CAROL O'CLEIREACAIN, Ph.D.
315 WEST 106TH STREET • NEW YORK • NEW YORK 10025
Tel 212 866 7663 coc315@gmail.com *Fax* 212 866 6526

Detroit's Bankruptcy, Pensions& Retirees
Forum on Illinois Pension Reform
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Good morning.

Thank you for your interest in Detroit's life after profligacy. But, a word of caution. Detroit's bankruptcy makes it unique, <u>not least</u> because States cannot access Chapter 9 and only half of them even allow that option to their localities.[1]

How Detroit got there is less unique. There is too much to go into here; but, a s the City's population dwindled from almost 2M in 1950 to less than 700,000 today, budget problems mounted and retirement related costs -- pensions and health benefits -- took an increasing share of a shrunken revenue base. The City often failed to make its pension contributions. And, officials relied on pension sweeteners instead of pay increases -- which raised pension costs, denuded the assets and, ironically, shrank the contributing workforce. The City also turned to borrowing.

Here's an egregious example. In 2005 Mayor Kilpatrick, now in prison, borrowed to fund the pension systems. This stuff should be outlawed. Pension bond deals are generally pitched as arbitrage: the City issues the bonds; the pension system invests the proceeds, which will earn more <u>on average</u> than the interest costs on the bonds. So, the spread makes it look like the pension shortfall has been refinanced at lower interest rates, saving a lot of money. The hitch, of course, is the risk on the interest rate. Detroit's deal -- which, by the way, won *Bond Buyer's* Midwest deal of the year award -- amounted to borrowing $1.4B through pension obligation certificates-of-participation (COPs),

[1] Only 12 states specifically authorize municipal bankruptcies and 12 more set up a number of conditions attached to it.

with corresponding interest-rate swaps covered by casino tax revenue. The swaps went against the City when interest rates plunged in the 2008 financial crisis, adding more debt.

Frankly, well before the *auto industry* crashed in 2008 and Chrysler & GM went into *bankruptcy* in April/May 2009, Detroit had made promises it could not keep to investors, residents, workers and retirees.

By 2013,[2] it owed about $18 billion:
- ✓ $3.5 billion unfunded pensions;
- ✓ $6 billion unfunded retiree health promises;
- ✓ More than $8 billion in financial paper.

Before resorting to the Federal court, the remedies used to address Detroit's unsustainable budget gap -- cutting workers, cutting benefits, cutting services to citizens, imposing a State emergency manager and oversight commission -- left out one big player: bondholders.

On **July 18, 2013,** Kevyn Orr, the State-appointed emergency manager -- facing numerous lawsuits and dwindling cash to meet payroll -- petitioned for Chapter 9 in federal district court, everyone with a vital interest -- money and a stake in survival -- ended up around the table. Bondholders had to make sacrifices just as taxpayers and residents and municipal workers and retirees..

Only 17 months later, in **December 2014,** Detroit exited bankruptcy**,** with changes in state law and the court's Plan of Adjustment (POA), agreed by all parties, governing Detroit's fiscal reality in the next decades, and very strictly until 2024.

The judges parceled out the pain in a roughly fair manner in a settlement that was highly creative:
- ✓ Not a zero sum game.
- ✓ Setting up Detroit's government to succeed going forward.

[2] By the way, there were three times the number of retirement checks going out than checks to working employees. See Nathan Bomey, *Detroit Resurrected: To Bankruptcy and Back,* p.51.

For $170M of one-shot cost, Chapter 9 eliminated $7.2B of ongoing costs from the City's budget -- $5.5B of which were pensions and retiree health benefits, which represent real human cost.

- ✓ The agreement froze the City's existing pension plans, closing them to existing and new employees. Monthly pension checks were reduced, on average 4.5 percent, COLAs were eliminated & annuity payments -- an item of past abuse -- were clawed back for general retirees;[3] police and fire retirees retained their monthly benefits, while their COLA went from 2.25 percent to 1 percent.
- ✓ More drastic pension cuts had been proposed, but foundations (Ford, Kresge, Kellogg, etc.) and the State of Michigan brought new money to the table. In "the Grand Bargain," they committed $445.4M over 20 years to be used only for retirees and to preserve the DIA's art.[4]
- ✓ Retiree health care was hit hard. The agreement cancelled direct benefits, replacing them with a monthly stipend. Two new VEBA trust funds, capitalized by the City, mange the stipends and available insurance. The City is no longer involved.
- ✓ Many retirees do not get Social Security, so the settlement addressed hardship issues by committing the annual savings from one class of bondholders' haircut (UTGO 26%) to prevent the most vulnerable from falling below the poverty line.[5]
- ✓ Bondholder haircuts varied -- one-quarter to one-third -- depending on the bonds. (The pension obligation bonds were settled for 13 cents on the dollar, the lowest rate of recovery. But, their insurers -- FGIC & Syncora -- fought doggedly up to the very end.)

Going forward, the PoA:

- Established two new hybrid retirement plans for existing and new employees, with mandatory contributions, lower benefits, and some risk sharing.
- Fixed the City's annual contribution to the pension systems for 10 years, allowing budget space until June 30, 2023, while foundations & others picked up the tab. In fiscal year 2024 regular City contributions to pension funding begin again. More on that in a couple of minutes…

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[3] Maximum cut of 20 percent to anyone's monthly pension check.

[4] Since then, foundations have invested an additional $80M into joint initiatives with the City.

[5] See Bomey p.164.

- Reserved $1.4B off the top for Plan of Adjustment revitalization initiatives to maximize the likelihood of providing future City services within a structurally balanced budget.
- Preserved key civic attractions: the Detroit Institute of Arts became a free standing non-profit and the State took over and improved Belle Isle.
- Established a new, empowered, CFO, along with a CIO, to improve government technology & systems; and imposed a control board (State Financial Review Commission or "FRC").

Separately, the suburbs were coerced into a new regional water authority, which now pays Detroit $50M/year to replace the aged pipes and sewers.

As a result, the City has produced three years of *audited* surpluses. The CFO did not budget these surpluses, but waited to apply them, after the fact, to one-time needs, which is important to the ongoing pension story.

Please remember, Detroit's liabilities are legacy pension plans that are closed -- the entire population is known and will decline, naturally, over the years. The City's obligation is to fund them through the last survivor.

In 2016, new data indicated that the pension liabilities were greater than estimated back at bankruptcy and written into the PoA. The City, with strong urging from the FRC, faced this reality quickly, hired independent actuaries, and put a plan in place to address the increase while ensuring structural budget balance.

The City created a savings fund -- the "Retiree Protection Fund" (RPF) -- into which it is budgeting current revenues -- beginning with $10M in each of FY2016 and FY2017, growing by $5M increments, to $60M in FY2023 -- thus, gradually getting the general fund budget used to the ongoing, annual, contribution for pensions well before FY2024. Also, it put $70M of (one-shot) surpluses ($20M in FY16 and $50M in FY17) into the RPF (an irrevocable trust at the Bank of NY).

There will be a total of at least $335M in the RPF at the end of FY2023. The next year, when the PoA requires Detroit to begin making actuarially based pension payments, they will come from two sources: the PRF and budgeted general fund revenues. The exact numbers will fluctuate with actuarial calculations and investment performance.[6]

So, Detroit has transformed the PoA's steep pension-funding cliff into a longer, gentler slope, through prudent planning, saving and budgeting. ***Moody's*** produced a credit upgrade. Last month ***PEW*** released a detailed study of Detroit's pension situation which validated this approach.[7] PEW's actuarial stress tests (low returns assumption) validate that Detroit has taken control of a funding deficit left over from the bankruptcy.[8]

In closing, let me paraphrase Kevyn Orr: 'the bankruptcy didn't resolve all the legacy obligations, it made them more affordable.' Detroit has to manage the future risks, which include, among other things, ensuring a growing revenue base and providing competitive wages & post-employment benefits to retain and recruit employees, especially police.

And, having resorted to Chapter 9 bankruptcy, Detroit will be waiting some time yet -- and working hard -- to regain its access to the credit markets.

Thanks for your attention. I look forward to questions. I also have some reading suggestions for those who want to delve into this in greater detail.

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[6] Reformed investment committees and the markets have improved fund performance. I watched the expected FY2014 contribution (2016 actuarial valuation) go from $182.7M in 2016, with favorable returns in 2017, down to $150.1, and with 10% returns in first 6 months of FY2018, down to $143.4M. [Note: At the last audit, General = 67% funded, P&F = 78% funded.

[7] *The Challenge of Meeting Detroit's Pension Promise. http://www.pewtrusts.org/en/research-and-analysis/reports/2018/03/the-challenge-of-meeting-detroits-pension-promises*

[8] Pew highlighted, also, some governance problems with the new, hybrid plans, which are overly complicated. There is plenty of time to address them.