MENDOCINO COUNTY'S FINANCIAL TIME BOMBS
In Place and Lit

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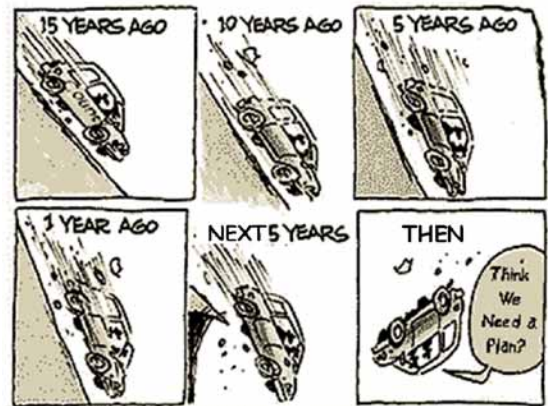
8/5/10



About a month ago I "saw' for the first time what I believe will likely be the specific path that will lead Mendocino County to something very much like "financial disaster". I may be wrong, but fear I'm not.

The County has built up one of the highest per resident debt levels in California - very likely the highest. Payments on that debt have consumed most of the County's reserves. When an organization like the County develops this level of financial weakness it is far more vulnerable to unexpected financial "shocks". If other Counties catch a "bad cold", Mendocino County catches pneumonia.

The Pension Fund's drastic loss in the stock market in 2008 and 2009 was such a shock. This set in motion a series of yearly events that together create a very dangerous financial threat to our County.

One of the big problems in "all this" is that the way Actuaries analyze pension funds is very complex. Not only regular citizens but even County Supervisors don't understand it. I've written another piece - "How Pension Fund's Work" - that explains the core concepts citizens and public officials need to understand. If some of the terms below are confusing, this document is available on our website.

As is usual if any of my "facts" are wrong please let me know. I'll correct it and if it significantly affects the analysis and conclusions I'll convey that to the public and if warranted I'll apologize.

Unfunded Pensions Are the Dynamite

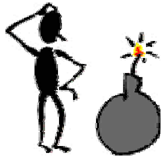
Mendocino County's Pension Fund was supposed to have about $400 million in June 2009. But it only had $270 million - it was $130 million "underfunded" on a "real" cash-value basis.

While both the County and its employees make "normal" yearly contributions, only the County is legally obligated to pay extra to eliminate unfunded pensions. Those payments started this year.

In addition the County still owes $85 million it borrowed by selling Pension Obligation Bonds to eliminate earlier unfunded pensions. Therefore County (which really means its people) owes $215 million for pensions that have already been earned by employees in the past. If the County's pension funding plans had "worked", it wouldn't owe a dime.

There is a series of financial time bombs already in place in the Pension Fund that are programmed to blow up each year for the next several years. Even if the Pension Fund earns its target investment returns over the next 5 years - two very bad things are likely to happen:

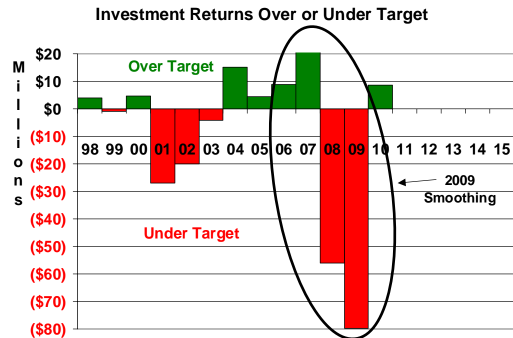
- The County's total annual debt payments will increase 250% from last year's $8 million or so to $20 million over the next five years. (There are probably several million more other "hidden" annual debt payments but they aren't reported in County financial statements.)
- The "official" value of unfunded pensions will triple from $67 million to $200 million or so.



Five Time Bombs

There are four (maybe five) financial "time bombs" that will create much greater financial stress for Mendocino County. They are now "built into" the County's Pension Fund. And they are ticking.

1. **2008 & 2009 Pension Fund Earnings Deficits**:



The County's Pension Fund was $135 million below its required target investment during these two years combined. A process called "smoothing" is used to avoid sudden chaotic changes in the County's required unfunded pension payments. The amount the Fund is above or below its investment target each year is "spread out" over that and the following four years. Only 20% is added each year.

Only $35 million of the $135 million deficit has been added into the unfunded pensions the County has to eliminate. There is another $100 million of earnings deficits that will be worked into the official value of unfunded pensions over the next 4 years. Each year the official value of unfunded pensions will increase which will trigger a new round of unfunded pension payments the County will have to make.

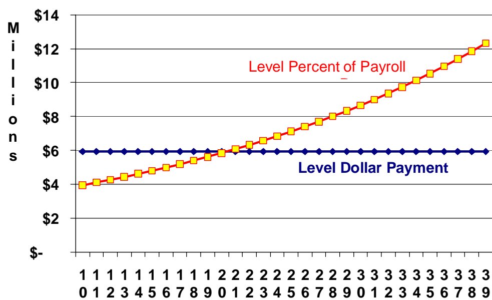
2. **"Level Percent of Payroll" Amortization Method**:

Just about everyone is familiar with the traditional 30 year fixed rate home mortgage. You borrow money to buy a house and pay it back by making equal payments every month for 30 years. In the beginning most of the payments goes to pay interest but by the end most of the payments reduce debt.

But unlike the "fixed payment" home mortgage, the County elected to use a "creative" method to pay this debt - the "Level Percent of Payroll". The County will pay over 30 years at 8% interest.

At first this seems only a little more complicated. First you estimate 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 you figure out a percentage of each year's payroll the County needs to pay to eliminate the unfunded pension debt in those 30 years. That's the County's yearly payment.

There are two arguments for why this is a good idea. First, although annual payments will grow as total payroll grows, at the same time the County will be earning more income because of increased taxes, fees and grants. So - this method supposedly evens out the financial burden over time.

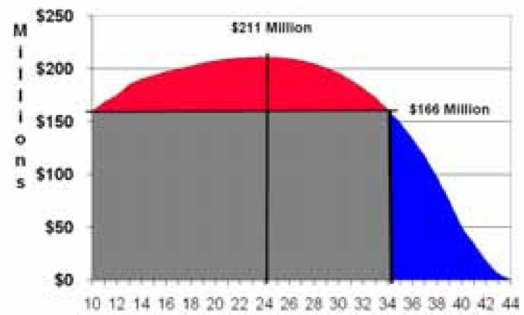


Second, the County's regular yearly pension contributions are figured as a percentage of its regular payroll each pay period. Since this "percentage of payroll" method is used for its regular yearly payments, it's easy to tack on a set percentage for unfunded pensions - basically the same system.

But that's not why this method was chosen. It's simple - the County will pay a whole lot less for the first 12 years than it would under the fixed payment method. Since the people who make the decision are in office now - they are making things a whole lot easier for themselves.

And that's where the unexpected results come in.

As stated above, a new series of unfunded pension payments will begin in each of the next five years. This graph shows the total balance of unfunded pensions related to those five payment series.



The amount the County will pay in the first 12 years of each series of payments is so low it won't even pay the interest expense each year. That means the amount of unfunded pension debt will actually increase each year. Total unfunded pensions for all 5 yearly payment series would grow from about $166 million to $211 million - an increase of $45 million - by 2024.

For each year's payment series, after 12 years total payroll will have grown enough so the yearly unfunded pension payments get large enough to start paying more than the yearly interest. The debt finally starts to get reduced. But the County won't get back to the original debt for 20 years. For all five payment series the balance won't get back to the original $166 million until 2034.

That means the entire amount of the debt we face today will be paid by the people of Mendocino County from 2034 through 2044. By that time annual debt payments will have tripled. And, the County will pay over $100 million more interest expense than under the Level Payment method.

However if as appears likely total payroll in the next several years is flat or even declines, then payments would stay flat or even decline which would reduce my projected payments over the first five years. But the tradeoff would be that the debt would increase even more, and that would increase the total interest expense over the entire 30 years.

3. Built In 8% Growth of Unfunded Pensions

County and retirement officials often say the Pension Fund's target rate of investment return is 8%. What they don't say, much less realize is that's true only if the Fund is "fully funded". That is, if it has at least as much money as its total pension liability.

But the Pension Fund can't earn investment profits on money it doesn't have.

The Fund's total liability at its last calculation was $400 million. If it were fully funded and earned its target rate of return it would earn $32 million in the next year. But it only had $270 million to invest. If it earned its target 8% it would earn $21.6 million - $10.4 million less than if it were fully funded - and more importantly, less than it needs.

This year the County started "paying off" the "official" value of unfunded pensions - $65 million. The County will pay about $4 million this year in unfunded pension payments. The County's $4 million payment reduces the amount the Fund would be short to $6.4 million.

That's how much the underlying unfunded pensions would have grown even if the Pension Fund earned its target of 8% return on investment and "all other things remain equal" (see the next Time Bomb).

The point is - the way the math of the Pension Fund works is that, in general, the amount of unfunded pensions will increase by 8% a year unless the County pays that entire 8% or the Pension Fund earns significantly more than its target 8% on the money it has to make up for the money it doesn't have.

That systematic underlying 8% growth of unfunded pensions eventually gets included in the "official" value of unfunded pensions that the County is legally obligated to eliminate. That in turn eventually increases the amount of debt payments the County is legally required to make.

My calculations indicate this dynamic will add $30 million or so to the County's unfunded pension debt over the next 5 years - above and beyond what the other "Time Bombs" will do.

4. Retirement Association Negative Cash Flow

MCERA has three major sources of income and three major types of expenses.

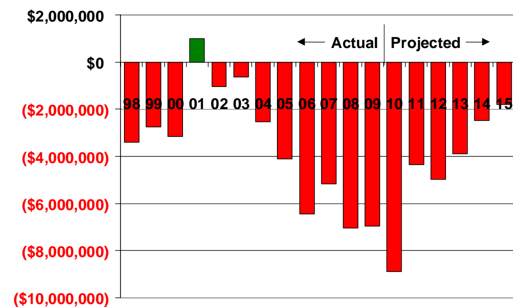
Revenue
- **Investment Income**
- **Pension Contributions (County and Employees)**
- **Reimbursements (County reimbursing minor MCERA expenses)**

Expenses
- **Retirement Benefits (Pension and Retiree Healthcare)**
- **Refunds (Leaving Employees Electing Not to Receive Pensions)**
- **Administration (MCERA's Operating Expenses)**

I stated above that the County's unfunded pension debt would grow by $6.4 million this year "even if the Pension Fund earns its target of 8% return on investment and '**all other things remain equal**'."

What I mean by "all other things" is the balance between these revenue and expense items without investment income. If we assume the Pension Fund will earn exactly its required rate of return of 8% investment earnings would be "neutral" in its affect on unfunded pensions. But remember, that's only for the amount of money the Fund has invested. Unfunded Pensions would increase by 8% of the amount of Fund's cash value deficit as discussed in Time Bomb 3 above.

This graph shows the net cash flow balance of these two sources of revenue and three types of expenses since 1998 and projected over the next five years.



There has been only one year when these revenues were more than expenses. Over the five years from 2005 through 2009 these three expenses averaged over $5 million more than Pension Contributions plus Reimbursements.

Therefore, all other things haven't been equal. This "negative cash flow" increased unfunded pensions dollar for dollar.

I'm assuming this negative amount will decline over the four years after fiscal year 2009-10. Two things will move this balance in a positive direction, one in a negative.

MCERA is supposed to stop diverting money out of the underfunded Pension Fund to pay Retiree Healthcare. However, MCERA diverted more money out of its underfunded Pension Fund to pay retiree healthcare in the fiscal year just ended (FY10). That's why the 2010 number is even more negative. But those payments are supposed to stop, and this won't be a drain out of the Pension Fund.

Further, the County has begun to pay unfunded pension payments in addition to its normal yearly contributions. Both these will help eliminate this negative cash flow.

However, even though the County has very significantly cut its staff, almost all the pensions it owes in the next five years have already been earned by employees in the past. My model projects the amount of actual pension payments will continue to grow over the next 5 years as in the past. Recent cuts in County staff won't produce a significant immediate decline in the growth rate of pension payments.

On balance the model projects this negative cash flow will decline from a total of about $30 million over the past five years to $17.5 million in the next five years. That's progress, but it still increases total unfunded pensions.

5. Writing Off the Fake $9.6 Million Receivable

Mendocino's Retirement Association is organized under the 1937 County Employee Retirement Act. That Act states that every dime the County pays to MCERA is supposed to go into the Pension Fund until the County's required pension contribution that year is paid. The Retirement Association diverted over $6 million out of the County's contributions to the Pension Fund in 2004 through 2006 to pay Retiree Healthcare. This may have been a direct and major violation of the law - but I'm not a lawyer. [1]

In 2006 MCERA decided it needed to "pay the County back" but unfortunately it had already spent the money. The way it "paid the County back" was by giving the County full credit for pension contributions in those years and creating a $6 million "receivable asset" called "Actuarial Value of Unrecorded Earnings".

At the same time it needed more money to pay Retiree Healthcare. So it took an additional $3.6 million out of the Pension Fund and added that amount to the "Actuarial Value of Unrecorded Earnings" - thereby making the total in that receivable $9.6 million.

Receivables are legitimate assets IF someone really owes you something. So - what is "Actuarial Value of Unrecorded Earnings" and who owes it to MCERA?

Basically - this is an amount of money MCERA believed it would earn sometime in the future above and beyond its target return - aka "Excess Earnings". It is a claim against Excess Earnings if and when MCERA will ever earn them.

Based on my 30 years of education and experience in financial planning and management, I don't believe this satisfies the legal definition of an asset. I believe this $9.6 million asset on MCERA's books is - "air". It doesn't exist. You can't say that earnings you expect to earn in the future are an asset today - you haven't earned it yet.

The Retirement Board appears to have finally "woken up" to this reality and is going to "write off" this asset. That means they will take the asset off the books - and? - Reduce the value of the Pension Fund by that same amount. It's an asset that never existed.

When it does that I believe it will immediately increase the calculated value of unfunded pensions by $9.6 million. And, over the five year smoothing period this amount will be added into the amount the County will be legally obligated to make debt payments to eliminate.

But Retirement Administrator Jim Andersen has stated this $9.6 million was not used by the Actuary in calculating the value of unfunded pensions, and its "write off" will not affect unfunded pensions.

However, my examination of the Retirement Association's financial statements and Actuarial Valuations makes me think it will affect unfunded pensions. But at this point I can't say with certainty.

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[1] See my website (address below) for further information about this diversion of County contributions and the law.

The County's Budget Crisis Will Get Much Worse

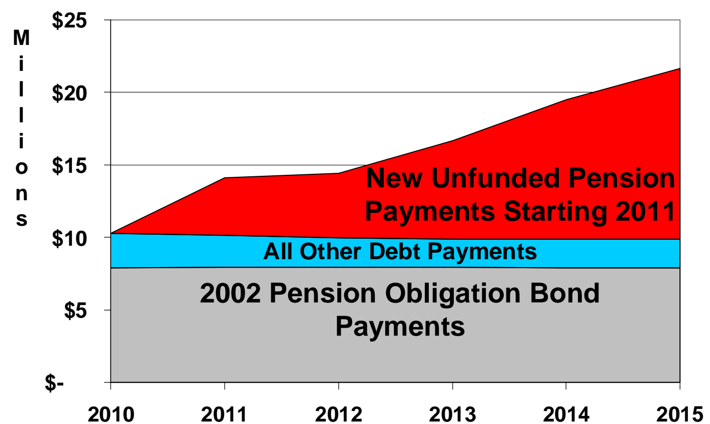
A year ago Mendocino County officials said they had a $7.5 million deficit they needed to eliminate. They eliminated hundreds of jobs and significantly cut salaries of those who remain.

Over the past year the County paid $8 million on its Pension Obligation Bond debt. If the County's pension funding plans had worked it wouldn't have owed a dime. And - there wouldn't have been a $7.5 million deficit.

Now County officials say they have to cut another $4 million out of its budget this year. Why? Because it is being forced to pay $4 million in new unfunded pension payments this year.

Almost every California County is struggling with various degrees of budget crises. It's notable that those with no debt are having the easiest time. Mendocino County's deficits that forced these cuts in jobs, salaries, and services are entirely caused by Mendocino County's unfunded pensions. If the Pension Fund had "worked" the way it was supposed to, there would not have been the deficit that forced cuts.

This graph shows my projection at this point of the County's debt payments over the next five years. I believe they will more than double from 2010.



I don't see any way further deep cuts can be avoided. They are going to get much worse.

As things stand today unfunded pension payments will probably increase another $8 million over the next five years. At some point the strain is so great you can't "bend" any more - something breaks.

What will it be?

I take no joy in this report. I wish this weren't happening, but it is.

The majority of our County's Board of Supervisors refuses to confront its real problem. In fact, I'm just about certain that no one in the County or Retirement Association has projected the County's debt payments out five years as I have in this report. They are running a $200 million County and a $400 million Pension Fund on a one year cash flow plan. They don't do any long-range financial planning other than what's implied in the Pension Fund's Actuarial Valuations - and the County has pretty much ignored the planning implications of that document.

I wish I could be hopeful - but I'm not. I think things are going to get a lot worse before they have a chance to get better. And I believe Mendocino County government in 2015 is going to look a lot different from what we have today.