MCERA Evaluation

Time to take the next step

April 18, 2012

Summary

Mendocino County is currently trying to dig its way out of a pension deficit that was created by excessive benefit enhancements, lack of solid accounting practices, below average market results, and poor understanding of long-term costs. The Mendocino County Employees' Retirement Association (MCERA) and the County Board of Supervisors (BOS) lacked thorough understanding and vetting of the audit, actuarial, and financial information used to make pension benefit and funding decisions. Prior to independent management established in 2008, MCERA and the BOS conducted business with a relatively simple approach: to increase pension benefits and other post-employment benefits (OPEB), regardless of financial sustainability.

MCERA has made great strides in improving its business and financial practices since 2008. Giant steps have been taken to increase transparency and reporting accuracy of Mendocino's pension obligations and investments. MCERA transitioned from a body with limited long-term vision to a more mature, process-oriented organization. MCERA is well positioned to support the BOS in actively managing the County's pension obligations going forward.

It is time for the BOS to "step up", with information in hand provided by MCERA, and take the necessary steps to actively manage the County's pension obligations into a sustainable state. There is an abundance of research and advice on how to create sustainable pension benefits. The BOS must provide the political will for County Counsel, the CEO, and MCERA to work on pension sustainability and to advise the BOS on enacting financially successful pension strategies.

The time has come to get out of the cul-de-sac and stop wishing for unrealistic market returns to restore pension sustainability. Proactive benefit management and timely adjustments to changing economic conditions are required.

Methods

The 2011-2012 Grand Jury (GJ) conducted an overview of MCERA from its inception to its present state with emphasis on organization, accuracy of the financial information reported, and management of the financial obligations going forward. The GJ attended MCERA and BOS meetings and interviewed past and current County and MCERA staff. The GJ reviewed MCERA and BOS resolutions pertaining to pension benefits and Pension Obligation Bonds (POB). All relevant material such as Government Accounting Standards Board (GASB) regulations, actuarial and auditor reports, and previous GJ reports were reviewed by the GJ.

Disclaimer

A member of the GJ committee was recused in mid-term.

Background

Mendocino County is one of 20 California counties that established retirement benefits under the County Employees' Retirement Law of 1937. The County Tax Collector was the administrator for MCERA until 2008. In 2007-2008 MCERA shifted from an arm of county government to an independent organization. In 2008, an independent administrator was hired to fulfill the increased emphasis on the fiduciary and administrative activities of the retirement board. In 2008, MCERA began taking steps to eliminate accounting and actuarial practices that did not accurately reflect the financial status of the pension plan. An independent audit published in June 2009 revealed that MCERA's previous actuary systematically underestimated the costs and liabilities of the pension plan.

Prior to 2007-2008, lack of knowledgeable stewardship by MCERA and the BOS contributed to increased pension liabilities. "Excess earnings" were filtered off and used to fund OPEB (*i.e.* health benefits). Since then, audit, actuarial, and financial consultants have been replaced, resulting in more transparent and reasonable accounting practices adopted by the new consultants. In 1998, health care benefits were eliminated for post 1998 hires.

Sustainability of public pension funds is problematic statewide, and Mendocino is no exception. This is the result of less money coming into the fund due to attrition and job cutbacks and more money going out to an increased retirement population.

Additional factors that contribute to the pension fund imbalance are:

1. Cost of Living Adjustments (COLA)
2. Salary and pension enhancements including:
   a) Eligible retirement age reduced from 55 to 50
   b) Salary enhancements that increase final year's base pay
   c) Management Safety Members: 3% @ 55 (3% of final year's base salary times the number of years employed)
   d) Safety Members: 2% @ 50
3. The failure of county government to establish pension reserves in good economic times
4. Poorer than expected returns on pension fund investments during some years, particularly following the financial crisis in 2007-2008

The BOS and MCERA are working to increase the long-term viability of the public pension plan. However, the GJ is convinced that most of the financial and demographic trends are headed in an unsustainable direction. The visibility of pension liability will increase with the implementation of a revised government accounting standard in 2013, GASB 25, which creates a new line item called Net Pension Liability (NPL) on the county's balance sheet. This new number will most likely reflect the county's largest obligation.

Findings

1. MCERA is responsible for the investment of retirement funds.
2. The County, under the direction of the BOS, is responsible for negotiating public employee benefits.

3. In 1998, retiree health benefits were discontinued for new employees after the date of the resolution.
4. The county continues to partially fund non-Medicare eligible retirees.
5. The county has 1044 active employees.
6. The county has 1174 retired employees.
7. COLA increases are allowed up to 3% per year.
8. Declines in the funded ratio due to market conditions, growing pension liabilities, and the opportunity to reduce interest costs on pension liabilities resulted in the issuance of POBs in 1996 and 2002.
9. This year's POB deficit is $82.98 million.
10. The Buck Consulting firm and MCERA collaborated in 2005 on questionable actuarial practices to justify "excess earnings" of $9.6 million.
11. Some of the 2005 "excess earnings" were diverted to fund health care.
12. Ultimately, this $9.6 million was written off as a loss in FY 2010-2011.
13. The IRS is currently reviewing the county's diversion of "excess earnings" as part of the Volunteer Correction Program (VCP). The VCP is associated with the maintenance of tax-exempt status.
14. In February 2007, the BOS and the Board of Retirement Ad Hoc Committee recommended hiring an independent MCERA Administrator.
15. The MCERA Administrator was hired in October 2008.
16. The new administrator position was created to establish an organization with supporting policies and procedures that increase the effectiveness and transparency of MCERA.
17. The hiring of a full time director and staff increased MCERA salary costs from $167,000 a year in 2007 to $322,000 a year in 2010.
18. The creation of an independent MCERA has increased the effectiveness and the cost of its operation with the creation of Comprehensive Annual Financial Reports (CAFR), a web presence, and televised meetings.
19. Since 2008, the following changes have been made through a formal Request For Proposal (RFP) process:
    - In October 2009 the financial consultant Peter Chan was replaced by Callan Associates
    - In March 2011 the actuarial consultants Buck Consulting was replaced by Segal Company
    - In July 2011 the audit consultant Jim Sligh was replaced by Gallina LLP.
20. MCERA's unfunded actuarial accrued liability (UAAL) as of June 30, 2010 was $91,784,613. In this year's actuarial valuation, the UAAL has increased to $124,912,676.
21. The revised GASB reporting standards, to be implemented in 2013, will reflect a current financial market value of pension assets and liabilities.
22. MCERA liquidates investment assets on an "as needed" basis to meet pension requirements.
23. Decision making information has not been readily available to MCERA due to failure to produce cash flow reports.
24. The CAFR is produced a full year after the financial reporting period, too late for planning purposes.
25. MCERA has lowered its 8% projected investment return rate to 7.75%, which has a 54% probability of fulfillment over the next 28 years.

Recommendations

The Grand Jury recommends that:

1. MCERA have a thorough understanding and a documented account of all fixed monthly pension costs. (Findings 1, 22-24)

2. MCERA encourage the BOS to revisit pension benefits to renegotiate and reduce benefits for new hires. (Findings 1-2, 20)

3. BOS have a working knowledge of the county's pension obligations and current investment return trends. (Findings 2, 20-21, 24-25)

4. BOS examine alternative pension strategies and proposals to reduce liabilities and increase funding. (Findings 2-7, 17, 20)

5. BOS examine pension benefits for new hires and renegotiate to reduce benefits, which are not sustainable. (Findings 2, 20, 25)

6. BOS authorize and support the creation of an initial plan to manage pension sustainability. (Findings 2, 4-6, 9, 12-13, 20, 25)

7. MCERA produce reports that facilitate better financial management to sustain principle assets and eliminate the need to sell off investment assets to pay for obligations. (Findings 1, 22, 23-24)

8. MCERA participate in the early trial implementation of the revised GASB 25 offered by the IRS. (Findings 13, 21)

Discussion

The current actuarial report states that Mendocino County has a UAAL of $124.9 million. The UAAL was $91.7 million the previous year. The trend is heading higher. In reviewing 2011 retiree benefits, it was found that many retirees are receiving almost as much, if not more, in retirement pay than when they were actively employed by the county. MCERA is becoming aware of the challenges it now faces in managing pension finances, but the County bears the burden of its vested entitlements.

The BOS are responsible for negotiating retiree benefits. MCERA is responsible for administrating the retirement investments. Poor record keeping and financial planning by MCERA and the BOS, compounded by the market downturn, created a large unfunded pension liability. The main reasons for the poor business practices by the BOS and MCERA are:

- Government accounting standards have not demanded transparency of actual liabilities
- Actuarial practices supported the reporting of questionable financial gains
- The due diligence required to oversee sustainable financial management was not performed

GASB is in the process of revising pension liability calculations and reporting requirements. Mendocino County will be required to adhere to the new standard in 2013. This will allow for a more standardized market valuation of data and a greater pension liability will most likely be reported.

MCERA is now positioned to produce more accurate and timely information. It is time for the BOS to leverage the knowledge MCERA can make available. The BOS must take steps to manage retirement benefits to a sustainable level.

Required Responses

Mendocino County Employees' Retirement Association (Findings 1-4, 7, 10-25; Recommendations 1-2, 7-8)

Board of Supervisors, Mendocino County (Findings 2-9, 13-17; Recommendations 3-6)

GLOSSARY

Actuarial
The computation of risks, rates, and the like according to probabilities indicated by recorded facts.

Audit
An examination of accounts and accounting records, comparing charges with vouchers, verifying balance sheet and income items, and stating the results. Usually performed by an impartial third party.

Cost Of Living Adjustments (COLA)
Inflationary percentage increases.

County's Pension Obligations
The county owned portion of vested retirement entitlements.

Excess Earnings
Investment earnings that exceed expected returns for that particular year. (Proven to be a debatable actuarial assumption)

GASB Regulations
The Government Accounting Standards Board is a body of national, state, and local government organizations and the Financial Accounting Foundation established to set accounting and financial reporting standards tailored specifically to state and local governments.

Liquidates Investment Assets
When assets are sold off to pay obligations.

Other post-employment benefits (OPEB)
Benefits other than a retirement pension check.

Probability of Fulfillment
The predicted possibility that a goal will be reached over an extended period of time. Usually 30 years in this type of actuarial prediction.

Safety Members
Includes Law Enforcement personnel such as Sheriff Deputies, Probation officers, and Correctional officers.

Sustainability
Being able to bear or keep up an action or process.

Unfunded Accrued Actuarial Liability (UAAL)
The amount of actuarial projected pension obligation not covered by assets.

Vetting
To subject to expert appraisal or correction.