Fitch Downgrades Detroit, MI ULTGOs to 'BB-' & LTGOs to 'B+'; Outlook Negative

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In the course of surveillance Fitch Ratings has taken the following rating actions on the city of Detroit:

--Approximately $453 million unlimited tax general obligation (ULTGO) bonds downgraded to 'BB-' from 'BB+';
--Approximately $486 million limited tax general obligation (LTGO) bonds downgraded to 'B+' from 'BB';
--Approximately $1.5 billion pension obligation certificates series 2005-A and 2006 A and B (Detroit Retirement Systems Funding Trust, MI) downgraded to 'BB-' from 'BB+'.

The Rating Outlook is Negative.

RATING RATIONALE:
--The downgrade is based on a lack of progress, despite concerted efforts, to address fiscal imbalances and the increasing challenges on an already highly stressed budget including revenue losses related to a weakened economy and population declines.
--The Negative Outlook reflects Fitch's belief that expectations for further weakening of the city's revenues and continued economic fragility, combined with the challenges of implementing additional spending reductions.
--Sizable budget imbalances, due in part to optimistic revenue projections, have resulted in a large accumulated general fund balance deficit, reduced only by the issuance of deficit reduction bonds.
--Economic indicators, including housing, wealth, and employment-related factors are chronically poor, and sources of economic analysis indicate limited expectation for improvement.
--Dependence on automobile manufacturing results in a sustained very high unemployment rate.
--The debt burden is exceptionally high, offset somewhat by a sizable amount of pension obligation bonds that result in well-funded pension plans.
--The timeliness of financial reporting has improved.

WHAT COULD TRIGGER A DOWNGRADE?
--Management's inability to begin to make progress in reducing the accumulated deficit with ongoing measures;
--Inability to manage liquidity needs without reliance on market access for cash flow notes;
--Continued weakening of economic factors.

SECURITY:
ULTGO bonds are supported by the city's unlimited property tax pledge. LTGO bonds are a first budget obligation. Pension certificates of participation are unconditional contractual obligations of the city, not subject to appropriation. If the city failed to make a COP debt service payment, the contract administrator could file a lawsuit against the city to enforce the obligation, and a court can compel the city to raise the payment through the levy of taxes without limit as to rate or amount pursuant to Michigan law.

CREDIT SUMMARY:
As reflected in the 'BB-' ULTGO rating and Negative Outlook, Fitch believes Detroit will continue to

struggle economically and financially as it has for the last several years. Economic indicators continue to be exceptionally weak, including an unemployment rate of 19.1% in April 2011, down from 23.2% in April 2010. While some job growth is evident in the year-over-year figures for April, the improvement in the unemployment rate resulted more from the 5.8% decline in the labor force than the 0.8% increase in resident employment. 2010 census data showed a surprisingly large drop in population to 713,777, a 25% decline from the 2000 census. The city administration is focused on identifying blighted areas and consolidating residents into more sustainable neighborhoods. Prospects for economic growth appear minimal, although the manufacturing sector is showing some job gains.

A sizable general fund operating deficit in fiscal 2009 added to an already negative fund balance position led to a large accumulated unreserved general fund deficit of $330 million, or a very high 23.6% of spending. Fiscal 2010 would have ended with a $71 million shortfall and an increased accumulated deficit were it not for the issuance of $249 million in deficit bonds. The bonds were designed to eliminate the accumulated deficit and the need for annual short-term cash flow borrowing for the next several years. However, operating results were more negative than expected, due primarily to revenue shortfalls. The general fund deficit for the year stood at $91.1 million, with an unreserved balance of negative $155 million or 12.2% of spending.

City officials expect fiscal 2011 to end with another, although smaller, operating deficit of $30-$33 million and an accumulated unreserved fund balance deficit of up to $188 million. In recent fiscal years, audited results have been quite a bit weaker than projections indicated, so Fitch is concerned that results for fiscal 2011 could follow the same trend.

As in fiscal 2011, the fiscal 2012 budget was adopted through a city council override of the Mayor's veto. The council reduced spending by $50 million beyond the Mayor's proposal, which included a $5 million surplus; however, it appears at least possible that the majority of the spending cuts will be restored through a budget amendment. Fitch views this type of contention in the budget process negatively.

The city should benefit from two recent changes in state legislation. The first affects Detroit directly, preserving some of its taxing powers despite its reduced population. The second is statewide legislation that, if upheld under challenge, would broaden the role of the emergency fiscal manager, a position which Detroit does not currently. However, Fitch believes that severe budget vulnerability for fiscal 2012 remains as tax revenue projections are optimistic and labor reductions needed to achieve balance have not yet been implemented.

The city has developed a five-year Deficit Elimination Plan (DEP) which addresses projected increasing out-year budget gaps with a combination of revenue initiatives, largely focused on improving income tax collections, as well as spending reductions focused on pension and medical costs. Fitch believes that the city is realistically expecting improvement in its financial position to be gradual but that some of the assumptions in the DEP are optimistic and alternatives appear limited.

Liquidity needs had been addressed with annual cash flow borrowing, which in March 2010 were replaced with a long-term deficit financing totaling $249 million. While Fitch generally views such financing as a credit negative, in this case it was intended to relieve the uncertainty associated with dependence on market access for notes each year. The borrowing also eliminated a portion of the accumulated deficit. Fitch does not expect the city to need to issue cash flow notes in the next few years; a further weakening in cash position could put further pressure on the rating.

Debt levels are exceptionally high as compared to Detroit's weak market value of property; overall debt is over 18% of market value. The debt burden is somewhat less dramatic relative to population but still high at $6,397 per capita - an increase from prior figures due to the incorporation of the lower 2010 Census population. Debt service comprised 16.8% of fiscal 2010 general and debt service fund spending.

Concerns about the high debt load, while significant, are somewhat tempered by the sound funding ratios for both of the city's pension programs as a result of issuance of the pension obligation certificates. However, the unfunded liability for other post-employment benefits when last calculated (June 30, 2009) was about the same size as overall debt. The city funds its OPEB obligation on a pay-as-you-go basis, which equates to about one-half of the annual required contribution on an actuarial basis. Agreements with counterparties regarding interest rate swaps on the pension obligation certificates have been modified to limit the city's exposure to large near-term termination payments but continue to present potential risks should a termination event occur.

Additional information is available at www.fitchratings.com.

In addition to the sources of information identified in Fitch's Tax-Supported Rating Criteria, this action was additionally informed by information from Creditscope, University Financial Associates, S&P/Case-Shiller Home Price Index, IHS Global Insight, Zillow.com, National Association of Realtors, Property and Portfolio Research.

Applicable Criteria and Related Research:
--'Tax-Supported Rating Criteria', dated Aug. 16, 2010;
--'U.S. Local Government Tax-Supported Rating Criteria', dated Oct. 8, 2010.

For information on Build America Bonds, visit www.fitchratings.com/BABs.

Applicable Criteria and Related Research:
U.S. Local Government Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=564566
Tax-Supported Rating Criteria
http://www.fitchratings.com/creditdesk/reports/report_frame.cfm?rpt_id=548605

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