Mendocino County's Bad News Just Got Much Worse
Pension Fund Payments to Double in Next Two Years
February 28, 2011

One Page Summary

In January 2011 the Mendocino County Employees Retirement Association's Actuary – Buck Consultants – admitted they made a very significant mistake in the Actuarial Valuations of Mendocino County's Pension Fund over the past decade or so. As a result the County's payments to the Fund will have to increase from $9 million this year to $13 million next year. Buck states this $4 million increase is a 30 year increase that will slowly increase – not just for one year.

Then, in February MCERA received an Actuarial Audit performed by EFI (another Actuary) on Buck's Valuation for 2009. Reformist Trustees on the Retirement Board demanded this Audit. EFI found that "the actuarial assumptions used by Buck are seriously flawed". EFI identified several errors beyond those admitted by Buck the month before and state they believe the County's payments to the Pension Fund need to increase by $8 million – nearly double.

MCERA is recommending the County's payments to the Pension Fund increase from $9 million to $13 million next year. MCERA will probably fire Buck and its new Actuary will perform the Valuation as of 6/30/11. If that confirms EFI's findings we can expect the County's payments to the Fund to increase to about $17 million the following year. And – this increase does not include several other factors that on their own will increase the County's payments to the Fund by about $5 million in the next 4 years or so. This steep increase in payments will force even further significant cuts in County staff.

The Stanislaus County Employees Retirement Association learned in December 2008 that Buck made exactly the same error re their Pension Fund as they made here in Mendocino County. Numerous press articles in 2009 reported on Buck's error in Stanislaus and the resulting very large increase in that County's payments to its Pension Fund. I found out about the Buck-Stanislaus problems in mid-late 2009.

I told two Mendocino County Supervisors about it in January 2010 – they had not heard of these problems before. One month later (2/2/10) I told the full County Board of Supervisors about Buck's problems in Stanislaus. Supervisor Kendall Smith told the audience that "Mendocino County doesn't have any flawed data relative to that earlier issue discovered in Stanislaus County". We now know Buck made precisely the same mistakes, and if EFI's analysis is correct Mendocino's payments to the Pension Fund will go about as much as Stanislaus County's did – about 90%.

Why did Supervisor Smith make an unequivocal statement that Buck had not made that error – when in fact it did? Why didn't other County Supervisors know about such a potentially damaging error – and yet one Supervisor (Smith) knew quite a bit of detail about it. As the Board of Supervisors' representative on the Retirement Board, wasn't it her duty to convey such a potential threat back to the full Board – and to make sure what she was reporting in the 2/2/10 meeting was correct?

Mendocino County's Bad News Just Got Much Worse

Pension Fund Payments to Double in Next Two Years

The people of Mendocino County got some pretty bad news in January and February 2011. It looks like the County's payments to its Pension Fund are going to increase from about $9 million this year to $17 million or more in two years – basically doubling in two years.

Our County is in a financial crisis – and that crisis just got a whole lot worse.

This report describes what happened, and tells the "story behind this story".

You can access all the documents discussed in this paper at my website www.YourPublicMoney.com, as well as considerably more information about our County's debt and the damage it's doing.

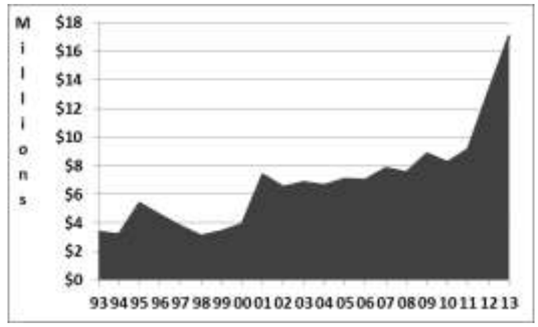


Figure 1-Historical and Projected (FY 12 & 13) Mendocino County Payments to its Pension Fund

I. The Bad News

A. <u>January 2011 – Buck Consulting Actuarial Valuation</u>

In its monthly meeting on January 19, 2011 the Retirement Board received the Actuarial Valuation for the last fiscal year that ended June 30, 2010. It was produced by their long-time Actuary – Buck Consultants.


Mendocino County
Employees' Retirement Association

Report on the
Actuarial Valuation
as of June 30, 2010

buckconsultants
1801 Century Park East, Suite 500
Los Angeles, CA 90067

Buck delivered some really bad news. On top of last year's $3 million increase, the County's payments to the Pension Fund are going to increase from $9 million to $13 million next year – a $4 million increase in one year.

They admitted they made two significant mistakes. The less costly mistake was in calculating how much the County had to pay last year in its first of 30 years of payments to eliminate the newly developed Pension Deficit. Turns out the County paid a lot less last year than it was supposed to – and this year's payments will go up about $550K to correct that mistake.

But they made a far bigger mistake probably over the past 10 years. Buck said this one error alone will cause the County's payments to the Pension Fund to increase $3.3 million next year – and that additional amount will continue to have to be paid for approximately 30 years.

If it hadn't been for several staff cost cuts – including a voluntary 10% pay cut for deputy sheriffs – the County's Pension Fund payments would have increased nearly $5 ½ million – the staff cost cuts reduced the increase by about $1.2 million.

B. **Buck's Big Mistake**

Sometimes employees leave the County's workforce before they're old enough to receive a County pension – but they've satisfied the requirements to receive a pension when they reach the threshold age. This can happen for many reasons such as taking another job.

Such an individual has a choice to make. They can …

- **Withdrawal**: Withdraw the balance in their individual member contribution account.
- **Vested Termination**: Leave the money in their account and wait until they are old enough at which time they will begin to receive a pension.

Buck assumed for years that people in this position make their decision solely based on how old they are. They assumed the younger people are - the more likely they are to take their money with them when they leave.

But that's not how it really works. The decision is not based simply on age – the number of years someone has worked for the County is more important in their decision. Once they are "vested" – that is they have satisfied the requirements to receive a pension with the sole exception of not yet being old enough – if they wait to receive a pension their pension will be paid not only out of the money in their individual pension account – but also from the amounts the County has paid into the Pension Fund.

In other words – if a person with this decision to make takes their money and runs – they are giving up their claim to receive any of the money the County has contributed to the Pension Fund. It turns out the more a person stands to receive in a pension in the future, the more likely they are to leave their money in no matter their age when the leave the County's employment.

Now – from the County's point of view – it almost always costs a lot less if these people take their money and run – because that means the County no longer has an obligation to pay anything toward their pension. It almost always costs the County more if they leave their money and wait until they're old enough to receive a pension.

Buck very seriously overestimated the number of people who would withdraw their contributions in this situation. And therefore they seriously underestimated how much the County's future pension payments were really going to be. And that means they seriously underestimated what the County's unfunded pension deficit is that they have to eliminate.

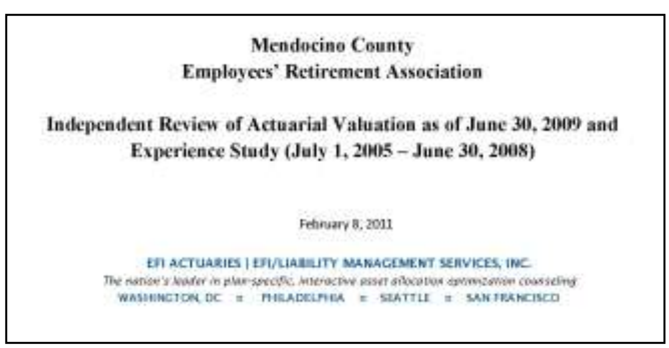
Buck's recognition of that error means our County has to start paying $3.3 million more for the next 30 years starting year next year.

And that's Buck's big mistake.

That was the bad news in January. Then in February the second bomb dropped.

C. **February 2011 – EFI Actuarial Audit of Buck Consulting's Valuation**

In its February 16, 2011 meeting the Retirement Board received what's called an "Actuarial Audit" of Buck's work produced by another actuary - EFI. Actuarial Audits aren't financial or forensic audits that look at how the Pension Fund's money has been managed. They are only about the Actuary's calculations in Valuations. This audit was produced by a different Actuary – called EFI. Reformist Retirement Directors demanded this audit.


Mendocino County
Employees' Retirement Association

Independent Review of Actuarial Valuation as of June 30, 2009 and Experience Study (July 1, 2005 – June 30, 2008)

February 8, 2011

EFI ACTUARIES | EFI/LIABILITY MANAGEMENT SERVICES, INC.
The nation's leader in plan-specific, interactive asset allocation optimization counseling
WASHINGTON, DC ▪ PHILADELPHIA ▪ SEATTLE ▪ SAN FRANCISCO

EFI audited Buck's 2009 Valuation – not the 2010 Valuation that was provided to the Retirement Board in January.

Here's a quote from the Audit's Executive Summary:

> *The actuarial assumptions used by Buck are seriously flawed.*
>
> *We encountered a number of demographic assumptions used by the current Actuary that are unreasonable and fall outside the range of generally accepted actuarial principles.*

The audit has a list of seven problems with Buck's work – all of which require the County to increase its payments to the Pension Fund.

Actuaries state the amount the County must pay to the Pension Fund in two ways – as an absolute dollar amount and as a percent of total payroll. What really happens is the County uses the percent of payroll to calculate for each payroll period the amount it needs to pay to the Pension Fund. Since the actual yearly payroll never – as a practical matter – turns out to be exactly the number the Actuary assumed, the actual dollar amount of the County's payments to the Fund will always vary from the value reported in the Valuation – but the percentage should be the same.

In its 2009 Valuation Buck recommended the County should pay 13.25% of its payroll into the Pension Fund. What EFI is saying above is that if all 7 of its recommendations are adopted, the actual percentage should have been 11.2% higher – or 24.45%. The dollar amount of the County's payments projected by Buck was $9.57 million. EFI is saying it should have been $17.66 million.

Further, Buck reported that the "Funded Ratio" of the County's Pension Fund was 83.4% as of June 30, 2009.[1] EFI is saying in its Audit that the ratio should have been 9.2% less – or 74.2%. That would have meant that instead of the $336.3 million reported by Buck as the Pension Fund's "Actuarial Value of Assets", EFI believes it should have been $299.2 million, $37 million less. And that means EFI believed the "Actuarial" value of unfunded pensions was really $103 million instead of the $67 million reported by Buck.

Buck had already fessed up to the "Withdrawal" v. "Leaving the Money In" error described above. The "corrections" of that problem is already included in next year's $4 million increase.

But those five other problems identified by EFI beyond what Buck admitted would increase the County's pension payments another $4 million on top of Buck's $4 million. So – the audit turned Buck's $4 million increase into about $8 million. And that produces the graph shown Figure 11on page 1.

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[1] This is based on the "Actuarial Value of Assets" and the resulting "Unfunded Actuarially Accrued Liability". This is not based on the real market value of the Pension Fund's investments. The "real market value" of the Funded Ratio was 67%. Very simply put – the "Actuarial Value" is based on a five year "moving average" of the Pension Fund's investment returns. The effect is to "slow down" changes in the total asset value used in Actuarial Valuations. The purpose is to prevent sudden precipitous increases in the employer's unfunded pension amortization payments. That is an understandable and reasonable goal. However, all too often people badly misinterpret what the Actuarial Value of Assets is – they talk as though that is the real value of assets in the Pension Fund. It isn't – and this confusion causes a lot of problems. See my report *How Pension Funds Work* at http://yourpublicmoney.com/data/data.shtml for a more complete explanation – scroll down the left side of the page.

D. <u>What Will Probably Happen</u>

Now what? The Retirement Board is recommending the County just increase its payments $4 million next year. It's a pretty safe bet Buck is going to get fired and a new Actuary will produce the next Valuation for June 2011. The Retirement Board will wait for <u>that</u> Valuation to see if it confirms the other problems identified in the audit. If it does – it's likely the County's payments will increase another $4 million – or more – two years from now. And that doesn't take into account other pressures that are likely to add a million or two to payments two years from now.

II. The Impact of Doubling Pension Fund Payments

Over the past 2 years our County cut about 350 jobs to eliminate $8 million of budget deficits.

Where's our County going to come up with another $8 million over the next two years? Barring a miracle it's going to have to come from the same place – more staffing cuts.

How far can the County cut staff before whole functions disappear? I fear we're going to find out.

Taxpayers will pay over a half billion dollars in the next 30 years to pay the County's debt – almost all of which is unfunded pensions - and get nothing in return. Many County services will no longer be provided. Hundreds of County employees will lose their jobs.

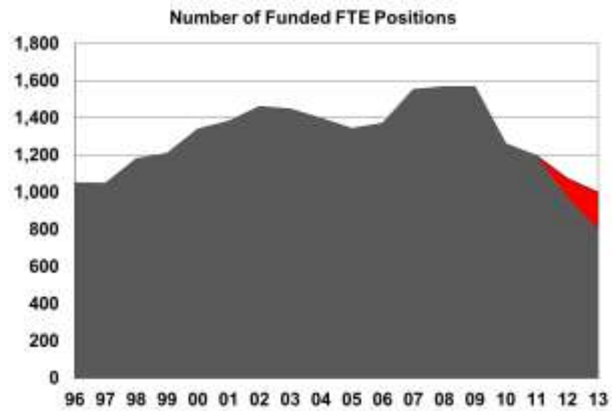

Figure 2 – Full Time Equivalent Funded Jobs County Budgets – FY12-13 Projected

III. The Story Behind the Story

A. <u>Stanislaus County</u>

Let me tell you a story about Stanislaus County.

All California Counties provide pensions. Most counties are members of "CalPERS" – the California Public Employee Retirement System. CalPERS is huge – one of the largest retirement systems in the world. It serves 1.6 million public employees and retirees from over 3000 public employers.

However, 21 California Counties elected to not participate in CalPERS but have their own separate "independent" retirement systems. Twenty of these are organized under the "1937 County Employees Retirement Act". These 20 independent retirement systems form the "State Association of County Retirement Systems" – known as "SACRS".

Mendocino County is the smallest of the 21 non-CalPERS counties. Stanislaus County is another of the 20 members of SACRS. Stanislaus also has an independent Pension Fund separate from CalPERS - the Stanislaus County Employees Retirement Association – or "Stan-Sarah".

Both Mendocino and Stanislaus' Retirement Associations are members of SACRS.

I track news from around the state and country about local government debt – especially related to unfunded retirement benefits. By fall of 2009 I had learned about a big problem in Stanislaus County's Pension Fund related to Buck Consultants. That really caught my attention – Buck has been the Actuary for Mendocino County's Pension Fund for over a decade.

I first found out about this from many reports in Stanislaus County's main newspaper – the Modesto Bee – during 2009.

> **3/11/09- County Pension Generates Tension**: "an actuarial firm audited the pension plan's past payout assumptions and found them flawed … The County's contribution to the pension fund would increase by 70 to 90 percent if the estimates are accurate."
>
> **4/8/09 - Stanislaus May Suspend Retirees' "Ad Hoc" Benefits**: "Actuaries said Wednesday the system is being 'eaten by two tigers', the second being the faulty assumptions made by the board's previous actuarial firm, Buck Consultants. According to the new Actuaries, Buck Consultants overstated the number of employees who will cash out benefits when they reach retirement eligibility. Veteran employees are much less likely to opt for lump sum payments today."
>
> **4/9/09 – County Retirees – Look at the Big Picture (Editorial)**: "We've known since December (2008) that serious long-term funding problems loom for the Stanislaus County Employee Retirement Association because of bad assumptions by its former actuarial firm."
>
> **12/24/09 – Retirees Challenge StanCERA over $60 Million Reserve Shift**: "RESCO (Retired Employees of Stanislaus Counties – an association of retirees – not StanCERA) also is suing StanCERA's previous actuaries, Buck Consultants. The lawsuit charges that the firm's faulty projections about the number of employees who will draw benefits from StanCERA resulted in a shortfall of employer contributions to the fund in recent years."

You can access these articles at www.YourPublicMoney.com.

B. Two Supervisors Didn't Know

I met individually with County Supervisors McCowen and Brown in January 2010. I asked each if they had heard anything about these problems with Buck in Stanislaus County. They said they never heard about these problems until I told them in those meetings.

C. February 2, 2010 Board of Supervisors Meeting

The next month I attended the February 2, 2010 meeting of the Mendocino County Board of Supervisors. Three financial professionals had formed a "Peer Review Group" who had reviewed my analysis and conclusions about the County's debt. Two were giving their conclusions to the Board. They concluded – basically – that my financial data was solid, my financial analysis was accurate, and my financial conclusions were compelling. (You can see a video of their report and Supervisor's reactions in the "Data-Video" section of www.YourPublicMoney.com.")

I addressed the Board in public comment about their review. But I switched subjects at the end of my statement. This is transcribed from a video made of the meeting by Ukiah Valley Community TV. You can see excerpts of the video on the home page of www.YourPublicMoney.com. (It will be moved to the "Data-Video" section a month or two after this report is released.)

There's another thing that I really want to bring to your attention. I have a feeling that this Board (of Supervisors) has not heard this story.

I have … copies of articles from the Modesto Bee *and I think this is something that I really think you need to look at. …*

Basically the County of Stanislaus, the County Pension Fund, the "Retired Employees" (RESCO) of Stanislaus County, the Actuary that was hired by the Pension Fund to review Buck Consulting's work, and the replacement of Buck Consulting (the Actuarial firm hired by StanCERA after they "fired" Buck) all say that Buck Consulting's flawed Actuarial studies is going to force an increase in the County's pension payments of 60% (sic – it was 70%) to 90% a year.

And they are being sued by the "Retired Employees" of Stanislaus County in Federal Court in Fresno for damages. I don't know the truth of that … is that real or not. But I know for instance that Harold Loeb (the lead Actuary for Buck who dealt with both Stanislaus and Mendocino County) has come here and presented to you many times is a co-defendant and the damages are $40 million that are being assessed against him by the retirees because of the damage done to their Pension Fund.

This is such a huge issue – you have *to find out what's going on with that. That's the guy that's been the Actuary here for 15 years.*

And the second thing that you really need as a Board … I don't think you knew about this. It's been going on for 16 months. You should have known this. Staff should have told you – somebody should have told you about this, and I don't think you've heard about it.

Think about what the impact would be if your payments (to the Pension Fund) went up 60% to 90% on pensions and that's what they're saying in Stanislaus happened.

There was quite a bit of reaction from County Supervisors to the presentations made by the members of the "Peer Review Group" – you can see this very interesting exchange between various Supervisors and one member of the Peer Group – Ted Stephens (who is now on the Retirement Board) – on the video about the Peer Review Group available at the page of my website mentioned above.

Towards the end of Supervisor comments Supervisor Kendall Smith from Fort Bragg spoke about what I had said. Supervisor Smith has been the Board of Supervisors' representative on the Retirement Board for at least 6 years. This is transcribed from her comments recorded on the video.

My other preliminary information about Buck Consultants is it's a huge corporation that has international offices. When the San Francisco office was consolidated into the LA office it's true there were some actuarial accounting mechanisms that were discovered that were not accurate or orchestrated. They were thoroughly reviewed, they went back retrospectively and looked how those would apply to other counties – and they looked specifically at Mendocino County. And specifically what they found … the same type of actuarial missteps that were formula based did not have much impact on Mendocino County's final numbers.

They looked at that in the last two Actuarial Reports. … Mendocino County doesn't have any flawed data relative to that earlier issue discovered in Stanislaus County.

It seems to me that Supervisor Smith made a very definitive statement that Buck Consultants had NOT made the same mistakes in Mendocino County as they made in Stanislaus County.

And now – a year later – we know that Buck Consulting made exactly the same mistakes in Mendocino County they made in Stanislaus – and indeed in at least one other County we now know about – Merced.

D. <u>Supervisor Smith and the Duty of County Officials</u>

The problems in Stanislaus emerged very publicly in mid-late 2008. Mendocino, Stanislaus and Merced Counties are members of the State Association of County Retirement Systems. Our County and Retirement officials have attended several meetings of that organization with reps from those other 2 counties every year. The main thing people do at those meetings – as is true of most such gatherings - is talk over drinks in the bar. Our officials never heard about any of this?

The Modesto Bee published a dozen articles in 2009 about the problems with Buck. No County or Retirement official ever caught wind of that?

Supervisors Brown and McCowen said in January 2010 they had not heard of the problems with Buck in Stanislaus County until I told them that month. Supervisor Smith's "defense" of Buck was quite detailed – it's clear she had heard about the problems with Buck in some detail.

Why didn't Supervisor Smith tell her fellow County Supervisors about this? Clearly the issues in Stanislaus were very serious involving huge sums of money. If the same thing had happened in Mendocino County (as we now know did) it would really hurt.

And – although I can't with certainty, I do pay attention to the Retirement Board and watch their meetings on Ukiah Valley Community TV video. I don't believe the Retirement Board ever discussed the problems in Stanislaus (although – again – even though I pay close attention I can't say with absolute certainty.)

This is not a trivial matter. Our County's payments to the Pension Fund are almost certainly going to double over the next 2 years – and I believe they will probably triple over the next 5. This will cause further extensive financial damage to our County.

Kendall Smith cares deeply about our County. She's often put forward many absolutely needed changes in our County's financial management – such as long term financial planning.

But she has been our Board of Supervisors' representative on the Retirement Board for 6 or 7 years now. Actions of the Retirement Association and the lack of understanding and diligence by the County Board of Supervisors over the past 15 years directly created hundreds of millions of dollars of debt that is today grinding our County's ability to meet its public duty into dust.

There's a higher standard our County's officials should be held to. They must demand of themselves that they learn what the truth really is – not just what their political friends assure them it is - no matter how unpleasant it may be. And they have to tell the people the truth no matter where the chips may fall.