. Alternatively, evidence of a substantial change in the relative trading levels would indicate that the proposal contained provisions that were unexpected by market participants.

Specifically, a key question is whether the market had anticipated the extent to which the creditor proposal "haircut" all outstanding debt issues, but especially the treatment of general obligation debt and the pension certificates. Another key question is how the market values bond insurance for those issues that have this credit-enhancement feature. Has the market differentiated among the various security pledges of city debt?

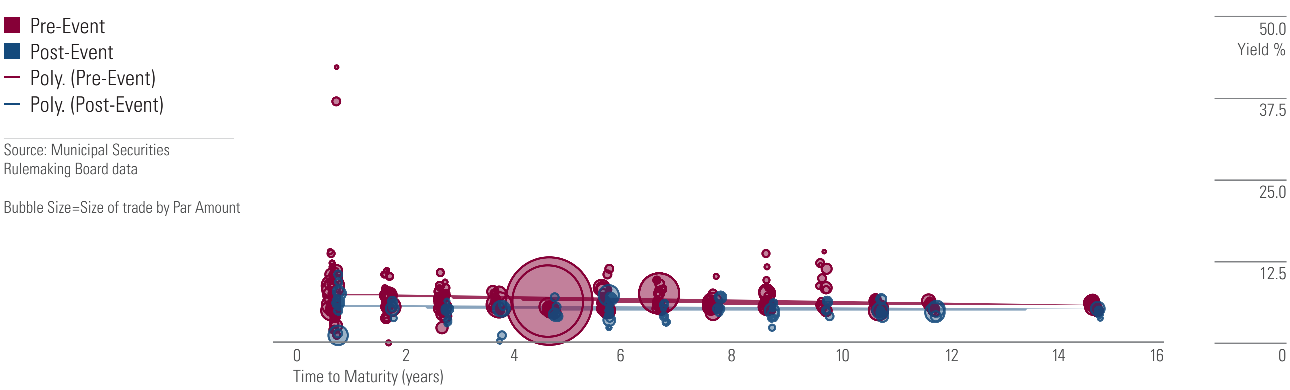
To answer these questions, Morningstar analyzed trade data from the Municipal Securities Rulemaking Board (MSRB). The MSRB collects information from dealers for all trades that occur in the municipal bond market and makes this data available to public at the website emma.msrb.org. This trade information was filtered to search for the various bond issues of the city which traded from May 1, 2013 through July 31, 2013. The period was divided into a segment prior before June 14, 2013 and a period after, representing the release of Orr's plan. Trades were analyzed across a number of factors including bond maturity and coupon, transaction size, type of trade (dealer, customer buy or sell), security pledge, and bond insurance. Each analytic subset is presented with trade data pre- and post-event for comparison.

General Obligation Analysis

Like many municipalities nationally, Detroit has issued two types of general obligation debt, unlimited and limited tax. One of the most controversial proposals from the emergency manager is that both types are viewed as unsecured debt with no differentiation in creditor standing. This assessment runs directly counter to the long-held view of the municipal market--that the specific legal rights afforded by an unlimited tax pledge exceed significantly those afforded by a limited tax pledge. Therefore, the analysis examined the trading levels of general obligation debt of both types. Graphically, each chart shows trades of differing lot size represented by the relative size of the circles, with yields as the Y axis and years to maturity on the X axis.

Exhibit 10 examines the general obligation unlimited tax debt of the city. As can be seen clearly, there has been a dramatic rise in yields in the post-event period. Across the maturity term, yields are anywhere from 200 to 500 basis points higher. Ten-year yields are approximately 8%.

Exhibit 10 Unlimited Tax General Obligation Bonds Trading Activity May 1- July 30, 2013



Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

Exhibit 11 Insured Limited Tax General Obligation Bonds—Trading Activity (May 1-July 30, 2013)

- Pre-Event
- Post-Event
- Poly. (Pre-Event)
- Poly. (Post-Event)

Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

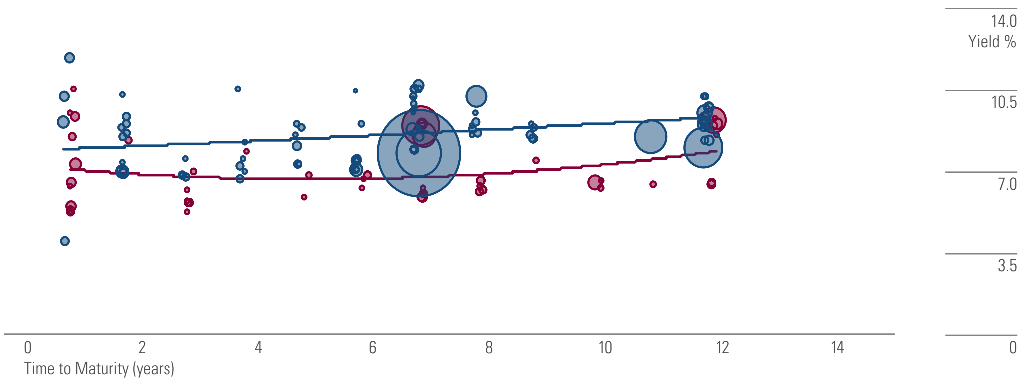


Exhibit 12 Uninsured DSA Limited Tax General Obligation Bonds—Trading Activity (May 1—July 30, 2013)

- Pre-Event
- Post-Event
- Poly. (Pre-Event)
- Poly. (Post-Event)

Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

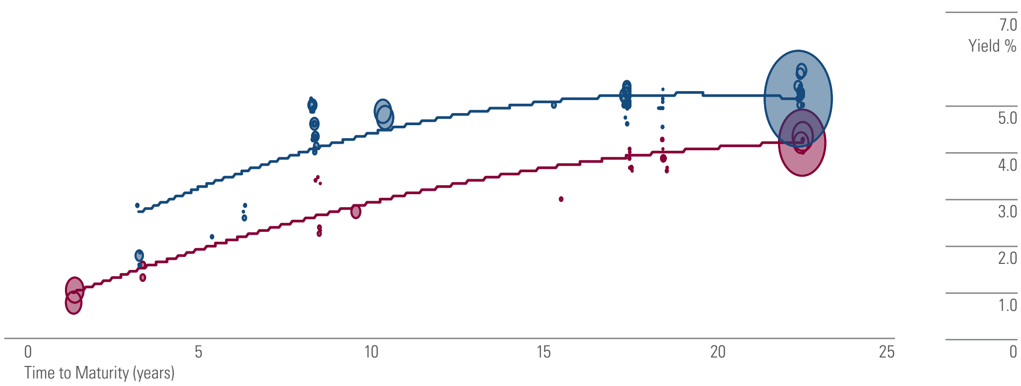
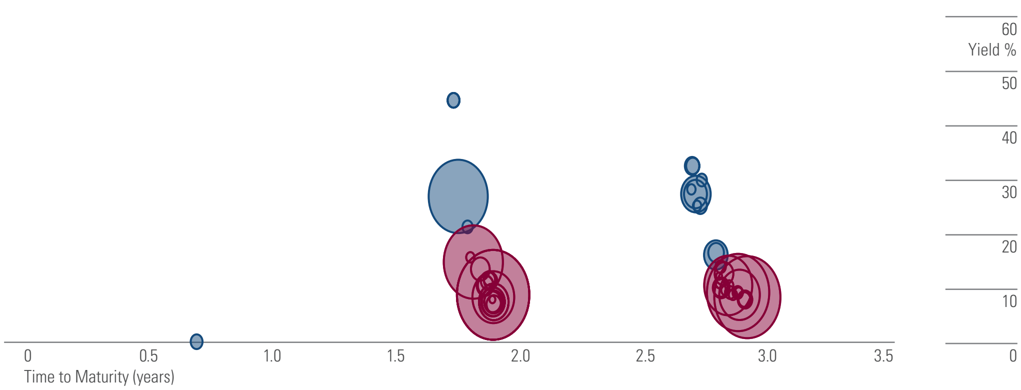


Exhibit 13 Uninsured Non-DSA Limited Tax General Obligation Bonds—Trading Activity (May 1–July 30, 2013)

- Pre-Event
- Post-Event

Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount



For the general obligation limited tax bonds that Detroit has issued, there are three distinct security categories. The first are issues that carry bond insurance from Ambac Assurance Corp. While the insurance is currently not rated, it is expected that the insurance will provide support for bondholders. While there are few trades to analyze, it is clear that the presence of insurance has not prevented bonds trading at elevated yields, with 10-year bonds around 8%.

Next is an analysis of general obligation limited tax bonds secured by state revenue sharing payments called distributable state aid. These bonds are not insured, but the pledge of the DSA does constitute a secured categorization in the plan. Here we see yields have clearly risen, but not to the extent that was seen for the GOULT trades. Yields for 10-year bonds are much lower at approximately 5%. This is in stark contrast to the yields observed with Ambac insurance, indicating that the market views the strength of the state revenue pledge as much stronger than the credit enhancement afforded from insurance.

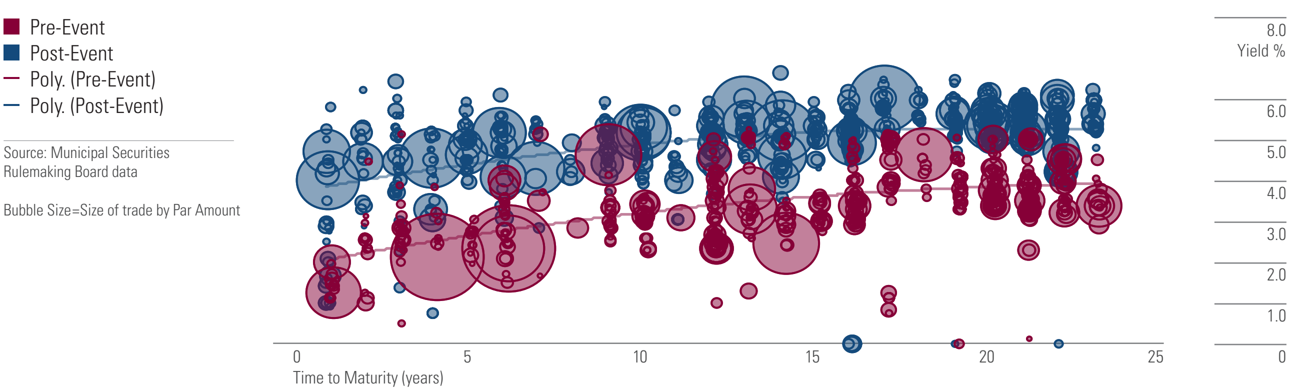
Isolating the general obligation limited tax bonds without DSA security or insurance results in few trades to analyze, but the data that is available is dramatic. Along with the pension obligation certificates, the uninsured general obligation limited tax bonds represent the least secured debt liability of the city. Yields are significantly higher, with short-term debt trading above 25%.

Water and Sewer Debt Analysis

The dataset of trades for the city's bonds secured by water system and sewer system revenue is much more robust than for general obligation debt. In each case, the security pledge is from dedicated revenue of the respective system. Both are considered secured in Orr's plan. In addition, virtually all of the outstanding water and sewer debt is insured as well.

An analysis of water revenue bonds with insurance shows that trade yields have risen sharply, with yields from 150 to 200 basis points higher post-event. Yields for bonds maturing in 10 years are approximately 5%.

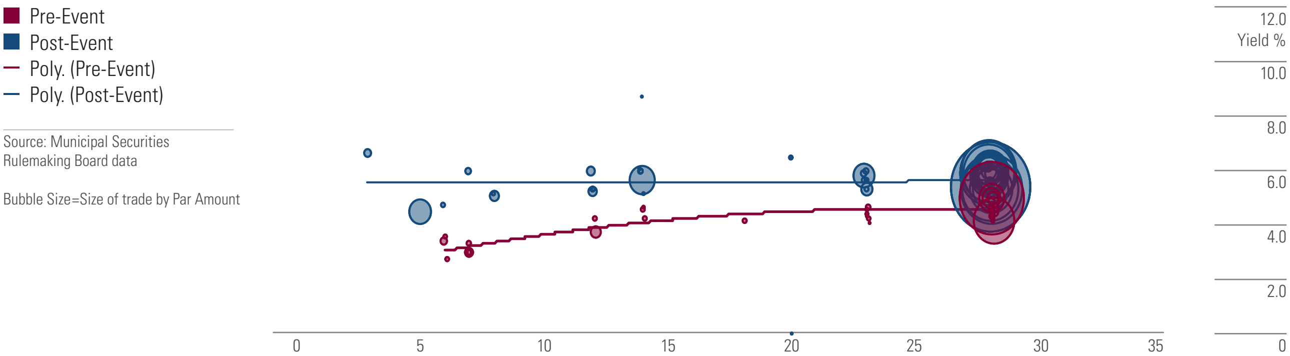
Exhibit 14 Insured Water Revenue Bonds—Trading Activity (May 1–July 30, 2013)



Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

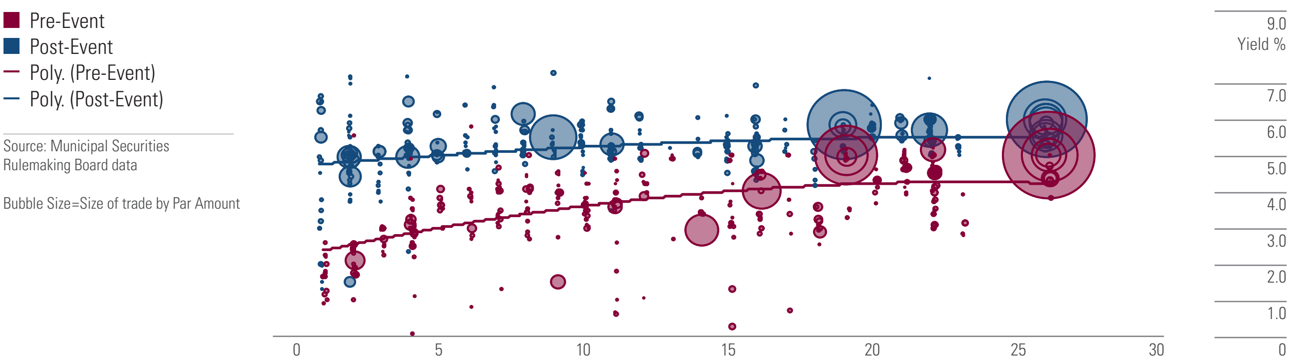
Exhibit 15 Uninsured Water Revenue Bonds—Trading Activity (May 1–July 30, 2013)



Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

Exhibit 16 Insured Sewer Revenue Bonds



Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

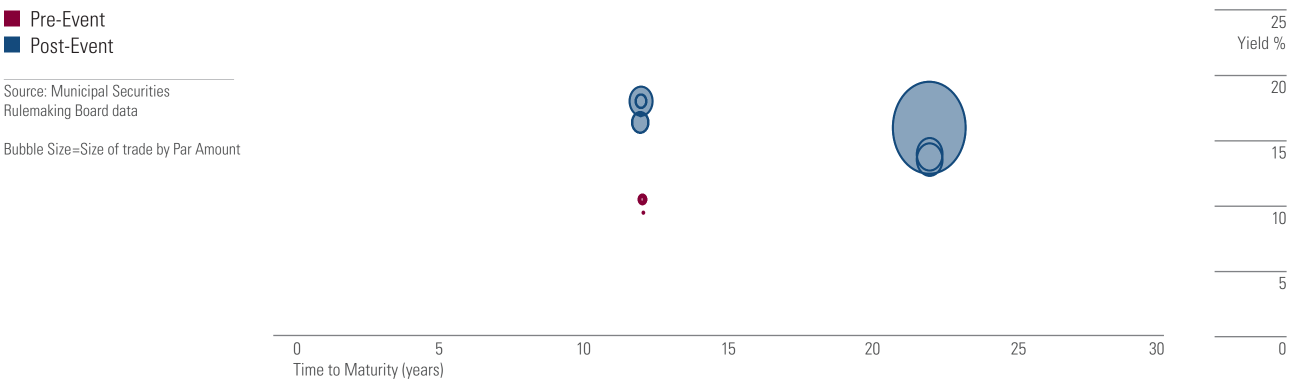
The same pattern of rising yields is represented with the water revenue bonds without insurance, albeit with nominally higher yield levels. Here we see yields rising around 200 basis points with 10-year yields at 5.75%.

The yield analysis for insured sewer system debt closely matches that for the data of the insured water system debt. This is not surprising, given that both are secured by essential service revenue. Again we see a rise in yields, with 10-year bonds yielding approximately 5.25%.

Pension Certificates

As noted previously, the city has issued debt obligations to fund pension obligations. Of all the outstanding debt obligations of the city, these are the only issues for which interest or principal payment has not been made to date.

Exhibit 17 Pension Obligation Certificates (Insured)—Trading Activity (May 1–July 30, 2013)



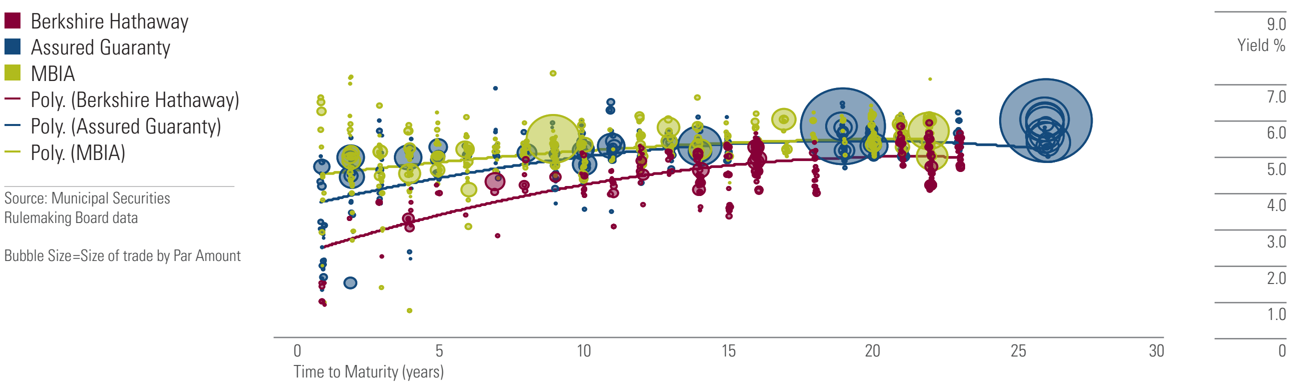
The available data for the 2005 and 2006 pension obligation certificates is sparse, representing a handful of trades, primarily from the post-event period. It is important to remember that the city chose not to make the interest payment required on June 15, 2013, for these issues, thus causing them to be in default. The yields at which these issues traded were at very high levels of more than 15%, despite the fact that the certificates are insured by Syncora, which did make payment of interest to bondholders for the June 15 coupon.

Insurance Comparative

Since the financial crisis, the role of bond insurance has diminished greatly in the municipal market. Immediately before the crisis, most municipal bond insurers carried AAA ratings and the majority of bonds issued annually came with an insurance wrapper. As the crisis unfolded, each of the active insurers' claims-paying ability became impaired, and ratings were adjusted downward. By 2010, only one of the primary insurers, Assured Guaranty, remained as an active underwriter. The situation in Detroit will be highly informational about the residual value of the insurance policies in place post-crisis, given that more than 85% of the city's outstanding debt carries insurance.

However, unlike the credit assessment of insurance before the crisis, the claims-paying ability of each insurer is viewed differently, with a wide range of ratings. Ambac and Syncora have seen their ratings drop precipitously. MBIA/National Public Finance Guarantee is now a "weak A" while Assured Guaranty is a "strong A", Berkshire Hathaway is still "AA". Ambac is the only insurer with exposure to the city's general obligation limited tax debt, while Syncora has the only exposure to pension certificates; thus, each can be assessed from the trade analysis for those security pledges presented previously.

Exhibit 18 Post-Event Trading By Insurer, June 17, 2013—July 30, 2013



Source: Municipal Securities Rulemaking Board data

Bubble Size=Size of trade by Par Amount

To make a comparative analysis of the three other insurers—Assured Guaranty, MBIA/National, and Berkshire—we performed an analysis of water and sewer system bond trades post-event. This allowed us to hold the underlying security pledge constant and analyze the relative yield information among the three insurers. The market is clearly showing a preference for Berkshire-backed debt, with yields between 50 and 75 basis points lower than those for either Assured or MBIA/National, both of which are trading at roughly equivalent yields.

Summary

It is clear from the analysis of trading activity that the proposals detailed by the emergency manager were not anticipated by the market. Yields have increased across all types of bonds that the city has outstanding. In particular, the difference between those types that are considered as secured (the water, sewer, and DSA bonds) versus unsecured (general obligation debt and pension certificates) is striking. Clearly the market is assessing the credit risk of the unsecured bonds as much greater post-event.

The value of insurance to bondholders is going to be tested as the bankruptcy proceedings play out. All of the major bond insurers have exposure. In the case of Syncora, a payment of interest has already been made due to the missed June 15 pension certificate payment by the city. Our analysis suggests that the market is differentiating among insurers to a very clear degree. Ambac and Syncora are being viewed as weak enhancement, MBIA/National and Assured as relatively strong, and Berkshire as the strongest.

Conclusion

Many municipalities have faced budget gaps, large pension liabilities, and economic stagnation in recent years, yet very few have experienced the decades of decline and mismanagement that resulted in Detroit's bankruptcy filing in July. From a credit perspective, the severity of the challenges that led Detroit to its current situation is unique. At the same time, how many of the questions facing Detroit are answered could have momentous implications for several areas of the municipal market.

Key Issues

- The sovereign rights of states and their constitutional protections versus the power of federal bankruptcy laws regarding pension benefits.

- The fundamental security offered by unlimited tax general obligation pledges, especially in the State of Michigan.

- Which costs ultimately take priority in fiscally stressed scenarios—pension liabilities or general obligation debt service payments.

- The determination of the value that bond insurance provides in the aftermath of the financial crisis.

All of these questions will take time to answer. Clarity will come through negotiations and legal direction. However, we cannot help but see this situation as a watershed moment for the municipal market.

.

What's in My Bond Fund? The Detroit Bankruptcy and Its Impact on Muni Bond Portfolios

Sarah Bush

When the city of Detroit filed for bankruptcy in mid-July, it made big headlines. That's for good reason: Detroit was once the fourth-most populated city in the nation, and it is the largest ever municipality to file under Chapter 9 of the United States Bankruptcy Code. (Chapter 9 is reserved for municipalities; corporations file under Chapter 7 or Chapter 11 of the code.) However, the filing didn't come as a huge surprise to market observers. Detroit has seen a decades-long decline as people and jobs have fled and the city's debts have ballooned, and its troubles were well-documented.

Stepping aside for a moment from the larger question of what impact the Detroit filing might have on the broader muni market, what's the potential impact of the Detroit bankruptcy on muni mutual fund portfolios?

Not All Detroit Exposure Is Created Equal

Detroit filed for bankruptcy with an estimated $19 billion in total liabilities, a staggering number by any measure. But not all of that amount is owed to bondholders. Indeed, the estimate includes roughly $10.0 billion in unfunded pension liabilities, unfunded other post-employment benefits—think health-care costs for retirees—and other associated liabilities. Morningstar's Beth Foos, municipal credit analyst, and Jeff Westergaard, director of municipal analytics, note that bondholders have not traditionally focused on pension liabilities, but that's changed with this bankruptcy. That's because bondholders and retirees are in direct competition for very limited resources under Detroit's proposed restructuring plan.

When we started looking at Detroit exposure in muni bond funds, we ran across a number of different bonds with "Detroit" in their name. We turned to our muni research team for help in sorting out those directly tied to the city's finances. Bonds issued by Detroit's school district, for example, have their own credit issues but were not affected by the bankruptcy. Even within the subset of bonds that we uncovered, however, there's a fair amount of variation in credit profiles.

Roughly $7.2 billion of Detroit's liabilities are backed by some kind of pledge of special revenues and are considered "secured debt" under the city's restructuring proposal. This basket includes more than $5.3 billion of bonds backed by water and sewer revenues. Detroit has continued to make interest payments on these bonds, and many observers expect that they will fare relatively well through the bankruptcy. It's also worth noting that a significant portion of the revenues backing the water and sewer bonds originate outside of Detroit proper through sales to suburban customers.

Debt considered “unsecured liabilities” per the restructuring plan includes unfunded pension liabilities, retiree health-care obligations, and approximately $530 million in general-obligation bonds. These bonds come in two flavors. Unlimited tax general-obligation bonds are voter approved and have historically been considered one of the strongest pledges in Michigan and for the muni market in general. Limited tax general-obligation bonds have priority over other budget line items but are subject to limitations on tax levies. Complicating the picture, specific general-obligation bond issues carry an additional pledge of certain state revenue-sharing payments (State Distributable Aid) that Detroit expects to receive; these are lumped in the secured bucket above. Investors will be watching carefully to see how the “unsecured” general-obligation bonds get treated in the bankruptcy proceedings. The city’s bankruptcy plan placed these bonds together with unfunded pension and other post-employment benefit liabilities in the unsecured liability bucket, surprising many market observers and raising the risk that general-obligation bondholders could see worse-than-expected recoveries.

Bond insurance presents one final wrinkle in determining the risk of the underlying holdings. More than 80% of Detroit’s obligations carry some kind of bond insurance. However, because the credit quality of the insurers also varies widely, it’s not a foregone conclusion that investors will receive full payment.

Overall, while there’s still a lot of uncertainty out there, investors in secured bonds backed by one of the stronger bond insurers could see decent recoveries. Holders of general-obligation debt that’s not insured or insured by a weaker guarantor are much more vulnerable.

What’s in Your Muni Fund?

Exposure to Detroit in the largest 10 national mutual funds is summarized below. Note the date of the most recently available portfolio; in some cases this exposure may have shifted materially since that date.

Exhibit 1 Direct exposure to Detroit in the largest 10 national municipal bond funds

Owner Name	Ticker	% Secured	% Unsecured	% Total Detroit
Vanguard Intermediate-Term Tax-Exempt*	VWITX	0.25	0.07	0.32
Vanguard Limited-Term Tax-Exempt*	VMLTX	0	0.02	0.02
Vanguard Short-Term Tax-Exempt*	VWSTX	0	0	0
Franklin Federal Tax-Free Income	FKTIX	0.9	0	0.9
American Funds Tax-Exempt Bond	AFTEX	0.23	0	0.23
Franklin High Yield Tax-Free Income	FRHIX	1.15	0	1.15
Vanguard Long-Term Tax-Exempt*	VWLTX	0.25	0.12	0.37
Nuveen High Yield Municipal Bond	NHMAX	0.61	0.36	0.97
Vanguard High-Yield Tax-Exempt*	VWAHX	0.33	0	0.33
Wells Fargo Advantage Ultra Short-Term Municipal Income	SMUAX	0.27	0	0.27

Note: Detroit exposure is as of June 2013 portfolio, except for funds marked with a *. In this case, exposure is as of the March 2013 portfolio.

For investors concerned about Detroit bonds in their mutual fund portfolios—regardless of their flavor—there's mostly good news. Detroit exposure in the largest national municipal bond mutual funds is relatively muted, typically running at less than 1% in the most recently available portfolios. For example, muni giant Vanguard Intermediate-Term Tax-Exempt VWITX held a relatively meager 0.32% stake in Detroit bonds as of March 2013, and the bulk of that was both secured and insured.

Even the handful of high-yield muni funds on the list didn't have a ton of exposure. Franklin High Yield Tax-Free Income FRHIX, for example, held combined exposure of just 1.15% as of June, mostly in water and sewer bonds. Meanwhile, its only exposure to general-obligation bonds was secured by a pledge of state revenues. The bulk of these holdings also carry some kind of insurance, although the general-obligation bonds do not.

Oppenheimer Rochester Limited Term Muni OPITX, held the largest position in the top-20 largest funds, a 3.7% stake in Detroit-related names as of June. Of that total, more than two thirds consisted of water and sewer revenue bonds, mostly with insurance. Approximately 1% of the fund's assets were in general-obligation debt additionally secured by the State Distributable Aid revenue pledge mentioned previously. The bonds held in the fund are a third lien on the state aid revenue stream, thus placing this particular issue third in line behind two previous city bond issues to receive the state funds. Despite the lien standing, Morningstar believes that the additional security offered by the state aid pledge significantly improves the credit strength of the holdings.

While large, national muni portfolios carry only modest exposure to Detroit, that's not true of dedicated Michigan muni bond funds. Indeed, of the 10 funds with the most exposure to Detroit (measured as a percentage of net assets), eight were Michigan muni funds, and for several the exposure ran into the double digits.

Exhibit 2 Largest exposures to Detroit as a percent of portfolio, closed and open-end portfolios

Portfolio date		Ticker	% Secured	% Unsecured	% Total Detroit
	Oppenheimer Rochester Michigan Municipal	ORMIX	11.02	3.64	14.66
	First Investors Michigan Tax Exempt	FTMIX	11.99	0	11.99
	Franklin Michigan Tax-Free Income	FTTMX	9.59	1.05	10.64
March 2013	PIMCO Municipal Income III	PMX	10.04	0	10.04
	Fidelity Michigan Municipal Income	FMHTX	9.48	0	9.48
April 2013	BlackRock MuniYield Michigan Quality II	MYM	6.99	0	6.99
	AllianceBernstein Municipal Income II Michigan	AMIAX	6.88	0	6.88
May 2013	Nuveen Michigan Quality Income Municipal	NUM	6.21	0	6.21
May 2013	Eaton Vance Michigan Municipal Income	EMI	6.17	0	6.17
	Nuveen Michigan Municipal Bond	FMITX	5.5	0	5.5

Note: Portfolios are as of June 2013 unless otherwise noted.

Within this list, a quick look at the underlying holdings shows a fair amount of variation. So, for example, eight funds on the list are invested entirely in debt secured by a pledge of special revenues, mostly water and sewer revenues, and are considered secured debt by city officials. Two funds on this list, First Investors Tax-Exempt Michigan FTMIX and AllianceBernstein Muni Income II Michigan AMIAX, held sizable stakes in general-obligation bonds (2.3% and 2.4%, respectively), but in both cases these were backed by State Distributable Aid receipts. Many also hold insurance on the underlying holdings, although, as noted above, the credit quality of the underlying insurers can vary significantly. So for example, Fidelity Michigan Municipal Income's FMHTX 9.5% stake in Detroit-related debt as of June 2013 was all secured by water and sewer revenues. Additionally, the majority of that—8.7 percentage points—was insured, mostly by higher-quality monoline insurers.

On the other hand, two funds had larger exposures to unsecured Detroit debt as of their most recently available portfolios. As of June, Oppenheimer Rochester Michigan Muni Fund ORMIX held a 3.6% stake in unsecured general-obligation bonds, and a total 14.7% position in Detroit-related debt. Offsetting this risk was the fact that most of this debt was insured, although by insurers of varying credit quality, including 1.6% of general-obligation debt backed by Ambac, a nonrated insurer. Franklin Michigan Tax-Free FTTMX had a smaller stake, roughly 1% of assets in unsecured, general-obligation bonds as of June 30. These, too carry insurance, but here by investment-grade-rated monolines.

Broader Implications

With exposure to Detroit at relatively low levels outside of Michigan muni funds, and Michigan muni funds mostly concentrated in secured and/or insured paper, the bigger question for many investors may well be what effect the bankruptcy will have on the broader muni markets. Morningstar's municipal bond analysts argue herethat the Detroit bankruptcy isn't a sign of widespread credit risk in the muni markets. However, its filing will, no doubt, have implications for muni investors. That may already be happening. While it's hard to isolate the impact of the Detroit filing, munis have been particularly hard-hit in the recent bond-market sell-off. The filing has also shone a spotlight on the troubles that underfunded pensions can wreak on municipal finances. Observers will be watching closely to see how Detroit's various creditors, and, in particular, pensioners and holders of its general-obligation debt, fare in federal bankruptcy court.

22 West Washington Street
Chicago, IL 60602 USA