Sustainable Pensions for Houston

October 2016

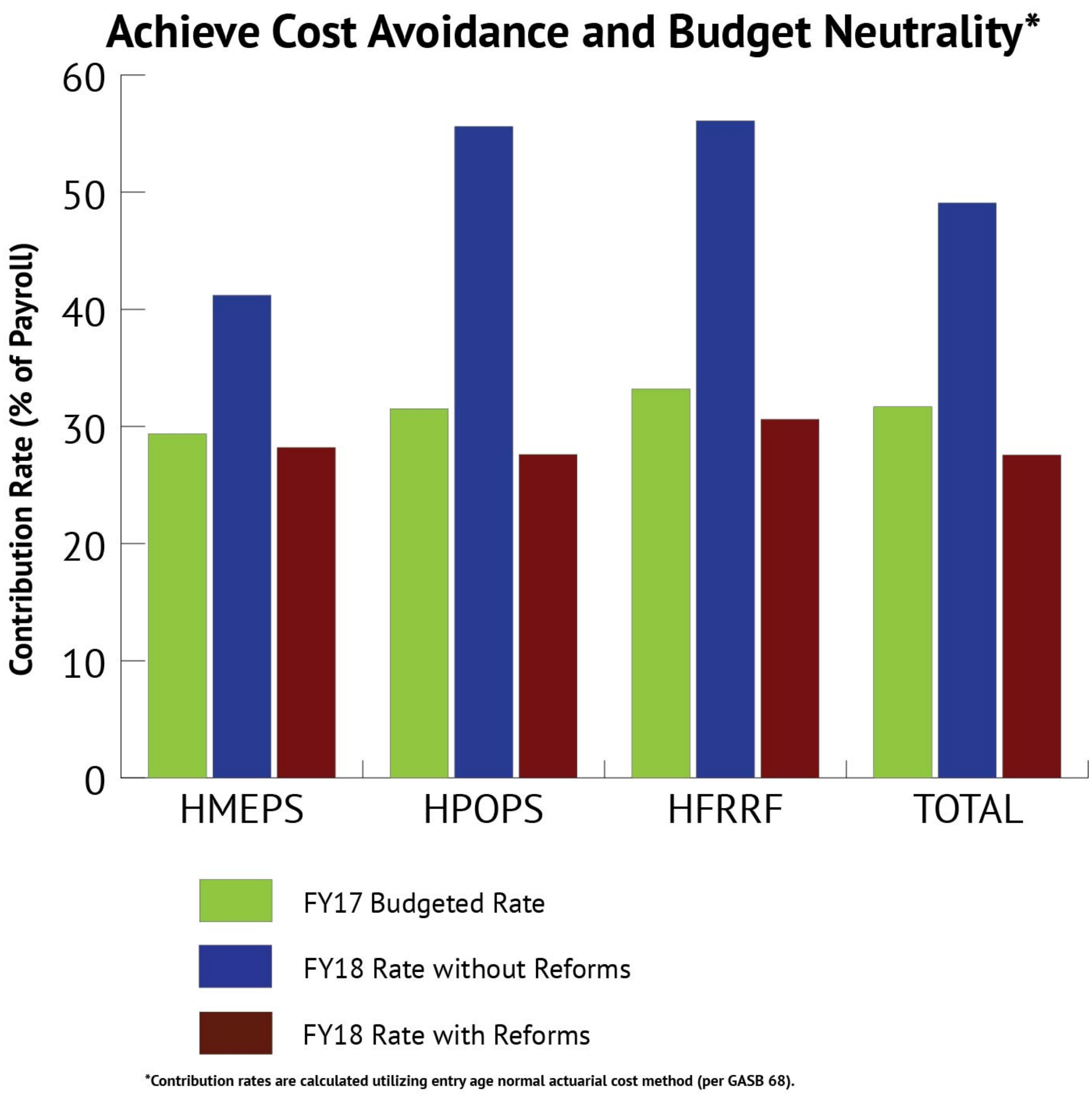
An affordable, sustainable pension for the City and its taxpayers.

We are pleased to announce a plan that immediately reduces and later eliminates the unfunded pension liability, controls costs going forward, helps the City retain employees and allows us to present to the Texas Legislature a blueprint for adoption of new state law. It is a 30-year fixed payoff solution to address the unfunded pension liability that is essentially budget neutral. We will have secure, sustainable and affordable defined-benefit pension plans that our employees can rely on and our taxpayers will find fiscally responsible.

Putting the Pieces Together

What are the basic components of Mayor Turner's pension reform plan?

Mayor Turner's pension reform plan focuses on keeping the defined-benefit retirement plans, with changes to benefits, reducing the City's net pension liability (NPL) by one third immediately which is then paid down over time. The City will pay what is required to fully fund the pension systems annually and avoid an increase in cost, now and in the future. The plan covers all three pension funds serving City of Houston employees: the Houston Police Officers' Pension System (HPOPS), the Houston Firefighters' Retirement and Relief Fund (HFRRF), and the Houston Municipal Employees Pension System (HMEPS).

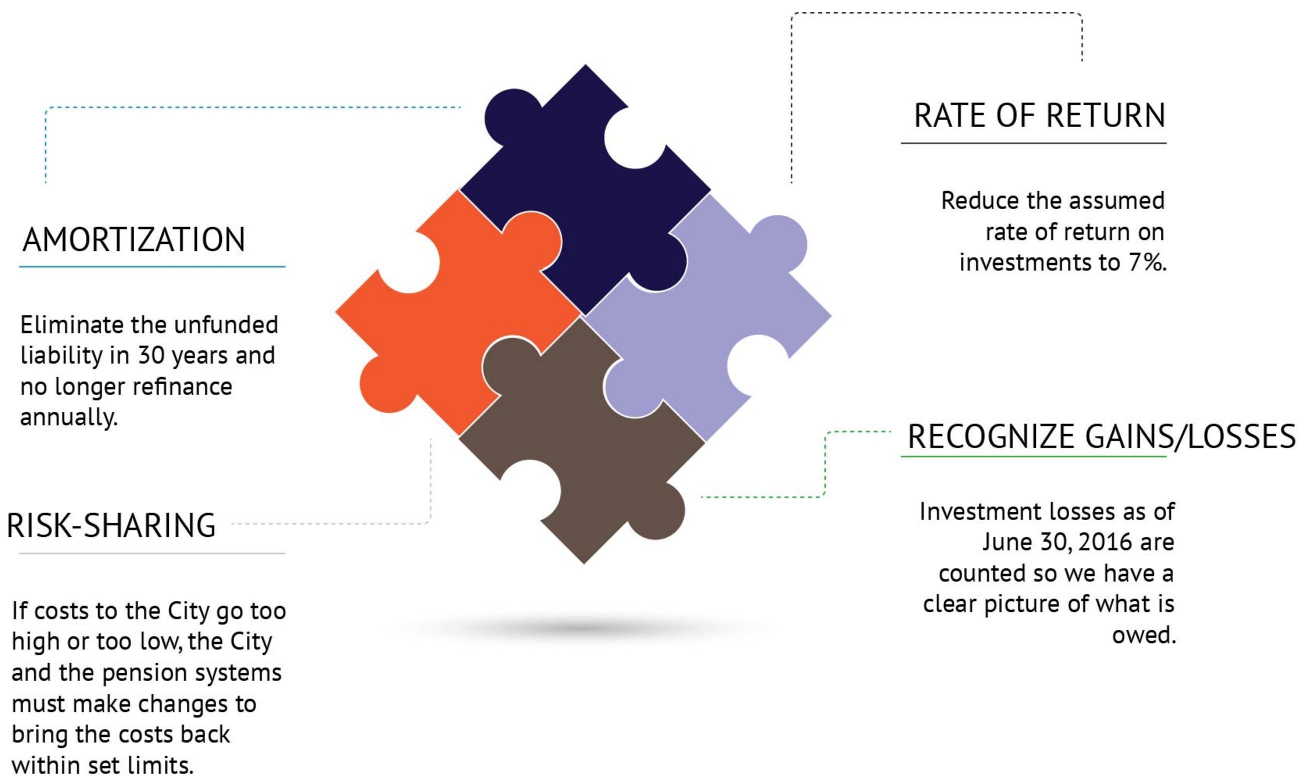


The City's net pension liability is estimated at $7.8 billion. The Mayor's plan would reduce the liability to $5.3 billion immediately through a combination of methods, including cost reductions identified by the three pension systems' governing bodies.

The proposed plan also includes a cost-management "corridor" to protect the City, the pension systems, City employees and taxpayers against future pension costs becoming unsustainable. The corridor approach sets upper and lower boundaries for pension costs, which are expressed as a percentage of the City's payroll. If costs go too high (or too low), the City and pension systems must make changes to the pension plan.

The Mayor's plan keeps defined-benefit plans while reducing net pension liability.

The Mayor's plan also adopts a 30-year closed amortization approach to paying off what the City owes. This works like a mortgage, where the amount owed is paid off on a schedule with regular, consistent payments. This will be an important change from the current system, where the money owed is recalculated on a new 30-year payout schedule each year. The current system looks like a mortgage except that it is refinanced every year – the amount you owe may go down, but will never be completely paid off. The new closed amortization approach, which is required by the City's financial policies as adopted by City Council, puts the City on a clear path to eliminating the net pension liability.

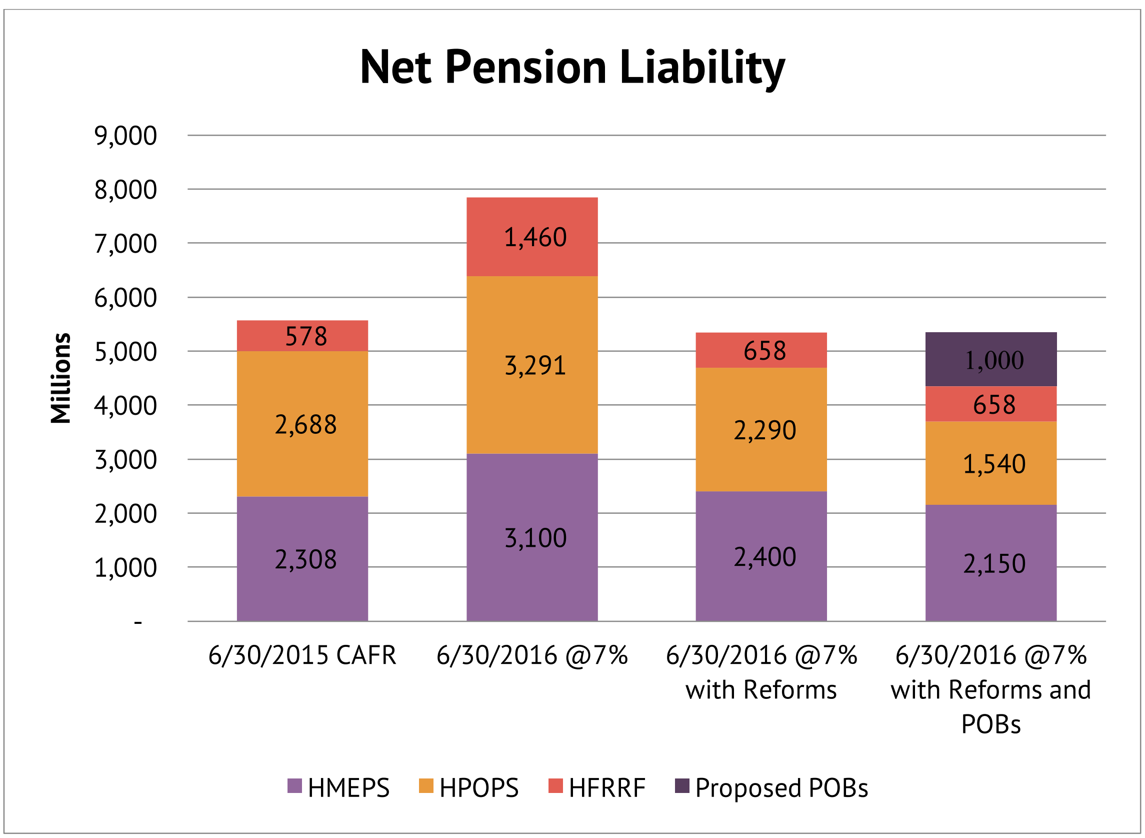


I thought the City's net pension liability was much less than $7.8 billion. Why did it increase?

Last year, the City's pension liability was estimated at $5.6 billion. The new figure of $7.8 billion is the most accurate estimate of Houston's pension liability – the increase is tied to two changes in how pension liability is calculated:

The Mayor's plan reduces the net pension liability by $2.5 billion immediately.

- First, all three systems have agreed to reduce their anticipated rate of return on investments to 7 percent per year. Earlier estimates of pension liability used a higher estimated rate of return, which is the amount the pension systems expect to earn on their investments each year. Reducing the rate of return to 7 percent annually means the pension systems expect less money from their investments. The 7 percent may not be achieved each year, but it is more reasonable over a longer period of time. With less expected to come in from investments, the total amount owed increases.
- Second, the pension systems have agreed to recognize all past investment gains and losses as of June 30, 2016. In pursuing pension reform, it was important to get the clearest possible picture of what the City owes. Under actuarial rules, investment losses can be deferred and not counted immediately. This "smoothing" approach helps keep the City's annual payments more predictable and stable, and will be utilized in a responsible manner going forward. By recognizing losses now instead of deferring them, the City and pension systems have established a much clearer look at what is actually owed over the long run.



Why are pension obligation bonds (POBs) a part of the solution?

This is an important part of the reform negotiations. For years under Meet and Confer agreements, the City underfunded the HPOPS and HMEPS pension systems. That underfunding contributed in part to the HPOPS and HMEPS current funding levels. As part of the agreements to reform pensions, HPOPS and HMEPS have been clear that they expect to be paid at least some of the deferred funding immediately. The City does not have the cash on hand, and so the funds must be borrowed. Fortunately, in the present economic environment, the City can borrow inexpensively.

> ***"POB use in conjunction with reforms to benefits and contribution practices increases the odds of strengthening funding positions and improving long-term sustainability."***
>
> ***Fitch, 9/16/16***

Hasn't the City used pension obligation bonds in the past?

Yes, the City issued pension obligation bonds in 2005, 2006, 2007, 2008 and 2011. There are two important differences. The proposed plan will ***require*** the City to fully fund future annual contributions every fiscal year for all three retirement systems. That will prevent future underfunding. Second, the cost of borrowing may be considerably lower than for prior pension obligation bonds.

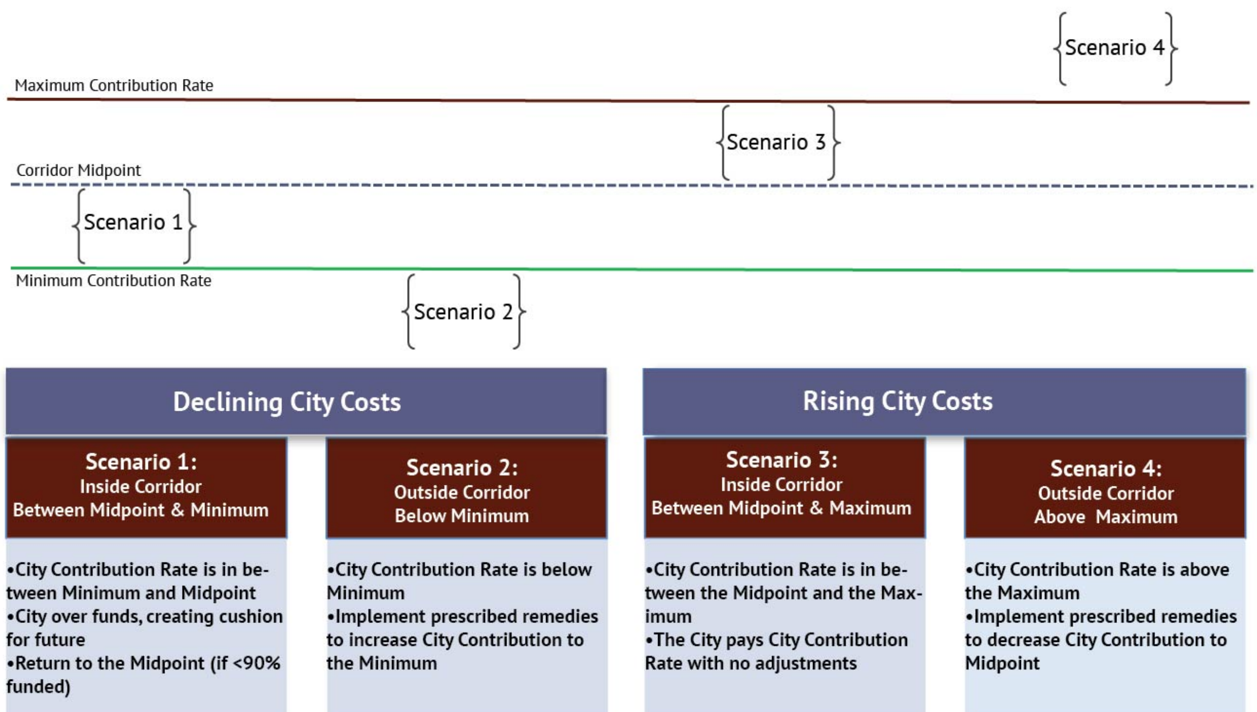
Can the City afford additional debt?

Issuing pension obligation bonds is not additional debt for the City. We are merely trading pension debt for bond debt. Additionally, this pension reform plan is essentially budget neutral, including the annual payment to the pension obligation bonds.

How does the corridor concept work?

As mentioned earlier, the corridor concept sets upper and lower limits for the City's pension costs, which are expressed as a percentage of payroll. The City currently pays approximately 32 percent of payroll toward pension costs. Under the corridor concept, if the City's costs fluctuate and move outside the limits of the corridor, the City and pension systems must make changes to bring costs back within the set limits. This will apply if costs go too high (they must be reduced) or if they drop too low.

If we had the corridor 15 years ago, we would not be in this situation today.



Why can't we just go with defined-contribution plans instead of defined-benefit?

An immediate shift to defined-contribution plans would have negative effects – including higher costs and greater risk – for the City and its taxpayers.

- Mayor Turner committed early in this process to protect the defined-benefit approach for the reasons above, to ensure that current and future employees and retirees are able to plan their retirements with confidence, and to keep the City of Houston an attractive place to work for quality employees. Had he not done so, the pension systems would not have agreed to $2.5 billion of benefit changes (whether it was for all employees or just for new employees, the pension systems did not want defined-contribution plans.)
- Applying defined-contribution only to new employees is more expensive over the next 30 years because the City would be paying the cost for the new plans while also trying to retire its liability from the old plans. The City's costs could easily go upwards of 50 percent of payroll.
- Thousands of Houston police officers and firefighters are also currently eligible to retire. There are 1,988 police officers and more than 1,100 firefighters eligible to retire right now. Moving them to a defined-contribution plan would eliminate their incentive to continue working, and Houston would likely find itself without enough emergency responders to meet the community's needs. We cannot jeopardize public safety and essential City services when there is a better way to address the issue.
- While defined-benefit plans offer employees greater security with a retirement payment they can count on, defined-contribution plans (used by most private companies) only guarantee what's paid into the employees' retirement account, not what will be paid out to employees when they retire.

What does this mean for employees and retirees?

Benefit changes for each of their respective retiree groups include scaling back Cost of Living Adjustments (COLAs), higher employee payroll contributions and phasing out the Deferred Retirement Option (DROP). All three pension plans will be stable. Employees can be more certain that when they are ready and eligible to retire, their pension benefits will be there for them. The City's general fund will also be more stable every year and will not require major cuts in services and staffing to cover a budget gap.

How will the pension systems reduce the unfunded liability?

By changing benefits, the details were left to the governing bodies of the pension systems that have agreed with the City, and will be outlined to Council. But the changes are designed to preserve the expectations of those least able to adjust to plan changes.

Where do we go from here?

Mayor Turner intends to seek a resolution of support from City Council before the end of October. He is also reaching out to other important stakeholders, including City employee groups, community and business leaders, good-government think tanks, news media and bloggers. Before the end of the year, the Mayor is to work with state legislators concerned about pension reform to file legislation that would implement the Mayor's plan for stabilizing and strengthening the City's pension systems.

DEFINITIONS

Actuary

In the context of pensions, a person who uses financial and statistical information to calculate the value of retirement benefits for pension plan participants. They consider such factors as interest rates, salary increases, termination of employment, disability, death and retirement in their analysis.

Closed Amortization

A closed amortization pays off debt with a repayment scheduled over a fixed period of time. This is in contrast to an open approach which resets the schedule every year and the City never pays down the unfunded liability.

Contribution Rate

The amount of money employees and the employer contribute to the pension, generally expressed as a percentage of salary.

Cost of Living Adjustment (COLA)

A cost of living adjustment in the context of pensions is an increase in benefits to cover the rate of inflation, which addresses the rising costs of basic needs like rent, food and gas.

Deferred Option Retirement Plan (DROP)

DROP is a program for employees who are eligible to retire and receive benefits but who choose to continue to work. An employee in DROP receives payment in to a DROP account equal to what the monthly retirement benefit would be. After the employee retires, this amount, plus interest, is disbursed to the employee.

Defined Benefit Plan

A defined benefit plan outlines now what will be available at retirement. It is sponsored by the employer and monthly payments are generally calculated based on factors like salary history and length of service. Benefits are designed to begin at a designated retirement age and last for the duration of the retiree's life.

Defined Contribution Plan

A defined contribution plan specifies how much money is going in to the retirement plan today, but it does not identify what will be available upon retirement, because that depends on how much the employee continues to contribute, how much the employer contributes, how long the funds remain in the plan and how well the money is invested.

DEFINITIONS

Net Pension Liability (NPL)
The amount of money an employer, state or local government owes the pension system(s) in which its employees are members that it simply does not have.

Pension Obligation Bonds (POBs)
POBs are bonds issued by state and local governments to pay amounts owed to the pension system(s) in which its employees are members.

Rate of Return
The gains or losses on an investment over a particular time period as a percentage of the cost of the investment.