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Detroit Bankruptcy Could Change Municipal Market, Chicago Fed Says.

Detroit's historic bankruptcy filing could upend long-established market views on the high standing of general obligation bonds, the form of debt sold most frequently in the U.S. municipal bond market, Chicago Federal Reserve Bank researchers said Friday.

The city's move in July to seek protection from creditors so far has had only a modest effect on the overall muni market, apart from driving up borrowing costs for issuers in Michigan.

But how the bankruptcy court rules on the treatment of different debt classes could profoundly alter market perceptions of their risk, particularly for issuers with mushrooming pension obligations like Detroit's, two of the bank's economists wrote in a monthly research note, the "Chicago Fed Letter."

A key issue in the city's pending Chapter 9 bankruptcy is whether Detroit's state-appointed emergency manager, Kevyn Orr, may treat certain general obligation bonds as unsecured debt on a par with its pension obligations, and repay them at just pennies on the dollar.

General obligation, or GO, bonds have long been viewed as the muni market's gold standard, and none of the handful of municipal bankruptcies since 1970 has resulted in a writedown of GO debt. Since 2003, GO bonds accounted for nearly 60 percent of new debt deals in the $3.7 trillion muni bond market, where cities, states, hospitals, school districts and others raise cash for capital projects and other needs.

Orr's proposed cuts to retirement benefits, which are being challenged in the bankruptcy case by labor unions, retirees and pension funds, conflict with strong protections in the Michigan Constitution against impairing those benefits.

The judge in the Detroit case has not yet determined if Detroit is eligible to formally enter bankruptcy protection, as hearings in that phase begin later this month.

A successful challenge by unions and retirees, on the basis of the U.S. Constitution's Tenth Amendment regarding states' rights, could impact the pricing of bonds issued by cities with large unfunded pension liabilities, according to the Fed report.

"If the court agrees with pension creditors that state protections hold supreme, this could change market expectations with respect to the relative standing of municipal debt issued by cities located in states with such protections," the Fed report said, pointing to Chicago, Los Angeles, and New York City.

Overall, large U.S. cities in a recent Pew study have funded only 57.5 percent of the $511.2 billion of retirement benefits they promised.

Orr has lumped about $411 million of unlimited tax GO bonds into the unsecured debt pile even though Detroit voters approved a special property tax levy to pay off the debt.

That pile also includes limited tax GO debt, secured only by Detroit's general fund revenue, and pension debt – neither of which was approved by voters.

"This issue will be ultimately settled by the court, and it might have wide-reaching consequences for the pricing of voter-approved GO debt," the report said.

Detroit defaulted on its "unsecured" GO bonds this week by skipping debt service payments due on Tuesday.