# Two Huge Financial Threats to the County of Mendocino - Next Five Years
## Two Page Brief – April 5, 2011

Mendocino County's Pension Fund was supposed to have $435 million on 6/30/10. But it was short $135 million – the County has to pay extra to eliminate this deficit. And the County still owed $85 million on money it borrowed in 1996 and 2002 by selling Pension Bonds to eliminate previous pension deficits. If the pension funding plan had worked the County wouldn't owe a dime. Instead the County owes $220 million. The County's **pension funding plan** achieved **less than half its funding goals** over the past **20 years**.

Our County is being ground between a rock it mostly didn't create – the bad economy – and a hard place it mostly did – this debt created by its failure to properly fund pensions. This paper describes the **two very specific threats** in this situation that could push our County **into insolvency within 5 years**.

### Threat 1 - Doubling of County Debt Payments – Three to Four Years

Seven specific factors will produce this result. Of these three are "built into" the math of Pension Funds.

First is "**smoothing**". The Pension Fund was $135 million below its target investment returns in 2008 and 2009. If that entire shortfall had been included in calculating the County's required pension deficit elimination payments in 2010 the County's payments to the Pension Fund would have gone from $8 million to $16 million in one year. The process called "Smoothing" spreads that increase out over 5 years. That means the County's pension deficit payments will increase that much over five years.

Second, the Pension Fund's target rate of return (8%) is also an **interest rate** applied to the pension deficit every year. That increases the deficit each year, which in turns increases the County unfunded pension deficit payments each year. So that magnifies the increase caused by "smoothing".

Third, the County had to choose one of two methods to calculate how much the yearly pension deficit payments would be over the next 30 years. It chose the "**Level Percent of Payroll**" method. Without going into the details that method starts out with low payments. Then **payments slowly triple over 30 years**. So that method itself causes payments to increase each year – on top of the two factors above. In fact the beginning payments are so low they don't even start to pay each year's interest expense for 12 years. Then it takes another 8 years just to pay off the interest that wasn't paid in those first 12 years. That means the County won't start to actually pay today's debt of until 20 years from now!

The other four factors are unique to the Mendocino County Employees Retirement Association. By far the most significant is the **Pension Fund's Actuary** – **Buck Consultants** – admitted in January 2011 they had been making a very **big calculation error for years** – and as a result the County **Pension Fund payments** need to **increase $3.3 million** in each of the **next 29 years** to make up for it. The next month another Actuary (EFI) presented what's called an "**Actuarial Audit**" – an evaluation of Buck's calculations. EFI said the County's payments needed to increase **$8 million a year**. This is huge.

In addition the **calculation** of the **first year County pension deficit payment** was **deeply flawed**. It understated the County's required unfunded pension payments. **Payments have to significantly increase** to correct that error. Also, the Retirement Association's pension payments and operating expenses have been significantly more than County and employee pension contributions some time. That "**negative operating cash flow**" increases the Pension Fund's deficit, and that increases the County's pension deficit payments. Finally the Retirement Association **"wrote off" a $9.6 million "receivable" as bad debt**. I think that was a "**fake asset**"; I'm highly concerned about several legal aspects related to this write off. Retirement Association officials say that write off won't affect future County pension deficit payments – I'm not convinced. We'll see.

## Threat 2 - Huge Increases in Reported Pension Expense and Debt

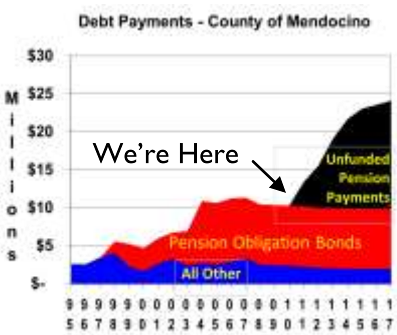
The Governmental Accounting Standards Board (**GASB**) intends to impose **huge changes** on pension financial reporting within five years. Their current standards have a **fatal flaw**. They allow state and local governments to **report pension expenses** related to **unfunded pension** deficits as an expense of the future - when the pension deficit debt is paid. But they aren't **- they're expenses of the past**. Government employees earn their pensions while they're working even though they don't receive them until after they retire. When they retire they have completely earned their pensions. **The true economic pension expense always happens before employees retire** - **never when they receive their pension payments - that is a payment of a debt**.

The biggest "shock" I've had in 5 years of digging into our County's debt was when I suddenly realized **Mendocino County** honest-to-God incurred **hundreds of millions of dollars of past retirement expenses** it **never reported to the people**. GASB intends to stop governments from getting away with that.

Today unfunded pensions are not actually reported as debt. They're just listed in a footnote. **GASB** would force them to be **reported directly as liabilities**. Other reforms will force the value of the debt to be **much higher than reported today**.

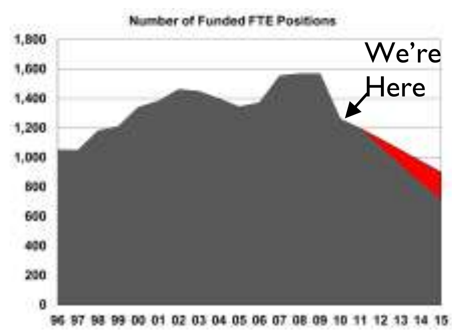
Mendocino County will also be forced to report **much higher pension expenses**. Instead of spreading pension expenses related to unfunded pension deficits over 30 years, the County will have only 12 to 15 years. The amount of pension expenses that can be shoved into the future will be hugely reduced. This will cause large reported pension expenses the year the new requirements go into effect. The County will also have to report the full interest expense related to pension deficits each year – not just the part it pays. Several other changes will also increase the County's reported pension expenses.

## The Impact of These Two Threats




Two-thirds of the County's expenses are payroll and benefits. Budget cuts necessarily mean staff cuts. The County **has already cut about 350 staff positions** – nearly a quarter. **About that many** are likely to be cut in the **next 3 years** solely because of increased debt payments.

What would be the additional impact in 2015 of the new GASB rules?




If GASB's concepts are imposed as currently stated, reported yearly pension expenses would increase from $20 million to about $65 million a year and a one-time extraordinary pension expense of around $35 million would be reported. The County's long-term debt would increase from about $190 million to closer to $500 million.

Our County receives most of its property tax income in two months – December and April. There are no cash reserves to carry it over the summer and fall. It relies on short term "working capital" loans to make it through. Such a huge jump in reported expenses and debt combined with further deterioration of cash caused by increased debt payments would seriously threaten the County's ability to continue to obtain these loans.

If the County could no longer borrow these short-term operating loans, payroll would be weeks late – maybe months. Then what?

And - It would be practically impossible for the County to report that it is satisfying the requirement of the State Constitution to operate with a balanced budget. Then what?

These two specific threats are likely to drive Mendocino County into insolvency within five years.

YourPublicMoney.Com ♦ PO Box 301 ♦ Redwood Valley, CA 95470
info@ YourPublicMoney.Com (707) 485-0702