HMEPS

HOUSTON MUNICIPAL EMPLOYEES PENSION SYSTEM

Response to City of Houston "Retirement Plan Design Study"

April 9, 2014

Introduction

On February 20, 2014, City of Houston Finance Director Kelly Dowe and City Chief Pension Executive Craig Mason made pension-related presentations to the Budget & Fiscal Affairs (BFA) Committee of the Houston City Council. Various "cost savings" ideas were highlighted in the presentations, based on a report by the City's actuary, Retirement Horizons, Inc. (RHI).

The RHI report purports to project the impact of various potential changes in the rules of the three pension systems (HMEPS, HPOPS and HFRRF), such as eliminating cost of living allowances or changing retirement ages. However, the report contains potentially significant errors and questionable assumptions, calling its methodology into question and making its conclusions impossible to judge.

The purpose of this response is to highlight problems with the RHI report and to provide an accurate picture of the Houston Municipal Employees Pension System (HMEPS).

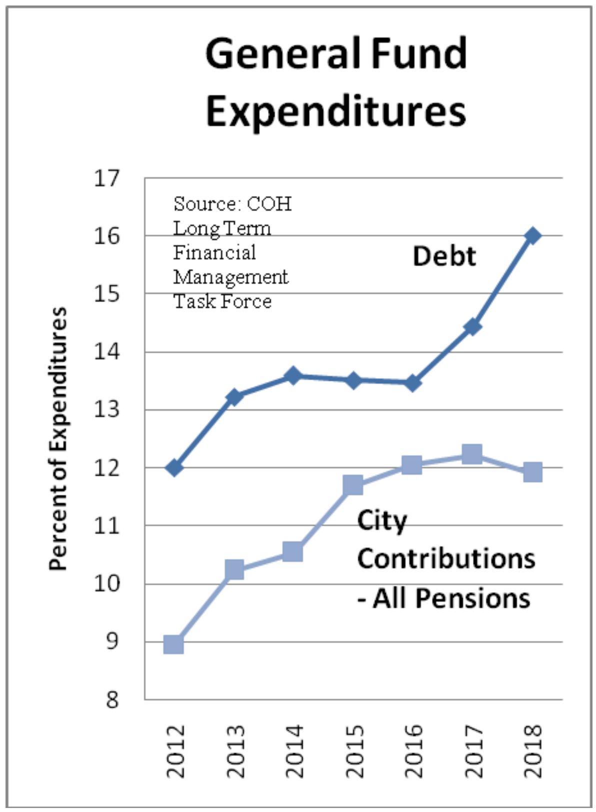
Overview

The RHI report was commissioned in 2013 by BFA Committee Chairman Stephen Costello with the stated goal of "honoring pension obligations." The report, however, is obviously designed to lay the groundwork for proposing more cuts to the already reduced benefits for current employees and retirees. The report examines the financial effects of potential changes to benefit plans, including cutting or eliminating altogether cost of living allowances (COLAs), freezing DROP accounts, and increasing the age for retirement.

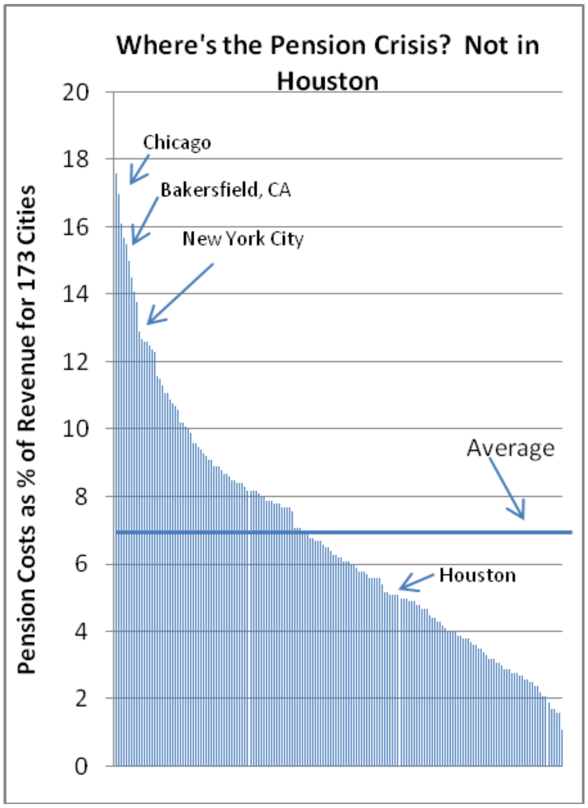
Manufactured Pension Crisis

It is currently fashionable to scapegoat public employee pension systems for the financial challenges facing state and local governments across the nation these days, and Houston is no exception. The reality, however, is far more complex.

The City of Houston, for example, faces a debt burden that grows faster than pension obligations, weakening revenue streams from franchise fees as the City has been unable to adjust to technological change, and caps on property tax revenue due to Propositions 1 and H. These propositions, passed after a City-driven campaign, cap the ability of the City to collect property tax revenue and thereby stunt its ability to provide the services required by a thriving and rapidly growing Houston.



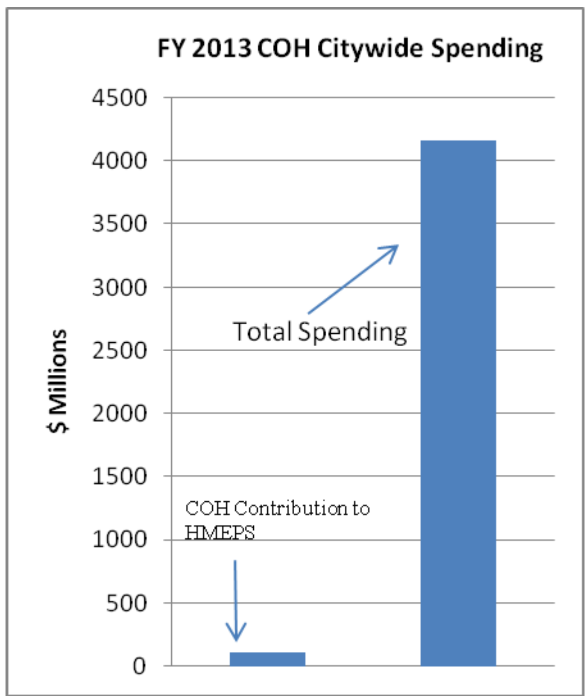
It is important to maintain proper perspective on the pension issue. The most rigorous analysis of the costs of municipal pensions to taxpayers was performed by the Center for Retirement Research at Boston College, which has been recognized by the *New York Times* as "the nation's leading center on retirement research." Their November 2013 study (found at http://crr.bc.edu/briefs/gauging-the-burden-of-public-pensions-on-cities/) concluded that it is a misconception that local governments nationally are overwhelmed by their pension obligations. Over 170 municipalities were studied and while there are serious problems in a few cases, such problems are the exception, not the norm. Cities were ranked by the cost of pensions to the taxpayers -- Houston ranked 107th, far below the average as shown in the following chart.



RHI Report Ignores Previous Reforms

The RHI report gives the impression that dramatic pension reductions are necessary in order to accomplish significant "savings" for the City decades down the road. In fact, due to previous substantial reforms -- made through the Meet & Confer process created by the Texas Legislature, which requires the City and HMEPS to mutually agree to any changes to the pension system -- we are *already* on this path. Over the next approximately 30 years HMEPS' unfunded liability is being paid off in a process very similar to a home mortgage. When complete, the City's contribution to HMEPS will reduce to the "normal cost" (the cost to maintain the system each year) which currently stands at less than 5.9% of payroll. The RHI report itself shows this trend in its "baseline" scenario.

Major changes to the pension plan were made in 2005 and 2008 – reforms that included over $850 million in future benefit reductions to participants. Additional changes, mutually agreed to in 2007 and 2011, gave the City increased flexibility to weather the economic downturn by temporarily lowering its payments to HMEPS. The City knew that by 2013 its required contribution to HMEPS would rise to about $116 million. The actual City contribution turned out to be less than projected, which at just under $112 million was about 2.67 percent of its budget for that year.



HMEPS is proud of its "Reform + Time = Success" formula, which began with substantial reforms nearly a decade ago. A report by the Center for State & Local Government Excellence identified HMEPS as one of five pension systems in the U.S.

that made reforms that make them "more fiscally sustainable while continuing to provide retirement security to their members."

RHI Report Contains Factual Errors & Misleading Remarks

There are a number of issues in the RHI report including:

- While RHI vouches for the overall accuracy of the report, they imply that the quality of the analysis was hindered because "…the City of Houston was unable to obtain (census data)." (page 55) **In fact, the reviewing actuary would have had access to this data had the City simply agreed to allow the reviewing actuary to sign an appropriate confidentiality agreement, which had been done in the past.**
- The report points out that City of Houston was opted out of Article XVI, Section 66 of the Texas Constitution which prohibits the impairment of accrued benefits, but also implies that the City can unilaterally "make final decisions" about pension benefits. **In fact, the City remains contractually obligated to the provisions of the Meet and Confer Agreement between the City and HMEPS. Furthermore, neither the City nor HMEPS can go to the state legislature to propose changes without the mutual agreement of both parties.**
- On page 12, the report states that the HMEPS DROP program (which is available only to those hired prior to 2008) is "similar" to one with the following three features:
    - DROP accounts are credited with the member's contributions to the pension. **In fact, HMEPS members who enter DROP do not have their contributions credited to their DROP account.**
    - Interest on the member's DROP balance is set at the return earned by the fund subject to a minimum of 5% and maximum of 10%. **In fact, the interest rate for the HMEPS DROP is half of the fund's return for the prior year, subject to a minimum of 2.5% and maximum of 7.5%.**
    - "Service pension during DROP …increases 2% per annum," i.e., the member's pension accrual continues to grow after entering DROP. **In fact, when an HMEPS member enters DROP, their accrual percentage is frozen.**
- On page 8, the RHI report states, "…the majority of HMEPS active members contribute 0% (except for group D which contributes 5%)." **In fact 6,777 out of 11,781 active members (over 57%) contribute 5% of their salaries as Group A participants. Group D participants do not make contributions.**

Questionable Assumptions

On page 57, the RHI report indicates that changes such as eliminating the DROP program are assumed to have no impact on the behavior of HMEPS participants. For a large portion of experienced employees, this would be the equivalent of continuing to work after retirement eligibility but without receiving additional benefits. Assuming that these workers will continue to work is highly questionable, yet this assumption undergirds the City's efforts to freeze or eliminate the DROP program.

Also, the RHI analysis appears to be based on the inaccurate assumption that benefit payments are paid at the beginning of the year while contributions are spread out throughout the year. This means the average asset level is understated. Since investment income is simply a percent of assets, the result of this assumption is that the RHI report is likely to be understating investment income by several million dollars per year.

Questionable Calculations

According to the report (p. 7), several of the contemplated changes would, in 30 years time, reduce the "actuarially determined City contribution rate" for HMEPS to *zero*. This includes changes such as reducing the COLA to 1%, increasing the retirement age, or freezing DROP accounts. We are baffled as to how it was determined that any one of these changes – or indeed any combination of them –would reduce the City's cost to zero. In order for the system to function, there is a minimum contribution – which is the "normal cost" (currently less than 5.9% of payroll). **More importantly, the plan changes that HMEPS implemented through the Meet and Confer Agreement over the last 10 years already will reduce the unfunded liability to zero in approximately 30 years, without any further changes to the plan such as those contained in the RHI report. This fact was noticeably absent from the RHI report and BFA presentations.**

Conclusion

The City of Houston is a multibillion-dollar service organization. While many of the City's assets are physical in nature, as a service organization its primary assets are the employees. Elected leaders routinely celebrate City employees and praise the important work they do on behalf of Houstonians. A secure retirement benefit is an important piece of the total compensation that employees earn in service to the City.

Municipal employees have done their part to make the pension system work. The City must continue to do its part to fulfill its obligations. These obligations are for compensation that retirees earned honestly in service to Houston, and they are not at the heart of COH's financial challenges. Rapidly increasing debt, slow adjustment to technological change, and self-imposed revenue limitations — this is where attention is needed.