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Casino Bonds' Value Goes Up.

Improvement of company that insures them spurs buying of controversial notes

A recent spate of purchases of Detroit's questionable casino revenue bonds has boosted the value of the city's possibly doomed debt by as much as 72 percent. But the sudden popularity of Motown bonds has nothing to do with the state of the city's finances, its landmark bankruptcy case or even the outlook for a negotiated settlement.

Instead, investors are buying up the bonds because of an improvement in the financial condition of the company that insures them.

"With any insured bond, the price reflects a bet on the recovery percentage on that bond if it defaults and the insurance company's ability to pay," says William Glasgall, program director for the Volker Alliance, a nonprofit focused on government policies.

The bonds are the controversial certificates of participation, or COPs, that give investors a chunk of Detroit's casino tax revenue. The city is arguing that the deal that created the COPs under the Kilpatrick administration was illegal, and that the bonds should be wiped out. While the city has settled with insurers over other Detroit bonds, it has made no public offer of any kind on the COPs.

Normally, an investor holding an insured bond wouldn't worry. Even if the bankruptcy judge allows the city to completely stiff bondholders on the COPs, the investors would collect all the guaranteed principal and interest on the same schedule between now and 2035, when the bonds mature.

But the insurer of much of the COPs in question is Financial Guaranty Insurance Co. of New York. FGIC, as it's known, insured not only Detroit's controversial casino revenue bonds, but also a lot of bonds based on risky mortgages that were issued during the housing bubble. FGIC took huge losses, eventually filing for Chapter 11 bankruptcy reorganization, and now operates under a rehabilitation plan administered by the state of New York.

Because of the financial hit FGIC took when the housing bubble burst, the company's assets are depleted. It's also barred from writing new bond insurance policies, which limits FGIC's ability to bring in new revenue. Instead, the company is in what's called "run-off mode," limited to managing its assets and claims, and paying just a fraction of the full value on the policies it already issued. Under its rehabilitation plan, FGIC initially pays 15 cents on the dollar when a bond goes into default.

Ultimately, the payout goes up if FGIC can do better than expected on its investments, has fewer than expected claims or finds other sources of income. And FGIC has found a good one: suing the big banks that churned out what were supposed to be ultra-safe bonds but were actually risky bets on a pile of toxic mortgages guaranteed to go bad.

On April 16, FGIC announced a settlement of $584 million — in cash — with Bank of America on mortgaged-backed debt FGIC had insured. In addition, FGIC has announced separate settlements with the Bank of New York Mellon, which acted as trustee on the issues. FGIC has already received $307 million under the completed settlements and will get about $48 million more if two more proposed settlements are reached.

That's nearly $1 billion of new cash on hand that means FGIC will have more money than expected to cover any losses on the bonds it insures, including the Detroit COPs.

"FGIC will have less losses than what they reserved," says Lisa Washburn, a bond analyst with Municipal Market Advisors. "FGIC isn't going to do as badly as anticipated."

When investors noticed the improvement in FGIC's balance sheet, they went on a shopping spree. The 2006 Series A COPs traded as low as 38.5 cents on the dollar in July 2013 when Detroit declared bankruptcy, according to data from Electronic Municipal Market Access.

The debt didn't trade for nearly a year, then dropped to 37.75 cents in March, just before FGIC settled with Bank of America. Then, this month, more than $53 million worth of the certificates were purchased at 56.25 cents on the dollar, an increase of 49 percent.

Series B bonds in the same issue had traded as low as 25 cents on the dollar in March. By July, the price had jumped to slightly over 43 cents, a gain of 72 percent. By comparison, certificates from the same Series B issue insured by the bond insurer now known as Syncora Guarantee, gained just 7 percent in the same time frame.

"FGIC is a bond insurer that crashed," Glasgall says. "When a insurer defaults, it's not necessarily going to pay off 100 cents on the dollar. It's going to pay a percentage of the liability."

Overall, investors looking at the COPs need to balance more than just the bond insurer's health. Other considerations include what they think the city may offer if it makes a settlement, and an early payment discount. With a financially sound insurer, the value of the bonds today might be 70 cents on the dollar.

If investors think the city will settle for 20 cents and FGIC can cover just 15 cents from insurance, they'd value the bonds at 35 cents on the dollar. But when FGIC's ability to pay more increases, so does the market price for the bonds.

Although the bond trades don't list the buyers and sellers, one industry expert who asked not to be identified because he isn't authorized to comment, said the buyers of FGIC-backed COPs were hedge funds. The large private investment pools have become active buyers of distressed municipal bond debt in the past few years. The sellers, according to a report in the Wall Street Journal, were European banks that bought Detroit bonds at nearly full value and took big losses on them after the city declared bankruptcy.

Now that the European banks are undergoing stress-testing to gauge their safety, those banks may have wanted to dump the low-value, distressed Detroit debt to reduce their risk, especially when they could get more money for the bonds than the value listed on the banks' balance sheets, explains James Spiotto, managing director of Chapman Strategic Advisors LLC.

"Its math," Spiotto says. "In a regulated environment, banks have to carry the debt at a discounted value. They've written it down and can realize some value now."

While that's good news for the European banks, and maybe for investors who think they'll profit thanks to FGIC's improved financial condition, the jump in bond prices says absolutely nothing about the legality of the casino revenue certificates, the outcome of Detroit's bankruptcy or the city's financial future.

“When all the bond insurance companies were rated AAA, it kind of didn’t matter, because you expected to get your full 100 cents on the dollar back,” Glasgall says. “Since the bond insurance industry collapsed, it’s become a play on the insurer’s balance sheet.”

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