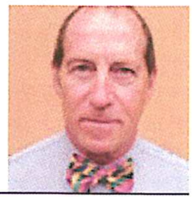


By Frank Shafroth

Bondholders Beware

Recent bankruptcy rulings have protected retirees. But at what expense?

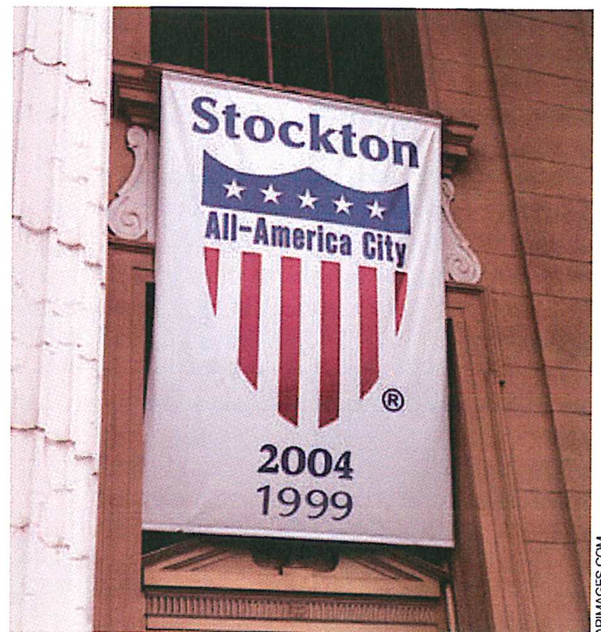
Four cities emerged from bankruptcy court this past year, and in each case, their road to fiscal stability was paved not with cuts to the pensions of firefighters, teachers and other local government employees, but to the wallets of bondholders who had invested in those cities. In California's San Bernardino, Stockton and Vallejo, and in Detroit, bondholders faced losses of up to 99 percent of their holdings, according to Moody's Investor Services. In the bankruptcy resolutions in all three California cities, the courts preserved full pensions for retirees, while in Detroit pensions were cut only by about 18 percent.

This has neither ensured nor clarified the future fiscal sustainability of those cities or for others with structural debt problems. It has merely perpetuated concerns that cities have found a get-out-of-jail-free card. In June, Moody's sharply downgraded Chicago's credit rating, attributing the decision almost entirely to the city's pension liabilities for its teachers and its inability to pay for schools. Should the Illinois Legislature grant Chicago and other municipalities access to bankruptcy, many fear that municipalities' political inabilities to rein in pension liabilities could trigger future bankruptcy court decisions that, as in California and Michigan, would have repercussions for municipal bondholders throughout the nation.

Naturally this is pitting bondholders against retirees. The former are critical to a municipality's future and its ability to raise money to build and modernize infrastructure and services. The latter are a fiscal burden, but their pensions are stabilizing factors in two ways: They help attract the most competitive applicants to provide city services, and they help ensure that retirees themselves do not become burdens. This was an imperative factor in the resolution of Detroit's plan to exit bankruptcy.

The importance of stable retiree income is echoed in federal law. The Pension Benefit Guaranty Corp. explicitly provides for continuity in pension benefits—but only for nonmunicipal corporate bankruptcies. The exclusion of cities and counties in this critical matter discriminates against the fiscal capacity of a city or county to invest in its own future. Some states, such as Michigan and Rhode Island, have reacted by making unique and needed commitments to the fiscal sustainability of their municipalities. Others such as Alabama and California leave cities to twist in the fiscal wind.

Almost every state that authorizes cities or counties to file for municipal bankruptcy imposes requirements or mandates. In Michigan, for example, that included the suspension or preemption of the authority of elected leaders. The post-bankruptcy process in Detroit of reverting to municipal authority came with strings attached, one of which is a decade of oversight by the state Financial Review Commission. The commission is charged with reviewing and approving Detroit's four-year financial plan and establishing programs and requirements for prudent fiscal management. To emerge from oversight in 2018, Detroit must maintain a balanced budget for three consecutive years.



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This state oversight is important to Detroit's fiscal future in two ways. First, it means the state has a stake in Detroit's long-term fiscal sustainability. Second, it means that municipal bond investors have greater assurance and incentives to purchase and hold the Motor City's bonds, providing critical capital investment for Detroit's future.

The bankruptcy events of the past two years—in California and Michigan specifically—suggest the need to establish firm and credible fiscal actions to guarantee citizens' essential services and pensioners' sufficient income. Fiscal boards, which are outside of political considerations, would bear the responsibility to guarantee the continuity and honor of the fiscal commitments agreed upon by states and their localities—especially in the wake of a restructuring process.

The road back from fiscal distress or bankruptcy for state and local governments is far more challenging under current federal laws than for nonmunicipal corporations, so innovations that encourage capital investments in these cities' futures are invaluable. Bondholders are watching. **G**

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