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Detroit Schools Split Raises Risk of Default on State-Aid Debt.

Michigan's plan to bail out the troubled Detroit public schools is putting debt backed by state aid at risk of falling into default if the bonds aren't refinanced by mid-October.

Ratings have been slashed twice by S&P Global Ratings since late June on the district's debt by a total of six levels to junk. Michigan's restructuring of the district's finances diverts state payments on about $370 million of bonds sold in 2011 and 2012 to a newly created school district that doesn't have any responsibility for the old debt. The state still lacks a plan to refinance the bonds, and S&P said absent a plan, it would likely consider this a distressed exchange that would merit being labeled as a default.

"S&P was in its rights to downgrade," said Tamara Lowin, director of research at Rye Brook, New York-based Belle Haven Investments, which oversees $5.3 billion of municipal debt and doesn't own any district debt. "There was debt outstanding for which the revenue stream has disappeared. That is in itself alarming."

The restructuring approved by state lawmakers and Governor Rick Snyder was designed to the give Detroit's schools, reeling from the same population decline that bankrupted the city, a "clean slate," Snyder said when he signed the bill June 21. Moody's Investors Service, in a report issued a week later, said the restructuring was "credit positive" for bondholders "given that the district was teetering on bankruptcy and was reportedly unable to make payroll absent an immediate infusion of revenue."

The restructuring separates the district into two entities, with a new district responsible for the education of about 46,000 students and funded with state aid. The existing district would continue to pay off the district's old debt, including about $2.2 billion of bonds and pension liabilities from property taxes. The state will provide about $467 million to help repay the old debt.

The Michigan Finance Authority, which issued the debt cut by S&P for the district, is putting together a plan to refinance the debt by Oct. 20, said Danelle Gittus, spokeswoman for State Treasurer Nick Khouri. She declined to provide any additional details.

"We're still in the middle of preparing, so there's nothing else we can say," said Gittus.

Negative Outlook

Since the legislation was signed, the dollar price of the 2012 bonds maturing in four years has fallen to par from about 108 cents on the dollar. S&P cut the 2011 bonds to BB from A and the 2012 bonds to BB- from A-. Moody's doesn't rate the bonds S&P cut, but has a Caa1 rating with a negative outlook on the district, seventh in the junk category.

"It's a surprise that it was in the A category, then it's BB," said Bill Bonawitz, director of municipal research at PNC Capital Advisors, which oversees $6.5 billion in municipal bonds. "How do you go from being an A rated bond to a BB rated bond in a matter of five weeks? That's a huge difference."

S&P said it made its assessment based "on the lack of a formal plan regarding bondholder repayment terms" and the elimination of one of the pledged revenue streams in the fiscal year that begins Oct. 1.

The restructuring needs to be in place before Oct. 20, when state aid moves to the new district, leaving the bonds rated with S&P with just the property-tax pledge. Lack of specific details on the plan to refinance the two bond series creates uncertainty for bondholders, S&P said, raising the risk of default.

Eroding Value

"If they don't get it refinanced, the loss of the revenue stream is going to seriously erode bondholder value," said Jane Ridley, an S&P analyst, in a phone interview. "The bondholders will lose security."

S&P, the only firm that rates the 2011 and 2012 bonds, said in an Aug. 3 report that separating the state-aid payments from the bonds creates a more than 50 percent chance the debt could be cut again in the next two months. It warned that it could use its D, or default category, if repayment is less than originally promised. The bonds will keep a property-tax pledge under the new structure once state aid goes to the new district.

"As October approaches and ushers in the new fiscal year, it creates greater uncertainty as to whether bondholders will receive full and timely payment," S&P wrote. "If the actions taken through this process provide bondholders with anything less than the full promise of the original bonds, it is likely to be considered a distressed exchange and therefore a default under our criteria."

It appears the district will end up refinancing its debt, said Lowin, who noted there's questions about the strength of the security on the bonds.

"It'll be interesting to see what kind of market access the new debt will have," she said.

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