

# SUSTAINABLEPENSIONS

Mayor Sylvester Turner  
City of Houston



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## Pension Reform - The Path Forward

When you find yourself in a hole, the first order of business is to stop digging. That's what we did – and pardon the pun here – with the pothole crisis. That's what we did with the biggest budget gap since the Great Recession. And that's what we are now doing with pensions. That's historic, but the even bigger news is the renewal of the can do attitude and cooperative spirit that has served our city well since its founding. Instead of continuing to fight as they have in the past, a broad spectrum of Houstonians are now putting aside their differences and working together to dig us out of this financial hole.

Through their pension governing boards, our City employees have put \$2.5 billion of concessions on the table. These hard-working public servants are giving up benefits to which they are entitled in order to create a more stable future for our city. City leaders are promising to no longer fudge on what we owe to City employees every year. The business community and legislative delegation are helping to get the plan enacted into law. And, as I have said many times before, I will later ask taxpayers to step up and share in these sacrifices by agreeing to repeal the revenue cap that is crippling the City's ability to meet its growing needs.

Now, let's take a closer look at the path forward. Just imagine reducing by more than \$200 million what the City will have to pay next year while also controlling what we have to pay every year after. Then imagine having \$7.7 billion of currently unfunded pension obligations immediately reduced and then eliminated entirely over time. This plan achieves fully funded, secure, sustainable and affordable retirement plans that our employees can rely on and taxpayers will find affordable, and we do it without increasing the City budget or needing to raise taxes.

Although we are dealing in the billions of dollars, this really isn't that much different than a consumer mortgage. We will have a 30-year fixed payment plan and just like a mortgage, the debt will be gone at the end of 30 years. The City will pay what it owes every year, and there will be no more refinancing every year to put us deeper in the hole.

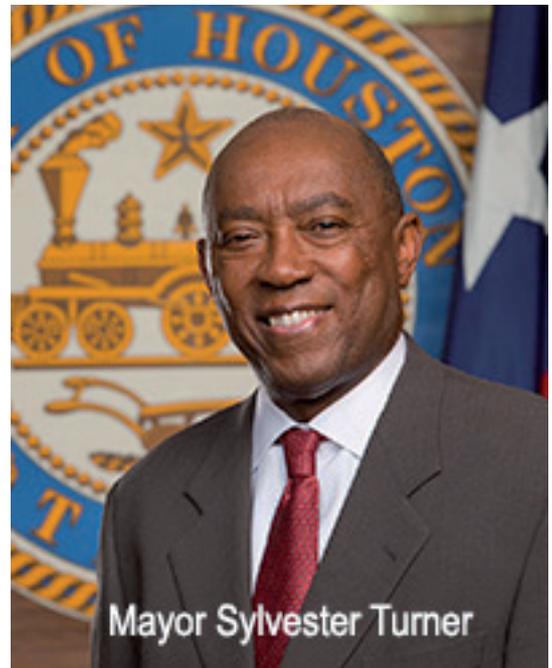
The benefits changes from the pension systems will immediately reduce our unfunded liability to \$5.2 billion for a 33% reduction right off the bat. Their offer is like the down payment. It is their upfront commitment to helping, and it has a significant impact on the total amount we will have to pay now and in the future. We will couple this with \$1 billion in pension obligation bonds (POB) to further reduce the unfunded liability. Yes, we are trading one form of debt for another, but at a lower interest rate. As Fitch Ratings recently noted, "POB use in conjunction with reforms to benefits and contribution practices increases the odds of strengthening funding positions and improving long-term sustainability."

In keeping with the national trend, we are also lowering the assumed rate of return on pension investments to a more realistic 7 percent.

And, to ensure the City never again finds itself facing a multi-billion dollar debt with no way to pay for it, we are limiting the amount to be spent each year for pension benefits. If anticipated costs rise above this limit, the City and the pension systems will have to return to the table to make adjustments to bring costs back in line. If this type of system had been put in place 15 years ago, we would not be where we are today.

For some time, we have known we had choices to make regarding our employee pensions. The current situation is straining our finances and putting at risk our ability to meet our pension obligations in the future. We have chosen a path that will minimize adverse impact on our hard working employees, especially the thousands of police, fire and municipal workers eligible to retire today.

No other plan provides both immediate and long-term benefits and takes the pension issue off the table for good. We are closer than ever before to solving this. There will be a few who will criticize but not one of them has presented anything that reduces the unfunded liability by even \$1 immediately and then pays it off entirely in 30 years while also moving us forward in a unified manner. Is it perfect? No. But is it a very good plan for City employees, taxpayers and the future of this great city? Absolutely!



A handwritten signature in black ink that reads "Sylvester Turner". The signature is written in a cursive, flowing style.

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*This plan achieves fully funded, secure, sustainable and affordable retirement plans that our employees can rely on and taxpayers will find affordable, and we do it without increasing the City budget or needing to raise taxes.*

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

”

## *Sustainable Pensions for Houston*

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*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.*



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*The Mayor’s plan keeps defined-benefit plans while  
 reducing net pension liability.*  
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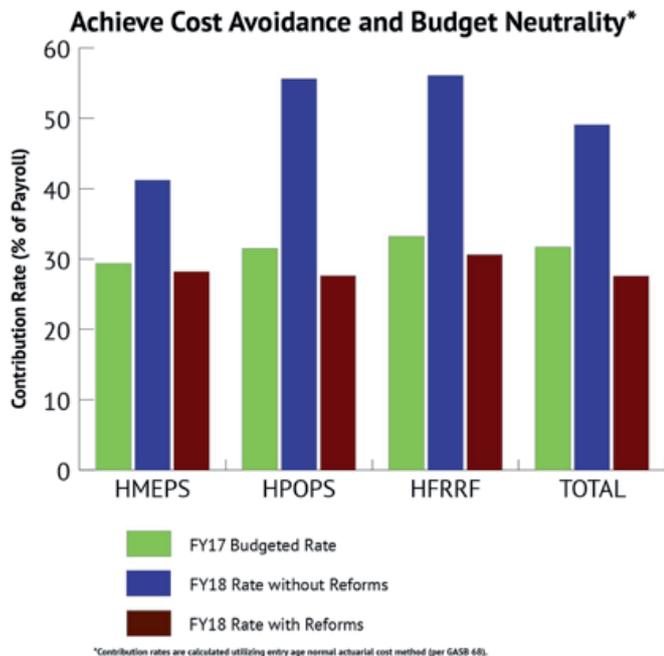
## Putting the Pieces Together

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

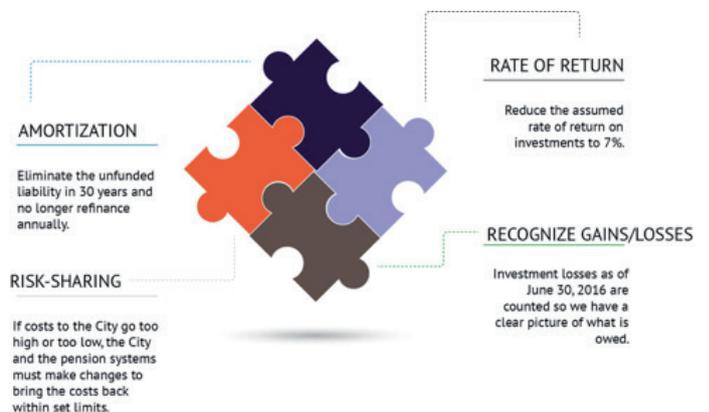
Mayor Turner’s pension reform plan focuses on keeping the defined-benefit retirement plans, with changes to benefits, reducing the City’s net pension liability (NPL) by one third immediately which is then paid down over time. The City will pay what is required to fully fund the pension systems annually 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 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 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.



The City’s net pension liability is estimated at \$8.1 billion. The Mayor’s plan would reduce the liability to \$5.6 billion immediately through a combination of methods, including cost reductions identified by the three pension systems’ governing bodies.



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*This “smoothing” approach helps keep the City’s annual payments more predictable and stable, and will be utilized in a responsible manner going forward.*  
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## *Net Pension Liability*

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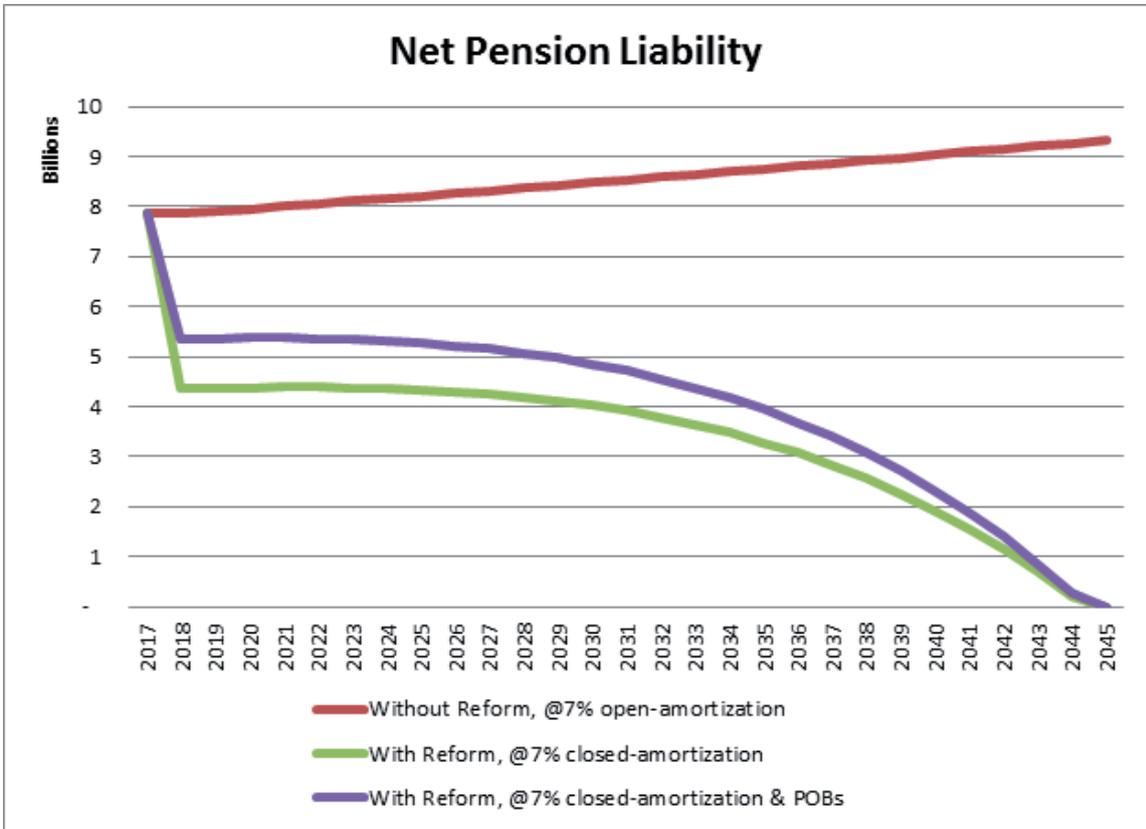
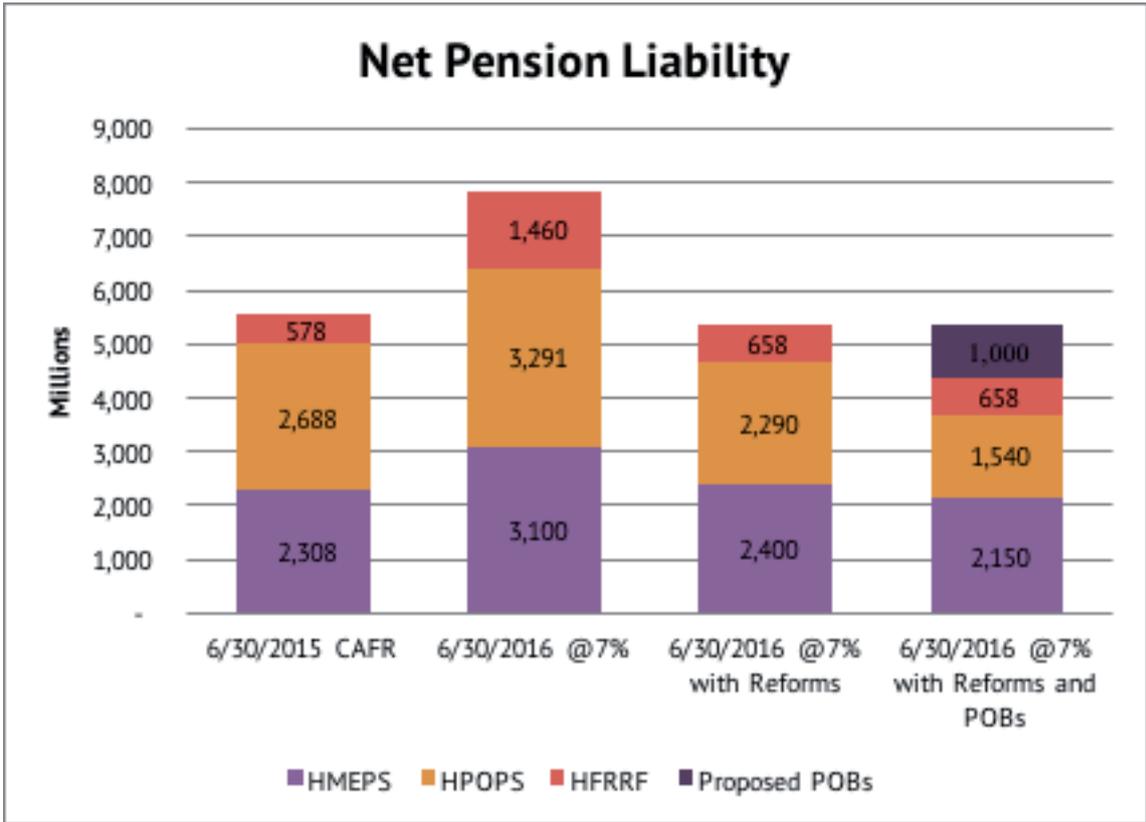
**I thought the City’s net pension liability was much less than \$8.1 billion. Why did it increase?**

**Last year, the City’s pension liability was estimated at \$5.6 billion. The new figure of \$8.1 billion is the most accurate estimate of Houston’s pension liability – the increase is tied to two changes in how pension liability is calculated:**

**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.*





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*(Pension obligation bond) use in conjunction with reforms to benefits and contribution practices increases the odds of strengthening funding positions and improving long-term sustainability.*

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- Fitch Ratings

## Pension Obligation Bonds (POBs)

### 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.*



- NEGOTIATION MEANS COMPROMISE**

The Police and Municipal pension systems agreed to major reforms, and asked the City to meet halfway and pay some of the money owed to their pensions - \$1 billion total.
- POBs REDUCE RISK**

The pension experts at Fitch stated that using POBs with reforms increases the likelihood of longterm sustainability.
- FIXED DEBT PAYMENTS**

The City will issue the POBs on a fixed payment schedule that is fiscally responsible.



## **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?**

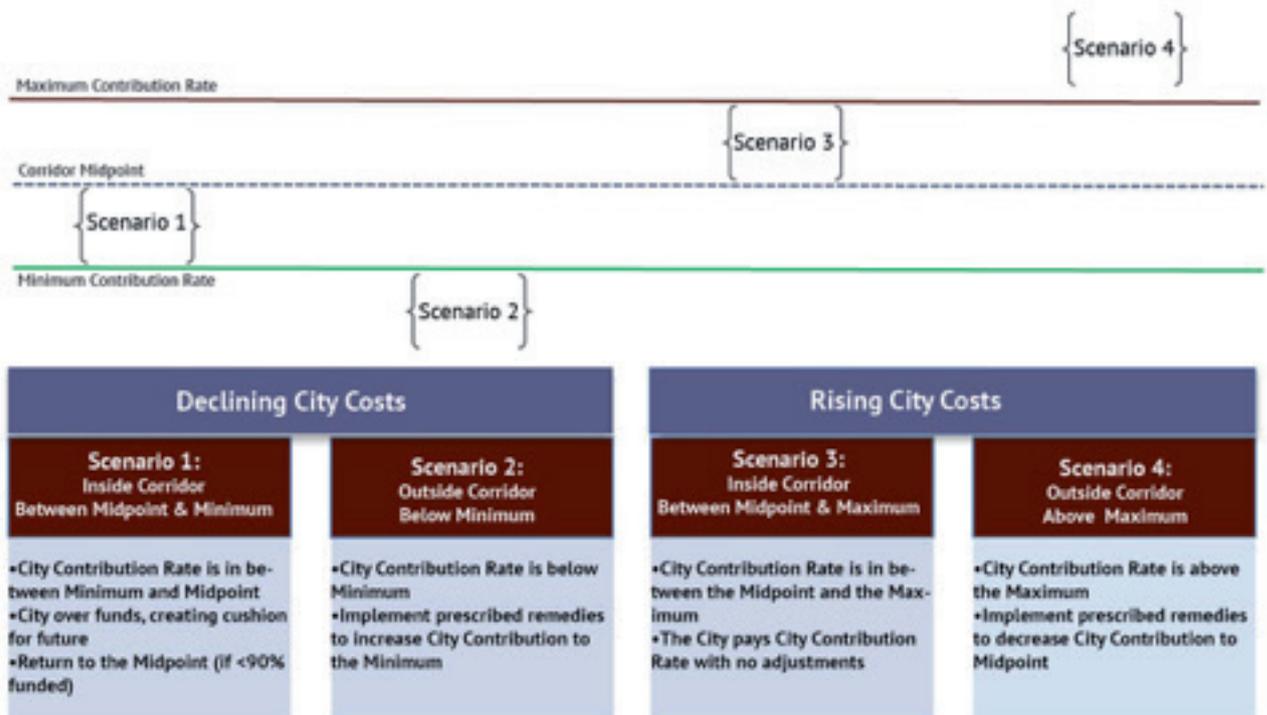
*Issuing pension obligation bonds is not additional debt for the City. We are merely trading pension debt for bond debt. Additionally, this pension reform plan is essentially budget neutral, including the annual payment to the pension obligation bonds.*



# The Cost Corridor

## 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.*



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*It's a new idea with great potential to solve a 15-year old problem in Houston. And, if the “corridor” mechanism is airtight and works as intended, it could become a case study for cities across the country.*

”

*- Marc Watts - Greater Houston Partnership*

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*The proposed agreements contain excellent framing language, explaining that the normal market fluctuations should be managed by the city, but the city and employees must share the burden of unusual economic events either good or bad. Other cities and states should consider using this framing language.*

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*- Bill Fulton, Director,  
Kinder Institute for Urban Studies at Rice University*

# What About Defined Contribution?

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## 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.)

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**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.

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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.

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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.**



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*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.*

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### **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.*

# *Appendices*

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# Fitch Ratings

**Fitch Ratings – Austin** - 16 September 2016: Houston, TX Mayor Sylvester Turner’s pension reform proposal contains several positive elements while also introducing some level of risk. The proposal, which the mayor outlined in broad terms in a speech on Sept. 14, includes reforms to benefits and contribution practices that could improve the sustainability of the city’s pensions. Reforms include benefit changes in the municipal, police and fire plans that reportedly could reduce the combined unfunded liability of the programs by 1/3; implementation of a closed 30-year amortization period; a reduction in the discount rate to 7% from rates currently ranging from 7.08% to 8.50%, and a requirement that the city make the actuarially required contribution annually. Fitch cautions that achieving even a 7% return assumption carries risk given recent market performance and the low interest rate environment.

The proposal also includes the issuance of \$1 billion of pension obligation bonds (POBs). Fitch views POBs as a neutral to negative credit consideration, noting the possible impact to overall financial flexibility and additional investment risks associated with their use. A key consideration is the use of proceeds from a POB borrowing: if proceeds are used to boost a system’s assets, they essentially

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*(Pension obligation bond) use in conjunction with reforms to benefits and contribution practices increases the odds of strengthening funding positions and improving long-term sustainability.*  
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replace one long-term liability with another. It is Fitch’s understanding that Houston’s POB proceeds would be used in this manner, rather than replacing contributions, and thus Fitch does not consider this deficit financing. POB use does entail interest rate risk, as investment returns on POB proceeds must exceed the cost of borrowing for the strategy to be considered a financial success.

POBs are typically used for plans that are poorly funded and with questionable long-term sustainability, and Houston’s pension programs fit into this category. Use of POBs alone typically is insufficient to correct underlying sustainability concerns and provides only temporary relief in the absence of broader reforms. However, POB use in conjunction with reforms to benefits and contribution practices increases the odds of strengthening funding positions and improving long-term sustainability.

Fitch’s evaluation of a local government’s long-term liability burden measures overall debt totals and net pension liabilities as a percentage of the economic base (as measured by total personal income). Houston’s burden currently is moderate at roughly 14%. Fitch will conduct a thorough analysis of Houston’s pension reform program once agreements between all parties are executed and any necessary legislative approval is obtained.



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## INSTITUTE FOR URBAN RESEARCH

October 25th, 2016

### **Houston's Pension Reform Package: Our Latest Analysis**

By Bill Fulton

The numbers for Mayor Sylvester Turner's pension reform plan generally add up, and the reforms generally move Houston in the right direction. In fact, this pension reform plan should be viewed by other cities as a national model, especially its risk-sharing aspect.

That's the conclusion of a new analysis of the reform plan by the Kinder Institute for Urban Research and the Center for Retirement Research at Boston College. You can quibble with some things, and the whole plan is not without some risk. But generally speaking it is a strong move in the right direction.

All three Houston pension boards have now signed off on Mayor Sylvester Turner's pension reform plan, and the City Council is scheduled to vote on it Wednesday. Assuming the council okays the deal, it will go to Austin for legislative action next year.

The deal is not significantly different than what Turner announced in September. But now we have more details about the overall numbers and the specifics about the pension reforms, the pension obligation bond, and the risk-sharing agreement or "corridor."

In August, the Kinder Institute issued a report laying out options for reform. In September, after Turner's initial press conference, the Kinder Institute issued a quick analysis. What follows is the result of our quick analysis of the new details issued over the last week.

### **The Deal and The Numbers**

If you read our September blog post, you'll remember that the deal went like this:

- Assumed rates of return would drop from 8% or 8.5% to a more realistic 7% for all three pension systems.
- Instead of using an open amortization period that resets every year, the city would use a closed 30-year amortization period.
- These two changes, along with some other miscellaneous recalculations, meant the city's unfunded liability is \$8.1 billion.
- The three pension boards would agree to then-unspecified reforms totaling around \$2.6 billion, bringing the unfunded liability down to \$5.2 billion.
- The city would issue a \$1 billion pension obligation bond, which would bring the total unfunded liability down to \$4.2 billion, though the city would still have to pay off the bond.
- The total annual cost — including the cost of paying off the bond — would be within the city's current budgeted amount for pension payments.



*It was a little hard to tell from the September information just whether and how the numbers added up. But as the table below shows, they actually do add up, assuming the 7% return on investment works out. Most specifically:*

- The city's FY 17 budget assumes that the pension payment will be 33.2% of payroll, or about \$416 million.
- After accounting for changed assumptions and proposed reforms but before accounting for the pension bond, the FY 17 pension payment would be 30.3% of payroll, or about \$420 million.
- Accounting for the \$1 billion pension bond – which will be applied to unfunded liability for both municipal employees and police – the FY 17 pension payment would be about \$355 million, leaving \$65 million to pay off the bond. This is sufficient to pay off a \$1 billion bond at a 5% interest rate.

## Reforms

The \$2.6 billion in reforms comes entirely from increased employee contributions and changes to the COLA (Cost Of Living Adjustment) and DROP (Deferred Retirement Option Program).

## Increased Employee Contributions

Police (10.25% of salary) and fire (10.5%) will now pay higher than the national average for public safety employees (9%). When measured against the “normal” cost – that is, the cost of benefits earned for each year of work – the police and fire contributions are right around the national average because Houston police officers and firefighters receive higher-than-average benefits.

Municipal employees will also pay higher contributions, including 8% for Group A (hired before 2008), 4% for Group B (hired before 2008), and 2% for Group D (hired after 2008). Group D employees currently pay no contributions but also receive much lower benefits.

The national average is currently 7.6% of salary for non-public safety employees and amounts to about half of the average normal cost. By comparison, Group D employees pay about half of the normal cost, Group B employees pay a bit more than half, and Group A employees pay almost all.

## COLA Reforms

All three pension boards agreed to COLA reforms, but all the deals are different.

Most police retiree COLAs will be frozen for three years and then linked to social security COLAs but capped at 2.5%. This is a best practice, protecting retirees' purchasing power while also protecting the city in the event of high inflation.

Firefighters will also take a three-year freeze and then receive COLAs linked to social security increases, but there is no cap. This could be a significant financial risk for the city if inflation ever increases dramatically.

Municipal employees will continue to receive a 1% COLA. If inflation in the future continues at around 2%, as it has for the past 20 years, retirees' buying power will erode over time.



## DROP Reforms

DROP is an option available to many city employees, especially those who have worked for the city for a long time. Employees leave the pension system while still working, meaning they begin receiving their pensions in addition to their salaries, and those pensions are then deposited into a DROP account on their behalf. When they leave the DROP system, the employees receive a lump sum and then begin collecting their pension directly. Only about 30% of large local government pension plans nationally have DROP programs.

The DROP program is intended to incentivize a small number of valued employees to keep working even after their pension benefits have been maximized, but in Houston it has been used by the vast majority of employees, partly because they are permitted to stay in the program for a long time.

The typical allowable period to remain in a DROP program is five years, but police officers and firefighters in particular stay longer. Police officers will be permitted to stay in DROP for between 10 and 20 years, while firefighters will be able to stay in DROP for between 7 and 10 years. New municipal employees are not eligible for DROP.

For all three programs, DROP participants are guaranteed a minimum rate of return ranging from between 2.5% and 4% per year.

## Shared Risk (The Corridor)

One of the most important features of the Houston reform plan is the shared risk or “corridor” concept. Under this concept, if investment returns are higher or lower than expected, negotiations will automatically be reopened between the city and the pension boards. Specifically, negotiations will be opened if the investment returns require an annual city payment of 5% or more above or below the expected payment. The negotiations must yield changes that will bring the payment back to +/- 5% within three years.

The proposed agreements contain excellent framing language, explaining that the normal market fluctuations should be managed by the city, but the city and employees must share the burden of unusual economic events either good or bad. Other cities and states should consider using this framing language.

The main goal, of course, is to ensure that if the investment returns are low, the combined contributions from the city and the employees do not underfund the pension system, as has happened in the past. More benefit cuts or employee contributions may be required. But as an inducement to accept this idea, the shared risk concept also requires a renegotiation if investment returns are higher than expected, opening the possibility of restoring benefits or paying unfunded liability down faster than expected.

The city’s plan does not specify what benefit cuts or increased employee contributions might go into effect as a result of the poor returns, only that negotiations are reopened. This is probably fine so long as the investment returns do not drop the pension funds below the corridor on a regular basis. If the investment consistently falls below 7%, it’s likely that the city and the pension boards will be in constant negotiation.

## Pension Obligation Bond

A pension obligation bond has many benefits. Among other things it provides the city with flexibility in cash-flow and in scheduling future payments. As Boston College’s Jean-Pierre Aubry noted at our recent panel discussion on pensions, bonding the pension debt puts the debt in the hands of people who are making a business decision to acquire it (bond buyers) rather than the hands of plan participants who would rather not have unfunded pension liabilities.

The risk, of course, is that the city is floating a bond without generating any additional revenue to pay the bond. As stated above, the city should save enough money from pension reforms to cover the payment on a \$1 billion floated at 5% — assuming the pension boards consistently hit the 7% return on their own investment funds.

## Defined Contribution Plans

Both Mayor Turner and the pension boards have consistently rejected the idea of switching to defined contribution plans (i.e., 401K-type plans), rather than guaranteed pensions, for new employees and such a system is not part of the mayor’s plan. Turner has been consistently criticized by his 2015 runoff opponent, Bill King, for not supporting the defined contribution concept.

The upside of a defined contribution system is that it assures that the unfunded liability problem won’t get worse many years down the road, because the city is not responsible for covering the cost of a guaranteed pension if investment returns are low. But a defined contribution system would not help reduce the current unfunded liability and some critics say it can harm recruiting.

	HMEPS	HPOPS	HFRRF	Total
Budgeted Rate	29.36%	34.0%		33.20%
Budget	\$178,060,000	\$147,290,000	\$91,600,000	\$ 416,950,000
8%/8.5% Rate	31.81%	40.1%		30.80%
8%/8.5% Contribution	\$ 192,918,549	\$ 173,920,171	\$ 84,978,313	\$ 451,817,033
7% Rate	38.98%	55.6%		56.10%
7% Contribution	\$ 236,402,548	\$ 241,146,172	\$ 154,781,928	\$ 632,330,647
7% Rate w/Reforms	29.33%	36.60%		30.30%
7% Contribution w/Reforms	\$ 177,878,059	\$ 158,740,106	\$ 83,598,795	\$ 420,216,960
7% Rate w/Reforms and POB	26.95%	24.90%		30.30%
7% Contribution w/Reforms and POB	\$ 163,444,040	\$ 107,995,318	\$ 83,598,795	\$ 355,038,153
Total Payroll	\$ 606,471,390	\$ 433,716,137	\$ 275,903,614	\$ 1,316,091,141



# CITYLAB

January 18th, 2017

## The Great Texas Pension Fix

Houston owes its police, fire, and city workers about \$7.8 billion, and it doesn't exactly have the cash on hand. Their hard-fought solution could serve as a model for the rest of Texas, and the nation.

By KRISTON CAPPS @kristoncapps

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When Houston Mayor Sylvester Turner took office last year, he inherited a sweeping pension crisis. The city had an unfunded liability of \$5.6 billion, a figure representing Houston's obligations to its fire, police, and municipal pension systems.

Then it got worse: After he took office and got a closer look at the books, Turner saw the revised figure—\$7.8 billion.

Pensions are the storm clouds on the horizon that threaten to wash out the so-called Texas Miracle, the wave of new jobs that kept the Lone Star State afloat through the Great Recession. Taken together, the four largest cities in Texas—Houston, Dallas, Austin, and San Antonio—owe more than \$22 billion in pension shortfalls. Dallas and Houston rank second and fourth, respectively, on the list of cities nationwide with the largest unfunded pension liabilities, per a ranking by Moody's. (At number one? Chicago.)

The road to pension crises is paved with good intentions. Officials in Houston and elsewhere tend to plan for funding pensions with sunny days in mind. When markets tank, the investments contributing to pension funds wither. And when the economy stumbles, cities sometimes withhold pension contributions to make up budget gaps. These effects add up over time, and correcting course usually involves contentious politics. Texas cities may have it worse than most because the local political climate is so hostile to tax revenues (even when Texas cities experience miraculous growth). Anywhere, though, officials and employees tend to kick the can down the road. It's retirement, after all.

Admitting that you have a problem is the first step toward solving it; cities in Texas, whether they like it or not, are being forced to take that step.

Houston is further along than most. A proposal that the city will put before the Texas legislature this year would restructure the city's obligations. The new dispensation would include benchmarks for bringing all parties back to the table to renegotiate terms, as necessary, until the unfunded liability is funded. It would also set a time period for meeting that obligation: a 30-year amortization schedule, something resembling a traditional home mortgage.

As Houston comes to grips with the severity of its pension crisis, the city's 30-year plan may serve as a model for other cities in Texas—and beyond—that are struggling with similar anxieties.

"When I was sworn in, I spent a lot of time talking about shared sacrifice, which can lead to shared benefits," says Turner. "What I said to employees was, 'We will not balance the city's books just on your backs.'"



## Recognizing the depth of the problem, and which solutions won't cut it

Houston has three civic pension systems—police, fire, and municipal employees—which are funded at ratios of 81 percent, 92 percent, and 54 percent, respectively. All three systems are different, and there isn't a one-size-fits-all solution to funding them. But when Turner took office, all three pension systems had one feature in common: Each of the funds enjoyed established rates of return of 8 or 8.5 percent.

These rates were much higher than what those investment funds were in fact drawing. Over the short term, the funds were averaging returns closer to 3 or 4 percent. While the returns were higher over a 10-year period, they still weren't meeting set expectations, introducing hidden shortfalls in the system.

One of Turner's first steps toward pension reform was to ask the pension funds to lower their rates of return to a more plausible 7 percent. In lowering the discount rate used to estimate future investment returns of pension fund assets, the city added another \$1.2 billion to its liability. The city further discovered about \$500 million in unreported losses for the pensions, bringing the total unfunded liability to \$7.8 billion. Progress!

"It's better to deal with a more realistic number than to be dealing with a number that we all knew was not close to being accurate," Turner says.

Then the city got to work developing a plan to meet its obligations. Part of that plan meant asking all three pensions to take a haircut.

"Because the unfunded liability turned out to be much higher than expected, we asked the employee groups to work with us to reduce that unfunded liability by as much as one-third from the first day that the pension reforms are approved," Turner says.

After months of negotiations extending through last fall, all three pension systems agreed. Police adjusted their future benefits by \$1 billion. The municipal and fire pensions adjusted their benefits by \$700 million and \$802 million, respectively. The cuts will largely take the form of scaled-back Cost of Living Adjustments (COLAs) and phased-out Deferred Retirement Options (DROPs). Among other things, that should mean that the most vulnerable pensioners won't see cuts to their fundamental retirement savings.

City employees got something in return for agreeing to benefits cuts. The mayor's plan fixed the amortization period for Houston's unfunded liability at 30 years, replacing an open amortization period that changed from year to year. Under the plan, the city will issue \$1 billion in pension obligation bonds, which will reduce Houston's unfunded liability a bit further. Most importantly, Houston won't be replacing pensions with 401(k) plans. "All three groups made it very clear to me from the beginning: They did not want a 401(k) plan," Turner says. "They didn't trust it."

Employees have good reason to be wary of 401(k) plans, otherwise known as defined-contribution plans. As *The Wall Street Journal* reports, many of the financial and human-resources executives who helped ushered in 401(k) plans to preeminence as the nation's favored system for retirement savings now have misgivings about defined-contribution plans; plenty of retirement experts agree that the near-total disappearance of pensions from the private sector since the 1980s has seriously damaged retirement security overall. Two recessions since 2000—which wiped out some of the market gains that made people so enthusiastic about 401(k) plans in the first place—plus low employee participation rates across the workforce have led to a pivot on defined-contribution plans.

Defined-benefit plans, on the other hand, remain popular among the now-small fraction of workers—largely city, state, and federal workers—who are still fortunate enough to be enrolled in them. But pensions aren't worth a damn if the city has no money to pay out benefits. This week, S&P Global joined Fitch Ratings and Moody's in downgrading the debt rating of Dallas over its unfunded pension obligations. Houston has seen its credit downgraded by Moody's and S&P, too, and earlier this month, *The Fiscal Times* ranked the finances of Houston and Dallas as among the worst in the nation—primarily over pension liability.

It took several months to hammer out a deal, but Houston officials and employees agreed to reforms

that balanced repayment terms with benefits adjustments. The city reduced its unfunded liability to roughly \$4.2 billion (including the \$1 billion in pension obligation bonds). Employees have greater guarantees about the terms of repayment.

However, mutual agreement is not the genius of Turner's pension reform plan. The real trick is in defusing pensions as a political issue going forward.

## Developing a “cost corridor” for defining benefits, now and later

Houston officials and employees might have been able to come to the table and agree on the city's pension obligations for the next fiscal year. But the contribution rate will change the year after that, and the year after that, and the year after that. Every year is a new opportunity for one side or the other to hold out for more.

Houston's way around that is the “cost corridor,” a kind of meta-scheme for deciding in the future what that contribution rate will be and how disputes will be resolved. The cost corridor depends on balance. When the city's pension funds enjoy a good year on their investments, then the city's contribution rate can go down. If the city's pension funds suffer a bad year on their investments, the contribution rate needs to go up. So far, so good.

The cost corridor sets a mid-point for the city's contribution rate, an actuarial sweet-spot that Houston aims to predict and achieve. The plan also sets high and low points, which serve as the corridor's “rails.” If the city's contribution rate moves more than 5 percent from the mid-point, one way or the other, it's beyond the rails. “Everything comes down to the contribution rate,” says Kelly Dowe, finance director for the City of Houston and one of the plan's chief architects. “That's what defines what the city pays every single year.”

So if the city's contribution rate for one of its pension funds rises to, say, 35 percent of payroll, when the target is 30 percent, then the city and the pension head back to the drawing board. If the city's cost contribution goes over the high end of the corridor, then officials and employees agree on benefits cuts to bring the city's contribution rate back into the cost corridor.

On the other hand, if Houston's contribution rate falls to 25 percent—because times are good and investments are zippy—then the city agrees to adjust its amortization schedule to pay down its liability more aggressively. Funding its pension obligations faster than the 30-year period would bring Houston's contribution rate back into the cost corridor. “There's a very prescriptive list of things that are slightly different between the funds,” Dowe says. “[Houston] can shorten the amortization period. We can say that now the unfunded liability is going to be paid off in 29, not 30 years. Or we can move from a 7-percent investment rate of return to 6 percent. Those things that make the system stronger.”

Houston also plans to invest more than the midpoint in order to keep to its repayment reschedule. If the mid-point of the cost corridor for a pension system falls at a 27-percent contribution rate, for example, Houston will commit to 30 percent.

According to Dowe, the cost corridor will serve Houston even after the city meets its pension liability (by 2047, if not sooner). “Once we get a funding ratio of 100 percent, then we can start talking about changing benefits for the plan. It has to be a fully funded plan,” Dowe says. “If you're 100 percent funded and below the bottom of the corridor, you can start the conversation about raising benefits. But that's way out in the future.”

## Getting to ‘yes’ after years of ‘no’

The Turner administration's cost corridor plan has the backing of all three pension systems. It's also won over the Greater Houston Partnership, the city's business alliance, as well as the Kinder Institute for Urban Research, the wonk shop at Rice University. The Baker Institute for Public Policy's John Diamond, who has advocated for defined-contribution plans, nevertheless supports the cost corridor as “self-enforcing mechanism” for funding Houston's pensions.

“Houston's problem is that, under the current plan, when Houston has a problem, if they go to the three pension boards and say, ‘We need to fix an unfunded problem,’ the pensions board can just say no,” Diamond said during a panel conferred by the Texas Public Policy Foundation, a conservative



think tank. “Then the political leaders can’t act.”

There is one lone hold-out on the Houston City Council: Mike Knox, a Houston police veteran with more than 15 years’ experience in the department. Knox insists that he does not oppose the mayor’s plan outright. He just wants to see specific figures before he is willing to sign off on it. “It’s all verbal,” Knox says. “I haven’t seen anything in writing from the mayor.”

Everyone in Houston, Knox adds, recognizes that something has to change, down to rank-and-file police officers. The status quo is unworkable.

For a cautionary example of what might come to pass if the Texas legislature doesn’t pass Houston’s plan during the session that opened this month, look to Dallas, where police and firefighters just rejected a \$2.3 billion slate of benefit changes. Dallas is “walking the fan blades” of municipal bankruptcy, according to Mayor Michael Rawlings—who has reached out to Mayor Turner to see whether Houston’s cost corridor could work three hours north along I-45.

Turner says that the cost corridor itself won’t address Houston’s root financial problems. His next goal is to try to persuade Houstonians to lift the self-imposed revenue cap that they voted into place back in 2004. That cap has caused Houston to cut property tax rates multiple times since 2014, meaning lost revenues, meaning a challenge for funding the city’s obligations. Mayor Turner hopes to see the revenue cap go up for reconsideration on the ballot in November.

For now, the cost corridor is Houston’s best bet to make sure that the city meets its pension obligations now and in the future. The cost corridor may be Texas’s best bet, too. If it works for the cities facing the worst pension crises—namely Houston and Dallas—then it may work elsewhere, including Phoenix (#3 on Moody’s list) and Los Angeles (#5). A similar scheme of mandatory arbitration and regular benchmarks might even rescue the imperiled pensions of workers in economically hobbled Detroit (#7). There isn’t any precedent for what Houston is trying to do.

“It’s good old-fashioned Houston ingenuity,” Dowe says.



## **Watts: A pension solution for Houston is in sight**

By Marc Watts

Mayor Sylvester Turner has had a very busy first 10 months. It started with fixing potholes, then he tackled the city budget and now he is pushing forward on pension reform, an issue of great concern to the Greater Houston Partnership. As the region's leading business organization, we work directly with a wide range of stakeholders and they all agree: We need a long-term pension solution in order to protect employees, put the city on solid financial footing and, ultimately, improve services. After two years of study, the Partnership developed and shared six principles meant to guide any comprehensive effort to reform the city's pension plans. Based on what we know to date, the mayor's plan is largely consistent with those principles.

### **Principle 1: Fully funded plans**

The mayor's proposal will ensure that the plans are well-funded in two ways. First, the proposed "corridor" mechanism will make pension debt payments a statutory requirement - thereby forcing the city to stay on schedule. Second, a closed amortization schedule will place the pension debt on a real path to elimination over no longer than 30 years.

### **Principle 2: Investment assumptions must be realistic**

Right now, the city's plans have some of the highest rate-of-return assumptions in the country - as high as 8.5 percent. These will be reduced to no more than 7 percent going forward, which will allow for a more accurate accounting of the magnitude of the city's pension debt. After lowering the discount rate and reflecting recent investment performance, the city's unfunded liability increased to almost \$8 billion, in line with Partnership's and other expert estimates.

### **Principle 3: City employees should be in savings-based plans**

In the pension reform process, a common approach is to place new employees into a defined contribution plan, a savings-based approach broadly adopted in the private sector and in many cities that have achieved comprehensive pension reform.

Mayor Turner's proposal does not include a defined contribution option. Instead, the mayor's plan takes a new approach: It creates a target range for the city's pension contributions. If the city's pension payments stay within the range, employees will continue to contribute at the same rate. If, however, the city's contributions go too high, employees may be required to contribute more or benefits may be adjusted.

This range of city contributions, which is being referred to as the "thermostat" or a fiscal "corridor," is a key part of the mayor's plan because it will force the city to constantly manage its pension payments and it will cap the city's contributions each year. This feature will reduce the city's risk relative to almost any other municipal defined benefit plan in the country.



## Principle 4: Benefits for current employees must be addressed

At the mayor's direction, all three pension systems formulated their own benefit reductions affecting current employees, which will reduce the city's pension debt by approximately \$2.5 billion in total. This step was absolutely essential to comprehensive reform. Many of these benefit reductions will deal directly with the changes made in 2000 and 2001 that increased costs dramatically.

## Principle 5: Complete transparency

Reaching this agreement required an unprecedented level of cooperation between the city and the pension systems. Actuaries on both sides of the bargaining table agreed that the proposed changes would have the intended effects. The agreements stipulate a similar degree of data sharing going forward.

## Principle 6: Good governance

Good governance is the final step in any reform plan. This essentially means creating a sustainable structure that will protect taxpayers and public workers in the future. The "corridor" mechanism addresses some of these concerns, but we need to learn more here. For example: Will there be independent oversight of investment returns? Have we eliminated conflict of interest fears?

Obviously, there's still work to be done, but the mayor has made great progress. It's a new idea with great potential to solve a 15-year old problem in Houston. And, if the "corridor" mechanism is airtight and works as intended, it could become a case study for cities across the country.

*Watts is chair of the Greater Houston Partnership's Municipal Finance Task Force.*

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*“In 2017, the Greater Houston Partnership plans to help the city of Houston pass its pension reform through the Texas Legislature, while also working with the city to tackle various infrastructure issues....”*

*“We will complete the pension reforms that we began calling for back in 2014, and which, under the leadership of Mayor (Sylvester) Turner and with the support of the Texas Legislature, we now have the opportunity to achieve,” (Greater Houston Partnership president Bob Harvey) said.”*

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- Houston Business Journal, "Greater Houston Partnership to focus on Super Bowl, pensions, infrastructure in 2017," January 20, 2017

# HOUSTON CHRONICLE

## Brown: Mayor's pension-reform plan is the right solution

By Chris B. Brown

**October 6, 2016** - If you regularly follow what goes on at Houston City Hall - and perhaps even if you don't - you are aware that in recent years, public employee pensions have become a significant policy (and political) issue for city government. Increased pension benefits - as a result of plan changes enacted in 2001 - chronic underfunding by the city, volatile investment returns and recently required changes in the way governments report their pension liabilities have combined to dramatically increase what the City of Houston owes. At the same time declining tax revenues - due to the energy industry downturn

and a voter-approved revenue cap - are shrinking available resources. This perfect storm threatens the city's financial future and its ability to deliver core services, such as public safety and critical infrastructure.

When Mayor Sylvester Turner and I were sworn into office in January, new required changes in accounting rules - known as GASB 68 - had ballooned the city's unfunded pension liability from \$3.2 billion to \$5.6 billion, essentially overnight. As a result,



the city's statement of net financial position, basically its net worth, dropped from \$3.2 billion to \$146 million.

At my first meeting addressing City Council as the city's independently elected chief financial officer, I sounded the alarm about our increasingly precarious fiscal situation, largely due to a growing unfunded pension liability, and warned that a structurally unbalanced budget would cripple the city's ability to serve its residents. I strongly urged the Mayor and City Council to take action.

To his credit, Mayor Turner has done just that. Calling for "shared sacrifice," he and his team quietly began the difficult work of engaging a diverse set of stakeholders.

In meeting with the three employee pension systems, members of City Council and the Texas Legislature - which will ultimately have to approve any changes - the business community and others, he built consensus on a solution to our pension problem. To their credit, the stakeholders responded in kind.

As a result, I was proud to stand with representatives from two of the three pension systems, members of City Council, the Legislature and business leaders as Mayor Turner announced the framework of a major pension reform plan. While final details must be worked out and agreed to in the next several weeks, if enacted, this plan will put the city on a path to a sustainable pension system. It will immediately eliminate \$2.5 billion in unfunded pension liability through benefit cuts, create a fixed 30-year schedule to eliminate the remaining liability and add a future risk-sharing component to ensure the plan remains affordable to the city.



This plan indeed requires shared sacrifice. From employees and retirees: Increased contributions, reductions in cost-of-living adjustments (COLAs) and reductions to deferred compensation will curb future cost growth. From the city: A commitment to fully fund its share of pension contributions after years of chronic underfunding ends the practice of kicking the proverbial can down the road.

The plan also calls for issuing \$1 billion in pension obligation bonds - not more, as has been asserted - which I would normally oppose, but will support to achieve this grand bargain. These bonds will immediately reduce an additional \$1 billion of the unfunded liability by injecting liquidity into the police and municipal plans. Additionally, they will provide substantial interest cost savings, due to the current historically low interest rate environment.

I want to restate the importance of the collaborative nature of the process leading to this pension deal. A final agreement between the city and the three pension systems will offer a much smoother path to legislative approval in Austin next year, and will avoid potential litigation that has stymied one-sided pension reform in other cities.

This pension reform plan does not solve our problem overnight, and it will require a sustained commitment from the city, as well as the three pension systems, to eliminate the unfunded liability over time. That said, it offers a clear path toward a sustainable retirement for city workers at a very uncertain time for city finances. I commend Mayor Turner and all stakeholders for their commitment to addressing an urgent problem in a timely manner. The longer we wait to implement a solution to our pension challenge, the more difficult it becomes for the city to succeed in solving it.

The time for action is now. I strongly urge support for this pension reform plan.

Brown is Houston city controller.

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*Brown is Houston city controller.*

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*No other plan provides both immediate and long-term benefits and takes the pension issue off the table for good. We are closer than ever before to solving this. There will be a few who will criticize but not one of them has presented anything that reduces the unfunded liability by even \$1 immediately and then pays it off entirely in 30 years while*

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HOUSTON★CHRONICLE



# HOUSTON★CHRONICLE

## Houston City Council Blesses Turner's Pension Reform Plan

By Mike Morris

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*Houston City Council on Wednesday endorsed Mayor Sylvester Turner's pension reform package in a 16-1 vote that was not legally required but was intended to signal local support for the proposal, which now will be drafted into legislation and sent to Austin.*

*Most council members heaped praise on Turner, calling the vote "historic" and saying they were proud to back reforms produced by Turner and his top advisors through months of negotiations with the city's police, firefighter and municipal pension trustees.*

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## Christie: Houston pension reform plan deserves support

By Jack Christie

The city of Houston is finally cleaning our financial house with pension reforms. Now we're asking the Texas Legislature to do its part and approve legislation that will protect Houston's future.

As chair of the City Council's Budget and Fiscal Affairs Committee and a committed fiscal conservative, I have been involved with the development of this plan, demanding a remedy that ensures long-term financial health for Houston. Digging ourselves out of this hole means that the city will continue to have the large annual pension payments that it has today. No assertion has ever been made to the contrary. Anyone who has alleviated personal debt knows they must rein in future spending while increasing payments to whom money is owed.

While the city is bound to full, annual funding of the pensions, the pension boards have agreed to cuts in benefits that were simply never sustainable without unreasonable revenue demands placed on Houstonians. And now, as the city operates under a revenue cap, the administration must continue to seek the most efficient and responsible use of your tax dollars to implement city services.

The Legislature should recognize this is a solution derived by, among and for Houstonians. The city itself cannot unilaterally dictate the terms of reform. Fixing the problem required agreement from the city's three pension boards. Ramming demands down the throats of city workers, fire fighters and police would have resulted in a continued stalemate while obligations grew. The three boards make clear that a defined contribution solution has always been a nonstarter and unacceptable to their participants. Defined contribution plans would not provide any cost savings now either. Remedying the imbalance through court-ordered solutions or bankruptcy is a nuclear option we absolutely must avoid. Inaction and continued gridlock now will continue to send us toward a more deeply challenged or altogether impossible financial scenario, with no chance for light at the end of the tunnel.

The opinions of nonpartisan, professional pension experts have approached unanimity on the merits of this proposal. Bill Fulton of the Kinder Institute for Urban Studies called the plan a "national model." Josh McGee, an expert with the largely anti-defined benefit Arnold Foundation, said the plan has the potential to be "one of the better reforms in the country." The credit rating agency Moody's has termed these reforms to be "credit positive." Fitch Ratings spoke optimistically of the reforms in August.

Houston is taking responsibility for itself and implementing a rigidly defined set of parameters referred to as the "corridor." Going forward, we share the risks of pension investment performance with the pension systems themselves. Within each of the agreements approved by each pension board, a process is outlined about how each pension system will meet with the city and agree upon what additional reductions "shall" be made if costs veer outside the corridor. And if an agreement cannot be reached, then specific reductions are required by law. This is not what "may" happen in this scenario - it is what "shall" happen.

The corridor buffers the city and taxpayers from financial pressure we have experienced unchecked in the past. And remember that plan holders will appreciate that the pensions will be fully funded per actuarially determined contributions - maximizing the health of the plans. I am also pleased that the current pension debt will be eliminated in 30 years. As with personal debt on a credit card, the goal is always to pay down what you owe, as soon as you're able. We are realizing this goal with these reforms.

This is a uniquely conservative Houston plan that I believe will be successful.

This is fair treatment of plan participants and is financially rational for taxpayers. Please tell your legislators to do their homework, and approve this plan for Houston. The Legislature should approve the Houston Sustainable Pensions Plan.

*Christie is an at-large member of City Council, and chairman of City Council's Budget and Fiscal Affairs Committee.*



**A RESOLUTION IN SUPPORT OF THE CITY’S PLAN TO REFORM THE CITY’S THREE PENSION SYSTEMS, THE HOUSTON POLICE OFFICERS’ PENSION SYSTEM (“HPOPS”), THE HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM (“HMEPS”), AND THE HOUSTON FIREFIGHTERS’ RELIEF AND RETIREMENT FUND (“HFRRF”), TO ENSURE LONG-TERM, SECURE, AND DEPENDABLE RETIREMENT SYSTEMS; CONTAINING FINDINGS AND OTHER PROVISIONS RELATING TO THE FOREGOING SUBJECT.**

\* \* \* \* \*

**WHEREAS**, cost increases required to support the City’s three pension systems since the early 2000s are not sustainable and have threatened the benefits provided by these systems; and

**WHEREAS**, the City’s fiscal circumstances are challenged by population growth increasing service demands, cost increases, property tax revenue limitations, and unfunded pension liabilities; and

**WHEREAS**, the City participates in three pension systems: the Houston Police Officers’ Pension System (“HPOPS”), the Houston Municipal Employees Pension System (“HMEPS”), and the Houston Firefighters’ Relief and Retirement Fund (“HFRRF”) (collectively the “Pensions”); and

**WHEREAS**, the City’s total unfunded pension liability has increased substantially and will continue increasing without pension reform; and

**WHEREAS**, Wall Street has taken notice of the City’s pension liability issues as illustrated by credit agencies expressing concerns about the City’s mounting pension debt and downgrading the City’s credit rating; and

**WHEREAS**, if the City does not reach a long-term pension solution, the City would face massive layoffs, service reductions, and leave the Pensions with a questionable future; and

**WHEREAS**, it is critical that the City implement a long-term strategy to address the City’s pension challenges, reduce the City’s long-term pension obligations, achieve immediate and future cost avoidance, and ensure secure, dependable Pensions for the City’s present and future retirees; and

**WHEREAS**, the City’s long-term pension strategy (the “City’s Pension Reform Plan”) encompasses the following points:

- 1) Creation of a sustainable defined benefit pension plan that employees and taxpayers can rely upon;



- 2) Reduction in the City's net pension liability now and in the future;
- 3) Achievement of cost avoidance and budget neutrality now and in the future;
- 4) Utilization of closed 30-year amortization period that sets a clear schedule and hard date for payoff;
- 5) Reduction of the assumed rate of return to 7% to reduce risk and better reflect likely market performance consistent with nationwide trends;
- 6) Full payment of the City's annual actuarially determined City Contribution Rate;
- 7) Recognition of all gains and losses as of June 30, 2016;
- 8) The issuance of pension obligation bonds in order to provide \$1B of funding to HPOPS (\$750M) and HMEPS (\$250M) to address past city underfunding of these systems;
- 9) A new risk-sharing cost-management component that requires costs to stay within a specified "corridor" and requires changes to benefits and/or contributions if the City's costs go too high or too low; and
- 10) Processes to enable the City and the Pensions to share information, such as information used in connection with assessing financial assumptions, performing actuarial studies, and other actuarial purposes; and

**WHEREAS**, the City's Pension Reform Plan will immediately decrease the City's current unfunded pension liability by approximately \$2.5 billion while achieving the City's goals of eventually eliminating the City's unfunded pension liability and fully funding the Pensions; and

**WHEREAS**, the City's Pension Reform Plan includes changes to employee contributions and benefits and significant adjustments to Cost of Living Adjustments (COLAs) and the Deferred Retirement Option Program (DROP), as well as plan-specific changes crafted by each pension system that will reduce each system's individual portion of the unfunded liability; and

**WHEREAS**, the components of the City's Pension Reform Plan specific to HMEPS are further described in Attachment A; and

**WHEREAS**, the components of the City's Pension Reform Plan specific to HPOPS are further described in Attachment B; and

**WHEREAS**, the components of the City's Pension Reform Plan specific to HFRRF are further described in Attachment C; and

**WHEREAS**, the City and the Pensions have worked towards finalizing the City's Pension Reform Plan for submission to the Texas Legislature for its consideration during the 2017 session; **NOW THEREFORE**,

**BE IT RESOLVED BY THE CITY COUNCIL OF THE CITY OF HOUSTON, TEXAS:**

**Section 1.** That the findings contained in the preamble of this Resolution are determined to be true and correct and are hereby adopted as part of this Resolution.

**Section 2.** That the City Council of the City of Houston formally declares its support for, and the City's efforts to implement, the City's Pension Reform Plan.

**Section 3.** That the City Council of the City of Houston encourages the Texas Legislature to support the City's Pension Reform Plan.

**Section 4.** That this Resolution shall take effect immediately upon its passage and approval by the Mayor; however, in the event that the Mayor fails to sign this Resolution within five days after its passage and adoption, it shall take effect in accordance with Article VI, Section 6, Houston City Charter.

**PASSED AND APPROVED** this \_\_\_\_\_ day of \_\_\_\_\_, 2016

**ADOPTED** this \_\_\_\_\_ day of \_\_\_\_\_, 2016

\_\_\_\_\_  
Mayor of the City of Houston, Texas

Pursuant to Article VI, Section 6, Houston City Charter, the effective date of the foregoing Resolution is \_\_\_\_\_, 2016.

\_\_\_\_\_  
Anna Russell, City Secretary



## Cost Avoidance

Every year, the City is required to make an actuarially determined contribution (ADC) into the three pension funds. The City has failed to make the full payments into two for more than a decade (Houston is statutorily required to make its payment to the firefighters' fund).

Under the agreement proposed by Mayor Turner, the City will make its full payment to all three funds every year. However, because of the reforms implemented, the ADC will be significantly lower.

All estimates below assume a 7 percent discount rate. All reform estimates assume the issuance of pension obligation bonds.

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### Houston Firefighters' Relief and Retirement Fund

Estimated FY 2018 Actuarially Determined Contribution	\$154.8 million
Estimated FY 2018 ADC with Reforms	\$79.1 million
<b>Cost Avoidance for HFRRF</b>	<b>\$71.2 million</b>

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### Houston Police Officers' Pension Fund

Estimated FY 2018 Actuarially Determined Contribution	\$241.2 million
Estimated FY 2018 ADC with Reforms	\$108 million
<b>Cost Avoidance for HPOPS</b>	<b>\$133.2 million</b>

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### Houston Municipal Employee Pension System

Estimated FY 2018 Actuarially Determined Contribution	\$236.4 million
Estimated FY 2018 ADC with Reforms	\$163.5 million
<b>Cost Avoidance for HMEPS</b>	<b>\$72.9 million</b>

## Total Cost Avoidance in FY 2018: \$217 million\*

\*\$277 million - \$60 million POB Service



# CITY OF HOUSTON PENSION REFORM LEGISLATIVE SUMMARY

## I. Introduction.

During the current legislative session, the Texas legislature will consider legislation amending the statutes governing the Houston Police Officers Pension System (HPOPS), Houston Municipal Employees Pension System (HMEPS), and the Houston Firefighters Relief and Retirement Fund (HFRRF). The amendments provide for:

- Required payment of the City of Houston's pension liabilities.
- Changes to benefits to reduce costs.
- Sharing the risk between each pension system and the City for future system cost fluctuations.

## II. Summary of Amendments.

Representatives of the City, HPOPS, and HMEPS have agreed to amendments to the employee and police pension statutes. While representatives of HFRRF and the City negotiated in good faith to reach agreement on HFRRF pension legislation and a term sheet was approved by the HFRRF board, the Mayor, and City Council in October 2016, no final agreement was reached. The HFRRF board also refused to provide actuarial data that would allow the City to accurately cost the amended benefits, therefore the HFRRF pension amendments reflect terms that are in the interest of the City, while preserving benefits for firefighters that are comparable to the benefits for police.

The existing statutes and the proposed amendments achieve the following:

- **Benefits and Contributions.** To reduce the cost of the pension systems, the amendments reduce future benefits and increase current employee contributions. No current payments to retirees are reduced by the proposed amendments.
- **Unfunded Liability.** The existing unfunded pension obligation (the "legacy liability") is amortized and required to be paid by the City over a 30-year period.
- **Future Costs.** Future costs of the pension system must be calculated each fiscal year by actuarial valuations carried out by the pension systems and the City. The valuation establishes the City's required payments to meet system costs.
- **Risk Sharing.** The City and the pension systems share the risk that returns on pension assets are less than projected so that the City's maximum contribution is capped.



### III. Background.

HPOPS, HMEPS, and HFRRF are created and governed by statute. Each pension system is a defined benefit plan, which guarantees retiree benefits based on years of service and salary. The City bears the financial risk of such plans: the City must fund the systems to pay the retiree's defined benefit regardless of why a pension system is underfunded.

Important elements of defined benefit pension plans—age and service requirements, benefit accrual, and DROP programs—incentivize employees to remain employed by the City. The other principal plan type, defined contribution plans, sets the amount the employee and the City must contribute to the plan, but do not guarantee the benefits that the retiree will receive. Investment risk is borne solely by the employee. Because benefits do not increase over time and are highly portable, such plans do not encourage valuable employees to stay with the City.

The three pension systems are funded from City contributions, employee contributions, and investment earnings, and the amount of funding required is related to the benefits to be paid to retirees. Each of the pension systems is currently underfunded. Based on the City's actuarial estimates of the current liability, HMEPS is underfunded by approximately \$3.2 billion, HPOPS is estimated to be underfunded by approximately \$3.4 billion, and HFRRF is estimated to be underfunded by approximately \$1.5 billion, for a total of \$8.1 billion. As of the pension systems' latest actuarial valuation reports, the funded ratios are 54.2% for HMEPS, 77.5% for HPOPS, and 89.4% for HFRRF. The HMEPS and HPOPS unfunded liabilities are in part a result of actuarial assumptions and investment losses, and in part the result of reduced City contributions under meet and confer agreements. The HFRRF unfunded liability is solely the result of investment and other actuarial losses.

For the financial stability of the pension systems and the City, the City's legacy liability must be reduced. However, without reform of the current pension plans, the City cannot provide for both new pension costs (the normal costs) and the legacy liability except by significantly reducing City services or increasing tax revenues and service charges.

### IV. Benefits and Contributions.

Collectively, based on the City actuarial firm's current estimates changes to benefits and increases in employee contributions will reduce the combined legacy liability from approximately \$8.1 billion to approximately \$5.5 billion.

The main benefits changed:

- Retirement age. By increasing the age at which an employee can retire with full benefits, pension costs are reduced. The amendments increase the retirement age for HPOPS and HFRRF members.
- Benefit accrual. By reducing the amount of benefits accrued in each year, pension costs are reduced. The amendments prospectively reduce the accrued benefits for HFRRF beginning with the effective date of the amendments.
- Salary included for payment of benefits. The ultimate pension benefit paid is based on salary

earned. By reducing the types of pay included in salary for pension benefit calculations, pension costs are reduced. The amendments exclude overtime pay for HFRRF (which is already excluded for HMEPS and HPOPS) and adjust the salary for certain appointed positions for HFRRF and HPOPS.

- COLA costs. Pension costs are reduced by temporarily suspending cost of living increases for certain retirees, decreasing the minimum guaranteed COLA, and increasing the age at which COLA increases begin. The amendments suspend COLA increases for certain existing retirees for three years for HPOPS, one year for HMEPS, and three years for HFRRF. In addition, the minimum guaranteed COLA for future benefits is reduced, and the age at which COLAs begin for retirees increases from no minimum age to age 55 for HPOPS, age 48 to age 50 for HMEPS, and age 48 to age 55 for HFRRF retirees.

- DROP Accounts. The amendments substantially change the Deferred Retirement Option Plans, or DROP, for active employee members of HFRRF and HPOPS. DROP allows an active employee to be paid a salary and have the pension benefit the employee would have received as a retiree credited to the DROP account. Credited benefits accumulate and are paid to the employee as a lump sum, with attributed earnings and with COLA increases, if any, at the end of the DROP period. Earnings may reflect actual earnings of the pension fund, but the DROP payment is guaranteed by the pension system, and ultimately the City. The proposed amendments reduce DROP costs in four principal ways:

- Reduction of DROP availability by restricting entry into DROP and reducing the period an employee can participate in DROP. Ultimately DROP will end for all pension systems.

- Reducing DROP earnings on amounts credited to a member's DROP account to better reflect actual earnings on the pension funds.

- Eliminating COLAs for monthly pension payments credited to DROP accounts.

- During DROP participation, the required DROP participant salary contributions to the pension systems will be deposited to the pension funds instead of credited to DROP accounts.

- Employee Contributions. The amendments increase employee contributions for all three plans. The contribution for active HFRRF and HPOPS members is increased to 10.5% of salary. The contribution for HMEPS members, which is divided into three separate groups based on hire date, is 8.0% for group A, 4% for group B, and 3% for group D. Contribution increases for HMEPS members will be phased-in over a two-year period.

## V. Legacy Liability and New Pension Costs.

The amount of the legacy liability resulted from actuarial assumptions, the deferral of payments pursuant to meet and confer agreements, and investment performance, and is currently estimated at \$8.1 billion. A primary purpose of the amendments is to require that the City amortize the legacy liability over a 30-year period, much like the payment of a home mortgage, and guarantee future contributions by the City of amounts required for new pension costs.



## VI. Pension Bonds

The City, HMEPS, and HPOPS have agreed that the City may issue pension obligation bonds to reduce the legacy liability. The legacy liability is effectively a loan by HMEPS and HPOPS to the City, and the issuance of pension bonds refinances part of that indebtedness. Issuing bonds will replace the obligation to pay the legacy liability with an obligation to pay bonded indebtedness. The infusion of cash from bond proceeds provides liquidity to the two pension systems with the lowest funding ratios: HPOPS and HMEPS. The pension bonds will not be issued unless the amendments are approved, and if the City cannot issue pension bonds by December 31, 2017, the amendments require that the amortization of the legacy liability be recalculated to reflect the failure to deliver bond proceeds. The City's issuance of pension bonds was negotiated with HPOPS and HMEPS under current state law, and changing the conditions under which the bonds can be delivered only undermines those agreements without reducing costs to the City.

## VII. Assumed Rate of Return.

The assumed rate of return on assets for all plans is reduced to 7% per annum. This conservative earnings assumption increases the legacy liability but provides for more realistic and achievable financial modeling.

## VIII. Risk Sharing.

The amendments codify a risk sharing and cost control mechanism. These provisions are unique and inform in large part the new governance concepts in this innovative legislation.

Under the amendments, the City and each pension system will share information and cooperate to evaluate the performance of the pension system. Each will do an annual study—an actuarial risk sharing valuation study (RSVS). The initial RSVS process will set the City's projected future contribution rates for each pension system for the next 31 years.

The projected contribution rates for each of those 31 years sets a contribution midpoint for the range of contributions that can be required from the City. The City bears the risk of pension costs increasing up to 5% above the contribution midpoint. If the increase is greater than 5%, then steps must be taken, including the reduction of benefits or increase of contributions, to reduce the City's cost. Conversely, if costs are 5% less than projected for any plan, steps must be taken to maintain the City's contribution at the minimum level.

The calculation of the City's contribution rate for future fiscal years is calculated by each subsequent year's RSVS.

## IX. Availability.

The Texas Legislative Council is currently reviewing and revising the text of the legislative amendments. The revised amendments are expected to be substituted for the current HB 43 by Representative Dan Flynn. HB 43 will be available at Texas Legislature Online, but the substitute bill will substantially change the text of the bill currently available at that link.

# 2017 GUIDE TO PUBLIC RETIREMENT SYSTEMS IN TEXAS

## TEXAS PENSION REVIEW BOARD

### HOUSTON FIREFIGHTERS' RELIEF & RETIREMENT FUND

Summary of Current Plan Data										
Date of Valuation	Actuarial Accrued Liability (millions)	Actuarial Value of Assets (millions)	Unfunded Actuarial Accrued Liability (millions)	Funded Ratio	Discount Rate	Amortization Period (years)	Membership		Contribution	
							Active	Annuitant	Employee	Employer
7/1/2015	\$4,397.01	\$3,929.99	\$467.02	89.38%	8.50%	30	4,109	3,134	9.00%	33.20%

The Houston Firefighters' Relief and Retirement Fund was initially created in 1937 under the authority of the Texas Local Fire Fighters Retirement Act. In 1975, the 64<sup>th</sup> Legislature enacted Article 6243e.2, Vernon's Texas Civil Statutes, establishing the Fund independently in statute. The Fund was recodified by the 75<sup>th</sup> Legislature in 1997 under Article 6243e.2(1), Vernon's Texas Civil Statutes. The Fund is a single-employer contributory defined benefit pension plan covering firefighters employed by the City of Houston that provides retirement, disability and death benefits to eligible members and their beneficiaries. Prior to 1988, the City of Houston provided the staff and financing for the daily administration of the Fund; effective July 1, 1988, the Board of Trustees assumed full responsibility for Fund administration.

**Governing Statute**  
Vernon's Texas Civil Statutes Article 6243e.2(1)

**Executive Director**  
 Ralph Marsh  
 4225 Interwood N Pkwy  
 Houston, TX 77032  
 (281) 372-5100  
[www.hfrf.org](http://www.hfrf.org)

**Houston Firefighters' Relief & Retirement Fund Board of Trustees**

Name	Position	Term Expires
David L. Keller, Jr., Chair	Active Firefighter	12/31/2019
Stephen R. Whitehead, Vice Chair	Active Firefighter	12/31/2017
Francis "Frank" Maher, Secretary	Retired Firefighter	12/31/2018
Garry W. Blackmon, Sr.	Active Firefighter	12/31/2017
Juliet N. Higgins	Active Firefighter	12/31/2019
Brett Robert Besselman	Active Firefighter	12/31/2018
Earnest W. Wotring	Mayor's Representative	N/A
Arif Rasheed	City Treasurer	N/A
Albertino Mays	Citizen Member	12/31/2018
The Honorable Carroll G. Robinson	Citizen Member	12/31/2017



# 2017 GUIDE TO PUBLIC RETIREMENT SYSTEMS IN TEXAS

## TEXAS PENSION REVIEW BOARD

### HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM (HMEPS)

Summary of Current Plan Data										
Date of Valuation	Actuarial Accrued Liability (millions)	Actuarial Value of Assets (millions)	Unfunded Actuarial Accrued Liability (millions)	Funded Ratio	Discount Rate	Amortization Period (years)	Membership		Contribution <sup>1</sup>	
							Active	Annuitant	Employee	Employer
7/1/2015	\$4,765.72	\$2,582.51	\$2,183.21	54.19%	8.00%	32	11,827	10,023	2.76%	27.36%

<sup>1</sup>Group A contributes 5%. Groups B and D are non-contributory. The member contribution rate reflects an average of all member contributions. City contribution rates are set by agreement determined in meet and confer process. According to the 7/1/2015 Actuarial Valuation, the city contribution was \$145.0 million

HMEPS was created in 1943 by an act of the 48th Legislature, and codified under Article 6243g, Vernon's Texas Civil Statutes. The System was reclassified by the 77th Texas Legislature in 2001 under Article 6243h, Vernon's Texas Civil Statutes. The System is a multiple-employer defined benefit pension plan and includes a contributory group (Group A) and two noncontributory groups (Group B and D). The System provides service retirement, disability retirement and death benefits for all full-time municipal employees, except police officers and fire fighters (other than certain police officers in the System as authorized by the Statute), elected city officials, full-time employees of the System, and eligible beneficiaries.

**Governing Statute**  
Vernon's Texas Civil Statutes  
Article 6243h

**Executive Director**  
 David L. Long  
 1201 Louisiana, Ste 900  
 Houston, TX 77002  
 (713) 595-0100  
[www.hmepps.org](http://www.hmepps.org)

Houston Municipal Employees Pension System Board of Trustees			Term Expires
Name	Position		
Sherry Mose, Chair	Employee Trustee		8/1/2018
Roy W. Sanchez, Vice Chair	Employee Trustee		8/1/2018
Lonnie Vara	Retiree Trustee		8/1/2020
Roderick J. Newman	Retiree Trustee		8/1/2018
Asha Patnaik	Employee Trustee		8/1/2020
Lenard Polk	Employee Trustee		8/1/2020
Barbara Chelette	Board Appointed Trustee		7/1/2017
Edward J. Hamb II	Controller Appointee		7/1/2017
David Donnelly	Mayoral Appointee		7/1/2017
Adrian Patterson	City Council Appointee		7/1/2017
Vacant			





**2017 GUIDE TO PUBLIC RETIREMENT SYSTEMS IN TEXAS**  
 TEXAS PENSION REVIEW BOARD

**HOUSTON POLICE OFFICER'S PENSION SYSTEM (HPOPS)**

Summary of Current Plan Data										
Date of Valuation	Actuarial Liability (millions)	Actuarial Value of Assets (millions)	Unfunded Actuarial Accrued Liability (millions)	Funded Ratio	Discount Rate	Amortization Period (years)	Membership		Contribution <sup>1</sup>	
							Active	Annuitant	Employee	Employer
7/1/2016	\$6,013.05	\$4,662.12	\$1,350.93	77.53%	8.00%	20	5,261	3,876	9.46%	31.80%

<sup>1</sup> Employees hired before 10/9/2004 pay 9%. Employees hired on or after 10/9/2004 pay 10.25%. The member contribution rate reflects an average of all member contributions. City contribution rates are set by agreement determined in meet and confer process. According to the 7/1/2016 Actuarial Valuation, city contribution was \$113.7 million.

HPOPS was created in 1947 by an act of the 50th Legislature, and is governed by Article 6243g-4, Vernon's Texas Civil Statutes. The System is a single employer contributory defined benefit pension plan covering police officers employed full time by the City of Houston that provides for service, disability and death benefits for eligible members and their beneficiaries.

<b>Governing Statute</b> <u>Vernon's Texas Civil Statutes Article 6243g-4</u>	<b>Executive Director</b> John Lawson 602 Sawyer St, Suite 300 Houston, TX 77007 (713) 869-8734 <a href="http://www.hpops.org">www.hpops.org</a>	<b>Houston Police Officer's Pension System Board of Trustees</b>	<b>Term Expires</b>
		<b>Name</b> Terry Bratton, Chair George Guerrero, Vice Chair J. Larry Doss, Secretary Dwayne Ready Michael J. Newsome Kelly Dowe Don Sanders	<b>Position</b> Retired Member Police Member Retired Member Police Member Police Member City Treasurer Mayor's Representative
			12/31/2017 12/31/2018 12/31/2018 12/31/2017 12/31/2016 N/A N/A



# STANDARD & POOR'S RATINGS SERVICES

McGRAW HILL FINANCIAL

March 18, 2016 (Partial Report)

Standard & Poor's Ratings Services lowered its rating on the City of Houston, Texas' existing general obligation (GO) debt by one notch to 'AA' from 'AA+'. The outlook is negative.

The downgrade reflects our opinion of the city's large unfunded pension liability that has been exacerbated by what we consider optimistic rate of return assumptions and a history of lower-than-actuarially determined contributions, which the current administration is seeking to correct. The impact that growing pension costs have on Houston's budgetary flexibility are magnified by charter limitations on revenue increases and more recently, the impact of low oil prices on local tax revenues. The negative outlook reflects our view that there is at least a one-in-three probability that we could lower the rating again within the next two years if Houston is unable to develop and implement a credible plan that lowers its unfunded pension liability or if continued softness in oil prices leads to ongoing contractions in tax revenue.

At the same time, Standard & Poor's assigned its 'AA' rating, and negative outlook, to the city's series 2016A public improvement refunding bonds. The series 2016A bonds are payable from an ad-valorem tax, levied within the limits prescribed by law, on all taxable property in the city. Bond proceeds will be used to refund commercial paper notes into longer-term financing commensurate with the useful lives of the assets funded by the commercial paper, and also refund existing debt for an estimated present value savings of roughly \$45 million. Officials intend to take the bulk of savings over the next two years.

Therefore, the 'AA' rating reflects our opinion of:

- Strong economy, with access to a broad and diverse metropolitan statistical area (MSA);
- Adequate budgetary performance, with an operating surplus in the general fund but an adjusted operating deficit at the total governmental fund level in fiscal 2015;
- Adequate budgetary flexibility, with an available fund balance in fiscal 2015 of 14.5% of operating expenditures, as well as limited capacity to raise revenues due to charter-imposed revenue-raising limitations;
- Very strong liquidity, with total government available liquidity at 47.5% of total governmental fund expenditures and 4.1x governmental debt service, and access to external liquidity we consider exceptional;
- Very strong management, with "strong" financial policies and practices under our financial management assessment

(FMA) methodology;

- Very weak debt and contingent liability position, with debt service carrying charges at 11.6% of expenditures and net direct debt that is 111.7% of total governmental fund revenue, as well as a large pension and other postemployment benefit (OPEB) obligation; and
- Strong institutional framework score.

## Strong economy

We consider Houston's economy strong. The city, with an estimated population of 2.2 million, is located in Fort Bend, Harris, and Montgomery counties in the Houston-The Woodlands-Sugar Land MSA, which we consider to be broad and diverse. The city has a projected per capita effective buying income of 91.6% of the national level and per capita market value of \$92,008. Overall, the city's market value grew by 10.1% over the past year to \$206.1 billion in 2016.

The weight-averaged unemployment rate of the counties was 4.9% in 2014.

In the years following the Great Recession, Houston emerged as one of the fastest-growing large MSAs in the nation.

Over a three-year period (ended in 2014), property tax revenues grew by 30% while sales tax revenues rose by 28%.

However, the oil industry, which has a sizable presence in Houston, has experienced slowdowns over the past year due to low oil prices. This, when combined with revenue caps has led to some softness in tax revenues. For fiscal 2016, officials are projecting property tax collections to increase by 2.4% relative to the previous year while year-to-date sales taxes are down 4.6% from the previous year.

While currently low oil prices create some uncertainty over near-term employment levels in the oil industry (which contains a significant presence in Houston), we believe the local economy is broad and diversified enough to withstand ongoing slowdowns in oil-related activity as long as they are not too protracted. Although it has not yet occurred, a prolonged slowdown could result in muted property tax base growth over the next few years. However, the city continues to see a boom in downstream petrochemical activity and continues to maintain a large medical presence, both of which are expected to help mitigate the impact of low oil prices.

## Adequate budgetary performance

Houston's budgetary performance is adequate in our opinion. The city had surplus operating results in the general fund of 1.9% of expenditures, but an adjusted deficit result across all governmental funds of 1.8% in fiscal 2015.



The results discussed above is adjusted to account for, among other things, what the city's financial results would have been had its funded its full actuarially determined contributions for its pension plans. Property taxes generated 49% of fiscal 2015 general fund revenue, followed by sales taxes (31%). The city is projecting a roughly \$85.9 million reduction of its fiscal 2016 year-end general fund balance, which can be attributed partially to sales tax revenue declines. While the city has not yet finalized its fiscal 2017 budget, officials expect to adopt a budget that demonstrates roughly break-even general fund and keeps the fund balance at just over 9.0%, which is over the formal policy of 7.5%.

Long-term financial forecast calls for continued operating deficits through fiscal year-end 2020. The city, however, has a demonstrated track record outperforming its budget with long-term forecasts serving as very conservative projections that are used more as a planning tool.

Weakening our view of Houston's budgetary performance is our opinion of the city's budgetary pressures related to pension costs, which we discuss in more detail below. We believe continued cost increases related to pension funding will remain a budgetary challenge, which is compounded by revenue-raising limitations and the impact of low oil prices. While the city is managing discretionary expenditures and reducing certain non-essential services, it is also exploring additional avenues to reduce future pension costs and increase future revenue. We will continue to monitor future budgetary performance; failure to maintain structural balance while addressing pension costs will likely lead to a lower rating.

## Outlook

The negative outlook reflects our view of at least a one-in-three chance that we could lower the rating again within the next two years if the city is unable to enact sustainable pension reforms that reduces its unfunded liability and future annual costs. Supporting the negative outlook is the recent slowdown in oil activity that has impacted sales tax revenues and Houston's charter-imposed revenue-raising limitations, which have resulted in an estimated cumulative lost property tax revenue of \$120 million in fiscal years 2015 and 2016, with the expectation that this loss will increase over the next few years. If the city is unable to address its pension liabilities within the next two years while maintaining structurally balanced operations, we will likely lower the rating.

However, if Houston is able to implement pension reform, we could revise the outlook to stable if we feel that such changes lead to a sustainable, structurally balanced budget that also addresses pension liabilities. Over the long term, we believe any modifications to existing charter-imposed revenue-raising limitations that reduces the amount of lost property tax revenue could provide additional credit strength.

“  
*However, if Houston is able to implement pension reform, we could revise the outlook to stable if we feel that such changes lead to a sustainable, structurally balanced budget that also addresses pension liabilities.*  
”



March 16, 2016

Moody's Investors Service has downgraded the City of Houston's (TX) general obligation limited tax rating to Aa3 from Aa2, affecting approximately \$3 billion in previously issued bonds. Concurrently, Moody's assigns a Aa3 to the City of Houston, TX's \$600 million Public Improvement Refunding Bonds, Series 2016A. The outlook remains negative.

The downgrade to Aa3 reflects weakening economic and financial performance driven by prolonged decreases in oil prices. It also reflects the city's high fixed costs, large unfunded pension liabilities (among the highest in the nation), as well as property tax caps.

The Aa3 also considers recent positive General Fund performance, and growth in non-energy sectors that has offset some of the softening. Additionally, the rating recognizes the positive actions taken by the new Mayor and his plan to engage several stakeholders to modify the city's fixed costs and generate additional revenues, all within the next 18 to 24 months. These plans signal a change from past initiatives, and positive movement on the plans will be key to stabilizing the credit profile.

## Rating Outlook

The negative outlook reflects the recent weakness in economic and sales tax performance, fueled by energy companies' reduced investments in personnel and capital, as oil prices have remained low. The recent weakening in sales taxes is also contributing to the expected budget gap at fiscal year end 2016, with the city expecting to draw on an already somewhat limited reserve position, compared to peers.

The negative outlook additionally reflects the challenges the city faces from growing pensions costs and liabilities, which are compounded by significantly limited revenue raising flexibility. Fixed costs remain a high portion of the budget (a little over 31% in FY 2015). Costs have grown significantly over the past five years, and are expected to grow absent any pension reform. Management, under the new Mayor, has identified initiatives to address the structural imbalance and stem the increase in long-term liabilities. Positive momentum and implementation of the plans will be key credit considerations going forward.

## Factors that Could Lead to an Upgrade

Stabilized economy with a return to strong growth; improvement in employment performance and other economic indicators

A sustainable plan to manage pension liabilities that do not threaten city's fiscal health; structurally balanced operations with full pension contribution

Removal of revenue cap, providing city with flexibility to capture growth in assessed values

Strong operating performance with a trend of surpluses to boost the reserve position, and increase liquidity

## Factors that Could Lead to a Downgrade

Further economic deterioration beyond current projections

Failure to address projected deficits either through revenue flexibility, reduced spending or a combination thereof, leading to a reduction in reserves

Lack of sustainable plan to address growing pension liability

## Legal Security

The bonds are secured by a direct and continuing annual ad valorem tax, levied against all taxable property within the limits prescribed by law.

## Use of Proceeds

Proceeds of the sale will refund about \$100 million of existing commercial paper debt, while the remainder will refund certain maturities of the city's outstanding debt for an expected net present value savings of 8.5%.

## Obligor Profile

The City of Houston is the largest city in the state, and fourth largest city by population in the U.S.. Located in Harris County, the city has home to an estimated 2.2 million people. Some of its main economic drivers include energy and resources, manufacturing, and logistics.

## Methodology

The principal methodology used in this rating was US Local Government General Obligation Debt published in January 2014. Please see the Ratings Methodologies page on [www.moody.com](http://www.moody.com) for a copy of this methodology.

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832.393.0805

