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Detroit's Lessons: Failed Financial Engineering Puts Pensions at Brink of Collapse

BY GEORGE M. KRAW

In 2005 and 2006, the city of Detroit funded shortfalls in its two largest defined benefit pension plans by borrowing on its "full faith and credit" in the municipal finance market and distributing the proceeds to the plans for reinvestment.

This strategy based on borrowing was a disaster for lenders and borrowers alike. The local and national financial crisis that followed ensured that the pension plans could not achieve anticipated investment gains, which were predicated on an approximately 8 percent assumed rate of return at the time of the city's default.

The answers to how this state of affairs came about—and what warnings that were missed—are contained in two documents. The first is the City of Detroit *Proposal for Creditors*,[1] issued on June 14, 2013. The second is a 2010 report from the Citizens Research Council of Michigan, *Legacy Costs and Indebtedness of the City of Detroit*.[2]

The financial information contained in the *Proposal for Creditors* depicts an insolvent Detroit whose retirement plans are now hopelessly underfunded. "There must be significant cuts in accrued, vested pension amounts for both active and currently retired persons," according to the *Proposal for Creditors*.[3] The city's default on general obligation debt as backed by its "full faith and credit" has shaken the municipal finance market nationwide. Commenting on the Detroit situation, *The Economist* magazine recently observed that America's $3.7 trillion municipal bond market has long had its doomsayers and asked, "Is this their moment?"[4]

Detroit's financial crisis presents unique challenges. Poor policy decisions and a reluctance to correct them have made matters worse. There are several lessons for private and public pension plans—and their regulators—in this dismal state of affairs.

The most important lessons are that:

- pension plans cannot be regulated, legislated, or ordered by courts into solvency when the plan sponsors lack the economic wherewithal to cover retirement obligations;

- financial engineering can create the illusion of solvency when it does not exist; and

- retirement plans and debt holders ignore one another's obligations at their peril.

Detroit's stakeholders recognized the city's financial problems long before this year's default. The city has been on a glide path to insolvency for four decades. It

George M. Kraw (gkraw@kraw.com) is a founding member of the Kraw Law Group in Mountain View and Newport Beach, Calif., and a former labor representative to the Pension Benefit Guaranty Corporation's Advisory Committee.

[1] City of Detroit *Proposal for Creditors*, http://www.detroitmi.gov/Portals/0/docs/EM/Reports/City%20of%20Detroit%20Proposal%20for%20Creditors1.pdf.

[2] Citizens Research Council of Michigan, *Legacy Costs and Indebtedness of the City of Detroit*, http://www.crcmich.org/PUBLICAT/2010s/2011/rpt373.pdf.

[3] *Proposal for Creditors*, page 109.

[4] *The Economist*, June 22, 2013 "State of Pay—What do the woes of Detroit mean for muni bonds?" http://www.economist.com/news/finance-and-economics/21579861-what-do-woes-detroit-mean-muni-bonds-state-pay. *The Economist* concludes that the national situation is "grim" but a wave of defaults is "not around the corner."

has lost more than 1 million residents since the 1950 census.[5] The local economy and tax base have been gutted by the collapse of the U.S. automobile industry. The city's crime rate makes it one of the most dangerous places in the nation. Basic city services, such as the repair of street lights, are erratic. Large sections of the city are' blighted, and thousands of buildings are abandoned.

In National Spotlight. By 2012, 38 percent of the city's revenues were spent servicing debt and legacy liabilities.[6] City government became dependent on handouts from corporate groups to keep city parks open and to pay for new police cars to replace its decrepit fleet. By 2013, the city had run out of cash, defaulted on debt payments, and gained national attention. How Detroit resolves its financial crisis is likely to set precedents for other local governments facing insolvency.

As late as 2006, the city considered its pension plans to be fully funded (or even overfunded).[7] That funding was an illusion, induced by a lethal combination of borrowed money and overly optimistic investment assumptions. In 2005, Detroit began issuing a series of certificates of participation, called COPs, to cover pension plan shortfalls. The money raised from the COPs was put to work in more volatile investments: stocks and private equity, including local infrastructure projects. This arbitrage was expected to return enough money to eliminate the plans' funding deficits, cover principal and interest payments, justify the pension plans' assumptions about investment returns, and maintain the plans' ''fully funded'' status.[8]

Off-Balance Sheet Liabilities. Many observers, including the Citizens Research Council of Michigan, soon realized that the city's financial engineering program was not working. The Council's 2010 report outlined the city's continuing problems, including increased legacy costs owed to retirement plan participants and failure of the city's funding efforts.[9] By 2013, the city owed an estimated $1.43 billion to COP note holders. The city's expected fiscal year-end balance sheet liabilities totaled nearly $9.05 billion. The city had off-balance sheet liabilities of $3.5 billion for pensions and $5.7 billion for post-retirement obligations, which included payments for retiree health care. The COP program had left the city deeper in debt without fixing the pension plans.[10]

On the same day that Detroit announced it was defaulting on interest payments on the COPs, the city's emergency manager, Kevyn Orr, called for ''shared sacrifice'' that included gutting the city's pensions and ending post-employment benefit payments.[11] Detroit retirees found themselves in line with other creditors for financial haircuts. The emergency manager's plan offered pennies on the dollar for pension participants and COP note holders alike.

The emergency manager also launched an investigation into possible fraud and abuse.[12] The following are key elements of the emergency manager's plan:

- obligations of similar priority will be treated in a similar manner;
- secured debt holders will receive treatment commensurate with the value of their collateral;
- unsecured bonds and similar obligations will receive a pro-rata portion of $2 billion in nonrecourse participation notes, payable to the extent the city's finances improve;
- pension benefits will be reduced consistent with available funding, and
- retiree health benefit plans will be abandoned, and retirees will be sent to Medicare and the Affordable Care Act's health care exchanges.

Looming Municipal Bankruptcy. No matter how courts might rearrange payment priorities, neither the pensioners nor the COP note holders are unlikely to be made whole. The money is not there to do so. The emergency manager's proposal would result in recoveries for some pensioners and COP note holders in the 10 percent range.[13] If the emergency manager is unsuccessful in persuading creditors to accept his plan, he wants the city to file the largest municipal bankruptcy in the nation's history.[14]

Pensioners and COP investors had believed they were at the front of the creditors' line. Pensioners had counted on a Michigan State Constitution provision that made the city's pensions a contractual obligation that could not be abandoned.[15] The COP notes were backed

[5] *Proposal for Creditors*, page 1.

[6] *Proposal for Creditors*, page 24.

[7] *Legacy Costs*, page 10.

[8] *Ibid.* pages 3-4.

[9] The report concluded by warning, ''It remains to be seen whether city officials, unions, contractors and other affected entities can develop and implement a strategy to restore the financial viability of the city, or whether the state, acting under (state law) PA 4 of 2011 or other authority, will be forced to intervene.'' *Legacy Costs and Indebtedness of the City of Detroit*, Citizens Research Council of Michigan, 2010, http://www.crcmich.org/PUBLICAT/2010s/2011/rpt373.pdf, page 28.

[10] *Proposal for Creditors,* page 31, Pension Liabilities Are not Fully Funded—Shortfall Has Been Understated.

[11] *Proposal for Creditors,* page 100.

[12] ''Detroit Emergency Manager Orders Probe of Pension Funds,'' *Wall Street Journal*, http://online.wsj.com/article/SB10001424127887323893504578557632380419050.html (subscription needed).

[13] ''Pennies or Bankruptcy, Detroit Tells Creditors,'' *Wall Street Journal*, June 14, 2013, http://online.wsj.com/article/SB10001424127887324688404578545373282545626.html (subscription needed).

[14] *Ibid*.

[15] ''The accrued financial benefits of each pension plan and retirement system of the state and its political subdivisions

by the full faith and credit of the city. Neither guaranty will overcome economic reality.

Detroit is on the precipice of financial collapse.[16]

This crisis is occurring in a dangerously weakened national and world economy, and at a time when chaotic financial markets have brought added risk and volatility previously unknown to local government finance. New York defaulted on its municipal debt in the 1970s, but it was eventually able to repay its creditors in full without filing bankruptcy and without cutting retirement benefits.[17] Cleveland and Philadelphia also managed to resolve fiscal crises without bankruptcy filings. Detroit is shaping up as an epic battle between bond holders and pension plan participants[18]. The resolution of Detroit's financial failure will likely set an example for troubled municipalities nationwide.

A final lesson from Detroit for public and private pension plans alike is that the better course for defined benefit pension plans is to address serious funding issues early and realistically. Like many other underfunded plans, Detroit chose to take increased risks, based on the hope that it would eventually earn the shortfall back. It ran out of time.

shall be a contractual obligation thereof which shall not be diminished or impaired thereby.'' Michigan Constitution (Article IX, Section 24 of the Michigan Constitution).

[16] The *Proposal for Creditors* states that ''The City is insolvent.'' It adds, ''Absent ongoing cash intervention (primarily in the form of payment deferrals and cost cutting), the City would have run out of cash before the end of FY 2013.''

[17] ''Detroit defaults on some debt to avoid bankruptcy filing,'' *Reuters*, June 14, 2013, http://www.reuters.com/article /2013/06/14/us-usa-detroit-creditors-idUSBRE95D0OS20130614.

[18] ''In Embattled Detroit, No Talk of Sharing Pain,'' *New York Times*, June 17, 2013, http://www.nytimes.com /2013/06/18/business/in-embattled-detroit-no-talk-of-sharing-pain.html?pagewanted=all.

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