

**SUBMITTAL TO THE BOARD OF SUPERVISORS  
COUNTY OF RIVERSIDE, STATE OF CALIFORNIA**



**FROM:** SUPERVISOR BOB BUSTER

**SUBMITTAL DATE:** 9-28-04

**SUBJECT:** County Pension reform: Next Steps

**RECOMMENDED MOTION:** That the Board request the CEO:

- Assemble the Budget Officer, CEO Finance Staff and Treasurer to develop a report combining projected pension costs against future budget resources based on conservative revenue forecasts.
- Engage independent municipal finance experts to review the work of the Treasurer's Pension Review Committee due in November; confirm or expand on the Committee's report; analyze County estimates of pension cost impacts on future budgets, service level growth and bond ratings; and offer recommendations to reduce the rate of growth of pension obligation payments.
- Include the Budget Officer in all upcoming labor union negotiations on pay and benefits or unit modifications having a budgetary impact as a co-equal part of the County team and as advisor to the Board of Supervisors on negotiating strategy.
- Adopt and announce to all unions a firm position on all future excess pension returns over the assumed rate of return are not to be considered to be available for distribution or pension increases, but are supposed to offset years of below average returns over the long term.
- Return to the Board in 120 days with a report to guide the County to containment and reduction of rising pension costs to include consideration of two-tier pension system, increased employee contributions to existing system and creating a defined contribution system.

**BACKGROUND:** Under the leadership of Treasurer Paul McDonnell the County has already taken action to reduce pension costs \$3 million this year through prepayment. The Treasurer's Pension Review Committee is also working out a bond program to even out the long-term payments on the County's \$300 million in unfunded liability.

Recent news stories detail the severe fiscal crisis that the City of San Diego now faces because of its irresponsible pension increases and employee payouts from "excess" pension funds. San Diego's pension meltdown is bigger than the Orange County bankruptcy!<sup>1</sup>

Even though the scale of Riverside County's situation is smaller, some of the same fundamental misunderstandings about defined benefit pension systems that underlie San Diego's mistakes also formed the basis for pension increase decisions here.

We must change that and begin what will be a tough process to reform.

Supervisor Bob Buster

<sup>1</sup> San Diego's unfunded liability is \$1.16 billion. Orange County's 1996 bond issuance to pay off its obligations was \$760 million or \$962 million in today's dollars.

3.64

**From:** Paul McDonnell  
**To:** Barbara Olivier; Bill Luna; Board of Sups; Larry Parrish; Ron Komers  
**Date:** 9/21/04 2:02PM  
**Subject:** Pension News

Posted on Tue, Sep. 21, 2004

County set to deny pension change

By Peter Felsenfeld

Contra Costa supervisors today are expected to reject dramatic changes to the county's retirement system recommended this summer by the civilian grand jury.

Warning that soaring costs would erode county services, the watchdog group in June urged the board to jettison its existing pension system in favor of a defined contribution plan, such as a 401(k).

In his response, County Administrator John Sweeten wrote that the proposed switch is not possible under state law. Furthermore, he wrote, the county should only change systems as part of a broad statewide approach that involves all other government employers.

To go it alone "would ... place the county at a serious competitive disadvantage in the recruitment and retention of employees," he wrote.

Supervisors will likely approve the response today.

The action comes less than two weeks after Contra Costa County learned its pension costs would increase next year by more than 20 percent. That alone should have prompted supervisors to seriously consider the recommendations, said Art Ronat, foreman when the grand jury wrote its report.

"The county should take a very close look at what we've done and not just brush us off."

The county now has a defined benefit plan. It gives retirees an annual pension based on their final average salary, age and years of service at retirement. Earnings from the county's pension fund cover the payments, with the employer and employee contributing to the fund each pay period.

The grand jury proposed a system in which the county and employees contribute a percentage of the employees' salaries into tax-deferred investment accounts. That money would accrue interest and be available to workers upon retirement.

To implement such a plan would not necessarily put Contra Costa at a competitive disadvantage, said Steven B. Frates, a senior fellow at the Rose Institute of State and Local Government at Claremont McKenna College. The systems can be quite lavish, he said.

And they do offer stability in terms of predicting long-term costs, he said.

"With a defined benefit the costs could balloon up to anything," he said. "The proof is what we're seeing now all over the state (in drastic costs increases in pension programs)."

Any changes would entail numerous challenges because Contra Costa is one of 20 counties governed by the state's County Employees' Retirement Law of 1937, better known as the 1937 Act.

The act does not allow counties to offer only 401(k)-type plans. So, to change systems, Contra Costa

would have two options, said Steve Keil, a legislative coordinator for the California State Association of Counties.

It could either remove itself from the 1937 Act, Keil said, which would likely require a approval of Contra Costa voters. Or it could seek special state legislation clearing the way for the benefit. "It would not be a simple transition," he said.

Neither is likely. Changing plans does not necessarily mean lowering costs, said Supervisor John Gioia of Richmond, who sits on the retirement board. Conceivably, he said, a negotiated 401(k) could turn out just as expensive.

Cities and counties statewide need to work together to find long-term, meaningful reform, he said.

"I know that pension costs have become a major problem for the county, as well as other local governments," he said. "But we're not going to find a solution with a knee-jerk reaction to one report."

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## San Diego Report Depicts Public Pension Meltdown: Joe Mysak

Sept. 22 (Bloomberg) -- Combine equal parts of accounting fiction, political games with budgets and optimistic assumed investment returns, and you get a multibillion dollar public pension headache for states and localities over the next decade.

Consider, for example, what's going on in the city of San Diego.

Back in January, the city sent out a special disclosure notice saying that its Employees' Retirement System (SDCERS) was only 67.2 percent funded. There was more than \$1 billion between what the system needed, and what it had on hand.

The announcement set off alarms at the rating companies, which lowered the city's credit rating, as well as at the Securities and Exchange Commission and the U.S. Attorney's office, both of which began investigating what happened and why.

The city hired the law firm of Vinson & Elkins to review its disclosure practices from January 1996 to February 2004, and to represent it before the SEC. Attorneys Paul Maco and Richard Sauer, who wrote the report, both used to work at the SEC, Maco as the head of the Office of Municipal Securities.

The firm last week released a 276-page report on its investigation, which makes for the most compelling municipal market reading since the U.S. Attorney's lawsuit against the ex- treasurer of Philadelphia and his friends back in June.

### Cut Contributions

That lawsuit depicted a pay to play culture in operation in Philadelphia. The Vinson & Elkins report isn't quite so lurid, yet it describes a much bigger and more widespread problem than municipal corruption.

The report said there was no evidence the city meant to deceive investors, but said its disclosure was prepared ``in a routine and occasionally careless manner that focused on current issues while regarding long-term concerns as speculative and inappropriate for disclosure."

The report also provides context.

``The history of the relationship between the City of San Diego and SDCERS plays out as a series of initiatives by the City to reduce (at least in the short term) its contributions to the System, typically in response either to economic conditions that caused budgetary strain or to concessions made to the City's labor organizations," says the report.

``Many of these initiatives have been supported by the labor representatives on the Board. The result in each case was the postponement of difficult budgetary decisions into the future, often exacerbating the problems through the delay in confronting them," the report continues.

### Surplus Earnings

Sound familiar? Let's not put as much money in the pension system as we should; let's increase benefits in the future instead. Let's not put in as much money in the pension system as we should; let's increase how much we think we'll make on the system's investments.

San Diego is not alone.

There are so many excellent parts to this report, which takes you right inside city government, that it's hard to know where to begin. Perhaps the one section every municipal official should read, though, is the one dealing with the concept of ``surplus earnings." This is where the city's troubles began.

In 1980, San Diego's city council decided to allocate 50 percent of the excess over the pension system's assumed rate of return to retirees, in the form of a 13th check."

"It looked very much as if this measure did no more than distribute investment windfalls to needy retirees," says the report. "This view, unfortunately, was based on a fundamental misunderstanding of the actuarial concepts that underlie the funding of pension systems, public and private."

Which is that above-average returns are supposed to offset years of below-average returns over the long haul.

#### Think Long Term

"The surplus earnings concept ignores this long-term dynamic of actuarial projections. It evaluates returns on a year-by-year basis and treats all cash generated by system assets (beyond assumed rates of return) as free money," says the report.

"This, of course, flies in the face of the basic premise of actuarially assumed returns: they are rarely met for any individual year, but are expected to average out over time to approximate the projections. Therefore the concept of 'surplus earnings' is a misnomer. Unless and until it can be demonstrated that the actuary's projections are unrealistically conservative, all earnings are necessary to support the long-term viability of the system -- none are truly 'surplus' or 'excess.' "

This will come as news to the public officials who cast a covetous eye on the outsized earnings pension plans wracked up in the late 1990s. As the report notes, "San Diego is far from unique in its embrace of the view of surplus earnings as a budgetary free lunch. Many other municipalities nationwide have used surplus earnings to fund benefits that otherwise would come out of their general budgets (or not be granted)."

Nobody talks about surplus earnings today, of course.

But because states and municipalities reduced their contributions, the money's not there. The obligation is. So are all those little goodies they gave away as enhancements, in both good times and bad. There's a mismatch here. The mismatch is that politicians think short-term, and pension plans are long-term. Big problem.

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**From:** Paul McDonnell  
**To:** PARC  
**Date:** 9/22/04 9:35AM  
**Subject:** Yet Another Pension Story

This story is taken from Dan Walters at sacbee.com.

Dan Walters: Fiscal irresponsibility also plagues local governments  
By Dan Walters -- Bee Columnist - (Published September 22, 2004)  
It would be difficult, perhaps impossible, to overstate the abject irresponsibility that former Gov. Gray Davis and a compliant Legislature exhibited in 2000 and 2001 when the state treasury experienced a sudden, but very short-lived, surge in revenues.

They went on a binge of spending and tax cutting that left the state budget with immense structural deficits when revenues returned to normal levels - deficits that now total something in excess of \$40 billion and are still rising.

Davis' dereliction of public duty cost him his governorship, but his successor, Arnold Schwarzenegger, has not been any more successful in closing the gap. Schwarzenegger's first gubernatorial act was to reinstate a \$4 billion-per-year reduction of taxes on cars that the state could not - and cannot - afford, and he backed down from his early declarations of spending austerity. Thus, it's likely that he and the Legislature will face another deficit in the \$7 billion to \$10 billion range next year.

As California's politicians were driving the nation's richest state into the poorhouse, they were also creating an immense mess in the pension systems for public employees. Just as gyrations in the stock market generated a very temporary surge in tax revenues, so did they temporarily fatten pension fund portfolios. Davis and the Legislature, caving in to pressure from public employee unions, sweetened benefits on the assurances of union-dominated pension boards that they would cost the taxpayers nothing.

When the stock market weakened and pension fund earnings plummeted, the state was left with a multibillion-dollar tab that contributed mightily to its budget crisis. In fact, the state is now borrowing money to meet those pension obligations because the deficit-ridden general fund budget can't cover them.

The budget-pension imbroglio is symptomatic of a larger and more insidious syndrome in politics - the willingness, even eagerness, to trade short-term political gain for longer-term grief. And, as we are learning, it's not confined to the Capitol.

A case in point is the growing financial crisis in San Diego, which for decades had prided itself on fiscal responsibility. When Standard & Poor's Rating Services suspended its credit ratings for San Diego this week, it was just the latest in a series of body blows stemming from mismanagement of the city's finances, especially its out-of-kilter pension system. San Diego is already under investigation by the Securities and Exchange Commission and the Department of Justice and, it appears, may be just one or two steps removed from having to file for bankruptcy protection.

What happened in San Diego is remarkably similar to what happened in Sacramento. Buoyed by momentary stock market gains, city officials lavished new pension benefits on their workers, and now the city's pension fund has a billion dollar-plus deficit that continues to grow because, once extended, pension

benefits cannot be retracted.

San Diego officials - once again emulating their state-level counterparts - masked the problem for several years but also went a step further and apparently made misstatements about the city's finances on documents relating to its bond issues - which could violate securities laws.

San Diego Mayor Dick Murphy is feeling the political heat because he voted for the expanded benefits and is facing a tough re-election fight against county Supervisor Ron Roberts, who has made the pension crisis his central issue. But as a supervisor, Roberts also voted for expanded benefits that led to the county's having to borrow money to cover its pension costs.

San Diego is the current poster child for fiscal irresponsibility, but the disease is much more widespread. When the state's politicians lavished new pension benefits on their workers - especially those in police and fire services - many local governments, pressured by their own unions, followed suit and now are facing immense bills from the Public Employees' Retirement System for the new benefits and pension fund shortfalls.

The pension obligations are inescapable, so their effect is to soak up money that otherwise would be available for vital public services. And we should never forget that it results from irresponsible political decisions by those elected to serve the larger public.

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# Fall From Frugality Puts San Diego on Fiscal Brink

A city once known for  
stewardship has a  
pension plan more than  
\$1 billion in the red.

By TONY PERRY  
*Times Staff Writer*

SAN DIEGO — Somewhere  
in tax-fighting heaven, Howard  
Jarvis must be spinning.

The city that the late sponsor  
of Proposition 13 once extolled  
as nonpareil in its stewardship of  
public money ("If all cities were  
run as well as San Diego, we  
wouldn't need Proposition 13")  
is now caught in a financial crisis

of colossal proportions.

Not one caused just by a  
downturn in the economy, al-  
though it has that feature. Not  
one caused just by a bad deal  
with a pro football team, al-  
though it has that, too.

Not even one caused mainly  
by a severe cutback in state sup-  
port, although that's part of it as  
well.

No, San Diego's financial  
problem is largely of its own  
making. By underfunding its  
public employee pension pro-  
gram, the city is now so deeply in  
the red, critics assert, that with-  
out drastic action, pension pay-  
ments will virtually suck the  
[See San Diego, Page A16]

# San Diego's Fiscal Nightmare

[San Diego, from Page A1]  
treasury dry.

Wall Street has lowered the city's bond rating. Moody's now rates the city's general obligation bonds at Aa3, the same as San Francisco and — embarrassingly for San Diego leaders — one level below Los Angeles. The lower rating potentially will pile on hundreds of millions of dollars in additional interest costs for building projects.

The city's pension program has an unfunded liability — a shortfall — of \$1.157 billion and growing. Add the bill for medical care for retirees and the tab goes up another billion or so.

"San Diego is in a real mess," said Scott Barnett, former executive director of the San Diego County Taxpayers Assn. "All the bad financial news is coming together at the same time, and the city is facing a load of hurt."

When the booming stock market made the city's pension accounts flush, San Diego officials sweetened benefits for city workers. Then the market crashed and they were left with much less money in the bank and bigger bills coming due.

Lots of other California cities and counties have similar problems, but this is San Diego, where fiscal conservatism was thought to be the civic religion.

"We found that the emperor has no clothes," said Carl DeMaio, executive director of the San Diego-based Performance Institute, a Libertarian think tank, studying the city's budget and budgeting process.

The crisis arose quickly — one study points to 2000 as the key year — but could take decades to resolve even if the City Council is forced to make painful choices.

Among those possible steps — things that have long been considered anathema — are cutting pension benefits, borrowing a lot of money, trimming the payroll, privatizing some services, and telling residents that services are going to be reduced even though the city already has fewer police officers and firefighters than almost any comparably sized municipality in the nation.

Like the fellow who borrows money from the neighborhood loan shark, the city finds itself barely able to pay the weekly interest while the principle gets larger and larger and the threat of dire consequences grows.

The City Council this year opted to trim library hours, close swimming pools and essentially abandon the filling of potholes in the streets.

The scandal has blocked the city from refinancing bonds for Petco Park, the new downtown ballpark for the San Diego Padres — costing it millions in higher interest payments.

Securities and Exchange Commission regulators and the U.S. attorney's office are sniffing to see if someone should face charges for filing incomplete statements with Wall Street prior to the selling of bonds.

The pension board, which advises the City Council, has sued its counsel for allegedly providing inadequate advice. Two lawsuits were filed by retirees who fear the city will end up defaulting on pensions.

Officials who initially downplayed the crisis now admit that this year's problems could be only a faint taste of what may come.

Mayor Dick Murphy, a mid-



**CRITIC:** Carl DeMaio, head of the San Diego-based Performance Institute, a Libertarian think tank, says two reform measures facing voters on the November ballot fall far short of what's needed.

mannered Republican now running for a second term, believes his critics are sensationalizing the issue.

"We have a pension situation that is a serious problem, but it is a problem that can be solved with some discipline," he said. "It's not a crisis; it's a problem, and we have a plan to deal with it."

In many ways, Murphy is re-playing the role he played during last year's disastrous wildfires: offering reassurance to a panicky public that the city, though bloodied, will survive.

Still, the city's own pension reform committee has warned that only a "miracle" in the stock market will bail out the city unless drastic and politically combustible action is taken, including capping benefits for current retirees and reducing them for future pensioners.

Amid controversy, the two city officials closest to the budgeting and bond process — City Manager Michael Uberaga and City Auditor Ed Ryan — have quietly retired.

"It's an ugly, ugly situation," said Jack McGrory, former San Diego city manager and now executive director of a land development company.

In hopes of restoring the city's reputation with Wall Street, the council is paying \$1 million to the KPMG accounting firm for an audit of the city's books and has hired a former SEC official to review the city's history of providing financial information to bond rating firms.

A pension reform committee has concluded that the city is caught in a "perfect storm" — but one of its own making.

In a draft of the committee's final report, a group of lawyers, pension experts and taxpayer advocates assembled by Murphy has concluded that three factors collided:

One was the City Council's decision to greatly increase benefits for retirees, making it possible for employees to retire earlier and with a higher percentage of their salary.

Second was a decision to reduce the amount the city contributes to the pension fund, which survives on interest on investments and on city contributions. For years the pension plan was 100% funded.

At 90%, Wall Street begins to get edgy. At 80%, analysts start to question the fiscal prudence of decision-makers. The city of San Diego's pension plan is now funded at less than 70%.

When the third factor — the stock market decline due to the bursting of the dot-com bubble — kicked in, the City Council initially failed to take action.

Far more than pensions in the private sector, public employee pensions are protected by state and federal law. Also, San Diego retirees have proven to be successful litigants when the pension board or City Council have done things that they see as a threat to their benefits.

Any attempt to roll back benefits would have angered the increasingly powerful public employee unions. Reducing city services to pump money into the pension fund would have brought the wrath of neighborhood groups. City Council members are elected by district; in habitually low-turnout elections, a few thousand votes can make or break a political career.

A number of business leaders see employee labor unions as the villains. Every current member of the City Council has enjoyed union support.

Union leaders dismiss the idea that avarice on the part of employees is driving the city to ruin.

They note that city employees do not qualify for Social Security and thus their pensions are their only reward for decades of service. City salaries, they insist, are low compared to other cities and to similar jobs in the private sector.

Indeed, a common budget tool for decades has been to freeze employee salaries. Also, promotions are slow in a city where the workforce is small compared with other cities and turnover is minimal.

Making matters worse, with a glut of baby-boomer workers nearing retirement, the City Council decided it needed to retain their expertise. So it devised the Deferred Retirement Option Plan, or DROP.

By delaying retirement by five years, an employee can receive both his salary and an early pension benefit. A portion of that pension benefit is put into an interest-earning account.

At the time of retirement, the employee can either take the money in a lump sum or let it ride to continue gathering interest. For most job categories, a worker with 30 years of service can retire with a pension of up to 90% of the final year's salary, along with annual cost-of-living increases and nearly fully covered health plans.

Pension board members estimate that the average city employee is eligible for a check of \$306,104 upon retirement and a lifetime pension of \$50,000 a year. The average pension has doubled in 10 years.

The pension committee has recommended dropping DROP and raising the average age of retirement from 55 to 62. Other critics want retirees to pay more for medical care.

"This is solvable, but it's going to be very painful," said April Boling, a certified public accountant who served as chairwoman of the pension reform committee.

So far, the City Council has put on the ballot only two of the less-controversial reform ideas: changing the membership of the pension board to dilute the impact of retirees, and banning future underfunding of the system but giving the city 15 years to clean up the current shortfall.

"These are not even a half-a-loaf — they're crumbs," snorts DeMaio of Propositions H and G on the Nov. 2 ballot.

County Supervisor Ron Roberts has made the city's financial problem a major issue in his run for mayor against Murphy, who defeated him handily four years ago. Murphy, Roberts notes, has been endorsed by the municipal employees union.

But the pension fund issue is incredibly complex and not easily made into a bumper sticker, unlike, for example, the city's controversial deal with the San Diego Chargers that required the city to pay for unsold tickets.

Roberts blasts Murphy for poor leadership and reneging on the fiscal legacy of their mentor, Pete Wilson, a fellow Republican who served as San Diego mayor from 1972 to 1983.

"San Diego is a very different city than it's been," Roberts said. "You'd have never seen this under Pete Wilson in the old days."

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# Bond Rating for San Diego Is Suspended

9-21-04

**Standard & Poor's says a promised outside audit of the fiscally troubled city is long overdue.**

By **TONY PERRY**  
*Times Staff Writer*

**SAN DIEGO** — Another day, another piece of bad financial news for City Hall as Standard & Poor's on Monday suspended its rating for city bonds.

The credit rating service said it could not continue to rate the city's fiscal integrity because a promised outside audit of the 2003 books is long overdue.

Standard & Poor's lowered its rating for the San Diego municipal bonds in April — although the city's ratings remained in the middle of the pack of American cities — and other agencies did the same. Lower ratings mean cities must pay higher interest rates on the bonds they issue.

The immediate effect of Standard & Poor's' action Monday is limited because the city is not in the market to sell bonds. The city is delaying, for example, going to Wall Street to refinance Petco Park, the Padres' downtown ballpark, until the controversy over the city's pension plan and misleading financial reports

is settled.

But the action is another indication of how far the once fiscally mighty city has fallen. Even longtime watchers of city finances are puzzled over the quick and precipitous fall from financial grace.

"San Diego is such a beautiful place, it's hard to picture problems this big in such an environment," said John Hallacy, an official with the New York-based Municipal Bond Insurance Assn. and former director of municipal securities for Merrill Lynch.

Hallacy said Standard & Poor's decision could make it difficult for current bondholders to resell San Diego bondings, the

so-called secondary market for bonds.

City officials are hoping an audit being done by auditing giant KPMG will help restore the confidence of Wall Street. Much is riding on the audit. KPMG gives the city an unqualified recommendation or a qualified recommendation or its analysis is hedged with concern about the city's budget process and pension debt.

Mayor Dick Murphy issued a statement that called the Standard & Poor's action "inappropriate" but noted that it is a product of the city's attempt to repair its financial house.

Suspending the city's

[See Bond, P. 1]

# Bond Rating Is Suspended for San Diego

[Bond, from Page B1]  
rating because the KPMG audit — considered the most complete the city has ever ordered — is not finished "is a short-term consequence of the long-term solution" to the pension problem, Murphy said. City officials have not been told when the audit will be completed.

Within minutes of being telephoned by officials of Standard & Poor's, City Manager Lamont Ewell held a news conference to announce the agency's move and to assure the public that the city is not considering filing for bankruptcy.

Last week, the city's pension reform committee issued a report calling for swift action to reduce the pension deficit.

One item being considered is the sale of \$600 million in pension bonds. In keeping with its tight-fisted reputation, the city has not issued such bonds in the past, although they are commonly used by many municipalities.

Also last week, a Washington law firm hired by the city issued a scathing indictment of the city management's competence in dealing with the pension fund and with what it called an "eccentric" method of depending on an ever-rising stock market to keep the fund flush. The firm, Vinson & Elkins, recommended several steps to improve oversight of financial information.

Ewell and Murphy said they hope that the law firm and pension reform committee reports, plus the KPMG audit, will convince Wall Street that the city can again be trusted.

Ewell was named city manager after Michael Uberaga retired under pressure from Murphy. Uberaga was singled out for scalding criticism by the Vinson & Elkins report for a *laissez-faire* style that let the pension deficit grow into the worst financial crisis since the city declared bankruptcy in the middle of the 19th century.

In announcing its lifting of the city's credit rating, Standard & Poor's noted that even when the audit is completed, the city will "remain on CreditWatch with negative implications" as long as it is being investigated by the Securities and Exchange Commission and the U.S. attorney.

The SEC became concerned when the city admitted that its previous submissions of information to various credit agen-

cies glossed over the pension problem. The Vinson & Elkins investigation suggested that incompetence, not criminality, was responsible for the omissions.

But Carl DiMaio, president of the San Diego-based Performance Institute, a fiscal watchdog, on Monday called the investigation "a whitewash that defends possible illegal behavior in City Hall."

The City Council is expected to receive the report at its meeting today.