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Another Pension System in the **RED**

Retiree health care on the chopping block as county refuses to back off expectations of future investment gain

This is part three in a four-part series. Read [part one](#) and [part two](#).

By SCOTT LEWIS
Voice Contributing Writer
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County pension board meetings aren't usually exciting spectacles, but so many people are expected to show up to the board's Sept. 1 meeting that officials have opted to hold the event at the spacious Mission Valley auditorium of the Scottish Rite Masonic Center.

It should not surprise anyone that former county employees and current workers will pack the house that day. At issue: whether to cut off funding for the health care of county pensioners. It is a bill the county's retirement fund has been paying for decades.

The county's \$1.2 billion deficit in its pension fund has forced pension officials to consider withholding the money that would usually pay for retiree health care and using it instead to supplement ballooning taxpayer contributions to the deficit. County leadership maintains that health care has always been an added benefit -- one the county could take away if it needed to.

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And there's more than just the taxpayers to think about. Next year, new government accounting standards will force the county and other governments to acknowledge how much they owe future retirees not only in pensions but in health care too. It will add potentially hundreds of millions of dollars of debt to the pension system.

Unless, somehow, the county can get out of it.

Retirees and employees say the county can't. They are expected to show up en masse at the September meeting, and they say that guaranteed health care when they retire is a vested benefit the employees have earned.

"The retirees feel that even if it's not an absolutely legal obligation at the very least the county has a moral obligation to maintain health benefits for retirees," said Skip Murphy, a member of Retired Employees of San Diego County, Inc.

At the root of the controversy are the county's pension investments and how much it expects to earn from them. The money that exceeds that annual expectation has traditionally been used to pay for retiree health care and other additional benefits not already included in the retirees' basic pension.

The concept is known as "excess earnings." The idea is that the fund earns more than it needs on investments some years so it can take that surplus and pay for things other than the basic pension debts. However, it does this even when the fund is facing a massive deficit and the "excess earnings" could be used to pay that down. It's an idea that even the county's leaders have questioned.

So now they're pushing for a change -- one that would throw out the practice of taking excess earnings and, at the same time, allow the county to stop funding for retiree health care.

And who benefits? The short answer is that the county would be able to cut down the amount of taxpayer contributions it makes to the fund.

So what exactly is an "excess earning?" How can a government with a pension fund \$1.2 billion in the red and an additional debt of \$1.27 billion in bonds declare each year that it has an "excess" amount of earnings?

Right now, the county expects to earn 8.25 percent every year from its more than \$5 billion in investments. Anything above that, in any one year, is excess. That's money that can go to health care. Significantly, however, there's nothing that accounts for years when investment returns come in below that. So bad years are always harder on the pension fund than good years are good.

The county pension board, confident in its past performance and methods, recently reaffirmed that assumed rate of return of 8.25 percent.

They had been offered a different option. In June, the relatively new advisor of the county's pension fund, an actuary from the firm The Segal Company, had recommended that the board of retirement of the San Diego County Employees' Retirement Association expect an 8 percent annual return rather than an 8.25 percent return.

The pension officials knew that if they opted for that new assumption, the fund's deficit would only grow.

Had county officials decided to lower the assumed rate of investment return by .25 percent, the county's pension forecast would have changed immediately. The pension fund's deficit would have **risen** from \$1.2 billion to \$1.36 billion. And the funded ratio - - the comparison of the pension fund's assets to its liabilities -- would have dropped to 79 percent.

The pension board, however, reported that it had other reasons for rejecting the assumption change.

Chief Investment Officer David Deutsch reported on the pension fund's Web site that the board had a confidence in its unique investing style.

"The investment program has earned excess return over the past 10 years of 1

percent to 2 percent," said Deutsch. "There is a 90 percent-plus chance that these results are due to skill and not chance."

The impact of the potential change in that assumed rate of investment return shows just how integral expected investment returns are to the pension system. The county, like all public pension funds, is counting on the stock market to keep it afloat.

If they don't reach the assumed rate of return investments, not only do officials not have any "excess earnings" to put into a reserve for health care, but taxpayers alone - not employees -- have to make up the difference.

Some wonder if that's a gamble or good management.

"The key question is how much is your plan for recovery is dependent on the market going up dramatically, because that's a bet, it's not a certainty. The market doesn't have to go up," said Emily Kessler, an actuary and staff fellow of the Society of Actuaries.

And, according to some, the county's 8.25 percent assumed rate of return on investments is not unreasonable.

"A prudently run fund, perhaps, could get something like that," said Steve Frates, president of the Center for Government Analysis.

For comparison, Orange County's employee pension system assumes its investments will earn 7.5 percent. The city of San Diego's pension system maintains an assumed rate of return of 8 percent.

Not only is 8.25 percent the return the county expects to get on its pension investments, it's also the cutoff point -- anything above that, on any given year is considered "excess earnings." And rather than head into the fund to make up for less fortunate investment years as is recommended, much of the excess earnings have traditionally been spent on what the county considers extra benefits, like retiree health insurance.

It's a system similar to that used at the city of San Diego, and one outside consultant investigating it actually came up with a name to describe the system of siphoning off excess earnings from good investment years. He said the process acted like a "snake in the garden."

County Supervisor Dianne Jacob, who also sits on the retirement board, made note of the paradox herself during a pension board meeting in June 2004.

She wondered why, with a deficit in the pension plan, the system could afford to spend investment earnings on anything but paying down the deficit.

"How can you even have excess benefits when you have debt to pay off?" she asked.

And that's what the controversy at September's pension board meeting comes down to. Pension administrators have put out a proposal to cut off the excess earnings model until the fund has an 85 percent funded ratio -- a level of health it has not been able to attain in the last three years despite a more than \$1.7 billion investment in the retirement system over that time period.

That means no money would fund retiree health care until the pension system is 85 percent funded. The county's pension has health care reserves, but with the rapidly increasing cost of medical care, those savings will be gone within five years.

But the county is committed to raising the funded ratio in its pension plan, officials said.

"I would certainly feel a lot more comfortable about the fund if we were north of 85 percent," said Supervisor Greg Cox.

And it's not only worries about the pension system that are driving the push to potentially siphon off the money flowing to retiree health care benefits. In 2006, all governments like San Diego County will have to list their health care obligations on their accounting sheets -- a move that will add billions in liabilities to municipal financial disclosures around the country.

"That is a cause for concern," Cox said. "How we deal with other post-employment benefits like health care in the future is our challenge. We will have to find an equitable solution for all the parties affected."

County Treasurer and Tax Collector Dan McAllister agreed.

"The impact on debt issuers of which all local government entities are part is looming fairly large because transparency is at the heart of what these new requirements are all about," he said.

What worries retirees, said Murphy, one of their representatives, is that the county will continue to lop off the peaks of good investment years. But instead of filling in the valleys, the county will just use the money to lower the amount it has to come up with to pay into the fund. In that case, retirees would lose health care even while the pension deficit remained high.

Murphy said that if the retirement board really wanted a healthier pension fund, it could just send county taxpayers the bill to do that.

"But they won't do it because it would hurt the county supervisors politically," Murphy said.

Please e-mail Scott Lewis at smikelewis@comcast.net with your thoughts, ideas, tips or personal stories.

Part Four: County pushing pension obligation onto future taxpayers.

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