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TREND IN THE REGION

Cash-Poor Detroit Resolves Swaps Mess

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By [Yvette Shields](#)

CHICAGO - Detroit late last month closed on amended swap agreements tied to its pension obligation certificates, ending a six-month headache that began in January when a downgrade triggered a swap termination event with an estimated \$400 million price tag.

Detroit - at the epicenter of the domestic auto industry's woes and struggling to deal with a projected \$300 million structural budget imbalance - just didn't have the money.

"The city didn't have \$400 million to cover the payment or to post as collateral and needed to work something out to avoid the payment and preserve the city's access to the market," said Tom Gavin of Robert W. Baird & Co., financial adviser to the city. "There was no template for how to accomplish that."

Detroit also needed to resolve the threat by the end of its fiscal year on June 30 in order to preserve its market access.

"It was important to the city that it resolve this issue within its financial capabilities and to allow it to continue to borrow for cash flow," said G. Allen Bass of Lewis & Munday, a legal adviser to the city on the swaps negotiations.

Detroit first announced a tentative deal in early April with its counterparties on the swaps. It won City Council approval to enter into the new agreement in late May and closed on the amended swap documents in late June, removing the immediate threat of a \$400 million drain on city coffers. The finalized agreement also cleared the way for a much-needed \$95 million tax anticipation note borrowing that was privately placed at the end of June for cash-flow purposes.

The headache began on Jan. 6 when Standard & Poor's stripped Detroit of its investment-grade rating, lowering \$2.4 billion of limited- and unlimited-tax general obligation bonds to BB from BBB-minus and BBB, respectively, and its pension certificates to BB from BBB-minus due to deterioration in the city's financial position.

The city had already lost its investment-grade rating from Moody's Investors Service on its limited-tax bonds, although the unlimited-tax bonds and pension bonds at the time still carried the lowest investment-grade credit of Baa3 and a stable outlook.

Under the swap agreements tied to its Detroit Retirement System Funds' \$948.5 million issue in 2006, the counterparties can terminate the agreements in the event that the certificates' ratings are



withdrawn, suspended, or stripped of their investment grade by one of two rating agencies, and at least one rating agency drops the insurers' ratings to below the low single-A category.

The city's counterparties on the transaction were UBS AG and SBS Financial Products Co., which is part of Siebert Brandford Shank & Co. Merrill Lynch & Co. provided a guarantee on the Siebert piece. UBS and Siebert also both served as co-senior managers on the pension financing. The agreements were insured by XL Capital Assurance Inc. - now Syncora Guarantee Inc. - and Financial Guaranty Insurance Co., both of which had lost their investment-grade ratings.

After being downgraded, the city received a termination notice from the counterparties within a week. Detroit's mayor at the time, Ken Cockrel Jr., and then-chief financial officer Joseph Harris hired Gavin, Bass and Orrick Herrington & Sutcliffe LLP to represent the city in negotiations with the counterparties.

"We sat down with the counterparties and suggested it was in their best interest to resolve this. The city wanted an amicable resolution and the counterparties were willing to work with us," Gavin recalled. Detroit wanted both to avoid the payment and any legal battle.

Officials weighed the benefits and negatives of a series of revenue streams available to pledge toward its annual \$50 million fixed-rate swap payment to the counterparties based on a 5.67% rate. Under the swaps, the counterparties pay the city a floating rate based on the London Interbank Offered Rate plus a 30 basis point spread.

The finance team sought to limit its choices to available revenues that would not need the approval of external entities like the state of Michigan, and quickly focused on the roughly \$180 million of casino tax revenue collected annually by the city for its general fund. The finance team had a comprehensive review of revenue projections and legal issues as the taxes had been recently considered as a pledge for bonds proposed by former Mayor Kwame Kilpatrick that were never issued.

"It was within the city's power to send those revenues directly to a custodian," Gavin said, lending strength to the pledge in the counterparties' minds.

US Bank NA is serving as the custodian. The revenue stream was favored over the city's share of state distributive aid because it left the aid available as a backup pledge for cash-flow borrowings that the city relies on to maintain operations.

From a legal perspective, Bass added that Detroit benefitted from its extensive home-rule powers under Michigan law. "It was fundamental to the city's ability to pledge any revenues," he said.

Under the agreement, Detroit places its casino tax revenue directly with the custodian, and once the city makes its \$4.2 million monthly fixed-rate swap payment from its general fund, the casino revenues are released.

The counterparties agreed to the pledge, but also sought a concession, adding 10 basis points, or \$800,000, to Detroit's annual fixed-rate payment of \$50 million beginning in fiscal 2011. In return, the counterparties withdrew their termination notice. The agreement removed a "huge weight" from the city, Cockrel said in May.

The new agreements include revised termination events. A termination is triggered if gaming revenue falls below 175% of the amount, or \$87 million, needed to secure the \$50 million annual payment. Detroit currently collects \$180 million. A one-notch credit downgrade for the city raises that threshold to 215%. A two-notch downgrade triggers a default, Gavin said.

During the negotiations, Detroit underwent a change in administration. Voters chose Dave Bing over Cockrel in a special May election to finish out Kilpatrick's term. Kilpatrick resigned in September as part of a plea deal on charges that he lied under oath in a civil whistleblower's trial.

The transition did not affect the negotiations, both Bass and Gavin said, as all parties realized the need to resolve the issue.

The city's success runs counter to Jefferson County, Ala.'s ongoing debt-related crisis. The county, which has negotiated unsuccessfully with creditors to restructure nearly \$3.2 billion of variable- and auction-rate sewer debt since early 2008, has seen its outstanding swaps terminated.

Four counterparties have calculated that the county owes a total of \$766.3 million in swap termination fees and expenses owed while forbearance agreements were in effect. A restructuring agreement was negotiated by Alabama Gov. Bob Riley that included forgiveness of the swap fees, but the agreement depended on the county getting permission from the state Legislature to contribute additional funding outside of sewer revenue. Political infighting and posturing about whom is to blame for the county's fiscal crisis in part prevented lawmakers from agreeing to the bill.

Detroit's current unlimited-tax ratings are BB with a stable outlook from Standard & Poor's, Baa2 on negative watch from Moody's, and BB with a negative outlook from Fitch Ratings. The limited-tax ratings are BB, Ba3 and BB-minus, respectively, and the pension certificates are rated BB, Ba2, and BB, respectively.

The City Council in May adopted a \$3.6 billion fiscal 2010 budget that relies on spending cuts of more than \$100 million achieved through 300 layoffs, the elimination of hundreds of vacant positions, pay cuts for non-union employees, and other measures to deal with faltering revenue. Bing faces a primary election next month and the general election is scheduled for November for a new term.

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