City of Houston

Presentation to the City Council Budget and Fiscal Affairs Committee Subcommittee on Pensions and Debt Service

Sustainable City of Houston Pensions

October 20, 2016

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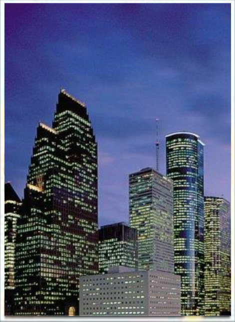
Overview

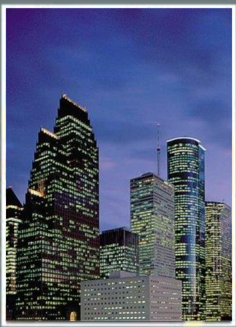
- Background
  - Mayor's commitment
  - Months of meetings
- Choosing a path: Defined benefit vs. defined contribution
- The City's plan
  - A clear look at what the City owes
  - Reduce the liability
  - Manage costs going forward
- What about pension obligation bonds (POBS)?
- The corridor
- Next steps

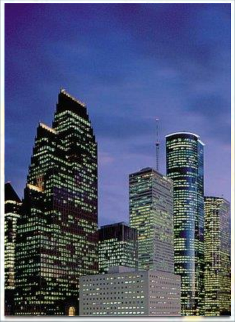

Background

- Mayor Turner committed to pension reform as a candidate for mayor, and has made it a priority
- Three objectives for now and in the future
  - Achieve cost avoidance and budget neutrality
  - Reduce unfunded liability
  - Achieve a solution that removes pension issues from the table
- Employees and taxpayers deserve a pension system that is fair, affordable and sustainable
- Shared sacrifice is required to meet the objectives
- Began meeting with pension system representatives in January 2016
- Meetings have continued over the past nine months and into this week

Choosing a Path: DB vs. DC



- Mayor’s commitment: achieve sustainable, affordable reform while protecting defined-benefit pensions
- Shift to defined contributions would do nothing to reduce $7.8 billion of pension liability
  - Would only slow its growth
- All three pension systems oppose shift to defined-contribution approach
  - Unlike the City’s plan, DC proposal would achieve no negotiated reductions to current pension liability



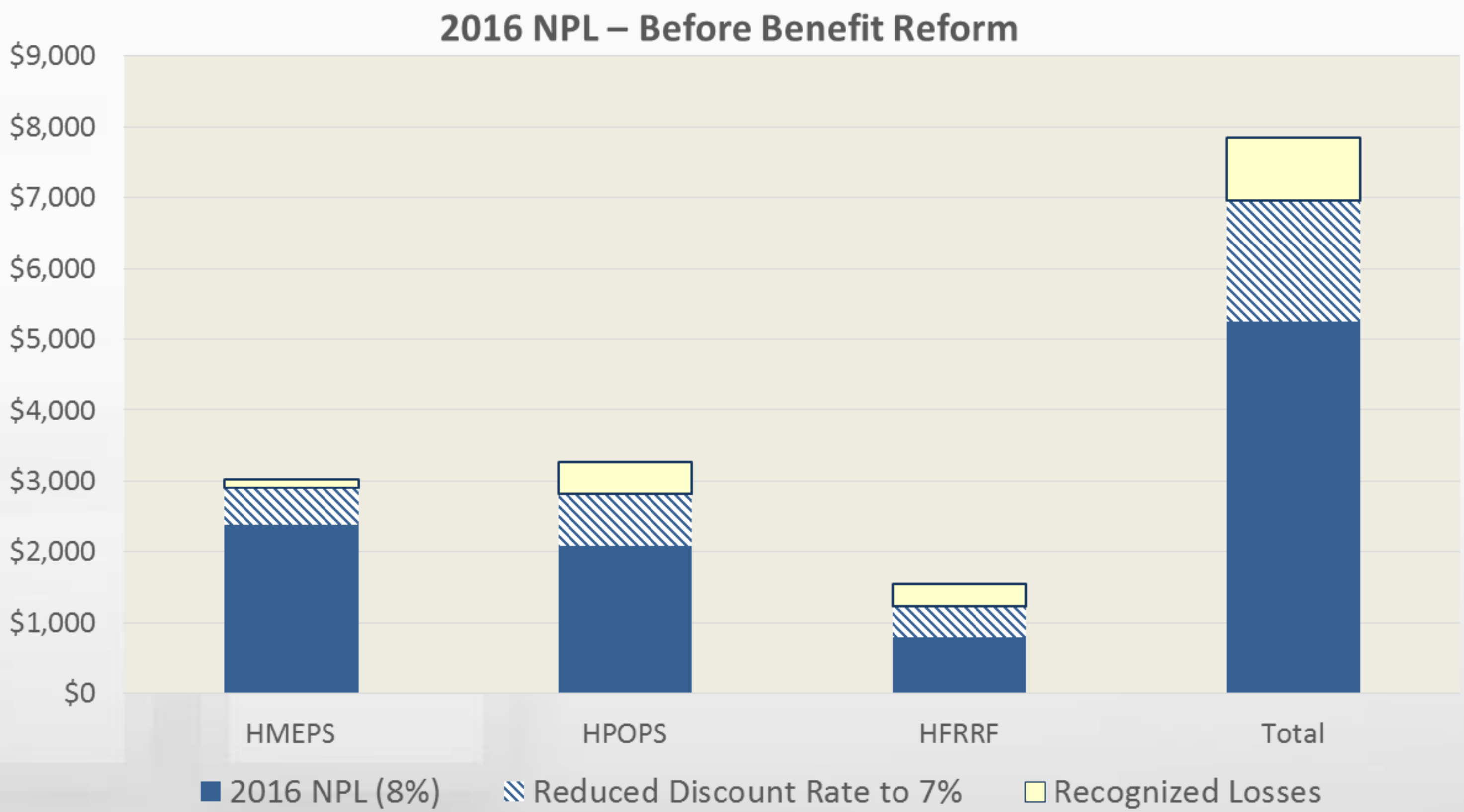
Choosing a Path: DB vs. DC

- Defined-contribution pensions could harm the City as an employer
  - Likely to prompt wave of retirements (nearly 2,000 police officers eligible right now)
  - Could also diminish City's appeal for prospective employees (most Texas cities offer a plan that provides some certainty regarding future benefits)
- In the long run, the proposed reform is more affordable
  - Without $2.5 billion of benefit changes, the $7.8 billion net pension liability costs 49 percent of payroll
  - The cost of the new DC plan would be in addition to this 49 percent
  - The $7.8 billion could grow without limit in the absence of the corridor to manage costs

The City’s Plan: What is owed?

- First step: Get a clearer look at what we owe
- Requires more accurate calculation of City’s net pension liability
  - Reduce anticipated rate of return (i.e., discount rate) for all three systems to 7 percent
  - Recognize all investment gains and losses as of June 30, 2016
- Impact: Increase City’s pension liability from \$5.6 billion to \$7.8 billion

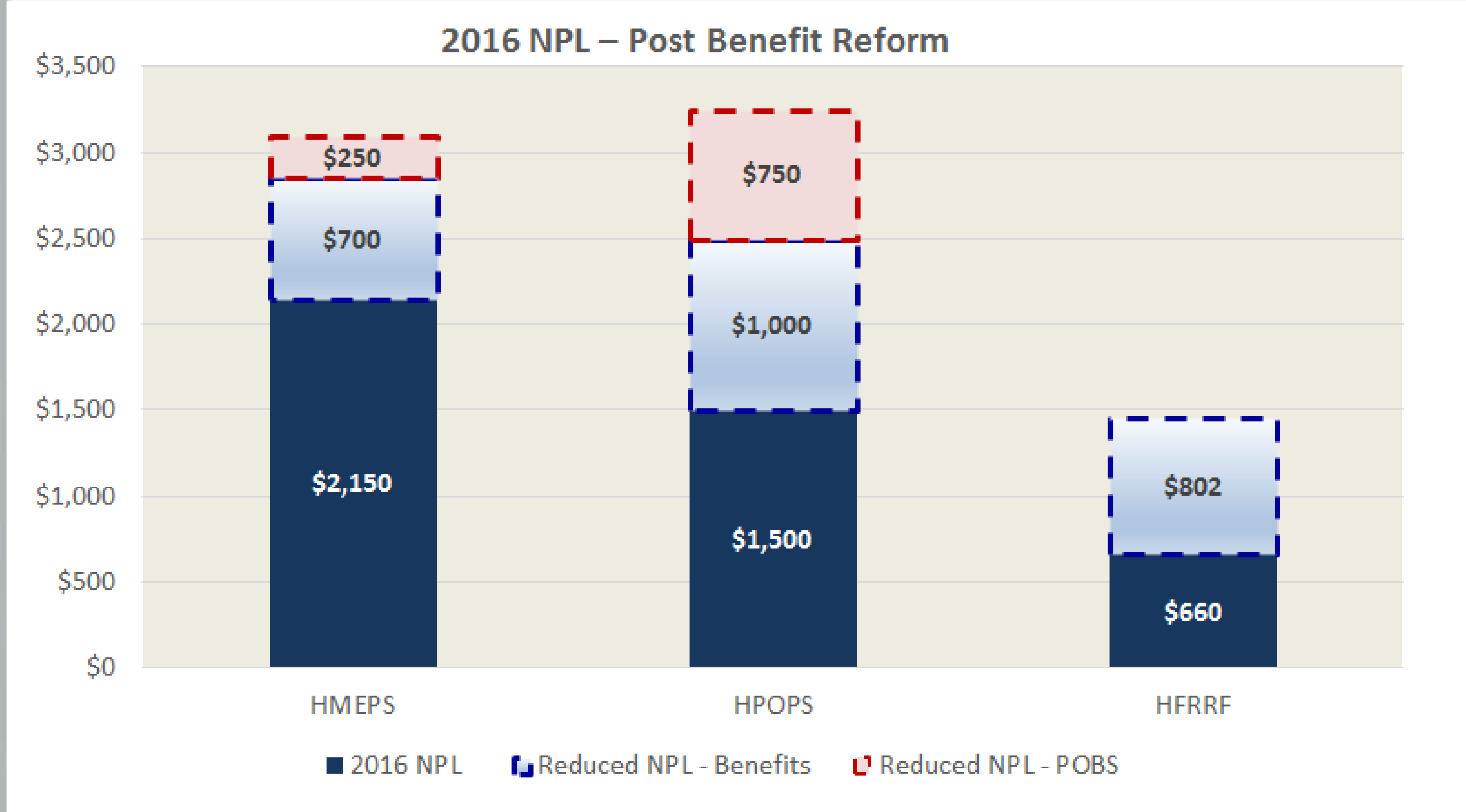
The City's Plan: What is owed?



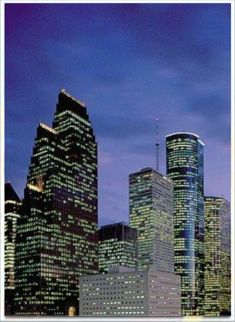
The City's Plan: Reduce liability

- Second step: Reduce the City's pension liability
  - Benefit adjustments in all three systems to reduce future costs: liability reduction of $2.5 billion
  - City addresses past underfunding with issuance of $1 billion in POBs
    - HMEPS ($250 million) and HPOPS ($750 million)
  - City required to make full annual contributions to each system: no more long-term underfunding
- Impact: Total immediate reduction in net pension liability of $3.5 billion

The City's Plan: Reduce liability



The City's Plan: Manage costs


- Third step: Better management of pension costs and liability in the future
  - Closed 30-year amortization sets clear schedule and hard date for payoff: no more "kicking the can"
  - Corridor sets City contribution boundaries that trigger pension system changes if breached

The City's Plan: What about POBs?

- Without POBs, there is no deal
  - City has underfunded HMEPS and HPOPS for years; both systems required infusion of cash as condition of reform
- Markets' concern is using POBs to replace contributions in a given year – we don't do that
  - Fitch: "POB use in conjunction with reforms to benefits and contribution practices increases the odds of strengthening funding positions and improving long-term sustainability." (Sept. 2016)

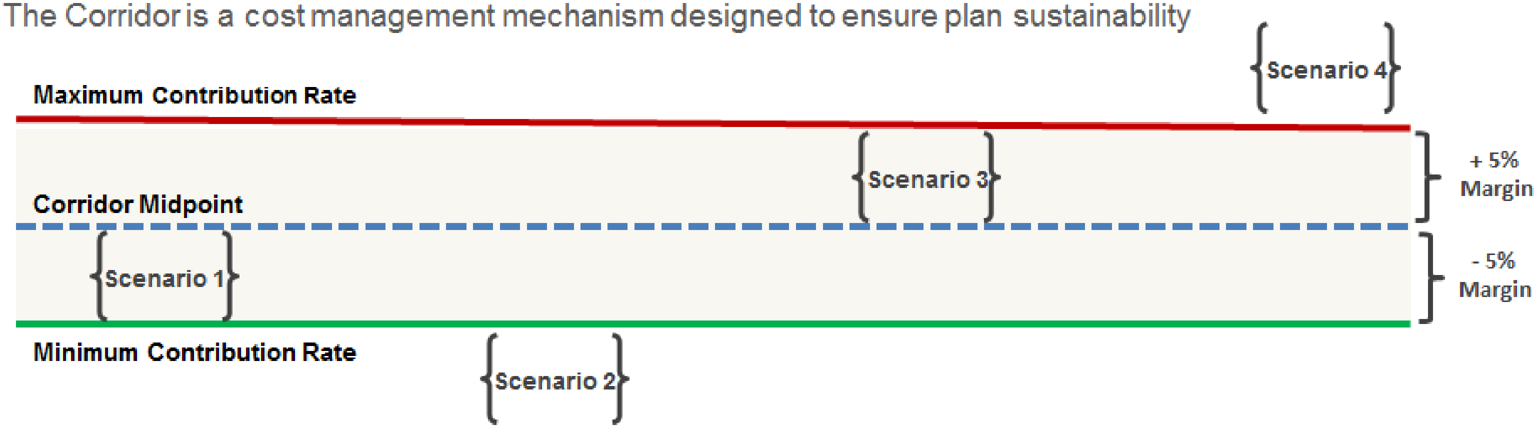
The City's Plan: What about POBs?

- POBs do not incur additional debt for the City
- City already owes the $1 billion to pension systems
- POBs do not increase the total amount the City owes
  - Before POBs pension liability with reform is $5.3 billion
  - After POBs, pension liability with reform is $4.3 billion and debt obligations increase by $1.0 billion
  - Total amount owed is still $5.3 billion

The City’s Plan: The corridor

Overview of Risk Sharing

The Corridor is a cost management mechanism designed to ensure plan sustainability



Declining Pension Costs

Scenario 1: Inside Corridor – between Midpoint and Minimum

- City Contribution Rate is in between Minimum and Midpoint
- City over funds, creating cushion for future
- Return to the Midpoint (if <90% funded)

Scenario 2: Outside Corridor – Below Minimum

- City Contribution Rate is below Minimum
- Pay down pension liability faster
- Take risk of underfunding off the table (by lowering assumed rate of return)

Rising Pension Costs

Scenario 3: Inside Corridor – between Midpoint and Maximum

- City Contribution Rate is in between the Midpoint and the Maximum
- Risk of increasing pension costs are paid by the City

Scenario 4: Outside Corridor – above Maximum

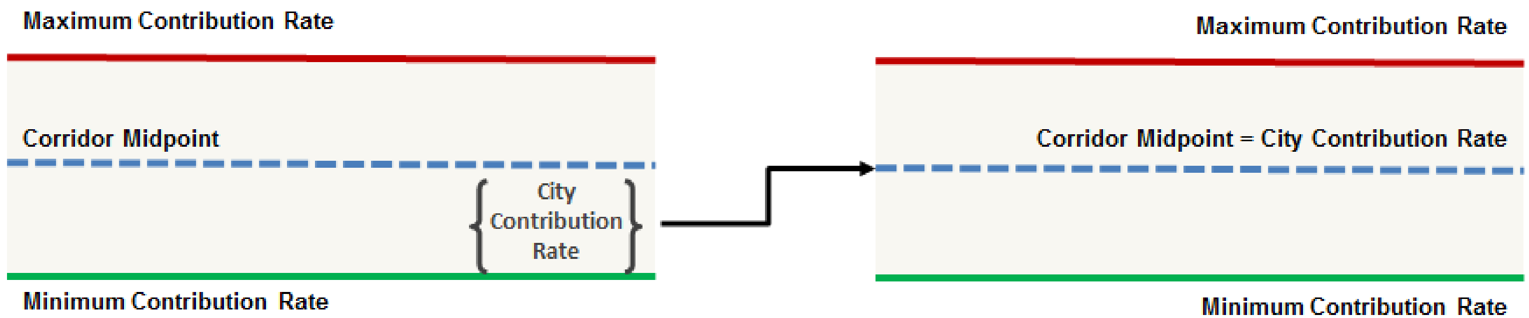
- City Contribution Rate is above the Maximum
- Use cushion, if any, built in Scenario 1, prior to remedies, to decrease City Contribution to Midpoint
- Ensures costs remain sustainable

Corridor Midpoint = proposed benefits package estimated cost

The City’s Plan: The corridor

Scenario 1: Declining Pension Costs

If City Contribution Rate is between the Minimum and Corridor Midpoint,



then the City shall take the following actions in listed order to bring the City Contribution Rate back to Corridor Midpoint

and Funded Ratio < 90%, then:

1. Over fund at the Corridor Midpoint.

UNLESS Funded Ratio ≥ 90%, then:

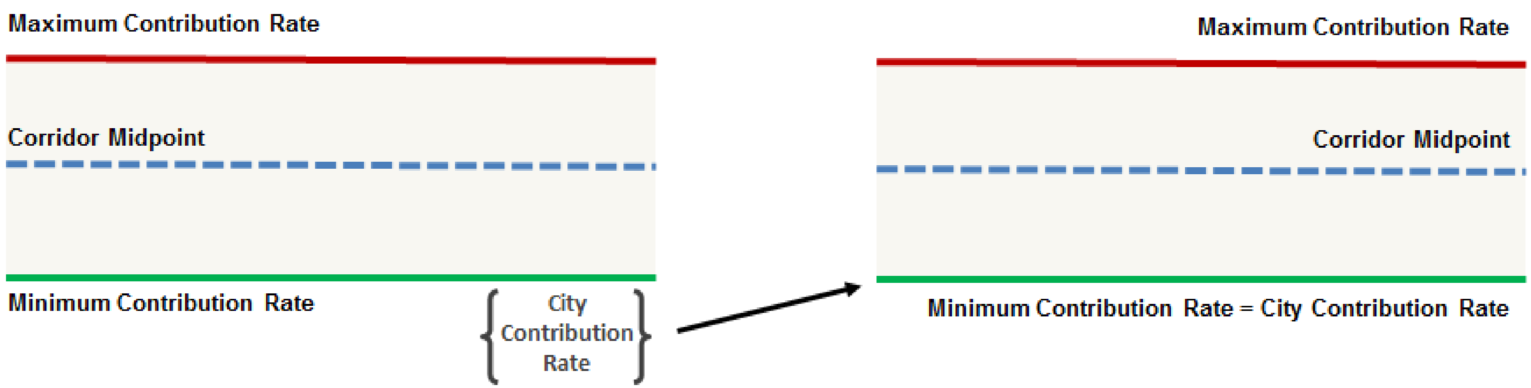
1. No remedies are undertaken, City pays City Contribution Rate (which will remain in between Midpoint and Minimum).

These remedies use gains to improve the systems’ financial strength

The City’s Plan: The corridor

Scenario 2: Declining Pension Costs

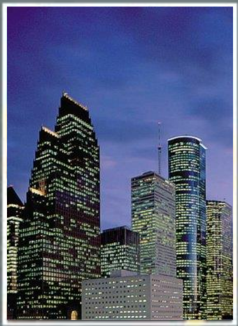
If City Contribution Rate is less than Minimum Contribution Rate,



then the City shall take the following actions in listed order until the City Contribution Rate equals the Minimum Contribution Rate

1. Prospectively, restore all or portion(s) of benefit cuts, if any, made subsequent to this agreement as a result of this Risk Sharing Provision.
2. Accelerate the payoff of the unfunded liability, but to no less than 20 years from inception of liability layer.
3. Take risk off the table by reducing the Discount Rate.
4. If the Funded Ratio is less than 90%, the City shall pay the Corridor Midpoint.
5. If the Funded Ratio is between 90% and 100%, the City shall pay the Minimum Contribution Rate.
6. If the Funded Ratio is at least 100%, reduce employee contributions and/or increase other pension benefits.

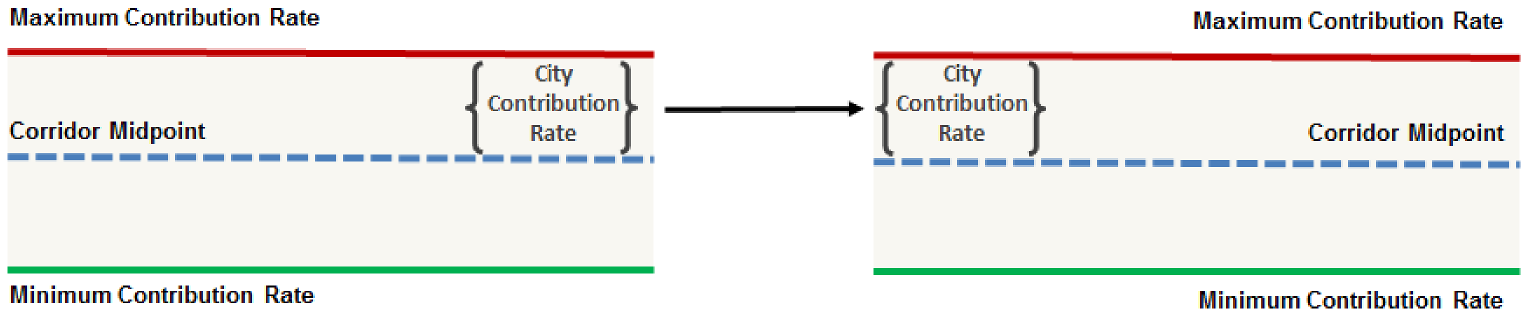
These remedies use gains to improve the systems’ financial strength



The City's Plan: The corridor

Scenario 3: Rising Pension Costs

If City Contribution Rate is between the Corridor Midpoint and Maximum,



then no adjustments are required and the City pays the City Contribution Rate

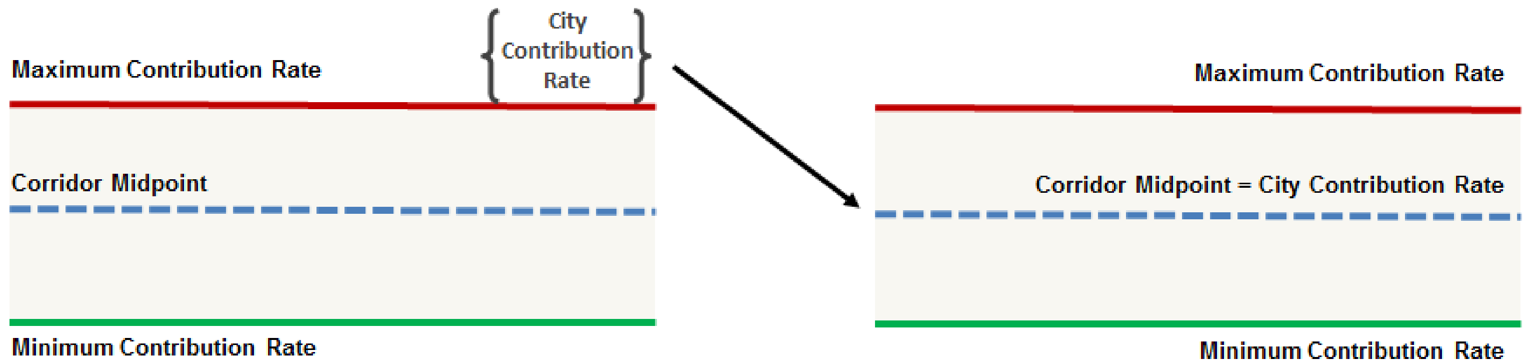
- The Corridor Midpoint is what the proposed benefits package is estimated to cost.
- A City Contribution Rate above this amount, up to the Maximum Contribution Rate, represents unexpected costs that the City would absorb

City bears the risk of increasing pension costs up to Maximum Contribution Rate

The City's Plan: The corridor

Scenario 4: Rising Pension Costs

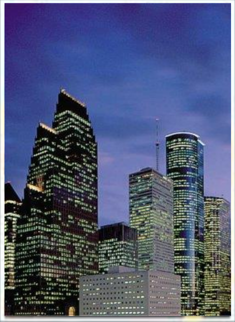
If City Contribution Rate is greater than Maximum Contribution Rate,



then the City shall take the following actions in listed order to bring the City Contribution Rate back to Corridor Midpoint

1. If previous gains in Scenario 2 resulted in accelerating payoff of the unfunded liability, then re-extend, but to no more than the original 30-year Payoff Year
2. Increase employee contributions and decrease pension benefits to bring the City Contribution Rate back to halfway between the Corridor Midpoint and the Maximum City Contribution Rate
3. If the City Contribution Rate remains above the Corridor Midpoint three years later, then increase employee contributions and decrease pension benefits to bring the City Contribution Rate back to the Corridor Midpoint

These remedies ensure pension costs remain sustainable



Next steps

- Resolution of support will be presented to Council October 26
  - Administration requests no tag
- State legislation to be filed as soon as possible
  - Earliest opportunity is mid-November