

## THE 800 POUND GORILLA IN THE ROOM



### The Built-In "Interest Expense" On Mendocino County's Unfunded Pension Obligations

An Extreme Threat to the County's Long-Term Finances

August 27, 2009

Copyright **YourPublicMoney.Com**, 2009

<b>I. BACKGROUND</b>	<b>1</b>
<b>II. LIES, DAMN LIES, AND ACTUARIAL STATISTICS</b>	<b>1</b>
<b>A. Calculating the Pension Fund’s Financial Position</b>	<b>1</b>
<b>B. The Need For and Proper Use of the “Actuarial Value of Assets”</b>	<b>1</b>
<b>C. Calculating Market Value and Actuarial Value of Assets</b>	<b>2</b>
<b>D. The Two Values Compared</b>	<b>2</b>
<b>III. THE 800 POUND GORILLA</b>	<b>2</b>
<b>IV. COUNTY’S OFFICIAL RESPONSE - LOWER PAYMENTS</b>	<b>3</b>
<b>V. FOUR SCENARIOS PROJECTED EIGHT YEARS TO 2017</b>	<b>4</b>
<b>VI. WHY THE PENSION FUND WON’T EARN ITS WAY OUT OF DEBT</b>	<b>4</b>
<b>VII. GIVEN THE ALTERNATIVES BEING CONSIDERED, WHAT IS LIKELY TO HAPPEN</b>	<b>4</b>
<b>VIII. CORE CRITICISMS</b>	<b>5</b>
<b>IX. WHAT SHOULD BE DONE IMMEDIATELY</b>	<b>5</b>
<b>X. REORGANIZE PUBLIC SERVICES IN THE COUNTY</b>	<b>5</b>
<b>XI. ATTACHMENT - PROJECTIONS OF PENSION FUND</b>	<b>6</b>

**The 800 Pound Gorilla:** The economic reality is that the current \$113 million Unfunded Pension Obligation (calculated using the real value of the Fund's Assets) will grow at 8% per year unless it is eliminated. There are basically only two ways it can be eliminated:

- County Unfunded Obligation Amortization Payments
- Pension Fund investment profits

## I. BACKGROUND

The County provides its employees with a "Guaranteed" or "Defined" Pension. A separate trust fund the County doesn't control - Mendocino County Employees Retirement Association (MCERA) - manages Mendocino County's Pension Fund. The Pension Fund's average return from 1996 through 2008 was 6.3% - 20% less than its 8% target. This is a major cause of the fact that the Pension Fund's Unfunded Obligations increased in 10 out of the last 12 years.

Mendocino County must deal with two severe budget threats it didn't create - the national recession and the State budget crisis. But the County caused an additional threat that makes its financial crisis much worse - extreme debt.

Mendocino County's total debt in 1993 was \$60 million. Today it's at least \$315 million. The County still owes \$92 million on money it borrowed in the past because of previous Unfunded Pensions.

The County was forced in 2008 to disclose for the first time it had \$130 million in Unfunded Retiree Healthcare Obligations. The financial management of the County's retiree benefits is the source of 85% to 90% of the County's Debt. Annual debt payments grew from \$2.5 million in 1995 to over \$13 million in 2009. Twenty percent of the 2000 discretionary budget went to debt payments. It's around ½ today.

Mendocino County is the most indebted County in the State relative to population and total appropriations.

## II. LIES, DAMN LIES, AND ACTUARIAL STATISTICS

### A. Calculating the Pension Fund's Financial Position

A Pension Fund's financial position is calculated by subtracting Total Pension Fund Obligations from Pension Fund Assets. The result is either Underfunded or Overfunded Obligations. But Actuaries use two values for Pension Fund Assets: Market Value and Actuarial Value

**Table 1 - Estimated Unfunded Pension Obligations  
6/30/09**

	Market Value	Actuarial Value
Pension Fund Assets	\$274 million	\$329 million
Less Total Obligations	- 387 million	- 387 million
Unfunded Pension Obligations	(\$113 million)	(\$58 million)

Why are there two different values? Are the Pension Fund's Assets worth \$274 million or \$329 million?

### B. The Need For and Proper Use of the "Actuarial Value of Assets"

Both the County and its employees make annual contributions to the Pension Fund for the pensions being earned each year. But only the County is obligated to make additional payments to eliminate significant Unfunded Pension Obligations. But how much do those "amortization payments" need to be?

The Market Value of the Pension Fund's assets is the real dollar value mostly determined by the stock market. It's what the Fund's Assets are really worth. It's what the Fund has available to invest, pay pensions, and fund other payments such as expenses.

Here's the problem - the Market Value of Assets can be very volatile because the stock market can bounce up and down. That in turn would make the County's amortization payments for Unfunded Pension Obligations change radically from year to year. These rapidly changing payments would be like a "bull in a china shop" in the County's budget - it would seriously damage the ability to have budget stability from year to year.

Actuaries developed a formula to "slow down" the rate of change of the County's required payments. This is a reasonable practice as long as the use of the modified Actuarial Value doesn't lead to a dangerous distortion of real Asset Value or obscure poor performance.

### C. Calculating Market Value and Actuarial Value of Assets

Most of the Pension Fund's Assets are its investments - in stocks, bonds, real estate, etc. The Market Value is what they could be sold for. For investments such as stocks and bonds that are sold in well-established markets it's fairly easy to establish their value - it's what they are selling for in the market. For real estate an estimate or appraisal is necessary.

An Actuary then modifies the Market Value to produce the Actuarial Value of Assets. Two formulas do this:

#### a) Smoothing

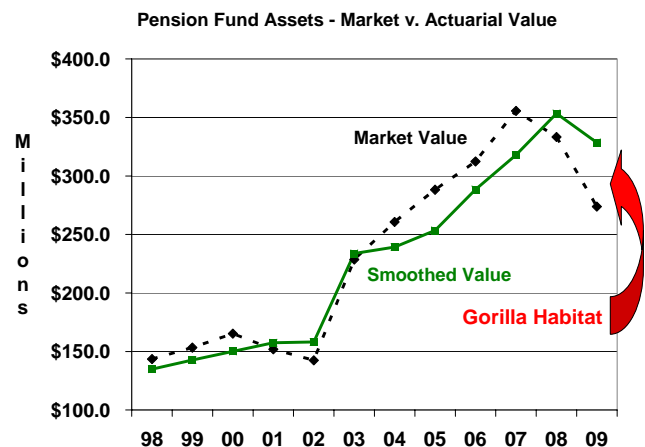
MCERA uses a five year smoothing period. Every year the amount actual returns are more or less than the Fund's target return of 8% is spread out over that and the following four years - 20% per year.

#### b) Corridor Limits - A Limit on Smoothing

This is a limit on how much the Actuarial Value of Assets may differ from the Market Value. At this time the Corridor Limit is 20%. The Actuarial Value can't be more than 20% different from the real Market Value.

### D. The Two Values Compared

The largest gap between these two values in at least 20 years exists today in 2009. In fact this is the first time in at least 2 decades - and probably forever - that the difference in the Pension Fund's Actual Market Value of Assets is more than 20% different from the "Smoothed" value. This is the first time the Corridor Limit has been used in at least the last 2 decades. This gap between the true Market Value and Actuarial Value is where the 800 pound gorilla lives.



## III. THE 800 POUND GORILLA

The proper use of the Actuarial Value is to reduce year to year changes in the County's Unfunded Obligation payments. But County and Retirement Association officials are taking this a step further by acting as though the Actuarial Value of Assets is the "Real" Value. It isn't - today it overstates the real Market Value by \$55 million. This is very dangerous. It enables officials to ignore the "800 pound Gorilla".

Actuaries figure out what the Pension Fund's Total Obligations are by discounting all future projected Pension Fund payments (mostly pensions that have already been earned) to their present value using MCERA's target annual rate of return - 8%. As a simple example, if the Pension Fund is expected to pay \$20 million 10 years from now, then it needs \$9 ¼ million today. Then, assuming it is invested and earns 8% a year, it will grow to be worth \$20 million in 10 years when those payments need to be made.

But the Fund today has about \$113 million less than it should. **It can't earn investment returns on money it doesn't have.** Even if it earns 8% on the \$275 million it has, total earnings will be \$9 million short (8% of the \$113 million deficit).

The Pension Fund's long term average returns have been 6.3% not including last year's disastrous losses in the stock market. The Fund needs to earn 20% more than it has since 1996 (not including 2008-09) just to reach its target of 8%. And even if it does, the Unfunded Obligations will increase 8% a year because the future payments are one year closer every year.

**The 800 Pound Gorilla - Built In Interest Expense: The economic reality is that the \$113 million Unfunded Obligation will grow at 8% per year unless it is eliminated. There are basically two ways it can be eliminated:**

- **The County pays it off**
- **High Pension Fund investment profits**

#### **IV. COUNTY'S OFFICIAL RESPONSE - LOWER PAYMENTS**

We can find no evidence that anyone in the County or Retirement Association has estimated how much the Unfunded Pension Obligation - and therefore the County's Debt - will grow if it isn't eliminated. Instead of concerning themselves with this huge threat, they are considering ways to reduce the County's payments to the Pension Fund for the next few years to "help with the budget crisis".

They'd do this by changing some "Actuarial Policies". For example, the "smoothing period" could be extended from 5 to 7 years which would spread the last two year's losses out over an additional 2 years thereby slowing down the decline in the Actuarial Value of Assets. Another idea is to widen the Corridor Limit from 20% to 25% so that the Actuarial Value can be even more different from the real Market Value.

The Smoothing Period and Corridor Value were discussed on the previous page. Two other policies not yet introduced are the number of years in the amortization period and an "allowable" Unfunded Obligation.

The "amortization period" is how many years the County would have to eliminate Unfunded Pensions. Today it's very short - only 7. Officials are considering extending it to 30 years. That would lower payments tremendously - but also greatly increase total interest expense.

Another concept is the "Allowable Unfunded Pension Obligation". This would mean the Pension Fund could have up to a set proportion of Unfunded Obligations without triggering the requirement for the County to eliminate them. Many public pension managers say that it's "OK" to have a certain level of Unfunded Obligations, usually in the range of 10% to 20%.

The Pension Fund's Actuary estimates the value of the Total Pension Obligation today is about \$387 million. If there were a 10% Allowable Unfunded Obligation, then the County would not be obligated to eliminate the first \$38.7 million of Unfunded Obligations. If it were 20%, the Allowable level would be about \$77 million.

However, any level of Unfunded Obligations directly forces future citizens to pay past expenses. If they are large enough it means future generations are being forced to pay expenses incurred by previous generations. (See [YourPublicMoney.Com](http://YourPublicMoney.Com) for more about this issue.)

**The Magic Unfunded Pension Obligation Disappearing Act:** If all these policy changes being considered were adopted they would transform \$113 million of real Unfunded Pension Obligations using the Market Value of Pension Fund Assets to \$6.1 million the County would be required to eliminate. And it would have 30 years to do so.

The problem is - underneath all those fancy calculations the remaining real cash value of the Unfunded Obligations would be growing by 8% a year - far more than the amount the County would be paying.

## V. FOUR SCENARIOS PROJECTED EIGHT YEARS TO 2017

We developed a spreadsheet model of the Pension Fund to test four "Master Scenarios". (More information about the model and the scenarios is in Attachment - Projections of Pension Fund on page 6.)

All scenarios were projected out 8 years. As a benchmark, in the last 8 years the County paid a total of \$54 million to the Pension Fund. These were all for the normal yearly contributions to the Pension Fund - not payments to eliminate Unfunded Obligations because the County has not had to do so since it borrowed about \$90 million in December 2002 to eliminate the Unfunded Obligations that then existed.

**"What happens if the County simply pays the Pension Fund what the Actuary tells it to according to current Actuarial Policies?"** It would pay the Fund \$276 million over the next 8 years, and in the 9<sup>th</sup> year - 2018 - it would pay another \$55 million.

**"What happens if all that happens is the policy changes described on the previous page are adopted?"** It would back-fire big time. Total County payments to the Pension Fund would be somewhere between \$135 million to \$155 million. In addition, the real dollar amount of the Unfunded Pension Obligation would have grown over the next 8 years to be between \$160 million to \$225 million.

**"What happens if the Unfunded Obligation is immediately eliminated by one big payment from the County?"** The amount the County would have to pay the Pension Fund this year to eliminate the Unfunded Pension Obligations depends on whether the Actuarial or Real Market Value is used. It would be \$60 million to eliminate the Actuarial Value or \$110 million to eliminate the real Market Value. Unfortunately if the dynamics continue that caused Unfunded Pension Obligations to increase in 10 out of the last 12 years the Unfunded Obligations would wind up between \$75 million to \$275 million in 8 years (depending on how much is paid up front). The County will pay between \$150 million to \$200 million to the Fund in that time.

**"How much would the Pension Fund's rate of investment returns have to be for it to eliminate the Unfunded Obligation through investment profits?"** The Pension Fund would have to earn between 14% to 16.5% returns in each of the next 8 years in order to eliminate the Unfunded Pension Obligations through investment profits. Even so the County would pay a total of \$90 million to the Fund in that time.

## VI. WHY THE PENSION FUND WON'T EARN ITS WAY OUT OF DEBT

MCERA would have to achieve in the range of 13% to 16.5% annual returns. It almost certainly will not do so for at least 3 reasons:

- MCERA would have to improve its performance 300% over 8 years. Not credible.
- The two investment bubbles in the past 12 years (Dot Com and Credit) are clearly aberrations. Federal policy makers will work to prevent a third bubble. Consensus projects a spotty and slow recovery from the current recession. Market returns of 3% to 8% are likely for a few years.
- About 1/3 of MCERA's investments are bonds that provide low returns of 2% to 3%. The 60% invested in the stock market would have to earn 22.5% a year. That's practically impossible.

## VII. GIVEN THE ALTERNATIVES BEING CONSIDERED, WHAT IS LIKELY TO HAPPEN

There are no good choices.

The Worst Choice would be to make no changes - to simply continue with the Actuarial Policies as they are and pay what the Actuary tells the County to each year. This would cause a very serious degradation of County services.

The scenario of the Pension Fund earning its way out of this predicament is really the same as making all the changes in Actuarial Policies discussed in this paper. If all that happened was that these policies were changed, the County would implicitly be betting the Pension Fund would eliminate the Unfunded Obligations through investment profits. There is very little chance of success - there is simply too much to overcome.

### The Least Bad Choice - Eliminate Significant Amount of Unfunded Obligation in 2010

In an immediate and narrow sense the County would be better off borrowing money to eliminate the Actual Market Value of the Unfunded Obligation. It's simple math - if the County could borrow at an interest rate of, say, 4.5%, that's better than having the Unfunded Obligation grow at 8%.

But this would increase the County's Pension Obligation Bond debt up to \$200 million - given the remaining balance due on previous Bonds. Annual interest expense on those bonds would be around \$9 million a year.

## VIII. CORE CRITICISMS

Over the past 2 decades Mendocino County has created the biggest per capita debt of all counties in California. Until County officials find out what's broken in the County's financial management and fix it, they do not deserve any more money. It really is throwing good money after bad.

County officials need to be figuring out how to eliminate the unfunded Obligations. Instead they are trying to lower their yearly payments to the Pension Fund for the next few years through smoke and mirrors. They aren't even projecting how this approach will blow up in their faces and create far more debt.

Once again the County is focusing only on getting by year to year. It's almost inconceivable the County doesn't plan more than one year ahead. If it did it would be clear to them how dangerous this situation is.

Mendocino County is forcing future generations to pay \$1/3 billion of past County operating expenses by pushing retirement benefit debt way out into the future.

And, once again, County officials are hiding the County's debt and its impact from the citizens.

## IX. WHAT SHOULD BE DONE IMMEDIATELY

The citizens should demand the following happen before allowing the County to borrow more money:

- "No holds barred" examination of the causes of Mendocino County's Debt. Qualified interested citizens must be involved in every stage.
- Reform the County's Financial Management.
- A complete "no holds barred" evaluation of MCERA, including alternatives to MCERA.

## X. REORGANIZE PUBLIC SERVICES IN THE COUNTY

There are three likely main outcomes over the next decade:

- Extreme cuts in vital public services
- Eliminate debt through bankruptcy - much of which is owed to retirees.
- Reorganize the way public services are organized, financed and delivered in the County (including all levels of local government) with 3 goals:
  - Cut a total of \$40 million in expenses across all local governments paid by local discretionary funding
  - Cut \$20 million of County expenses paid by local discretionary funding
  - Wind up with stronger service providers

Such a reorganization is the **only way** to cut costs, maintain key services, and pay off the debt.

## XI. ATTACHMENT - PROJECTIONS OF PENSION FUND

We developed a spreadsheet model of the Pension Fund to test three "Master Scenarios" (the third has two parts - each is described in the paper above as a separate scenario):

- 1 **As Is** No changes in policies, no voluntary payment to retire Unfunded Obligation
- 2 **Change Policies** Extend Smoothing Period from 5 to 7 years, widen Corridor Limit from 20% to 25%, Change Unfunded Pension Obligation Allowance to 10%, adopt 30 year amortization
- 3 **Eliminate Unfunded Obligation** Eliminate the Unfunded Obligation either by making an immediate payment or earning investment profits adequate to eliminate it after the 8 year period

The **As Is** Scenario assumes MCERA will earn its target rate of return.

The **Change Policy Scenario** has 3 variations regarding rate of return: the

- **Target Return:** Target rate of 8%
- **Long Term MCERA Average:** MCERA's long-term average return of 6.3%
- **Long Term Independent County Pension Fund Average Return:** 9.7%.
- 

The **Eliminate Unfunded Pension Obligation** has two variations, each of which also has 2 variations.

- **Payment:** Big County payment in 2010 based on Actuarial and Market Values
- **Profit:** Investment Profits eliminate Unfunded Obligation based on Actuarial and Market Values

### Results

In the last 8 years the County has paid a total of \$54 million to the Pension Fund. This table shows projections of the results of the scenarios defined above:

Scenario			Unfunded Pension Obligation on June 30, 2017 With Assets Valued at ...		Additional "Interest" Expense	Total County Payments	Rate Of Return
			Actuarial Value	Market Value			
1-As Is		1	(\$55 million)	(\$55 million)	\$79 million	\$276 million	8%
2 - Change Policies	Target Return	2A	(220 million)	(220 million)	119 million	145 million	8%
	Long Term Average	2B	(255 million)	(274 million)	135 million	152 million	6.3%
	County Fund Average	2C	(182 million)	(158 million)	102 million	137 million	9.7%
3 - Eliminate Unfunded Pensions	Immediate Payment	3A1	(174 million)	(174 million)	82 million	154 million	8%
		3A2	(76 million)	(76 million)	37 million	201 million	8%
	High Returns	3B1	0	161 million <sup>1</sup>	24 million	91 million	16.3%
		3B2	(97 million)	0	60 million	92 million	13.9%

<sup>1</sup> The Pension Fund would be over-funded by this amount.