Judy Zeller - Citizens' Letter

From: "John Dickerson" <JohnD@YourPublicMoney.com>
To: "John Pinches" <pinchesj@co.mendocino.ca.us>, "Carre Brown" <browncj@co....
Date: 4/21/2014 9:41 AM
Subject: Citizens' Letter
CC: "Bob Mirata" <bobmirata@gmail.com>, "Craig Walker" <craig.walker211@gmai...
Attachments: image001.jpg; John G Dickerson.vcf; Key Questions 140417_Sum.pdf

Our group – "Reform Our County Coalition" (ROCC) – will deliver a Citizen's Letter to you in tomorrow's pension workshop. We want you to know it's coming.

The letter is below. The 7 page summary and questions it refers to is attached. The full report can be downloaded from the home page of www.YourPublicMoney.com.

John Dickerson and the ROCC Steering Committee

April 22, 2014

To:

- Mendocino County Board of Supervisors, CEO, Auditor-Controller, Treasurer-Tax Collector
- Mendocino County Employees Retirement Association – Retirement Directors
- Major Mendocino County Bargaining Units

From: **Concerned Citizens of Mendocino County (see attached list of names)**

Please read the attached *Questions about Mendocino County's Unfunded Pension Debt and Analysis of that Debt* produced by the "Reform our County Coalition – Mendocino". We ask you to confirm or disprove their analysis and conclusions, answer their questions, and - is it true that:

- new rules next year will force our County to report about $200 million of past pension expenses that were never reported to us - and we have much more debt than assets?
- over $500 million is expected to be paid to eliminate unfunded pension debt that isn't supposed to exist?
- State Controller data shows the County Pension Fund's investment record is among the worst for County Funds?
- we were told about $35 million of retiree health benefits was paid with so-called Pension Fund "excess earnings" but the truth is every dime increased our County's debt?
- every County employee received pension increases and 1/3 were retroactive to when they were hired even though our County owed $100 million in unfunded pension debt?
- the Retirement Board created most of this debt the People have to pay but it isn't accountable to us?

- employees and retirees have no obligation to help pay unfunded pension debt even though 2/3 of the Retirement Board is composed of employees and retirees?

Before we can solve big problems we first have to recognize we have them. Then we need to understand what they are. Before talking about solutions we need to know what's true and accurate. **Are the attached analysis and findings essentially correct? If they aren't, please relieve our deep concern by proving they're wrong.**

We know you are very busy – but **please let us know when you can provide us with these answers.** We hope you can do so by the end of June. Thank you for your time and attention.

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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

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.

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Table of Contents

I. How Mendocino County's Pension Fund Should and Shouldn't "Work"

A. How Mendocino County Pensions are Funded

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. Balance of Debt

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. Pension-Related Payments (Normal Contribution + POB Pmts. + Amortization Pmts.)

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. <u>County Delayed Four Years to Learn Impact of New Retiree Healthcare Reporting</u>

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. <u>Major New Pension Financial Reporting Rules</u>

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. <u>City of San Diego Voluntary Compliance Statement - Internal Revenue Code</u>

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 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 of the County's employees receive pension increases that were retroactive back to the first day on the job?

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?

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.

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.

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.

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.

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.

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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.

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.

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

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.

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.

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?

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.

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

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?

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.

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.

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.

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.

This is a reply sent today – 5/22/14 - to Supervisor John McCowen's letter regarding the report I wrote that Mr. McCowen distributed to the BOR and others. My comments are in blue below.

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 <u>symptom</u> 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 systemic 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.

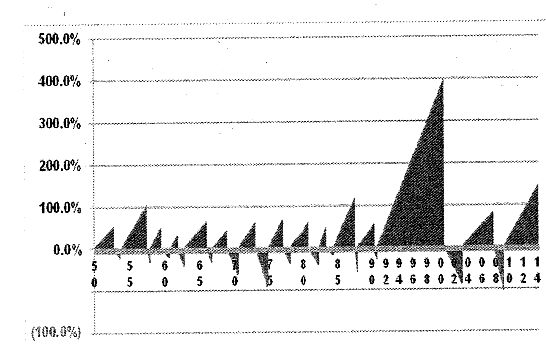
Those exceptions to the rule appear to be driven by one or a small number of individuals who refused to go down the slippery slope the system in place in County Pension Funds creates that led to massive public debt. They refused to do what everyone else was doing – create massive unfunded pension debt – 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 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 any 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". Every 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 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 minimum the County must do (as I'll describe below). Second – I admit I simplify some 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 – on 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 2007. Given history, my guess was UAAL payments weren't required for the year ending 6/30/07 particularly since the ratio for 2008 was 94.5%.

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/'or 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 assumed 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%
		1410	

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 institutional failures that have not 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"?

Pensions 101:
A Primer on the Mendocino County Retirement System

April 22, 2014

By the Mendocino County Executive Office

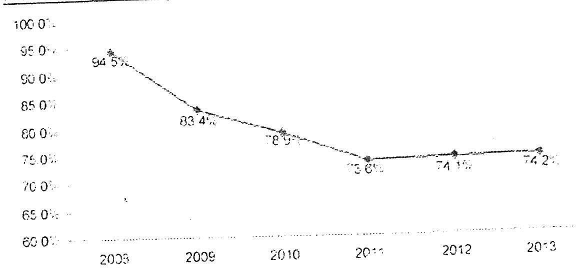
System Administrator

Tom Watson – Interim Administrator of the Mendocino County Employees Retirement Association (MCERA)

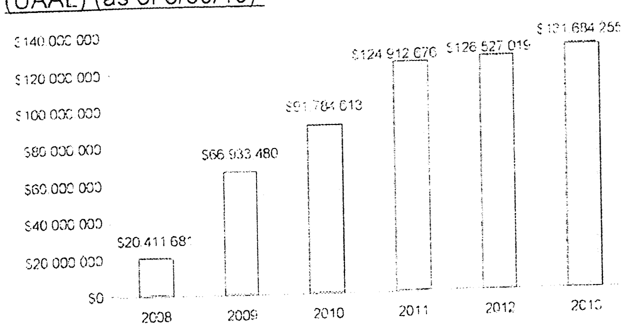
MCERA Board Members

- Shari Schapmire, *Chair*
- Lloyd Weer, *Vice-Chair*
- Tim Knudsen, *Secretary*
- Bob Mirata, *Trustee*
- Randy Goodman, *Trustee*
- John McCowen, *Trustee*
- Craig Walker, *Trustee*
- John Sakowicz, *Trustee*
- Ted Stephens, *Trustee*
- Richard Shoemaker, *Alternate Trustee*
- Vacant, *Alternate Trustee*

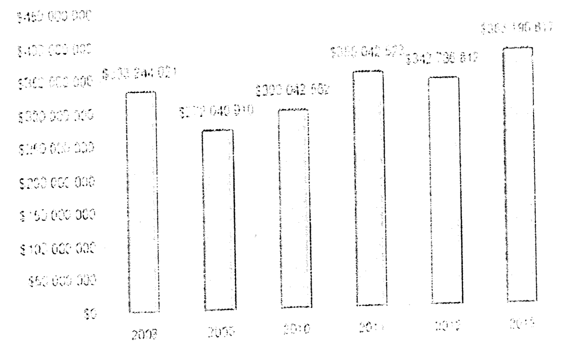
Funded Ratio (as of 6/30/13)[1]



Current Unfunded Actuarial Accrued Liabilities (UAAL) (as of 6/30/13)[1]



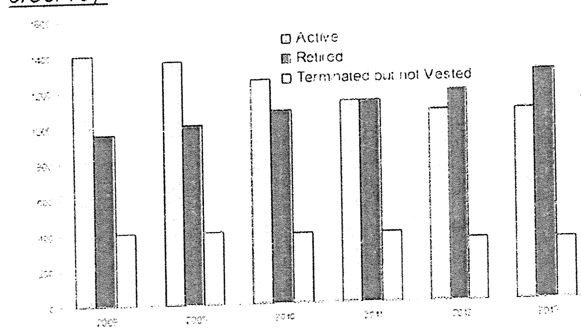
Current Market Value of Assets (as of 6/30/13)[1]



List of Actuarial Assumptions[1]

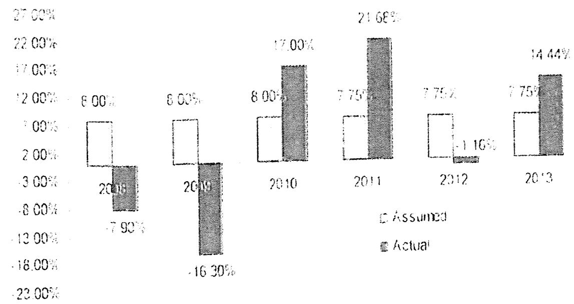
Actuarial Assumptions (from 6/30/13 Segal Consulting report)	
Category	**Figure**
Investment Rate of Return	7.75%
Inflation Rate	3.50%
Real Across-the-Board Salary Increases	0.50%
Projected Salary Increases	4.50% to 9.00%
Cost of Living Adjustments	3.00% of retirement income for General Tiers 1,2, and 3

Current Ratio of Actives and Retirees (as of 6/30/13)[1]

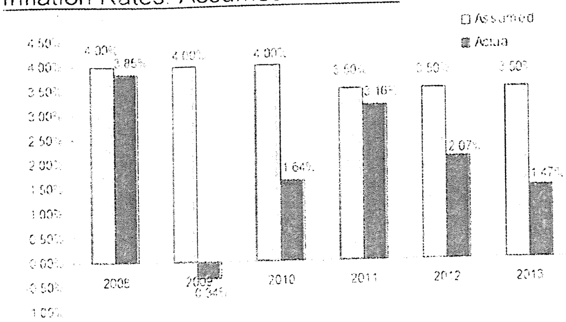


EM – QUICK FACTS DASHBOARD

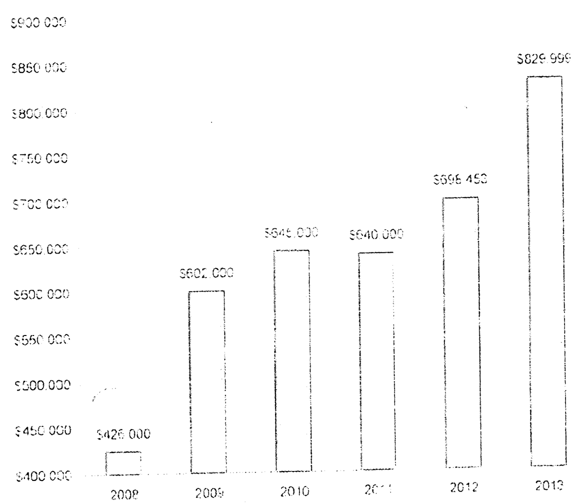
Investment Rate of Return: Assumed vs Actual[2]



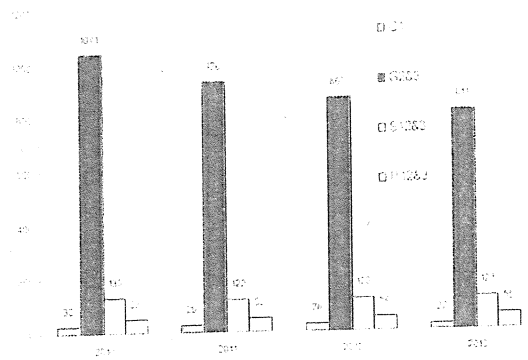
Inflation Rates: Assumed vs. Actual



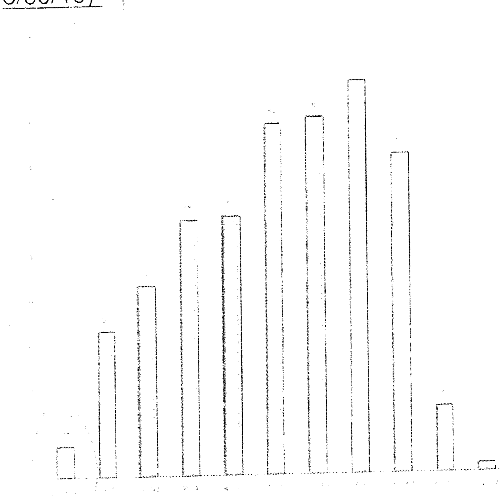
Administrative Costs[2]



Number of Active Members by Tier (as of 6/30/13)[1]



Distribution of Active Members by Age (as of 6/30/13)[1]



References:

1 – 6/30/13 Segal Consulting Valuation Report

2 – 3/11/2014 MCERA Comprehensive Annual Financial Report (CAFR) for Fiscal Years 2012 and 2013

PENSION SYSTEM TIMELINE

Mendocino County established its Retirement system under the COUNTY EMPLOYEES' RETIREMENT LAW OF 1937 on January 1, 1948. The Retirement System integrated with the Federal Insurance Contributions Act (FICA) on January 1, 1956.

September 1, 1969 – The Board of Supervisors adopted a Resolution including Safety Membership in the system. Safety Members are those eligible and qualified employees whose principal duties consist of active law enforcement.

January 1, 1979 – The Board of Supervisors rescinded the right for all employees hired after that date to purchase Military service time with Mendocino County Employees' Retirement System.

May 25, 1982 – The Board of Supervisors passed Resolution #82-119, adopting Section 31672.1 which reduced minimum retirement age from 55 to age 50 with 10 years of service.

September 1, 1985 – The Board of Supervisors adopted a Resolution allowing 100% of accrued sick leave to be counted toward service credit upon retirement. (Only applied when eligible to retire with 10 full years of service, age 50 and retiring immediately after terminating employment with Mendocino County).

January 1, 1987 – The Board of Supervisors adopted a Resolution making all employee contributions into the retirement system tax deferred.

September 1, 1998 – The Board of Supervisors adopted a Resolution declaring employees hired after that date will have no health insurance benefits upon retirement.

January 1, 2002 – The Board of Supervisors passed a Resolution adopting Section 31676.12 that increased retirement benefits for Department Heads, Management, Management Exempt, and Confidential bargaining units.

February 26, 2002 – The Board of Supervisors adopts Resolution 02-039 adopting Section 31664 which initiated Safety Retirment Benefits for certain Probation Employees, including Probation Department Head and Management.

October 1, 2003 – The Board of Supervisors passed a Resolution adopting Section 31676.12 that increased retirement benefits for General Members in SEIU bargaining unit.

December 1, 2004 – The Cemetery District passed a Resolution adopting Section 31676.12 that increased retirement benefits for its employees.

July 1, 2005 – The Board of Supervisors passed a Resolution adopting section 31664.2 that increased retirement benefits for Deputy Sheriff's Association (DSA) and Mendocino County Law Enforcement Management Association (MCLEMA).

Effective June 2009 - Adoption of 30-year amortization schedule (Board of Retirement)

December 11, 2012 - Adoption of new PEPRA Tiers (Board of Supervisors)

January 29, 2014 – Receipt of IRS Determination Letter

WHERE DO WE GO FROM HERE?

Space left empty for information arising from April 22, 2014 Pension Workshop.

and achieved a more level annual debt service pattern. The 2002 issuance set a 25-year repayment schedule, with the last maturity date in 2027. Over the course of its lifetime, the bond will cost the County $82 Million in interest. However, as many people will note, it can be looked at from the perspective that reducing the total amount of unfunded actuarial accrued liabilities (UAAL) greatly reduced the interest accrued on that total debt.

The reader should note that the Series 1996 POBs were paid off in 2010, and the Series 2002 POBs are on track to be fully paid off in the year 2027. The current balance on the 2002 Pension Obligation Bonds, as of April 17, 2014, is $72, 245,000.

Mendocino County approved the issuance of two major bonds to greatly reduce its unfunded actuarial accrued liability. One series was approved and issued in 1996, and the most recent series was approved and issued in 2002. These bonds are called "Pension Obligation Bonds," or POBs, and are backed by the County of Mendocino itself through an authority called a "debenture." A debenture is a legal document stating that the bond is not backed by physical collateral, but rather is backed by the general creditworthiness of the issuer. In this case, the County of Mendocino as the issuer of the bond is the entity that is ultimately responsible for repayment of these bonds. The word "Obligation" is used in the title of these bonds because repayment on the bonds is an absolute and unconditional obligation of the County and is enforceable by law.

Mendocino County
Summary of Debt Service Payments

Fiscal Year	1996 Pension Obligation Bonds		2002 Pension Obligation Bonds		Total Est. Annual Debt Service		Annual Total
	Principal	Interest	Principal	Interest	Principal	Interest	
[illegible]	[illegible]	[illegible]		[illegible]	[illegible]	[illegible]	[illegible]
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The 1996 series of Pension Obligation Bonds was in the total amount of $30,720,000. The 2002 series of Pension Obligation Bonds was in the total amount of $91,945,000. When the 2002 POBs were issued, the bond's Plan of Financing specified that they would be paid off by 2027: a 25-year repayment schedule. When these two POBs and their respective interest payments are combined, the County of Mendocino has been paying approximately $8,000,000 per year in debt service. Had the bonds not been issued, the County would have continued to pay on its pre-existing UAAL at the much higher interest rate as represented by the assumed rate of return.

Repayment on these bonds and the interest they accumulate does not include what the County must pay to amortize the UAAL. These are two separate, distinct payments, and when added together equal out to more than $20 Million per year that the County – inclusive of all funds – pays on retirement. One major goal of issuing these Pension Obligation Bonds, both in 1996 and again in 2002, was to increase the "funded ratio" of the MCERA retirement system by reducing the UAAL. An important side effect of these bond issuances was to allow the County to apply a more stable percentage in interest on what it was paying on the UAAL.

When the 2002 POB was issued, a portion of that money was used to "defease" the 1996 POBs. Put another way, the money raised from the 2002 POBs offset the remaining principal amount of the debt from the 1996 POBs. Further, this defeasing reduced the interest on that series of bonds and decreased the time frame to repay those 1996 POBs. In doing so, the County restructured the amortization schedule of its outstanding debt keep their anticipated age of retirement from service under the PEPRA reform legislation. However, other areas of reform such as retroactive pension increases did impact current employees.

In September of 2012, Mendocino County formed the PEPRA Work Group to prepare the Board of Supervisors for several key decisions before the end of 2012. The work group was composed of members of the County's Executive Office, Department of Human Resources, the Auditor's Office and the Board of Retirement. The Board of Supervisors was required to implement PEPRA-compliant tiers by January 1, 2013, and on December 11, 2012 made the following decisions on benefit formulas for *new* employees hired after January 1, 2013:

Tier	Selected PEPRA-Compliant Tier	Reduction in % of Covered Payroll from existing formula at that time[7]	Estimated Average Annual Savings in Employer Contributions per Employee[8]
General Tier 4	Option 1 2.5% @ 67 0% COLA	3.53%	$1,891
Safety Tier 3	Option 1 2.7% @ 57 0% COLA	7.36%	$4,230
Safety Probation Tier 3	Option 1 2.7% @ 57 0% COLA	5.40%	$2,377

The County of Mendocino Executive Office, at the direction of the Board of Supervisors, continues to research ways in which the Board may further reduce the County's liabilities from unfunded pension costs. The Pension Workshop on April 22, 2014, is the first step in a series of reviews that will enable the Board to learn more about mitigating the Unfunded Actuarial Accrued Liability (UAAL).

7 Savings based on estimates provided by Segal Consulting
8 Savings based on estimates provided by Segal Consulting

In 2013, the California State Legislature passed the biggest reform of public employees pension systems in decades. The California Public Employees Pension Reform Act (PEPRA) of 2013 assimilated to a 12-point proposal that Governor Jerry Brown laid out in his opening term as Governor after being elected (for the second time) in 2008. The proposal unveiled a series of reforms that were intended to curtail a looming unfunded liability crisis that many critics were calling for an answer to. As stated on his website, the 12-points apply to all public employees and employers, whether they be schools, state, local or any other public employer. The 12 points are as follows:

Governor Jerry Brown's October 2011 "12-Point Proposal" for Pension Reform

1. Equal Sharing of Pension Costs: All Employees and Employers
   - 50-50 sharing of costs to fund a pension
2. "Hybrid" Risk-Sharing Pension Plan: New Employees
   - Reduced defined benefit plan with the expansion of defined contribution (i.e. 401(k) plans)
3. Increase Retirement Ages: New Employees
   - Align retirement ages with actual working years and life expectancy
4. Require Three-Year Final Compensation to Stop Spiking: New Employees
   - Move from the highest one-year Final Average Salary to the highest three-year calculation Final Average Salary for purposes of calculating the retirement allowance
5. Calculate Benefits Based on Regular, Recurring Pay to Stop Spiking: New Employees
   - Prevent spiking of pension benefits when employees use special bonuses, unused vacation time, excessive overtime and other pay perks.
6. Limit Post-Retirement Employment: All Employees
   - Prohibit the "return" employee who retires Friday and heads back to service the following month while collecting a pension
7. Felons Forfeit Pension Benefits: All Employees
   - Retirees would forfeit their pension benefits if convicted for a felony violation of the law
8. Prohibit Retroactive Pension Increases: All Employees
   - Prohibit pension benefit enhancements from applying to work already performed by current employees and retirees
9. Prohibit Pension Holidays: All Employees and Employers
   - Prohibit employers and employees from taking a "holiday" from contributing to the retirement fund just because there is a good year of investment returns
10. Prohibit Purchases of Service Credits: All Employees
    - Buying "airtime" had been a past practice where employees could purchase service credits for time they didn't actually work. This would in effect increase the employer contribution responsibility for an artificially inflated amount of time worked, and at the same time increase the employee's pension benefit.
11. Increase Pension Board Independence and Expertise
    - Enhance the composition of the CalPERS Board by adding the California Director of Finance and two independent, public members with a background and expertise in finance
12. Reduce Retiree Health Care Costs
    - Would require more years of service from state workers before they are eligible for health care coverage[6]

The final legislation to implement PEPRA was passed and signed by Governor Brown in September of 2012. However, this resulting legislation did not incorporate all aspects of Governor Brown's originally proposed 12-point reform plan. In most cases, *current* employees – those working in public service at the time the legislation was signed into law – were not affected by much of the legislation. The greatest impact will be felt on *new* employees, or those who were and will be hired after January 1, 2013. This is especially true when it comes to retirement ages – only new employees will be affected by the PEPRA legislation. Current employees – or those employed in the service of the County at the time the legislation was signed into law – will still be able to

[6] See http://gov.ca.gov/docs/Twelve_Point_Pension_Reform_10.27.11.pdf for more information.

There is also the issue of local accountability. Members of a 1937 Act system are able to hold administrators more responsible than they might over a statewide program. Similarly, members and stakeholders can express concerns to the local Board of Supervisors or labor organizations and have a more immediate impact.

An important issue of the 1937 Act retirement system administration is exposure to risk. Local administrators of these systems can more sensitively calibrate the risk portfolios based on their local proximity to the plans members. Most '37 Act retirement systems will not accept high exposure to risk, and prefer investments that are safer rather than maximized.

Even though '37 Act Retirement Boards are independent entities, counties play a proportionately larger role than statewide systems. Most notably are the following characteristics:

- The County is the dominant participating employer, with usually more than 90% of the retirement system's members working for the County. Statewide systems generally only administer benefits to no more than 50% of those employees from any single employer;
- The County's financial soundness and ability to pay liabilities is critical to the plan;
- Most systems use the County's accounting framework to process monthly payouts to members and other expenditures;
- The County continues to control job classifications and compensation levels for most employees of the retirement system.[5]

One final aspect worth noting of the 1937 Act systems is the difference from statewide systems in what is considered "pensionable compensation." Meaning, what types of cash and salaries paid to employees are able to be counted towards salary in calculating the final highest average salary for purposes of retirement benefits. There are two major court decisions – generally known as the 'Ventura' decisions – that changed the previous definitions of pensionable compensation. Following this decision, the following types of compensation were ordered to be included in the calculation of the final average salary:

- Education incentive pay
- Bi-lingual pay
- Up to certain limits, lump-sum cash-outs of sick leave and vacation leave prior to termination

Overtime pay is excluded from these calculations. The 2013 California Public Employees Pension Reform Act (PEPRA) placed strict controls over the ability of employees to "spike" their pensions. Thus, there are now more restricted guidelines for counting cash-outs of accrued sick leave and vacation leave for the purposes of calculating the highest average salary.

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[5] Information taken from a California State Senate testimony: http://sper.senate.ca.gov/sites/sper.senate.ca.gov/files/PREPARED STATEMENT OF ROBERT PALMER %20 Chino.pdf

MENDOCINO COUNTY'S PLACE AS A '37 ACT COUNTY

MCERA is the smallest of the 20 counties that still operate under 1937 Act California Employees Retirement Law (CERL). Los Angeles County is the largest of the 1937 Act retirement systems at $41.7 Billion in net assets. As of April 15, 2014, MCERA's net assets stand at a little over $430 Million, as reported in its most up-to-date financial reports.

As written in the original text of the law, much of which is still in force today, the purpose of the 1937 Act Retirement law is to:

"*... recognize a public obligation to county and district employees who become incapacitated by age or long service in public employment and its accompanying physical disabilities by making provision for retirement compensation and death benefit as additional elements of compensation for future services and to provide a means by which public employees who become incapacitated may be replaced by more capable employees to the betterment of the public service without prejudice and without inflicting a hardship upon the employees removed.*"[4]

Specifically, the focus of the system is to provide a defined benefit plan under the guidelines established by the 1937 Act language. Broadly speaking, the Act provides for the following administrative parameters:

- Plans provide a guaranteed pension benefit based on a specific formula, the final average salary, number of years served, and the employee's age at retirement;
- Pension benefits are funded by contributions from both the employer and the employee and also from investment earnings on the fund;
- The retirement system shall be a separate trust fund from the County's General Fund. The money in this fund must be used exclusively to provide benefits to members and to pay administrative costs.

Some other statistics about the 1937 Act California Employee's Retirement Law are:

- More than 170 local governments in California utilize this form of retirement administration for its employees;
- Collectively these systems manage close to $90 Billion in net assets;
- The median size of the 1937 Act system net assets is $1.7 Billion;
- All systems feature local control through a retirement board, with the following composition:
  - Four members elected by employees (Two by General members, One by Safety members plus One Safety alternate);
  - One member elected by retirees (plus one alternate);
  - Four members appointed by the County's Board of Supervisors;
  - The County Treasurer (or equivalent position);
  - All shall serve three-year terms, with the exception of the County Treasurer who serves on the Board during the tenure of his or her term of office.
- The California State Constitution vests the Retirement Board with the exclusive authority to manage the system in carrying out its fiduciary duties to members;
- Administrative costs are limited to 0.21% of plan liabilities;
- There are requirements for annual financial audits and actuarial valuations;
- '37 Act Retirement Boards must comply with open meeting laws provided for in the Brown Act.

One of the *main* differences between a 1937 Act Retirement System and the California Public Employees Retirement System (CalPERS) is **local control**. 1937 Act systems are controlled and managed by local boards of retirement that are generally more knowledgeable about the circumstances of the local workforce. The idea is that local management is better able to tailor these systems to the needs of its employees. Also, these local plans can be modified much more quickly than a state-run plan.

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[4] See CA Govt. Code § 31451

MCERA uses what is called a Defined Benefit plan. These types of plans are uncommon in the private sector, as they are costly for employers. The largest concentrations of these plans exist in the public sector among local and state governments. This type of retirement system is called a "defined" plan because the benefits that employees receive in retirement are set by law and cannot be changed.

The Defined Benefit plan has the employer assume all risk and it is the employer who is ultimately responsible for ensuring those retirement benefit promises are met. It is impossible to correctly forecast the fluctuations in investment returns due to an often volatile market. Thus, even a defined plan that is 100% funded in one year can theoretically drop the next year to being only 80% funded if it has a spectacularly bad year of losses. This happened to MCERA in 2009 when the pension fund lost 16.30% in market value due to a major crash in stock prices in the U.S. After this loss in value, MCERA's defined benefit plan went from being 94.5% funded to 83.4% funded – a drop of more than 10%. Conversely, the plan could also theoretically make up for such a loss with a 10% gain or greater if there are very high returns on investment in a given year.

A Defined Contribution plan, on the other hand, is a retirement option where the employee and sometimes the employer contribute an amount to the plan every year. The individual employee usually has total say in the risk profile of that plan by determining the percentage allocation of resources by asset class (i.e. stocks and bonds). In a Defined Contribution Plan, it is the employee who assumes all the risks associated with an incorrect assumed rate of return. In a Defined Benefit plan, it is the employer who assumes all the risks associated with an incorrect assumed rate of return.

One very clear advantage for employers using *only* a defined contribution system is that it eliminates any risk of unfunded actuarial accrued liability. The employee takes out what was put in, minus any losses or plus any gains. This is not the case with a defined benefit plan – pension benefits to retirees are guaranteed by law, and the employer remains ultimately responsible for delivering those benefits. More specifically, if the assumed rate of return is not met by the investment returns for that year, the employer is responsible for making up that loss. This puts the employer at substantial risk when actuarial assumptions are proven wrong with experience. At the same time, the employer stands to benefit from an upswing in investment returns in that they would pay less into the system that year.

Mendocino County's Other Post-Employment Benefits (OPEB)

Many 1937 Act Counties in California provide their retirees with benefits in their retirement other than a pension. In California, when Other Post-Employment Benefits (OPEB) are talked about it generally refers to healthcare for retirees in addition to their pensions. In the case of Mendocino County, MCERA retired members were allowed access to health care through the County for those who were non-eligible for Medicare. However, the Affordable Care Act dramatically changed the conversation around this topic by offering affordable and comprehensive new health care coverage as a viable alternative to retiree health care. Further, many retirees were able to matriculate into Medicare due to changing demographics and an aging population of County retirees. In early 2012, the Mendocino County Board of Supervisors voted to completely transition these retirees into the Affordable Care Act health system and Medicare, effective December 31, 2013. According to Aon Consulting's Actuarial Valuation Study of August 21, 2008, this action shielded the County from liability of between $97.8 million and $140.9 million in 2008 dollars.

Recent Actions Taken to Lower County Pension and OPEB Liabilities

- December 31, 2013 elimination of OPEB liability – eliminating County subsidized healthcare benefits for pre-MediCare elible retirees. (BOS)
- January 1, 2013 implementation of General Member Tier 4, Safety Tier 3, and Probation Tier 3. (BOS)
- January 1, 2013 implementation of Cost of Living Adjustment (COLA) termination for new tiers. (BOS)
- April 17, 2013 adoption of "layering" policy for new UAAL's incurred after June 2012 on an 18-year amortization table – thereby eliminating future negative amortization. (BOR)

In its June 30, 2013 Comprehensive Annual Financial Report (CAFR), MCERA reported the following composition of its investments at fair value for years 2013 and 2012:

Note 3: Investments, continued:

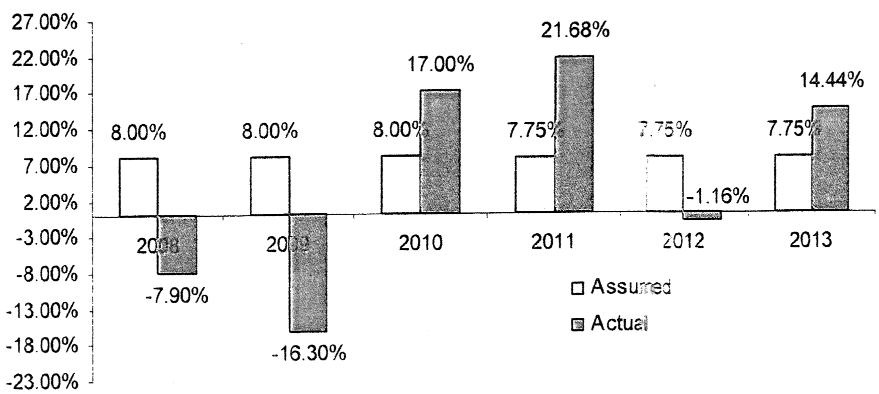
The Association's cash and investments stated at fair value as of June 30, 2013 and 2012 are as follows:

		2013		2012
Cash in trust - Mendocino County	$	2,144,579	$	2,354,560
Total cash equivalents		2,144,579		2,354,560
U.S. Government and corporate bonds		95,171,941		92,293,393
International equities		79,092,537		62,250,363
Domestic equities – small cap		25,034,337		17,224,355
Domestic equities – mid cap		19,618,107		21,744,297
Domestic equities – large cap		85,658,431		81,792,546
Total mutual funds		304,575,349		275,304,957
Public equity securities		42,628,535		33,517,464
Real estate partnerships		32,994,779		29,736,494
Real estate – 625 Kings Court, Ukiah, CA		864,000		732,992
Total Cash Equivalents and Investments	$	383,207,549	$	342,552,767

The Association's investment consultant, Callan Associates, is responsible for advising on the portfolio composition. Specifically, the goal of these investments is to maximize return while keeping MCERA's risk profile – or exposure to market volatility and credit risk – within the dedicated set of parameters. As it states in its most recent CAFR:

MCERA's Investment Policy does not allow for a single investment in real estate that is in excess of 5% of total assets. With respect to common stocks, MCERA has a goal of diversifying the portfolio among a cross-section of industries that have sound long-term growth potential. Similar restrictions apply to fixed income securities.[3]

The historic returns on the pension fund can be found in the dashboard of this report and also below:



In 2013, MCERA received a return on investments, measured at fair value, of 14.44%, or $48.9 Million.

Defined Benefit vs. Defined Contribution

[3] Pg. 28 of the MCERA Comprehensive Annual Financial Report

- The **COLA**, or Cost-of-Living-Adjustment, to account for yearly inflation that would raise the price of common food staples and other goods deemed necessary for life
- The **Salary Increase**, which accounts for inflation plus promotions and merit increases

The Second Source of Money – Employer Contribution

Like the employees, the employer pays the other half of the normal cost of the retirement system. Unlike the employees, the employer's financial responsibility towards the system does not end here.

Because of the employer's responsibility toward all risk associated with assumptions, the employer pays not only its half of the normal cost of retirement but also 100% of the Unfunded Actuarily Accrued Liability (UAAL). If an actuarial assumption turns out to be incorrect, it can either increase or reduce the UAAL.

So, what exactly is a UAAL?

The Unfunded Actuarially Accrued Liability (UAAL) is the difference between the current projected cost to cover all members that are *eligible to receive retirement benefits*[2] and the actuarially adjusted value of assets. In simpler terms, the difference between what the fund currently holds in assets and what is projected as the cost to fully fund all retirement benefits. The UAAL is created by assumptions that are proven incorrect with experience (e.g. Increased longevity of retiree population).

Projected costs to fully cover all members in their retirement — Actuarially Adjusted Value of MCERA's Assets = UAAL

Employers may also contribute towards the pension system through an Employer Paid Member Contribution (EPMC). An EPMC is where the employer pays either fully or in part for the employee's portion of the normal cost, thereby adding to the employee's net pay. This benefit is typically negotiated and in Mendocino County, only DSA members and MCLEMA members receive this benefit.

To summarize, Mendocino County is responsible as the employer for three major costs:

Cost #1 – Normal Cost:
- The normal cost covers the "Basic" and "COLA" net present costs. In essence, what is required right now to invest at the assumed rate of return to fully fund each member's retirement benefit.

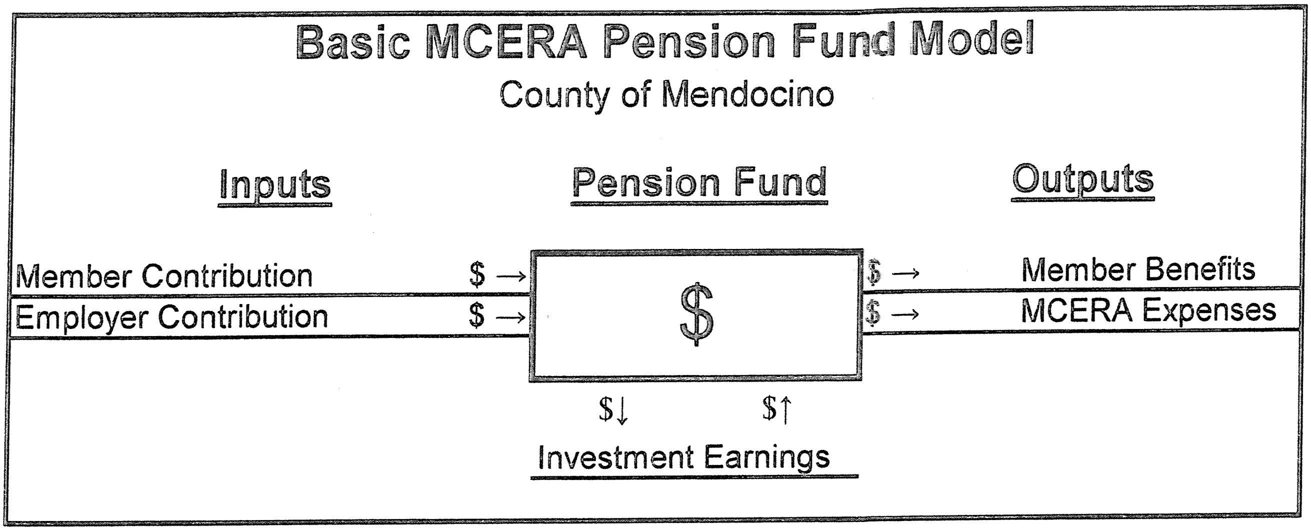
Cost #2 – UAAL Amortization
- The cost to amortize the Unfunded Actuarial Accrued Liability (UAAL) on a yearly basis in order to eliminate the UAAL by 2039. On April 17, 2013, the MCERA Board adopted a policy that any new UAAL incurred after June 30, 2012, would be shifted into separate annual layers of UAAL amortization payments. These new amortization time periods for any UAAL established after the 2012 date would depend on what the source of the new debt was (i.e. gains and losses are amortized over 18 years).

Cost #3 – Employer Paid Member Contribution:
- This benefit only applies to Mendocino County members that are Safety members and part of Tiers 1 & 2.

The Third Source of Money – Investments

[2] To be a member of MCERA: General Tier – Must be 4/5 FTE; Safety Tier – Automatic; Probation Tier – depends on job classification; Elected Officials – optional to join.

How Does the Pension System Work?



The above graph depicts the basic pension fund model divided into three sections: Inputs, Pension Fund, and Outputs.

Inputs

Member Contributions: Percentage of hourly wage, the normal cost.
Employer Contributions: Percentage of hourly wages, Employer Paid Member Contribution (if any), Unfunded Actuarially Accrued Liability (UAAL).

Pension Fund

Investment Earnings: gains and losses on investments in the marketplace.

Outputs

Member Benefits: Monthly payments made to vested retirees or their survivors under certain circumstances.
MCERA Expenses: The costs of administering the pension funds and system.

The First Source of Money – Employee Wages

For each hour that an employee works, a percentage of their pay is deducted to pay 45%-50% of the normal cost of the retirement benefit. The "normal cost," or the *basic contribution*, accounts for how much each member has to pay into the system each pay period to cover what the system plans to pay out to that same member in their retirement. Members must also pay 45%-50% of the total projected cost to fund their cost-of-living benefits – the employer picks up the other 50%-55%. Once the member makes their contribution of 45%-50% of the normal cost, the member's responsibility to fund the pension system ends.

The total normal cost will depend on which tier an employee falls in, their age, and the actuarial assumptions made. Below are some major assumptions MCERA's contracted actuarial company, Segal Consulting, must use in order to arrive at these calculations of normal cost:

Primary Assumptions

- The **investment rate of return** set by the Board of Retirement for the actuarial return on investment
- The **mortality rate** for humans as determined by the National Society of Actuaries, and which differs by tier

- All members
  - Eligibility requirement: No age or service requirements.
  - 50% of the final compensation or 100% of service retirement benefit, if greater.
- **Pre-Retirement Death**
  - All members
    - Eligibility requirement: none.
    - Basic lump sum benefit: Refund of employee contributions with interest, plus one month's compensation for each year of service to a maximum of six month's compensation.
    - Death in line-of-duty: 50% of Final Compensation or 100% of Service Retirement benefit, if greater, payable to spouse – or eligible domestic partner – or minor children.
  - Vested members
    - Eligibility requirement: 5 years of service.
    - Basic benefit: 60% of the greater of Service Retirement or Non-Service Connected Disability Retirement benefit payable to surviving eligible spouse, in lieu of the basic lump sum benefit above.
    - Death in line-of-duty: 50% of Final compensation or 100% of Service Retirement benefit, if greater, payable to spouse – or eligible domestic partner – or minor children.
- **Death After Retirement**
  - All members
    - Service or non-service connected disability retirement: 60% of member's unmodified allowance continued to eligible spouse. An eligible spouse is a surviving spouse – or eligible domestic partner – who was married to the member at least one year prior to the date of retirement.
    - Service-connected disability: 100% of member's allowance continued to eligible spouse
- **Withdrawal Benefits**
  - Less than 5 years of service: Refund of accumulated employee contributions with interest, or earned benefit at age 70.
  - More than 5 years of service: If contributions left on deposit, entitled to earned benefits commencing at any time after eligible to retire.

	June 1, 1982.
Safety Tier 2	All employees appointed to a position in active law enforcement who were hired on or after June 1, 1982 and prior to January 1, 2013.
Safety Tier 3	All employees appointed to a position in active law enforcement who were hired on or after January 1, 2013.
Probation Tier 1	All employees appointed to positions with specific job classifications within the Departments of Probation, Juvenile Hall, and Social Services who were hired prior to July 1, 1984.
Probation Tier 2	All employees appointed to positions with specific job classifications within the Departments of Probation, Juvenile Hall, and Social Services who were hired on or after July 1, 1984 and prior to January 1, 2013.
Probation Tier 3	All employees appointed to positions with specific job classifications within the Departments of Probation, Juvenile Hall, and Social Services who were hired on or after January 1, 2013.

The maximum amount that is allowed to be used in calculating retirement allowances is determined by which tier an employee is in. The following lists by tier the Final Average Salary that can be used to calculate retirement benefits:

Tier	Description
General Tier 1, Safety Tier 1, and Probation Tier 1	Highest consecutive twelve months of compensation earnable
General Tiers 2 and 3, Safety Tier 2, and Probation Tier 2	Highest consecutive thirty-six months of compensation earnable
General Tier 4, Safety Tier 3, and Probation Tier 3	Highest consecutive thirty-six months of pensionable compensation

Below is a table of the number of employees by tier (as of April 17, 2014):

Tier	Employees
General Tier 1	18
General Tier 2	0
General Tier 3	679
General Tier 4	142
Safety Tier 1	2
Safety Tier 2	113
Safety Tier 3	17
Probation Tier 1	0
Probation Tier 2	48
Probation Tier 3	4
Total	**1023**

Benefits associated with retirement

Employees are also eligible for benefits other than retirement. These other benefits include disability, death and survivor benefits. Specifically, the following additional benefits are given to Mendocino County employees:

- **Non-Service Connected Disability**
  - Vested members
    - Eligibility requirement: 5 years of service.
    - Benefit formula: 1.8% per year of service. If the benefit does not exceed one-third of Final Compensation, the service is projected to 62 for General members and to 55 for Safety and Probation members, but the total benefit cannot be more than one-third of Final Compensation.
- **Service-Connected Disability**

How Does the Pension Benefit Work?

Every employee who works for the County (or the two other plan sponsors) for more than five (5) years becomes "vested" in the system, meaning they will be eligible for a pension. Thus, a retired employee would then be able to collect payments from MCERA once they turn 50 years old or have worked thirty years or more for the County, whichever comes first. General Tier employees must be at least 50 years old or have served for 30 years – whichever comes first – to be eligible by State law for these payments. Safety-Probation Tier members, on the other hand, may receive retirement if they have completed 10 years of service and are at least 50 years old, or if they have completed at least 20 years of service they may also retire regardless of age.

Following are a few formulas that a General Tier 3 member, for example, could choose from depending on the age they want to start receiving their pension benefits. Let's assume the highest three consecutive years of salary for this particular employee was $45,000, $55,000 and $60,000 and he or she had worked for 15 years:

	Percentage Factor	Average of Highest Consecutive 3 Years of Salary	Benefit Formula[1]	Unmodified Annual Retirement Benefit
50 Years of Age	1.34%	($45,000+$55,000+$60,000)/3 = $53,333	((.0134*53,333) – (.33*.0134*$350*12)) x 15 years worked for County	$10,441
55 Years of Age	1.77%	($45,000+$55,000+$60,000)/3 = $53,333	((.0177*53,333) – (.33*.0177*$350*12)) x 15 years worked for County	$13,792
60 Years of Age	2.34%	($45,000+$55,000+$60,000)/3 = $53,333	((.0234*53,333) – (.33*.0234*$350*12)) x 15 years worked for County	$18,233
62 Years or Older	2.62%	($45,000+$55,000+$60,000)/3 = $53,333	((.0262*53,333) – (.33*.0262*$350*12)) x 15 years worked for County	$20,415

The estimated final figure can be arrived at by taking into account a reduction for also having Social Security coverage. This is meant to offset the amount an employee pays into Social Security by reducing their contribution into MCERA. A chart is provided by MCERA for an employee to look up the equivalent pay reduction when estimating their final monthly benefit after retirement.

What is the "tier" system?

Depending on the date an employee is hired, they will be placed into one of four separate tiers of membership: Tier's 1 through 4. Also, depending upon their job classification, employees will be placed into one of three appropriate member classifications: General, Safety, and Probation. Below is an in-depth look at the date and classification eligibility requirements used to place an employee in each tier:

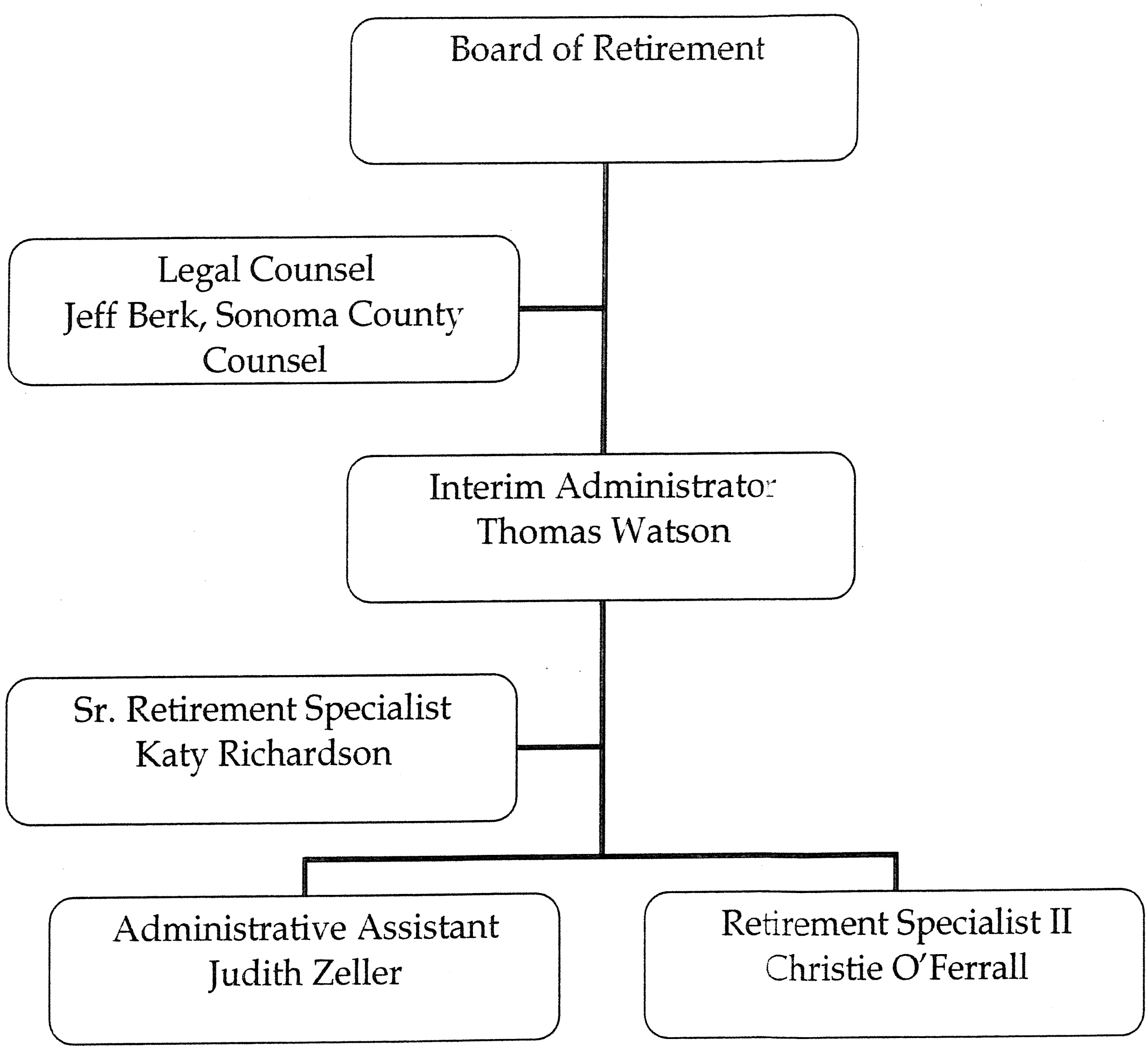
Tier Placement Requirements	
General Tier 1	All General members appointed to a permanent position of four-fifths time, or more, in service of the County of Mendocino or in the service of a participating District, who were hired prior to July 1, 1984.
General Tier 2	General Tier 2 has been replaced by General Tier 3
General Tier 3	All General members appointed to a permanent position of four-fifths time, or more, in service of the County of Mendocino or in the service of a participating District, who were hired on or after July 1, 1984 and prior to January 1, 2013.
General Tier 4	All General members appointed to a permanent position of four-fifths time, or more, in service of the County of Mendocino or in the service of a participating District, who were hired on or after January 1, 2013.
Safety Tier 1	All employees appointed to a position in active law enforcement who were hired prior to

[1] Taken from page 61 of June 30, 2013 Segal Consulting Actuarial Valuation Report for more information, available at http://www.co.mendocino.ca.us/retirement/reports.htm. *It is recommended that employees make an appointment with MCERA staff to arrive at an exact estimate of retirement allowance instead of trying to calculate it on their own.*

MCERA Administrative Staff

MCERA employs a professional staff and contracts with independent consultants for investment, audit and actuarial services. The purpose of incurring these administrative costs is to ensure a smoothly functioning system that delivers reliable payments to retirees; assures adherence to legal requirements outlined in the 1937 Act statutes; prepares annual financial reports; and implements actions taken by the Board of Retirement.

The Board of Retirement is organized as follows (Note: the Board of Retirement recently added a position for a financial investment officer):



MCERA covers members from three different organizations:

1. County of Mendocino
2. Superior Court of Mendocino County
3. Russian River Cemetery District

Getting to Know the Mendocino County Employees' Retirement System

The Mendocino County Employees Retirement Association (MCERA) is overseen by the Board of Retirement. The Board employs an administrative staff to manage MCERA's retirement benefit payments and carry out other administrative duties. It is important to note that this Board is an entirely separate entity from the Board of Supervisors, both in its fiduciary duties and its powers. Specifically, MCERA provides retirement, disability, death and survivor benefits to employees who have retired from service with the County. The retirement plan is administered pursuant to the County Employees Retirement Law of 1937 (Cal. Gov. Code §31450, et. seq.). Mendocino County is one of 20 counties in California that has a retirement system operating under the 1937 Act Retirement Law. All other counties in California are part of the California Public Employees Retirement System (CalPERS) or have local retirement systems as part of the county's charter.

MCERA was established by the County of Mendocino on January 1, 1948. The association operates independently but relies on the County's Auditor's Office and the Treasurer/Tax Collector's Office for some administrative services. The Board of Retirement's legal authority over the administration of the system derives from the California Constitution, Article XVI, Section 17. This section of the California Constitution grants the Board "plenary authority and fiduciary responsibility for investment of moneys and the administration of the system." This section of the California Constitution also states that the Association's Board of Retirement:

"... shall discharge their duties with respect to the system solely in the interest of, and for the exclusive purposes of providing benefits to, participants and their beneficiaries, minimizing employer contributions thereto, and defraying reasonable expenses of administering the system."

Who sits on the Board of Retirement?

There are 11 seats on the Mendocino County Retirement Association Board (one is currently vacant). The current composition of the Board (as of June 30, 2013) is as follows:

Name	***Board Position***	***Appointment/Election***
Shari Schapmire	Chair, Mendocino County Treasurer/Tax-Collector	Automatic Seat as County Treasurer (Ex-Officio)
Lloyd Weer	Vice-Chair	Elected by Active General Membership
Randy Goodman	Trustee	Elected by Active General Membership
Richard Shoemaker	Alternate Trustee	Elected by Retired Membership
Tim Knudsen	Secretary	Elected by Retired Membership
Bob Mirata	Trustee	Appointed by Board of Supervisors
John McCowen	Trustee and Member, Board of Supervisors	Appointed by Board of Supervisors
John Sakowicz	Trustee	Appointed by Board of Supervisors
Ted Stephens	Trustee	Appointed by Board of Supervisors
Craig Walker	Trustee	Elected by Active Safety Membership

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