City of Houston Pension Update

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Key Terms

- Cost of living adjustment (COLA): increase in benefits to address rising consumer costs
- Unfunded liability (UAAL): Pension fund's future liability minus assets ($1 billion - $800 million = $200 million)
- Net pension liability (NPL): Difference between "total pension liability" (similar to actuarial accrued liability) and "fiduciary net position" (fair value of plan assets)
- Funded ratio: Pension fund's assets divided by future liability ($800 million / $1 billion = 80 percent)
- Actuarially determined contribution (ADC): Annual payment required to cover current costs and also bring down unfunded liability
- Assumed rate of return: Percent return on pension fund's investment portfolio required to fund projected retirement benefits
- DROP: Deferred Retirement Option Plan

Organizational Framework

- Three separate defined-benefit plans – civilians, police, firefighters
- Administration of plans outsourced to three separate independent trust organizations
  - Houston Municipal Employees Pension System (HMEPS)
  - Houston Police Officers’ Pension System (HPOPS)
  - Houston Firefighters Relief and Retirement Fund (HFRRF)
- The independent trust organizations are established and governed by three separate state statutes to:
  - Manage the plan’s investments, and
  - Pay the benefits when they are due

Organizational Framework

- The descriptions of the benefits (plan design) are included in the applicable state statute
  - HMEPS and HPOPS have the ability to trump their statutes through Meet & Confer with the City
  - HFRRF statute requires legislative approval of proposed plan changes
- Pension benefits are considered separately from other elements of the City's total compensation program
- The actuary advising on funding and expense options reports to the plan administrator rather than the City as plan sponsor bearing the funding risks and expense reporting responsibilities

Pension Board Composition

	HMEPS	HPOPS	HFRRF
1. Elected active beneficiary trustees	4	3	5
2. Elected retired beneficiary trustees	2	2	1
3. Trustees appointed by:			
a. Mayor	1	1	1
b. City Council	2		
c. City Controller	1		
d. City Finance Director		1	1
e. Elected Beneficiary Trustees	1		2
4. Total Trustees	11	7	10

The City’s Pension Liability

- Total pension liability of $5.6 billion as of June 30, 2015
- Mayor has committed to hold to present defined-benefit approach rather than shifting to defined-contribution plans
  - Employees and retirees deserve sustainable, fair pensions they can count on
  - Has indicated to employees and pension representatives that this commitment will require review of other pension components including COLAs, contributions and retirement age/eligibility
- Reform is necessary: Credit rating agencies have expressed concern about City’s unfunded pension liability and called for a plan to address it

Defined Benefit and Defined Contribution Are:

- Categories of methods for delivering deferred compensation benefits to employees
- Fundamentally different
- Not interchangeable
- Not mutually exclusive
- Defined-benefit plans provide consistent, predictable benefits but may require employer and/or employee contributions to fluctuate depending on pension plan’s investment returns
- Defined-contribution plans rely on consistent, predictable contribution levels (often with employer providing a match to employee contributions) but benefits will fluctuate depending on pension plan’s investment returns

Key Drivers of Pension Liability

- Cost of living adjustments (COLAs)
- Contributions (employee and employer)
- Retirement age and eligibility
- Rate of return
- DROP

Key Drivers: COLAs

- Cost of living adjustments increase pension benefits to compensate for rising consumer costs (inflation)
- Often expressed as a percent of benefit or a percent of Consumer Price Index or similar measure
- Higher COLAs = higher liability (benefits projected to increase more in the future)
- Lower COLAs = less liability (benefits increase more slowly)

Key Drivers: Contributions

- Contributions to pension plans come from employees (for some plans) and employer
- Employee contributions are often a percentage of wages/salary
- Employer contributions should be relatively stable, but can fluctuate if investment returns and employee contributions are not sufficient to cover benefit payments

Key Drivers: Retirement Age/Eligibility

- Retirement eligibility can be defined by:
  - Age
  - Years of service
  - Combination of the two (e.g. rule of 80: years of service plus age must equal at least 80)
- Related to vesting – how long an employee must work before becoming eligible for future pension
- Requiring pension participants to work longer before retirement, or increasing number of years to vest, can improve pension solvency by increasing employee contributions, reducing benefits and limiting number of participants

Key Drivers: Rate of Return

- Pension plans invest their funds with an expectation of return on investment or rate of return
- If investments exceed expected rate of return, pension liability decreases
- If investments underperform expected rate of return, pension liability increases
  - Difference must be addressed through increased contributions (employer and/or employee) or through reduced benefits

Deferred Retirement Option Plan (DROP)

- DROP stands for Deferred Retirement Option Plan and is a provision whereby an employee who would otherwise be entitled to retire and receive pension benefits elects to continue working
- In most cases, employee's additional years of service and compensation do not continue to accrue for pension proposes, but a notional deferred compensation account is established and credited each year with the amount of pension he or she would have received if retired plus interest
- In most cases, at subsequent retirement the employee receives the accumulated value of his or her deferred compensation account plus the pension benefit based on pay and service when he or she entered DROP

Key Elements of DROP

- Potentially provide substantial increases over formula benefits at the employee's option only
- Specific to individual – cannot generalize
- Variables include:
  - Provisions of DROP
  - Age and service at DROP entry and exit
  - Basic benefit accrual rates without DROP
  - Salary changes during DROP
  - Employee contributions during DROP
  - Interest credits on DROP account

Next Steps

- Administration continues to meet and work closely with representatives from all three pension funds
- Emphasis is on reaching a solution for consideration by the 2017 Texas Legislature
- Mayor’s goals:
  - Reduce City’s long-term pension liability
  - Reduce City’s annual pension costs
  - Ensure employees have sustainable, secure and fair pension benefits they can count on
  - Remove this issue from the table over the long term
- Target: Reach agreement by end of 2016