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HEADLINE: Detroit Uses COPs to Shift Pension Burden and Set a Few Records

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BODY:

Detroit won The Bond Buyers's Midwest regional Deal of the Year award this month for its $1.44 billion sale of certificates of participation that allowed the city to lower its obligation on unfunded accrued pension liabilities and bring in budget savings.

The Detroit Retirement System Funding Trust in May and June issued $640 million of taxable fixed-rate Series A COPs and $800 million of taxable floating-rate Series B COPs in a sale that marked several firsts for the state and the city.

The issue was the first pension financing for any municipality in the state, and the largest municipal financing ever offered in Michigan. It also marked the largest local-level pension financing in the nation, according to the team that came together to find a way for the city to fund its unfunded pension obligations and attract investor interest.

Officials had been looking for a way to lower expenses related to the unfunded pension liability as costs climbed higher in recent years and the city's budget began to reflect a struggling economy. When he introduced his fiscal 2006 budget earlier this year, Mayor Kwame Kilpatrick warned of further problems and said he would reorganize city government and lay off about 750 people.

From that time on, Kilpatrick, the financial team, and the bond professionals worked on a plan to shift the burden of unfunded pension costs from the city to service corporations through the use of certificates of participation.

In order to meet the legal requirements for the city's debt limits and ensure the strength of the credit, the attorneys working on the deal relied on a unique combination of legal precedents for the municipal market.

Without the necessary enabling legislation that would allow the city to issue the notes without their counting against its state-imposed debt limit, officials looked to laws dating back to the 19th century. The laws that created a service contract for municipalities proved to be essential.

The service contract allowed municipalities to contract with a third party for services. Detroit's payments to the service corporation under the service contract are not subject to appropriation, but rather are unconditional contractual obligations of the city. Those payments back the debt. In addition, the city is constitutionally and statutorily responsible for its pension liability under Michigan law.

The service contract that allows the city to contract over a period of years for future benefits apparently has been used in at least one previous municipal bond issue, according to an attorney who worked on the deal. The Detroit transaction, however, would take the concept further.

The team of professionals started working on the transaction in earnest in the summer of 2004. While the city had considered methods to shift its unfunded pension obligations, the need became more apparent as the budget became squeezed by lower state aid payments and tax revenue, and higher health care costs.

Detroit needed to find a way to free up as much of its ongoing revenue as possible to avoid adding pressure to its budget.

The city sought to shift its assumed rate of payment on pension obligations for the two funds - the General Retirement System and the Police and Fire Retirement System - to a lower rate. The certificates of participation would lower that rate to between 5.6% and 5.8% from the assumed rate of 7.9% and 7.8%, respectively, officials working on the deal projected. The city also would shift the mechanism for paying the unfunded pension liability from the city to the service company.

Though the concept seemed simple, officials said it took the combination of fortunate market timing, knowledge of the "skeleton" of any bond structure, legal expertise, problems and questions raised and answered, and the expertise of a host of bond professionals to bring the deal together.

The actuarial firm Gabriel, Roeder, Smith & Co. was only one among many in the veritable army of professionals that worked to complete the sale - and those who invested in the product.

The city employed Lewis & Munday as bond counsel, relying on their expertise and history in the state to help create and ensure the legal framework would work. For those special questions that the transaction raised, including the tax status of the bonds, Mayer Brown Rowe & Maw worked as special tax counsel.

UBS Financial Services Inc. served as the book-running senior manager. Robert W. Baird & Co. and Scott Balice Strategies worked as co-financial advisers on the deal.

Underwriter's counsel was Honigman Miller Schwartz & Cohn. The trustee and contract administrator on the deal was US Bank and trustee's counsel was Bodman.

Financial Guaranty Insurance Co. and XL Capital Assurance insured the COPs.

Then there was the team that brought the certificates to a mostly international market. The co-senior managers on the Series A fixed-rate portion included Citigroup Global Markets Inc., Merrill Lynch & Co., Siebert, Brandford, Shank & Co., Loop Capital Markets, and Morgan Stanley. Twelve co-managers worked to market the Series A certificates. Loop, Merrill, and Morgan Stanley worked as the co-senior managers for the Series B floating-rate certificates, including a Libor-indexed swap.

Though rating agency analysts cited an additional obligation for payment of the COPs, the savings that the city would realize and the structure of the deal meant the ratings on the certificates were consistent with the city's other debt.

In May, ahead of the sale, Moody's Investors Service rated the COPs Baa1 with a negative outlook, which was consistent with the city's unlimited-tax general obligation bond rating, and rated the limited-tax GOs Baa2. Moody's also assigned what would be only its sixth corporate-equivalent rating for a municipal transaction, an Aa1 with a stable outlook. The enabled mostly foreign investors understand the unique nature of the debt in relation to the more familiar corporate credits.

Fitch Ratings assigned a BBB-plus rating to the COPs with a stable outlook, which was comparable to the city's GO rating. Standard & Poor's rated the city's unlimited-tax GO debt at BBB-plus and the limited-tax at GOs at a stable BBB.

The ratings reflected both that the COPs were not a general obligation of Detroit, and that the city had a constitutional requirement to pay its pension obligations. That requirement was the key to ensuring investors that, no matter what, the city has to pay its obligations on the COPs.

To ensure the payment of the certificates and to meet its criteria for keeping additional debt off the books, the city used the legal structure that matched the constitutional obligation with its ability to enter into a service contract with a third party.

The city created the service contract with two nonprofit entities created solely for the purpose of the transaction. The Detroit General Retirement System Service Corp. and the Detroit Police and Fire Retirement System Service Corp. acted as the third party the city needed. The city makes service contract payments to the corporation, which pays the obligations through a trustee and contract administrator. The administrator forwards payments to the pension system.

The deal also brought in present-value savings to help Detroit reduce a shortfall of about $90 million, savings that were built into the fiscal 2006 budget. Though the City Council approved the budget, members weren't immediately convinced of the team's approach to reducing the pension liability. After months of negotiations and presentations, the council eventually approved the ordinances that allowed the COPs to be issued.

The city brought the deal to the market in May and closed it in June. The sale brought in $112 million of savings for the fiscal 2006 budget. Officials expect to save $508 million over the life of the COPs.

The final sale also reached the city's requirement for breaking even and actually was lower than anticipated, allowing Detroit to shift its pension obligation to a lower interest rate. The final cost was 5.30%, including issuance costs. The estimate had been about 5.80% to 5.85%.

Since then, the city has gone through an election that caused delays in implementing changes that Kilpatrick used in his budget earlier this year. Analysts reviewed their ratings, taking into account the need for the city to balance the budget in the remaining six months of fiscal 2006. Recently, all three agencies downgraded Detroit, citing the need for the city to shore up its budget and finances.

Moody's last month lowered the city's unlimited-tax GOs to Baa2 from Baa1, a rating change that also applied to the pension obligation COPs. The agency also downgraded the limited-tax GOs to Baa3 from Baa2. The ratings carry a stable outlook. Moody's lowered Detroit's corporate-equivalent rating to Aa2 from Aa1.

Standard & Poor's in November also downgraded the unlimited-tax GOs to BBB from BBB-plus and the limited-tax debt to BBB-minus from BBB debt. The outlook is negative. Finally, Fitch earlier this month downgraded Detroit to BBB from BBB-plus and placed the credit on negative watch, a rating that also applies to the COPs.

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GRAPHIC: photo, Kwame Kilpatrick; Amy Resnick

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