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THE SETTLEMENT OF THE DETROIT BANKRUPTCY AND ITS EFFECT ON THE MUNICIPAL BOND MARKET

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In November 2014, the bankruptcy filing by the City of Detroit was approved and finalized only 16 months after it was filed in July 2013. Initially, pensioners were threatened with cuts of at least 34%. Thanks to a "Grand Bargain" by various entities (primarily the Detroit Art Museum), the final settlement included most pensioners having their benefits cut by 4% and most giving up their COLA adjustments. Conversely, bondholders did not fare as well as a result of the settlement, with "haircuts" wiping out between 26% and 66% of their value. Overall, $7 billion of bondholders' obligations were wiped out at the stroke of a pen by the bankruptcy judge.

Even with these massive cuts to the pension obligations of Detroit their pension funds remain well underfunded. The City of Detroit is unable to fund the annual contributions needed to maintain a financially viable status for these funds. For instance, the annual pension obligations due pensioners is currently over $500 million, or nearly twice the total operating budget of the City of Detroit. Unless Detroit accomplishes a significant recovery including new jobs and expanding their population, it is unlikely the remaining pension obligations can be honored. Detroit has already indicated that they plan to only partially fund their pension obligations over the next few decades or longer.

It is interesting to note that even with this recent outcome in Detroit, other pension obligation bonds continue to trade with little adjustment as a result. Certain areas, such as Illinois, have seen some depressed price action for their pension obligation bonds, but most other states and municipalities continue to trade in line with other high grade bonds. Nevertheless, many states and municipalities continue to underfund their pension obligations and/or borrow additional funds in lieu of contributing cash towards these obligations. While better investment returns and some job growth recovery have modestly improved some districts underfunding, most districts continue to be well underfunded.

We continue to advise our clients and our portfolio managers to be very cautious in selecting municipal credits directly or indirectly tied to pension obligations. It is our belief that the major rating agencies have not adjusted their ratings on these bonds adequately enough to factor in the risk of their underfunded obligations. While we realize that many of these General Obligation bonds involve analyzing the legal risks of various entities, we believe it is best for individual bond buyers to avoid these uncertainties whenever possible.

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