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[NYT: Detroit’s Bankruptcy Deal Hinges on 2 Banks.]

The future of Detroit’s pensioners may depend on an insurer’s resolution of a dispute with Bank of America and UBS.

Syncora Guarantee, Detroit’s most vociferous adversary in bankruptcy, is close to a breakthrough settlement with the city, but before it can close the deal it must resolve a related dispute with two big banks, Bank of America and UBS.

The bankruptcy judge, Steven Rhodes, has adjourned a trial in the case until Monday. If Syncora cannot reach an agreement with the banks by then, it will face a breakdown of its whole deal with Detroit, which would give it a stake in vehicle tolls from the tunnel that runs between Detroit and Windsor, Ontario, as well as some nearby land.

Syncora’s dispute with the banks goes back to a $1.4 billion borrowing by Detroit in 2005. The city was already in dire financial straits and did not have enough to make its required pension contributions. After city unions sued, Detroit decided to borrow the money, and UBS and a precursor to Bank of America underwrote the deal. Syncora insured it along with another bond insurer, the Financial Guaranty Insurance Company.

The $1.4 billion did not solve Detroit’s problems, though — it merely bought the city some time and labor peace. Ultimately, it increased the amount of debt Detroit now has to deal with in its historic Chapter 9 bankruptcy case. In the bankruptcy framework, the borrowing has turned out to be so messy and intractable for the municipal bond market that it almost seems to stand as an example of why it is a bad idea to fund public pensions with borrowed money. Such deals continue to be done in many places, however.

In bankruptcy, Detroit’s approach to the 2005 debt has been to argue that the whole borrowing was illegal from the start because the city had reached its debt ceiling. It contends the deal should be voided, which would result in hundreds of millions of dollars in losses for both Syncora and Financial Guaranty.

In fact, until Syncora’s announcement on Tuesday that it had an agreement in principle with Detroit, both insurers stood to receive one of the lowest recoveries of the bankruptcy. That outcome would have significant negative implications for the municipal bond industry because it would leave Detroit’s pensioners higher on the creditors’ pecking order than the investors who bought Detroit’s debt in 2005.

The investors had no idea Detroit would later call the borrowing illegal, because the underwriters obtained legal opinions from both the state and independent bond counsel that the debt was valid, binding and enforceable.

It would be highly unusual for a government to repudiate debt marketed with such assurances. Municipal bond analysts have been warning that if Detroit prevails, it will cast a shadow over every other city bringing debt to market in the future.

Complicating matters, when Detroit borrowed in 2005, it tried to hold down the cost by issuing variable-rate debt, then hedging it with a type of derivative called interest-rate swaps. The swaps were intended to protect Detroit if interest rates rose — but if they fell, the city would have to pay the swap counterparties, which happened to be Bank of America and UBS.

The two insurers wrote guarantees for both the debt instruments, called certificates of participation, and for the interest-rate swaps. That protected the investors who bought the certificates and Bank of America and UBS from any missed payments on the swaps.

The borrowing was considered so innovative in 2005 that it won a Deal of the Year award from The Bond Buyer, a trade publication, and was said to have solved Detroit's pension problem once and for all. But by 2009, interest rates had plunged, and Detroit's mandatory swap payments to the two banks ballooned beyond anybody's expectations.

With cash flying out the door, the city's fiscal problems grew bad enough to activate provisions requiring it to terminate the swaps — but that required Detroit to buy out the two banks at the full present value of all the swap payments it would otherwise have to make for the life of the certificates. Once again, it did not have the money.

Detroit bought some time by restructuring the swaps and backstopped its obligations to the banks by pledging the cash it receives from a tax on casinos, an important source of revenue for the city.

After that, Detroit kept right on paying the swaps, even after declaring bankruptcy last year, when it estimated the cost of terminating its swaps at about $345 million. The city and the banks did reach a proposed settlement of $165 million, but the judge rejected it.

"It's just too much money," Judge Rhodes said at the time, and he ordered both sides to negotiate a lower deal. A few weeks later, the banks accepted $85 million.

Syncora's lawyers saw that the banks planned on turning their losses on the swaps into insurance claims that it and Financial Guaranty would be expected to pay.

That is what Syncora and the two banks will be thrashing out in their closed-door sessions this week. Financial Guaranty is not participating in those talks but has been in touch with Detroit about other possible settlements.

Both insurers say that if the 2005 borrowing was in fact illegal, as the city says, then they were fraudulently induced to insure it. If so, then their policies are also void, they say, and they do not owe the banks any money.

No one wants to touch the third rail underlying all this: If the 2005 borrowing was truly illegal, and must therefore be voided, then the city pension system should be required to give the investors back the $1.4 billion they provided back in 2005. That would sink Detroit's hard-won exit strategy.

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