Bond Case Briefs

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Detroit Plan Revives Investor Scrutiny of Michigan: Bloomberg Muni Credit.

Detroit's plan to reduce its $18 billion of liabilities may derail the biggest wave of Michigan debt issuance since 2009 and elevate borrowing costs as investors renew focus on the state's approach to bondholders.

A proposal last week from Detroit Emergency Manager Kevyn Orr would pay pensioners at more than twice the rate of some bondholders and give 46 cents on the dollar for general obligations backed by the city's unlimited taxing power.

Issuance from Michigan has just started to revive after Detroit's July filing. The state's municipalities sold $464 million of debt in January, the most for the month in five years, data compiled by Bloomberg show. They did so at a price: The developments since July have boosted yields as much as 0.5 percentage point, according to research firm Municipal Market Advisors. Michigan itself pays the second-highest yield spread among states, Bloomberg data show.

"The bottom line as an investor in Michigan debt is you have a governor and leadership there who are complicit in subordinating" bondholders to pensioners, said Adam Mackey, head of munis in Philadelphia at PNC Capital Advisors, which oversees about $6.5 billion in local debt. "There will have to be more compensation for us as a lender."

Favoring Michiganders

Detroit's bankruptcy may set precedents for how retirees and bondholders are prioritized when a locality in the $3.7 trillion municipal market falls into distress. The episode is testing the assumption that bonds backed by the full faith and credit of states and cities are the safest among local debt.

Fitch Ratings said in a report last week that Republican Governor Rick Snyder was contributing to a mentality of "us versus them," in part by a plan that would favor retired state workers, and even artwork, over bondholders. He proposed last month that the state pay $350 million over 20 years specifically for Detroit pensioners.

Snyder said this week that it was "premature" to conclude that borrowing costs would rise for Michigan issuers because of how bondholders have been treated in Detroit's bankruptcy proceedings.

"Bankruptcy is something I hope no one aspires to be in, because it's very difficult for anyone involved," he said at a press conference to discuss his budget plan.

Repayment Menu

Under Orr's latest plan, pensions would get 45 to 50 cents on the dollar, though retiree health-care liabilities would recoup just 13 cents. Investors who loaned $1.4 billion to shore up the two pension funds would receive 20 percent of their claims. Holders of $369 million in unlimited-tax general obligations would recover 46 percent, and the $161 million of limited-tax general obligations would get 28 percent.

The plan to cut payments to general-obligation holders and the governor's proposal for Detroit retirees "means higher costs for municipalities that don't deserve higher costs," said John Mousseau, who helps manage $1.8 billion of munis as director of fixed income at Cumberland Advisors in Sarasota, Florida.

Mousseau also estimated a penalty of about 0.5 percentage point for localities in the state.

In the face of higher borrowing costs, Genesee County, Battle Creek and Saginaw County postponed a combined $131 million of issuance in the month after Detroit's bankruptcy filing. All three eventually sold their debt.

School Finances

In January, about 20 school districts and Fenton Township joined Saginaw County in offering a combined $464 million of bonds, compared with $175 million in January 2013, according to Bloomberg data. They borrowed amid the municipal market's biggest monthly rally since September.

In one example of the penalty Michigan issuers have paid, Dearborn School District nine miles (14 kilometers) west of Detroit priced about $68 million of bonds on Jan. 15 with an Aa2 grade from Moody's Investors Service, two below the top. The 10-year segment yielded 3.4 percent, or 0.71 percentage point more than benchmark munis.

By comparison, Hermantown Independent School District No. 700 in Minnesota issued $49 million of bonds on Jan. 23, with the 10-year portion yielding 0.15 percentage point more than AAAs. In Washington, Auburn School District No. 408 sold about $44 million last week with a segment due in about 10 years priced to yield 0.1 percentage point more than the benchmark.

The former issuer has a Moody's grade equivalent to the Dearborn district, while the latter is one level higher.

'Cumulative Penalty'

Minnesota and Washington, like Michigan, have school-bond enhancement programs that help districts access capital markets and reduce borrowing costs.

In Michigan, "small school districts are going to pay another half a percent more than they would need to pay otherwise," Mousseau said. "That's fine if you're a bondholder and you're capturing incremental yield for no additional risk, but there's a cumulative penalty that the surrounding areas pay."

Investors "look at each entity individually and judge them on their own credit ratings and history," said Terry Stanton, a spokesman for the Michigan Department of Treasury, which oversees the school bond qualification and loan program. "There continue to be an abundance of sound, smart investments to make in Michigan and in our local communities."

Michigan debt trailed the broader market last month. The yield on 10-year state general obligations fell 0.15 percentage point, compared with a drop of 0.32 percentage point for benchmark bonds, Bloomberg data show.

Trailing California

The state's average yield spread since Detroit filed for bankruptcy protection is almost double what it was in the first half of 2013.

The eighth-most-populous state pays the second-highest yield relative to benchmark munis, with only Illinois facing a higher cost, Bloomberg data show.

That wasn't always the case. Before Detroit's filing, investors demanded a higher yield to own bonds from California, which has a Standard & Poor's rating two levels below Michigan's.

"Michigan has made it clear — in actions related to Detroit's bankruptcy — that it views municipal bondholders as effectively subordinate to pensioners and less important than protecting artwork," Concord, Massachusetts-based Municipal Market Advisors said in its report.

Four Michigan issuers are offering new bonds this week, Bloomberg data show. The $17 million of debt would be the least for a non-holiday week since November, the data show. The localities are borrowing as benchmark 10-year yields are the highest since Jan. 16.

By Brian Chappatta Feb 6, 2014 5:00 PM PT

To contact the reporter on this story: Brian Chappatta in New York at bchappatta1@bloomberg.net

To contact the editor responsible for this story: Stephen Merelman at smerelman@bloomberg.net