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Detroit Bond Sale Closer as Holders Offered Pennies: Bloomberg.

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Detroit's plan to end backfiring interest-rate hedges taken on almost a decade ago is its first step back to the municipal bond market even as investors gird for a return of pennies on the dollar to current holders.

U.S. Bankruptcy Judge Steven Rhodes this week may approve a $285 million loan to the city from Barclays Plc. That starts the countdown for a probable return to the $3.7 trillion municipal market to fund the city's exit from Chapter 9 bankruptcy, which Emergency Manager Kevyn Orr has said he wants to arrange by September.

The city would follow Jefferson County, Alabama, which in November issued long-term debt while in bankruptcy. The county paid more than 2.5 percentage points over top-rated munis on some of its sewer debt, data compiled by Bloomberg show.

"Somebody's going to give them credit," Lyle Fitterer, who helps manage $31 billion of state and local debt at Wells Capital Management in Menomonee Falls, Wisconsin, said of Detroit. "How much it is going to cost, it's too early to speculate."

The Motor City in July filed a record U.S. municipal bankruptcy, with liabilities of about $18 billion, after losing a quarter of its population since 2000. It would differ from Jefferson County in that the money it borrows would be for use while in bankruptcy. The move may set a precedent for any localities that follow it into Chapter 9, the category designed to let municipalities restructure.

Funding Source

Bill Nowling, spokesman for Orr, said the city will probably seek financing from the municipal market to fund the bankruptcy exit.

Rhodes asked the city to file a plan by March to adjust its debt. Details of any bonds designed to fund the bankruptcy exit would probably be included in that proposal. It must be approved by Rhodes, who will take into account a vote of creditors and give their lawyers a chance to object. He must find that the plan complies with federal and state law, that it treats similar debts the same and that any cuts are fair.

Orange County, California, which sought protection in 1994 after losses on derivatives, also borrowed while in bankruptcy. It used the money to pay some creditors early and reduce obligations. That strategy was designed by lawyer Bruce Bennett, who is among attorneys leading Detroit's case.

Tap Test

For Detroit, the test will be whether it can tap investors to turn the Barclays loan into long-term debt when it tries to emerge from Chapter 9, said Matt Fabian, an analyst with Municipal Market Advisors.

"It's a gamble that the city will have sufficient market access, or frankly, sufficient revenues," to roll the loan over into bonds, Fabian, whose firm is based in Concord, Massachusetts, said in an e-mail.

Bart Mosley, co-president of Trident Municipal Research, and Fitterer at Wells Capital Management said Jefferson County's experience shows investors will buy the debt even as Orr's proposal would pay some unsecured creditors about 20 cents on the dollar.

"At a price, they will have market access," New York-based Mosley said of Detroit.

35 Cents

Some uninsured Detroit bonds have traded in recent months for about one-third of their face value. General-obligation bonds maturing in April 2016 have traded for an average price of 35 cents on the dollar since July, Bloomberg data show.

Detroit skipped an October interest payment on the bonds. The city of 700,000 has struggled to provide basic services such as street lights. Orr said in June that the city would skip payments on general-obligations not backed by state aid as well as certificates of participation.

The city would be borrowing to free up cash that has been tied up in payments for interest-rate swaps it entered into as part of debt sales in 2005 and 2006 to fund pensions. Part of the proceeds would pay UBS AG (UBSN) and Bank of America Corp., providers of the hedges, and $120 million would go toward city services.

The swaps contracts are supposed to reduce borrowing costs on debt with variable rates and hedge against rising rates. In some cases, the agreements backfired after the financial crisis, leaving municipalities owing money to exit the instruments.

Issuers nationwide, including Detroit's utilities and Louisiana, have paid at least $4 billion to banks to end the agreements.

2009 Pledge

In 2009, Detroit officials pledged casino-tax revenue to secure the swaps and avert a termination payment of about $400 million. The city has since paid more than $200 million to the banks as part of the swaps, according to public city records.

Although the casino taxes will be collateral for the Barclays loan, there will be no restrictions on the cash unless Detroit defaults, Nowling said. Currently, the money is first held in an account by an administrator who must pay swaps investors before releasing leftover funds to the city, Nowling said.

Ending the bankruptcy by September means that, should Orr need to borrow to pay creditors, Detroit would probably return to the bond market before then.

Nowling, Orr's spokesman, didn't specify the kind of debt the city would sell to come out of bankruptcy.

"That decision has not been made, but we anticipate that we will," he said.

Meantime in the municipal market, localities have scheduled about $6.8 billion of borrowing in the next 30 days, about 25 percent below the one-year average.

The issuance slowdown has fueled a debt rally. Benchmark 10-year munis yield 2.8 percent, the lowest since Nov. 13, and compared with 2.86 percent for similar-maturity Treasuries. The muni interest rate fell 0.19 percentage point last week, the most since December 2011.

The bankruptcy case is In re City of Detroit, 13-bk-53846, U.S. Bankruptcy Court, Eastern District of Michigan (Detroit).

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