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Fitch: Michigan Governor's Detroit Proposal Troubling for Bondholders.

Fitch Ratings believes that the Michigan governor's recent proposal to contribute $350 million towards Detroit's unfunded pension liabilities demonstrates continued weak support for bondholder security and repayment stemming from Detroit's bankruptcy. In Fitch's opinion, action that suggests pensions' claim on limited resources should be given priority to that of bondholders could establish a troubling precedent, at least in Michigan and perhaps beyond, given the paucity of significant municipal bankruptcy filings historically and the resulting focus on the Detroit case. Moreover, the governor's comment that state funds will not bail out bondholders or Wall Street but are going to Michiganders suggests an 'us versus them' orientation to debt repayment that undermines willingness to pay public debt in Michigan.

The governor's recent action follows Michigan's implicit support of the emergency manager's decision to treat Detroit's small amount of unlimited tax general obligation (GO) debt as a general unsecured obligation. Fitch has previously stated its concern for the lack of priority for GO debt. It stands in stark contrast to the decision made by Rhode Island in the Central Falls bankruptcy case to protect GO bondholders by applying a statutory lien to all such local government debt in the state.

The governor's plan, which requires legislative approval, would be funded by carving off a portion of the state's annual tobacco settlement revenue. The state funding would match a like amount of donations from private foundations seeking to protect the collection of the Detroit art museum. The state and private contributions reportedly are contingent upon the funds being used exclusively for Detroit's pensions, and the combined amount would essentially equal the total unfunded pension liability calculated using standard actuarial methodology for government pensions. In announcing the plan last week, the governor was quoted as highlighting the fact that none of the funds would go to bondholders.

Michigan has long been recognized for conservative management of its own finances and proactive involvement with its distressed local governments. Fitch views Michigan's Act 436 and its predecessor emergency manager laws as among the strongest state fiscal intervention programs in the nation. However, the state's actions related to numerous aspects of the Detroit bankruptcy have been contrary to Fitch's prior expectations of the benefits to local government bondholders that such a program provides.

Fitch recognizes the delicate political situation surrounding the Detroit bankruptcy and that there are still many decisions to be made before the proceedings come to a close. The Detroit emergency manager has proposed reducing pension liabilities, and in December 2013 a federal bankruptcy court judge ruled that pensions could be adjusted in bankruptcy, stating that 'nothing distinguishes pension debts from other debts.' As the state and city continue down what could be a long road, actions and rhetoric that suggest bondholder rights are not an important consideration will continue to damage market perception of the state and its local governments.

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