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## Accounting Rule Changes Put Public Pension Shortfalls in the Spotlight

The cost of public employee pensions has become a significant credit consideration for many issuers in the municipal marketplace. As we noted in our December 2011 comments on state pension funding, future pension funding needs are becoming increasingly significant in the eyes of the rating agencies, and the extent to which states fail to address these needs will likely begin to have material rating impacts in the intermediate term. In recent days, the adoption of new pension reporting rules for governments has again placed public pension funding in the spotlight of the national business press and investors.

On June 25, the Governmental Accounting Standards Board (GASB), the organization that establishes financial reporting standards for state and local governments, adopted new rules covering how public pension funding is reported. The new rules, which go into effect beginning in June 2013, do not have any effect on the level of pension payments to public employees or how governments choose to fund those payments. Rather, the rules make changes to the way in which those long-term obligations are calculated. The most significant changes introduced by the new GASB rules include:

1. Governments will be required to account for future pension obligations as a liability on their balance sheet, rather than disclosing that information only in the notes to the financial statements;
2. Plan assets must be valued at market value, rather than using a multi-year smoothing approach; and
3. Plan liabilities must be valued using a blended discount rate that will be lower than the average rate currently used by public plans, which will significantly increase the liability figures reported.

The Center for Retirement Research at Boston College (CRR) projects that, under the new GASB guidelines, adjusting the liability discount rate to the new GASB approach would have resulted in pension funding levels in the largest public pension funds for fiscal year 2010 dropping from an average 76.4% funded to an average of only 56.8% funded (that is, the pension trust funds hold investments with an expected future value of 57% of the expected future liability of pension costs).

Does the accounting change reflect a decline in the credit quality of state and local issuers that have public pension obligations? We do not believe that the new GASB rules change the credit landscape for governmental issuers. As we have said in the past, pension liabilities are long-term obligations that must be dealt with in a responsible manner over a long timeframe, and most municipal issuers do a reasonable job of funding future pension obligations. Governments have been required to disclose their pension funding practices and funded levels in the footnotes to their financial statements for a number of years. While the data can be hard to gather and analyze, rating agencies and municipal analysts have been focused on pension liabilities and pension funding for many years and routinely factor it into their credit evaluations. The new rules will move that disclosure out of the footnotes and on to the balance sheet. Although the liability is not new, it will be shown in a new way that will have much more prominence for investors, and the business media, and will draw greater attention and scrutiny going forward.

The rating agencies have commented that they do not expect the reporting changes to have a material impact on credit ratings in the near term. Credit criteria already incorporate analysis of pension obligations and long-term funding and the agencies argue that pension funding practices are already reflected in public issuer credit ratings. At present, we do not believe that there will be a material near-term impact on credit ratings from the GASB changes. There could be isolated cases of issuers surprising the raters and the market with an unexpectedly large liability, but we do not expect these to be common.

Ascent's investment approach already considers future pension obligations in our analysis of the credit risk of individual bond holdings. We do not target a specific pension funding level for public issuers. Rather, we look for issuers that have managed their pension obligations in a responsible manner. If we begin to see pension funding levels have a larger effect on credit rating changes or market trading levels, we will adapt our credit selection approach to reduce the credit and market risk to which our clients are exposed.

We do expect that pension funding will become a much more significant factor in investors' consideration of municipal bonds going forward. Because they represent obligations over very long timeframes, pension assets and liabilities are very large numbers. With the changes GASB made in how pension assets will be reported, we expect pension assets going forward will be highly correlated with the performance of U.S. equity markets. As a result, we anticipate there will be more volatility in pension funding levels over time. Like most investors, governments suffered significant investment losses in 2008 and 2009. As a result, reported pension funding levels dropped dramatically in 2009 and 2010. Whereas in the past these figures would be both smoothed over a number of years and not prominently displayed in the financial reports, going forward substantial changes in investment performance will immediately impact the financial statements of governments.

We also expect that the new accounting regime might change how investors view some larger city and county issuers. The majority of media discussion of public pensions has focused on states and state pension funding levels. While these figures are interesting, they are aggregates of the various underlying pension programs in each state and do not incorporate the pension plans of the large municipalities within the states. It is likely that more prominent disclosure of pension funding levels of some local issuers will be highly publicized by local media, and may take some investors by surprise.

The table below shows the projected impacts of the new GASB rules on the pension funding levels of a number of the largest pension plans. The plans are ranked by projected funding level after incorporating the changes under the new GASB rules. The table also shows the percentage drop in funding level resulting from the rules change. Even the worst funded plans will have time to make changes to establish a sounder long-term footing. By the estimates of the CRR, the plans with the lowest funding levels have at least until 2016 – and most until 2020 or later - until they exhaust their assets and begin to force payment of pension benefits from general revenues. The final column also shows CRR's estimate of the year that the plan's assets would be exhausted, assuming investment returns of 6% annually on fund assets.

### Lowest Funding Levels Among Public Pension Plans Under the New GASB Reporting Requirements (FY 2010)

Plan	FY 2010 GASB Adjusted Funded %	FY 2010 Reported Funded %	% Funding Change Under New GASB Rules	Years to Exhaustion of Plan Assets <sup>1</sup>
Illinois Teachers	18.80%	48.40%	-29.6%	17 (2029)
Kentucky ERS	23.00	40.30	-17.3	4 (2016)
Illinois SERS	23.50	46.10	-22.6	9 (2021)
New Jersey Teachers	25.90	57.60	-31.7	17 (2029)
Chicago Teachers	31.00	67.10	-36.1	34 (2046)
New Jersey PERS	31.20	62.00	-30.8	17 (2029)
Texas LECOS	32.50	86.30	-53.8	8 (2020)
Minnesota PERF	34.10	76.40	-42.3	15 (2027)
PA School Employees	34.20	75.10	-40.9	22 (2034)
NJ Police and Fire	35.00	69.00	-34.0	18 (2030)

<sup>1</sup>CRR estimated years to exhaustion of assets for plans based upon 2009 Actuarial Valuation Reports and CRR's calculations assuming ongoing administration of the plan using a 6% estimated average annual investment return.

Sources: "Can State and Local Pensions Muddle Through?" CRR, March 2011; "How Would GASB Proposals Affect State and Local Pension Reporting?" CRR, June 2012.



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