Reform Our County Coalition

Mendocino

SUMMARY

QUESTIONS ABOUT MENDOCINO COUNTY'S UNFUNDED PENSION DEBT AND ANALYSIS OF THAT DEBT

4/17/14

John G Dickerson

www.YourPublicMoney.com

7/24/14 – only two errors in the larger paper have been identified by county and/or retirement officials. Only one of those appeared in this summary. The correction is on page S6 – only 15% of County employees received pension increases retroactive to the day they were hired – not the 1/3 I originally wrote.

This is a 7 page summary of a larger 23 page report that describes:

- Mendocino County's unfunded pension debt
- How it developed
- Financial impacts on the County
- The immediate causes of the debt
- Several "stories" I believe demonstrate significantly flawed financial management of the County's pension and retiree healthcare benefits
- One (of several) of what I believe are the "fundamental" causes of our County's unfunded pension debt

The summary has the same outline (not as "deep" in some areas) as the larger paper. You can read the summary and if you want to see more about a particular topic you can go to the same section in the larger report. The Table of Contents on the next page shows the page numbers for both the summary and the larger report.

This summary is all text, has no footnotes, doesn't identify where data comes from, no attachments, and doesn't have much explanation of terms and calculations.

The larger report has numerous graphs and tables, footnotes, identifies where much of the data came from, several attachments, and more explanations of terms and calculations.

The report and this summary will be available at www.YourPublicMoney.com Friday 4/18/14.

Table of Contents

Table of Contents

I. HOW MENDOCINO COUNTY'S PENSION FUND SHOULD AND SHOULDN'T "WORK"

A. <u>How Mendocino County Pensions are Funded</u>

Each year the Retirement Board adopts an "Actuarial Valuation" that is a "pension funding plan". It defines 2 types of payments – the Normal Contribution (supposed to fully fund pensions along with investment profits – both the County and employees pay a share), and Unfunded Pension Amortization Payments (paid only by the County.) If the County has to pay Amortization payments it can opt to sell Pension Obligation Bonds (POB) thereby converting its debt to the Pension Fund to bonded debt – hoping for a lower interest rate.

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?

In the real world the objectives and assumptions in Actuarial Valuations will never be perfectly achieved. In order for only Normal Contributions and investment profits to fund future pension payments a "Successful County Pension Fund" would be "over-funded" in some years and "underfunded" in others – averaging fully funded in the long run.

A failing County Pension Fund imposes more and more unfunded pension debt over time. on the County and its 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?

II. MENDOCINO COUNTY'S UNFUNDED PENSION DEBT

A. <u>Balance of Debt</u>

Mendocino County's Total Unfunded Pension Debt (Net Pension Liability + Pension Obligation Bond balance) increased from about $40 million 1993 to over $200 million 2013. From the point of view of the People of Mendocino County this is a "failing" pension fund. The County borrowed $45 million in 1996 by selling Pension Bonds (POB) and another $80 million by selling POB in 2002. In 2009 the 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. Total County debt as of June 30, 2013 (including Net Pension Liability) was about $250 million. Pension Bonds and Net Pension Liability were 80% of Total County 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?

Mendocino County's Pension Fund should have had $510 million as of June 30, 2013 to be "fully funded". The Market Value of Pension Fund Assets was $383 million – about 75% of Total Pension Liability. But the County still owed $76 million on POB and had paid $20 million of Net Pension Liability Amortization Payments. If MendoCERA had achieved its self-proclaimed goal of fully funding pensions requiring only Normal Contributions and investment profits the County wouldn't have had to borrow money by selling Pension Bonds nor would it have had to pay Amortization payments.

Do you agree that the County's Pension Fund achieved only about 55% of its funding requirements based solely on Normal Contributions and investment returns <u>on those Normal Contributions</u>, and the rest is debt imposed on the County (including its residents and taxpayers) that wouldn't exist had MendoCERA achieved its funding plans?

B. <u>Pension-Related Payments (Normal Contribution + POB Pmts. + Amortization Pmts.)</u>

Over the past 2 decades payment of all other debt was about $2 million a year. Pension Bond and Net Pension Liability amortization payments went from zero to $15 million making total debt payments $17 million this year. For every dollar of payroll two decades ago the County paid 10 to 15 cents for all pension-related payments. Today it's about 45 cents. County payments were slightly more than employee payments 2 decades ago - today they're four times more.

POB PAYMENTS: From 1997 through 2027 the County will pay about $210 million to eliminate its POB.

NET PENSION LIABILITY PAYMENTS: The plan is to pay $375 million from 2010 through 2040 as Amortization payments. If all other actuarial assumptions come true the County plans to increase the Net Pension Liability by $13 million over the first 10 years because it isn't paying all the yearly interest expense. The County plans to impose the obligation to pay today's dollar debt on County residents from 2030 through 2040.

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?

In total if all goes according to plan about nearly $600 million (including $360 million of interest expense) will be paid to eliminate Net Pension Liability created to date. That money won't produce any direct services or infrastructure.

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?

Do you agree that none of these payments would have been necessary had MendoCERA achieved its adopted funding goals inherent in every Actuarial Valuation adopted by the Retirement Board over the past 2 decades – that is, that future pension payments would be fully funded from Normal Contributions and Investment Profits?

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?

III. GASB 68

A. County Delayed Four Years to Learn Impact of New Retiree Healthcare Reporting

Major new government accounting rules were published in June 2004 that required the County to report its unfunded retiree healthcare obligation no later than June 2008. The County of Mendocino waited until the last possible moment August 2008 - before learning its unfunded retiree healthcare liability was about $136 million.

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?

B. Major New Pension Financial Reporting Rules

Major new government accounting rules were published at the end of June, 2012 that require very significant changes in reporting pension finances. MendoCERA must use the new rules starting June 2014 and the County starting June 2015.

Has Mendocino County projected the impact of these new rules on financial statements? If not, why not?

The County reported a $42 million Net Pension Asset in its June 30, 2013 audited statements. This Net Pension Asset will be completely written off. The County must put the Net Pension Liability on its Balance Sheet for the first time. That would have been an additional $127 million debt in 2013. The County reported Net Assets (New Worth) of $79 million in 2013. Under the new rules it would have been a negative ($90 million). Next year Mendocino County will report it has significantly more debt than the value of its assets.

I don't know which of two current methods of calculating pension expense the County uses. Depending on which was used County expenses would have been from $80 million to $160 million more from 2004 through 2011. The County reported $60 million in surpluses in those years. It would have reported from $20 million to $100 million deficits.

Will the County report more debt than assets under the new rules – and will increased pension expenses force it to report significant operating deficits?

IV. IMMEDIATE CAUSES OF THE UNFUNDED PENSION DEBT

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?

Do you significantly disagree with the description of the causes of Mendocino County's Unfunded Pension Debt in the rest of this section "Immediate Causes of the Unfunded Pension Debt"?

Three things each caused roughly a quarter of Mendocino County's Unfunded Pension Debt – a) The Pension Fund's rate of return was below target, b) The Fund didn't have enough money to invest, and c) Use of "Excess Earnings" to pay Retiree Healthcare. A bunch of other things caused the last 25%.

A. Rate of Investment Return below Target

From 1998 through 2011 the Pension Fund's average rate of return was about 6.5% - about 1/5th below target. According to State Controller data this was the second worst performance among the 21 County Funds.

B. Not Enough Invested

Had the Fund been fully funded about 25% of the County's Unfunded Pension Debt would not have developed.

C. Payments of Retiree Healthcare from Pension Fund "Excess Earnings"

For decades officials said retiree healthcare benefits were paid from Pension Fund - "**Excess Earnings**". CERL defines Pension Fund "Excess Earnings" and what can be done with it. The actual definition is a little more complex, but this simplification correctly captures almost all the mathematics of the definition - "*Excess Earnings" are any above the target rate of return in any individual year regardless of the Fund's financial position*".

Do you agree that this simplified understanding of how CERL defines Pension Fund Excess Earnings is essentially correct? If not please explain your understanding.

CERL authorizes the use of Excess Earnings to pay benefits in addition to pensions including retiree healthcare benefits of various types, accrued sick leave, and increases in pension payments above that defined in collective bargaining agreements. But if every time earnings are more than target they are taken out of the Pension Fund to pay retiree healthcare, how can the Pension Fund average its target rate over the long run?

The obvious answer is – **IT CAN'T**.

For two decades County and Retirement officials said retiree healthcare was paid with "Excess Earnings" even though the Pension Fund earned significantly less than target over those years, unfunded pension debt increased in almost all those years (not including Pension Bond proceeds), the County borrowed $110 million by selling Pension Bonds, and the Pension Fund was always underfunded.

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?

Can the Board of Supervisors terminate this 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?

The payment of health benefits and lost investment profits lowered retained investment earnings from 88% of target to 2/3 of target. This produced about 25% of our County's unfunded pension debt.

MendoCERA's Actuaries calculated the "Normal Contribution" – split between the County and employees - based on the assumption the Pension Fund would AVERAGE its target rate of return. But clearly the Actuaries knew that the diversion of "Excess Earnings" to pay retiree healthcare made it impossible to average the target rate of return given the financial position of the Pension Fund in those years. Therefore the Actuaries designed more County debt into MendoCERA's Actuarial Valuations. And – therefore the Retirement Board adopted Actuarial Valuations that would unavoidably produce more County debt.

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?

D. Other Causes of Unfunded Pensions

There are numerous other causes – but this paper doesn't delve into them.

E. Basic Financial Questions

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.**

V. EXAMPLES FLAWED FINANCIAL MANAGEMENT

A. 1998 Retiree Healthcare Policy - Board Policy 40 - Diversions of Contributions

Do you disagree with this description in this section A of what happened?

In September 1998 the Board of Supervisors adopted a Retiree Healthcare Policy. According to that policy - Employees hired before the policy was adopted will get this benefit if they work for the County for 10 years but those hired after that date won't get this benefit. Pension Fund "Excess Earnings" will be the primary source of funds but if there aren't any the County will split the costs 50 50 with retirees. And the method of funding Retiree Healthcare will conform to federal tax laws.

In 2002 when the Board of Supervisors approved the 2002 Bonds they also adopted "Board Policy 40". These are excerpts – "*With the goal of … providing assurance to the County's taxpayers that the County is well managed and financially sound, the County will endeavor to avoid the creation of additional (unfunded pensions) in the future.*

… the County shall - quantify, by actuarial study, both the near-term and long-term financial impact of all ... proposed actions (that could increase unfunded pensions). Should such ... findings indicate an increase to the county's (debt), the County shall carefully evaluate the financial impact ..."

Eighteen months after the adoption of Board Policy 40 there were no "Excess Earnings".

According to the 1998 Retiree Healthcare policy at that point the County would "split" the cost of retiree health insurance 50-50. Instead from 2004 through 2006 MendoCERA – with the County's blessing - diverted $6 million directly out of the COUNTY'S Normal Contributions to pay retiree healthcare – at no cost to retirees. They took money being paid to the Pension Fund by the County to fund its current employees' future pensions and paid a benefit for retirees that many current employees could never get.

Then their Actuary told the Retirement Board they "may be" violating state law (they were). The Retirement Board stopped diverting part of the County's Normal Contribution – but took another $3½ million directly out of the Pension Fund to pay healthcare.

MendoCERA officials said they "paid the County back". With what? The money was gone. And it isn't about paying the County back – it's about the money is supposed to be in the Pension Fund.

They “paid the Pension Fund back” with a $9½ million asset called “Actuarial Value of Unrecorded Earnings”. I believe this was a claim against future Excess Earnings if and when they may ever occur. If so that isn’t an asset. You can’t claim future earnings as an asset today – you haven’t earned them yet.

MendoCERA wrote the $9½ million off as worthless in 2010 – which immediately increased the calculated value of the County’s Net Pension Liability.

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?

This is a footnote attached to Mendocino County’s audited financial statements for 6/30/2006 (page 53):

> *Note 13: Post-Retirement Benefits*
>
> *The County pays in accordance with County ordinance, post-retirement medical benefits for retirees who have at least ten years of County service. If the retiree has less than ten years of service, then the retiree pays a percentage of the medical benefits. The benefits paid by the County are funded on a pay-as-you-go basis. At fiscal year-end, there were 851 County retirees, of which, 623 received healthcare benefits totaling $3,720,135 for the year ended June 30, 2006.*

Is this explanation of the method of financing medical benefits for retirees in this footnote deceptive?

B. City of San Diego Voluntary Compliance Statement - Internal Revenue Code

A pension scandal raged in the City of San Diego from 2002 through 2009. This is one little part.

In December 2007 the City and its Pension Fund signed a “Voluntary Compliance Agreement” (see page **Error! Bookmark not defined.**). The IRS signed the agreement in January 2008. The agreement stated that– according to Federal Tax Law “… *payment of retiree health benefits … cannot be funded directly or indirectly from pension assets, including plan earnings*”. The obvious implication is that the provision of CERL that allows Pension Fund “Excess Earnings” to fund retiree health benefits is a violation of Federal Tax Law.

The State Association of County Retirement Systems (SACRS) held a conference 10 months later on November 11, 2008 in Costa Mesa. The IRS official in charge of all Voluntary Correction Programs (VCP) for public retirement systems in the US and a principal of the firm that represented MendoCERA in its VCP attended a session. I understand representatives from all 20 County Pension Funds organized under CERL attended this session – including MendoCERA. They directly talked about the fact that all 20 were about to go through the same process as the City of San Diego.

In the 3 years following this conference MendoCERA paid $10 million of retiree healthcare benefits saying it was funded by “Excess Earnings”.

Did County and/or MendoCERA officials attend that conference?

Do you agree that it was clear by early 2008 – and unavoidably so as of that conference - that MendoCERA’s use of Pension Fund “Excess Earnings” to pay retiree healthcare was a major violation of the Internal Revenue Code, and that MendoCERA paid about $10 million more retiree healthcare after that conference saying it was funding from Excess Earnings?

C. Pension Increases (~~⅓~~ 15% Retroactive) When Unfunded Pension Debt was over $100 Million

The BOS directed staff to prepare a second issuance of Pension Obligation Bonds in July 2002. At that moment the County's total unfunded pension debt was $110 million using the true market value of Pension Fund Assets – and $95 million based on the "smoothed" value of Assets.

In December 2002 the County borrowed $92 million from the sale of the 2002 POBs. Payments on Pension Bonds before the 2002 Bonds were sold were $3.5 million in FY2002. The year after they were sold – FY2004 – Pension Bond payments increased to $8.2 million. The 2002 Bonds increased County debt payments nearly $5 million a year.

Six months before the BOS directed staff to prepare to borrow $92 million the pension benefits for three groups of County employees were significantly increased. Less than a year after the bonds were sold pensions were significantly increased for SEIU and Probation employees. Probation employees got retroactive increases back to when they were hired. Deputy Sheriffs got the same retroactive increases a year and a half later.

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 ~~1/3~~ 15% of the County's employees receive pension increases that were retroactive back to the first day on the job? (This is the largest error in this paper pointed out by county/retirement officials.)

Was there an Agreement with the Bargaining Units as to how these pension increases would be funded, and if so, did the actual funding in subsequent years conform to this agreement?

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?

D. MendoCERA Audited Financial Statements

I received copies of 10 consecutive years of audited annual financial statements for MendoCERA beginning with statements for June 30, 1998.Many of the return on investment values are absurd and impossible on their face.

For example in 1998 the Healthcare Fund began the year with $1.8 million, received no contributions, and earned a net investment return of $6.7 million – a 375% return on beginning assets. Pension Fund average assets through the year were $134 million, investment return was $6.2 million – a 4.6% return on average assets and 4.7% return on beginning assets. The two funds are invested together. This is absurd.

The Board of Supervisors and Retirement Board held a Joint Meeting on April 28, 2009. During the meeting a County Supervisor asked about the very incorrect investment return values discussed above. MendoCERA officials (Tim Knudsen and Jim Andersen) blamed faulty rules issued by the State Controller's Office (SCO) about how to produce audited financial statements. After that meeting I contacted Betty Moya - Manager of the SCO Local Government Reporting Section. I sent a video of the meeting and transcript of key segments. Ms. Moya told me the State Controller directions to which the MendoCERA officials referred don't have anything to do with how local governments - including County Retirement Associations - produce their annual audited financial statements. They only have to do with how local governments provide information her office needs to produce annual compilations of local government finances. I asked Ms. Moya to communicate what she told me to County officials. However, Ms. Moya said her office doesn't "get involved in local political issues".

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 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.**

E. The Retiree Healthcare Benefit

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. 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 financial policies such as the 1998 Resolution and Board Policy 40 are actually followed – including by itself?

F. Assumed Pension Fund Rate of Return Too High

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 the Pension Fund needed to fully fund pensions, shouldn't the target rate of return be no more than 6.6%, and in fact shouldn't it be less to prevent more service-destroying debt?

Shouldn't the County adopt a serious goal of producing no more unfunded pension debt?

VI. Retirement Board - Conflict of Interest

Do you agree that 2/3 of the members of the Retirement Board are employees (including 2 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?**

VII. Why Must Only the People of Mendocino County Pay this Debt?

We expect adults to take responsibility for their actions. We the People, County officials, the Retirement Association, the Unions, employees and retirees all played a role in the creation of this debt. There are no innocent victims.

Somewhere around $600 million will be paid to eliminate unfunded pension debt created through 2013. Most of this debt was created by the direct failure of the Retirement Board to achieve its self-adopted pension funding plans. That $600 million will be extracted from our weak local economy but won't directly provide one minute of public services or fill one pothole. It won't be paid to benefit next generation of County employees. Kids not even born yet will pay a significant part of this debt but will not receive any services or improved infrastructure for it. This debt has imposed very significantly reduced services on the People of Mendocino County for a generation.

The People should NOT be the only group expected to pay the resulting damages when we did the least to create them.

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?