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Detroit Bankruptcy 'All Negative' For Muni Investors – MMA.

I spent my Current Yield column this week discussing how the outcomes of the Detroit and Stockton bankruptcies are pretty uniformly bad for muni bond investors, since both of those cases upended the preferential treatment bondholders have traditionally received in Chapter 9 cases compared with other creditors. Instead, bondholders got the short end of the repayment stick in both cases, as public employees and pensions recovered a lot more of what each city owed them than bondholders did.

The outcome of the Detroit case was so bad that it prompted Matt Fabian of Municipal Market Advisors today to label the situation "all negative" for muni investors, particularly in the state of Michigan, adding that "takeaways for the municipal market from Detroit's bankruptcy are uniformly negative."

Fabian offers his own version of Bank of America Merrill Lynch's seven lessons for investors from Detroit's bankruptcy. Here's a brief version:

- **Pensions > Bonds:** "In the absence of legal precedents to the contrary, local unsecured GO bondholders, particularly those in MI, have to assume their position in the capital structure is subordinate to pensioners and indeed that of almost any other politically connected creditor," Fabian writes. That's some serious food for thought if you own muni bonds in Michigan.
- **OPEBs = Bonds:** Fabian points out that unsecured bondholders weren't treated better than OPEBs, which he calls "a complete change in thinking" for the muni market.
- **Secured credits got impaired too:** Fabian says Detroit represented "the largest municipal payment default in recent history" for secured creditors, despite the allegedly superior investor protections afforded secured creditors.
- **Bondholders can be bullied:** After this case, Fabian sees "no reason why future debtor advisors would not similarly be able to harass municipal creditors into large losses."
- **State as adversary, not partner:** Fabian says Michigan "played a key role in steering losses onto" bondholders, and that lower-rated government bonds in Michigan "may no longer be suitable for traditional retail investors."
- **Investor ambivalence:** Fabian says investors have continued to buy Michigan bonds, and underwriters have continued to issue them, with little negative consequence to the state despite the unfavorable treatment of Detroit bondholders.

Fabian adds that Detroit still needs revenue growth to make its bankruptcy-exit plan work, and he calls the court case "undeniably a success for Detroit's restructuring advisors, who followed a corporate-style, adversarial strategy that set creditor losses as its highest priority" and in doing so set a precedent for future municipal bankruptcy cases. He says the outcome may even prompt more federal scrutiny of profligate municipal governments, saying it even incrementally increases the risk that the federal government might revoke the tax-exempt status of municipal bonds.

As for Stockton, Fabian says the unfavorable treatment of certificates of participation in that case "should incrementally reduce the value and liquidity of [California] COPs." He adds that COPs have been an important financing structure for California local governments, which are "likely to see their borrowing costs rise as a result."

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By Michael Aneiro

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