

EXHIBIT C

CITY OF DETROIT, MICHIGAN
NOTICE OF PRELIMINARY FINANCIAL REVIEW FINDINGS
AND
APPOINTMENT OF A FINANCIAL REVIEW TEAM

The following information is provided by the City of Detroit, Michigan (the "City") pursuant to certain Continuing Disclosure Agreements executed and delivered by the City in connection with the issuance of certain obligations (the "Obligations"), in compliance with Securities and Exchange Commission Rule 15c2-12.

Since 2008, the City has been experiencing significant financial problems caused by the loss of residents, the financial challenges of the automobile industry, the disruptions in the financial markets and the overall economic issues faced by the country. In early December 2011, Governor Rick Snyder (the "Governor") directed State Treasurer Andy Dillon (the "Treasurer") to conduct a preliminary review of the City's finances pursuant to Public Act 4 of 2011, the Local Government and School District Financial Accountability Act ("Act 4"). On December 21, 2011, the Treasurer, after completing his preliminary review, issued a report in which he made a determination that the City was in a state of "probable financial stress" under Act 4 based on a number of factors set forth in the Treasurer's report.

In accordance with Act 4, upon a finding of "probable financial stress," the Governor is required to appoint a financial review team to undertake a more extensive financial management review of the City. On December 27, 2011, the Governor announced the appointments of a 10 member financial review team. Under Act 4, the financial review team must report its findings to the Governor within 60 days, unless a 30-day extension is requested and granted or the Governor requests that the review team report to him in less than 60 days. Under Act 4, the review team must reach one of the following conclusions in its report: (i) no or mild financial stress exists in the City; (ii) severe financial stress exists in the City but a consent agreement containing a plan to resolve the problem has been adopted; (iii) severe financial stress exists in the City and a consent agreement has not been adopted; or (iv) a financial emergency exists in the City and no satisfactory plan exists to resolve the emergency.

Attached to this Notice as Exhibit A is a copy of the December 21, 2011 report of the Treasurer.


Dated: January 13, 2012



STATE OF MICHIGAN
DEPARTMENT OF TREASURY
LANSING

RICK SNYDER
GOVERNOR

ANDY DILLON
STATE TREASURER

DATE: December 21, 2011
TO: Rick Snyder, Governor
FROM: Andy Dillon, State Treasurer 
SUBJECT: Preliminary Review of the City of Detroit

I. Background

On December 6, 2011, the Department of Treasury commenced a preliminary review of the finances of the City of Detroit to determine whether or not a local government financial problem existed. Section 12(1) of Public Act 4 of 2011, the Local Government and School District Fiscal Accountability Act, permits a preliminary review to be conducted if one or more of the conditions enumerated therein occurs. The preliminary review of the City of Detroit resulted from the conditions enumerated in subdivision (j), (m), (o), (q) and (r) of Section 12(1) having occurred within the City.¹

As summarized below, based upon information received and considered as part of the preliminary review -- including the inability of the City to avoid fund deficits, recurrent accumulated deficit spending, severe projected cash flow shortages resulting in an improper reliance on inter-fund and external borrowing, the lack of funding of the City's other post-retirement benefits, and the increasing debt of the City -- I conclude that probable financial stress exists in the City of Detroit and recommend appointment of a financial review team. Appointment of a financial review team is a prerequisite step in the Act 4 process to the appointment of an emergency manager.

II. Preliminary Review Findings

The preliminary review found the following:

- The City has violated requirements of section 17 of Public Act 2 of 1968, the Uniform Budgeting and Accounting Act, as amended, which states that the "the legislative body of the local unit shall amend the general appropriations act as soon as it becomes apparent that a deviation from the original general appropriations act is necessary and the amount of the deviation

¹ Subsection (j) provides that "[t]he local government has violated a requirement of sections 17 to 20 of the uniform budgeting and accounting act, 1968 PA 2, MCL 141.437 to 141.440. Subsection (m) provides that "[a] local government is in breach of its obligations under a deficit elimination plan or an agreement entered into pursuant to a deficit elimination plan." Subsection (o) provides that "[a] municipal government has ended a fiscal year in a deficit condition." Subsection (q) provides that "[a] local government has been assigned a long-term debt rating within or below the BBB category or its equivalent by 1 or more nationally recognized credit rating agencies." Subsection (r) provides that "[t]he existence of other facts or circumstances that in the state treasurer's sole discretion for a municipal government are indicative of municipal financial stress."

can be determined.” For example for the year ending June 30, 2010, the Human Resources - Apprentice Training program went over budget by over \$2.3 million, the Insurance Premium line item exceeded its budget by over \$12 million and the Police Operations line item went over budget by \$15.8 million. Consequently, the general fund had line items that exceeded its budget by almost \$58 million. Unaudited 2011 figures indicated that line items amounting to \$97 million exceeded their budget including an excess of \$25 million over budget for fire and \$44 million for police.

- City officials have not filed an adequate or approved deficit elimination plan with the Department of Treasury for the fiscal year ending June 30, 2010. On December 20, 2010, City officials filed an audit report that reflected a \$155 million cumulative deficit in the general fund, a \$1.4 million cumulative deficit in the airport fund, and a \$3.5 million cumulative deficit in the local street fund. As of December 2011, City officials have not filed a plan that would reduce the general fund deficit. In fact, new data estimate the general fund’s deficit increasing to \$196 million for 2011 (the 2011 audit report has not yet been filed). The deficits in the airport and local street funds have been eliminated in 2011.

There have been deficits in the general fund that exceed \$100 million dating back to 2005. These deficits have fluctuated between over \$155 million and over \$300 million. One of the primary methods the City has used to reduce the deficits has been to issue more debt. Total general fund debt and other long term liability proceeds for the years between 2005 and 2010 was over \$600 million, temporarily reducing the deficits by an equal amount. Debt proceeds reduce the deficit in the year the debt is issued, but reduce fund balance over time as debt service payments increase.

General Fund Deficits and Debt Proceeds:

<u>Year</u>	<u>Deficit</u>	<u>Debt Proceeds</u>
2005	(155,404,035)	248,440,183
2006	(173,678,707)	34,892,659
2007	(155,575,800)	
2008	(219,158,138)	75,210,007
2009	(331,925,012)	
2010	(155,692,159)	251,663,225
2011	(196,577,910)	

For the City on a whole (excluding component units), there was a 2010 unrestricted net assets deficit of over \$1.6 billion and a similar amount for the unaudited 2011 fiscal year².

² Net Assets are calculated on the government-wide financial statements that use the accrual basis of accounting and include such items as capital assets and long-term debt. The unrestricted amount measures the net assets that are appropriate for expenditure and are not legally segregated for a specific future use.

- The City's deficit elimination plans and budget proposals have proven to be unrealistic. City officials are either incapable or unwilling to manage its own finances. For example, the 2008 deficit elimination plan reported \$58 million in expenditure reductions in the general fund and \$69 million (excluding debt proceeds and revenue sharing) in revenue enhancements for 2010. However, the 2010 general fund balance ended in a deficit condition of over \$155 million and would have been much greater if not for \$250 million in new debt. Again, the 2009 deficit elimination plan certified in November of 2010 projected a 2011 surplus while the actual fund balance for the general fund ended with a deficit estimated at close to \$200 million. The City had promised restructuring and consolidation including hiring freezes and improved tax collection. Finally in mid-2011, City officials submitted a deficit elimination plan for the 2010 deficit which included revenue initiatives of over \$200 million and expenditure reductions of over \$300 million, most of which would take place in future periods and were questionable, such as the \$10 million to sell tunnel rights and \$50 million in better income tax collection. One version of the plan estimated that the City would be able to obtain an additional \$154 million each year from the collection of income taxes from residents who work outside the City. Projected expenditure reductions rely heavily on union concessions which have not historically materialized.
- The City has a mounting debt problem. In 2010, annual debt service requirements exceeded \$597 million. As of June of 2011, the long-term debt of the City exceeded \$8 billion excluding unfunded actuarial pension and other postemployment benefit (OPEB) liabilities and discretely presented component units such as the Library and Downtown Development Authority. However, if one includes the unfunded actuarial pension liability of \$615 million (offset by an almost \$1.4 billion pension asset) and the unfunded other postemployment benefit liability of over \$4.9 billion, the City's total long-term liabilities are over \$12 billion, which does not include substantial sums of interest which are over \$4.9 billion. In comparison if one took the total long-term debt of the City compared to total net assets, the City would have a 2010³ factor of 32.64 debt to 1 in net assets or 32.64⁴. Other major cities in Michigan have factors of less than 1 such as Flint with a factor of 0.59, Lansing with a factor of 0.67 and Grand Rapids with a factor of 0.39. Major Cities around the United States have smaller factors such as the City of Los Angeles with a factor of 1.13 and Indianapolis with a factor of 4.67.⁵

³ The factor for Detroit's 2011 fiscal year is not meaningful since total net assets declined by \$281 million and are in a deficit condition.

⁴ Less than 1 is considered good.

⁵ Chicago was the only City compared that was in poor shape comparably with a factor that was not meaningful because of a negative total net assets balance.

	General Obligation	Revenue	POC	Other
Governmental	\$ 1,033,233,278	\$ 125,520,622	\$ 1,194,003,260	\$ 284,276,052
Sewage		2,894,198,302	90,114,924	15,046,961
Transportation	6,271,722		105,143,913	28,238,095
Water		2,159,831,662	79,517,902	25,979,109
Automobile		11,341,382		10,225,829
Other				162,187
Unallocable				
	<u>\$ 1,039,505,000</u>	<u>\$ 5,190,891,968</u>	<u>\$ 1,468,779,999</u>	<u>\$ 363,928,233</u>

	OPEB	Pension Liability	Pension Asset*	Total
Governmental				\$ 2,637,033,212
Sewage				2,999,360,187
Transportation				139,653,730
Water				2,265,328,673
Automobile				21,567,211
Other				162,187
Unallocable	\$ 4,982,355,243	\$ 615,701,032	\$ (1,371,848,955)	4,226,207,320
	<u>\$ 4,982,355,243</u>	<u>\$ 615,701,032</u>	<u>\$ (1,371,848,955)</u>	<u>\$ 12,289,312,520</u>

Pension Obligation Certificates (POC); Other Postemployment Benefits (OPEB)
 *Pension asset may already be factored into actuarially determined pension liability

- Prior to 2008, in order to obtain better interest rates and reduce debt related costs, the City entered into interest rate swaps and swaptions where two or more parties enter into an agreement to exchange interest cash flows. Switching or “swapping” a variable interest rate for a fixed rate would benefit the City if market interest rates increased. However, rates subsequently fell impacting the City negatively. Because the fall in interest rates was not predicted, ramifications of increased annual payments resulted. In addition to principal and interest payments, the City must pay amounts called “hedging derivatives”, which over the life of the debt is an additional \$1,136,007,248.

The City is in risk of a termination event which would occur if the City’s credit is downgraded below Baa3 or its equivalent. On January 8, 2009, such an event occurred. However, the City avoided the immediate demand for payment by entering into another agreement that would allocate wagering tax revenues to a Trust to be used as collateral for future payments thus reducing the benefits of those cash flows to the City. New termination events include the agreement that the Trust will maintain a certain level of funds, further downgrades in the City’s credit rating, and the appointment of an emergency manager. As stated by the City’s auditors, “[s]hould such Termination Events occur in connection with the Swap Agreements, and not be cured, there presently exists significant risk in connection with the City’s ability to meet the cash demands under the terms of the amended Swap Agreements.” According to estimates if an “event” occurred, the City would be facing a \$280 million to \$400 million termination pay-

ment. According to recent reports, the City intends to sell water and sewer bonds to unwind a portion of the swaps. The notional amount, or face value, of these outstanding hedging derivatives in 2011 was over \$3.8 billion and had a market value of (\$560 million).

- The City's long-term bond rating fell below the BBB category and is considered "junk", speculative or highly speculative. According to a Thomson Reuters June 24, 2011 article, "Fitch downgraded the rating on about \$453 million of Detroit's unlimited-tax general obligation bonds to BB-minus from BB-plus, and dropped the rating on the City's approximately \$486 million of limited-tax GO bonds to B-plus from BB. The rating on about \$1.5 billion of pension bonds was cut to BB-minus from BB-plus. The lower unlimited-tax GO rating from Fitch matches the Ba3 rating with a negative outlook from Moody's Investors Service. Standard & Poor's Ratings Services rates Detroit's GO bonds BB with a stable outlook."
- Not only does the City have large external debts, but it also has large debts due to itself in the form of interfund loans. As of June 30, 2010, the City had interfund balances amounting to over \$447 million and unaudited 2011 balances of \$334 million. Concurrently, the City has been able to have net operating surpluses in its general fund for most of the more recent fiscal years. However, the City incurs substantial deficits in the fund because of the subsidies it pays to other funds such as \$72 million to the transportation fund. However, most of the transfers (\$133 million) were made for debt service and pension funds. The total amount transferred from the general fund according to 2011 draft figures is \$215 million.
- The City is experiencing significant cash flow shortages. In 2010, the City received \$250 million in fiscal stabilization bonds. The City has also received \$55 million in delinquent property tax receipts from the county and \$20 million from the DTE Escrow account. However despite these inflows of substantial amounts of cash, the City is projecting a cash shortage.

Based on recent projections made available by the City, the general fund had a forecasted ending cash balance of \$115,500,000 as of October 28, 2011. The actual cash balance as of that date was \$96,100,000, an overestimation of \$19,400,000. The City revised its cash forecast based on a series of new assumptions and it is projected that the City will experience a cash shortage starting in April 2012, of (\$1,600,000) and will end its fiscal year in June 2012 with a cash shortage of (\$44,100,000).

- The City has had trouble making its required payments to its pension plans. Years of exceptional pension benefits have increased the costs to the City. Current police and fire employees enjoy multipliers of 2.5 for 25 years of service and 2.1 thereafter⁶. However, a newer one-year agreement was approved to limit the factor for earnings after September 2011 to

⁶ Multipliers are used in calculating retirement pay in defined benefit plans. For example, a 2.5 multiplier would be used by calculating 2.5% of the years of service times the final average compensation to calculate the yearly pension. For example, an employee working 30 years and making \$50,000 per year before retiring would receive \$37,500 in retirement (.025x30x50,000). Compare that to a factor of 1.5 and the annual retirement would be \$22,500, a \$15,000 difference annually.

2.1. General employees have negotiated a tiered system of 1.6 for the first 10 years, 1.8 for the next 10 years, 2.0 for the next five years, and 2.2 for the remaining years.

In June of 2005, the City issued \$1.44 billion of new debt in the form of Pension Obligation Certificates (POC) to fund its two retirement systems with a renegotiated repayment schedule of 30 years. More recently, the City contemplated not making required payments to the plans to save money. However, subsequent negotiations with representatives of the plans resulted in a "smoothing" that would allow them to make five-year pension payments over a seven-year period. Annual required payments as of the last audit report filed, not including debt payments related to the POCs, is \$110 million which is an increase of \$41 million from 2010.

Other legacy costs include growing unfunded pension and other postemployment benefits that have already been noted, but also include the current salary and benefit structure. Others have calculated the fringe benefit costs to the City in addition to salaries and benefits at almost \$1 billion annually. However, this amount has not been verified.

- There are questionable balances in the 2010 audit report of the City's pension plans. The auditors were unable to obtain sufficient evidence supporting approximately \$216 million of the retirement plans' alternative investments.
- Audit reports for the fiscal year ending June 30, 2010 show that the City's poor financial management impacts the City's administration of Federal grant programs and poses likely threats to the City's continued receipt of Federal funds for social service programs. Eighty pages of a KPMG audit site numerous findings and offer the following examples of questioned and potentially disallowed costs:
 - Nutrition for Women, Infants and Children – Approximately \$1.0 million in questioned costs in addition to accounting, eligibility and fund reconciliation issues.
 - Community Development Block Grant – Approximately \$12.7 million in questioned salary costs.
 - HOME (Home investment partnership program) – Approximately \$846,000 in salary costs; \$273,000 in questioned indirect planning costs.

cc: Roger Fraser, Deputy State Treasurer
Frederick Headen, Director, Bureau of Local Government Services