Municipal Pension Fund Accounting Rules are Changing **(6/29/2012)**

Tomorrow's Headlines May Have a More Lasting Effect than Prior Pronouncements

Meredith Whitney's prior clarion call ("*60 Minutes*: Dec 2010") for billions of municipal defaults, created a massive 2011 buying opportunity by roiling the market and creating a window of opportunity for high-quality municipal investors. While the *"60 Minutes"* segment was a made for TV "drama queen moment", this window eventually closed later in 2011 as cooler heads ultimately prevailed.

We suspect that the next round of headlines -- which will be coming shortly -- will have a longer and more lasting effect on the perception of the municipal market, if not a negative impact on credit ratings.

Public Pensions Will Soon Look Worse -- Rules of the Game Are Changing

Most of the recent headlines regarding municipal pensions have been relatively positive. States have been taking various actions to slow down the growth of pension liabilities, employees are being asked to contribute more, and various court decisions, to date, have on average, been supportive. These actions for the most part will have a positive impact in the future and tend to affect newer employees. Voters in San Diego and San Jose recently followed San Francisco's prior actions and approved reforms that will lower future pension obligations.

The Governmental Accounting Standards Board (GASB) will be implementing new standards for pension valuations and reporting that will, in most cases, especially for the weaker funded pensions, add to the reported liabilities while weakening funded ratios. While these changes are not expected to take place until 2015, the new requirements have been previously released, and therefore we suspect that many states and jurisdictions will adopt the new proposals relatively soon.

As of 2010, the average funded ratio of state pensions was approximately 72%, with a wide range encompassing Delaware, Wisconsin, New York, and North Carolina at over 95% funded, to as low as Puerto Rico (8.5%), Illinois (45%) and Connecticut (53%).

Various industry studies suggest that adoption of the new accounting standards for public pensions will cause the average to fall into the 50% range. We believe that this will result in a series of new headlines that may again roil the municipal market and change perceptions for impacted states and localities. However, unlike the Meredith Whitney induced headlines, we believe the story behind these headlines may have a more lasting impact on the municipal market.

While a detailed analysis of the new public pension guidelines are beyond the scope of this commentary (however feel free to contact us for further discussion), the following points should be considered:

- Despite a truer and weaker depiction of pension liabilities, we foresee no immediate credit downgrades as pensions remain a long term issue whereas most states have sufficient assets over the intermediate term.
- Accounting rule changes should provide further impetus for accelerated reform.
- Those states and jurisdictions that continue to kick the can down the road will be subjected to downgrades over time and widening spreads.
- State and local governments will continue to confront budgetary distress as the global slowdown and continuing demands for social services in a tax increase adverse environment will make for hard choices.

State and local governments are in the early stages of tackling difficult and challenging structural issues -- some of them once referred to as the "third rail" of politics. As we have always said, solutions to problems are rarely forthcoming until politicians stare in to the abyss and the anger of the taxpayers. At RSW, we remain vigilant, and believe it is not the time to "chase yield", but instead focus our efforts on an investment discipline that emphasizes strong credit quality.

Robert S. Waas **Managing Member**	**Robert K. Coates** **Senior Portfolio Manager**	**Matthew T. Werner** **Portfolio Manager**	**Mark J. Tenenhaus** **Director of Municipal Research**	**John A. Carlson** **Director of Business Development**	**Marites A. Vidal** **Data Analyst**	**Randy J. Fox** **Operations Associate**	**Brian E. Pawl** **Operations Associate**	**Edgardo M. Brigino** **Operations Associate**