Triumph in turnaround
Municipal restructuring
Bankruptcy risk among US municipalities has historically been a low-probability and little-debated question for investors, citizens and elected officials. However, with Detroit, Michigan having recently emerged from the largest municipal bankruptcy in US history, successfully restructuring US$18.5 billion in liabilities, the issue deserves a closer look. The role of municipal bankruptcy as a catalyst for economic renewal has become more significant after Detroit’s case.

The Detroit scenario reflects a broader situation of financial distress across many other US municipalities and municipal entities, including school systems and utilities. Other US cities also face mounting liabilities and eroding asset bases. More cities are experiencing periods of revenue decline while operating expenditures continue to escalate. Still-soft economic fundamentals, high debt levels, large underfunded pension and retiree healthcare liabilities suggest that some of these municipalities could become insolvent. While funded levels among plans differ substantially, it is significant to note that several large plans, such as the State Employees Retirement System (SERS) in Connecticut and those in Illinois (SERS, teachers and universities) have funded levels below 50%. Many plans also have aggressive discount rate assumptions: 86% use a 7.5% rate, with 4% using a rate of less than 7%. This has significant implications for the estimated size of unfunded liabilities, for example, a one percentage point reduction in the assumed rate would increase these liabilities by US$700 billion. Unfunded other post-employment benefits (OPEB) are another large liability. Typically, they do not appear on cities’ balance sheets, but are nonetheless a huge potential source of financial strain.

These dynamics create an urgency for policymakers to rethink the implications of bankruptcy, head off insolvency and achieve economic renewal. Financial discipline, effective negotiations and a focus on reinvestment are the critical ingredients for turning distress into a new start for municipal growth.

Bankruptcy should not be considered the first or even the preferred tool to achieve a successful municipal restructuring. However, a restructuring process, whether in court or out of court, provides a catalyst for municipalities to rethink the structure of their financial obligations, including pensions, and to reconsider their capital investment strategy. In this way, municipalities can both drive financial sustainability over the long term and support economic renewal.

An effective municipal restructuring strategy focuses on economic development, operating efficiencies, liability reduction and implementation
High debt, falling revenues and inflexible operating costs set the stage for municipal restructurings

While no single cause exists, municipal restructuring cases share similar financial fundamentals. At their core, distressed municipalities often witness declining revenues, possibly resulting from an aging population, unemployment or other economic factors. A decline in revenues places pressure on operating expense levels, which continue to escalate due to highly inflexible cost components such as labor, which is normally a more variable cost. These significant cash flow drivers impact not only operations, but also the servicing of long-term obligations, which may cause distress in their own right. Distressed municipalities are left with fewer funds available to pay down general obligation (GO) debts and non-traditional debt, such as underfunded pension and health care benefits. Finally, maintenance and development capital investments are likely to be skipped, driving the municipality into a worse physical condition. These drivers have been common in general municipal bankruptcies and also with other distressed municipal entities, such as school and health care systems. Weak fundamentals impede a municipality’s ability to withstand external shocks, such as an economic downturn, which could then potentially launch its financial distress into a financial crisis.

Structural budget deficits are the red alert

Recurring annual budget deficits represent a typical early sign of financial distress. Municipalities usually address these fiscal imbalances temporarily by cutting labor costs, issuing short-term debt, reducing contributions to legacy liabilities and sometimes monetizing assets through privatization or public-private partnerships. After applying short-term solutions, if the structural imbalances persist, municipalities come to the realization that they cannot continue to mask these issues. By this point, a municipality’s options will have reduced due to limited access to credit markets, labor costs and head count levels. The City of Detroit’s historical financials demonstrate how a municipality’s budget deficits ring the alarm on poor fundamentals (see Figure 1).

Liquidity shortfalls are the next sign of distress

Weak fundamentals manifest themselves in the cash position of insolvent municipalities. Distressed cash balances and near-term cash forecasts alert the municipality to poor liquidity and drive the timeline for financial firefighting and, ultimately, restructuring. For example, depletion of the general fund balance was associated with bankruptcies of Vallejo, Stockton and San Bernardino. Sometimes, however, the true liquidity profile of a municipality can be masked by the use of pooled cash accounts. Not only was this a complicating factor in the Detroit case, but it also presented itself in San Bernardino, where the city relied on a variety of one-time measures, including draining special purpose funds, to prop up its cash position.

Figure 1: COD historical deficit

<table>
<thead>
<tr>
<th>Year</th>
<th>Actual deficit</th>
<th>Debt proceeds</th>
<th>Approximate cumulative deficit without debt proceeds*</th>
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<tbody>
<tr>
<td>2005</td>
<td>($155.4)</td>
<td>$248.4</td>
<td>($403.8)</td>
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<tr>
<td>2006</td>
<td>($173.7)</td>
<td>$34.9</td>
<td>($457.0)</td>
</tr>
<tr>
<td>2007</td>
<td>($155.6)</td>
<td>–</td>
<td>($438.9)</td>
</tr>
<tr>
<td>2008</td>
<td>($219.2)</td>
<td>$75.2</td>
<td>($577.7)</td>
</tr>
<tr>
<td>2009</td>
<td>($331.9)</td>
<td>–</td>
<td>($690.5)</td>
</tr>
<tr>
<td>2010</td>
<td>($155.7)</td>
<td>$251.7</td>
<td>($765.9)</td>
</tr>
<tr>
<td>2011</td>
<td>($196.6)</td>
<td>–</td>
<td>($806.8)</td>
</tr>
<tr>
<td>2012</td>
<td>($326.6)</td>
<td>–</td>
<td>($936.8)</td>
</tr>
</tbody>
</table>

An effective municipal restructuring strategy focuses on investment, liability reduction and operating efficiencies

Focus on capital investment today for a sustainable future

To ensure that a fiscal turnaround can be maintained, governments need to focus on initiatives to support future economic growth, which should be concurrent with restructuring efforts. This includes a strategy for investment to drive increased productivity, economic activity and revenues. Further, reinvestment and replenishment are necessary to strengthen communities, and support public safety and quality of life.

For administrators, this means first devising a strategy for smart reinvestment of fiscal savings. This should include a clear, long-term plan for investment in infrastructure and other capital assets to support ongoing capital investment initiatives through budgetary cycles. This involves estimating the size of the infrastructure and other capital needs, and forecasting the appropriate funds necessary for maintenance, repair and growth spending on capital projects.

Investment plans should be part of a broader economic development, or economic revitalization, plan for the municipality. Such plans should look out several decades and include elements of investment in:

- Public spaces and parks
- Municipal services including social services and police and
- Social infrastructure, including housing

Economic development plans could also include strategies to grow specific industries, industry clusters or areas of competitive advantage. Plans should also identify key enablers. For example, municipalities could partner with nonprofit or community-based organizations in developing their master plans to strengthen their inclusiveness, equity and support for innovation. Furthermore, these plans could include provisions for partnering with the state on economic development strategies to ensure complementarity and also garner financial support where possible.

Second, policymakers need to focus on securing sustainable financing to drive capital expansion, including effectively leveraging private capital. 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 the use of a state infrastructure bank. Administrators also need to focus on clear reforms to provide the necessary regulatory and legal conditions to attract private investment. This is both on the financing side and for other enablers of private investment, including land zoning codes and tax or other concessions.

Third, administrators need to develop initiatives for winding down old infrastructure in addition to growing the municipality’s infrastructure and spending on normal municipal operations. To support this process, investment in leadership capacity, or external support, on modelling the potential impact of investment, wind down and other capital initiatives is crucial. Administrators may consider commissioning an external review of assets and investment needs as internal teams build expertise through recruitment or training. These efforts should support the development of a clear return-on-investment approach to evaluating alternative strategies, with transparent metrics for the assessment and selection of capital projects.

Figure 2: Capital investment is a key element of the Detroit restructuring plan

Source: United States Bankruptcy Court, Eastern District of Michigan, Southern Division
Make cost and revenue controls an ongoing imperative

Municipalities should drive greater efficiencies in their operating budgets, critically consider their role in core vs. non-core services and explore partnerships with public and private sector entities. At the same time, although municipalities typically have a relatively fixed revenue composition, it is critical to monitor collection rates and comparable fees for services to keep finances on a sustainable keel.

A municipality’s cost structure is clearly distinct from that of a corporation; this discrepancy is perhaps best exemplified by the uniqueness of public safety operations (i.e., police and fire), which usually make up the majority of city and county budgets. The expenses associated with these critical operations have to be effectively managed by incorporating specific data analytics.

Also, often time reduction efforts in municipalities are undertaken in a top-down approach, for example a 10% reduction in budgets across the board. These actions typically do not produce the anticipated benefits in a timely fashion due to unintended service delivery issues as well as a large number of exceptions. Despite the typical urgency associated with cost reductions, it is as critical to undertake a department-by-department analysis.

It is also important for administrators to first assess the municipality’s current liquidity position, trends and costs and then devise appropriate cost reduction plans and their associated liquidity impact. Ongoing monitoring of cash activity, liquidity and variances are critical feedback measures to assess the impact of actions undertaken.

For cost reductions, this can include HR and technology systems, and the critical evaluation and implementation of a shared services model. Municipalities should also consider the broad possibilities of partnership in service delivery (see Figure 3), including public-private, municipality relationships.

Just as with cost control vigilance, revenue sources must be periodically assessed

Although the composition of the revenue stream is generally consistent year over year, it is critical to monitor the underlying metrics to and trends that will impact future revenue estimates. Often, municipalities rely on one-time revenues, such as asset sales or long-term debt issuance proceeds, to balance budgets that can shadow the systemic imbalance in annual operating budgets.

For many municipalities, eroding revenue sources without replacing the inflow of dollars has hurt their budgets. As a result, municipalities also need to review revenue sources regularly and adapt their budgeting accordingly. Grant funding is an important aspect here and maintaining sufficient budget reporting is critical to ensure that this source of funds continues, particularly in the early days of restructuring.

Regular monitoring and big-picture financial review beyond audits

Finally, the importance of financial controls in general cannot be overstated for municipalities that are undergoing restructuring. Cities need to have a long-term perspective on their financial review, beyond periodic audits, to ensure that they are on track for financial sustainability. This includes capital investment in systems, updated budgeting and audit processes, as well as the implementation of strategic reviews of this information.

Figure 3: Cities have broad options for service delivery in a shared model
Ensure restructuring efforts encompass all liabilities

Funding of structural deficits through debt issuance, adverse economic trends and optimistic pension assumptions are only some of the reasons many governments are facing large-scale liabilities. Faced with a declining revenue environment and significant legacy liabilities, municipalities may realize that cost-saving and revenue-generating initiatives would not be sufficient to permanently address their structural deficits. As a result, in certain cases, restructuring of long-term liabilities is the only viable alternative to achieve sustainable fiscal stability. A key challenge for municipalities is to ensure that all liabilities are considered for restructuring.

A. Pension liabilities

Pension liabilities can be challenging to restructure given contractual and state law protections, and may require a bankruptcy filing if the objective is to impair not only future accruals but also benefits already earned by employees and retirees.

Public sector officials should understand the state law provisions that may impact their ability to restructure these liabilities. It is also imperative to invest in actuarial analyses, financial forecasts and scenario planning under a range of key assumptions. Administrators should then engage with retiree and union groups to ascertain the impact of the proposed restructuring on their benefits.

B. Retiree health care liabilities

Administrators should conduct a thorough review of existing medical plans and benefits for actives and retirees, and benchmark them to peers. In addition, municipalities need to be aware of available federal subsidies to retirees for medical coverage and leverage these benefits as part of a comprehensive proposal. Armed with this analysis, officials should work to cap the municipality’s commitment to future funding requirements of these obligations, which results in a significant reduction of the long-term obligation.

C. General obligation debt

General obligation bonds are likely to be subject to impairment as part of a bankruptcy process, despite being backed by the full faith and taxing power of the municipality. However, each debt instrument needs to be analyzed individually to assess the strength of its pledge or security. Certain general obligation bonds have a dedicated tax revenue stream to service them while others are limited general obligation instruments. Relative recovery levels will likely be dependent on the type of instrument and the structure of the security and pledge on dedicated revenue streams.

Work with creditors for a consensual restructuring

Administrations need to work with creditors with the objective of achieving a consensual plan of adjustment. With municipal employees and retirees being key constituents as far as long-term liabilities are concerned, this is particularly critical. To do this, public sector

Figure 4: Detroit UAALs

The city plan of adjustment (POA) assumes 50% reduction in total liabilities and 75% reduction in unsecured liabilities

1. Pre-petition liabilities are based on CAFR and June 14th Creditor Proposal, actual claim amounts may differ. Treatment of DWSD and other secured debt to be determined
2. Represents net present value of cash flows to unsecured creditors discounted at 5%. Actual liabilities at emergence are estimated to be slightly lower
3. Hypothetical treatment of unsecured creditors is subject to on-going discussions and could change materially
officials need to engage in negotiation sessions with all creditor representatives. Negotiations can take the form of informal meetings and presentations or formal processes such as collective bargaining, mediation and arbitration.

The preparation of a clear blueprint of the restructuring plan with proposed distributions to all creditors, including pension funds, hedge funds and bondholders, is instrumental to a productive negotiation process. Municipalities can also consider innovative financing structures, including funding from external sources, to lighten the extent of the proposed cuts and enhance expected recoveries.

**Effective negotiations result in the rightsizing of long-term liabilities**

A comprehensive restructuring process creates much-needed breathing space for a distressed municipality to address its obligations and work to set them at affordable levels. This is achieved through tailored negotiations with each creditor group.

For example, the City of Detroit negotiated with a spectrum of creditors that included financial creditors, bond insurers, swap counterparties, union leaders and retiree groups via multiple rounds of informal negotiations and court-supervised settlement discussions through a mediation process. These ultimately resulted in the City reducing about 70% of its unsecured obligations. The City offered unsecured creditors (certain financial creditors, retirees and trade creditors) a US$2.9 billion payout on US$11.5 billion of long-term obligations, which included US$5.7 billion in retiree health benefits and US$3.5 billion in 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, the City “de-risked” its pension plans by reducing the pension plan liabilities for both the General Retirement System (GRS) and the Police and Fire Retirement System (PFRS,) and also reducing the assumed rates of return. Under the pension settlement, general retirees saw their pensions cut by 4.5%, and lost their cost of living adjustments while uniformed retirees did not see any reductions to their pension checks but gave up a portion of the future increases to their benefits. It is important to note that City leaders were careful to minimize the level of cuts to pension benefits. In fact, with benefit levels to retirees already low (average annual pension of approximately US$19,000 for the GRS and US$30,000 for the PFRS), significant reductions would have been difficult for many of the retirees to bear.

The City also reduced its retiree medical liabilities by establishing two voluntary employee beneficiary associations (VEBAs) to administer retiree health care benefits going forward. In this way, the City was able to cap its exposure to this ever-increasing liability and to reduce its outstanding obligation by approximately $5 billion.

In the case of benefits to active employees, the City 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 the necessary City employees. Furthermore, many of the proposals had to be adjusted for fairness and equity across the different unions. It should be noted that these negotiations took place in good faith as employees continued their daily responsibilities, despite a high likelihood of reduced benefits on the horizon.

With respect to financial creditors, the City negotiated discounts to bondholders’ claims, based on their terms and level of security, with financial unsecured creditor recoveries ranging from 13 cents to 74 cents on the dollar.

**Figure 5: Negotiations flashcard — the EY guide to structuring an effective negotiation for city officials**

- **Credible financial projections that both parties can rely on are critical. Information sharing through a coordinated diligence process is also crucial.**
  - In Detroit, financial projections as well as source data were regularly shared with creditors.
  - Additionally, financial status reports were prepared and shared with creditors to show the City’s cash position.

- **Professional representation is key to removing emotion (in the case of retirees) from negotiations.**
  - The role of advisor was absolutely essential in the Detroit case due to the link between the City and its creditors. Many creditors were not “financial creditors,” but rather former or current employees of the City.

- **Judges acting as mediators who listen to both positions are instrumental in moving the process along.**
  - Engage a team of mediators to cover all negotiations.
  - Judges can assist with equity across unions.
  - As mediators, they can propose and facilitate creative solutions, such as the Detroit Grand Bargain.
  - Mediation allows for further separation between employer (the City) and employee/retiree.

- **Strive for creativity in finding solutions acceptable to both parties, such as the Grand bargain.**
  - The overarching goal of such solutions is unique — a municipality is not like a company looking to maximize profit, but is rather seeking “quality of life” for its citizens.
  - Municipalities cannot be liquidated in the same way that a company can be dissolved.
  - This has implications for a broad group of stakeholders, including state and federal government and the community.
  - Balance creativity with execution — the ability to push through the political agenda of the city and state administrations will be an ultimate determinant of success.
Cities can drive triumph in turnaround with investment and financial discipline at the forefront.

Bankruptcy provides a catalyst for cities to rethink the structure of their financial obligations, including pensions, and to reconsider their capital investment strategy. In this way, it can drive financial sustainability over the long term and also support economic renewal.

To execute a successful and sustainable turnaround, distressed municipalities may need to restructure their legacy liabilities (i.e., pensions, retiree health care and GO debt). They should consider the economic and quality-of-life implications for their constituents, thereby prioritizing negotiations with key creditors. Underpinning any informed and effective “supported” negotiation is a clear understanding of the financial information, as well as an ability to project forward the impact of altered terms.

Cities will also need to provide the necessary resources to invest in infrastructure and core services that are required for the community to become attractive to citizens and businesses once again. To grow the potential of the economy and support solvent, long-term capital investment should be the focus of any new fiscal headroom in an effective structuring plan. For this to become a reality, a city must get serious on cost and financial controls immediately upon executing the turnaround.

Figure 6: Comprehensive review and restructuring of city liabilities is crucial in driving results

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<thead>
<tr>
<th>Select activities</th>
<th>Phase I: short-term outlook</th>
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<tbody>
<tr>
<td></td>
<td>Development of comprehensive short-term cash flow projections, including identification of risks and opportunities</td>
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<td></td>
<td>Revenue and cost-saving initiatives to eliminate structural deficit</td>
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<tr>
<td></td>
<td>Union negotiations to achieve labor-related savings (wages, benefits, pension and work rules)</td>
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<th>Phase II: long-term outlook</th>
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<td>Assessment of long-term liabilities</td>
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<td>Funded debt</td>
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<td>Pension</td>
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<td>OPEB</td>
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<tr>
<td>Development of 10-year financial projections</td>
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<tr>
<td>Identification of key drivers of structural deficit</td>
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<td>Development of strategy and action plan to achieve long-term financial stability</td>
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<th>Expected results</th>
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<tr>
<td>Enhanced public safety</td>
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<tr>
<td>Revitalization of neighborhoods</td>
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<tr>
<td>Improvement in level of services to citizens</td>
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<tr>
<td>Reinvestment in City infrastructure</td>
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<td>Public safety facilities and fleet</td>
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<td>Streetlights</td>
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<td>Transportation</td>
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<td>Recreation</td>
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<td>Information systems</td>
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<td>Long-term fiscal stability</td>
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Restructuring services

At EY, we assist companies and municipalities in developing and implementing financial, strategic and operational strategies to help improve liquidity, credit availability and stakeholder returns. Our services span the financial spectrum from healthy to distressed. For healthy entities, we are able to assist by eliminating expenses, conserving capital and positioning the organization for growth. For distressed entities, we can assist in the restructuring of their balance sheets and operations.

We are an independent advisor that brings fresh objectivity to all situations along the pendulum of financial health and are supported by sector-focused professionals. Our multidisciplinary team offers integrated, objective advice that helps you evaluate opportunities, improve the benefits of transactions and achieve your strategic goals — whether you are positioning your company for growth, buying or selling a distressed asset, restructuring your business or dealing with underperformance or cash management challenges.

Service offerings

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<tr>
<th>Distressed municipalities</th>
<th>Distressed corporate and bankruptcy advisory</th>
<th>Creditor advisory</th>
<th>Distressed supplier advisory</th>
<th>Cash flow forecasting</th>
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<tr>
<td>• Cities, school districts, counties, states and agencies</td>
<td>• Liquidity management</td>
<td>• Independent business review</td>
<td>• Early earning screening systems</td>
<td>• Strategic liquidity management tools</td>
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<td>• Short- and long-term financial projections</td>
<td>• Business planning</td>
<td>• Collateral analysis</td>
<td>• Troubled supplier risk assessment</td>
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<td>• Bankruptcy support</td>
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