

# Grand Jury Report

## RESPONSE FORM

Grand Jury Report Title : **UNFUNDED LIABILITY-OUR CHILDREN'S INHERITANCE**

Report Dated : **Jun 3, 2010**

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### Response Form Submitted By:

Jim Anderson, Administrator  
MCERA  
625 B Kings Court  
Ukiah, CA 95482

Response **MUST** be submitted, per Penal Code §933.05, no later than:

**August 3, 2010**

I have reviewed the report and submit my responses to the **FINDINGS** portion of the report as follows:

I (we) agree with the Findings numbered:

1, 6, 8, 9, 12

I (we) disagree wholly or partially with the Findings numbered below, and have **attached, as required**, a statement specifying any portion of the Finding that are disputed with an explanation of the reasons therefore.

2, 3, 4, 5, 7, 10, 11, 13, 14, 15, 16, 17, 18, 19, 20, 21

I have reviewed the report and submit my responses to the **RECOMMENDATIONS** portion of the report as follows:

The following Recommendation(s) have been implemented and **attached, as required**, is a summary describing the implemented actions:

1, 4, 5, 6

The following Recommendation(s) have not yet been implemented, but will be implemented in the future, **attached, as required** is a time frame for implementation:

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- The following Recommendation(s) require further analysis, and **attached as required**, is an explanation and the scope and parameters of the planned analysis, and a time frame for the matter to be prepared, discussed and approved by the officer and/or director of the agency or department being investigated or reviewed: (This time frame shall not exceed six (6) months from the date of publication of the Grand Jury Report)

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- The following Recommendations will NOT be implemented because they are not warranted and/or are not deemed reasonable, **attached, as required** is an explanation therefore:

3

*I have completed the above responses, and have attached, as required the following number of pages to this response form:*

Number of Pages attached: 8

*I understand that responses to Grand Jury Reports are public records. They will be posted on the Grand Jury website: [www.co.mendocino.ca.us/grandjury](http://www.co.mendocino.ca.us/grandjury). The clerk of the responding agency is required to maintain a copy of the response.*

*I understand that I must submit this signed response form and any attachments as follows:*

First Step: E-mail (word documents or scanned pdf file format) to:


- The Grand Jury Foreperson at: [grandjury@co.mendocino.ca.us](mailto:grandjury@co.mendocino.ca.us)
- The Presiding Judge: [grandjury@mendocino.courts.ca.gov](mailto:grandjury@mendocino.courts.ca.gov)
- The County's Executive Office: [ceo@co.mendocino.ca.us](mailto:ceo@co.mendocino.ca.us)

Second Step: Mail all originals to:

Mendocino County Grand Jury  
P.O. Box 939  
Ukiah, CA 95482

Printed Name: James M. Andersen

Title: Retirement Administrator

Signed: 

Date: 7/21/10

Before addressing the **Findings** and **Recommendations** of the Grand Jury, the Association believes it is important to clarify the roles and authority of the Board of Retirement and the Board of Supervisors. Both bodies have roles to play, and unique legal responsibilities, which are important to understand when reading the **Findings, Recommendations** and responses. Also, the Grand Jury made introductory and closing comments that the Association believes need to be addressed.

The Mendocino County Employees' Retirement Association (MCERA) is responsible for forecasting the financing that will be needed to meet pension obligations, recommending contribution rates from the employers and employees, and investing those contributions prudently to achieve the highest rate of return within reasonable levels of investment risk. MCERA is also responsible for administering pension benefits and evaluating applications for disability related retirements. The Board of Supervisors, on the other hand, is responsible for evaluating and negotiating compensation for its employees. Areas of compensation include wages, retirement formulas, subsidized employee retirement contributions, etc. In addition, there are variables that contribute toward pension obligations that neither party controls, but need to be aware of and consider as they make decisions. These include demographics such as life expectancy and the size of the retiree population, economic variables such as inflation and cycles in the capital markets, and legislative and regulatory changes. The two boards, though independent, are intended to work in a coordinated fashion as described in the Board of Supervisors' policy # 40. The Board of Supervisors manages the County's service delivery system in a manner that attempts to minimize the creation of unfunded pension liabilities while the Board of Retirement attempts to manage pension assets in a way that, over the long-term, finance the pension obligations created by the collective decisions of the Boards of Supervisors.

In its introductory comments, the Grand Jury states that there is an unfunded pension liability of \$80 million to \$129 million. As of June 30, 2009, our actuary, Buck Consultants, calculated the unfunded liability at \$66.9 million. In addition, the Grand Jury stated that the County pays approximately \$20 million in interest per year on this unfunded liability. The County contribution for 2010/11 includes approximately \$8 million in interest on Unfunded Accrued Actuarial Liability (UAAL) and Pension Obligation Bonds (POB). The entire payment from the County for both principal and interest does not come close to \$20 million per year. We believe that it is critical to use accurate data from professional sources. The Grand Jury relied heavily in this report on what it describes as "critics" and "economic experts" without, to our knowledge, evaluating the qualifications of such individuals or validating the accuracy of their numbers. The Board of Retirement members as fiduciaries of the pension assets must make prudent decisions based upon reliable and replicable information prepared by actuarial and investment professionals.

Finally, MCERA believes that it has made great strides in its efforts to be transparent. During the past eighteen (18) months the Association has begun to televise its meetings, developed its first Comprehensive Annual Financial Report (CAFR), participated in state and national comparative studies of retirement systems, developed a website with information from all meetings as well as all reports from actuaries and investment consultants, held a joint meeting with the Board of Supervisors on pension issues, and appeared before the Board of Supervisors on numerous occasions to discuss the impacts of the 2008 market losses and how to minimize impacts on the County's budget while still protecting the pension. MCERA agrees with the Grand Jury that it is important to communicate with the public in a transparent manner to ensure a level of confidence in the management of our public pension plan, and its sustainability into the future.

## Findings

1. In 1996 the County authorized issuance of \$30.7 million in POB.

Agree.

2. In 1998 the BOS created a two-tier employee health care system. Employees hired after 1998 no longer receive retiree health benefits.

Partially agree. The Association believes the Grand Jury is referring to Resolution 98-147 which, in part, stated that only those employees hired before September 1, 1998, and with a minimum of ten (10) years of service with Mendocino County would be eligible for retiree health care as described in the resolution. Active employee health care was unaffected.

3. In 2002 a second POB was issued for approximately \$92 million, at a time when interest rates were favorable, which included the defeasance of one half of the \$31 million POB issued in 1996.

Partially agree. The issuance of POBs in December 2002, in the amount of \$91,945,000 were used in part to fund an escrow account to defease one half (1/2) of the outstanding principle of 1996 POBs at the earliest allowable date. The outstanding principle was \$23,795,000, and the proceeds used to prefund the defeasance of the 1996 POBs amounted to approximately \$13,220,000.

4. From 2004 through 2006 MCERA diverted over \$9.6 million from the County pension fund to pay retiree healthcare costs. This was a questionable action; MCERA devised this as a way to solve funding issues for a shortfall in retiree health care. It may have been in conflict with California Government codes §31584 and §31587.]

Partially disagree. From 2004 to 2006 MCERA used a portion of the County's Annual Required Contribution (ARC) to the pension fund to pay for costs of retiree health care. The use of County contributions was done in consultation with the Association's actuaries, Buck Consultants, and was presented to the Board of Retirement as being compliant with the California Employees' Retirement Law of 1937 and the IRS code. The Association does not believe that the action was in conflict with Government Code sections 31584 or 31587. In addition, in fiscal year 2005/06, the County reserves were restored in full. The Board of Supervisors was informed that the County reserves were restored in an open session presentation on February 2, 2006.

In June of 2010, the Board of Retirement adopted a new Interest Crediting and Undistributed Earnings policy which changed the method by which excess earnings will be calculated in the future. Along with the change of policy, the Board of Retirement asked staff to determine the most appropriate method of removing \$9.6 million in Accrued Actuarial Unrecorded Earnings from MCERA's assets; the excess earnings that financed the repayment of County reserves and Retiree Health Insurance reserves. We expect that to be addressed in July 2010.

- 5. In 2008 the MCERA Board took the action of hiring its own manager independent of the BOS.**

Disagree. MCERA's hiring of a manager was preceded by a study requested by the Board of Supervisors regarding the advantages and disadvantages of having an independent retirement system. In addition, given that the Retirement Administrator is a County employee, the position and salary must be approved by the Board of Supervisors (Government Code 31522.2). Although the Board of Retirement is the appointing authority, hiring a Retirement Administrator was agreed upon by both the Board of Retirement and Board of Supervisors. Prior to hiring a Retirement Administrator, the system was managed by the Treasurer, which is an independent elected officer.

- 6. In 2009 the MCERA Board projected a \$66.9 million UAAL. This amount has been disputed by citizens who argue that using the market value of holdings makes the UAAL twice as much.**

Agree. The Board of Retirement must contract with an actuary to perform an actuarial valuation no less than every three years (Government Code section 31453). MCERA conducts an actuarial valuation every year. The actuarial calculations for determining Unfunded Accrued Actuarial Liability (UAAL) are consistent with actuarial standards and industry practices. Voter approved Proposition 162, established that the Board of Retirement is solely responsible for conferring with the actuary to establish the practices and underlying assumptions of the valuation. Proposition 162 also directs that due diligence be taken to ensure that the valuation process is free from political influences.

- 7. In 2009 the State of California instructed public entities to follow GASB standards to include UAAL as a foot note in their financial statements. This may increase the interest charges on borrowed funds.**

Neither agree nor disagree. The County should respond to this finding as it is within the Board of Supervisors legal authority.

- 8. The County is one of few 1937 Act Counties in the State where the "excess earnings" from investments have continued to be used to provide health insurance funding for retirees. This fund is projected to be depleted by the first quarter of 2011.**

Agree. Through the late 1990s, our best data show that the majority of retirement systems still used excess earnings for retiree health care. Those systems that continue to use excess earnings for retiree health care are beginning to sunset their programs or ensure that pension reserves are funded to a particular level (90% to 100%) prior to using excess earnings for retiree health care.

- 9. The MCERA Board has produced reports which demonstrate their investments have performed at or above the level of peer counties.**

Agree.

**10. Mendocino County uses financial fund advisors to project investment performance over time. Investment returns on assets have been projected at 8% through 2026, when economic experts have said that the 30-year rolling average for a stock-bond portfolio is 4.4%.**

Partially disagree. Mendocino County has contracts with Callan Associates as its investment consultant and Buck Consultants as its actuary. Both the investment consultant and actuary project return on investments over time, with the actuary using a much longer time horizon. Buck defended using an 8% return on investments in its most recent experience study (2005 to 2008), and reviewed the return assumption prior to their most recent valuation. Callan Associates projected a 7.8% return over the next ten years given a specific asset allocation model.

The Association does not know the source of data used for the second half of the statement above, and therefore is unable to comment on its accuracy.

**11. Other entities have questioned the assumptions and data used by MCERA's contracted actuary.**

Neither agree nor disagree. The "other entities" are not named. MCERA is aware of one other retirement system and one retiree group that have questioned the work products of our actuary in their jurisdictions. As part of its regular due diligence, MCERA has initiated a Request for Proposal (RFP) to audit our actuary. The audit scope is very detailed, including a replication of the June 30, 2009 actuarial valuation, as well as a written and verbal presentation regarding methodologies and calculations performed by our actuary.

**12. An approved industry process called "smoothing" is also used to level financial changes over time. Using this process helps the County avoid dramatic annual changes in their share of payment toward the retirement fund, making the budget projections more predictable. Normally, the actuaries "smooth" investment gains and losses over five years.**

Agree.

**13. In 2008 changes in GASB reporting standards §43 and §45 required that all State and local government entities disclose future retirement health care obligations and resources for this obligation. The County's unfunded liability for health care is currently about \$130 million.**

Disagree. The most recent actuarial study conducted by the County is not current, and precedes at least two actions of the Board of Supervisors to reduce and/or eliminate future retiree health care liabilities. It is our understanding from County sources that Fitch Ratings recently has concurred that the GASB 43/45 liability for Mendocino County is now zero (\$0).

**14. In 1998 when the BOS ceased offering retiree health benefits for new employees they did not address the insufficiency of funds for health benefits already given to employees.**

Neither agree nor disagree. The County should respond to this finding as it is within the Board of Supervisors legal authority.

**15. Funding for the retiree health plan was to come from excess earnings from retirement systems investments. The County states that excess earnings have been calculated on an annual basis. Critics have noted that when UAAL is considered, excess earnings have never occurred.**

Partially disagree. Critics have argued that excess earnings cannot exist if there is an unfunded liability in the pension fund. The Board of Retirement adopted an Interest Crediting and Undistributed Earnings policy in June 2010 that requires all excess earnings to be used to pay down UAAL before being used for any other legal purpose. The law is very clear, though, that excess earnings is calculated on a fiscal year basis.

**16. The economic downturn which began in the fall of 2008 has compounded fiscal problems for cities and counties. Major cuts from the State have severely restricted County funds.**

Neither agree nor disagree. The County should respond to this finding as it is within the Board of Supervisors legal authority.

**17. Investment funds have not fully recovered from the 2008 stock market downturn. Critics have projected it would take an increase of 17% per year for eight years to grow the MCERA investments back to cover the recent losses. Critics see this as an unrealistic expectation.**

Partially disagree. Investment funds for pensions systems nationally have not fully recovered from the 2008 stock market downturn. We have no basis from which to evaluate the critics' analysis. The Board of Retirement members are fiduciaries of the pension fund and must invest as a "prudent" person; seeking qualified experts to advise them (Government Code Section 31595).

**18. Revenues from property and sales taxes are decreasing.**

Neither agree nor disagree. The County should respond to this finding as it is within the Board of Supervisors legal authority.

**19. Individual health care and retirement payroll contributions are increasing, while positions are being eliminated due to budgetary shortfall.**

Neither agree nor disagree. The County should respond to this finding as it is within the Board of Supervisors legal authority.

**20. For the first time, the number of retired County employees is expected to be greater than the number of current County employees, due to layoffs.**

Neither agree nor disagree. The County should respond to this finding as it is within the Board of Supervisors legal authority.

**21. Prior GJ pension fund reports have been ignored by the BOS, evidenced by the fact that they have not adjusted the debt repayment.**

Disagree. The finding is unclear, in that it references the "BOS" and not the Association. The Association, to the best of its knowledge, has always responded to Grand Jury findings and recommendations; albeit not always as the Grand Jury might prefer. If the Grand Jury is referring to the funding agreement associated with the 2002 POBs, and the debt amortization schedule, then the Board of Supervisors and Board of Retirement did agree to amend the funding target to 100% until the funding agreement was deemed by both parties to hinder the prudent management of UAAL and County contribution levels.

### ***Recommendations***

**1. the MCERA Board adopt a rate of return that reflects the current economic environment and question the actuarial recommendations. (Findings 9-12, 16-18)**

Recommendation has been implemented. The current rate of return was reviewed by the actuary, Buck Consultants, in 2009, prior to completion of the most recent actuarial valuation. The rate was also reviewed by Callan Associates in 2010 as part of their Liability and Asset Allocation Study. Callan determined an asset mix that should yield investment returns of 7.8% over the next ten years. The 7.8% is without any added value (alpha) from skilled investing by asset managers. Based upon presentations by our consultants and other economists, MCERA does believe that returns in the capital markets will be less in the near term, and will be impacted by a prolonged global economic recovery. Those market conditions were considered by Callan Associates in developing their return assumption, but we will continue to monitor returns and discuss the most appropriate rate.

**2. the MCERA Board insure that an independent audit be performed on past and present actuarial assumptions and make a full and transparent disclosure of the results to the public. (Findings 6-7, 9-12)**

Recommendation has not yet been implemented, but will be in the future. The Association released an RFP for an audit of our actuary. Proposals are due on July 16, 2010, with selection of a preferred proposer to occur in August. We anticipate a contract for an actuarial audit to be brought before the Board of Retirement in September, 2010

**3. a citizens' financial oversight committee be established to monitor the County obligations assumed by the transactions of the MCERA Board, and to bring a critical view, transparency and fresh ideas to the UAAL problem. (Findings 4, 6-7, 9-12, 15)**



Recommendation will not be implemented. As described above, the Board of Retirement performs a fiduciary function, well defined in law, and must make prudent decisions based upon expert advice. In addition, the Board must ensure, consistent with Proposition 162, that political forces do not come into play when directing actuarial valuations or making investment decisions. A citizen's oversight committee brings the risk of political influence to both the actuarial and investment activities of the fiduciaries.

It should also be noted that the composition of the Board of Retirement includes four members appointed by the Board of Supervisors, which may include one Board of Supervisor member. The public members must have no connection to or receive a pension benefit from the Association. MCERA believes that these members represent a public view on the Board. Finally, the Board of Retirement holds open meetings and the public is invited to attend and comment.

- 4. the MCERA Board and Administrator closely monitor the impact of the retirement fund on the County budget, rather than comparing the performance with other counties. (All Findings)**

Recommendation has been implemented. The MCERA Board and Administrator have worked very closely with County staff and an ad hoc committee of the Board of Supervisors to understand the impact of any action of the Association on County contributions, and by extension County services. In addition, the County has requested assistance from the Association from time to time regarding actions that the Board of Supervisors may take, and the impact that it would have on UAAL. I believe the parties are working closely together at this time.

That having been said, we believe that comparisons of MCERA to other retirement systems provides important measurements of how well the Board, staff and consultants are performing their duties. We anticipate continuing with comparative measurements, and possibly expanding them into the future.

- 5. all MCERA financial reports be structured so that both the actuarial value of assets and the market value of the pension fund assets (as of a specific date) be made public. (Findings 6, 8-9, 11-12)**

Recommendation has been implemented. The annual actuarial valuation includes both market and actuarial values of assets. In addition, the Association discloses the market value of its investments on a monthly basis at each Board meeting.

6. **the MCERA conduct a review of excess earnings; develop a policy that articulates the definition of excess earnings and plans for future allocation. (Findings 4, 6-8, 10-12, 15, 17)**

Recommendation has been implemented. In June, 2010, the Board adopted a revised Interest Crediting and Undistributed Earnings policy. The policy clearly defines excess earnings and the hierarchy in which they will be applied in the future.

7. **the MCERA Board monitor and study the issues and solutions developed by other counties. (Findings 7-20), e.g.:**
- **clearly state the Retirement Fund's financial position regularly and, when necessary project the amount needed for recovery and develop a plan,**
  - **design a two tier retirement plan for employees. Other counties are developing a "401-K" type plan. Existing employee plans have been frozen with future contributions put into a "401-K" type plan. The County could make a small percentage matching contribution,**
  - **no defined benefit plans for new employees, reducing the amount of benefits paid by the County,**
  - **reduce the pension plans for all employees, enabling them to retire earlier and allowing new employees to start at lower salary and benefit levels, and/or delay pension payment until the employee reaches age 65,**
  - **reduce staff levels, consolidate functions, and review salaries, freeing money to pay down debt,**
  - **closer monitoring of investment risk,**
  - **full disclosure of unfunded liability,**
  - **no payment be given an employee who opts out of the health plan.**

Recommendation requires further analysis. Salaries and benefits offered to current and future employees fall under the authority of the Board of Supervisors, and are arrived at through negotiations with those employees. As stated above, the Association has been and will continue to assist the Board of Supervisors in evaluating the potential impact that any changes to compensation may have on the pension fund, most notably its UAAL.

The Association has already implemented close monitoring of investment risk, as it receives and reviews analyses of the risk of its investments on a quarterly basis. This is a fundamental element of reviewing our investment performance. We have also already implemented full disclosure of our unfunded liability in our annual actuarial valuation which is prepared by professionals using approved actuarial standards.