

## UNFUNDED LIABILITY – OUR CHILDREN’S INHERITANCE

### (ANOTHER) UPDATE ON THE MENDOCINO COUNTY RETIREMENT SYSTEM

JUNE 3, 2010

#### **Summary**

A national economic downturn began in the third quarter of 2008. California Public Employee Retirement System, (Cal-PERS), lost approximately 25% of its invested value: \$55 billion. The Mendocino County Pension Fund, (pension fund), value after initial recovery, was reduced by 16.55%, further impacting existing unfunded Actuarial Accrued Liability, (UAAL). The pension fund like most others, has partially recovered from earlier stock losses. **However, a large unfunded liability remains.** As of September 2009, Mendocino County Employee Retirement Association, (MCERA), reported that the pension fund was approximately 82% funded and the unfunded liability was between \$80 million and \$129 million. The County pays approximately \$20 million in interest per year on this debt. The Mendocino County Grand Jury, (GJ), is concerned that MCERA neither reflect realistic possibilities for financial growth, nor demonstrate transparency in their reporting.

Mendocino County’s, (County), short term thinking has resulted in the real possibility of financial disaster including bankruptcy. Like most government entities, the County faces extraordinary budget shortfalls and unfunded pension liabilities. Continuing to fund the retiree health care program as it was done in the past, is not feasible. Major cuts in personnel, salaries and services are necessary to start the County on a path toward financial viability.

#### **Methods**

The GJ attended meetings of MCERA, the Board of Supervisors, (BOS), and elected officials. The GJ interviewed County staff, management of the Retirement Board, Labor Union Officials, and involved citizens. The GJ reviewed budgets, reports, and analysis relating to the subject.

#### **Background**

Escalating employee pension fund and insurance liability costs are threatening the financial viability of many cities and counties within the State of California and the Nation. This trend is compounded by a general downturn in the economy that appears to be continuing into the foreseeable future.

In 1996 the County issued \$30,720,000 in Pension Obligation Bonds, (POB), in order to meet the mandated requirement of Government Accounting Standards

Board, (GASB), 25. During the late 1990s to early 2000s, many public and private entities found themselves competing for staff in a tight labor market. They attracted the staff they needed by increasing wages and benefits. From 1997 through 2002, the County added 413 funded positions, a 39% increase. This was 10 times faster than the underlying growth of the County's population. The retirement fund was not allocated funds appropriately to cover future obligations. The County was fifth of 58 California counties increasing numbers of employees per capita: two and one-half times more than average.

In 2000, a County funded Slavin study determined that the County salary scale was significantly lower than comparable jurisdictions. Many salaries were raised without matching funds being allocated to the retirement reserves. In 2002, the County assumed additional debt at a lower interest rate, to partially refinance the loans of 1996. Stock market indices were soaring at that time. A national economic downturn began in the third quarter of 2008, and the value of Mendocino County's pension fund significantly declined, further impacting UAAL.

The County now has a number of employees with salaries the County can't afford.

There exists a conflict as to the amount of the UAAL. The MCERA Board data and the figures of community analysts disagree. While the stock market has recouped some of its losses, the MCERA continues to have a projected disproportionate unfunded pension liability.

### ***Findings***

1. In 1996 the County authorized issuance of \$30.7 million in POB.
2. In 1998 the BOS created a two-tier employee health care system. Employees hired after 1998 no longer receive retiree health benefits.
3. In 2002 a second POB was issued for approximately \$92 million, at a time when interest rates were favorable, which included the defeasance<sup>1</sup> of one half of the \$31 million POB issued in 1996.
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)
5. In 2008 the MCERA Board took the action of hiring its own manager independent of the BOS.
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.

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<sup>1</sup> Defeasance: Auditors may allow a debt to be 'defeased' or extinguished for reporting purposes provided that pre-conditions are met.

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.
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.
9. The MCERA Board has produced reports which demonstrate their investments have performed at or above the level of peer counties.
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%.
11. Other entities have questioned the assumptions and data used by MCERA’s contracted 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.
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.
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.
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.
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.
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.
18. Revenues from property and sales taxes are decreasing.
19. Individual health care and retirement payroll contributions are increasing, while positions are being eliminated due to budgetary shortfall.
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.
21. Prior GJ pension fund reports have been ignored by the BOS, evidenced by the fact that they have not adjusted the debt repayment.

### ***Recommendations***

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)
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)
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)
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)
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)
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)
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.

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

### ***Discussion***

The history of the of the retirees' health care fund needs to be disclosed. In 1998 the BOS created the two-tier system of retiree health benefits. They were aware of future funding problems and did not adequately address the funding obligation. The BOS had an additional opportunity to address the long-term funding problem in 2004-2006. Instead, the BOS borrowed money from the retirement fund to pay for retiree health care, which created additional future debt.

Several past GJ reports have made recommendations regarding the size of the UAAL and the rate of repayment of the debt. These reports have been ignored, evidenced by the fact that the BOS has not adjusted the debt repayment. Current criticism by community members cannot be easily ignored. The questions raised need to be answered and there must be a vehicle for community input for pension plan funding. Communications with the public must be transparent and accurate, especially since GASB will force the County to do so.

Basic assumptions of MCERA need to be examined. Critics believe it was an error to use excess earnings for employee benefits other than pensions; they also believe holding 90% of projected assets needed are insufficient for pension needs. Expecting current and future employees to pay for past employees pensions is pushing current liability on future generations.

The advent of GASB §43/45 will force the County to examine how they are reserving and funding other post-employment benefits liabilities.

The GJ feels strongly that full disclosure of the UAAL value and costs of MCERA holdings is essential to re-establish the trust of the community tax payers. That is why the GJ supports the formation of a Financial Advisory Committee to MCERA. The citizens of Mendocino County need to hear truth, not rhetoric.

### ***Required Responses***

Mendocino County Employee Retirement Board (All Findings; Recommendations 1-7)

Mendocino County Board of Supervisors (All Findings; All Recommendations)

Mendocino County CEO (All Findings; All Recommendations)

***Requested Responses***

Your PublicMoney.com (All Findings; All Recommendations)

Services Employees International Union, (SEIU). (All Findings; All Recommendations)

Appendix A

Cal. Gov't. Code §31584.

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.

Cal. Gov't. Code 31587.

The 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.

Second, in an amount equal during each fiscal year to the payments made from contributions by the county or district during the year for death benefits.

Third, the balance of such contributions on the liabilities accrued on account of prior service benefits.