

Two Huge Financial Threats County of Mendocino Next Five Years April 5, 2011

Mendocino County (like many other local governments) is caught between a rock it mostly didn't create – the bad economy – and a hard place it mostly did – huge unfunded retiree benefit debt. This paper describes two very specific financial threats that could force the County into insolvency (the inability to make payments when due) within 3 to 5 years. Those threats are:

- Doubling of debt payments in 3 to 5 years.
- Loss of operating loans.

This paper does not offer solutions for three reasons.

First – although the debt is certainly very dangerous it is a symptom of the “real” disease - which has two parts. One is within the County - the combination of deeply flawed County financial management and the failure of County officials to live up to their financial duty to the people. The other is the failure of the people to hold the County accountable. The debt must be confronted, but even more importantly the County's financial management must be “fixed” and accountability must be established. This is a much larger issue that will be addressed in another report.

Second – before you can solve a problem you need to know what it is. This is particularly true regarding the scale and timing of the specific financial crisis in the next several years addressed by this report. Many “conceptual solutions” are likely to be put forward that don't address this scale and timing and therefore are flawed from the start. Proposed solutions must be tested as to whether or not they will “solve” the scale and timing of the financial problem. Let's first generally agree on this “scale and timing”.

Third – the easiest thing for most people to do is to interpret “all this” in ideological terms. That would be a huge mistake. Ideology didn't cause this debt – deeply flawed financial management did. Not only does that have to be the focus of any “real” fix, but we must avoid falling into our all-too-familiar political battle lines. That would lead to stalemate – when what we need is focused action. There is far more potential agreement across the political spectrum about what the real problems are than most people think. We need to first define that “common ground”.

Two reports to be released in the near future will lay out my analysis of our County's financial problems that must be “fixed”, and what I think needs to be done to “fix them”.

This report is my responsibility. In a report of this breadth there are probably mistakes. I've tried to make sure the data used and calculations are accurate. But I wouldn't want to put my head in a guillotine as a guarantee. But - please - if you see an assertion of fact that you think isn't correct - please let me know.

As always, interpretation and analysis are subject to debate. But it seems to me the evidence is overwhelming.

John G Dickerson

Two Huge Financial Threats to the County of Mendocino - Next Five Years Two Page Summary

Mendocino County's Pension Fund was supposed to have \$435 million on 6/30/10. But it was short \$135 million – the County has to pay extra to eliminate this deficit. And the County still owed \$85 million on money it borrowed in 1996 and 2002 by selling Pension Bonds to eliminate previous pension deficits. If the pension funding plan had worked the County wouldn't owe a dime. Instead the County owes \$220 million. The County's **pension funding plan** achieved **less than half its funding goals** over the past **20 years**.

Our County is being ground between a rock it mostly didn't create – the bad economy – and a hard place it mostly did – this debt created by its failure to properly fund pensions. This paper describes the **two very specific threats** in this situation that could push our County **into insolvency within 5 years**.

Threat I - Doubling of County Debt Payments – Three to Four Years

Seven specific factors will produce this result. Of these three are “built into” the math of Pension Funds.

First is “**smoothing**”. The Pension Fund was \$135 million below its target investment returns in 2008 and 2009. If that entire shortfall had been included in calculating the County's required pension deficit elimination payments in 2010 the County's payments to the Pension Fund would have gone from \$8 million to \$16 million in one year. The process called “Smoothing” spreads that increase out over 5 years. That means the County's pension deficit payments will increase that much over five years.

Second, the Pension Fund's target rate of return (8%) is also an **interest rate** applied to the pension deficit every year. That increases the deficit each year, which in turns increases the County unfunded pension deficit payments each year. So that magnifies the increase caused by “smoothing”.

Third, the County had to choose one of two methods to calculate how much the yearly pension deficit payments would be over the next 30 years. It chose the “**Level Percent of Payroll**” method. Without going into the details that method starts out with low payments. Then **payments slowly triple over 30 years**. So that method itself causes payments to increase each year – on top of the two factors above. In fact the beginning payments are so low they don't even start to pay each year's interest expense for 12 years. Then it takes another 8 years just to pay off the interest that wasn't paid in those first 12 years. That means the County won't start to actually pay today's debt of until 20 years from now!

The other four factors are unique to the Mendocino County Employees Retirement Association. By far the most significant is the **Pension Fund's Actuary – Buck Consultants** – admitted in January 2011 they had been making a very **big calculation error for years** – and as a result the County **Pension Fund payments** need to **increase \$3.3 million** in each of the **next 29 years** to make up for it. The next month another Actuary (EFI) presented what's called an “**Actuarial Audit**” – an evaluation of Buck's calculations. EFI said the County's payments needed to increase **\$8 million a year**. This is huge.

In addition the **calculation** of the **first year County pension deficit payment** was **deeply flawed**. It understated the County's required unfunded pension payments. **Payments have to significantly increase** to correct that error. Also, the Retirement Association's pension payments and operating expenses have been significantly more than County and employee pension contributions some time. That “**negative operating cash flow**” increases the Pension Fund's deficit, and that increases the County's pension deficit payments. Finally the Retirement Association “**wrote off**” a **\$9.6 million “receivable” as bad debt**. I think that was a “**fake asset**”; I'm highly concerned about several legal aspects related to this write off. Retirement Association officials say that write off won't affect future County pension deficit payments – I'm not convinced. We'll see.

Threat 2 - Huge Increases in Reported Pension Expense and Debt

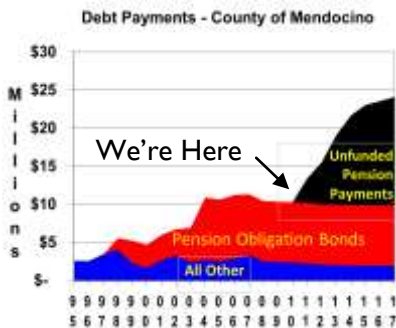
The Governmental Accounting Standards Board (**GASB**) intends to impose **huge changes** on pension financial reporting within five years. Their current standards have a **fatal flaw**. They allow state and local governments to **report pension expenses** related to **unfunded pension** deficits as an expense of the future - when the pension deficit debt is paid. But they aren't - **they're expenses of the past**. Government employees earn their pensions while they're working even though they don't receive them until after they retire. When they retire they have completely earned their pensions. **The true economic pension expense always happens before employees retire - never when they receive their pension payments - that is a payment of a debt.**

My biggest "shock" in 5 years of digging into our County's debt was when I suddenly realized **Mendocino County** honest-to-God incurred **hundreds of millions of dollars of past retirement expenses** it **never reported to the people**. GASB intends to stop governments from getting away with that.

Today unfunded pensions are not actually reported as debt. They're just listed in a footnote. **GASB** would force them to be **reported directly as liabilities**. Other reforms will force the value of the debt to be **much higher than reported today**.

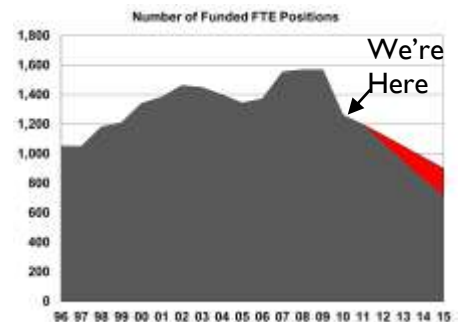
Mendocino County will also be forced to report **much higher pension expenses**. Instead of spreading pension expenses related to unfunded pension deficits over 30 years, the County will have only 12 to 15 years. The amount of pension expenses that can be shoved into the future will be hugely reduced. This will cause large reported pension expenses the year the new requirements go into effect. The County will also have to report the full interest expense related to pension deficits each year – not just the part it pays. Several other changes will also increase the County's reported pension expenses.

The Impact of These Two Threats



Two-thirds of the County's expenses are payroll and benefits. Budget cuts necessarily mean staff cuts. The County **has already cut about 350 staff positions** – nearly a quarter. **About that many** are likely to be cut in the **next 3 years** solely because of increased debt payments.

What would be the additional impact in 2015 of the new GASB rules?



If GASB's current concepts are imposed reported yearly pension expenses would increase from \$20 million to about \$65 million a year and a one-time extraordinary pension expense of around \$35 million would be reported. The County's long-term debt would increase from about \$190 million to closer to \$500 million.

Our County receives most of its property tax income in two months – December and April. There are no cash reserves to carry it over the summer and fall. It relies on short term "working capital" loans to make it through. Such a huge jump in reported expenses and debt combined with further deterioration of cash caused by increased debt payments would seriously threaten the County's ability to continue to obtain these loans.

If the County could no longer borrow these short-term operating loans, payroll would be weeks late – maybe months. Then what? And - It would be practically impossible for the County to report that it is satisfying the requirement of the State Constitution to operate with a balanced budget. Then what?

These two specific threats are likely to drive Mendocino County into insolvency within five years.

Table of Contents

I. INTRODUCTION - TWO HUGE FINANCIAL THREATS.....	1
II. BRIEF REVIEW – DEVELOPMENT OF COUNTY DEBT	2
III. THREAT ONE - DOUBLING OF DEBT PAYMENTS – THREE TO FIVE YEARS	3
A. INHERENT FINANCIAL DYNAMICS WITHIN THE PENSION FUND	3
1. <i>Three Dynamics</i>	3
a) “Smoothing” the 2008 and 2009 Pension Fund Earnings Deficits.....	3
b) Built In 8% Growth of Unfunded Pensions	5
c) “Level Percent of Payroll” Amortization Method	5
2. <i>Combined Effect of the Three Dynamics</i>	6
B. ISSUES SPECIFIC TO THE RETIREMENT ASSOCIATION	8
1. <i>Four Issues</i>	8
a) Deeply Flawed Actuarial Valuations	8
b) Flawed Amortization Schedule	8
c) Retirement Association Negative Cash Flow	9
d) Writing Off the \$9.6 Million “Actuarial Value of Unrecorded Earnings”.....	9
2. <i>Financial Impact of These Four Issues</i>	9
C. PROJECTIONS OF COMBINED FINANCIAL IMPACT	10
IV. THREAT 2 – FORCED REPORTING OF HUGE DEBT AND INCREASED PENSION EXPENSE - COLLAPSE OF CREDIT	13
A. FIRST ROUND OF REFORM: 1994 - 1998	13
1. <i>GASB 27 - Pension Reporting Requirements</i>	13
2. <i>Mendocino County’s Accounting and Financial Reporting Under GASB 27</i>	14
a) Annual Recognition of County Pension Expense	14
b) County Financial Reporting Related to Unfunded Pension Deficits.....	14
(1) The 2002 Pension Obligation Bonds.....	14
(2) The June 2009 Pension Deficit.....	14
B. GASB RECONSIDERS	15
1. <i>GASB’s Fundamental Principles - Violated by GASB 27</i>	15
a) GASB’s Broad Goals.....	15
b) GASB’s Fundamental Concept about Guaranteed Retiree Benefits	15
c) How GASB 27 “Got It Wrong”	15
2. <i>The Blunt Economic Truth - Mendocino County’s Operating Expenses Have Been At Least \$220 Million More Than Reported</i>	16
C. THE CONCEPTUAL BASIS FOR GASB’S IMMINENT PENSION ACCOUNTING REVOLUTION.....	16
1. <i>GASB’s Goal - Conformance with Fundamental Accounting Principles</i>	16
2. <i>Separate Pension Accounting and Reporting from Actuarial Valuations</i>	17
D. SPECIFIC CHANGES TO THE COUNTY’S FINANCIAL STATEMENTS	17
1. <i>Changes to the County’s Balance Sheet</i>	17
a) Unfunded Pensions Will Be Reported As a Liability in the Balance Sheet	17
b) Reported at Market Value - not “Smoothed” Value	17
c) Blended Discount Rate to Determine Total Pension Liability	17
d) Impact on Balance Sheet	17
2. <i>Changes to Income Statement</i>	17
a) Change in Annual Pension Expense	17
b) Yearly Implicit Interest on Average Pension Fund Deficit.....	17
c) When Pension Expenses Related to Unfunded Pensions Must Be Reported	18
(1) Years to Report These Pension Expenses Cut At Least in Half	18
(2) “Excess” Cumulative Investment Shortfall Reported as Expense (and Vice Versa)	18
d) Impact on Income Statement	18
V. PROJECTED IMPACT OF THE TWO THREATS IN 2015.....	19

I. INTRODUCTION - TWO HUGE FINANCIAL THREATS

Mendocino County started 2009 with about 1500 employee positions. Since then about 350 positions – nearly a quarter - were cut. If my projections are accurate, I believe we're likely to see nearly that many more jobs cut in the next 3 years. If so, our County's staff would be cut in the range of 40% to 50% from 2009 through 2014. Whole functions are likely to disappear.

This paper describes the two specific financial threats I see driving these cuts and the impact of those threats on County debt, interest expense, debt payments, and solvency over the next 7 years:

- **More than doubling of County debt payments over the next three to five years.**
- **Loss of Access to Operating Loans.**

Both threats arise from our County's unfunded pension debt. Our County is caught between a rock it mostly didn't create – the bad economy – and a hard place it mostly did – a huge deficit in its Pension Fund. From my perspective as a financial professional I know our County's retirement benefits could have been exactly what they were without creating anywhere near the level of debt that is today destroying County jobs and services. This crisis was almost entirely avoidable.

I say that without taking any position on what our County's retirement benefits should be. I absolutely take the position that whatever these benefits are their finances must be reported accurately and honestly to the people, and they must be properly financed. County officials who had the duty to manage the finances of our county failed to do this for the past two decades. The crisis in which we find ourselves is the result.

I've written extensively about how County officials created this huge Pension deficit (see the Mendo Debt section of my website www.YourPublicMoney.com). But this paper doesn't address our County's financial management. That is an extremely complex and difficult topic all on its own. This paper is “nuts and bolts” about the “dollars and cents” of these two specific financial threats and their likely impact.

This paper also doesn't offer any specific financial solutions to these two specific threats. Why?

I believe we're entering several years of the most intense political strife about our County in living memory.

The easiest and most likely thing to do is to fall into our well-practiced political battle lines and fight essentially the same ideological war we've been fighting for decades. We need to act decisively. But such strife would “freeze” our politics into stalemate. Far more damage would be done to our County. And frankly the truth is our “normal ideological fighting-words” completely miss what caused our debt.

Ideology didn't create the debt – a failure of duty and deeply flawed financial management did.

Until a strong majority of concerned citizens understand this, discussions about “solutions” are going to be far too ideological and not grounded in our real material-financial reality.

Our ship is sinking. We can't afford “politics as usual”!

Opinion leaders across the political spectrum need to put their heart-felt politics aside for a time and look at the specific evidence. They will be surprised at how much they will agree with people with whom they normally fight like cats and dogs - about the causes of our County's debt, what the situation is, what any realistic solution must accomplish, and even about what many of the elements of such a solution should be.

II. BRIEF REVIEW – DEVELOPMENT OF COUNTY DEBT¹

Mendocino County's debt is about \$300 million - 85% of which was created by unfunded pensions. This doesn't include what would have been another \$130 million of unfunded retiree healthcare benefits. The County terminated its obligation to pay those benefits in 2009.

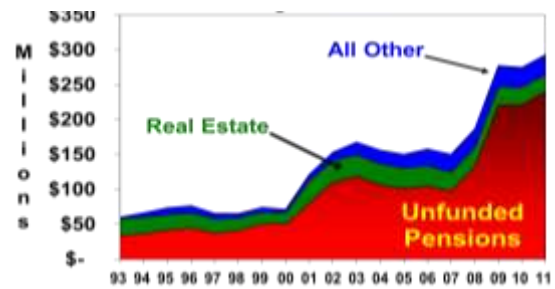


Figure 1 - Source & Growth of Debt

The County borrowed \$110 million in 1996 and 2002 to eliminate Pension deficits by selling Pension Obligation Bonds. The balance on those bonds is about \$83 million. Instead of borrowing more money to eliminate the \$130 million surge in pension deficits that developed in 2008 and 2009 the County elected to make additional payments to the Pension Fund over the next 30 years.

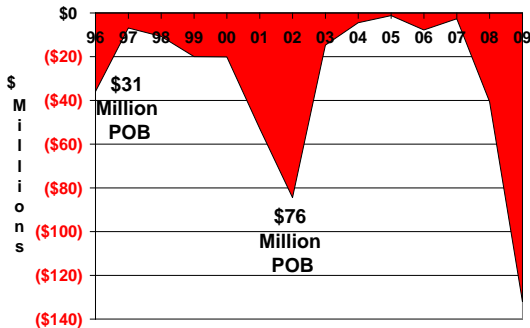


Figure 2 - Unfunded Pension Deficits Actual Market Value of Investments

The County's Pension Fund was supposed to have \$435 million on 6/30/10. But it had a third less based on the market value of its investments. The County also still owed about \$86 million on Pension Bonds at that time. The County isn't supposed to owe a dime of unfunded pensions. But it achieved less than half its pension funding requirements in the past 2 decades.

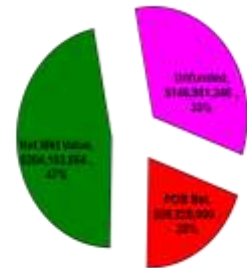


Figure 3 - Results of Pension Funding Plan - June 2010

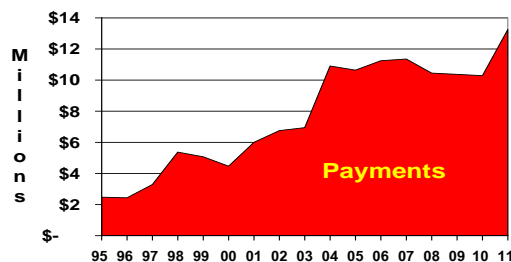


Figure 5 - Payments on Debt

The County's debt payments grew from a little over \$2 million in 1995 to nearly \$14 million this year.

Mendocino County is the most indebted California County per capita – according to data from the State Controller's Office.

These figures do not include unfunded pensions because those values for 2008 are not yet available for all Counties.

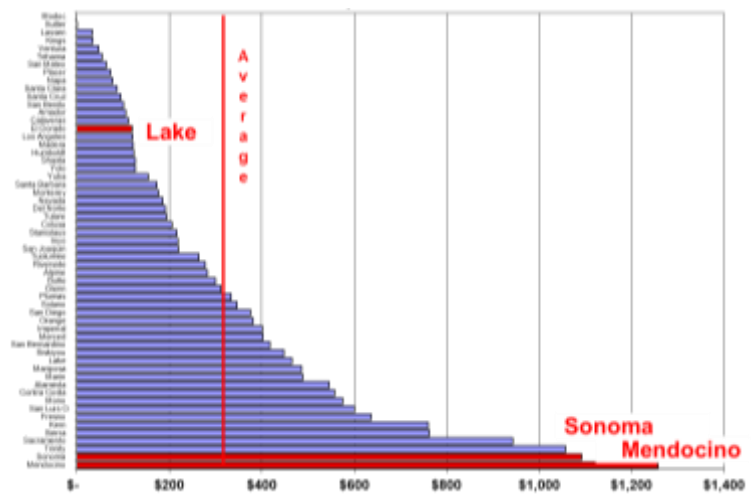


Figure 4 - Per Capita Balance Sheet Debt - 2008

¹ This is a very brief review of the development of Mendocino County's debt. More information is available at www.YourPublicMoney.com

III. THREAT ONE - DOUBLING OF DEBT PAYMENTS – THREE TO FIVE YEARS

If there were no pension-created debt our County would not have a budget crisis. Without a financial miracle, pension debt payments will more than double in 3 to 5 years and grind against the continuing difficult economy to destroy many more County jobs and services.

Two types of factors will cause an increase in pension debt payments. First are financial dynamics common to hundreds of public Pension Funds in the US. Second are factors unique to our County's Pension Fund.

A. Inherent Financial Dynamics within the Pension Fund

Our County provides what are called “defined benefit” pensions – as do most state and local governments. The “financial math” of these kinds of pensions is complicated. One aspect of that math is that financial trends seem to move in “slow motion”. It takes years to see the financial impact of many things that happen. Bad events are like bad guests – they “hang around” long after they've worn out their welcome. And good news is like virtue – it takes a long time to make itself felt.

If our County's Pension Fund had been managed properly we would not have the kind of debt we see in Mendocino County. But “bad things happened” in our County's Pension Fund and the result is something very much like a slow motion train wreck.

When the Pension Fund develops a significant deficit (as shown in Figure 3 above) the County is obligated to eliminate it – unless the Fund is able to “earn” its way out of the deficit. There are three ways the County can eliminate a Pension Fund deficit. It can make a payment from its cash reserves (impossible for Mendocino County because it has no cash reserves.) Or it can borrow enough money to eliminate the Pension deficit as it did in 1996 and 2002 by selling Pension Obligation Bonds. Of course that simply restructures the debt by moving the Pension deficit into Pension Bonds which must still be paid.

The County's third option is to make “deficit amortization payments” on top of its “normal” yearly payments to the Pension Fund that are calculated to fully fund the part of future pension payments being earned by employees each year. The County chose this third option for this most recent deficit.

The “slow motion math” discussed above that is inherent in the math of all government pension benefits organized like Mendocino County's is now imposing destructive results over the next 5 years.

1. Three Dynamics

a) “Smoothing” the 2008 and 2009 Pension Fund Earnings Deficits

This is a quote from *How Pension Funds Work*².

*If there is a significant Unfunded Pension Liability, the Actuary has to calculate how much the government must pay to eliminate the Unfunded Liability over a given number of years. But since the **stock market is notoriously volatile** if the Actuary used the Market Value of investments, these **government payments to eliminate unfunded pensions** would occasionally **change radically** from year to year. This would play havoc with **budget stability**.*

Actuaries developed a formula to “slow down” the rate of change of the County's required payments

*An Actuary **modifies the Market Value** to produce the Actuarial Value of Assets using two formulas - “**Smoothing**” and “**Corridor Limits**”.*

² If you really want to grasp how our County's Pension Fund caused so much debt and participate in the specifics of what needs to be done you must understand the complex math of Pension Funds. My paper *How Pension Funds Work* explains this math. It is available at <http://yourpublicmoney.com/data/data.shtml> - scroll down the left column to find this paper.

The purpose of smoothing is to slow down rapid changes in the Market Value of assets so that **changes in additional government payments to eliminate unfunded pensions won't be too drastic**. This is to allow for more **stability in government budgets**. The Corridor Limit prevents Smoothing from going too far.³

MCERA uses a five year smoothing period.⁴ The amount that its actual returns are over or under its target in any year is "spread" in equal amounts over 5 years- 20% a year.

This modified – or "smoothed" value of assets is called "Actuarial Value of Assets" (AVA).

In 2008 and 2009 the Pension Fund was under its investment target by a total of about \$135 million. Smoothing adds a portion of these shortfalls back into the Market Value of the Pension Fund's investments each year – 80% the first year, 60% the second, and so on until there is no more shortfall to add back. (There is a one year lag time between investment results and when they are "smoothed".)

This table shows the amount of the shortfall in those two years that is being added back each year (\$ Millions):

<u>Added Back During</u>	<u>Shortfall</u>		<u>Total Added Back</u>
	<u>From 2008</u>	<u>From 2009</u>	
2010	44		44
2011	33	64	97
2012	22	48	70
2013	11	32	43
2014	0	16	16
2015		0	0
Shortfall	55	80	135

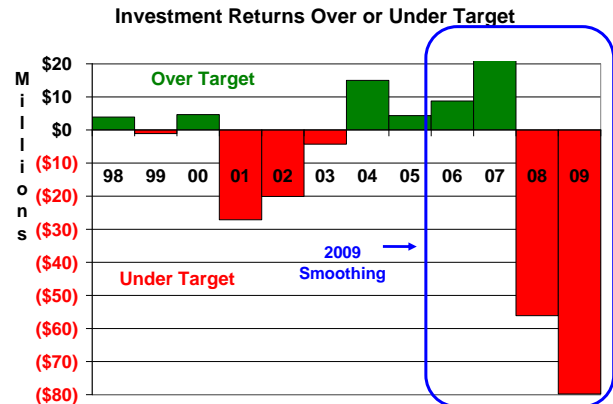


Figure 6 - Over/Short Target Return & Amounts "Smoothed" 6/30/09

In calculating what Pension deficit amortization payments needed to be during 2011 the Actuary added \$97 million back into the real market value of assets – which greatly decreased the amount of the County's amortization payments in 2011.

Every year as less and less of the shortfall of those two years is added back to the market value of the Fund's investments the calculated Pension deficit will increase.

Therefore a significant amount of Pension Fund deficit will "drop out of" smoothing in each of next four years.

This will force the County's Pension Fund deficit amortization payments to increase each year through 2014 – depending on what the Fund's investment returns are in the intervening years.

³ Mendocino County's Pension Fund is supposed to earn 8% a year. If in one year it earns 20% less, but the next year it earns 20% more, then in simple terms there's no problem because the average is 8%. Unfortunately, Mendocino County's Pension Fund's long term average has been significantly below its target of 8%. But that's another story. The "Corridor Limit" prevents the modified value of investments from being more than a certain percentage different from the true market value. This is supposed to keep the "smoothed" value of assets from being "too" unreal (but the limit can be and has been changed).

⁴ Pension Funds aren't required to use Smoothing. If they do, smoothing periods range from 3 to 7 years.

b) Built In 8% Growth of Unfunded Pensions

The most important assumption in the County’s Pension funding plan is that the Pension Fund will earn investment returns averaging 8% a year⁵. But – without going into details (see *How Pension Funds Work*) that also **assumes the Pension Fund is fully funded every year**.

The Pension Fund can’t make investment profits on money it doesn’t have (the Pension Fund’s deficit). As seen in Figure 3 the Fund was 1/3 or \$145 million short of what it was supposed to have on June 30, 2010. Therefore – even if the fund earned 8% on the money it has, it would still be \$11 ½ million short of its dollar target (8% of the Pension Fund deficit of \$145 million).

Unless the Pension Fund earns a much higher rate of return on the money it has to make up for the “lost returns” because of its deficit the Fund will “sink” deeper into deficit which simply increases County debt, Therefore an effective interest expense rate equal to the Fund’s target rate of return (8%) is applied to the average market value of unfunded pensions each year.

And – the effect, once again, is that **the Pension Fund’s deficit increases, which in turn increases the amount of the County’s Pension deficit amortization payments** in future years.

c) “Level Percent of Payroll” Amortization Method

Mendocino County’s Pension Fund’s Actuary presented two options for calculating the County’s Pension Fund deficit amortization payments. The first, called “Level Payment”, is like the well-known 30 year fixed payment home mortgage. Over 30 years the County would pay the same amount each month. At the end of 30 years the County would have eliminated the Pension Fund’s deficit.

The other method is “Level Percent of Payroll”. Instead of paying the same dollar amount each year this method aims to have the County pay an amount that would be the same percentage of its annual payroll in each of the next 30 years. Total payroll is expected to substantially increase over 30 years. The math of this method is first to assume that over those 30 years the County’s total payroll will increase a set percentage each year. The Actuary assumed the yearly increase in total payroll would average 4%. Then the Actuary calculated a specific percentage of each year’s projected payroll that would eliminate the Pension deficit over 30 years.

The County chose to use the Level Percent of Payroll Method. This makes the County’s Pension Fund deficit reduction payments lower than they would have been under the “Level Dollar Payment” method for the first 12 years as shown in this graph. But after 12 years the payments grow to be higher than what they would have been had the Level Dollar Payment method been used.

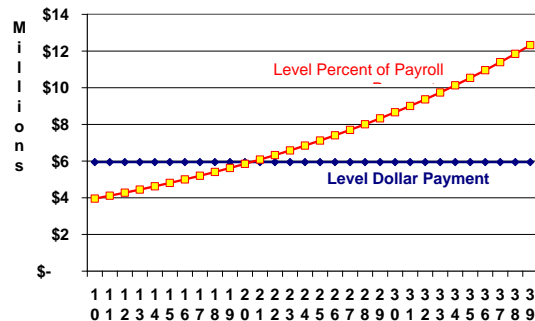


Figure 7 - Payments - FY11 Series

⁵ Although 8% has been the most common assumption for Pension Funds like Mendocino County’s the trend has been to lower that assumed return. That increases the reported amount of Pension Fund deficits and increases the amount the County and its employees must contribute each year. See *How Pension Funds Work*.

Now - there's a very powerful unfortunate "byproduct" of this method. Payments during the first 12 years are so low they don't even pay the annual 8% interest expense. This is called "negative amortization" - the debt increases instead of decreases.

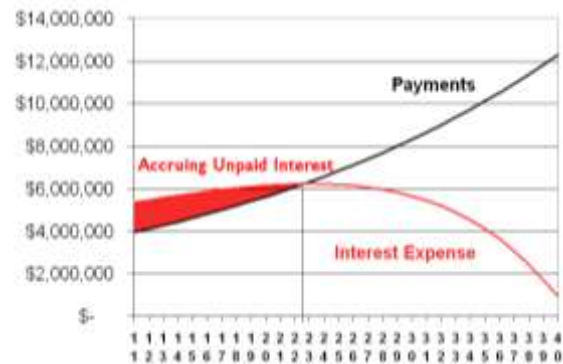


Figure 8 - Negative Amortization Fy10-11 Series of Payments

It then takes another 8 years simply to pay the unpaid interest expense built up over the first 12 years. That means payments for the first 20 years are "interest only". The County wouldn't get around to actually paying down any of today's Pension Fund deficit until 20 years from now. And therefore the unpaid interest adds up and once again the Pension Fund's deficit increases.

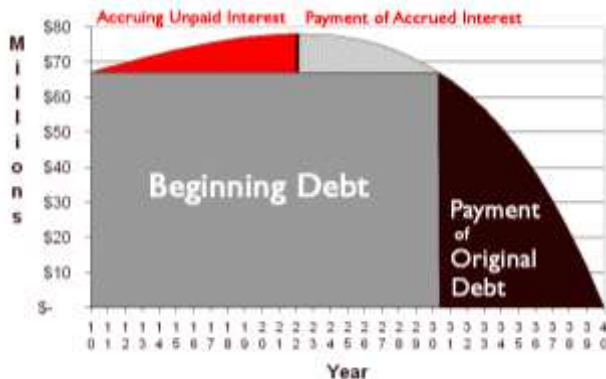


Figure 9 - Pension Deficit Debt Balance FY11 Payment Series

This method not only explicitly increases the County's Pension deficit payments each year but it also increases the County's debt that in turn even further increases the County's payments.

2. Combined Effect of the Three Dynamics

These three dynamics combine to produce a stronger growth of debt payments than most would expect. The values discussed below are those caused by these dynamics. These are based on what we knew last year. At that time we did not know the specifics about the Deeply Flawed Actuarial Valuations described on page 8, although we were certainly suspicious. Had we known the specific facts these values would have been significantly higher. These flawed Valuations and three other factors also influence these payments and the balance of debt. These other factors will be discussed below.

- **Smoothing:** As the substantial earnings shortfalls in 2008 and 2009 are included in the calculated pension deficit over the following four years a new series of amortization payments will begin each year. Therefore total pension deficit reduction payments will increase from FY2010 through FY2015.
- **Built-in 8% Interest:** In general terms, the average amount of unfunded pensions each year based on the market value of the Pension Fund's assets will increase 8% a year unless a) the Fund earns enough investment profit above 8% on the money it has invested to prevent that increase, or b) the County pays in enough to "cover" that 8% each year (or some combination). This will almost certainly increase the unfunded pension deficit.
- **Level Percent of Payroll:** By its nature the Level Percent of Payroll method causes payments to increase every year. Part of the increase is caused by "negative amortization" – payments for the first 12 years don't even cover the interest expense – therefore the Pension deficit increases.

Figure 10 shows projected unfunded pension deficit **payments for all payment series** that will start each year from FY11 through FY15 as calculated before we received confirmation that indeed the Pension Fund's Actuary had very significantly understated the Pension Fund's deficit and the amount the County and its employees needed to be paying into the Fund. This only includes the effect of the 3 factors described in this section - the actual payments will be greater (see below).

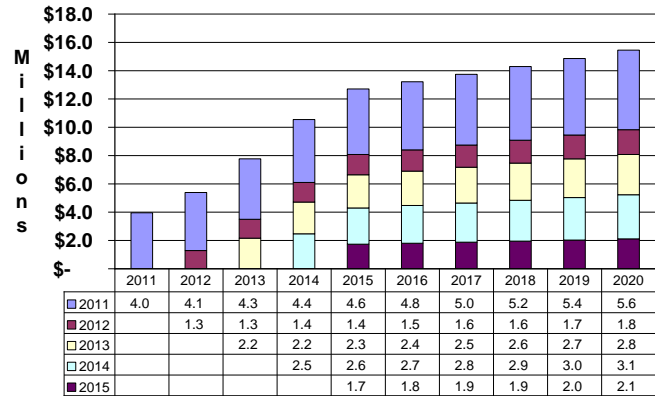


Figure 10 - Payment Series - Pension Deficit

First - the five-year smoothing process produces a new series of pension deficit payments each year from FY 2011 through FY2015 (see the table rows).

Second - the Level Percent of Payroll method causes annual payments in each payment series to increase each year. The combined effect can be seen in the graph especially after FY2015.

Figure 11 shows total yearly pension deficit payments and each year's 8% interest expense on the full market value of the unfunded pension deficit of \$132 million as of June 30, 2009. Note that as shown in "Built In 8% Growth of Unfunded Pensions" on page 5 if the Pension Fund earned its target 8% return on investment it would still accrue over \$10 million in effective interest expense on the \$132 million market value pension deficit shown in June 2009. The accruing interest through 2024 will increase the unfunded pension deficit, which in turn increases the deficit payments.

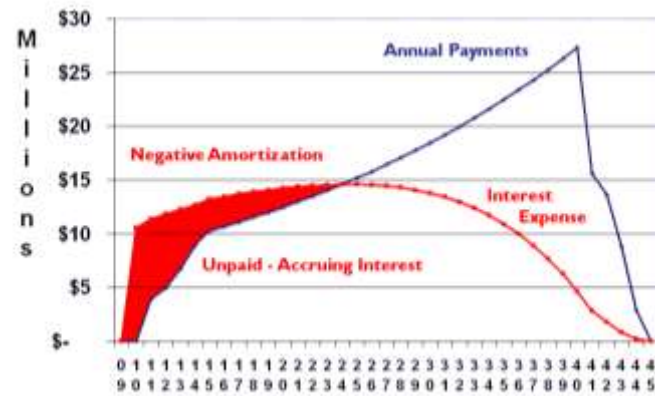


Figure 11 - Payments and Interest - Resulting only from These Three Factors

Because of "negative amortization" **the total debt will increase nearly \$100 million.** We wouldn't arrive back at the original debt of \$132 million until 2035. That means the **original debt would be paid** by County residents from **2035 through 2044. Over \$600 million will be paid over 35 years.**

B. Issues Specific to the Retirement Association

The factors described above will increase the County's Pension Fund deficit payments in each of the next 7 years (actually beyond that – but this analysis focuses on the next 7 years). These increases are a consequence of the math of Pension Funds – and the math of the “level percent of payroll” amortization method – that spreads and amplifies the negative effects of having earned significantly less than the Pension Fund's target rate of return and the other actions that created the Pension Fund's deficit.

The issues in this section are different in character. The math above is common to all similar Pension Funds in terms of how Pension deficits are amortized given the choices of methods taken by the County and Retirement Association. In contrast the issues below are “idiosyncratic” to our County's Pension Fund. They are not common to all similar Pension Funds.

1. Four Issues

a) Deeply Flawed Actuarial Valuations

In January 2011 the Mendocino County Employee Retirement Association's **Actuary** – Buck Consultants – **admitted they had made a very significant mistake**⁶ in its Actuarial Valuations of Mendocino County's Pension Fund. As a result the **County's payments to the Fund will have to increase from \$9 million this year to \$13 million next year.**

In **February** MCERA received an **Actuarial Audit**⁷ performed by EFI (another Actuary) on Buck's Valuation for 2009. EFI found that “the **actuarial assumptions used by Buck are seriously flawed**”. EFI identified several errors beyond those admitted by Buck the month before and state they believe the **County's payments** to the Pension Fund **need to increase by \$8 million** –nearly double.

MCERA is recommending the County's payments to the Pension Fund increase from \$9 million to \$13 million next year. MCERA will probably fire Buck and its new Actuary will perform the **Valuation** as of **6/30/11**. **If that confirms EFI's findings** we can expect the County's payments to the Fund to increase to about **\$17 million the following year.**

This one factor – all on its own – will nearly double the County's payments to the Pension Fund in two years.⁸

b) Flawed Amortization Schedule

The Pension Fund deficit amortization payments calculated by the Pension Fund's Actuary described in “Level Percent of Payroll” Amortization Method above were – frankly – badly flawed in several ways.

- The “year to year” math is substantially incorrect.
- The specified payments in fact do not pay of the debt in 30 years.
- The schedule only dealt with half the pension deficit the County is obligated to eliminate.
- The schedule over-estimated the County's payroll and therefore produces inadequate payments.

⁶ Buck's made the exact same error that was discovered in Stanislaus County two years earlier. Mendocino County and Retirement officials learned about what happened in Stanislaus well over a year ago – they chose either to deny that Buck had made the same mistake in our County or ignored the issue. But that's another story.

⁷ **Praise where praise is due. "Reformist Trustees"** on the Retirement Board demanded this Actuarial Audit be produced. It isn't an accident Buck fessed up the month before the Audit was released.

⁸ See my report *Mendocino County's Bad News Just Got Much Worse - Pension Fund Payments to Double in Next Two Years* for more information – available at <http://yourpublicmoney.com/data/data.shtml>, scroll down the left column to find a link to the paper.

I pointed these mistakes out to County and Retirement officials within two weeks of receiving these flawed amortization payment schedules in spring 2010.⁹ However, they did nothing to correct them and waited until the next Actuarial report received the following winter.

In its report received by the Retirement Board in January 2011 the **Actuary admitted the mistake** and reported the **County must increase its Pension deficit amortization payments \$550,000 a year.**

I suspect this is not enough to make up for the combined effect of these mistakes. However, at the time of this report I haven't yet checked the math.

c) Retirement Association Negative Cash Flow

There was only one year in the past ten when Pension Fund revenues were more than expenses (disregarding investment activity). My current projections are this negative cash flow will decline from a total of \$30 million over the past five years to \$17.5 million in the next five years.

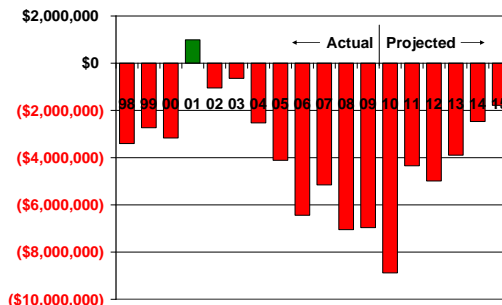


Figure 12 - MCERA Cash Flow Not Including Investments

Basically **the Pension Fund's pension payments and expenses are more than the contributions received from the County and its employees.** Since the Pension Fund is underfunded, this negative cash flow simply **increases the amount the Fund is underfunded,** and again thereby **directly increases the County's Pension deficit amortization payments.**

As long as the Pension Fund is underfunded, if the Retirement Association's pension payments and expenses are more than the amount received from the County and its employees in any year the Pension deficit increases and the County must eliminate that increase with higher payments.

d) Writing Off the \$9.6 Million "Actuarial Value of Unrecorded Earnings"

The Retirement Association diverted \$6 million from the County's Pension contributions in 2004 through 2006 to pay Retiree Healthcare. This may have been a direct and major violation of the law. MCERA "paid the County back" by giving the County full credit for pension contributions and creating a \$6 million "receivable asset" called "Actuarial Value of Unrecorded Earnings". At the same time it needed more money to pay Retiree Healthcare. So it took an additional \$3.6 million out of the Pension Fund and added that amount to the receivable making its total \$9.6 million. This was a claim against Excess Earnings if and when they are earned. I don't believe this satisfies the legal definition of an asset. The Retirement Board "wrote off" this asset this past summer and reduced the value of the Pension Fund by that amount.

Although the Retirement Administrator disputes this - **I think this will increase the Pension Fund's deficit** and once again thereby **directly increase the amount of the County's required Pension Fund deficit amortization payments.**

2. Financial Impact of These Four Issues

Especially given the recently admitted mistake made by Buck Consultants in the Pension Fund's Valuations, the factors discussed in this section by themselves will more than double the County's payments to the Pension Fund within 3 years.

⁹ See my analysis *Unfunded Pension Payment Schedules (Amortization)* available at <http://yourpublicmoney.com/data/data.shtml> - scroll down the left column.

C. Projections of Combined Financial Impact

I analyzed 3 factors inherent to the math of Pension Funds:

- Smoothing
- “Built-in” 8% interest rate on Pension Fund deficits
- The nature of the “level Percent of Payroll” method of determining the County’s Pension Fund deficit amortization payments

I also described four factors unique to the Mendocino County Employee Retirement Association:

- Seriously flawed Actuarial Valuations by Buck Consultants
- Flawed Level Percent of Payroll Amortization Schedule
- Retirement Association negative cash flow
- Write off of the \$9.6 million “Actuarial Value of Unrecorded Earnings”

Each of these seven factors is increasing the County’s Pension deficit payments (with the possible exception of the \$9.6 million write off – we’ll see.)

What is their combined impact likely to be?

I created three main scenarios to project the County’s debt payments given all the factors described above. There were several “variations” with those three main scenarios – a total of 7 in all.¹⁰

Figure 13 is the result of my “most likely” scenario regarding increased County debt payments. Note – this is only payments on debt. The County’s “normal” yearly payments to the Pension Fund are in addition to this.

In 2000 Mendocino County debt payments totaled about \$4.7 million. That more than doubled in the following decade to about \$10 million in 2010.

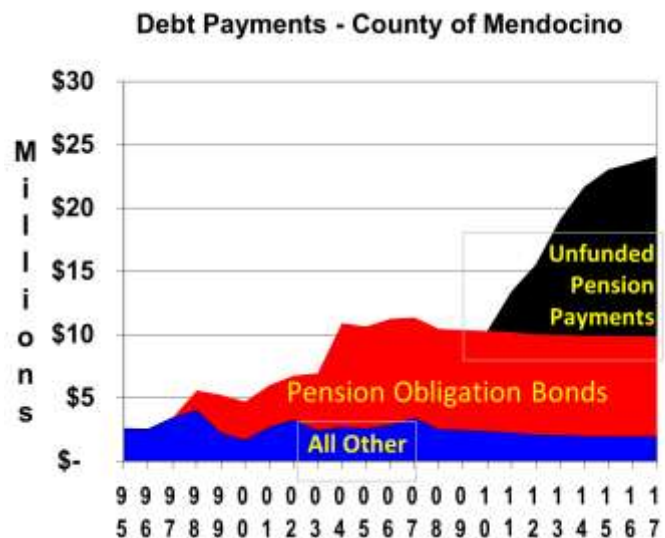


Figure 13 – “Most Likely Scenario”

My “most likely” scenario projection indicates they would more than double again by 2014.

Figure 14 shows the County’s debt payments and budget deficit as it went into the last fiscal year (7/09 - 6/10). Payments on existing Pension Obligations Bonds were about \$8 million - a little more than the budget deficit. If the County hadn’t had those Pension Bond payments it wouldn’t have had a budget deficit.

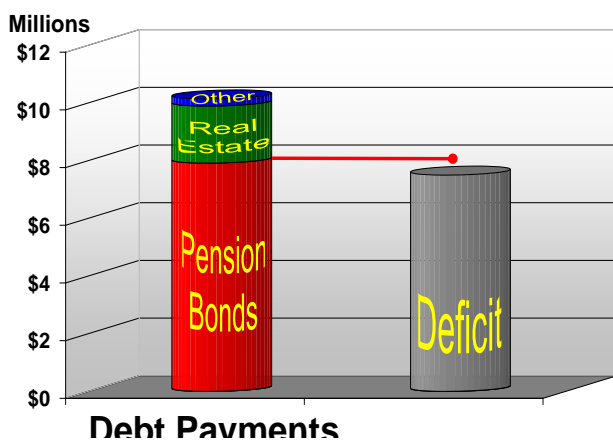


Figure 14: FY09-10 Budget Deficit & POB

¹⁰ This paper does not discuss those scenarios. A description of these and their results has been provided to County officials. They are complex.

Figure 16 shows the situation as it was described by County officials during summer 2010 as the County prepared its budget for July 2010 through June 2011. The County was required to begin a new series of Pension Fund deficit reduction payments of about \$3 million. County officials said the County's operating deficit was about \$2.5 million – this was in spite last year's budget cuts to close the deficit shown in Figure 14. If the County hadn't had those new Pension deficit payments it wouldn't have had a new budget deficit.

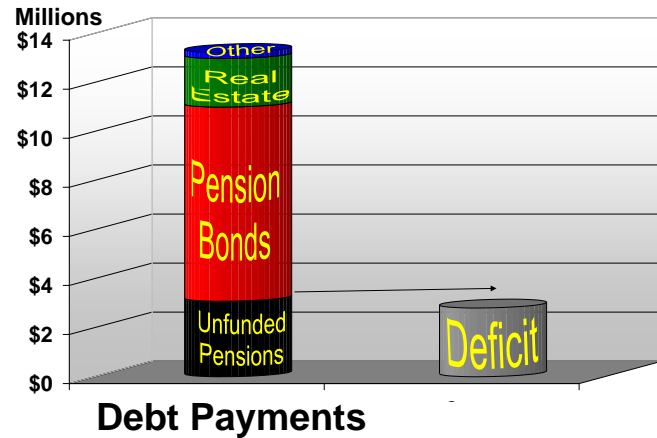


Figure 16 – FY10-11 County Deficit & Debt Pmts

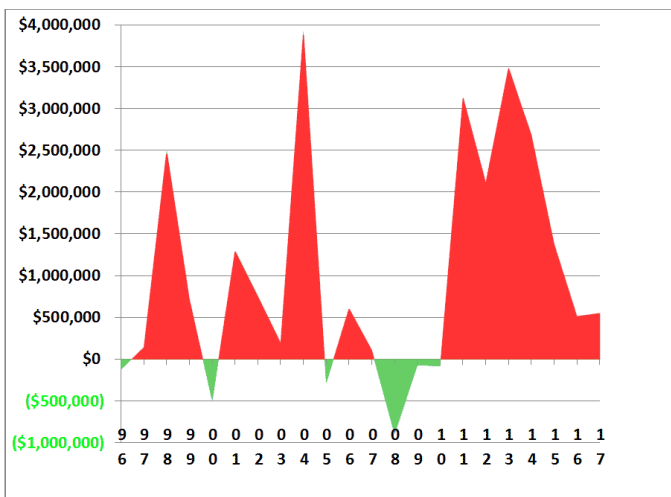


Figure 15 – Changes in Total Debt Payments

Figure 15 shows the change in total debt payments. The changes above “zero” are red because they represent increases in debt payments – generally a negative. Those below “zero” are green because they represent declining payments.

The two most significant “surges” in payments before 2010 resulted from the first year’s payments of the two sales of Pension Obligation Bonds during fiscal years 96-97 and 02-03. Both were one-year events.

We are now in a period in which comparable increases in total debt payments will not be contained in just one year as previously – but rather are extended from fiscal year 10-11 through the following 4 years through 14-15.

The County Executive Office’s outlook is not good. They expect cuts in funding from both the Federal and State governments, and they expect the State to force more service costs onto counties. Further, they don’t see any significant increase in property taxes for some time.

These increases in debt payments will probably translate into increases in budget deficits that will have to be eliminated each year – similar to the situation shown in Figure 16.

How will the County do that?

This shows the typical proportion of total payroll and benefits compared to all other Operational Expenditures for Mendocino County. Staff expenses consume about ¾ of Operating Expenditures – all other uses take ¼.

The blunt fact is that when faced with budget deficits of this magnitude the County has no choice – it must eliminate most of the deficit by cutting staff expenditures.



Figure 17 – Operational Spending

Figure 18 shows the number of “funded” full-time equivalent¹¹ (FTE) County job positions as shown in the County’s annual budgets since 1996 – with projections of the likely range after 2011.

The County had slightly over 1000 FTE positions in 1996 and 1997. The number of positions grew to about 1450 when the combination of the “Dot Com Bubble” crash in 2003-04 with its resulted recession and the sharp increase in debt payments resulting from the 2002-03 Pension Obligation Bonds forced the County to cut about 100 jobs. After the County’s revenues recovered they increased their FTE jobs up to a high of nearly 1600 jobs in 2008.

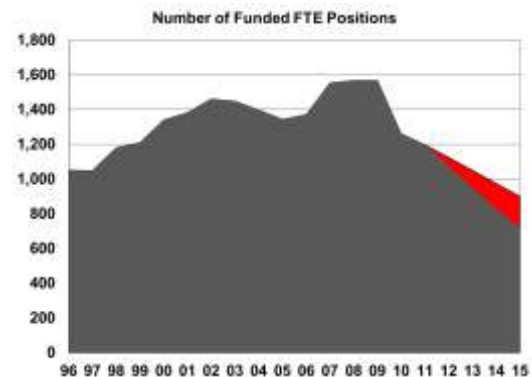
And now as a result of the most recent recession and greatly increasing Pension Fund deficit payments the County has cut the number of FTE jobs to around 1200 – what it was 12 years before.

Although I realize there are considerable uncertainties in projecting the County’s complex finances, it seems quite likely that the County will be forced to continue cutting FTE job positions as they have in the past two years to eliminate deficits. The red area seems to me to be a reasonable projection of the range in which the County’s number of FTE jobs will decline over the next four years.

If this projection “comes true” – the County will more or less cut its staff in half from 2008 through 2015.

How can the County’s staff be cut in half without significant reductions of services – probably including the termination of entire programs?

Very few people realize what the impact of such huge staff and service cuts is going to be.



**Figure 18 –
Full Time Equivalent County Jobs**

¹¹ “Full Time Equivalent” (FTE) – example, two half time positions = 1 FTE.

IV. THREAT 2 – FORCED REPORTING OF HUGE DEBT AND INCREASED PENSION EXPENSE - COLLAPSE OF CREDIT

The threat described above directly effects cash flow by increasing debt payments. This second threat is not about cash flow directly - it's about financial reporting. It won't impact cash immediately. But it directly affects County creditworthiness which can have a powerful effect on County cash flow. More fundamentally, it has to do with whether or not the County's financial reports provide "the truth" about the County's financial health in a way that supports public accountability and good long-term decision making. In the long run, those do have a profound effect on the County's solvency and financial strength

The Governmental Accounting Standards Board (GASB – pronounced "GAZ-Bee") establishes "Generally Accepted Accounting Principles" for state and local governments. GASB is serious about imposing huge changes on thousands of governments about how they report the finances of their retirement benefit within the next five years. These changes will force thousands of governments to disclose much higher levels of previously unreported retiree benefit funding deficits and expenses. The impact of those new standards will hit thousands of governments like a ton of bricks - including the County of Mendocino.

A. First Round of Reform: 1994 - 1998

When GASB was organized in 1984 state and local governments reported their pension benefits on a **Cash Basis**. Pension expense was reported when paid. Unfunded pension debt was not reported. Governments increased pension benefits without any immediate impact. No cost was applied to that decision - it appeared to be "free". GASB released its first "reform" of pension financial reporting in 1994.

GASB establishes new accounting and reporting standards by issuing "Statements". The first – "Statement No. 1" – was issued in July 1984. The most recent – "Statement 62" – was issued in December 2010.

GASB's first major reform effort was contained in **GASB Statement 27 - Accounting for Pensions by State and Local Governmental Employers (issued 11/94 – effective 6/97)**

1. GASB 27 - Pension Reporting Requirements

GASB 27 attempted to devise accounting and reporting standards that would not conflict with how Actuaries produce "Actuarial Valuations" for Pension and other Retirement Funds. This subordination of accounting and reporting to Actuarial processes created huge problems, as will be described below. It was a "fatal flaw" that, among other things, allowed governments to incur billions of dollars of true yearly expenses without every reporting it.

GASB adopted the Actuarial meaning of the term "Annual Required Contribution" (ARC) which is the amount an Actuary calculates the government must contribute during a year so that the part of future pension payments employees are earning that year will be completely funded. What's supposed to happen is that amount augmented by achieving target investment profits will be sufficient to pay those future pension payments. This is the only money a government should ever have to pay into the Pension Fund. The annual required contribution (ARC) is then reported as that year's pension expense.

Employer governments also must provide specific information about the Pension Fund's "funding progress" in "Required Supplemental Information" which is attached to the financial statements after the footnotes to the statements. These values include the Actuarial Value of Assets (see "Smoothing" the 2008 and 2009 Pension Fund Earnings Deficits on page 3", Actuarially Accrued Liability (the net present value of the parts of future pension payments that have already been earned by employees in the past), the difference between the two, and other information.

2. Mendocino County's Accounting and Financial Reporting under GASB 27

a) Annual Recognition of County Pension Expense

The “simple” accounting theory imposed by GASB 27 is that the Annual Required Contribution (ARC) as defined in the Actuarial Valuation is reported as that year’s pension expense.

b) County Financial Reporting Related to Unfunded Pension Deficits

In 1996 the Pension Fund developed a \$40 million unfunded pension deficit based on the market value of its assets. It borrowed about \$35 million by selling “Pension Obligation Bonds”. Then in 2002 it developed another pension deficit - this time about \$80 million. It sold an additional \$75 million of Pension Bonds. The County reported a third unfunded pension deficit in 2009 - this time \$132 million.

(1) The 2002 Pension Obligation Bonds

Mendocino County used a complex legal process to “circumvent” two problems - unfunded pensions are not classified as a “legal liability” under GASB 27 and the requirement that California governments must submit major debt to a vote of the people. (More information is available at www.YourPublicMoney.com)

The accounting related to the Bonds shows the fatal flaw hidden in GASB 27. Under GASB 27 the County reports the amount the Actuary specifies as the “ARC” (see above) as that year’s pension expense. BUT – it also includes an amount roughly equal to its payments of principal on its Pension Bond debt. This is a HUGE distortion of financial reality – and is the mechanism that has allowed governments to create huge debts without ever reporting the expense that created those debts to the people.

The County’s financial reporting pursuant to GASB 27 makes it appear the cost of employee benefits has greatly expanded relative to salaries. But half that shift was caused by this distortion of reporting payments on the Pension Bond debt as if it’s part of each year’s pension expense rather than simply payment of debt.

As an example of the economic absurdity allowed by GASB 27 - the last payment on the 2002 Pension Bond debt will be \$7.5 million in 2027 - 25 years after the Pension Bonds were sold. The County’s current method of accounting will add that \$7.5 million to that year’s pension expenses. That \$7.5 million pension expense will be reported at least 25 years after County employees actually earned them - and therefore 25 years after the expense was really incurred by the County.

(2) The June 2009 Pension Deficit

The County’s Pension Fund recently developed another unfunded pension deficit - this time \$132 million as of 6/09. Instead of borrowing more money the County is making payments to the Pension Fund to eliminate this deficit. I won’t know how the County will report the finances of these payments in its financial reports until it releases its audited statements for June 30, 2011.

The County’s beginning payments are so low they create “negative amortization” (See “Level Percent of Payroll” Amortization Method on page 5). The County won’t begin to actually pay down the original amount of this recent deficit of \$132 million until 2035. I suspect the County will report the full amount of its payments until 2035 as interest expense, and won’t start reporting the pension expense that caused this \$135 million deficit until that year. If so – the County will defer reporting \$135 million of pension expenses that really occurred before 2009 until 2035 through 2044.¹²

¹² It’s hard for me to describe how outrageous I believe this is. The single biggest shock I’ve experienced in my search for what was happening to our County’s finances was when I suddenly realized that our County had honest-to-God incurred hundreds of millions of dollars of true economic expenses (pension and retiree healthcare) that it never reported to the people. I was literally stunned that County financial officials would have done that. I consider that a breath-taking violation of financial duty and of the public trust.

B. GASB Reconsiders

Over the past few years the astonishing scale of unfunded pension and other retirement benefit debt of state and local governments has become public knowledge and caused GASB to realize the error in Statement 27. GASB's standards failed their essential requirement - to provide accurate and "actionable" information in a timely fashion that can support "good" decision making. GASB made its standards conform to certain practices used by Actuaries. It's extremely important to realize two things about Actuarial practices -

- They are assumptions, estimates, and projections and a plan based on them, and are developed assuming from that point forward everything will "work perfectly".
- Assumptions, estimates and projections can and often are incorrect.

The result has been very seriously flawed government financial reporting.

Only fraudulent financial reporting allows state and local governments to pretend they have balanced budgets.

Bill Gates – 2010 Aspen Ideas Festival

1. GASB's Fundamental Principles - Violated by GASB 27

a) GASB's Broad Goals

GASB uses three criteria to evaluate accounting and reporting approaches. **Accountability** is the primary objective - public officials have a duty to provide constituents accurate financial accounting that, among other things, will allow the public to hold those officials accountable. **Decision-usefulness** reflects the extent to which financial reports provide users with the information they need to make informed decisions. **Interperiod (inter-generational) equity** relates to the goal of having the costs of current services paid by current taxpayers and avoiding shifting costs to future taxpayers.

b) GASB's Fundamental Concept about Guaranteed Retiree Benefits

"Guaranteed Retiree Benefits" means a retiree receives a defined benefit for the rest of their lives. They are part of the compensation that government employees earn each year even though they don't receive them until after they retire. The cost of those future benefits is part of the cost of providing public services today. If governments don't report their true long term debt for these benefits the public won't know the true cost of the services they receive, won't be able to evaluate the financial health of governments, and future generations will probably be forced to pay part of the cost of services previous generations received.

c) How GASB 27 "Got It Wrong"

GASB's states "the long-term rate of return on plan investments ... is a key factor in determining what it costs a government (reported as expenses) to provide a given level of pension benefits." If investments earn less than expected pension expenses are greater. If they earn more pension expenses are less.

Mendocino County's Pension Fund's target rate of return has been 8% for about 20 years. The Pension Fund's Actuary used that assumed return to define the amount the County needed to pay into the Pension Fund each year and report as its yearly pension expense. The target rate of return is an estimate. The estimate was wrong. The Pension Fund's actual rate of return was 4.4% from 1996 through 2009. If the Actuary had known what the actual rate of return was going to be the County and its employees would have been required to pay in nearly twice as much **AND** report that higher number as its pension expense.

The amounts that were reported earlier as pension expenses were estimates that turned out to have been significantly low. The County now has to pull a lot of money out of its current budget to make up the difference. The question is - when did the pension expense "really happen"?

- In the past? (The cost of pensions in the past was more than officials hoped.)
- Today? (When officials found out there isn't enough money in the Pension Fund.)
- In the future? (When officials pay the resulting debt.)

GASB 27 allows state and local governments to report the expense related to unfunded pension deficits as an expense of the future - when the unfunded pension deficit debt is paid.

But they aren't expenses of the future - they are expenses of the past.

GASB 27 therefore allows governments to radically understate their real current operating expenses and their true accumulating unfunded pension debt thereby transferring costs that should be paid by residents receiving government services today to future generations.

And that is GASB 27's fatal flaw.

2. The Blunt Economic Truth - Mendocino County's Operating Expenses Have Been At Least \$220 Million More Than Reported

The Pension Fund was supposed to have \$435 million on 6/30/10. But the fund had \$145 million less than it was supposed to have. In addition the County still owed about \$85 million in Pension Bond debt. That means the County achieved less than half its required Pension Funding over the past 20 years. Out of the \$435 million the Pension Fund was supposed to have, the County still owed \$235 million.

It hasn't yet reported a dime of that \$235 million of true pension expense that occurred in the past that created that debt. The people of Mendocino County don't know their County's real operating expense has been \$235 million more than the County ever told them.

The County of Mendocino reported that it operated with a balanced budget for the past 20 years or so. But the blunt truth is it really had a \$220 million budget deficit over that time.

C. The Conceptual Basis for GASB's Imminent Pension Accounting Revolution

1. GASB's Goal - Conformance with Fundamental Accounting Principles

GASB's previous effort to accommodate its pension accounting and reporting standards to Actuarial Valuations produced very poor information and disastrous levels of debt. GASB is now prepared to impose standards based much more on "fundamental accounting principles". I don't take the time to describe these principles here – but among the most important in terms of GASB's move to radically change its standards regarding financial reporting of the finances of governmental retirement benefits are

- Conservatism: This does not refer to the political philosophy. This means that it is far more important to convey financial problems and risks to people outside an organization than to make management look good.
- Matching Principle: It's important to identify the revenues of an organization during each year – but even more important to match the expenses that are supposed to be paid by those revenues so that you can truly understand if an organization (including governments) are "covering their true expenses" or falling deeper and deeper into financial deterioration.
- Recognize expenses when they are incurred, not when they are paid. Match and compare revenues earned and expenses incurred in the same period of time to report the "real" "profit or loss", "excess or deficit".
- Realization v. Recognition: Realization is when an economic event actually occurs – as an example, when the pension expense actually happens. Recognition is when you report economic events. They can be very different. Mendocino County realized hundreds of millions of pension expenses years before it is reporting – i.e. "recognizing" them on their financial statements. The goal must be to make "realization" and "recognition" happen at the same time as much as possible. This fundamental principle has been deeply violated in governmental accounting.

2. Separate Pension Accounting and Reporting from Actuarial Valuations

GASB **must** sever its standards from the practices of Actuaries and instead put them squarely on a foundation of “Fundamental Accounting Principles”.

D. Specific Changes to the County’s Financial Statements

These changes are still in the “conceptual” stage. GASB’s next step in changing its rules of reporting of retirement benefit finances by governments will be to issue draft standards during summer 2011. The descriptions below are taken from “Conceptual Statements”.

1. Changes to the County’s Balance Sheet

a) Unfunded Pensions Will Be Reported As a Liability in the Balance Sheet

Today Pension Fund deficits are disclosed as “Required Supplemental Information” – essentially footnotes to financial statements. GASB’s concept is to make them listed directly on governmental financial statements as bona fide debt.

b) Reported at Market Value - not “Smoothed” Value

This is a huge change. “Smoothing” would no longer be used to “slow down” changes in the reported financial status of government retirement benefits. The liability would be expressed based on actual market value of investments.

c) Blended Discount Rate to Determine Total Pension Liability

GASB will no longer allow governments to discount the unfunded portion of future pension payments by the Pension Fund’s target rate of return. After all, if the Fund doesn’t have the money it can’t earn that target return. They will have to use a “high quality” Municipal Bond Rate - roughly 4% today to calculate the value of a Pension Fund deficit. This will produce an astonishing increase in our County’s reported debt.

d) Impact on Balance Sheet

Mendocino County reported total liabilities as of June 30, 2009 of \$160 million. These changes would have added \$365 million to that figure for a total reported debt of about \$525 million - a stunning impact.

2. Changes to Income Statement

There would be several very significant impacts on Mendocino County’s Income Statement

a) Change in Annual Pension Expense

The amount of the Annual Required Contribution (ARC) as defined by the Actuary in the Actuarial Valuation (see page 14) would continue to be reported as each year’s pension expense. However, another item that was ignored in the past would be added to this value.

As discussed on page 9 MCERA’s benefit payments to retirees and its internal expenses have greatly exceeded contributions received from the County and its employees. In the past these simply increased the Pension Fund’s deficit. If GASB’s concept about this issue makes it into the final GASB Statement this “negative cash flow” would be added into each year’s pension expense. Conversely – if MCERA’s cash flow other than related to investments were positive that would reduce the year’s pension expense. But in Mendocino County’s case, if this provision had been in effect in 2009 the County’s reported pension expense would have been about \$7 million higher.

b) Yearly Implicit Interest on Average Pension Fund Deficit

As discussed in Built In 8% Growth of Unfunded Pensions on page 5 there is a “built in” interest expense related to Pension Fund deficits. In the past the County didn’t have to report this as an expense. GASB’s changes would force them to do so. If this provision had been in effect for 2009 the County would have reported an additional \$12 million of interest expense.

c) When Pension Expenses Related to Unfunded Pensions Must Be Reported

As stated on page 15 the current GASB standards have a fatal flaw. They allow governments to create billions of dollars of unfunded retirement benefits without reporting to the people that those are not only real debts, but were created by real economic retirement benefit expenses in the past.

Because of this “fatal flaw” Mendocino County has not yet reported \$83 million of pension expenses that were truly incurred before it borrowed money in 2002 by selling Pension Bonds. Further, it has not yet reported about \$140 million of pension expenses that really occurred economically before the County was forced to begin to make Pension Fund deficit reduction payments in 2010. All told the County has not reported about \$220 million of real economic pension expenses incurred in the past.

Although the proposed GASB changes don’t go as far as I would prefer – they go a long way and will force huge impacts onto the County’s financial statements. Two specific provisions will be the main drivers:

(1) Years to Report These Pension Expenses Cut At Least in Half

The maximum deferral period to report pension expenses related to unfunded pensions will be reduced from 30 years to the average number of years current staff is expected to be employed (12 to 15 years). This will greatly increase reported pension expenses when unfunded pensions are being amortized.

A major reason for this change is to make the people who are receiving services from a government’s current staff pay for that staff’s pensions by contributing enough into the Pension Fund so that - assuming it earns adequate investment returns - future pension payments to the current staff will be able to be paid without forcing future citizens to pay them.

Now - GASB is not asserting authority over the funding of pensions. It is asserting authority over the financial reporting related to them. Simply forcing governments to report pension expenses related to unfunded pension deficits earlier will not by itself force the government to actually fund the pensions in the same time frame. However, the combination of putting the “real” financial information in front of all the people with the usual state constitutional requirement that governments must operate with balanced budgets will bring far more pressure on governments to properly fund their pension benefits.

(2) “Excess” Cumulative Investment Shortfall Reported as Expense (and Vice Versa)

GASB’s proposed changes would establish a limit for how big a Pension Fund’s investment income shortfall can get without reporting the related pension expense. The current proposal is that if a Fund’s cumulative investment earnings shortfall is more than 15% of the value of the Pension Fund’s investments, the amount above that limit **MUST** be reported as an extraordinary pension expense in the year the limit is exceeded.

If this standard had been in place in 2009, a one-time extraordinary additional pension expense of about \$35 million would have been reported on the County of Mendocino’s audited financial statements.

d) Impact on Income Statement

The County’s financial statements for June 30, 2009 reported the County operated with nearly a “balanced budget”. But if these changes to the County’s Income Statement had been in effect for the 2009 statements, Mendocino County’s reported pension expense would have increased around \$40 million to \$50 million, and a one-time extraordinary expense related to Pension Fund earnings deficiencies would have been reported to be \$35 million. The net impact would have been the County would have reported an operating deficit of somewhere around \$80 million.

This brings up a critical question - what would be the impact of the County’s obligation under the State Constitution to operate with a “balanced budget”. My guess is the County would have to cut an additional \$40 million to \$50 million out of its operating budget - but I’d guess the \$35 million one-time extraordinary expense might not affect the County’s future budgets - but I really don’t know. That is pure conjecture. What isn’t “pure” conjecture is this – this GASB imposed change will force a very tense confrontation about what the “balanced budget” requirement really means.

V. PROJECTED IMPACT OF THE TWO THREATS IN 2015

What would 2015 look like if the trends discussed in Threat One - Doubling of Debt Payments – Three to Five Years beginning on page 3 developed and new GASB standards along the lines described in Threat 2 – Forced Reporting of Huge Debt and Increased Pension Expense - Collapse of Credit beginning on page 13 converged in fiscal year 2015?

This projection is based on my “Most Likely Scenario”. I produced 7 different scenarios which produced somewhat varying results – but this is the result I think is “most likely”.¹³

The impacts of the 7 trends that compose the first Threat would double the County’s debt payments from \$10 million last year to over \$20 million by 2013 or 2014. They would be about \$23 million in 2015.

The Market Value of the Pension Fund’s Assets would be around \$420 million and the Total Pension Liability discounted at the 8% target rate of return would be about \$630 million. Therefore the Market Value of the Pension Deficit would be in the range of \$190 million.

But then we apply the GASB changes described above.

By applying a 4% discount rate instead of 8% (roughly a Municipal Bond rate rather than the target rate of return) to the part of future pension payments that would be considered “unfunded” given the Market Value of Assets, the Total Pension Liability would be about \$1 million instead of \$630 million.

So – if in 2015 Mendocino County has to report for the first time its Unfunded Pension deficit based on the changes as stated in GASB’s current concepts, **the County would report an additional nearly \$400,000 of debt in 2015 than it would have under current GASB standards.** My current projections for 2015 of the County’s other indebtedness that is currently reported in its financial statements as liabilities is a little over \$100,000 (which assumes the County would not take on any more long-term debt in the meantime).

Therefore – **the County’s reported debt would increase from around \$100,000 to \$500,000 – five times more debt than would be reported under current standards!**

If all the assumptions in the “Most Likely” Scenario and interpretations of GASB rules are correct, the County would report around, **\$45 million more pension related expenses** in 2015, and an additional **\$35 million or so one-time extraordinary pension expense.**

Therefore **total expenses in 2015 would be around \$80 million more than they would be without the GASB changes. After 2015 annual expenses for the next few years would be about \$50 million more.**

Therefore, if all these things happen as described in this paper – the County’s reported expenses in 2015 would roughly be 50% higher than they would under current GASB standards and 25% higher thereafter.

Will credit rating agencies ignore these huge negative shifts in the County’s financial statements? I very much doubt it. The most likely result would be that if they haven’t yet pushed Mendocino County’s rating into “junk bond” status by the time these new accounting standards are imposed they will do so soon after.

I believe the combination of actual increased debt payments with these seriously more negative financial statements – and the resulting significant lowering of the County’s credit rating – is likely to eliminate the County’s ability to borrow “working capital” loans – which would immediately push the County into insolvency – the inability to pay bills when due.

¹³ These scenarios should go through several more iterations with more accurate data in some respects and the input of more people to get it to the point it could be properly used in planning our County’s financial future. I believe this is a “good” effort at this stage – but there is room for improvement.