Bond pricing in the biggest city bankruptcy in history: The effects of state emergency management laws on default risk

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**Abstract**

This study investigates the returns to bondholders around important events in the Detroit bankruptcy that impacted market expectations of recoveries on the City’s debt. It illustrates how stricter State interference in the financial affairs of a distressed local government can increase the likely payoff to that entity’s own creditors. However, such interventions are also shown to potentially raise the default risk of economically related municipalities. Further investigations indicated that increases in Michigan’s emergency management powers did not positively impact the returns on a broad sample of distressed municipal bonds in Michigan nor improve the overall credit quality of the State and its political subdivisions.

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1. Introduction

This study examines the prices of the largest public bond obligation of the Michigan City of Detroit actively traded during and around the City’s Chapter 9 Bankruptcy proceedings, along with the returns on other municipals at that time. The research illustrates the significant impact on debt values of individual announcements regarding the financial distress of that City during the 2011–2014 interval on even the default risk of debts with insured payments. It is the first event study of how financially troubled municipalities being managed by higher government authorities affect the obligations of the local governments subject to intervention and other municipal debts. It thereby provides informative insights on whether and how State powers to intervene in local political subdivisions can affect municipal credit.

The bonds of the School District of Detroit that is a separate government entity from the City of Detroit itself but existing in the same area are also examined in this research. This particular investigation indicates that emergency managers and the powers they wield can have an adverse impact on the default risk of governmental entities located around a likely target of such state intervention. In particular, the return on the bonds of the Detroit School District were found to have a sign opposite to that of the obligations of the City of Detroit bonds in some cases where the economic viability of the city was negatively (positively) impacted in ways that increased (reduced) the value of the existing obligations of the City of Detroit itself.

Further analysis of the returns to a diversified portfolio of obligations of Michigan municipalities provided no significant evidence that emergency management powers or different methods of resolving the financial crisis of a local municipality benefit the overall credit quality of governmental issuers in the state or reduce the cost of municipal debt in the aggregate. In addition, an investigation into the returns to the municipal bonds of all financially distressed political subdivisions in Michigan revealed that greater (less) emergency management powers are more likely to have an adverse (beneficial) impact on municipal bond values than a beneficial (adverse) effect.

2. Special legal factors affecting the default risk of municipalities

The risk of default on municipal bonds in the United States (U.S.) is subject to special legal factors which need to be understood by municipal debt investors, issuers, local government employees, rating agencies, and insurers alike. One main factor involved here is the 11th Amendment to the U.S. Constitution which restricts the federal government from interfering in lawsuits against the individual States of the Union or their political subdivisions. Any collection...
on unfulfilled contractual obligations of municipalities can therefore only be resolved through the courts, laws, and constitutions in the State of a local government that are subject to the whims of the State’s voters who have actually abrogated some municipal debts in the distant past (Kennedy, 2016). As a result, recoveries on defaulting municipal debts are subject to particularities that vary by the individual State of the Union (Pollard, 2015).

Even though a municipality may back its general obligation bonds with its full faith and credit, including with a pledge to increase taxes to ensure payments on its debts, State constitutions, laws, and courts can enable subordination of local government bonds to other obligations of the municipality (such as a duty to pay for the costs of providing public services and pay for pensions contracted with the employees of the local government), as well as limit a local government’s authority to access new financing or raise revenue from taxes to make payments to creditors (Kennedy, 2016). For instance, Section 24 of Article 9 in the Michigan State Constitution states that promised pension payments contractually accrued by the employees of the State or its political subdivisions cannot be “diminished or impaired”, but Michigan courts (and courts in other states like Hawaii and Louisiana) have ruled that such a constitutional guarantee does not apply to benefit increases accruing due to future events like continuing employment and pay increases (Monahan, 2010). However, Section 21 of Article 7 in Michigan’s Constitution allows the State government to pass laws restricting the ability of a municipality in Michigan to legally contract such liabilities or any other debts at any time through the imposition of debt ceilings legislated by the State government. The latter Section 21 of the Michigan Constitution also effectively limits the liability of the State with respect to the obligations of its political subdivisions, as the incorporation of local governments protects the State government from the liabilities of those created municipalities, which are separate from the State government, and which are only allowed to levy taxes for the public purposes of the municipality that are specified by the State.

In a majority of States, laws have been passed to permit a State government takeover of a municipality’s operations if a local government has a financial emergency, with Michigan having the most ‘extreme authority’ over its distressed municipalities under such conditions (Calvert and Maher, 2016). These emergency management statutes are designed to enable the State to intervene in the case of a potential insolvency of a local government in order to protect the credit of the governing State and its political subdivisions. One of the major purposes of these laws is to decrease the gross debt costs of municipalities in the state, including both the promised interest and principal as well as any insurance premiums owed by an issuing government to guarantee its debts against default. State intervention in the financial affairs of its political subdivisions is thus intended to reduce the default risk of local government bonds and thereby decrease the total costs of the debt, just as does municipal bond insurance, albeit in a different way. In particular, State emergency management affects the financial operation of a distressed municipality in an attempt to increase the payoff to creditors, whereas municipal bond insurance involves private companies agreeing to make payments on the obligations of a defaulting local government in return for an upfront fee.1

When a municipality is able to show that it cannot make payments on its obligations, U.S. laws permit it to file for protection from creditors under Chapter 9 of the Federal Bankruptcy Code. These laws were initially enacted in 1937 (after over two thousand state and local governments defaulted on their debts in the Great Depression) to facilitate interstate municipal debt consolidation if the local government is unable to arrange a settlement outside bankruptcy such as when there are a minority of creditors holding out for full payment. Nevertheless, the United States Constitution requires federal courts to respect the laws and constitutions of the individual States, including those relating to any obligation of the State or its political subdivisions. The majority of individual States have laws allowing oversight by federal bankruptcy courts, but many of those require the permission of the State government for filing Chapter 9 (Kennedy, 2016).

This research examines the effect of individual events surrounding a municipal bankruptcy for the first time by investigating the exact market price reactions of the most actively traded bonds of the City of Detroit to 61 events relating to the City’s defaults.2 This case study shows details of how greater power for a higher government authority to manage local governments (and the exercise of that power) can reduce the default risk for the particular bonds of a municipality having a large likelihood of such State intervention. However, this Detroit case illustrates that emergency management can’t eliminate the risk of default and may not be better for bondholders than operation under the supervision of federal bankruptcy courts. The investigation study thus provides some financial evidence on issues raised by Spiotto (2013) and Kennedy (2016) regarding different ways of resolving municipal insolvencies.

3. Data and investigative procedures

The test of the impact of State intervention and other events on bond values is conducted by an examination of the effect of announcements relevant to the case of Detroit that are indicated in a time line of the Detroit’s financial crisis published by the Detroit News (2014). Each of the listed events there is checked with older

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1 Many local government bonds have their debt payments guaranteed by insurance firms, such as by Ambac, which initiated the first such municipal bond policies. In return for upfront paid premiums, municipal bond insurance contracts provide for timely payment of interest and principal by the insurer in case of a payout default by the issuer, with such guarantees legally requiring the insurance company to maintain reserves and equity capital that are regulated by state governments (Nanda and Singh, 2004). The regulatory reserves provide some backing for the insurance in the case of the insolvency of the insuring firm, with most such guarantees having been fulfilled in their entirety in the past even by insurance companies that have been bankrupted (Chenery, 2015). Private firm guarantees of municipal bond payments not only reduce the default risk of the obligations but also increase the trading liquidity of the insured debts, as the insuring companies effectively reduce information asymmetries for investors through their evaluations of the costs of the guarantees (that are affected by the financial situations of the municipalities buying the insurance) as well as provide a back-up payment source for bondholders (Denison, 2003). Despite the benefits of such insurance, its usage by municipal bond issuers has declined greatly in recent years. The financial crisis of 2007–2009 created major financial problems for many municipal issuers, most of which had suffered extreme losses on their unrelated guarantees of mortgage debts, and thus had their own capacity to fulfill their separate municipal insurance obligations subject to question by investors. At least partially as a result, the percentage of such newly issued debt of state and local governments guaranteed by insurance companies has fallen from over half to 10% of all such municipal issues, with only one remaining insurance company (Assured Guaranty Corporation) actively insuring municipal bonds recently (Lai and Zhang, 2013).

2 A news report by Devitt (2013) around the time of the events surrounding the default of the City of Detroit indicated that the market value of some of the City’s privately insured obligations declined by only 4.4% then (to 95.6% of par). In contrast, the transaction prices of the City’s uninsured obligations were reported to have fallen by 32% (to 64% of par) from prior transaction prices recorded on them months previously. These relative price changes supply an indication of the fact that, while insurance on municipal bonds reduces default risk, it doesn’t eliminate it, since the insurance company itself can become insolvent. On the other hand, the prices of some obligations of the City of Detroit guaranteed by the State of Michigan were reported to fall only 0.2% to 101% of par around the same long time interval. Such long-term price changes that can have many causes may mask the true default risk of such obligations. For instance, as this research illustrates through a separate detailed examination of the price movements of Detroit School District bonds on particular event dates, local government debts guaranteed by the State are perceived to have significant default risk even when they are also privately insulated.
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