The Reform our County Coalition in Mendocino County published a report by John G Dickerson (me) titled *Questions about Mendocino County's Unfunded Pension Debt and Analysis of that Debt* on 4/17/14. The report is briefly described below.

A few weeks later Mendocino County Supervisor John McCowen – also a member of the Mendocino County Employees Retirement Association Retirement Board – wrote this response to my paper.

I sent a reply to McCowen's response on 5/22/14 to Supervisor John McCowen, the Retirement Board and County Board of Supervisors. My comments are in blue below interspersed among McCowen's response.

To: Mendocino County Board of Retirement
From: Board of Retirement Member John McCowen
RE: Response to "Citizen's Letter" dated April 22, 2014

Background: John G. Dickerson has authored a report titled *Questions About Mendocino County's Unfunded Pension Debt and Analysis of That Debt* dated April 17, 2014 and issued under the banner of "Reform Our County Coalition" (ROCC). A seven page summary of the report is included in today's agenda packet. The report poses a series of questions related to the Mendocino County public employees retirement system and Mr. Dickerson's analysis of that system, particularly as it relates to the unfunded pension obligation. Mr. Dickerson has also distributed a "Citizen's Letter" dated April 22, 2014 that is addressed to County and Retirement Association officials and "Major Mendocino County Bargaining Units." The letter requests that the recipients confirm or disprove the analysis and conclusions and answer the questions contained in the report.

I have reviewed Mr. Dickerson's latest report in detail and the questions he poses. I appreciate the work that Mr. Dickerson has done to raise public awareness regarding public employee pension systems and the unfunded pension obligation associated with them. There is no question that the unfunded pension obligation poses a critical challenge for Mendocino County, the Mendocino County Employees Retirement Association (MCERA), and their governing bodies, the Board of Supervisors (BOS) and the Board of Retirement (BOR). The struggle to fully fund the pension obligation, balanced against the continuing need to provide critical public services, is the greatest challenge facing most public employers and their retirement systems, and this is no less true in Mendocino County.

John D in blue: It's very good to see this communicated to the people – and to employees and retirees. However, once again, the debt is a symptom of the underlying disease – it's too high, it's dangerous, it must be brought down. But it didn't cause itself. And until it's clear what caused it and institutional mechanisms are put in place to prevent the causes from creating more debt we remain vulnerable to history repeating itself.

The BOR and MCERA staff have a fiduciary responsibility to manage the assets of the retirement system for the benefit of current and future beneficiaries of the system. As a result, the BOR is required by law to engage professional investment advisors and actuaries to assist in evaluating how best to invest the assets and evaluate the soundness of the plan and its underlying assumptions. MCERA currently contracts with two nationally respected firms, Callan Associates Inc., for investment analysis services and Segal Consulting for actuarial analysis. The investment of time and the high level of interest by concerned citizens is appreciated but the decisions of the BOR must guided by the recommendations of qualified investment and actuarial professionals.

As long as:

1. the County provides the current form of defined pension benefits
2. the funding mechanisms remain the same (County and employees split Normal Contribution – only County pays to eliminate unfunded pension debt)
3. Six of the 9 retirement directors are employees and retirees (including 2 elected County officials)
4. A profound lack of accountability continues within the County and Retirement structure, and of the County by the People continues …

… the perverse incentive that drove the creation of our County's unfunded pension debt will continue to create more debt.

Who hires the professionals? I assume the Retirement Administrator recommends contracting with them and the Retirement Board approves entering into a contract. My observations of County Pension Funds all over California has led me to conclude that for the most part (not all – but most) Retirement Boards hire professionals who tell them what they want to hear in order to allow employees to pay less than they should, retirees to get more than they paid for, county officials to have more money to spend on salaries next year – all paid for by increasing county debt imposed on the People – both as taxpayers and also as users of county services and roads.

Until that perverse incentive is destroyed and competent accountable governance of retirement systems is implemented – we will continue to have more debt created.

Unfortunately, for the reasons stated below, it is my conclusion that Mr. Dickerson's report lacks credibility. Therefore, rather than ask staff to "confirm or disprove [the report's] analysis and conclusions," I suggest an appropriate response is to thank and acknowledge the ROCC and the "Concerned Citizens of Mendocino County" for their interest and concern. They should be encouraged to stay involved in the process and be directed to the wealth of accurate information which is available. I suggest a good starting point is *Pensions 101: A Primer on the Mendocino County Retirement System* which relies on verifiable data and factual information, and which was presented to the BOS on April 22, 2014 by the Mendocino County Executive Office. A wealth of information is also available on the MCERA website.

Partial list of concerns regarding *Questions About Mendocino County's Unfunded Pension Debt and Analysis of That Debt:*

1.) The report appears to be based on the false premise that there is something uniquely "wrong" in Mendocino County that must be "fixed". In fact, the problems associated with Mendocino County's retirement system and its unfunded pension obligation are substantially similar to the problems facing other public employee retirement systems in California and nationwide. Significant issues are posed by an ageing workforce and an increasing ratio of retirees to current employees. Effort needs to be devoted to understanding the future trajectory of the retirement obligation, its magnitude, duration, funding and other issues to ensure the requisite information is available to support intelligent decisions that create balance between the needs of the County's workforce and retirees and the need to provide public services.

I've just re-read my analysis. Where does it say I believe there is something "uniquely wrong" in Mendocino County? Where does it even imply that?

Now - My observation is the behavior of past county and retirement officials in Mendocino County was – in fact – worse than in most – but not all other places I've learned enough about to make that comparison. However, I don't have the complete range of information I'd need to place super high confidence in that impression. The great preponderance of evidence in my view indicates that's true – but there's enough I don't know to prevent me from saying I'm absolutely firmly convinced of it.

It's clear to me there are deep <u>systemic</u> flaws in how government pension benefits are structured in California at both the state and local levels. Those systemic flaws must be "fixed" – and that isn't "only" a Mendocino County problem.

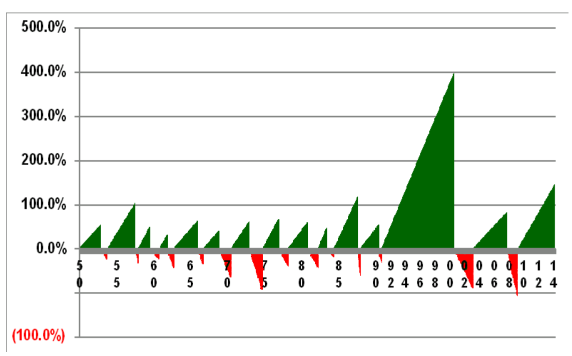
There are some counties – Tulare apparently being the best example – where the Pension Fund has been managed rather well and the levels of unfunded pension debt seen elsewhere have not developed. Interesting – same County Employee Retirement Law, therefore same structure of the Retirement Board, same investments available to both – yet Tulare is in pretty good shape and most others aren't.
Those exceptions to the rule appear to be driven by one or a small number of individuals who refused to go down the slippery slope the <u>system</u> in place in County Pension Funds creates that led to massive public debt. They refused to do what everyone else was doing – create massive unfunded pension debt – because of their internal standards about they considered to be their duty.

It would be very instructive to compare the actions in Tulare to others including Mendocino. I'm quite confident the failings in Mendocino and elsewhere would be obvious in comparison.

Yes – there are huge challenges built into the aging work force, etc. Some government officials may be more and more realizing the difficulties created by these demographic trends – but actuaries have known about them for decades. They are supposed to incorporate those long-term trends into their funding plan – that's fundamental to their profession. But again – who signs their checks and what are their motivations that determine who they write the check to? It would be utterly disingenuous for actuaries to say they are surprised by how much longer people are living.

2.) The report largely ignores the impact of the financial collapse of 2008, which was the greatest economic downturn since the Great Depression. RVKuhns & Associates, Inc. (based on Bloomberg Professional Service and Federal Reserve Economic Data) has calculated that the five lowest calendar year returns for the Standard and Poor's 500 index, from 1976 to the present are, in order, 2008, 2002, 2001, 2000, and 1977.

This shows the bull and bear stock markets since WWII as reflected in the S&P 500 broad stock market index. The length of the base of the triangles is how long the bull or bear market lasted. The height of the bull markets in green and depth of bear markets in red shows how much the market changed from the beginning of the bull or bear.




Yes – the Great Recession was terrible. But it's not the most remarkable aspect of this graph. The decade long bull market in the '90's was the longest and strongest bull stock market in American history. Some very bad habits developed in the public pension world. CalPERS successfully lobbied the legislature to pass SB400 in 1999 that gave significant pension increases to the Highway Patrol and made them retroactive. That was just before the peak. SB400 started a cascade of similar pension increases that were also retroactive for "safety" employees all across the state. But by the time Mendocino County granted those increases the Dot Com bubble had burst and the early 2000's recession was in force. But the County went ahead and gave those increases anyway.

Mendocino County retirement officials often said that "80%" funding was a "good – adequate" funding level. Now – this wasn't unique to our County – government retirement officials all over the country repeated this "myth". I say "myth" because – first, it's financially absurd, and second, because (in my experience) the best analyst about "all this" is Girard Miller who published an article 1/5/12 titled Pension Puffery (see page . This is an excerpt:

> *One of my pet peeves in the ongoing debates over public pension reform is the way partisans on each side try to pitch half-truths and myths to support their arguments. The other side seldom believes any of these, but they help rally the allies on the speaker's side. Sometimes the press naively re-circulates these fallacies, which leaves the general public even more confused about what to believe. There's an old saying in politics that if you tell the same lie long enough, the public will eventually believe it — and that apparently is the mentality of lobbyists on both sides. In an effort to start the new year with a clean slate for public debate, I'd like to set the record straight on a dozen of the most glaring fallacies and silly slogans.*
>
> *...*
>
> *Half-truth #4: "Experts consider 80 percent to be a healthy funding level for a public pension fund."*
>
> *This urban legend has now invaded the popular press, so it's about time somebody set the record straight. No panel of experts ever made such a pronouncement. No reputable and objective expert that I can find has ever been quoted as saying this.*
>
> *... Like UFOs, these "experts" are always unidentified. That's because they don't actually exist. They can't exist, because the pension math and 80 years of data from capital markets history just don't support these unsubstantiated claims.*
>
> *With only one rare and fleeting exception (which occurs at the very bottom of a business cycle, similar to the green flash in a tropical sunset), 80 percent funding is not a sufficient, sound or healthy funding level for a pension fund.*
>
> *... a fully funded pension plan must today have market-value assets of 125 percent of current accrued actuarial liabilities near the peak of an average business cycle — in order to offset the near-certain loss of stock market values in the following recession.*

The reason the Great Recession was so hard on the County's Pension Fund is largely (not only) because of the "myth" that 80% funding was good. There will always be another recession. A well-run pension fund should be overfunded at the peak of investment values – say 125% - and perhaps below at the bottom of market cycles – maybe 80%. But if a pension fund doesn't average 100% funding it is imposing debt – period.

It isn't rocket science to know the County pension fund should have built up a surplus during the extraordinary '90's bull market. But it's as if County and Retirement officials thought the good times would go on forever.

There's always another recession – it's just a question of when.

3.) The report appears to be based on the belief that Mendocino County and the BOS, and MCERA and the BOR, are unaware of the nature and extent of the pension obligation problem and have done nothing to address it. In fact, both the BOS and BOR have taken significant steps to address pension related issues and to improve overall financial stability and accountability.

Actions taken by the BOR include the following: hiring the first full time administrator for MCERA; hiring a new investment advisor, a new auditor and a new actuary; conducting an experience study and reducing the assumed rate of return to 7.75%; hiring EFI to audit the work of the prior actuary, resulting in a settlement in MCERA's favor; reform of the excess earnings policy to provide that excess earnings may only be declared if the retirement plan is 100% funded; engaging in a Voluntary Correction Program with the Internal Revenue Service which has cleared the way for reauthorization of the tax exempt status for the retirement plan and employee retirement benefits; requiring that future unfunded liability be amortized over 18 years; video recording and televising of all BOR meetings; posting meeting agendas, background materials and other relevant financial materials to the MCERA website. Additionally, the MCERA Comprehensive Annual Financial Report (CAFR) received the Government Financial Officers Award of Excellence for fiscal years 2011/12 and 2012/13.

To reorganize this list of Retirement Board actions and comment:

> *hiring the first full time administrator for MCERA; hiring a new investment advisor, a new auditor and a new actuary; requiring that future unfunded liability be amortized over 18 years; video recording and televising of all BOR meetings; posting meeting agendas, background materials and other relevant financial materials to the MCERA website. Additionally, the MCERA Comprehensive Annual Financial Report (CAFR) received the Government Financial Officers Award of Excellence for fiscal years 2011/12 and 2012/13.*

These are indeed good things – although more fundamentally I really question if Mendocino County is large enough to be able to properly support an independent pension fund and hold it accountable.

> *hiring EFI to audit the work of the prior actuary, resulting in a settlement in MCERA's favor; engaging in a Voluntary Correction Program with the Internal Revenue Service which has cleared the way for reauthorization of the tax exempt status for the retirement plan and employee retirement benefits;*

These are ambiguous. I was impressed with EFI in many ways. But I strongly sense the damage done by Buck Consultants was much greater than the settlement. I'm disappointed by the results of the IRS VCP – more below.

> *conducting an experience study and reducing the assumed rate of return to 7.75%; reform of the excess earnings policy to provide that excess earnings may only be declared if the retirement plan is 100% funded;*

I can't count these as good actions.

As long as only the County – and through the County its residents and taxpayers – must pay unfunded pension debt, that costs much more than if the proper Normal Contribution had been paid, then the rate should be much lower to make sure unfunded pension debt doesn't develop. We all know the investment advisors have reported their best judgment is there is a 50-50 chance of the "optimal portfolio" earning 6.6%. Even then that means there's a 50% chance of creating more debt only the county has to pay.

It would be different if employees and retirees agreed to split the payments to eliminate unfunded pension debt and not to balance that with increases in pensions and/or salaries. But as long as only the county must pay – then the rate should really be BELOW the 50-50 rate to make it less than 50-50 that more debt will be created.

The 7.75% assumed rate is utterly indefensible from the public's point of view.

The idea that "Excess Earnings" would be withdrawn from the pension fund under <u>any</u> circumstances is reprehensible. See the discussion about the "80% myth" above.

Further – after having hundreds of millions of unfunded pension debt payments imposed on the people – for which they don't receive any services or filled potholes – if the pension fund actually earned more than its return the "excess earnings" should be either retained to reduce the unfunded pension debt faster or the County's payments should be reduced in favor of fixing roads.

A stake should be driven through the heart of "Excess Earnings". <u>Every</u> private sector financial professional I've shown this to believes there really is no such thing as "Excess Earnings" unless perhaps the fund approaches, say, 150% funding. And even then – as long as the pension is a "defined benefit" then those excess earnings should be retained to protect the people from unfunded pension debt in the future.

Actions taken by the BOS include the following: significant reductions in workforce; significant reductions in employee compensation; successfully negotiating with all County bargaining groups the right to adopt new retirement tiers for new employees (superseded by PEPRA prior to implementation); adoption of new retirement tiers for all new employees beginning January 1, 2013 as authorized by PEPRA; decision to adopt a zero COLA for new employees beginning January 1, 2013 as authorized by PEPRA. Although the County's discretionary revenue has remained flat since 2008 while costs have escalated, by prudent use of one time revenues and constantly achieving greater operational efficiencies, the County has been able to meet the increased costs while simultaneously paying down debt and building a reserve fund.

To reorganize this list of County Board of Supervisors actions and comment:

> *Although the County's discretionary revenue has remained flat since 2008 while costs have escalated, by prudent use of one time revenues and constantly achieving greater operational efficiencies, the County has been able to meet the increased costs while simultaneously paying down debt and building a reserve fund.*

This is very good – very commendable.

> *significant reductions in workforce; significant reductions in employee compensation;*

While this was necessary given the situation, difficult to do, and the BOS is to be commended for doing this tough thing - this is like treating the too-high temperature instead of curing the underlying disease. You had to do this or become cash-flow insolvent. You really had no choice unless you were really willing to jump off the cliff with your eyes open. Now – this does obviously reduce the total obligation – but it isn't preventing most of the underlying causes that created the debt in the first place.

> *successfully negotiating with all County bargaining groups the right to adopt new retirement tiers for new employees (superseded by PEPRA prior to implementation); adoption of new retirement tiers for all new employees beginning January 1, 2013 as authorized by PEPRA; decision to adopt a zero COLA for new employees beginning January 1, 2013 as authorized by PEPRA.*

One of the groups who will disproportionally bear the burden of this debt – and the actions by officials and the Retirement Board that created it - is the next generation or two of County employees. They are being thrown under the bus by previous generations of county employees who are still working or are retired. Given the constraints on what the BOS can do legally this also was probably necessary. But it isn't a fair resolution of the debt problem that exists.

4.) The report relies on State Controller's Office (SCO) data reports and conclusions despite inherent limitations with this data source. Over six years ago Mr. Dickerson shared with me an analysis he was working on comparing the finances of about a dozen "comparable" California cities, including Ukiah. During our meeting Mr. Dickerson cited numerous problems with the SCO data, including: cities were required to use a "one size fits all" format; some expenses did not fit cleanly into the required categories; different cities entered identical expenditures into different categories; some cities combined different expenses and entered them into a single box instead of reporting them separately as required; one city reported no expense for public safety, a very unlikely result. The SCO personnel who compile the data reports are not financial analysts, and in the case of public pension systems, they are not actuaries. It is also my understanding that the SCO records and analyzes the data they receive, including copies of annual financial statements and actuarial reports, but there is no requirement to reconcile the types of inconsistencies cited above.

I agree there are limitations inherent in some of the SCO data sources – but it's important to identify what parts of their data are suspect. SCO produces 11 series of compilations of financial and other data for local governments including public retirement systems, cities, counties, special districts, etc. All told this is a massive amount of data. I have found more errors than there should be in some specific parts of this data but it's still the most complete set of financial data about local governments in the state I know of.

The statement "the report relies on (SCO) data" itself is very misleading. In fact very little of the report uses SCO data. The full report is 22 pages long not including attachments. I just looked back through the full report. The only place I find where I use SCO data is in IV. Immediate Causes of the Unfunded Pension Debt – A rate of Investment Return below Target – a total of about ½ page. Only a very small part of this overall report "relies" on SCO data.

There are two subsections.

In 1. Average Rate of Investment Return About 6.5% over 18 Years – About 1/5 Below Target SCO is one of three data sources I cite, the other two being return values reported by the actuaries and my calculations using MendoCERA audited financial statements. It turns out the SCO data and that reported by the actuaries are quite close.

In 2. Second Worst Performance of 21 County Pension Funds I only had SCO data. This is the only place in the entire report I rely only on SCO data. However – 2 things. First, as shown above, the SCO data regarding returns is very close to MendoCERA's actuarial reports, and second, SCO calculations are based on values reported by the 21 County Funds themselves. I used their data because we need long-term data, not just 5 year data. We need data that covers more than one business – stock market cycle to get an understanding of MendoCERA's long-term returns.

5.) The report often lacks a clear demarcation between data and charts taken from other sources and that generated by Mr. Dickerson. Likewise, financial totals and the time periods they refer to are often unclear. Financial totals are often stated in relative terms, using the qualifier "about" instead of simply giving actual totals for ease of comparability and verification.

Since specific instances of the lack of a clear demarcation aren't given I can't respond. Ditto financial totals and time periods. As far as using "rounded" values – I do so because the majority opinion of the ROCC Steering Committee is specific values are too confusing and detailed for most concerned citizens, and I should use "round numbers" in the millions or even billions. As long as the scale of rounded values is generally correct they feel the "less cluttered" rounded numbers helps comprehension of most concerned citizens. That's why I do this.

6.) The report frequently confuses the roles and responsibilities of the BOR and BOS.

Two general issues. First – there are in fact many instances in which BOR decisions don't really establish what the County must do – but in fact establish the <u>minimum</u> the County must do (as I'll describe below). Second – I admit I simplify <u>some</u> references to the County because – frankly – very few concerned citizens even know the BOR exists. The relationship between the BOR and BOS and the rest of the County is complex and almost always confusing to those first being introduced to these issues But I'd have to have the specific examples of this alleged "confusing of roles" pointed out to reply specifically to this allegation.

7.) The report is characterized by false and misleading statements, including:

Page 2: "As of June 30, 2009 Net Pension Liability was about $132 million on top of the $89 million Pension Bond balance. Instead of selling more Pension Bonds the County began to pay 'UAAL' Amortization Payments to the Pension Fund." In fact, the County has made payments on the Unfunded Actuarially Arrived Liability (UAAL) for decades, including before, during, and after the issuance of Pension Obligation Bonds in 1996 and 2002.

This one you better be prepared to prove. There have been two attempts I can recall to disprove anything I've said. Both failed – one spectacularly. If you say that about me – prove it.

I only have actuarial valuations back to 6/30/08. That valuation defined UAAL Amortization payments that would begin in 2010. However, I have the "Funding Agreement" between the County and MendoCERA dated 12/19/02. It was executed as part of a number of actions involved with the sale of the POBs that month. Among its provisions:

> *Section 2. SUSPENSION OF FUTURE UAAL PAYMENTS*
>
> *The Payment (note - refers to payment - in essence - of the UAAL existing at the time of the agreement with funds obtained from 2002 Pension Obligation Bonds) shall be considered the actuarial equivalent (as determined in the Actuarial Study) of the County's periodic payments toward the UAAL otherwise due to the Association for the period beginning the date hereof and the date of final maturity of the Bonds (the "Suspension Period"). **Except as noted below, the County shall not be required to make further periodic payments toward the UAAL, until the payroll period immediately following the end of the Suspension Period**,(emphasis added – JGD) at such time the County shall resume periodic payments with respect to the UAAL and contribution rates set for the forth in the then-current actuarial study.*
>
> *This Agreement shall have no effect on the County's periodic payment of "Normal Contributions" or "Employee Contributions".*
>
> *Section 3. EXCEPTION OF SUSPENSION OF UAAL PAYMENTS*
>
> *The parties understand that during the term of the Suspension Period, the Association will continue to conduct annual actuarial valuations of the retirement system, including a measurement of the UAAL, (the "Future UAAL"). The results of such valuation shall be present (sic) to the County on an annual basis and shall include a schedule of the estimated UAAL balances for each year and through the term of the Suspension Period.*
>
> *Should the amount of Future UAAL (at the then current valuation date) exceed the "Target Balance" (defined as an amount equal to ten percent of the Association's then projected total actuarial liability), then the County will resume immediate amortization of the amount by which said Future UAAL exceeds the Target Balance (the "Excess UAAL") over the remaining term of the Suspension Period or other period, not to exceed 15 years as reasonably agreed to by the parties.*
>
> *It is the intent and objective of the County to avoid the creation of Excess UAAL over the term of this Agreement. Should the above referenced, forward looking UAAL schedule show that an estimated Excess UAAL balance will occur within 7 years from the then current valuation date, the County may elect to forego and/or modify the above described suspension mechanism for the purpose of resuming current UAAL payments to the Association. Any other modification by the County to the suspension mechanism described herein would require the approval of the Association.*

The 2008 valuation has a schedule of funding progress that goes back to 1993. According to that schedule and subsequent valuations the pension funding ratio from 2002 through 2012 valuations was:

| | Unfunded Pensions | |
|---|---|---|
| 6/30/xx | Smoothed | Market |
| 02 | 69.7% | 62.8% |
| 03 | 96.1% | 94.0% |
| 04 | 90.2% | 98.3% |
| 05 | 87.6% | 99.6% |
| 06 | 90.1% | 97.6% |
| 07 | 88.7% | 99.3% |
| 08 | 94.5% | 89.1% |
| 09 | 83.4% | 67.3% |
| 10 | 78.9% | 69.0% |
| 11 | 73.6% | 75.1% |
| 12 | 74.1% | 70.1% |

The smoothed value of unfunded pensions – that is the UAAL – was above 90% until 2005, but the following year it was back above (barely) 90%. It dipped below 90% in 2007 but was once again over 90% the following year. Given history, my guess was UAAL payments weren't required for the year ending either 6/30/05 or 6/30/07 particularly since the ratios for the following years were above 90% and because Actuarial Valuations are approved about half way through the following fiscal year the Retirement Board would have known returns were better and likely to boost the smoothed value of unfunded pensions back above 90%.

Incidentally – my understanding is the "forward looking" projection of UAAL specified in the first paragraph of Section 3 above was never produced.

So – given the provisions of the Funding Agreement it appeared to me UAAL Amortization payments weren't being made until they were imposed in the aftermath of the Great Recession.

What is your data source that shows UAAL Amortization payments were made?

Page 3: "Through 2013 Mendocino County paid nearly $100 million on its Pension Bonds. It will pay another $110 million through 2040 to eliminate the current balance of Pension Bonds." In fact, the current balance of Pension Obligation Bonds will be paid in full by June 30, 2027.

The UAAL Amortization period extends (as I understand it) to 2040. I inadvertently used that year in the narrative in the full report re Pension Bonds. However table 1 shows the year the Bonds will be paid off is 2027. Also, I used the year 2027 in the summary report.

I've always said if I make a mistake please tell me. I'll correct it and if warranted apologize. I've also said in analysis this complex I'm sure there are mistakes. I've corrected the year in the text – but I really don't think this rises to the level of requiring an apology. Thanks for pointing this out.

Page 3: "The County began making amortization payments in fiscal year 2010." In fact, as previously stated, the County has made amortization payments on the unfunded liability (or UAAL) for decades.

Page 3: "[The County] made two major decisions about those amortization payments - How long to take - and which of two 'methods' to use." In fact, these decisions were made by the BOR, not "the County". What purpose is served by confusing the rolls and responsibilities of the BOR and BOS?

This demonstrates my point about many BOR decisions not being what the BOS must do, but rather is the minimum the BOS must do. I'm quite certain the BOR would not have sent checks back to the County that were larger than the minimum they said the County had to pay. Just because the BOR says the County can take 30 years and use Level Percent of Payroll does not mean the County MUST do so. County officials were completely free to pay more – such as an amortization method that would prevent "negative amortization" and an amortization period no longer than the average remaining years of service for the then-current staff.

I suppose it's possible no one on the County side of the line realized they could pay more. However, if so then I'd have to ask "why?" Why wouldn't anyone realize that's the case? I strongly suspect no one wanted to.

I believe the County effectively made the decision to take 30 years and do Level Percent of Payroll assuming 4% annual increase in payroll. It was a decision to do that.

But it is convenient for County officials to be able to point the finger at the BOR re negative amortization, etc.

Page 4: The report cites "Level Dollar" and "Level Percent of Payroll" as optional amortization methods; makes the case that Level Dollar is preferable; and faults "the County" for using Level Percent of Payroll. In fact this was a decision made by the BOR based on advice from its actuary. It is my understanding that

Level Percent of Payroll is the most commonly used method. I would like to know if there is a data source with information to the contrary. Like 'excess earnings,' it is easy to raise questions about Level Percent of Payroll after the fact. This may well be a topic that merits serious discussion, but it is somewhat disingenuous to infer that it is a uniquely Mendocino County problem.

I don't see any language in my report that even hints that Level Percent isn't the most common. In fact in other reports about the 6 Bay Area County Pension Funds I've shown they all use Level Percent. However, with one slight exception, they all have amortization periods no longer than the average remaining years of service for their current staff when the amortization began. It turns out if you do that you don't get negative amortization in most cases.

And nowhere do I say the use of that method is a uniquely Mendocino County problem.

Page 5: Refers to "the County's plan" to describe decisions made by the BOR.

Again – nothing prevents the County from paying the unfunded obligation faster and avoiding negative amortization. The County is completely free to choose to eliminate the UAAL faster. Therefore it is in fact the County's plan to take 30 years and incur negative amortization.

Page 8 and 9: The report compares three data sources for various years and notes that the Actuarial Valuations and SCO calculated rates of return "are fairly close whereas my calculations...are rather different from the other two. By weighting my calculation at half that of the other two - I estimate the average rate of return over these years was 6.5% - about 1/5th below target." Mr. Dickerson does not state the factual or analytical basis for weighting his calculation. Also, using only the years for which he has data for all three sources significantly understates the rate of return as reported by the Actuarial Valuations and the SCO. Finally, on page 24 Mr. Dickerson states: "The average ROA in MCERA's Valuations is 6.8%. That's also the average for both MCERA and SCO data for 1997 through 2011. I'll assume the 6.8% value is 'correct' for the purposes of this paper." Therefore, what purpose was served by the apples to oranges comparison of three different data sources for three different sets of years and why was it included in the report?

The issue of what the Pension Fund's long-term actual rate of return has been very controversial. I have three data sources and cite them in the report. They cover slightly different time periods. So – I also showed what each of the 3 shows the average was over the years I have for each data source. By doing that I avoided the "apples to oranges" comparison Mr. McCowen asserts I did.

As I wrote "The most important observation is that the Pension Fund's returns in all three data series were below target" – and that's true.

My calculations based on MendoCERA's audited statements were significantly lower than the results of the other two data series. However, I've checked my calculations and believe them to be correct <u>given the data reported in the audited statements</u>. I must say that we know beyond a shadow of a doubt that many of those audits in the early years were very significantly incorrect. But that's the data that was reported. Because my calculations based on the audits was significantly lower, I reduced its weight which resulted in a higher calculated rate of return – which was favorable to MendoCERA. I didn't want folks (like Mr. McCowen?) to be able to say I calculated an absurdly low return value purposefully to drag the rate of return down.

However – the far more important point is <u>something</u> caused the unfunded pension debt, and competent professional financial management would have produced a fairly exact analysis defining what those factors were with a dollar amount of the debt assigned to each factor. The "Experience Studies" could do that, but to the extent they address the variances between planned and actual results they don't assign dollar amounts to the variances.

That's why I ask – **what does your analysis show? If you disagree with my analysis – what's yours?** I've never seen any County analysis defining what factors caused how much of the County's unfunded pension debt. If there are no calculations there is no financial analysis – where are the county's calculations that show what created the unfunded pension debt?

That is – indeed – a significant failing of professional fianncial management 'standards', and I'm completely qualified by education, training and experience to make that statement. When I earned by MBA from UT-Austin the Graduate School of Business was typically ranked the #1 graduate accounting program in the country. (I didn't get an MPA – but I understand accounting and financial analysis very well.) It's not my nature to say stuff like this, but I was awarded the "Sord Award for Academic Excellence" by the Graduate School of Business which put me in the top 10 or so of my class. My career has been in small businesses. I've analyzed hundreds of financial statements, produced financial analyses for dozens of firms and nonprofits, developed a number of accounting systems, produced market-industry analysis for venture capital-funded ventures, and so on. Mr. McCowen may find it convenient to say I don't have the professional qualifications I have – but I do.

But don't take my word for it – go find completely disinterested financial professionals experienced in variance analysis and ask them if the County should have produced a report showing the dollar value of the debt produced by the most significant causes of the debt. It's absolutely elemental to financial management.

Page 14: "The obvious implication [of the City of San Diego Voluntary Compliance Statement] is that the provision of CERL that allows Pension Fund 'excess earnings' to fund retiree health benefits is a violation of Federal Tax Law." In fact, use of 'excess earnings' to fund retiree health benefits, while certainly questionable, is legal under California law and allowed by IRS regulations if proper procedures are followed. Which explains why the IRS is only requiring repayment of 'excess earnings' that were diverted from the retirement fund from June 30, 2002 through June 30, 2006.

This is the language in the Voluntary Correction Program Compliance Statement for the City of San Diego's Pension Fund executed by the IRS 1/10/08 regarding retiree healthcare:

> *Failure #7*
>
> *During the plan years that ended in 1998 through 2005 the terms of the Plan and its operation did not comply with all of the requirements of Code sections 401 (a)(2) and 401(h) as they relate to retiree health benefits because the terms of the Plan provided that earnings of the trust would ultimately be used to fund these benefits resulting in the underfunding of the Plan. While retiree health benefits were paid from the Plan's retiree health account as required by the Code, the flow of funds was structured in a manner which made it extremely difficult, if not impossible to resolve that there was no inappropriate use of the Plan's assets.*
>
> *Correction for Failure #7*
>
> *The Applicant and Plan Sponsor agree that in order to comply with all of the requirements of Code sections 401(a) and 401(h) the payment of retiree health benefits must be funded by separately designated employer contributions and cannot be funded (directly or indirectly) from pension assets, including plan earnings. Effective as of July 1. 2005, retiree health benefits were no longer paid out of the Plan's 401(h) account. Instead, such benefits were paid directly by the Plan Sponsor without the involvement of the Plan. To codify this action, the Plan Sponsor will amend the Plan to retroactively to remove these provisions effective as of July 1, 2005.*

I don't know how the language could more plainly say what it says – "…the payment of retiree health benefits must be funded by separately designated employer contributions and cannot be funded (directly or indirectly) from pension assets, including plan earnings". And – "the Plan Sponsor (the City) will amend the Plan to retroactively to (sic) remove these provisions …"

That agreement was established at the beginning of 2008, and at the end of 2008 SACRS had a conference I describe in the report. My understanding is representatives of all 20 CERL Pension Funds including Mendocino were at that conference, and that the most "intense" session focused precisely on the IRS VCP process. The idea that Mendocino County Retirement Officials were not aware of the San Diego agreement is not credible; it was the "talk of the town" among California retirement systems especially those that used "Surplus" or "Excess Earnings" to pay retiree healthcare.

However – I now believe I misunderstood how the VCP program works. I had thought the IRS was more "active" in imposing language in the VCP agreements. I now know that the Pension Fund and its tax attorney mostly control the language.

The City of San Diego voters restructured the City's Retirement Board, threw all the old directors out of office, and appointed an entirely new Board (I assume some were selected by employees and retirees but don't know for sure). That new Board voluntarily put their Retirement Association into the VCP. They were a "reformer" board that wanted to get to the bottom of what had happened in their City. I now read the language above in the context that it was formed by the Retirement Association's tax attorneys at the direction of that Retirement Board.

And – therefore – I read Mendocino County's VCP agreement in that context as well – it was mostly written by MendoCERA's tax attorney at the direction of the Retirement Administrator and Retirement Board, maybe with input from MendoCERA's "corporate attorney".

And from what I and many others see – unlike the City of San Diego's Retirement Board, the MendoCERA Retirement Board does NOT want to get to the bottom of what happened in our County.

Now – today MendoCERA along with the other 19 CERL County Pension Funds (I assume all) are lobbying the state legislature to amend CERL not to remove the ability to use Excess Earnings but rather to "dress up" the language so it complies with IRC requirements but will still be allowed.

The BOS should terminate the provision that allows the use of Excess Earnings for any purpose other than to be retained in the Pension Fund, and should lobby the legislature to have the ability to use Excess Earnings for any other purpose be removed from CERL.

Page 15 and 16: The report states that "about 1/3 of the County's employees receive[d] pension benefits that were retroactive back to the first day on the job". It is true that Safety and Probation members negotiated for benefits that were retroactive to commencement of their employment, but the members of these groups have never come close to constituting 1/3 of the County workforce.

In looking back at my data and calculations I indeed appear to have made a significant error. The oldest actuarial valuation I have is 6/30/2008. This data is in that valuation:

| | | | |
|---|---|---|---|
| General | | | |
| Male | 375 | | |
| Female | 832 | | |
| | 1207 | 1207 | 86% |
| | | | |
| Retroactive Benefit Increases | | | |
| Probation | 47 | | |
| Safety | 156 | | |
| | 203 | 203 | 14% |

I believe I did probably seriously overstate the proportion of employees who received retroactive benefit increases, and this is a substantial enough error that I do indeed apologize.

I appreciate this error being brought to my attention.

However, I will say the more fundamental issue still remains – the County should have produced long ago a variance report identifying the specific causes of its unfunded pension debt and assigned dollar amounts of debt created by each cause. I didn't attempt to assign a dollar value in this part of my report.

Further, again the more fundamental observation stands – these pension increases including what I now concede was probably more like 15% of which were granted retroactively – happened when the County owed about $100 million of unfunded pension debt in the form of Pension Bonds.

And – the question begs itself – why and how could the BOS have done that?

The report does a disservice by focusing on well known errors of the past, many of which (like "excess earnings" and unfunded retiree health insurance) have been corrected. I believe it would be more productive to focus on long term solutions. For example, the report makes no mention of the "California Rule" which locks in retirement benefits as of the date of employment, instead of the date the benefit is earned. The current inability to reset the clock for future benefits not yet earned, a condition that is apparently unique to California public employers, may be the single greatest barrier to creating a sustainable and affordable pension benefit that is fairly balanced against the ongoing need to pay for public services.

Until a stake is driven through the heart of Excess Earnings that "error of the past" is not corrected. And what about the history of a severe lack of making sure County and MendoCERA financial disclosures are correct, much less not full of obvious huge misstatements of fact? And why should anyone believe the BOS will follow its own policies that are supposed to have corrected errors when past BOS obviously and very significantly violated their own policies? Simply saying they've been corrected obviously does not really mean they've been corrected.

There are profound <u>institutional</u> failures that have <u>not</u> been corrected by implementation of new and real institutionalized accountability systems.

I believe the constant rehashing of the well established history of decisions that may have seemed reasonable at the time, but which (with the benefit of hindsight) we now know contributed to the unfunded pension obligation, serves as a distraction to the work of identifying and implementing solutions. Again, I suggest that a reasonable starting point for those who are sincerely interested in understanding pension fund issues is *Pensions 101.* I personally encourage ROCC members and the Concerned Citizens to review that report and make suggestions for how it can be improved. Additions to the report could include an explanation of the "California Rule"; amortization schedules for the UAAL; the RVKuhns & Associates Five Year Annualized Total Fund Returns; the history and current policy relating to "excess earnings"; and the history and current status of the Internal Revenue Service reauthorization and the Voluntary Correction Program.

In closing, I believe everyone involved needs to understand the recent history of the retirement system and to acknowledge the magnitude of the problems that confront us. I also believe the BOR and BOS appreciate the concerns and welcome the interest of an engaged public, but that interest can best be served by relying on accurate and verifiable data and financial analysis.

## THE FUNDAMENTAL AND OTHER QUESTIONS STILL STAND UNANSWERED

Mr. McCowen didn't begin to address many of the most fundamental questions.

This set of questions goes to the very heart of the most important issues:

> *Did the Retirement Board's failure to achieve its funding plans create most of the unfunded pension debt?*
>
> *Why should the People of Mendocino County be obligated to pay this debt when the Retirement Board is not accountable to the People?*
>
> *What is your moral argument as to why only the People of Mendocino County must pay this debt and the next generation of County employees must receive significantly lower salaries and benefits?*

What – indeed – is your and the Retirement Board's moral argument to the people who elected you that they should pay this debt all by themselves, and current employees and retirees should have no obligation to do so even though they directly elected 4 of the 9 Retirement Directors and the 2 County officials in fact are also influenced by their individual interests as employees and who will be retirees – and the Retirement Board is not accountable to the people who must pay this debt?

This set of questions is directly relevant to how the County's retirement benefit should be structured and governed:

> *Do you agree pensions should be fully funded requiring only Normal Contributions and investment profits and unfunded pension debts should not be imposed on the County and the People?*
>
> *Do you agree that if the Normal Contribution was paid and yet significant unfunded pension debt is imposed on the County, then given how things turned out a) the Normal Contributions was TOO LOW to fully fund pensions, b) the County and employees should have paid more Normal Contribution, and c) the part employees would have paid – but didn't - was transferred to the County and the People as interest bearing debt?*
>
> *What are the County's projections of Total Unfunded Pension Liability (Net Pension Liability + Pension Obligation Bonds) – and how far into the future do those projections go? How does the County project the financial impact of its pension benefit on the County?*
>
> *Shouldn't the County adopt a serious goal of producing no more unfunded pension debt?*
>
> *Do you agree that 2/3 of the members of the Retirement Board are employees (including elected officials) and retirees?*
>
> *Do you agree that over the past 2 decades:*
>
> - *the amounts withheld from their paychecks as their share of the Normal Contribution was significantly less than was required to prevent the development of today's unfunded pension debt,*
> - *the County also paid significantly less as its share of the Normal Contribution that would have been required to prevent today's debt which allowed County officials to spend tens of millions mostly on current staff in those years,*
> - *around $37 million was paid out of the Pension Fund for retiree healthcare every dime of which created interest-bearing County debt that with "lost profits" created $55 million of debt, and*
> - *all that must now be paid by the People of Mendocino County through 2040?*

These questions focus on what the impact of this debt is on the People of Mendocino County – the people who elected you and rely on you to do your duty to them:

> *Based on all actuarial assumptions do you agree Mendocino County plans to increase the Net Pension Liability about $13 million over the first decade of amortization payments, to require about $50 million*

*more interest expense to be paid that what would be required using the Level Dollar method, and the actual dollar value of the beginning Net Pension Liability will be paid by the County and its People from 2029 through 2040 – thereby imposing the obligation to pay today's dollar value of Net Pension Liability on younger generations who won't receive services or infrastructure for their money?*

*What are the County's projections of Total Unfunded Pension Debt Payments (Net Pension Liability + Pension Obligation Bonds) – and how far into the future do those projections go?*

*Assuming all other actuarial assumptions come true, do you agree that the main and perhaps exclusive source of the money for these payments will come from our County's local revenue base – taxes and fees – and that the People of Mendocino County won't directly get one minute of public services or one dime of County infrastructure for the nearly $600 million of these debt payments from 1996 through 2040 – of which $360 million is interest expense?*

*Will the County report significantly more debt than assets under the new (GASB pension financial reporting) rules – and will increased pension expenses force it to report significant operating deficits?*

*Given the combination of the Pension Fund's actual returns on investment and the diversion of Pension Fund "Excess Earnings" in 1993 through 2011 - do you agree that:*

- *The Normal Contributions defined in the Actuarial Valuations adopted by the Retirement Board in those years were significantly too low to fully fund the portion of future pensions being earned by employees in those years – that is, at least in retrospect – they should have been much higher?*
- *If so – then both employees and the County should have paid significantly more into the Pension Fund during those years to fully fund future pensions employees earned in those years.*
- *If so – then a significant portion of the amount employees should have paid to fund their fair share of their future pensions they were earning in those years was transferred from them to the County – and through the County to the People of Mendocino County – as interest-bearing unfunded pension debt.*

These questions focus on what appear to be examples of significant failures to competently and professionally manage the County's finances as it relates to retiree benefits:

*Did the County wait more than four years after GASB 45 was adopted before learning it had a $136 million unfunded retiree healthcare liability that would have to be reported to retirees and the People?*

*Has Mendocino County projected the numeric impact of these new (GASB pension financial reporting) rules on its financial statements, and if not, why not?*

*Do you agree that Unfunded Pensions have imposed a very significant debt on Mendocino County, and it's important to know what caused that debt so that changes can be made to prevent the creation of more debt?*

*Does the County and/or Retirement Board possess a financial variance analysis report (or reports) clearly quantifying the causes of its Unfunded Pension Debt over the past 20 years?*

*Is it true these actions started 18 months after the BOS adopted Board Policy 40 and that there was no actuarial evaluation of these actions or careful consideration?*

*Is it true County officials ignored the 1998 policy that retirees would pay 50% of the cost if there were no "Excess Earnings"?*

*Was the County given "credit" for having paid the $6 million to the Retiree Healthcare Fund (Reserve) and later given credit that made it appear it had paid its full contribution to the Pension Fund even though the County didn't pay any extra money to the Pension Fund?*

*May we have copies of any documents from MendoCERA's actuaries providing assurance to MendoCERA that these diversions out of the County's Normal Contributions were not violations of IRS regulations or the Internal Revenue Code?*

*Did every Mendocino County employee get significant pension increases during years in which the County owed more than $100 million of Total Unfunded Pension Debt (Net Pension Liability + Pension Bonds)? Did about 15% (mea culpa) of the County's employees receive pension increases that were retroactive back to the first day on the job?*

*From fiscal year 2002 when the first of these increases were granted through fiscal year 2006 – the year in which the last of these increases took effect, did annual County payments to eliminate unfunded pensions increase from $3½ million to $8½ million?*

*Do you agree or disagree with these statements:*

- *A major duty of County financial officials and the Board of Supervisors is to make sure County and MendoCERA audited statements are accurate.*
- *MendoCERA's audited financial statements cited above conveyed significantly distorted financial information as described above that constitute significant violations of generally accepted government accounting principles ("GAAP") in the US.*
- *County officials simply accepted these deeply flawed audited statements "at face value" and did not challenge their accuracy until Mr. Dickerson raised these issues.*
- *Were Mr. Knudsen's and Mr. Andersen's assertion that these errors in MendoCERA's audited financial statements were forced by flawed rules issued by the State Controller's Office true?*
- *After the 4/28/09 Joint Meeting County officials did nothing further about these issues.*

*Do you agree with this statement? The 1998 County Board of Supervisors Retiree Health Benefit Resolution said that if there were no "Pension Fund Excess Earnings" the County would split the cost 50-50 with retirees. Twice while that resolution was still in effect MendoCERA had no Pension Fund Excess Earnings. But the County never implemented the 50-50 split that was supposed to happen in that situation. The first time it cooperated with MendoCERA's diversion of a portion of the County's Normal Contribution to the Pension Fund which directly increased the County's unfunded pension debt. The second time the County simply terminated its 1998 Retiree Healthcare resolution.*

*What methods does the BOS have to make sure that policies such as the 1998 Resolution and Board Policy 40 are actually followed – including by itself?*

*Given the fact that MendoCERA significantly failed to achieve its funding plan over the past 2 decades and therefore the Normal Contribution paid by employees and the County turned out to be very significantly less than it needed to be to fully fund pensions, shouldn't the target rate of return be no more than 6.6%, and in fact should probably be less to protect the People from more service-destroying debt?*

*Do you agree that every dime of retiree healthcare benefits paid with "Excess Earnings" over the past 2 decades increased the County's interest-bearing Unfunded Pension Debt? If not, why not?*

*Can the Board of Supervisors terminate the authorization of the Retirement Board to use "Excess Earnings" for anything other than paying pensions including terminating the Retirement Board's ability to increase benefits in any way on its own volition? If so – has the BOS done so?*

*Given the Pension Fund's actual rates of return from at least 1993 through 2011 do you agree that the diversion of "Excess Earnings" to pay retiree healthcare made it impossible to average the target rate of return and yet the Actuarial Valuations adopted by the Retirement Board assumed the Pension Fund would average that target rate?*

If these assertions are true – then what institutional changes have been made to make sure these things don't happen again?

And – how can you argue all this isn't identifying many (not all) of the things we need to do going forward to "address the problem"?