Detroit Bankruptcy Reverberates in Michigan and in Bond Markets

Investors Are Surprised City Could Slash Value of General-Obligation Debt

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KELLY NOLAN

MIKE CHERNEY

MATT WIRZ

Detroit's bankruptcy cast a pall over the $3.7 trillion municipal-bond market on Friday as investors and local officials tried to minimize the damage.

Investors and borrowers were rankled that Thursday's bankruptcy filing was expected to hit bondholders of some of the city's general-obligation debt following a proposal by Detroit's emergency manager, Kevyn Orr, to rank these bonds alongside other unsecured debt. Some investors expressed surprise that the city could slash the general-obligation bonds' value, as they are backed by Detroit tax revenue and payments are guaranteed by the Michigan Constitution.

This type of debt is typically considered among the safest types of muni bonds.

While Detroit has suffered from an economic decline for years, other parts of Michigan have remained more stable and been issuing debt easily. In fact, many parts of the state have seen their prospects improve, in part because of recoveries by U.S. auto makers since the financial crisis.

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The chief financial officer of Kalamazoo, Tom Skrobola, said he was "concerned that whatever happens in Detroit" would reverberate in his city and in others in Michigan, though he doesn't plan to issue debt until later this year.

"I understand why the bond market would penalize us, but I think it's unfair," he said. "We are not remotely impacted by Detroit's bankruptcy."

Teri Weingarden, treasurer of the affluent Detroit suburb of West Bloomfield, said she is confident about a roughly $1 million bond sale the township has planned for next week to fund a civic-center complex parking lot.

"Saying that Detroit and West Bloomfield have much in common other than geographic location is inaccurate," Ms. Weingarden said.

Investors sold Detroit's general-obligation bonds Friday, amid broader declines in the muni market. One Detroit general-obligation bond traded at 84.575 cents on the dollar Friday, down from 95 cents on Thursday, even though it is insured by a bond-insurance company, according to Electronic Municipal Market Access. Some 10-year uninsured general-obligation bonds had an average price of 39 cents on the dollar Friday, compared with an average price of 70.5 cents this month, according to pricing service Markit.

Overall, yields on highly rated, long-dated muni bonds were up 0.11 percentage point on Friday, according to a benchmark scale from Thomson Reuters Municipal Market Data. When bond prices fall, yields rise.

Concerns about Detroit were adding "fuel to the fire" in a muni-market selloff that began a couple of weeks ago, said Peter Delahunt, managing director of municipal trading at Raymond James. Investors have taken roughly $13.7 billion from weekly reporting muni-bond mutual and exchange-traded funds over the past eight weeks, according to Lipper, fearing the Federal Reserve might stem its bond-buying programs.

In Portage, Mich., finance director Daniel Foecking said he might have to pay slightly higher rates to sell $3.13 million in general-obligation bonds next week, but that Detroit's bankruptcy wouldn't derail his fundraising. Portage, a city of about 46,000, is about 140 miles west of Detroit.

Some investors said the filing seemed almost out of character for the state, given its strong oversight of stressed cities, towns and schools.

"Michigan has been touted for years as one of the most bond-friendly states out there," said Robert Miller, senior portfolio manager at Wells Capital Management, which oversees $32 billion in munis. "That reputation is shot."

Share prices of bond insurance companies, which guaranteed interest and principal payments on many of Detroit's municipal bonds, fell Friday as they have much to lose in the city's bankruptcy. When insured bonds fall into default, the insurers step into bondholders' shoes as creditors.

The insurers, including Assured Guaranty Ltd. AGO -1.30% and units of MBIA Inc. MBI -2.62% and Ambac Financial Group Inc., AMBC -1.38% insured some of Detroit's $1 billion of general-obligation debt, and much of its $5.3 billion of bonds backed by water and sewage revenue.

The insurers had been trying to craft a plan with Detroit officials to restructure the city's debt and avoid bankruptcy, said people familiar with the talks.

Write to Kelly Nolan at kelly.nolan@dowjones.com, Mike Cherney at mike.cherney@dowjones.com and Matt Wirz at matthieu.wirz@wsj.com

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