

DETROIT'S (POSSIBLE) IMPACT ON CREDIT ANALYSIS & MARKET ACCESS FOR DISTRESSED MUNICIPALITIES

Lisa Washburn, Managing Director

November 8, 2013

Detroit Didn't Surprise the Market

- Challenges evolved over decades
- Population flight, high poverty & significant tax burden
- Structural imbalance; inability to align revenues and expenses as nearly all revenues declined
- History of financial mismanagement and corruption
- Below investment grade since 2009
- State-assisted financings since 2010

Michigan Surprised the Market

- Previously hailed for its oversight of distressed local governments
- Various laws over the past 3 decades, repayment of debt a priority
- Fiscal stability agreement with Detroit put in place (finally)
- Public Act 436 replaces repealed Public Act 4; state oversight via emergency manager viewed positively
- Seemingly encouraging Detroit—its largest city—to go bankrupt and default
- State support for unprecedented general obligation bond losses
- Lack of leadership visibility and poor communication strategy

Investors Worried Over Strength of Security Pledge

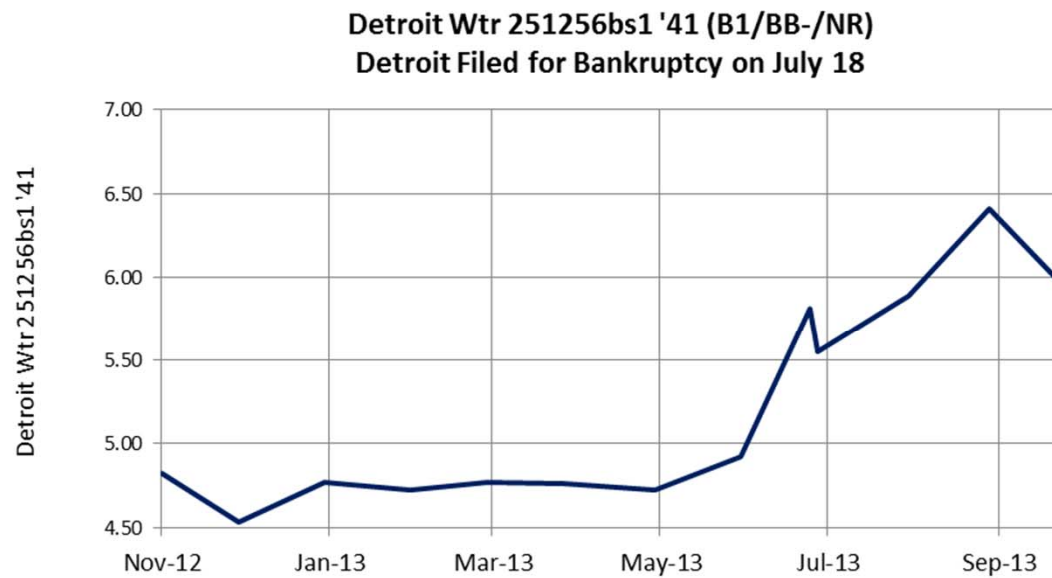
- Security matters upon default and in bankruptcy
- Full, faith and credit, unlimited general obligation pledge historically viewed strongest tax-backed pledge
 - Pricing and ratings benefit
- Treatment of unlimited general obligation pledge on parity with other unsecured creditors
 - Voter-approved, dedicated tax unable to be used for general fund purposes thought to remove incentive to impair as well
- Pension obligations on parity or above?
- Consideration of an equal, allowable claim for OPEBs
 - Typically viewed as adjustable; concerning if any portion is on par

And, State Did Damage to Investor View of Oversight Program

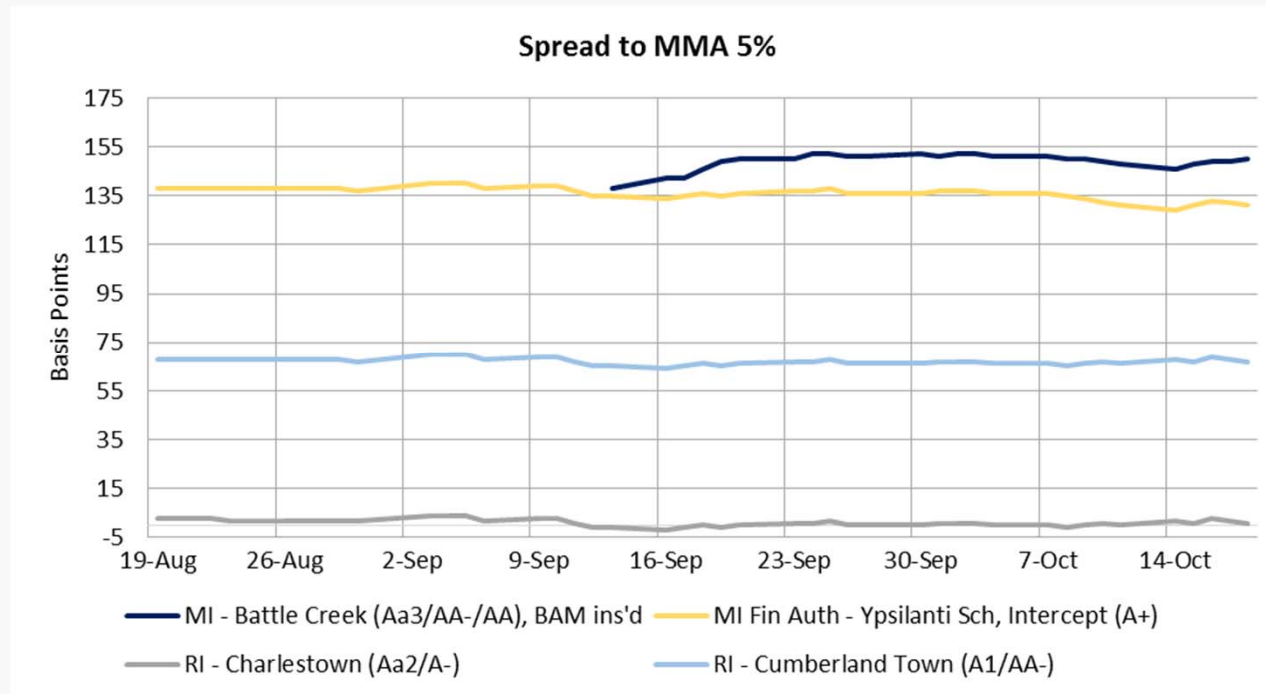
- Local governments in states with strong oversight history and/or mechanisms typically are awarded a pricing benefit

- Detroit and two school district defaults reverse view of Michigan's program
 - There had been no Michigan local government defaults or bankruptcies over the past several decades

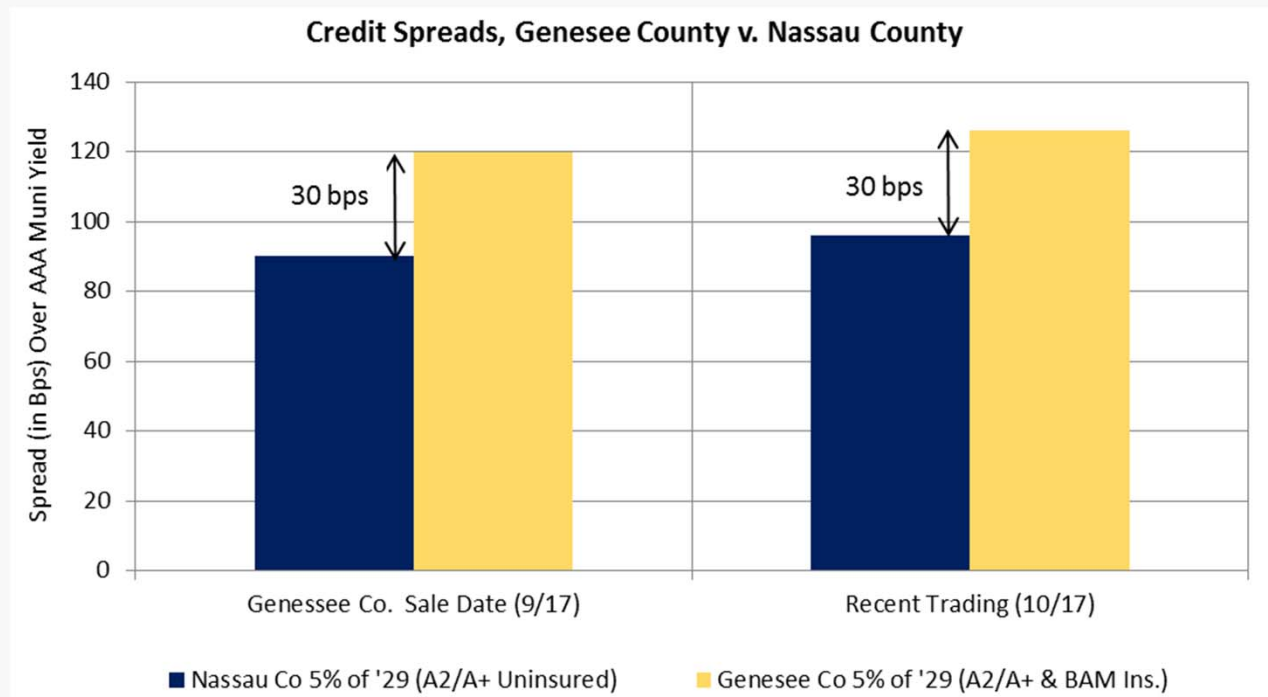
Detroit's Bankruptcy Hits the City's Secured Bonds



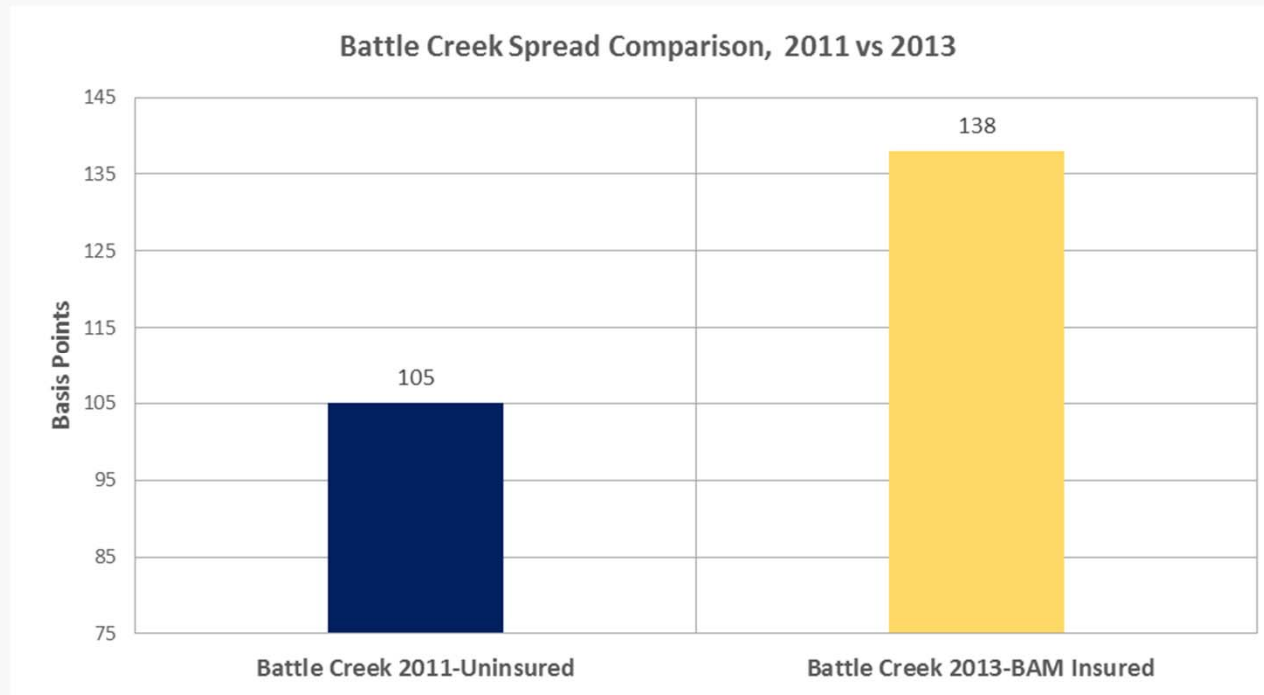
Michigan Issuers See Higher Spreads Following Bankruptcy



Effect on Recent Michigan Local Government Issuers



Effect on Recent Michigan Local Government Issuers



Market Will Adapt to Detroit Bankruptcy Decisions

- Price “heals all wounds”
- But, rating downgrades could amplify market impact
 - If rating agencies consider all pledges general fund pledges
 - If bondholder payments subordinate to pension payments
 - If OPEBs are considered debt obligations
- Extension of decisions to local governments in other states unknown
 - 50 states with different set of laws regarding access to bankruptcy and protections for bonds and pensions
 - Broadness/narrowness of the decision
- In theory, local governments in states that permit bankruptcy filings without a statutory lien that benefits general obligation debt are more vulnerable

Market Access for Distressed Municipalities

- New York City, Philadelphia and District of Columbia (cover all the bases)
 - Oversight
 - Independent authority created to refinance debt
 - Access to a source of funds (revenues and/or access to loans)
- Rhode Island (clarify prioritization)
 - Legislation that prioritized general obligation debt
 - Statutory lien created so unimpaired in chapter 9
- New Jersey Municipal Bond Program, Buffalo and Detroit (capture revenues)
 - Intercept, set-aside, lockbox or direct pay
 - Insulate against municipality's credit risk
 - Structure is working as intended in Detroit, secured and unimpaired
- Moral obligation pledge or guarantee (if permissible)

Credit. Man's Confidence in Man.

- Market access will require investor trust
 - Particularly important in municipal bond market
 - On average about 250 new transactions per week across different states, sectors, security pledges
 - Disclosure issues
 - Amplified because of participation level of individuals and banks
 - Very headline sensitive
- Michigan's adversarial approach in Detroit situation will make this harder
- In addition to the strength of the structure, investors will likely focus on:
 - Leadership/management/oversight
 - Support (or lack thereof) from state
 - Availability of financial resources

Key Takeaways

- Main concerns stem from Michigan's actions, not Detroit's decline
- Michigan market has been affected and issuers are paying a penalty
- Market access could get more costly and ratings could decline for local governments depending on bankruptcy-related decisions
- Structures have been used to enable access to capital for distressed municipalities...but usually as part of a plan to avert default
- State effort will likely be required to rebuild investor confidence and trust