Grand Jury Report

RESPONSE FORM

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

Report Dated: Jun 7, 2010

Response Form Submitted By:

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

September 3, 2010

(Note - since my response is requested and not required, my understanding is that the provisions of the Penal Code cited above do no apply.)

I have reviewed the report and submit my responses to the <u>FINDINGS</u> portion of the report as follows:

☒ I (we) agree with the Findings numbered:

1, 3, 5, 6, 12, 14, 16, 17, 18, 20, 21

☒ 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, 4, 6, 7, 8, 9, 10, 11, 13, 15, 19

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

NOTE: Since I am not an official, employee or agent of either the County or Retirement Association I am not directly involved in decisions regarding implementation of any of the Recommendations. I have restated the categories below accordingly.

☒ The following Recommendation(s) should be implemented:

2,

☒ The following Recommendation(s) require further analysis or modification:

1, 3, 4, 5, 6, 7, 8

☒ The following Recommendations should NOT be implemented:

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

Number of Pages attached: _______

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. 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
. • The Presiding Judge: grandjury@mendocino.courts.ca.gov
. • The County's Executive Office: ceo@co.mendocino.ca.us

Second Step: Mail all originals to:

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

Printed Name: ____

Title: ____

Signed:________________________ Date: _________

Findings

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

YourPublicMoney.Com Agrees

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

YourPublicMoney.Com Partially Agrees

The BOS created a two-tier ***retiree*** health care benefit - not an ***employee*** health care benefit**.**

3. In 2002 a second POB was issued for approximately $92 million, at a time when interest rates were favorable, which included the defeasance[1] of one half of the $31 million POB issued in 1996.

YourPublicMoney.Com Agrees

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. (Appendix A)

YourPublicMoney.Com Partially Agrees

My comments and suggested corrections to this finding are a little complex. In summary:

A) Not all the $9.6 million referenced by the Grand Jury in this finding was diverted out of the Pension Fund. About $6.1 million was diverted from the County's required annual pension contribution before it was deposited into the Pension Fund. Therefore the diversion was not from the Pension Fund because the money appears to have never gotten there. This diversion is directly relevant to California Government Code Section 31587 (cited by the Grand Jury) which defines how the Retirement Board must apply the County's contributions to the Retirement System (see below).

B) The remaining approximately $3.4 million (out of the $9.6 million identified in this finding) was diverted out of the Pension Fund in 2006 and transferred to the retiree healthcare fund. However, this diversion does not appear to be directly relevant to either of the two Government Code sections cited by the Grand Jury. It is directly relevant to Government Code "Article 5 - Financial Provisions, Section 31592.2 - Excess interest; disposition" in the *1937 County Employee Retirement Law* regarding the notion of "Pension Fund Excess Earnings". The legal justification for this diversion offered by former Retirement Administrator Tim Knudsen appears to not conform to the requirements of this Code Section. MCERA has not provided citations to specific Code

Sections or other specific legal authority for the method used to justify the transfer of this $3.4 million to pay retiree healthcare.

C) The $9.6 million value cited by the Grand Jury is the total of the two types of diversions into the Retiree Healthcare Fund during this period, as reported by Knudsen. This total of $9.6 million is itself the amount of another legally questionable action of MCERA (see below).

D) Government Code Section 31584 cited by the Grand Jury does not apply to the Retirement Board; it defines various obligations of certain County officials regarding the payment of annual pension contributions. This Code Section is relevant to actions of County officials during 2004-2006. Given the language of this Government Code Section cited by the Grand Jury it does appear there is cause to question if certain actions of County officials during this period conformed to the requirements of the Code (see below).

An attachment to this response provides further information.

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

<u>YourPublicMoney.Com does not have enough knowledge to comment.</u>

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.

<u>YourPublicMoney.Com partially disagrees</u>

I'm probably the citizen referred to by the Grand Jury.

The term "UAAL" - Unfunded Actuarially Accrued Liability" - is a technical term that only refers to the value of unfunded pensions based on the <u>Actuarial Value of Assets</u>.

The value of unfunded pensions based on market value of assets is not a "UAAL" - it is however a truly more accurate measurement of unfunded pensions because it is based on the money the Pension Fund actually has to invest and pay pensions.

The value of unfunded pensions based on the market value of assets is twice the UAAL reported as of June 30, 2008.

See the Attachment for more information.

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.

YourPublicMoney.Com Disagrees (or Partially Disagrees)

The Government Accounting Standards Board (GASB) issued its "GASB Statement 27" in November 1994. I believe the provisions of GASB 27 became effective for the County of Mendocino in 1998, but I'm not certain. If not, it would not be more than a year or so different.

GASB 27 requires state and local government entities in the US that provide defined pension benefits (as does Mendocino County) to, among other things, include a table in "Required Supplemental Information" information about the funding status of their Pension Funds based on the Actuarial Value of Assets. It does not require disclosure of the real Market Value of Assets or the Market Value of Unfunded Pensions.

The County of Mendocino has conformed to this requirement since, I believe, 1998.

It's my understanding the State of California has had a "blanket" requirement for local government entities to conform to GASB requirements for quite some time. Although I can't say for certain, I'm fairly sure the State did not wait until 2009 to require local governments to disclose the financial position of their Pension Funds - including the value of the UAAL.

My understanding is that state and local governments that do not conform to GASB standards are at a severe disadvantage in obtaining debt funding from traditional sources. Those sources (banks, bond houses, etc.) almost universally require state and local governments to conform to GASB requirements.

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.

YourPublicMoney.Com Agrees

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

YourPublicMoney.Com Partially Agrees

I know of only one report produced by anyone associated with MCERA that shows this result. There may be others, but I don't know of them.

Retirement Administrator Jim Andersen released a report dated March 18, 2009 titled "Results of Pension Systems Survey". Former Administrator Tim Knudsen had conducted a survey of County retirement systems that didn't participate in CalPERS.

The report shows that MCERA's investment returns ranked fourth out of 20 such County systems with a "5 Year Total Policy Return" of 10.74% in the five fiscal years 2004 through 2008.

There are several very basic problems with MCERA's report.

First - MCERA diverted at least $35 million out of the Pension Fund over the past 15 years to pay Retiree Healthcare benefits. The Pension Fund was underfunded during that entire time. It diverted a little over $16 million during the five years 2004-2008. But MCERA does not adjust its reported rate of return to reflect these diversions. In other words, the rate of return MCERA asserts it earned is <u>before</u> these diversions. A more “honest” rate of return for the Pension Fund would be to calculate the Pension Fund’s returns using the <u>retained</u> earnings each year - the amount of investment returns that remained in the Pension Fund.

Total returns on investment during those five years were about $113 million. MCERA’s March 2009 report indicated a Return of 10.74%. If the $16 million diversion is removed, the return percentage would be around 9.2%.

My understanding is that most if not all other County systems had abandoned the use of so called “Pension Fund Excess Earnings” to pay retirement benefits other than pensions by this time. If so, then MCERA would have been ranked 14th out of the 20 systems.

Second, the California State Controller’s Office (SCO) produces a number of annual compilations of financial data for various types of governmental entities that are established by the State, one of which is the Annual Public Retirement Systems Report. A table in that report shows the reported returns on investment of the 21 County Retirement Systems that do not participate in CalPERS. MCERA’s average reported investment return from 1996 though 2007 was 7.9% - only slightly below its 8% target. However, again this value is before retiree healthcare was diverted. After those diversions the average return was a little below 7%.

The 7.9% average return based on the SCO data in the over those 12 years placed MCERA 20th out of 21 non-CalPERS County systems.

Third, MCERA’s Actuarial Valuations provide a table showing various returns on investment values. The average return on market value for 2004 through 2008 based on the Valuations indicates an average of 9% - 1 ¾% less than the value reported in MCERA’s March 2009 report.

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%.

<u>YourPublicMoney.Com does not have enough knowledge to comment.</u>

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

<u>YourPublicMoney.Com partially agrees</u>

This finding does not identify who the “other entities” are or which assumptions and data have been questioned. Therefore I can’t reply to a specific reference.

The Stanislaus County Employee Retirement System (StanCERS) is reported to have “fired” Buck because of serious actuarial errors. Both the Actuary that performed an Actuarial Audit on Buck’s work and the Actuary that replaced Buck for StanCERA agreed the errors were very significant. These may be the “other entities” to which the Grand Jury is referring.

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.

<u>YourPublicMoney.Com agrees</u>

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.

<u>YourPublicMoney.Com partially agrees</u>

GASB (Governmental Accounting Standards Board) issued its Statement 45 during fiscal year 2003-04 that required the County to report its unfunded retiree healthcare liability in the *Supplemental Information* footnotes attached to its annual audited financial reports for the fiscal year ending June 30, 2008. The County received an Actuarial Valuation for its retiree healthcare benefit in August 2008. This Valuation indicated the County should report that its unfunded retiree healthcare liability as of June 30, 2008 was $129 million. The County did so.

Since then the County Board of Supervisors amended the 1998 Policy that governed this benefit to indicate the County would no longer assure that if there were no so-called “Pension Fund Excess Earnings” that it would pay half the cost of the benefit out of the County’s General Fund. This is broadly interpreted as meaning the County no longer has any potential or contingent liability related to this benefit.

There is broad disagreement with this conclusion among County retirees who have received this benefit. Many assert they were told when they were hired this benefit would be provided for the rest of their lives. Some retiree groups in other counties have sued their Retirement Associations claiming that their termination of similar benefits violated contracts. My understanding is that the Association of Mendocino County Retirees (not certain of name) is waiting to see the result of those other lawsuits before considering filing one of its own.

Although I’m not an attorney, it appears to me that if the County’s position that it had no contractual obligation to provide funding for this benefit is correct, then the County wouldn’t have any unfunded liability for this benefit. However, it also appears that many retirees believe there were contractual obligations and may assert that claim subject to the results of the similar lawsuits moving through the Courts in other counties.

Therefore I believe this issue isn't really "settled".

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.

YourPublicMoney.Com partially agrees

I assume the Grand Jury is referring to retiree healthcare benefits provided to employees before its change of policy in September 1998.

Very clearly the BOS in 1998 did not address the insufficiency of funds for retiree health benefits - nor did any BOS since then until the current BOS terminated the County's obligation to provide funds for this benefit.

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.

YourPublicMoney.Com agrees

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.

YourPublicMoney.Com agrees

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.

YourPublicMoney.Com agrees

I am that "critic". I calculated a year ago that it would take returns of around 17% a year over 8 years for the Pension Fund to "earn" its way out of its deficit. More recent calculations indicate that returns would have to be higher or the duration of these returns would have to be longer.

The more important point is that even after asking a number of County and Retirement Officials it appears no one in the County or MCERA has attempted to perform this analysis.

18. Revenues from property and sales taxes are decreasing.

YourPublicMoney.Com doesn't have enough information to comment.

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

<u>YourPublicMoney.Com agrees</u>

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.

<u>YourPublicMoney.Com doesn't have enough information to comment.</u>

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

<u>YourPublicMoney.Com partially agrees.</u>

The BOS responded as required by law to the previous Grand Jury reports, and therefore it probably isn't correct to say the BOS "ignored" those reports. What the Grand Jury probably means is that the BOS and/or MCERA have not implemented the major recommendations made in previous Grand Jury reports, which seems to me to be true.

The Grand Jury recommends that
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)

<u>YourPublicMoney.Com partially agrees.</u>

This is a very complicated subject.

It's clear that the County and MCERA have very seriously failed to achieve the Pension Funding Plan goals inherent in MCERA's Actuarial Valuations over the past two decades. These inherent plans are based on the assumption that only two sources of funds should be required to maintain a fully funded Pension Fund - 1) Annual pension contributions from the employer government and 2) returns on investment of those annual contributions.

As of June 30, 2009 the Pension Fund's Actuarially Accrued Pension Liability (AAL) was about $400 million. That's how much needed to be in the Pension Fund to be able to pay future pensions that had already been earned, assuming those funds would earn the target 8% each year in the future.

At that time the market value of the Pension Fund's assets was $132 million less - 1/'3 of the total AAL. Further, the County still owed about $90 million on its previous Pension Obligation Bonds - nearly 25% of the total AAL.

From the County's financial point of view, it not only owed the $90 million remaining to be paid on the Bonds, but it is also responsible to eliminate the full $132 million market value deficit.

I assert that means that only about $180 million of the Pension Fund's actual value of assets was obtained from contributions and returns on those contributions - that is, the inherent plan that the only money required should be annual contributions and returns on those contributions achieved only 45% of what should be its goal of a fully funded Pension Fund.

My analysis indicates the biggest reason the Pension Fund produced these very dismal results is earnings significantly below target, and the second reason was the diversion of money out of the underfunded Pension Fund to pay retiree healthcare.

MCERA has projected an 8% annual return on its investments for the past 15 years or so. It has very significantly failed to obtain that return. The Grand Jury's recommendation that a rate should be adopted that reflects the current economic environment certainly makes sense. But I would say an even more compelling reason to lower the assumed rate of return is that MCERA's actual performance over a long period of time was significantly below its target.

It would be far better in the long run to plan on achieving a lower return than is actually achieved than it is to plan on a higher return. Because MCERA planned on achieving 8% and then achieved significantly less, the County now faces a terrible financial crisis. It would have been far better to have an over-funded Pension Fund at this time demanding far lower annual County contributions.

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)

<u>YourPublicMoney.Com agrees.</u>

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)

<u>YourPublicMoney.Com partially agrees.</u>

We have proposed that an independent audit committee be established for the County of Mendocino. The proposed concept would have one County Supervisor on this committee, but the majority would be local or regional financial professionals with proven expertise in auditing, financial analysis, and related fields. These professionals must not have any conflicts of interest as regards the County, MCERA, or any of the other entities directly controlled by the County or its officers. The committee would be chaired by one of these outside professionals. This body would hire the County's annual outside auditing CPA firm and direct their work. It would review the CPA's findings and provide further direction if needed. It would approve the final form of the audit.

It would also be charged initially with “digging into” the wide range of assertions that have been made by various citizens about possible financial mismanagement and even wrong-doing and making a report to the public of its findings. It would also be charged with identifying any other areas in the County’s financial management that should be investigated.

The County can’t establish a similar body for MCERA, although such a body should be established by MCERA itself. However, one of the County’s independent audit committee’s specific charges would be to review MCERA’s financial reports and financial activities and report on their effect on the County’s finances. If MCERA is as transparent as they claim they are there should be no problem with their totally opening their records to the independent audit committee, although legally they would have the right to not do so.

While I generally agree with the “thrust” of the Grand Jury’s recommendation, I believe the committee should be a formal independent audit committee for the County, it should be populated with highly qualified financial professionals, it’s focus should not be limited to any particular aspect of the County’s finances, and while it should focus very intently on MCERA it would not have the legal authority to compel MCERA to cooperate.

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)

<u>YourPublicMoney.Com partially agrees.</u>

Again, this is complicated.

By law MCERA is obligated to consider its impact on the County’s budget, but that is subordinate to fulfilling its fiduciary responsibility to present and future retirees. Yes - MCERA should consider the County’s budget, but it should focus most intently on building and maintaining the soundness of its Pension Fund.

If it turns out that even though the Pension Fund is well managed (which I believe has not been the case) but the demands for funding from the County are deemed by the BOS to be excessive, then the BOS is responsible to adjust its retiree benefits so their cost bears a proper relationship with all the other financial demands made on the County.

The County’s financial officials (Auditor-Controller, Treasurer-Tax Collector, Executive Office, and BOS) should very carefully monitor the impact of the Pension Fund and MCERA on the County’s finances. I assert these officials have been very deficient in this duty for the better part of two decades.

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)

<u>YourPublicMoney.Com partially agrees.</u>

These values are currently reported in MCERA's annual audited financial reports and/or its Actuarial Valuations. However, very few citizens, even those who are relatively sophisticated financially, understand these reports. MCERA should strive to explain in much more easily understood terms how the Pension Fund "works" and what its problems are.

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)

<u>YourPublicMoney.Com partially agrees.</u>

MCERA seriously damaged the County's finances through its practice of using Pension Fund Excess Earnings to pay for retiree healthcare. From a private sector financial perspective, there are no "Excess Earnings" if the Pension Fund is underfunded. But it's also true that the notion of "Pension Fund Excess Earnings" as defined in California state law is absurd when viewed from the private sector perspective.

We can expect Pension Fund investment returns to be over target and under target in various years through time. If the policy is that any time returns in any year are more than the earnings target they are swept out of the Pension Fund to pay for other benefits - especially for benefits the County is not obligated to provide to its retirees - that dooms the Pension Fund to be underfunded. And that in turns forces the County to pay additional money to the Fund to eliminate the resulting unfunded pensions.

The Pension Fund has to absorb its shortfalls but never retains its surpluses.

The policy adopted by MCERA to which it refers does not prohibit the use of Excess Earnings if the Pension Fund is fully funded. That's a much better policy than what MCERA has done, but it still makes no sense. Over time returns will be over and under target. If the Fund is overfunded for a few years it's quite likely it will slip backwards in less productive years. Those surpluses should be retained to make up for future "rainy days".

The BOS should adopt a policy opposed to the use of Pension Fund Excess Earnings to pay any other benefits other than perhaps cost of living adjustments - and that is even questionable. If cost of living adjustments are required they should be incorporated in the Pension Fund's target rate of return.

More to the point, the BOS should take whatever actions it can that would prevent MCERA from using Pension Fund Excess Earnings to pay for anything other than the Pensions the County is obligated to pay.

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 a 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.**

<u>YourPublicMoney.Com partially agrees.</u>

I believe this Grand Jury recommendation should be directed mostly at the County, and not only the BOS. The Auditor-Controller and Treasurer-Tax Collector, and the County's chief financial officers should also be charged with these duties.

And - while I sympathize with the desire to state specific "solutions", the fact is there are a very wide range of potential solutions that could be implemented.

But whatever solutions are implemented, the County's obligation to the people as regards its retiree benefits should be that the only money the County should have to pay into the Pension Fund is its normal annual contributions. The County's duty should be to avoid the creation of significant unfunded retiree benefit debt. The retirement benefits of future retirees must be completely funded while they are still employed.

If MCERA can't achieve its Pension Funding plan then the BOS must either increase its annual contributions to compensate or change the retirement benefits so their costs don't crowd out current services.

There are many ideas other than the ones offered by the Grand Jury about how the County's retirement benefit costs can be properly financed. The County should evaluate that full range of options, and adopt and implement a set of new policies and structures that will result in fully funded retirement benefits based solely on what the County contributes each year.

8. The BOS immediately take steps to rectify the unfunded liability.

<u>YourPublicMoney.Com partially agrees.</u>

Again, this is very complicated. It's very hard to "make right" the unfunded liability. It must be reduced. How, and will it lead to the destruction of vital County services?

First - the BOS has chosen to make it easier on itself in the short term but also to impose a much greater burden on the future. The County and MCERA have adopted a method of eliminating the unfunded liability that we believe is extraordinarily irresponsible. The current plan is to eliminate the unfunded liability over 30 years using an amortization method called “Level Percent of Payroll”.

First an estimate is made of how much the County’s total payroll will be in each of the next 30 years assuming it will grow the same percent each year (the County adopted a 4% yearly payroll growth rate). Then a percentage is calculated that when applied to each year’s payroll will produce enough money to eliminate the unfunded pension debt in those 30 years. That’s the County’s yearly payment.

This method produces payments that are less than the annual interest expense for the first 12 years. This is called “negative amortization” which means the debt is going up, not down. The unfunded pension liability would increase 20% to 25% in those 12 years.

In fact, the unfunded balance won’t get back to today’s level for 20 years. That means - all other things remaining equal - the dollar value of today’s unfunded pensions will be entirely paid from 20 to 30 years from now.

We are forcing kids in elementary school to pay for retirement costs that were economically incurred 10 to 20 years ago.

Second - The Government Accounting Standards Board (GASB) recently released for public comment several concepts it intended to develop into a new set of requirements for pension accounting. Among these concepts are a) unfunded retiree liabilities would be reported as liabilities directly on balance sheets as opposed to footnotes, b) the value of unfunded retirement debt will be calculated using the market value of assets, not the “actuarial” value, c) the amount of future pension payments that have already been earned but that aren’t currently “funded” will be “discounted” using a municipal bond rate instead of the target rate of return (this will greatly increase the value of unfunded pension debt), d) the full “interest expense” of unfunded pensions will be reported each year, e) unfunded pensions will be amortized over much shorter periods of time (12 to 15 years instead of 30), and f) amounts of unfunded pensions over 15% of total pension liabilities will be immediately reported as expense.

Altogether these changes would greatly increase both the County’s unfunded pension liability and annual pension expense. My calculations indicate the debt would about triple and annual expense would be somewhere between two to three times that reported today.

Indications are that these concepts will be implemented in new accounting standards in about five years. Assuming Mendocino County still has significant unfunded pension debt, the debt would almost certainly greatly increase - the “opposite” of being “rectified”.

ATTACHMENT

John G Dickerson/YourPublicMoney.Com Response

Further Information about Finding 4

The information immediately below supports my statements A and C above. Statement D is discussed in the following section.

On March 17, 2010 the Retirement Board met with this item on its agenda - "Discussion and Possible Action Regarding the use of Excess Earnings". The meeting was recorded by Ukiah Valley Community TV and is available to be viewed at their website - http://www.uvctv.org/vid/ret031710/

At the request of some members of the Retirement Board Former Retirement Administrator and County Treasurer-Tax Collector Tim Knudsen gave a report on the history over the past 10 years of how MCERA paid for retiree healthcare.

Mr. Knudsen provided a written memo and table to support his presentation. The written memo is dated March 3, 2010 to the Board of Retirement - Subject: Excess Earnings/Health Insurance. The following quote is from this memo (underlines added):

> *During this time period (stated earlier to be 2003 through 2006) MCERA began a process for payment of retiree health insurance that was thought necessary in order to be in compliance with Internal Revenue Services Regulations. The instructions we had (from the IRS through the actuary) regarding retiree health insurance payments were that all payments must be made by the county. During this time we followed a process of "diverting" a portion of the monthly County Contributions made to the Retirement System into the reserve for retiree health insurance ... After a numbers of years we were informed by the actuary that since the county was not making any contributions toward an unfunded liability, because of the 2002 POB agreement, the process of diverting money to the reserve to pay for retiree health insurance meant the county was not making the "normal contribution" to the retirement system and violated certain sections of the 1937 Act Government Code.*
>
> *With the receipt of this information we immediately reverted to the system of recognizing a portion of market value appreciation and repaid the full amount that had been diverted from the county contribution amounts. We also recognized an amount ($3,427,200) that would cover expected health insurance payments for the remainder of that FY thereby using a total of $9,557,912 from the actuary recommended plan. It should be noted here that this amount has remained on the retirement systems books since that time and has been carried in the "Actuarial Value of Unrecorded Earnings (Account 1300).*

Item A) Diversion of $6.1 million from County Pension Contributions

California Government Code Section 31587 referred to by the Grand Jury states:

> *The (retirement) board shall apply the contributions of the county or district to its obligations under the system in the order and amounts as follows:*
>
> *First, in an amount equal during each fiscal year to the liability accruing to the county or district because of service rendered during such year and on account of service and disability pensions, in an amount determined by the actuarial valuation as interpreted by the actuary. ...*

According to the table provided by Mr. Knudsen to the Retirement Board these were the amounts taken out of the County's contribution to the Pension Fund in those years:

Fiscal Year	Amount Diverted to Pay Healthcare
2004	$1,728,689
2005	2,662,304
2006	1,739,719

A table on page 27 of the *Report on the Actuarial Valuation as of June 30, 2009* produced for MCERA by its Actuary - Buck Consultants - showed the County contributed these percentages of its Annual Required Contributions to the Pension Fund:

2000	100%
2001	100%
2002	100%
2003	100%
2004	63%
2005	47%
2006	79%
2007	100%
2008	100%
2009	141%

(I question the accuracy of the 141% contribution in 2009 - but that's not relevant to this Grand Jury finding.)

This table indicates the County contributed significantly less than its required annual contributions in 2004 through 2006. However, it appears the County paid an amount close to or equal to its required annual contribution and these percentages reflect the amount of those contributions that were not diverted to the healthcare fund.

Former Retirement Administrator Knudsen specifically stated in his memo:

> *... we followed a process of "diverting" a portion of the monthly County Contributions made to the Retirement System into the reserve for retiree health insurance* .

Knudsen specifically states MERA diverted approximately $6.1 million from the County's annual contributions to the Pension Fund from 2004 through 2006. That action appears to not conform to the language of California Government Code Section 31587 cited above.

In its response to this finding in the Grand Jury Report MCERA's Administrator Andersen stated these diversions were "*presented to the Board of Retirement as being compliant with the California Employees' Retirement Law of 1937 and IRS code. The Association does not believe that the action was in conflict with Government Code sections 31584 or 31587*."

However, Andersen no where cites specific Code Sections or other specific legal authority to support that position. In contrast, the description of the events given by former Administrator Knudsen seems clearly to not conform to the requirements of Code Section 31587.

Therefore I agree with the Grand Jury's Finding as it relates to the approximately $6.1 million diverted from the County's required annual Pension contribution - it appears to be in conflict with Government Code Section 31587.

<u>Item C) "Repayment" of $6.1 million of County Contributions to the Pension Fund and of $3.4 million Transferred from Pension Fund in 2006</u>

The quote cited above from Tim Knudsen's memo to the Retirement Board states:

> *With the receipt of this information <u>we immediately</u> reverted to the system of recognizing a portion of market value appreciation and <u>repaid the full amount that had been diverted from the county contribution amounts.</u> We <u>also</u> recognized an amount <u>($3,427,200)</u> that would <u>cover expected health insurance payments for the remainder of that FY</u> thereby using a t<u>otal of $9,557,91</u>2 from the actuary recommended plan. It should be noted here that<u> this amount has remained on the retirement systems books since that time and has been carried in the "Actuarial Value of Unrecorded Earnings"</u> (Account 1300).*

The transaction Knudsen states "paid the County back" must be analyzed to understand the financial and legal issues.

Code Section 31587 states the County's contributions in each year must first go to:

> *... the liability accruing to the county or district because of service rendered during such year and on account of service and disability pensions, in an amount determined by the actuarial valuation as interpreted by the actuary.*

The liability that accrues to Mendocino County for service rendered during each year is its obligation to the Pension Fund. The focus of this Code Section is not on whether or not the County is "credited" for having paid its required annual Pension contribution; it's on where the money goes - it is supposed to go into the Pension Fund.

What was supposed to happen is that all the cash would have gone into the Pension Fund and the County would have been "credited" for having paid what it was supposed to have paid into the Pension Fund.

What happened is that only part of the money that was supposed to go into the Pension Fund was actually deposited in that Fund - AND the County only got credit for having paid that amount into the Pension Fund. Then - the amount that was diverted - a total of $6.1 million over those 3 years, was deposited into the Healthcare Fund and the County got credit for paying that much into the Healthcare Fund.

Right there it appears MCERA did not conform to Code Section 31587.

But then later in order to "make things right" MCERA would have had to transfer $6.1 million <u>out of the Healthcare Fund and into the Pension Fund</u>. And, to "balance" the transaction that amount would have been taken out of the account that records the County's contributions to Healthcare and added to the account that records the County's contributions to the Pension Fund.

MCERA made the second of those two entries. It's that "crediting" of the account that records the County's contributions to the Pension Fund that Knudsen claims constitutes "paying the County back".

But, again, that's not the issue. The issue is where is the money?

MCERA had already spent the money on Healthcare - it was gone. There was no money in the Healthcare Fund to move to the Pension Fund. So - what was the County supposedly "paid back" with?

It was "paid back" with what Knudsen says is an asset account on MCERA's books titled "Actuarial Value of Unrecorded Earnings".

(In fact to "make things right" an amount equal to the compounded target rate of return - 8% - would also have to be moved from the Healthcare Fund to the Pension Fund because since the money wasn't in the Pension Fund's investments that Fund could not earn investment returns - which are absolutely necessary to be able to pay future pensions in full. But I'll keep this explanation simple and not include "lost income".)

Knudsen also reported that an additional $3.4 million was taken out of the Pension Fund in 2006 to "cover expected health insurance payments for the remainder of that FY" (fiscal year). And so the total in "Actuarial Value of Unrecorded Earnings" was $9.6 million - the $6.1 million represented by the diversions from the County's contributions and the $3.4 million taken out of the Pension Fund (there is a slight rounding error in these numbers).

What is "Actuarial Value of Unrecorded Earnings"? I earned my MBA in Strategic Planning and Economic History from the University of Texas which was generally ranked the #1 graduate accounting school in the USA at the time. I have 30 years of experience in financial management, accounting, financial/industry/market analysis and similar fields. I've never been able to understand any explanation offered by anyone associated with MCERA of the nature of "Actuarial Value of Unrecorded Earnings". Although I can't say with absolute certainty I very much doubt this account would truly qualify as an "asset".

I believe “Actuarial Value of Unrecorded Earnings” is really a claim against future so-called Pension Fund “Excess Earnings” in some uncertain year in the future. It is essentially a claim against future “profits” if and when they occur.

How can MCERA claim that future Excess Earnings at some uncertain date is an asset? It makes no sense to me. In my experience Generally Accepted Accounting Principles (GAAP) do not allow the “capitalization” of expected future profits that have not yet been earned - that is, I don’t believe GAAP allows the expectation of future but as of yet unearned profits to be listed as an Asset on the Balance Sheet - or Statement of Net Assets. To me this appears to be a “fake” asset.

However - since most of my experience has been in the private sector I can’t say it isn’t an asset with absolute certainty because I am not as experienced with how GAAP in governmental accounting defines what is and isn’t an asset. I can say that no explanation of this account provided so far from MCERA I’ve seen makes sense to me and certainly doesn’t justify listing it as an asset, in my experience. My judgment is it isn’t an asset - but there is a slight uncertainty in my opinion.

I believe this view is confirmed by the fact that the Retirement Board has elected to “write off” the $9.6 million in this account essentially as “uncollectible” during the 2010-2011 fiscal year - as if it were a “bad account receivable.” They have explicitly declared the account has no value.

I believe it’s further confirmed by comments made by the video of the 3/17/2010 Retirement Board meeting. On that video Retirement Administrator Andersen states at one point when discussing this account:

> *There’s still $9.557 million (in the “Actuarial Value of Unrecorded Earnings” account) that’s still outstanding from that practice (Actuarial Adjustment). ... there may be a way we can “eliminate” that **asset**.*
>
> *... This **liability** that’s sitting on the books(referring to the same account) - what is the disposition of the Board as far as addressing that in the future?*

But regardless of the legal status of “Actuarial Value of Unrecorded Earnings”, the fact is that $6.1 million was diverted out of the County’s pension contributions and that cash was never put into the Pension Fund. That appears to me to be a direct violation of Code Section 31587.

Item D) California Government Code Section 31584

This Grand Jury finding states the actions of MCERA described in the finding may have been in conflict with Code Section 31584. This isn’t correct because that Code Section applies to the County - not to the Retirement Association.

Code Section 31584 states:

> *The board of supervisors shall make the appropriations, and if it fails or neglects to make the appropriations, the county auditor shall transfer from any money available in any fund in the county treasury the sums specified by this chapter and this transfer*

shall have the same force and effect as it would have had if the required appropriation had been made by the board of supervisors.

I believe other Code Sections indicate the “appropriations” refers to all the monies the County is obligated to pay to the Retirement Association under the 1937 Law, which for Mendocino County is almost totally Pension obligations.

It appears the County paid approximately the amount it was told to pay by MCERA’s Actuary during 2004 - 2006. However, as seen above, MCERA diverted $6.1 million out of those payments and put that cash into the Retirement Healthcare Fund.

The following makes me believe the County knew about this diversion and effectively agreed with the diversion.

* Tim Knudsen was both the County Treasurer-Tax Collector and MCERA’s Retirement Administrator during those years. Clearly he knew about the diversions and was an elected County official responsible to safeguard the County’s financial assets.

* The County Board of Supervisors, Administration, Auditor-Controller, and obviously the Treasurer-Tax Collector all received copies of MCERA’s annual Actuarial Valuations. As shown above, those Valuations contained tables showing the County’s contributions to the Pension Fund were significantly less than required. The percentages reported in the Valuation were based on what was left in the County’s pension contributions after the approximately $6.1 million diversions to the Retiree Healthcare Fund. It appears the County never objected to this indication from MCERA and its Actuary that MCERA’s records indicated the County did not pay a significant amount of the required annual pension contribution defined by the Actuary.

* Footnotes in the County’s audited annual financial statements for those years indicate the County contributed significantly less to the Pension Fund that it was supposed to.

So - the County actually paid about the amount it was told to contribute to the Pension Fund by MCERA’s Actuary, but the County’s financial reports indicate it didn’t.

This indicates many County officials knew about these diversions and had to agree with them. Even though the Board of Supervisors may have “technically” appropriated the amounts it was told to for the Pension Fund in its budget, its clear County officials knew MCERA was diverting $6.1 million to healthcare and was not depositing that amount into the Pension Fund.

While the BOS may have technically satisfied the requirements in Code Section 31584 in its budgets, I believe it knowingly did not fulfill the substance of the requirement of that Code Section - which is that the County should pay all its annual pension contribution into the Pension Fund.

Further Information for Finding 6

Actuaries produce “Actuarial Valuations” for Pension Funds. One aspect of such Valuations is determining how much the Fund is worth compared to the amount of money it should have so it would be able to pay all the pensions that have already been earned by employees in the past.

The financial position of the County's Pension Fund is determined by:

Pension Fund Assets
- Pension Fund Obligations
Unfunded or Over-Funded Pension Obligations

If Assets are less than Obligations, there is an "Unfunded Obligation". If greater, the Fund is "Over-Funded".

Actuaries use two different values for Pension Fund Assets:

- Market Value of Assets
- Actuarial Value of Assets

Therefore there are two values for Unfunded or Over-Funded Pension Obligations. This table shows their values based on data contained in the 6/30/09 Actuarial Valuation of the Pension Fund:

	Market Value	Actuarial Value
Pension Fund Assets	$271 million	$336 million
Less Total Obligations	- 403 million	- 403 million
Unfunded Pension Obligations	($132 million)	($67 million)

The Unfunded Obligation based on the Actuarial Value of Assets is called the "Unfunded Actuarially Accrued Liability", or "UAAL". The Unfunded Obligation based on Market Value of Assets is not the UAAL.

Therefore - this is one correction offered to this Grand Jury finding. There is no "UAAL" based on the Market Value of Assets. "UAAL" is a "technical term" that refers only to the value of the Unfunded Pension Obligation measured using the Actuarial Value of Assets.

However, it is absolutely correct to say that the Unfunded Pension Obligation measured using the Market Value of Assets was twice as much as that measured using the Actuarial Value of Assets.

And, the gap between Actuarial and Market Value of Pension Assets on 6/30/2009 was the largest it's ever been - the Actuarial Value was $65 million more than the Market Value. That is also the gap between Unfunded Pension Obligations based on Actuarial Value of Assets compared to Market Value of Assets.

The importance of this distinction is related to its impact on 1) the amount of Unfunded Pension Amortization Payments the County must pay over several years, and 2) the amount the Pension Fund actually has to invest seeking to earn its required investment profits.

County Unfunded Pension Amortization Payments

Both the County and its employees make annual contributions to the Pension Fund. These are intended only to fund the pensions that are being earned by employees that year.

But if an Unfunded Pension Obligation develops large enough to threaten the Pension Fund's ability to make future payments of all pensions already earned only the County is obligated to eliminate it by making additional payments. It's this second kind of payment - the "Unfunded Pension Amortization" payment - that creates the need for a modified value of the Pension Fund's Assets - the "Actuarial Value of Assets".

The stock market is notoriously volatile. If the Actuary used the Market Value of Assets to determine the value of the County's Unfunded Obligation Amortization payments those payments would often change radically from year to year. This would play havoc with the County's budget stability from year to year.

Pension Funds are long-lived financial entities. The point is to maintain the Fund's financial strength over the long run rather than immediately correct small short falls. Right or wrong, Actuaries decided that over the long run the damage to year to year government budgetary stability would cause more harm than misstating the Value of Pension Fund Assets, within limits.

Actuaries developed a formula to "slow down" the rate of change of the County's required payments. This is a reasonable objective <u>as long as the use of the modified Actuarial Value doesn't lead to a dangerous distortion of real Asset Value or obscure poor performance</u>.

The Market Value of the Pension Fund's Assets is what they are really worth. It's what the Fund has to invest, pay pensions, and pay expenses. Most of the Assets are investments - stocks, bonds, real estate, etc. Their Market Value is what they could be sold for. It's easy to establish what stocks and bonds are worth - it's what they are selling for in the market. For real estate an estimate or appraisal is needed.

An Actuary modifies the Market Value to produce the Actuarial Value of Assets using two formulas:

<u>Smoothing</u>: MCERA uses a five year smoothing period. The amount that its actual returns are more or less than its target in any year is recognized in that and the following four years in equal amounts - 20% a year. This is what "slows down" the changes in the County's Unfunded Pension Amortization Payments.

<u>Corridor Limits</u>: A Limit on Smoothing: This limits how much the Actuarial Value of Assets may differ from the Market Value. The Actuarial Value can't be more than 25% different from the real Market Value. The Corridor Limit was raised from 20% to 25% for the 6/30/2009 Valuation in order to increase the amount the Actuarial Value of Assets could be higher than the Market Value so that the County's Unfunded Pension Amortization Payments would be lower than had the Limit remained at 20%.

For the first time ever as of June 30, 2009 the Smoothing process produced a "Smoothed Value of Assets" that was more than the Corridor Limit - and therefore the Smoothed Value was not used - the Corridor Limit was.

Market Value of Assets	$271 million
Upper Corridor Limit (125%)	339 million
Smoothed Value of Assets	356 million

The Smoothed Value was $17 million more than the Upper Corridor Limit (25% more than the Market Value). Therefore the Corridor Limit was used. Two reserves totaling $3 million were deducted from that value to produce the final “Net Actuarial Value of Assets” of $336 million.

Using this Net Actuarial Value of Assets the UAAL was $67 million. The County was obligated to begin making UAAL Amortization payments on that amount in fiscal year 2010-2011.

The importance of the difference between Actuarial and Market Value of Assets as regards Unfunded Pension Amortization Payments is that the County’s payments in fiscal year 2010-2011 is calculated using only half of the real “Market Value” of Unfunded Pension Obligations.

The Pension Fund earned $135 million <u>less</u> than its target returns in 2008 and 2009. However, $100 million of that sub-target investment return is <u>not yet included</u> in the UAAL - it has been “smoothed” to be incorporated into the UAAL over the next four years. The Fund enjoyed returns over its target in 2006 and 2007 - but the remaining amount of those “over target returns” to be included for the first time in the UAAL is only $12 million. Even if the Fund earns its target rate of returns of 8% over the next four years, the value of the UAAL will increase by around $100 million over the next four years - mostly but totally because of the gradual inclusion of the $100 million under-target returns in 2008 and 2009.

That means the County’s UAAL Amortization Payments will almost certainly greatly increase over those years - more than double.

This is one of the inherent dangers when the Actuarial Value of Assets is much greater than the “real” Market Value - unless the Fund can completely earn back its sub-target returns over the next four years the County’s UAAL Amortization payments will very significantly increase.

I don’t think the County or MCERA has calculated what that increase will be. My calculations indicate the UAAL Amortization payments will increase from about $4 million in fiscal year 2011 to around $10 million in fiscal year 2015 - a very large increase.

<u>Potential Returns on Investment</u>

The other main inherent danger when the real Market Value of Assets is much lower than the Actuarial Value as was at the last available Actuarial Valuation is that people make the very grave mistake of thinking the Actuarial Value of Assets is “real” - that is, as if the Pension Fund has that much money to invest.

It doesn’t. The Pension Fund was supposed to have $400 million as of June 2009 but in fact only had $270 million to invest. <u>The Fund can’t earn investment returns on money it</u>

doesn't have. The actual mathematical assumption underlying the Pension Fund is that it will have all the money it's supposed to have in any year and it will earn its target rate of return each year on that amount.

The Pension Fund's target rate of return is 8% - but that means that it needs to earn $32 million during the current fiscal year (8% of $400 million) in order to "stay even" with its Pension Funding Plan. But if it only earns its target rate of 8% on the $270 million it actually has it will earn only $22 million - $10 million less than what it really needs to earn. In order to earn $32 million the Fund would have to earn 12%. That means if it earns 50% more than its target rate of return on the money it actually has to invest it will only be "staying even". If it earns its target of 8% it will fall $10 million below its target - which increases the real value of Unfunded Pensions by that amount.

These are the two main reasons the distinction between Actuarial and Market Value of Assets is so important to understand given the Pension Fund's current situation.