The Detroit crisis and the municipal bond racket

Timeline of Detroit debt crisis

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In justifying the takeover of Detroit by an unelected emergency manager, the political and media establishment have sought to blame the city's debt crisis on the victims themselves, claiming that the residents of the poorest big city in America have been "living beyond their means" for decades.

In reality, Detroit is one of many US cities that have taken on crushing levels of debt to offset cuts in federal aid and state revenue sharing, the loss of revenue due to decades of corporate tax breaks and, most recently the impact of the financial crash of 2008.

Cities, school districts and other public entities across the country have turned to the municipal bond market to borrow money to cover operating expenses, pension obligations, and the cost of servicing billions of dollars in debt. Since 2005, the muni-bond market in the US has virtually doubled from $1.9 trillion to $3.7 trillion.

Like the sub-prime mortgages before them, muni bonds have become one of the latest speculative bubbles, with high-risk bonds being traded and re-traded on the market. Working on behalf of a small number of financial institutions controlling vast sums of private capital, the hedge fund managers, insurers and brokers who control the bond market have made billions in profits, generally free from federal, state and local taxes.

The biggest bondholders have assumed enormous power over public decisions. The appointment of an emergency manager in Detroit—an unelected official with unprecedented powers to slash the wages and pensions of city workers, gut essential services and sell off public assets—is in reality the imposition of a bankers' dictatorship over the city.

The descent of the Motor City into insolvency has long roots, which are ultimately bound up with the decline of American capitalism, the systematic dismantling of industries deemed by the ruling class to be unprofitable and an increasing shift to financial speculation, which has little or no connection to the process of production.

The city's debt burden increased exponentially in the mid-2000s as the auto industry hemorrhaged, eliminating 83,000 jobs in the state between 1993 and 2008 before General Motors and Chrysler declared bankruptcy. In 2005, with the city of Detroit scheduled to pay almost a billion dollars on bonds, notes and debts, including nearly $366 million for interest payments alone, former mayor Kwame Kilpatrick floated $1.4 billion in municipal bonds to meet obligations to the city's underfunded pension funds.

The deal—which required paying UBS Financial Services and other banks $46.4 million upfront in fees—was sold as a way of saving $13 million a year by lowering interest rates on the city's debt. (See, "US cities face crushing debt burden".) According to *Bloomberg News*, the following year, the city paid another $61.8 million, including insurance costs, for UBS to sell $948.5 million in bonds replacing two-thirds of the debt sold the previous year.

Since 2005, Bank of America's Merrill Lynch, JP Morgan Chase, UBS and other global banks have executed about $3.7 billion in bond sales for the city to cover deficits, pension shortfalls and debt payments, according to *Bloomberg News*. The debt sales cost Detroit $474 million and included payments for underwriting expenses, bond-insurance premiums and fees for wrong-way bets on credit default swaps, according to the *Bloomberg* article, "Only Wall Street Wins in Detroit Crisis Reaping $474 Million Fee."

Detroit officials entered into the swaps to hedge against increases in interest rates and thus insure themselves against default on $800 million in pension debt and $1.6

billion in water department bonds.

This involved entering into contractual agreements with "swap counterparties" including Zurich-based UBS and the minority-owned New York firm Siebert, Brandford, Shank & Co. (SBS Financial Products). One agreement required the city's casino revenue—which was $181 million in 2012—to be sent directly to a trust and held as collateral for quarterly payments and termination payments owed to the providers.

However, after the Crash of 2008 when the Federal Reserve implemented a policy of sharply lower interest rates, the city was left with a liability of $439 million on June 30, 2012, according to a city report. Several downgrades by credit rating agencies made the cost of borrowing even higher. This forced the city to turn to the Michigan Finance Authority, chaired by Governor Rick Snyder's state treasurer, Democrat Andy Dillon, which arranged a $129.5 million bond issue underwritten by a Bank of America unit, *Bloomberg* reported.

Under the swap agreements credit downgrades, a default or state takeover was considered a "termination event," that would allow the banks to impose massive penalty fees. Last year, Detroit's water and sewerage department reportedly borrowed to pay more than $300 million to unwind swap contracts.

With the appointment of an emergency manager the swap counterparties can demand termination payments of up to $440 million—or 22 percent of the city's annual operating budget. The city is reportedly currently in negotiations on those fees.

At a Rhode Island symposium on distressed municipalities held in early March sponsored by the *Bond Buyer*, the most influential publication on the municipal bond industry, Michigan State Treasurer Dillon assured investors that although the new EM would have the power to unilaterally rip up labor agreements and pension obligations, those holding the swap derivative transactions agreed to by the city had nothing to worry about. Asked if the costly deals could be dissolved, Dillon said, "Unilaterally? I don't think that applies because these agreements have been executed."

Prior to the appointment of an emergency manager by his Republican boss, Dillon repeatedly complained that the city's charter was an obstacle to slashing pension benefits for future retirees. The charter required that the City Council first order an independent audit on the impact of such cuts and then wait three months before taking any action.

The new EM can overhaul the benefits outside of the city charter or without union consent. Claiming that retirement health care benefits and so-called OPEBs, or Other Post-Employment Benefits, were the "city's single largest liability," Dillon's Financial Review Board wrote on the eve of the appointment, "any uncertainties and delays relating to adjusting this obligation would greatly impede the ability of city officials to negotiate with other creditors of the city."

In other words, the path has been cleared for a savage attack on pensions, along with the jobs, wages and other benefits of city workers to pay back the bondholders in full. In addition, the EM is eyeing the profitable water department and other public assets for sale to private speculators—something the city charter could have made more difficult by posing certain legal obstacles.

After the repeal of the previous emergency manager law by Michigan voters in November 2012, Moody's Investor Service reduced the rating on the city's general obligation bonds to seven steps below investment grade citing what it said was a cash crunch that could result in bankruptcy or default in the next 12 to 24 months.

On March 14 Michigan's Republican governor Rick Snyder appointed Kevyn Orr—a bankruptcy attorney from a law firm that represents UBS, Bank of America and other investors who hold Detroit's debt—as the city's emergency managers. Standard & Poor's quickly raised its outlook to stable from negative.

On the eve of Orr's appointment, the *Bond Buyer* ran an article, entitled, "Detroit Takeover Bodes Well for Investors, Muni Experts Say," praising the impending move. "The problems of the city are particularly entrenched," Howard Cure, director of municipal research at Evercore Wealth Management, told the web site. "But I don't see the city solving them itself, and an emergency manager would have the authority to make unilateral decisions on their own. I think bondholders would be pleased with the decision."