STATE OF MICHIGAN
DEPARTMENT OF TREASURY

RICK SNYDER
GOVERNOR

NICK A. KHOURI
STATE TREASURER

DATE: November 24, 2015

TO: Governor Rick Snyder

FROM: Ann Storberg, Senior Policy Advisor to State Treasurer Nick A. Khouri

SUBJECT: Financial Review Commission's Biannual Report on Detroit

On behalf of Mr. Ron Rose, Executive Director for the Office of the Financial Review Commission, I am attaching for your consideration the second biannual report by the Financial Review Commission for the City of Detroit as required by Section 6(8) of P.A. 181 of 2014. The report details the Commission's activities and formal requirements since the Commission became official under section 6(1) of the Act on the effective date of Detroit's plan of adjustment, December 10, 2014.

Attachment

Cc: Senator Arlan Meekhof, Majority Leader
Representative Kevin Cotter, Speaker of the House
Mayor Mike Duggan, City of Detroit
Council Member Brenda Jones, President Detroit City Council
Financial Review Commission members
Ron Rose

STATE OF MICHIGAN
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GOVERNOR

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DATE: November 24, 2015

TO: Governor Rick Snyder

FROM: Ronald L. Rose, Executive Director
Financial Review Commission

SUBJECT: Detroit Financial Review Commission Biannual Report

This report is being filed on behalf of the Financial Review Commission (FRC) for the City of Detroit, by its Executive Director, pursuant to the requirements of Section 6(8) of Public Act 181 of 2014, the Michigan Financial Review Commission Act (the "Act"). A copy of this report is being delivered to the Senate Majority Leader and the Speaker of the House of Representatives, and posted on the FRC's Department of Treasury website. A copy is also being delivered to the Mayor and City Council President of Detroit.

Pursuant to Section 6(1) of the Act, the FRC's oversight of the City began on the effective date of the City's plan of adjustment, December 10, 2014. The FRC is responsible for determining the City is complying with the Act and with its plan of adjustment. This is the Commission's second report, following the previous report submitted on May 28, 2015. It reports on the Commission's activities and significant developments in the City's finances.

Statutory Oversight Activities

Sections 6 and 7 of the Act include various powers and duties of the Commission in its oversight of the City. Those statutory requirements and compliance with them to date are noted below.

Requirement	Act Sec. No.	Compliance
Compliance with plan of adjustment, the Act, and other revised statutory requirements	6(2) and 6(3)	City is implementing programs consistent with the plan of adjustment. FRC provided its annual certification of City's statutory compliance on September 28, 2015.
FRC review and approval of annual four-year financial plan	6(4) and 7(b)	City submitted its FY 2016-FY 2019 plan on March 19, 2015. FRC approved it on April 20, 2015.
FRC review and approval of all applicable contracts	6(6)	City has submitted 237 applicable contracts and contract amendments to date. FRC has approved all submitted contracts to date.
City and CFO provide needed information and documents and attend FRC meetings when needed	6(7), 7(d), and 7(m)	City and CFO have been responsive to requests for information and documents and have attended meetings when requested.
FRC review and approval of collective bargaining agreements	6(9)	City has submitted 1 collective bargaining agreement to date, which was between the Detroit Department of Transportation and the Amalgamated Transit Union, Local 26. FRC approved it on October 26, 2015.

City submits quarterly debt service certifications	6(11)	City has provided complete certifications for each quarter to date.
Consensus revenue estimates	7(a)	City held consensus revenue estimating conferences in February 2015 and September 2015 as required. City provided its revenue estimates to FRC for review.
FRC review and approval of budget amendments	7(c)	City has submitted 3 budget amendments to date. All have been budget-neutral. FRC has approved all submitted amendments to date.
FRC review and approval of requests to issue debt	7(e)	City has submitted 3 debt issuance requests to date. All have been for the Detroit Water and Sewerage Department. FRC has approved all submitted debt issuance requests to date.
FRC approval of Chief Financial Officer appointment	7(g)	FRC approved the appointment of the current Chief Financial Officer of the City on January 26, 2015.

City's Legacy Pension Requirements

During the chapter 9 proceedings of Detroit, there were extensive analyses and negotiation regarding the two major legacy pension plans for employees and retirees of the City, namely the General Retirement System (GRS) and the Police and Fire Retirement System (PFRS, and together the Systems).[1] The results of the chapter 9 analyses and negotiations were that during the fiscal years 2014-2023 payments into the Systems is required as set forth in the following table and after fiscal year 2023 the City's General Fund must then fund the Systems on a 30-year level principal closed amortization method thereafter.

City of Detroit
Plan of Adjustment - Legacy Pension Contributions (FY15-FY24)
($ in millions)

GRS & PFRS	2015	2016	2017	2018	2019	2020	2021	2022	2023	2024	Total
DWSD	$ 65.4	$ 45.4	$ 45.4	$ 45.4	$ 45.4	$ 45.4	$ 45.4	$ 45.4	$ 45.4	$ -	**$ 428.6**
Library	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.9	**25.4**
UTGO Millage	4.4	4.0	4.0	3.9	3.7	3.7	3.6	2.3	2.0	1.6	**33.2**
State	194.8	-	-	-	-	-	-	-	-	-	**194.8**
Foundations	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	18.3	**183.0**
DIA	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	**50.0**
General Fund	12.1	20.0	20.0	20.0	20.0	-	-	-	-	111.0	**203.1**
Total	**$ 302.5**	**$ 95.2**	**$ 95.2**	**$ 95.1**	**$ 94.9**	**$ 74.9**	**$ 74.8**	**$ 73.5**	**$ 73.2**	**$ 138.8**	**$ 1,118.1**

Based on the above analysis, after the 10 years ending June 30, 2023, the City would have to start funding a substantial portion of the pension obligations to the Systems from its General Fund.[2] As shown by the above table, the amount projected to be paid by the City's General Fund

[1] This portion of the Report refers to the two legacy pension plans in effect at the time the City filed its chapter 9 proceedings. The two legacy pension plans (also referred to as the "Component II" plans) were both frozen and modified in the chapter 9 proceedings. This Report does not discuss the two new plans adopted as part of the bankruptcy known as the "hybrid" or "Component I" pension plans, one for employees of the police and fire departments and the other for all other employees.

[2] It is likely that some relatively small portion will be paid from or reimbursed to the General Fund by other City Funds. The FRC does not believe that this will be a material amount.

in fiscal year 2024 was estimated to be $111.0 million. In years after 2024, the annual amount payable decreases by about $2 million per year.

During November 2015, Gabriel Roeder Smith, the actuary for each of the Systems issued a new actuarial report for each of the Systems (the Gabriel Roeder Reports[3]). The amount projected to be paid by the City's General Fund in fiscal year 2024 in the Gabriel Roeder Reports was increased from the City's plan of adjustment (POA) projection of $111.0 million to $194.4 million. The Gabriel Roeder Reports state that the projected required General Fund payment in Fiscal Year 2024 will be $94.5 million for the PFRS and $99.9 million for the GRS.

One material reason for the change from the POA projections to the projections contained in the Gabriel Roeder Reports is a change in mortality tables. The POA projections were based on year 2000 static mortality tables. After Gabriel Roeder performed a mortality study for each System for the years 2008-2013, which studies were concluded in early 2015, each System changed its mortality tables from year 2000 static mortality tables to fully generational 2014 mortality tables.

There are a variety of other factors accounting for the large changes in projected fiscal year 2024 obligations. For example, POA projections assumed that the Effective Date of the POA would be the same date the pension plans were amended, June 30, 2014. The Effective Date of the POA was not until December 10, 2014 and it took another few months after December 10, 2014 to effectuate the changes. The result was that retirees in both the GRS and PFRS plans received about nine months of benefits that otherwise would have been reduced. Because of the terms of the pension plans, these over-payments cannot be recouped.

It is important to understand that many changes in the projections will occur over the next few years and these changes may be positive or negative. As examples, future changes may be caused by actual mortality experience differing from assumed mortality experience and actual return on investments being higher or lower than projected returns. In addition, because of the major changes that occurred in the benefits under each of the pension plans, the projected liability has been estimated and the Systems are in the process of performing detailed analyses on each of the plans' beneficiaries. The detailed analysis is likely to result in changes to the projections.

Before the FRC and the City were aware of the increased projected fiscal year 2024 liability by the Gabriel Roeder Reports, discussions had already commenced regarding the large amount of money that the City has to commence paying in fiscal year 2024 under the terms of the POA. With the Gabriel Roeder Reports showing a much higher amount than contemplated by the POA, the City and FRC have accelerated these discussions. The City has formulated a strategy to begin to address the fiscal year 2024 and thereafter funding requirements. The City will issue a request for proposals (RFP) for a consultant to, among other things, test the sensitivity of the assumptions and research how others have dealt successfully with similar issues. The consultant will then make recommendations to the City as to options for retiring the pension liabilities described. The recommendations will be provided to and reviewed by the FRC as part of a budget submission or budget revision once they have been fully vetted and accepted by the city.

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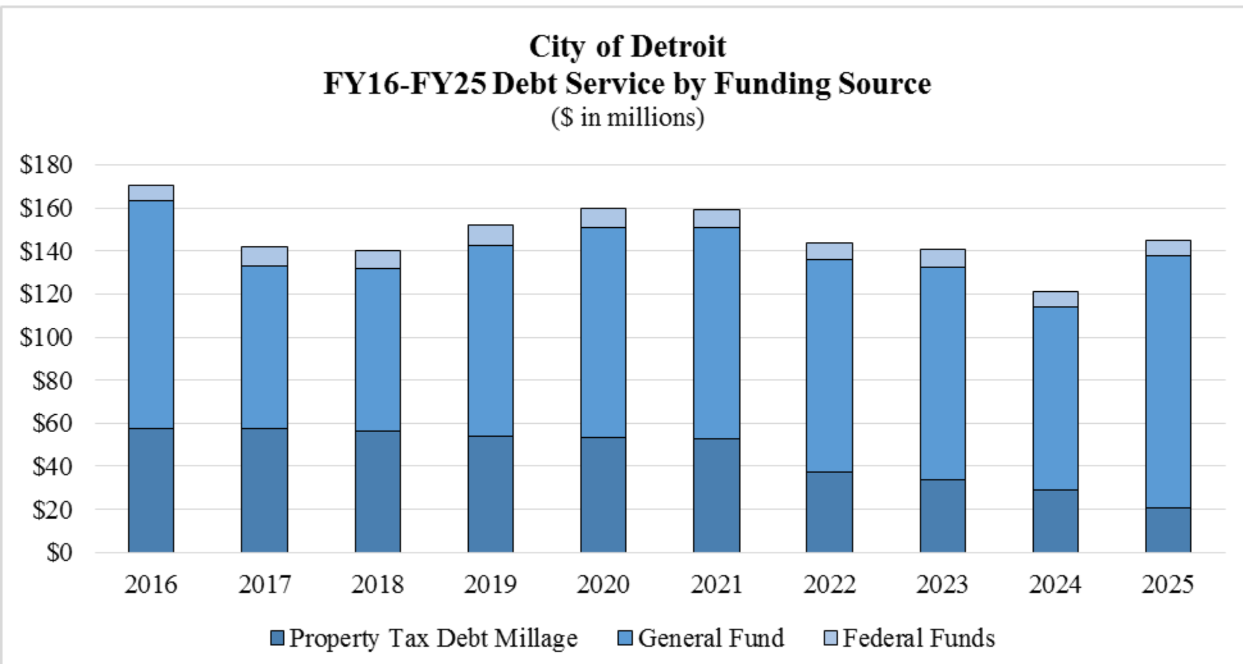
[3] The Gabriel Roeder Report for the GRS is in final form. The Gabriel Roeder Report for the PFRS is, as of the date of this Report, in draft form. It has been approved by the PFRS Investment Committee and is anticipated to be approved by the PFRS Board of Trustees on December 3, 2015. Once approved by the PFRS Board of Trustees, it will be issued in final form.

The timetable is for the City to issue the RFP before the beginning of calendar year 2016. The City is working internally and will work with the consultant it retains as the beginning of the process of developing and evaluating potential solutions for these pension issues.

City's Debt Service Requirements

In addition to the pension obligations discussed above, the City's debt service, even after the debt relief provided in the plan of adjustment, remains substantial. The City is required to provide quarterly debt service reports to the FRC certifying its ability to meet those requirements through the end of the fiscal year. The last tranche of current City debt matures in fiscal year 2044, and the current annual debt service requirements through fiscal year 2025 are shown in the graph below, averaging $147.4 million annually. These amounts do not include the Detroit Water and Sewerage Department's revenue bonds, which are payable from water and sewer system revenues.



On August 19, 2015, the City completed its sale of $245 million of Financial Recovery Bonds to remarket its bankruptcy exit financing debt. The City opted to pay down $30 million of the original $275 million borrowing from December 2014 and also achieved a lower overall interest rate than the plan of adjustment and City budget assumed. The graph above reflects the lower debt service expense due to these changes. The City received an investment-grade rating on the exit financing bonds, which are secured by a statutory lien on City income tax revenue. The City's underlying general obligation bond rating currently remains below investment grade.

City's Budget, Revenues, and Reinvestment Initiatives

Although the year-end closing and audit process is still underway, the City expects it will record a larger than expected surplus for the year ending June 30, 2015 (fiscal year 2015). The City will publish its final results when it completes its fiscal year 2015 comprehensive annual financial report (CAFR), which is expected no later than March 2016. The City already used a portion of this surplus to pay down $30 million of its exit financing debt (as referenced above). The City will also designate a portion of this surplus to create its 5% budget reserve fund, as required by statute (MCL 117.4t (1)(b)(vi)). It will also set aside a portion of it to support restructuring and reinvestment initiatives (RRIs), which are discussed further below. The plan of adjustment contemplated using annual operating surpluses for RRIs.

Based on first-quarter fiscal year 2016 results (July 2015 to September 2015), the City projected a $35 million budget surplus for the year. Notably, the City continues to make conservative assumptions in its projections to minimize risk. It projects spending near budgeted levels (over $1 billion for the General Fund), although there is a reasonable chance planned spending on some initiatives may experience a slower start than originally expected. It estimates major revenues slightly higher based on improvement in the previous year's unaudited actuals. However, the City's revenue growth estimates continue excluding any benefit from the transfer of income tax collection to the State and other enhanced collection efforts until more data is available after implementation.

The City's plan of adjustment and its FY 2016-FY 2019 financial plan assumed spending on RRIs intended to improve City operations and the quality of life for residents. The plan of adjustment assumed the City would spend about $1.7 billion over ten years (FY 2014-FY 2023), which it would fund with over $200 million in exit financing debt, new revenues and cost savings initiatives, annual operating surpluses, and any other available City resources. Note the plan provides for annual operating surpluses to fund RRIs through fiscal year 2023 by largely deferring City-funded pension payments until fiscal year 2024 (as discussed in the pension section above).

The FRC will continue monitoring the City's progress on achieving its RRI goals. The City has approved and begun spending on various RRI projects to date, including new financial management and human resources information systems, blight removal, new police and fire vehicles and radios, and other service-level and internal operations enhancements. The City has implemented a business case review process whereby departments must request funding for RRIs by documenting the financial and service-level return on investment. RRIs consist of the following categories:

- **Additional departmental operating expenditures**: recurring costs to achieve measurable service-level improvements, which must be sustainable and built into departmental operating budgets

- **Capital investments**: nonrecurring costs to invest in the City, which are evaluated on their financial and service-level return on investment

- **Blight**: ongoing City efforts to remove blight throughout the City using available City funding and grants

Other Upcoming Activities

In addition to monitoring ongoing developments in the many issues discussed above, the FRC also expects to see substantial activity in the following areas over the next six months:

- City departments will continue restructuring their operations to improve their efficiency and effectiveness, including major changes and consolidations in the areas of finance, human resources, information technology, planning, and housing.

- In January 2016, the State of Michigan Department of Treasury will take over processing the City’s tax year 2015 individual income tax returns, allowing City filers to submit returns electronically for the first time.

- In January 2016, the Detroit Water and Sewerage Department (DWSD) expects to formally split into the new Great Lakes Water Authority (GLWA) and DWSD-Retail (DWSD-R). While Detroit retains ownership of the entire tri-county water and sewer system, GLWA will manage the regional system outside the city, and DWSD-R will control the local Detroit system.

- In February 2016, the City will hold its second formal consensus revenue estimating conference of the current fiscal year.

- The City will present its FY 2017-FY 2020 financial plan to the FRC in March 2016. Following a one-month review, the FRC will consider it for approval at its April 2016 meeting.

- By March 2016, the City expects to have completed its fiscal year 2015 comprehensive annual financial report (CAFR).

- In March/April 2016, the City expects to launch its new enterprise resource planning (ERP) system for core financial management and human resources functions. The City plans to use the new financial system for the year beginning July 1, 2016 (fiscal year 2017).