

REPORT ON THE STATE OF THE COH PENSION SYSTEMS

Introduction

During the decade of the 90s, the three pension systems sponsored by the City of Houston for the purpose of providing pension benefits to its employees (HMEPS, HPOPS, and HFRRF) were funded adequately on an actuarially sound, consistent, and financially supportable basis with annual contributions from the City of approximately:

- 10% of payroll to HMEPS,
- 17% of payroll to HPOPS, and
- 15% of payroll to HFRRF.

The period of years 2001 – 2003 was a watershed period for all three of the pension systems in that, during that period, decisions were made and actions taken that resulted in dramatic, undesired, and financially insupportable increases in the City's pension funding obligations. As a result of changes in benefits prior to 2004 the actuarially determined City contributions had increased:

- From 10% to over 50% of payroll for HMEPS,
- From 17% to around 30% of payroll for HPOPS, and
- From 15% to around 30% of payroll for HFRRF.

Because the increased actuarially determined City contributions were not financially supportable by the City and its taxpayers, the security of the employees' benefits was placed in jeopardy.

Therefore, beginning in 2004, the current City administration began the process of reforming pension practices to make the benefits more secure by bringing those pension liabilities and funding obligations to a manageable level that could be supported long term by the City and its taxpayers.

This report briefly summarizes (1) the events during that watershed period (2001-2003) which resulted in the undesirable increases in pension liabilities, (2) the steps taken in 2004-2007 to bring those liabilities down to a manageable level, and (3) the current funding status of each system as reported in the most recent actuarial valuation reports as of July 1, 2007.

In addition, in order to help prevent future undesirable increases in pension liabilities, the Administration recommends certain changes in the City employee pension systems.

With respect to the measurement and projections of all three of the pension plans' funding liabilities, it is assumed that the investment rate of return over the long term will be 8.5% per year. The liabilities would increase if the plans fail to achieve the 8.5% per year investment rate of return over the long term. Current market conditions will certainly have a negative, short-term effect on the investment returns in all three plans. However, the investment portfolios of all three plans have been carefully constructed with a long-term focus on attaining the target 8.5% rate of return while protecting against losses that are correlated to the broad market including the current global financial crisis. All three funds continue to expect to achieve a long term rate of return of 8.5%.

HMEPS

Historical Perspective

In 2001, a decision was made to revise the benefit structure of HMEPS. The HMEPS board made a commitment to the City and to the employees of being able to deliver the revised benefits to the employees provided the City would agree to increase its annual contributions to HMEPS from a 10% of payroll level to approximately 15% of payroll. Based on that commitment, the City Council agreed and approved the revised benefit structure.

In the latter part of 2003, the HMEPS board realized that it had underestimated the increase in liabilities associated with the revised benefit structure and, in fact, could not meet its commitment to deliver the revised benefits to the City employees at the approval based City contribution rate of 15% of payroll. An actuarial analysis indicated that, in order to be able to deliver the revised benefits to employees, the City would need to increase its contribution to HMEPS to over 50% of payroll.

In early 2004, the current City administration had just taken office and had to take some immediate, emergency steps to address the unexpected and insupportable pension liabilities created by the revised benefit structure. Working with the HMEPS board, some interim, short-term steps were taken, which included:

- An “extra” non-cash City contribution in FY2005 of an asset valued at \$300 million,

- A reduction in the rates of future benefit accruals for employees, based on revised benefits going forward,
- An increase in the employees' contribution rate from 4% of pay to 5% of pay, and
- A schedule of increasing City contributions for fiscal years 2005 through 2007.

The financial effect of these interim, short-term steps was to reduce the actuarially determined City contribution rate from over 50% of payroll to about 24% of payroll. So the 24% rate was substantially greater than the 15% of payroll rate that was approved by City Council in 2001 based on the HMEPS commitment. The Administration proposed reforms which would further reduce liabilities, but under state law there could be no benefit changes without agreement by the pension board.

Additional steps were, therefore, taken in 2007 to provide a more permanent, long-term solution to bringing future City contributions to HMEPS closer to the desired, financially supportable, and approval based rate of 15% of payroll. These additional steps, **which were taken without reducing any current employee's accrued or projected benefit,** included:

- Implementing a new benefit structure applicable to employees hired in 2008 and after, and
- Establishing a schedule of increasing City contributions for fiscal years 2008 through 2011.

The new benefit structure for employees hired in 2008 and after is an objective based benefit structure designed to meet some very specific objectives, including:

- Being an element of a competitive total compensation package;
- Providing, **at no cost to the employee**, adequate income replacement benefits when combined with Social Security for retiring “career” employees;
- Giving employees the flexibility to enhance their “free” City provided benefit with voluntary employee contributions based on their individual needs and circumstances;
- and
- Enhancing the City’s ability to attract mid-career employees.

Current Funding Status

The City’s scheduled contributions to HMEPS for FY2009, Fy2010, and FY2011 are \$78.5 million, \$83.5 million, and \$88.5 million respectively, which are projected to be in the 16% - 17% of payroll range each year. The unfunded accrued liability as of July 1, 2007 is \$934,969 with a funded ratio (the ratio of current assets to current actuarial accrued liability) of approximately 70%, up from a low of 46% in 2003.

Over the long term, as the new benefit structure becomes increasingly applicable to “future” employees, the projected actuarially determined City contributions to HMEPS after 2011 are expected to remain at the 16%-17% of payroll range, slightly above the 15% of payroll rate approved in 2001. In addition, the funded ratio, a component of the

measurement of the benefit security for employees, is expected to continue to improve to approximately 80% within the next ten years.

Over the next 20 years, assets in the fund are projected to continue to increase and be sufficient to pay benefits to the beneficiaries when they are due. The actuarial projections are made as of July 1, 2007 and do not include the actual investment results for the year ended June 30, 2008.

HPOPS

Historical Perspective

Prior to 2004, some HPOPS members and the HPD/City administration took advantage of certain HPOPS plan provisions, which allowed them to make some “anti-selection” decisions – decisions regarding individual benefits that increased the overall plan’s liabilities more than desired. In addition, some compensation changes were made through collective bargaining between the City and HPOU apparently without due consideration of their impact on the pension liabilities in HPOPS. As a consequence of these events, the City’s actuarially determined annual funding level to HPOPS increased substantially from approximately 17 % of payroll to approximately 30% of payroll by 2004.

As with HMEPS, the new City administration in 2004 collaborated with HPOPS in 2004 to make changes to bring the pension funding liabilities to a manageable level. These changes were intended to produce a system in long term balance and included:

- Eliminating the plan provisions that were conducive to individual anti-selection decisions;
- Establishing a new benefit structure for police officers hired after 10/9/2004; and
- Providing for a schedule of gradually and predictably increasing City contributions to HPOPS over many years.

Current Funding Status

The FY2009 City contribution to HPOPS is \$68 million, which is projected to be approximately 20% of payroll. The unfunded accrued liability as of July 1, 2007 is \$852,753 with a funded ratio of 78%, up from a low of 74%.

As of 2007, the actuarial projections indicate:

- The agreed upon scheduled contributions will equal or exceed the actuarially determined contributions within 10 years, and will level off at the 25%-26% of payroll range, and
- The funded ratio will continue to improve to 90% within 15 years.

Over the next 20 years, the assets in the fund are projected to continue to increase and be sufficient to pay benefits to beneficiaries when due. The actuarial projections are made as of July 1, 2007 and do not include the actual investment results for the year ended June 30, 2008.

HFRRF

Historical Perspective

In 2001, the City agreed to, and approved, some benefit changes to HFRRF based on a commitment from the HFRRF board to the City and to the firefighters that it could deliver the new benefits to firefighters provided the City increase its contribution from 15.4% of payroll to 18% of payroll and the members' increase their contribution rate from 7.7% of pay to 9% of pay. These contribution rates were intended to maintain a mutually agreed upon objective of a 2 to 1 ratio of City to member contributions. In part because firefighters themselves pay into their pension system a higher percentage of payroll, the assets of the system were closer to the liabilities than was the case in the other systems.

In 2004, based on an actuarial analysis, the HFRRF board realized it could not meet its commitment to deliver the revised benefits to firefighters at those contribution rates. The actuarial analysis indicated that, in order to provide the new benefit structure, the City contributions to HFRRF should be approximately 30% of payroll. To address this financially insupportable level of contributions, and recognizing the well funded status of the plan, the HFRRF board agreed to set the City's contribution rate at 23.8% of payroll for the fiscal years 2006 through 2008. And, the City agreed to make no proposal to adjust the benefit structure. These agreements were made with the understanding that the funded status of the plan would be reassessed in 2007 for determining whether adjustments need to be made in contributions and/or benefits beginning in FY2009.

In assessing the funded status of HFRRF as of 7/1/2007, the actuarial analysis indicated that, because of the outstanding investment results achieved for the preceding four years, the minimum actuarially determined City contribution for FY2009 would be 19.3% of payroll. In order to maintain an objective of stability in contribution levels, the City proposed to keep its contribution rate at the higher level of 23.8% of payroll for at least FY2009 and FY2010. The HFRRF board, however, elected to discount the full amount of the investment gains achieved over the preceding four years, abandon the objective of maintaining a level contribution pattern, and mandate an increased City contribution rate of 29.4% of payroll for FY2009.

Current Funding Status

The City contribution to HFRRF for FY2009 is 29.4% of payroll, which is estimated to be approximately \$68 million. The unfunded accrued liability as of July 1, 2007 is \$258,667 with a funded ratio of 91%, up from a low of 86%.

The actuarial projections as of 2007 indicate that the City contribution rate will decrease from the 29.4% level in FY2009 to approximately 18% of payroll over the next 5 years, and the funded ratio will improve to 100% within the next 3 years.

Over the next 20 years the assets in the fund are projected to continue to increase and be sufficient to pay benefits to the beneficiaries when due. The actuarial projections are

made as of July 1, 2007 and do not include the actual investment results for the year ended June 30, 2008.

RECOMMENDATIONS

To help prevent future undesirable increases in pension liabilities, the following changes in the operations of the pension systems should be considered:

- 1) Employment of an actuary by the City to estimate the cost impact of plan design changes under consideration (rather than relying solely on the plan administrator's actuary to provide such estimates).
- 2) Employment of an actuary by the City to assess the impact on pension liabilities of potential compensation changes (through collective bargaining or otherwise) prior to their implementation.
- 3) Writing the legal obligations of the City into municipal law, rather than state law, so that elected officials in Houston itself would be responsible for the cost and security of the system.
- 4) Implementation of conflict of interest rules which would prevent beneficiaries serving on boards or third party administrators from raising their own benefits without corresponding responsibility of funding those benefits.

The root cause of the unexpected, insupportable increases in pension liabilities for all three plans was poor plan design resulting from the artificial separation of two interdependent elements of a pension plan – plan design and funding requirement. Plan

design is the articulation of the actual promise from the City, as plan sponsor, to its employees to pay certain benefits in the future as part of its overall compensation package. Funding requirement is the amount and pattern of annual contributions from the City and its employees sufficient to meet the benefit promise articulated in the plan design. The plan design element should involve two parties - the City and its employees. The funding requirement element involves a third party, the pension board as the plan administrator, and a fourth party, the State Legislature as overseer of funding adequacy and benefit security.

You cannot have a different set of individuals – such as a pension system or the State – setting the level of benefits and another organization, the City of Houston, responsible for setting the ad valorem tax rates to fund the liability. Remember that the City receives no funding from the State for benefit levels it mandates. In the cases of HMEPS and HFRRF, mismanagement of the plan design/funding relationship occurred because the respective pension boards communicated erroneous information to both the City and the State Legislature regarding the estimated cost of proposed plan design changes. In the case of HPOPS, there was apparently a lack of knowledge and accountability for the impact on pension system liabilities of the anti-selection decisions and compensation changes being made.

HMEPS, HPOPS, and HFRRF, as the plan administrators, are independent trust organizations established by state statute to perform two primary functions – (1) investment of the contributions received from the City and its employees and (2) payment

of the benefits to the beneficiaries in accordance with the plan design. HMEPS, HPOPS, and HFRRF are each governed by a separate board of trustees.

Plan design, as an element of the City's total compensation package, should involve only the City and its employees. Plan design should not be a function of a third party plan administrator. A third party plan administrator has no accountability to the taxpayers and has no role in setting overall compensation, benefit, and retirement benefits. Further, as many of the plan administrators' trustees are also beneficiaries of the plan, avoidance of plan design issues would remove those trustees from any potential liability associated with being placed in a conflicted position of making "self-dealing" decisions. **The role of the third part administrator should be limited to managing the investments and paying benefits according to the plan design.**

Similarly, the State of Texas has no role in either funding these plans or setting overall compensation, Also, the State Legislature meets only every two years, making it difficult to make desired plan design changes in a timely manner. **The role of the State Legislature should be limited to addressing the issues of funding adequacy and benefit security.**

The rationale for recommendations (1) and (2) above should be self evident in light of the City's reliance upon erroneous information communicated by HMEPS and HFRRF regarding the estimated costs of proposed plan enhancements and the apparent lack of accounting for compensation changes affecting HPOPS.