RESEARCH

Banking Watch

US

Houston, July 23, 2013
Economic Analysis

U.S.
Alejandro Vargas
alejandro.vargas@bbvacompass.com

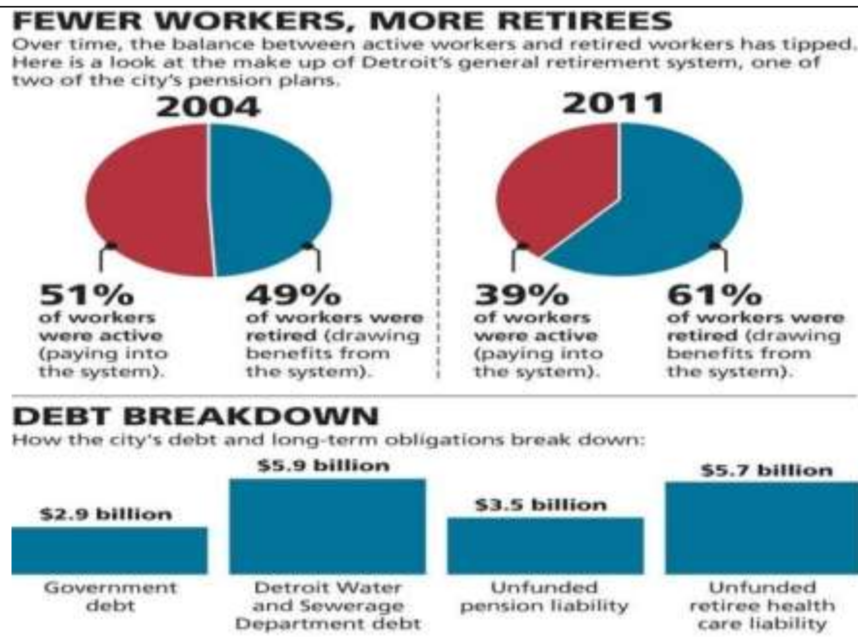
Boyd Nash-Stacey
boyd.stacey@bbvacompass.com

Detroit Files Chapter 9 Bankruptcy on $18bn in Debt

- Largest municipal bankruptcy in U.S. history by more than fourfold
- Declining population and infrastructure crippled the cities revenue
- Contagion will be minimal since Detroit is a unique and extreme case

On July 17th, Detroit filed for bankruptcy on $18bn in debt, in what became the largest municipal bankruptcy filed in the U.S. since Jefferson County, AL in 2011. In lieu of weak finances Standard and Poor's has downgraded its rating from CC to C, one notch away from the lowest possible rating. However, the size of the Detroit bankruptcy may not be the most important aspect of the largest bankruptcy filing in U.S. history. From a legal perspective, allowing Detroit to renegotiate its pensions could complicate future Chapter 9 filings that involve state or municipalities with underfunded or unfunded pensions. Many other states constitutionally guarantee public pensions. However, both pension renegotiation, which is allowed under Chapter 9 bankruptcy proceedings, and no renegotiation governed by Michigan's constitution are legally valid arguments. Thus, this case could provide the standard for which how pensions are treated in states with constitutional guaranteed pensions.

Chart 1



Source: Kevyn Orr's 45-day report and proposal for creditors

The path laid before Detroit is still very much unknown but what we do know is that Detroit stands on the precipice of insolvency with a foot dangling very much over the edge. Since the filing on July 17th, circuit Judge Rosemarie Aquilina has ruled the Chapter 9 bankruptcy request unconstitutional because it violates a clause in Michigan's constitution that bars any action that will lessen the pension benefits of public employees. Her ruling will, for the time being, protect the pensions of public employees but Judge Steve Rhodes will begin hearing cases from creditors and the city on July 24th. The fact that the 2011 Jefferson County Bankruptcy filing is still ongoing, and was for an amount less than a fourth of Detroit's, suggests a quick resolution is unlikely. Moreover, there are over 100,000 listed creditors in the Chapter 9 filing which will certainly take time to get rolling.

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Detroit, home of motor vehicle behemoths GM and Ford, has been on the decline since the height of its economic influence in the mid-20th century when it ranked as the nation's 4th largest city. Detroit's inability to attract high-growth industries such as technology and healthcare companies has been a key factor to a sharp decline. Since the late 1950's, Michigan's largest city has been in a population free fall, from a peak of 1.85 million in the 1950's to its current level of just over 700,000.

Detroit's lack of industrial diversity has reduced the city's potential growth and made it more vulnerable to economic cycles. For example, close to one third of its population lives in poverty and in 2011 the median household income was $15,261 compared to a national average of $27,915. The city also has an unemployment rate (16%) more than twice as high as the U.S. In July 2009, it peaked at 27.8%.

Demographics, economic growth and income levels heavily influence revenues, spending and quality of infrastructure. Although Detroit's square mileage is larger than Boston, Manhattan and San Francisco combined it has less than a third of the population. As a result struggles to generate revenues and keep basic public services running. For example, Boston collects 8.2 times more than Detroit per square mile in property taxes while Chicago collects 2.5 times more than Detroit. This is despite Detroit having the 10th largest tax burden for families earning $150K or more.

Most importantly, the underfunded public pensions are a fundamental issue of the restructuring debate as nearly 10% of the population is employed in government positions. Close to a decade ago, about 51% of the work force was paying into the system with the remaining 49% drawing from the system. Unfortunately, through a combination of weak economic growth and declining population, the ratio has become one sided. As of 2011, 39% of the workforce was paying into the system while 61% were drawing from it. This has left Detroit with $3.5bn in unfunded pension liabilities that it is now seeking to restructure. Given that the city's public debt depends upon medical and pension accounts, and demographics are becoming less favorable, liabilities could rise as more people begin drawing from their pension accounts.

The remaining shortfall relates to general government obligations and is estimated to be 8.8bn or 4.5% of annual GDP. Unlike the unfunded pension liabilities, these obligations are not directly related to employees but rather, to the sale of municipal debt which pays for infrastructure project, educational improvements, and public works projects. Of the $8.8bn, $2.9bn or 16.9% of the total estimated debt relates to public works and services accounts. The final $5.9bn of the debt relates to city's water and sewage department. Bonds are the most common means of generating funds for the water department, for new projects or improving infrastructure and have been tied to upgrades to water treatment facilities and replacing old and damaged water systems.

Many other cities face similar problems with public spending and obligations outweighing revenue. Chicago, for instance, was recently downgraded by Moody's because of $19bn in under-funded pension liabilities, a dilemma Detroit faced long ago and never rectified. Cities like Chicago, Cincinnati, Minneapolis and Portland have high unemployment rates and growing deficits that can lead to fiscal stress. While the aforementioned cities accumulated fiscal deficits throughout the recession, recent financial filings suggests that revenues have rebounded, and should sufficiently offset the trending general obligation and pension liabilities. Moreover, state and local finances continue to improve according to our fiscal stress index (see our 2Q13 US Outlook for more information). However, Detroit is a city where spiraling pension and benefit liabilities are coupled with a failing infrastructure, high crime rates and a struggling socioeconomic divide, symptoms that no other city under watch exhibits.

Bottom Line:

Detroit is far from reigniting its economic engine and is closer to a legal stall that will complicate efforts to improve the battered infrastructure and impoverished population. Detroit's long term growth prospects remain in taters with high unemployment and little investment growth. The nature of the filing lends itself to rising borrowing costs and a drawn out legal battle between the city and creditors, which could complicate the solution even more. Sadly, poor management and politics made a bad situation worse. However, these actions could be the first step of a long transformation that hopefully will revitalize urban Detroit once again.