THE MENDOCINO COUNTY EMPLOYEES RETIREMENT ASSOCIATION

As a part of the Grand Jury's oversight responsibilities, as mandated by the California Penal Code, the 2002-2003 Grand Jury selected the Mendocino County Employees Retirement Association, (MCERA or "the association"), for a review of operations, cost structure, and asset development, including the large unfunded actuarial accrued liability, (UAAL).

METHODS OF INVESTIGATION

In accomplishing its review of the County Retirement Association, the Grand Jury interviewed the County Treasurer, the Association's Certified Public Accountant, the Association's actuarial firm in San Francisco, and independent investment advisors, and, also attended County Board of Supervisors and County Retirement Board meetings.

In addition, the Grand Jury reviewed the 3 most recent actuarial reports, the Financial Statements for the last 3 years, the County of Mendocino Audit Report of June 30, 2001, the Association's By Laws, the County Treasurer's Financial and Statistical reports, the "Mission Statement and Departmental Functions" for the Treasurer-Tax Collector, the planned 2002-2003 County Budget for the administration of the retirement system, Resolution No. 1999/2000-2 of the Mendocino County Employees Retirement Association Board of Retirement Establishing Investment Policies, MCERA Performance Measurement Report for the Period Ending 6/30/02, the prospectus for the 1996 County of Mendocino

Taxable Pension Obligation Bonds and the related "Funding Agreement" between the County of Mendocino and the Mendocino County Employees Retirement Association, Minutes from the Association Board meetings for the last several years, the California Constitution, applicable state government codes, and the County Employees Retirement Law of 1937, as amended.

BACKGROUND INFORMATION

The Employees Retirement Association was formed in 1948 and operates pursuant to the County Employees Retirement Law of 1937, and, as subsequently amended. This law provides the option for Counties to establish and manage their own "defined benefit pension plan". Such plans, including the Mendocino County Employees Retirement Association, are totally controlled and operated by a "Retirement Board". MCERA's board consists of nine members, four are appointed by the County Board of Supervisors, two are elected by general county employees, one is elected by county retirees, one is elected by county safety employees, and one is the County Treasurer, (ex-officio), and who is also the administrator of the retirement system. All functions must also be conducted in accordance with California State Constitution, California Government Codes, and other governing policies such as the Association's "By Laws".

Article 16 § 17(a) of the California Constitution clearly articulates the responsibilities of the Retirement Board by stating: "The retirement board of a public pension or retirement system shall have the sole and exclusive fiduciary responsibility over the assets of the public pension or retirement system. The retirement board shall also have sole and exclusive responsibility to administer the system in a manner that will assure prompt delivery of benefits and related services to the participants and their beneficiaries. The assets of a public pension or retirement system are trust funds and shall be held for the exclusive purposes of providing benefits to participants in the pension or retirement system and their beneficiaries and defraying reasonable expenses of administering the system”.

Under Article 16 § 17(b) the Constitution goes on to say that, “A retirement board’s duty to its participants and their beneficiaries shall take precedence over any other duty”.

In accordance with Section 31584 of the County Employees Retirement Law of 1937, the County Board of Supervisors is obligated to make payments to the Retirement Association for amounts arising as a result of retirement benefits accruing to members of the Association.

MCERA is a “cost sharing multiple employer plan” that includes not only employees of the County of Mendocino, but also the Cemetery District of the Redwoods, and the Russian River Cemetery District. As of June 30, 2001, there were 2,450 total active plan members. Of this number, 683 are retirees and beneficiaries receiving benefits, 316 are plan members entitled to receive benefits but who are not yet doing so, and 1,451 are active (working) plan members.

It is beyond the scope and time available to this Grand Jury to analyze all the administration and investment expenses, both soft and hard, incurred in maintaining an independent retirement system, and compare the overall performance to other alternatives such as CALPERS with a concomitant comparison of asset performance and service to retirees and beneficiaries.

FINDINGS

1. The Association reimburses the County for costs incurred in the administration of the retirement system. Reimbursement of 1/3 of the salary and benefits of the County Treasurer as Retirement Administrator suggests that the treasurer allocates about 1/3 of his time in this role.

2. The projected/requested county budget growth for retirement system activities in the 2002-2003 budget year although large on a percentage basis, seems appropriate when related to a relatively small budget base and the need for additional staffing.

3. The Association Board routinely retains outside counsel for assistance regarding disability retirement applications and litigation resulting from decisions about applications. Further, County Counsel provides “ongoing legal advisory services” and may represent the Association in other lawsuits. The Association does not retain outside and independent legal counsel for operational and business issues.

4. Association Resolution 1999/2000-2 establishes general investment objectives, qualitative guidelines, and parameters for the allocation of assets of the Employees Retirement Association. The Retirement Board has broad discretion over investments, and regularly relies on outside advisors as to specific investments. Investment portfolio performance appears to be within reasonable norms.

There is no prohibition of investing in derivatives, although both futures and options are prohibited. Direct real estate investment is also not prohibited.

Additionally, although the resolution does provides for a quarterly comparison of “results and risk” of investment managers, there is no apparent provision for the analysis and comparison of both direct and indirect investment expenses.

5. Health insurance benefits for retired employees will continue to be funded by the basic plan until the Associations health care reserves have been totally used, and, “earnings on investments are not in excess of required transfers of earnings to retirement reserve accounts”. Effective September 1, 1998, the County of Mendocino assumed responsibility for the funding of health care premiums once the above reserves are depleted.

6. The key financial “road map” for those responsible for the successful operation of the Retirement Association is provided by the Association’s Actuaries. The data developed by the Actuaries, and presented in their annual Actuarial Reports, should be driving the many decisions necessary to maintain the financial health of the Association.

7. The assets of the Mendocino County Employees’ Retirement Association funds as of June 30, 2001 alternately were:

Financial Statement	$147,373,404
Report to Plan Participants (By Treasurer)	$169,949,917
Actuarial Report (As of 7/1/01)	$157,545,000

The variance between the Financial Statement and the Actuarial Report is explained by the actuarial process of “smoothing” investment gains and losses. The difference between the Financial Statement and the Annual Report to Plan Participants is explained by the fact that equities are carried "at cost" in the Report to Participants as opposed to "market" by the Financial Statement. The "at cost" numbers will tend to be more favorable in a declining equity market, and less so in an advancing equity marketplace. The Grand Jury also notes the difference between the "net market value" of assets related in the financial statement, and that related in the most recent Actuarial Report ($151,671,408).

NOTE: The actuarial technique of "smoothing" is described in the June 30, 2001 Actuarial Report (page 3) as a method wherein "realized and unrealized gains and losses are spread over five years, i.e. only 20% is recognized in any one year." This is designed to level or "smooth" results and reduce the volatility of realized and unrealized gains and losses in order to be able to achieve a more rational planning process.

8. The level of the Associations assets is more significant when compared to the Actuarial Accrued Liability (AAL), and the resultant "Unfunded Actuarial Accrued Liability" (UAAL). This (UAAL) represents the shortfall between the benefits already earned by plan participants (Actuarial Accrued Liability or AAL), and the "present value" of the Associations assets (or Actuarial Value of Assets). The following numbers were obtained from the June 30, 2001 Actuarial Report. This is the most recent data available.

Actuarial Valuation Date	Actuarial Value of Asset	Actuarial Accrued Liability (AAL)	Unfunded AAL (UAAL)	Funded Ratio
7/1/93	$ 72,062,000	$105,866,000	$33,804,000	68.1%
7/1/94	$ 75,976,000	$112,535,000	$36,559,000	67.5%
7/1/95	$ 79,322,000	$121,027,000	$41,705,000	65.5%
7/1/96	$ 84,992,000	$130,036,000	$45,044,000	65.4%
7/1/97	$124,286,000	$140,783,000	$16,497,000	88.3%
7/1/98	$134,836,000	$154,263,000	$19,427,000	87.4%
7/1/99	$142,775,000	$173,250,000	$30,475,000	82.4%
7/1/00	$150,056,000	$185,423,000	$35,367,000	80.9%
7/1/01	$157,545,000	$204,699,000	$47,154,000	77.0%

9. The reduction in UAAL reflected on 7/1/97 (and the attendant increase of assets) was due to the issuance of $30,720,000 Pension Obligation Bond in late 1996, the proceeds of which were given to the Association by the County in order to reduce the UAAL.

10. Under the 1996 ”Funding Agreement” between the County and the Retirement Association, payments by the County toward the remaining UAAL were suspended based upon the proceeds of the Pension Obligation Bond being the “actuarial equivalent of the County’s otherwise monthly payments owed to the Association for the (Suspension Period)”.

An initial schedule of estimated UAAL balances, which if exceeded by 5% in subsequent actuarial valuations, compels the County “to begin funding the incremental increase in the UAAL balance on a current basis without regard to the Suspension Period”.

11. The Unfunded Actuarial Accrued Liability is troublesome both in terms of it’s growing magnitude as well as the complexity of the forces that have created it. Indications are, that the UAAL as of June 30, 2002 will be approximately $72,500,000. If this trend continues unabated in 2003 and 2004, one cannot help but project that the County and the Association are potentially facing a staggering **shortfall**.

12.There appear to be many reasons for the growing UAAL. Unfortunately, the factors are complex, and are not necessarily common to each annual period. The entire process is made even more difficult by the need to project ultimate costs, (benefits), as far as 60 to 70 years in the future. The factors that seem to be driving the increasing UAAL include:

* Capital losses (on equities) and less than expected dividends for the most recent several years.
* Larger than expected salary increases.
* New benefit levels
* Lengthening life expectancy tables (1999)
* The funding of health care benefits from the retirement funds.
* Failure to fully retire the 1996-1997 level of UAAL with the 1996 Pension Obligation Bond, and subsequent inability to amortize the remaining balance.
* And, one cannot escape the obvious conclusion, that, for whatever reasons, contributions have not kept pace with the factors that have driven up the Actuarial Accrued Liability, (ultimate benefit cost).

13. In order to compare the level of funding of the Mendocino County Employees Retirement Association with other 1937 Act Counties, we include the following most recent table of "1937 Act Counties" funding levels obtained from the California State Controllers Office, "Public Retirement Systems Annual Report" dated April 30, 2002. While the data is several years old, it does provide a sense of just how Mendocino compares with other counties. (A funded ratio of 100% means that all of the Acutarial Acrued Liability are covered by the assets of the fund.)

FISCAL YEARS ENDING 7/1/98 & 7/1/99

COUNTY	FUNDED RATIO A/0 7/1/98	FUNDED RATIO A/O 7/1/99
Alameda (A/O 12/31/98)	108.30	
Contra Costa (A/O 12/31/98)	80.50	
Fresno	106.40	
Imperial	126.50	
Kern	102.00	
Los Angeles	99.50	
Marin	96.30	
Mendocino (A/O 6/30/98)	**87.40**	**82.40 (A/O 6/30/99)**
Merced	78.20	
Orange (A/O 12/31/98)	95.20	
Sacramento	107.90	
San Bernardino	116.10	108.30
San Diego	105.90	
San Joaquin (A/0 12/31/97)	104.90	

San Luis Obispo (A/0 1/1/98)	97.10	
San Mateo	89.90	92.00
Santa Barbara (A/ 12/31/98)	98.70	
Sonoma (A/O 1/1/97)	100.00	98.70 (A/O 1/1/99)
Stanislaus	105.80	
Tulare	102.10	104.80
Ventura	115.00	123.00
Average (Unweighted)	**101.13**	**101.53**

Note: The most recent funded level percentage for Mendocino (as per item 7. above) is 77.0% as of July 1, 2001.

RECOMMENDATIONS

A. The Treasurer include and explain the Unfunded Actuarial Accrued Liability data in the Annual Report to Plan Participants. Further, that the Treasurer and the Retirement Association Board include any applicable "pro-formas" or preliminary estimates regarding UAAL in this Annual Report.

B. The Retirement Association Board retain independent counsel to represent the Association in operational matters. (Finding 3)

C. The Association consider modifying its investment prohibitions to include derivatives, and direct real estate (due to lack of liquidity). (Finding 4)

D. The Association include in its quarterly investment manager analysis, an analysis and comparison of both direct and indirect investment expenses. (Finding 4)

E. The Mendocino County Employees Retirement Association Board of Directors, in conjunction with their actuaries, quickly develop "preliminary" estimates of the 6/30/02 and a "pro-forma" of the 6/30/03 and 6/30/04 Unfunded Actuarial Accrued Liability numbers, and immediately present to the County Board of Supervisors for their information and budget planning processes. (Findings 6 through 12)

F. The Board of Supervisors in conjunction with the Association Board and Plan Administrator develop both a tactical and strategic plan for fully funding the Actuarial Accrued Liability and, thus **eliminating** the UAAL. This process should include the **professional** exploration of other options such as CALPERS as opposed to the present independent system. While the Grand Jury has no judgement about the feasibility of such a move, it would seem appropriate to explore such options from time to time. An outside consultant would be helpful in this regard. (Findings 6 through 12)

COMMENTS

By continuing to carry an ongoing and increasing UAAL, the Board of Supervisors, whether intentional or not, is effectively subsidizing the County's fiscal budget with monies that should have been allocated each year to adequately fund the Retirement Association.

NOTE: Absolutely true!

Additionally, it would seem that while another Pension Obligation Bond would solve the Board of Supervisors funding problem in the near term, it is only a band-aid that does not address all the forces that are driving the UAAL ever higher. It should also be noted that in so doing, the County Board of Supervisors would, again, be shifting the financial burden for past (retirement fund) liabilities to future generations of taxpayers with no guarantee that accrued future benefits would be funded on a "pay as you go", or incurred basis.

NOTE: Absolutely true. But - BOS and MCERA Ignored!

While this kind of financial "logic" is common practice at the Federal level, the Grand Jury feels that the notion of constantly pushing the payment of past obligations, (accrued benefits), into the future is a financial philosophy that is not sound for the plan participants or the Mendocino County taxpayers.

Special Note: The Grand Jury wishes to acknowledge the current actions of the Pension Administrator, the Pension Board, the County Board of Supervisors and many others in defining and working toward resolving the difficult and complex problem of Unfunded Actuarial Accrued Liability. This "work in progress" is not only taking place as this report is being written, but will, of necessity, require continuing attention on an annual basis. Additionally, it is probable that by the time this report is published, there may be significant changes in the status of the problems identified and potential solutions.

RESPONSE REQUIRED

Mendocino County Board of Supervisors

Mendocino County Employees Retirement Association Board

Mendocino County Counsel

RESPONSE REQUESTED

Association Investment Advisor

Association Actuarial Firm