Rising from the Ashes once more

On the morning of 11 June 1805, a fire started in a Detroit bakery. The blaze spread quickly, destroying wooden buildings. Despite the best efforts of citizens who tackled the fire, most of the city burned down.

The Great Fire of 1805 is commemorated on the city's flag, which carries the motto, in Latin: "It will rise from the ashes." And rise it did. Grand boulevards were built, the city's population expanded, its men fought bravely on the fields of Gettysburg, and it thrived in the 20th century, powered by industrialization, armament and, of course, the automotive industry.

But, 200 years after the Great Fire, the city faced another crisis. As manufacturing industries declined and the population fell, Detroit became a byword for urban decline. High rates of unemployment and crime, coupled with blighted neighborhoods and a widespread failure to collect taxes, put intolerable pressure on the city's finances. On 18 July 2013, Detroit became the largest city in the US to file for bankruptcy. Five months later, it was declared bankrupt, with liabilities of US$18.5b.

Detroit rose from the ashes once more, emerging from bankruptcy in December 2014. Its liabilities have been restructured and the city is now on course for a second revival. So, could this happen in other cities, and what can be learned from the experience of Detroit?

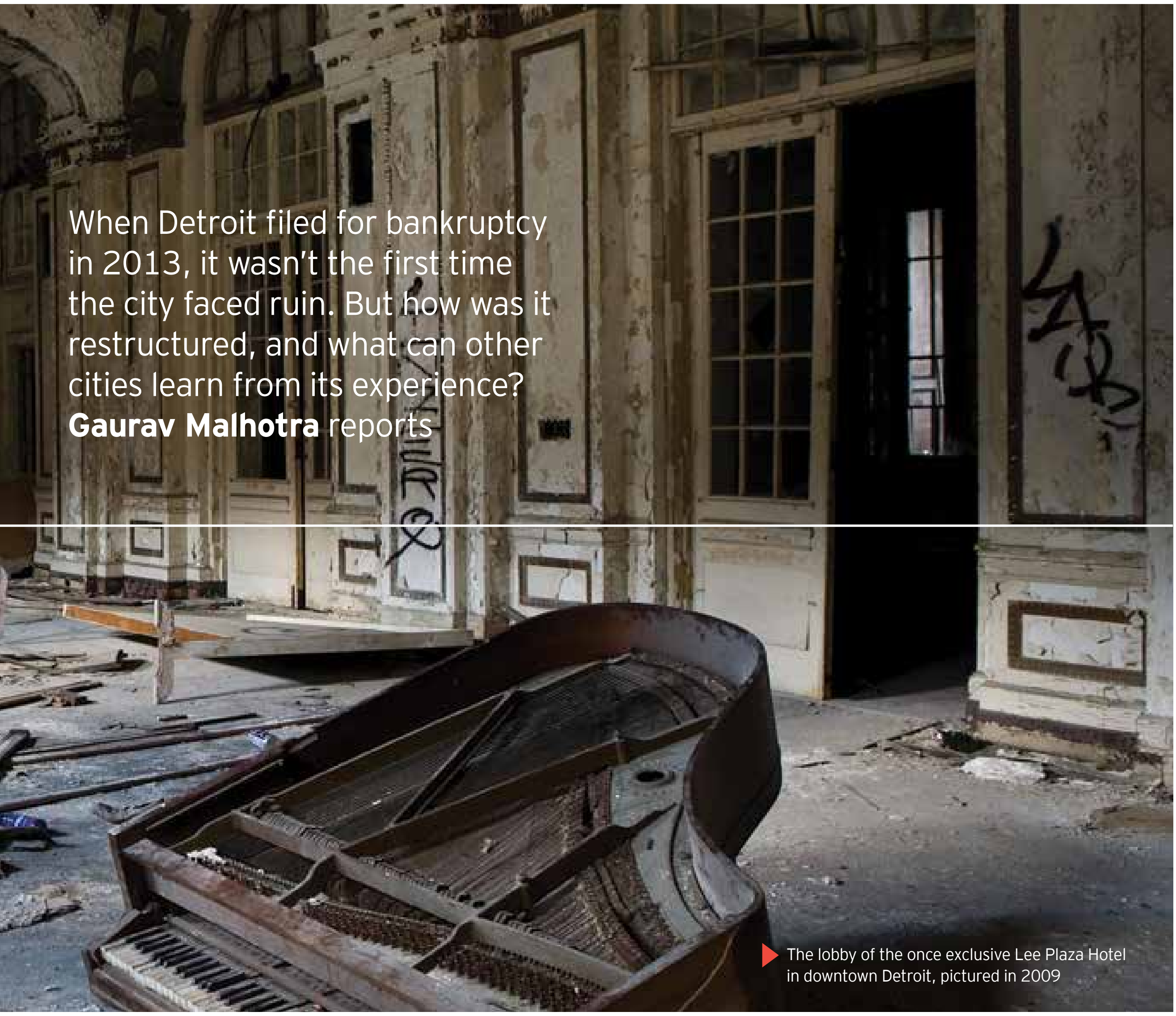
Heightened risk

Detroit's story reflects a broader situation of financial distress across many other cities and municipal entities, including school systems and utilities. More cities are finding it difficult to raise revenue, while their operating and legacy expenditures continue to escalate.

Other cities face insolvency as they grapple with difficult underlying economic conditions, high levels of debt, and large, underfunded liabilities, such as pensions and retiree healthcare. So, it seems a good time for municipal policymakers to rethink the possibility and implications of a comprehensive restructuring process.

Downward spiral

Most cities that plunge into financial crisis follow a similar path. A combination of broad demographic and economic trends, such as an ageing and declining population or



When Detroit filed for bankruptcy in 2013, it wasn't the first time the city faced ruin. But how was it restructured, and what can other cities learn from its experience? **Gaurav Malhotra** reports

The lobby of the once exclusive Lee Plaza Hotel in downtown Detroit, pictured in 2009

rise in local unemployment, means that revenues tend to decline. The city still needs to provide core services to citizens. With more people getting old or losing their job, demand for these services grows. So the city finds it hard to control costs.

The city must also continue to serve its long-term obligations. There are fewer funds available to pay down debts, such as pension and health care benefits. In the effort to keep a minimum level of services running and pensions paid, the city is forced to spend less on maintaining its infrastructure, including public safety fleet and equipment, recreation facilities, transportation and public lighting. It becomes a less attractive place in which to live, and people with sufficient financial means tend to move to the suburbs in search of a better quality of life, taking their tax dollars with them.

The city then starts running annual budget deficits. Policymakers tackle the deficit by cutting labor costs, issuing short-term debt, reducing contributions to liabilities and privatizing assets. If the structural imbalances in the budget persist, even after applying these short-term solutions, then crisis takes hold. The city's access to credit markets becomes limited. Its cash position deteriorates. How much longer can it pay its workers? Policymakers come to realize that financial firefighting is putting off the inevitable need for restructuring.

So, what happens to a city that files for bankruptcy? EY assisted in devising and implementing Detroit's restructuring plan under the leadership of the City Mayor, CFO and Emergency Manager. Of course, each municipality will have its own set of circumstances and priorities. But our work with Detroit has enabled us to draw together the features of a successful approach to restructuring.

Control costs and revenue now and in the future

The first feature is controlling costs and revenue. As part of the restructuring plan, cities can look for efficiencies in their operating budgets, consider whether they should continue to provide non-core services, and explore partnerships with public and private sector entities.

When it comes to cutting costs, cities may be tempted to take a top-down approach, and decide to cut, say, 10% across the board. However, this is unlikely to produce the anticipated benefits. Cities must deliver public safety services, such as police and fire, and these services take up big chunks of their budgets. Blunt tools, such as a uniform cut, don't take into account the large number of exceptions that would have to be made in an effort to keep services going. So, despite the urgency associated with reducing costs, it is critical to undertake a department-by-department analysis.

Just as controlling costs is vital, so is protecting revenue. Although the composition of a city's revenue stream is generally consistent year after year, it is critical to monitor the underlying trends that will affect future revenue estimates.

In the effort to balance the budget, cities often rely on one-time revenues, such as asset sales or proceeds from issuing long-term debt. This can mask a systemic imbalance in annual budgets in the short term. Some cities suffer from the failure to replace eroding revenue sources. As a result, they need to review sources regularly and adapt their budgeting accordingly. Identifying new grant funding opportunities is an important ingredient, and maintaining sufficient budget reporting is critical to ensuring that this source of funds continues, particularly in the early days of restructuring.

The importance of financial controls cannot be overstated. It is good practice to have a long-term perspective on city finances, beyond periodic audits. This requires capital investment in systems, updated budgeting and audit processes, and regular strategic financial reviews.

Get a grip on liabilities

Focusing on costs and revenue may not be enough. Restructuring long-term liabilities may also be necessary to make a city's finances sustainable.

It can be a challenge to restructure pension liabilities, given contractual and state law protections. City officials should understand the state law provisions that may affect their ability to restructure these liabilities. It is also important to invest in actuarial analyses, financial forecasts and scenario planning.

Administrators can conduct a thorough review of existing medical plans and benefits for active employees and retirees, and benchmark them against other cities. In addition, municipalities need to be aware of the federal subsidies that are available to retirees for medical coverage, and take these benefits into account when developing a proposal. Armed with this analysis, officials can seek to cap the municipality's commitment to funding these obligations in the future.

Debt instruments need to be analyzed individually in order to assess the strength of the pledge or security. Certain general obligation bonds have a dedicated tax revenue stream to service them, while others are limited general obligation instruments. A city's ability to restructure debt obligations is likely to be dependent on the type of instrument and the structure of the security or pledge on dedicated revenue streams.

Negotiate smartly with creditors

City employees and retirees are key stakeholders in negotiations. They work, or have worked, for the good of the city, and reductions in their benefits are likely to

Construction on the M-1 light rail transit project along Woodward Avenue in Detroit: the project is a symbol of the city's regeneration be sensitive and controversial. Against this backdrop, city officials need to negotiate with representatives of all creditors. Negotiations can take the form of informal meetings or formal processes such as collective bargaining, mediation and arbitration. The preparation of a clear blueprint of the restructuring plan, with proposals for all creditors, including unions, pension systems and debt holders, is critical to a productive negotiation process.

Comprehensive restructuring creates much-needed breathing space for the city to negotiate with each creditor group. The city of Detroit negotiated with financial creditors, bond insurers, swap counterparties, union leaders and retiree groups in informal talks and court-supervised discussions.

> “On 18 July 2013, Detroit became the largest city in the US to file for bankruptcy”

These negotiations ultimately resulted in the city reducing about 70% of its unsecured obligations. It offered unsecured creditors (certain financial creditors, retirees and trade creditors) an estimated recovery of approximately US$2.9b on US$11.5b of long-term obligations, which included US$5.7b in retiree health benefits and US$3.5b in underfunded pension liabilities. Access to bankruptcy proceedings provided the city with greater capacity to prioritize its obligations, allowing significant, and unprecedented, negotiation with claim holders.

Through the negotiation process, Detroit de-risked its pension plans by negotiating a reduction in the pension plan liabilities for both the General Retirement System and the Police and Fire Retirement System, and reducing the assumed rates of return. Under the pension settlement, general retirees saw their pensions cut by 4.5% and the elimination of future cost of living adjustments. Uniformed retirees did not see any reductions to their pension checks, but gave up a portion of the future increases to their benefits. With benefit levels to retirees already low, city leaders were careful to minimize cuts to pension benefits.

The city also reduced its retiree medical liabilities by establishing two voluntary employee beneficiary associations to administer retiree health care benefits. In this way, the city was able to cap its exposure to this liability and reduce its outstanding obligation by approximately $5b.

In the case of benefits to active employees, Detroit participated in mediation sessions with its various police, fire and general employee unions to establish terms for new collective bargaining agreements. This process had to balance the goal of sustainable cash flows for the city against appropriate incentives for retaining and hiring employees. These negotiations took place in good faith, with employees continuing their daily duties, despite the threat of reduced benefits.

With respect to financial creditors, the city negotiated discounts to bondholders' claims, based on a variety of factors including their terms and level of security, with financial unsecured creditor recoveries ranging from 13 cents to 74 cents on the dollar.

Invest today for a better tomorrow

No city can look forward to sustainable growth without investing in its economy. This is necessary to strengthen communities, ensure public safety and improve citizen's quality of life – and to attract new investment and jobs.

So, a broad economic development plan is required. Once budget savings have been made, the challenge for administrators is to reinvest these savings smartly. This includes making clear, long-term plans for investment in core municipal services such as public safety, improving neighborhoods, updating infrastructure and providing incentives for businesses to move into the city.

Another priority is securing sustainable financing for capital expansion. Distressed municipalities, faced with less favorable debt markets, need to engage private investment for capital projects. Some examples include public-private partnerships, privatization of assets or utilities, and the exploration of other financing channels, such as a state infrastructure bank. The city may consider offering tax breaks or other concessions to attract private investment. Administrators can also look at winding down old infrastructure. They may consider commissioning an external review of assets and investment needs. A clear return on investment should be the main criterion when deciding the capital projects in which to invest.

Facing the future

Back in 1805, when their city was blazing, the people of Detroit formed a human chain from the river to the fire. They passed buckets of river water up the chain in a vain attempt to control and extinguish the fire. In the 21st century, when the city faced financial ruin, the tools at its disposal were more sophisticated.

Financial discipline, reducing liabilities, effective negotiation and planning for economic development enabled it to turn financial distress into a platform for growth. Detroit can once again face the future with confidence. CT

Gaurav Malhotra is Senior Managing Director at Ernst & Young Capital Advisors LLC