ROCKFLEET financial services
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MUNI MARKET UPDATE

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ABOUT ROCKFLEET

Rockfleet Financial Services, Inc., serves clients nationally through its brokerage and investment banking businesses.

The company's brokerage division offers fixed income products and services specifically designed to address the needs of institutions and high net worth and affluent individuals.

The company's investment bank division provides fixed income securities products, advisory

EVALUATING OPEBs

By Larry Levitz

State and local governments are currently grappling with a myriad of budgetary and fiscal problems. Concerns over the growing costs of funding their long-term financial commitments to public employees have taken center stage. Government promises at all levels to fund retirement costs have become a huge issue today, especially since the Great Recession has decimated government finances and taxpayers' ability to support them.

With the implementation of relatively new accounting rules for public employee retirement benefits, municipal bond investors have a new tool to assist them in evaluating state and local government credit. The unfunded pension and retiree benefit liabilities of municipal issuers represent real threats to their future fiscal health.

This article will focus on other post employment benefits or OPEBS, recent efforts to quantify and account for them and what effects these changes are having on government behaviors.

What Are OPEBs?

OPEBs represent all non-pension retiree benefits which governments are currently paying or have promised to their active employees. These may consist of retiree medical benefits including prescription drugs, dental, vision, hearing, and non-medical benefits such as life insurance, disability, and long-term care not provided separately within a pension plan.

> *"Perhaps most importantly for OPEBS, issuers with sizable liabilities should demonstrate that they are taking or plan to take actions designed to reduce their unfunded commitments."*

Retiree Health Care Benefits Are the Largest Component

Medicaid represents the highest health care-related cost for state and local governments. The largest cost component of OPEBs is retiree health care benefits. Since the 1960s, government

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THIS WEEK'S CALENDAR

Date	Amount	Issuer
03/30/10	15,280M	C/O Biddeford
03/30/10	14,500M	Eldred CSD
03/30/10	1,631M	Harpursville CSD
03/30/10	7,992M	Roxbury Twp
03/30/10	1,195M	V/O Clayton
03/30/10	23,135M	Schuylerville CSD
03/31/10	487,700M	S/O North Carolina
03/31/10	47,165M	Maine-Endwell CSD
03/31/10	112,840M	Port Auth of NY & NJ (NON-AMT)
03/31/10	9,880M	West Milford Twp
03/31/10	6,125M	C/O White Plains
04/01/10	2,035M	Cotuit Fire Dist
04/01/10	1,785M	V/O Great Neck Plaza
04/01/10	5,200M	T/O Holden
04/01/10	7,925M	Holland Patent CSD
04/01/10	2.950M	Monticello Fire Dist
04/01/10	4,582M	Gorham-Middlesex CSD

Click here for calendar updates.

EVALUATING OPEBs (CONT'D)

officials have granted increasingly generous retirement benefits to employees due in part to the ability of public employee unions to negotiate generous OPEB concessions. While Medicaid costs far exceed retiree medical expenditures, state and local government health benefits are rapidly growing, totaling $15.8 billion in 2008 for nearly 3 million retirees.

Most governments fulfilled their retirement obligations on an annual pay-as-you-go basis with no attempt either to determine the magnitude of their future costs or to set aside funds to meet those obligations.

GASB 45

As health care costs increased sharply during the 1990s (see chart[1]), public concerns mounted over the sustainability of government commitments. In 2004, the Governmental Accounting Standards Board (GASB), the organization that establishes generally acceptable accounting principles (GAAP) for state and local governments, issued Statement 45 (GASB 45). GASB 45 took effect on a phased-in basis beginning with the largest states' and localities' fiscal years beginning after Dec. 15, 2006.

Application of Actuarial Methodologies

GASB 45 requires that state and local governments apply actuarial methodologies to their OPEB costs in order to measure and disclose their future liabilities. It also serves to align the recognition of the provision of benefits to the period when employees earn those benefits.

GASB 45 requires that government employers determine the unfunded actuarial accrued liability (UAAL) of their OPEB plan. The UAAL consists of the actuarial accrued liability (AAL), the present value of future subsidies, less the accrued assets the government has set aside to cover them. Assets can only be counted against the liability if they are deposited into an irrevocable, dedicated trust fund established to pay future OPEB costs.

Annual Required Contribution

The annual required contribution (ARC) represents the yearly amount required to pay current benefit costs and to fully fund the UAAL over a 30-year period. GASB 45 does not

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[1] "State & Public Employee Health Benefits: Trends Across the States." Presentation by Richard Cauchi, Director, Health Program of the National Conference of State Legislatures to the Michigan Legislature Public Employee Health Care Reform Committee, September 17, 2009.

MUNICIPAL MARKET UPDATE

Municipal yields moved sharply higher on front end and intermediate maturities as the yield curve flattened. 5 year MMD rose 30 basis points, 10 year 22 basis points, and 15 year 14 basis points, while 30 year yields only adjusted 2 basis points higher.

With respect to credit concerns, Moody's plan to adjust municipal ratings to a global scale should result in rating increases for a large proportion of issuers. Given this likely outcome, the rating agency will be sending a strong message regarding the aggregate credit quality of the tax exempt sector.

Institutional investors have become more selective regarding coupon structures as renewed fears of rising rates have increased demand for premium bonds rather than par or discount structures.

Retail flows remained stagnant and may remain so through mid-April's tax date.

VISIBLE SUPPLY

The 30-day visible supply of municipal bonds totaled $6.641 billion, down $2.227 billion from the previous session, according to The Bond Buyer.

That comprises $2.103 billion of competitive bonds, which is down $785.1 million and $4.539 billion of negotiated bonds, which is down $1.442 billion.

Week of March 22, 2010

Total supply: $10.61B

Taxable/BABs: $2.4B

Tax-Exempt: $8.21B

Week of March 29, 2010

Total supply: $3.04B

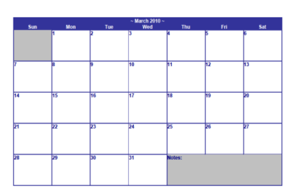
Taxable/BABs: $0.69B

Tax-Exempt: $2.35B

The 30-day visible supply is calculated by The Bond Buyer and reflects the total dollar volume of bonds to be offered at competitive bidding and through negotiation over the next 30 days.

Source: Thomson Reuters.

ECONOMIC CALENDAR



EVALUATING OPEBs (CONT'D)

mandate that governments fund these liabilities.

Depending upon the situation, ARC payments can be two to ten times greater than current pay-as-you-go funding. However, GASB 45 does require that unpaid ARC amounts each year must be recognized as liabilities on government balance sheets.

OPEB vs. Pension Valuations

While GASB 45 generally applies accounting rules for pensions to OPEB plans, OPEB valuations are much more variable and speculative than pension valuations given the uncertainties of health care costs. Pension valuations, on the other hand, are based on well-established mortality data.

OPEBs Are Seriously Underfunded

GASB 45 was implemented for most cities and states in their fiscal 2008 and 2009 audits. The results are eye opening.

The Pew Center on the States compiled the actuarial valuations of OPEB costs for all 50 states and determined an aggregate unfunded liability of $587 billion against only $32 billion in set-aside assets. This represents a funding ratio of only 5.5%.

The Pew Center article also estimates a combined pension and OPEB state funding gap of $1 trillion.

States with the Largest Unfunded OPEB Liabilities

New Jersey — $69B
California — $62B
New York — $56B

And much of the data was compiled from fiscal 2008 fiscal year statements; it is likely that these numbers are understated, given the severe investment losses incurred during the latter six months of 2008.

Local Governments Also Impacted

Local governments must also confront their OPEB costs. A recent GAO report estimated that unfunded OPEB costs for 39 of the largest U.S. cities were approximately $139 billion. New York City's most recently reported unfunded OPEB liability valuation is now up to $65 billion.

Governments Are Taking Action

As the numbers are reported, state and local governments are taking action to reduce their OPEB liabilities. Most of these actions involved lowering government contributions to their plans, modifying the plan itself; altering employee eligibility requirements to qualify for plan benefits.

Funding Through Bond Issuance

Another option is to pre-fund the OPEB plan through the issuance of bonds. Bond proceeds provide an immediate lift to the OPEB funding ratio, generate investment earnings and can lower OPEB costs as long as debt service is less than the ARC over the life of the bonds.

The risks of bonding include the possibility that investment losses on bond proceeds could end up costing the government more than if it had not pre-funded. In addition, bond financing transforms a flexible funding option that could be deferred in times of stress into a hard and fast obligation.

Because of these concerns and a concerted effort on the part of many governments with sizable OPEB liabilities to limit their retiree health costs, relatively few governments there issued OPEB bonds to date.

Case Study for Bond Issuance: Oakland County, Michigan

One entity that has sold bonds as part of an overall plan to manage its OPEBs, is Oakland County, Michigan. The County sold $557

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Governments Are Taking Action

In 2009, the **City of Gainesville, Florida** changed its contribution formula from a specified percentage of a retiree's health insurance premium to a fixed dollar amount based on the retiree's years of service and age at the time benefits began. This gave the City the ability to manage its costs rather than base them on uncontrollable premium increases.

The **State of South Carolina** reduced the level of government contribution for employees hired after May 2, 2008, who become eligible for retiree health benefits.

Harris County, Texas, in 2007, increased the number of years of service needed for an individual to receive a government contribution for the cost of his or her retiree health benefits and reduced the amount of that contribution.

In 2007, the **State of New Jersey** began requiring some retirees to contribute towards the cost of their health insurance premiums.

Oakland County, Michigan switched from a defined benefit plan to a defined contribution plan for new employees hired in 2006 or later. Many states are considering this option.

The **State of Vermont** lengthened the vesting period for employees to receive full health benefits from five years to 10 years.

In 2008, the **Commonwealth of Kentucky** required new employees to contribute 1% of their salaries to help fund OPEB costs.

The **City of Arlington, Texas** stopped offering retiree health care benefits to employees hired after 2006.

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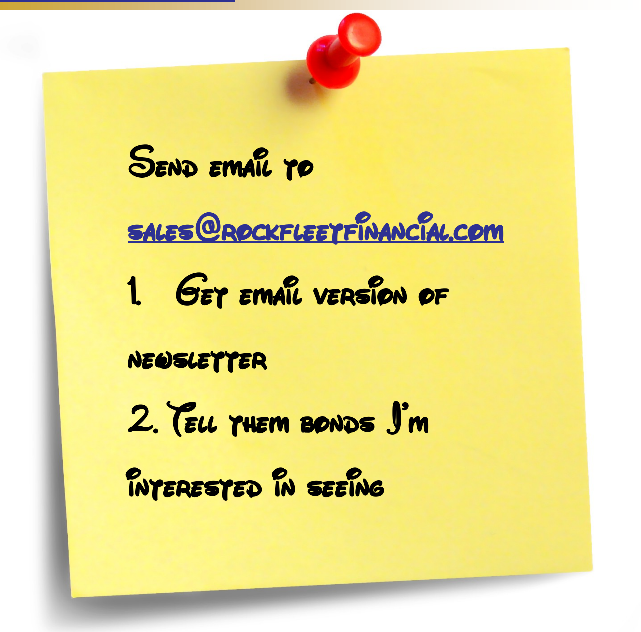

EVALUATING OPEBs (CONT'D)

million of 20 year bonds in 2007 of which about $500 million was used to fund a $480 million UAAL.

The County did not deposit the proceeds directly into its irrevocable OPEB trust fund (a voluntary employee benefits association – VEBA) but placed them into an interim trust fund. Trust fund monies are used, with earnings, to make the ARC payment to VEBA each year.

Although the County intends to fund its ARC payments from the interim trust fund, if there are future changes to the way health care is paid which serves to reduce or eliminate the County's OPEB responsibilities, any remaining funds can be used to pay down the OPEB bonds.

At the end of fiscal 2008, the County reported investment losses in the interim trust fund of $54 million; however, it is too early in the cycle to determine if the bond strategy will be a success.

Financial Statements

Information on OPEB plans can be found in the Notes to Financial Statements section of the government's most recent audited financial statements. Large governments were required to comply with GASB 45 in their fiscal 2008 statements while smaller local governments were given a year's reprieve to fiscal 2009.

Investors should review the numbers for an issuer's OPEB and pension plans for the magnitude of the liabilities and the annual contributions required. The annual required contributions for both plans should be evaluated within the context of the issuer's overall budget in order to gauge the burden of compliance.

Perhaps most importantly for OPEBS, issuers with sizable liabilities should demonstrate that they are taking or plan to take actions designed to reduce their unfunded commitments. Failure to do so may be indicative of weak or ineffective management and should be factored into the credit analysis. ♣