The city of Detroit filed for bankruptcy on July 18, 2013. Burdened with more than $18 billion in debt and $3.5 billion in unfunded pension obligations, Detroit became the largest American city to seek bankruptcy protection. The Federal Reserve is among those closely watching how courts address the situation.

To learn more about the issue, Forefront talked to Thomas Fitzpatrick IV, an economist at the Cleveland Fed who is a member of a special team examining the condition of municipal finances.

Forefront: The Detroit bankruptcy has captured nationwide attention. But why is staff at the Federal Reserve looking at it? This seems like an area outside of the central bank’s traditional purview.

Fitzpatrick: It is. After the financial crisis, the Federal Reserve System established financial monitoring teams to keep an eye on areas that might be sources of systemic risk. One of those areas is municipal finance.

If municipalities stopped paying their debts, there could be ripple effects that spread through bond insurers or the banking system. Here’s how: Bond insurers may come under stress from taking over payments for the municipalities, leading to downgrades of other bonds they insure. About $7 billion of Detroit’s debt is insured, and the list of companies insuring municipal debt is pretty small. When viewed in context of coinciding municipal bankruptcies, there is enough insured debt to raise the question whether insurers could cover all current and future losses. The banking system could be another transmission channel. The banking system might be vulnerable if distressed municipalities ceased making loan or bond payments.

While the municipal debt market is small relative to the banking system, it is not necessarily evenly distributed: Some banks may have large exposures to specific states or municipalities.

Forefront: Detroit is, of course, not alone in facing fiscal distress. What financial conditions are common among other cities facing bankruptcy?

Fitzpatrick: Many factors come into play. Most of the time, a handful of episodes are to blame — a project that went south and became very expensive (like the sewer project in Jefferson County, Alabama) or a bad investment (like the derivatives purchased by Orange County, California). And of course, the recession amplified everything by reducing tax receipts and funding levels for public pensions. In Detroit, the problem is a bit more structural, as the city has lost so much population, and with it, tax base.

One issue that is common to nearly all of these bankruptcies is growing public pension and healthcare obligations. Consider some of the states where cities have declared bankruptcy. In California (Stockton, San Bernardino) and Michigan (Detroit), state law strongly protects public pension benefits (private pensions are governed by a completely different set of rules). That means that these benefits cannot be reduced by the city or town, even when they grow to an unaffordable level, unless pensioners agree to the reductions, which almost never happens.

Forefront: Given that pensions are a large part of the problem, have courts ever allowed public pension benefits to be modified in municipal bankruptcies?

Fitzpatrick: Most states have strong pension protections, so in most cases courts might be the only way to modify benefits without pensioner consent. However, while courts have approved modifications to benefits when the city and pensioners have agreed to them, they have never forced a modification without those agreements. The most recent example happened in Central Falls, Rhode Island. In July 2011, Rhode Island passed a law that required the state’s municipalities to make...
payments on their general obligation bonds, and put a lien on the city’s taxes so that the tax revenue would go to the city’s bondholders in the event of a bankruptcy.

Shortly thereafter, Central Falls filed for bankruptcy. The purpose of the law was to change the negotiating posture of Central Falls and its pensioners in bankruptcy. Its practical effect was to grant general obligation bondholders the right to be paid before pensioners in bankruptcy. The pensioners would be paid as unsecured creditors and would have the right to payments that remained only after all the secured creditors were paid. As a result, the city and pensioners settled, agreeing to steep cuts in pension benefits (estimating that their benefits would be even lower otherwise), and the bankruptcy court approved that plan.

Forefront: So the courts won’t modify pension benefits without approval from pensioners?

Fitzpatrick: It’s true that courts have never modified pension obligations without the agreement of pensioners. But it is definitely on the table now. This is an issue being litigated in California bankruptcies and that will be litigated in the Detroit bankruptcy. There are other questions that will be litigated in these jurisdictions if the courts decide that pensions can be modified — such as their priority relative to other creditors.

Forefront: Not that we want to stray into hypothetical territory, but what would be the implications if, for example, Detroit were allowed to modify pension benefits without employee approval?

Fitzpatrick: You would likely see pensioners in states with strong protections be less likely to hold out when their municipal employer is under stress. That’s really the purpose of municipal bankruptcy: to solve the holdout problem that arises when all of your creditors except one (or a handful) agree to take partial cuts to what they are owed in order to make the situation work for everyone. In Detroit, it means that you would see all creditors (pensioners, bondholders, etc.) take some pretty big haircuts on what they are owed. How big depends on how their debts are treated. In the case of pension benefits, this means that the court will also have to decide if the special protection public pensions are offered under state law changes the way those debts are treated in bankruptcy. To oversimplify, if the court decides public pension benefits can be modified, it will then have to decide how they can be modified.

Forefront: Alternatively, what if the city isn’t allowed to modify benefits without employee approval?

Fitzpatrick: If the court decides that they cannot be modified, it means that at least $3.5 billion of Detroit’s total debt has to be paid in full according to the original terms. That means there will be less left for all the other creditors. It is worth noting that only the public pension benefits are protected by the state constitution, and not the health benefits that are also owed to pensioners (and sum to about $6 billion of Detroit’s debt).

Forefront: It would have been nice if cities hadn’t gotten themselves into this situation in the first place. In the future, what sort of incentives might be useful to put in place so that municipalities more appropriately fund and structure their pension plans?

Fitzpatrick: Generally there are three areas of potential focus: funding, investing, and benefit adjustments. Most states that protect public pension benefits do not have a law requiring that the pensions be funded in a way that ensures sufficient funds will be there to pay the benefits when they are due. When they do have laws that seem to require funding, courts can be reluctant to enforce them. Most state laws also allow actuarial assumptions about expected rates of return that may not reflect market rates. Creating credible funding mechanisms could help solve this problem in the future.

Similarly, in the past, courts have been reluctant to enforce laws requiring that funds for public pensions be invested prudently. Sometimes investment cases can be very difficult to decide, because the line between prudent and imprudent investments is not always clear. Other times it is a bit more obvious. Federal pensions solve this problem by investing only in US Treasuries. Such a strategy would increase the required annual funding of public pensions, but would also largely immunize them against large market fluctuations.

Finally, when large market fluctuations do occur or when public employers are financially stressed, there has to be some way to modify public pension benefits that have been earned. After all, promises to pay can be enforced only if the promisor has the money to pay.

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