WEK HPOPS BILL ANALYSIS
February 13, 2017

I have completed an initial and preliminary review of what I believe is the bill that modify the police pension system. Because of the secrecy in which this process is shrouded, I am not certain that I have the most recent version. The mere fact that the City and the legislators involves in this process are carrying this out in this cloak and dagger fashion is shameful and, of course, very telling about the good faith of those involved.

<u>Overview</u>

At the outset, everyone should understand that the City's proposal is <u>not</u> a permanent solution to the City's pension woes. At best, it represents (i) about a 14% cut in cost of the plans to the City from a combination of benefit reductions and increases in employee contributions (ii) a and hideously complex mechanism that, if enforced in good faith, will limit the percentage of payroll the City must contribute to the pension. These improvements are not trivial, but neither are they an ultimate solution. However, if defined contribution plans were added for new employees and the "corridor" mechanism tightened down so it would be both effective and enforceable, we might be able get to something that more resembles a real fix.

We have seen this movie before. When Bill White was elected in 2003, he was handed a new actuary report that showed the run-up in benefits during Lee Brown's administration were going to cost much more than had been previously estimated. To his credit, White immediately attacked problem winning significant concessions from the police and municipal pensions. He also used about $600 million in pension bonds to prop up the systems. But he failed to make the fundamental reform that the private sector had taken --- phasing out defined benefit plans. So while there is no question that White's reform efforts bent the cost curve downward, he did not address the fundamental flaw – defined benefits plan do not work, and especially do not work in the public sector. Now, a decade after his reform measures, the City's pension debt has increased fourfold and driven the City into insolvency.

There is no permanent solution to the City's pension crisis without a plan to phase out the defined benefit systems. Anything short of that dooms us to another pension crisis in the future.

<u>Why this plan will likely fail</u>

Standing alone, however, in its current form, the plan will almost certainly fail and when it does the City will be deeper in debt, with even a more intractable problem. Here's why:

- **The percentages of payrolls that are being discussed are unsustainable.** The preliminary numbers announced by the City was that it would take an average of about 32% of payroll to pay for the plan over 30 years. Under the terms of the plan, the percentage could rise to 37% before the pension systems would be required to reduce benefits or increase employee contributions. I have seen more recent numbers that indicate the percentages may be coming in even higher than the 32/37% range. I saw some numbers that the police plan is coming in at 41/46%. This simply unsustainable over time. It will impossible for the City to pay competitive wages to attract top personnel or provide adequate services to citizens with this level of payroll add-on.

- **If the corridor mechanism is enforced, employee contributions could rise to intolerable levels.** Most of the room to lower the City contribution rate will come from raising employee contributions. (There is not much room left on COLAs and raises to retirement ages have a relatively small actuarial impact.) Because the liability is so large relative to the payroll (total pension liability is approximately 15X payroll), it will take large increases in employee contributions to make up even modest misses on the investment performance. Every 1% investment miss, roughly equates to 8% of payroll. The employee contribution levels in the new agreement are about 10%. So, a consistent 1% miss on the investment goal of 7%, would eventually require the employee contribution to go to 18%. At contributions anywhere in that kind of range, the City will not be able to recruit or retain employees.

- **Back-end loaded repayment schedule will become unbearable.** The amortization schedule that the plan proposed to use is the "level percentage of payroll method." This method produces low payments in the early years (actually negatively amortizing the pension debt for about 8-10) then ramps up the payments dramatically in the out years. Depending on the percentage payroll growth you assume, the ending payments will be as much as 150% of the initial payment. Toward the end of the amortization schedule, the payments under this plan would be about $1.2 billion, likely well over 50% of the City's property tax revenue at that time. At some point in time, the City's ability to pay for basic services will simply collapse under the weight of those higher payments.

- **The plan reduces funding in the short term.** We are constant extolled by pension experts and the pension boards that the City should increase its funding to the pensions. Ironically, this plan <u>reduces</u> the City's contribution for about the first 3-4 years because of the negative amortization (not counting the pension bond proceeds). In the first year, funding will decrease by about $66 million.

- **Corridor Issues.** If the "corridor" mechanism were to work as advertised, it would be a significant brake on the acceleration of the City's contributions to the plans. However, there are two fundamental problems with the corridor mechanism. It is reactive, allowing additional debt to accumulate, and there are significant risks it cannot/will not be enforced.

  - **Lag Time.** The process by which the City contributions would be limited are based on actuarial studies ("RSVS") which will be prepared by the end of the calendar based on information for the previous fiscal year (July 1-June 30), with the revision in the City contribution rate or decrease in benefits/increase in employee contributions to be effective the following July 1. The process repeats each year.

    This lag in the time between the results in the pension plans' performance and any adjustment could (and probably will) result in the accumulation of significant additional pension debt. Take the current year's performance as an example. The plans projected they would earn an average of 8.2%. They actually earned a negative 1.5%. The result was shortfall for just last year of just short of $1 billion. Absent any other actuarial assumption changes then, the pension debt would have increased by $1 billion last year.

That is roughly equivalent to adding 5% of payroll to the City's contribution. So, if the plans were to have the same investment performance next year, they would hit the cap in the first year. The adjustment in the employees' benefits or contribution would not start until the following July and then the changes would not affect the amount of the debt for several more years because of the negative amortization schedule.

As a result, it is entirely possible, and I believe likely, that you will see the pension debt continue to rise for, at least, a decade. The 5% increase in the cap accommodates about $1.1 billion of additional debt. In other words, if the cap is reached the City will have additional debt of about $1.1 billion. But because of the lagging effect of the adjustments, the debt could continue to rise even after the cap is hit. And each time the pension's miss their investment returns and have an actuarial loss, that is a new tranche of debt on which the amortization is pushed out beyond the original 30-year term.

- **Will the City Enforce? -** The threshold enforcement issue is that the plan relies on a good faith enforcement by the City administration. If the City fails to enforce the agreement, taxpayers do not have standing to do so. (*See Brown v. Todd*, 53 SW 3d 297 - Texas Supreme Court 2001). Given the history of how the City has administered and enforced the charter restrictions put in place in 2004 to limit revenues and expenses and the drainage fee charter amendment, I do not think we can assume the City will do so with respect to this plan. Once the city contribution cap is breached, the City will be under tremendous pressure from the employee groups to not enforce the benefit cuts or employee contribution increases. Can we rely on City Council to authorize suing the pension plans to enforce the plan when they continue to accept massive campaign contributions from the employee unions?

- **Can the City Enforce? -** The corridor mechanism is hideously complex. It introduces several dozen new terms and concepts which have never been interpreted by the courts. There are dozens of ways the pension plans or a City administration not enthusiastic about enforcing the statute could manipulate the results, at least, in the short to medium term. Many of these could be tighten up with better drafted provisions, and that should be a priority if the plan goes forward. But the reality is that this kind of complexity and ambiguity will likely lead to protracted litigation between the city and the pension plans when the going gets rough. That litigation will likely lead to delays in the enforcement of the corridor at a minimum. You will also likely see a significant increase in the administrative costs of the plans as result of this complexity.

<u>Improving/Vetting the Bill</u>

The following are changes that would in my opinion improve the chances of its enforcement and success. Also, included are various items that should checked before the bill is finalized. I have omitted what are essentially typographical or grammatical edits, but the ones I noted while reviewing the bill are noted in my comments in the attached draft.

- Section 2(4-d)/(17d) - The pension plan actuary has no minimum qualifications and this provisions allows the City actuary to similarly unqualified. This is particularly problematic given the influence the actuaries have over the preparation of the RSVS and, therefore, the amount of the City's contribution and the RSVS averaging provision. See Section 9A below.

- Section 2 (5-d) – Midpoint is set by RSVS. According to Section 9A the initial RSVS is to be completed by March 31. If so, the actual numbers should be used. If not, there will be some ambiguity about what the beginning midpoint is.

- Section 2 (13-b) – What is the mechanism for determining the final NPV of the benefits reductions and increase to member contributions?

- Section 2 (14-c) - "Administrative expense" is not defined. Does it include investment expenses? HPD administrative expenses as defined by CAFR were $3.6MM last year and HPD payroll was $769MM, so this would allow administrative expenses to double w/o City's agreement. With an agreement, there is no limitation.

- Section 2 (14d) - This section is amended to use the Rule of 70 for retirement age. Under the previous definition, a member retires at any age with 20 years of service. So, a member hired at 22 could retire at 42. This would change would increase the age for a 22-year old to 46. This should be increased.

- Section 2(15a) - This appears to be an attempt to define base pay. Uses several undefined terms (e.g. "strategic officer staffing program pay"). CITY AND PENSION BOARDS CAN AMEND AT ANY TIME. This means at any City Council meeting they can add back, say, overtime. Who is going to monitor this from for the next 30 years?

- Section 2(17-d) – This section gives the pension board the power to adjust the inflation index plus/minus 50 basis points. What conceivable basis is there for the pension board to have the power to adjust the inflation assumption at all. They will obviously always adjust it in their favor. Has anyone calculated what the effect of the board routinely adjusting this assumption?

- Section 2(17-f) - Public Fund Survey not defined. There is website, http://publicfundsurvey.org/. It is maintained by three non-profits and Boston College. I could not find anything on the website that was referred to as "median return." They have a very incomplete data set (Houston police and muni were not included). Also, there is no reference to what year(s) would be used to establish. City and pension plans can agree to agree other "reference point" is PFS is "unusable." This basically opens up for the City and pensions to set the "reference point" anywhere they want. **Section 9A(c)(1)(H) provides assumed rate of return cannot be below this "reference point".**

- Section 2 (25)/Section 9A(c)(1)(B)/Section 9A(b)(2)(A) – These two sections provide for 5-year asset smoothing. This should be eliminated and strictly market value used. This is especially true since we suspect the plans may have some large unrealized losses in their alternative investment portfolio (police plan in particular). In Section 9A(b)(2)(A) allows the pension plans to use market value to avoid benefit cuts/employee contribution increases. Goose and gander!

- Section 2(26)/ Section 9A(c)(1)(B) – These two sections provide for the use of Ultimate Entry Age Normal. This should be changed to Normal Age Entry.

- Section 4(a) – Allows employees to go to Austin to lobby on pensions on City time.

- Section 6(f)(1)(C) – This language is far too board. Could be interpreted to give the power to change anything in the statute. This is limited very generally by next subsection (D), but even there "fundamentally" is not defined and the limitation is therefore, vague. Some additional protection of Section 9 and 9A are included in Section 6(f)(2).

- Section 6(l) – This language to too board.

- Section 8 - Overtime and some other pay items are excluded from calculating employee contribution. This could be used to game the calculation in future meet & confer agreements. Would be better if based on total compensation.

- Section 9(a)(1) - Pensionable payroll is aggregate of "pay" which excludes overtime, etc. This is less than current law which used total direct pay as one of the factors. What is the effect of excluding these items?

- Section 9(c)(1) – This section gives the City and the pension boards the unrestricted power to change the methodology for RSVS. This must be deleted.

- Section 9A(c)(1)(H) – This provides the assumed rate of return cannot be less than the "Reference Point" which apparently is supposed to be some kind of national average less 150 bps. What if one of the plans has a large write-off? What possible justification could there be for this limitation?

- Section 9A(c)(1)(I) – Allows the pension board to periodically reset the inflation assumption based on an "experience study" (undefined term) and only requires every five years. No justification for this kind of discretion. Inflation should be tied to an established index.

- Section 9A(c)(1)(J)/ Section 9A(c)(1)(K) – These sections deal with the assumption on payroll growth for the level percentage of payroll amortization schedule. Basically, actuaries decide in "consultation with the city finance director." This assumption is critical because it determines the steepness of the amortization curve. The discretion needs to taken out and tied to something objective, like historical grown. Also, "annual payroll growth rate assumption" is not a defined term.

- Section 9A(c)(1)(K)(3) – Draft RSVS should be public record, published on the City website.

- Section 9A(c)(1)(K)(4) – This section provides that if pension system RSVS is with 2% of City's that pension system is used. 2% of payroll is about $25MM today (counting all three systems), but would grow to almost $80 over 30 years. More importantly, the pension system could effectively game this provision to turn the 5% corridor into a 7% corridor. Even worse, is the procedure to resolve any dispute by an arithmetic average. This creates an incentive for the pension board actuary to come back with a result that benefits the pension system which will vary based on the circumstances, e.g., trying to keep the City contribution just below the cap.

- Section 9(e) – This section governs additional voluntary contributions by the City to the plan. This is the only provision that I can find that would affect the City issuance of new POBs. Under this section, if the City issued new POBs and made a voluntary, additional contribution to the plan, the midpoint (and therefore the corridor) would be adjusted down in the next RSVS to take into account the actuarial effect of the contribution as if it were a liability layer gain. I have not tried to analyze whether this is section is specific enough to ensure that would be the effect, but that is clearly the intent.

  This is a very minimal, and in my view wholly inadequate, protection from new POBs. POBs should only be used to extract benefit concessions, not as an arbitrage bet. Nothing in this provision would keep the City from making that kind of bet. Even worse, however, there is nothing that would keep the City from borrowing its annual contribution, like Bill White did on several occasions. **Tightening up the restrictions on the issuance of new POBs is critical.**

- Section 9A(f) - Need to add increasing maximum contribution. This section would prohibit City from adopting DC plans.

- Section 9A(g) - This deals with POBs not being issued before initial RSVS is prepared, but assumes they will be delivered at some point. What if they are not? Also, this does not prohibit the City from issuing additional POBs or require that additional POBs be taken into account in subsequent RSVSs.

- Section 12(c)/(c-1) – These are the sections that cut COLAs. This is a much more severe cut than described in the term sheet. Tied to investment results and there will be no COLAs in any year where the investment return is less than 5%. Last two years, there would be no COLAs for anyone. I, and I think the public is going to have a problem with cutting off COLAs for employees that retired prior to the run-up in benefits in 2002 and who are receiving relatively nominal payments. I understand the logic behind tying to investment results but seems like this could produce some anomalous results. I think tying to actual DOL COLA with some kind of means testing would be a better approach.

- Section 12(l) – This is a new section that provides that anytime that a member spends on workman's comp benefits is counted toward his/her retirement benefits based on the salary that would have been receiving had they not been on worker comp. There is an equitable logic to this provision, but we should, at least, get some idea of what this costs.

- Section 14(b) – This provision changes participation in DROP from being option to mandatory for members hired before 2004. I think virtually everyone does elect for DROP so not sure what the purpose of this section is.

- Section 14(c) – Keeps pre-effective date DROP benefit intact, changes then prospectively after effective date.

- Section 14(d) – Appears this section eliminates the previous rule that all the DROP participant's contribution was credited to his/her drop account. This is a significant change.

- Section 14(e) – This section changes the interest rate for DROP accounts. Previously was the trailing 5-year average for the plan. New rule is 65% of <u>compounded</u> 5-year average. I don't see any logic behind using a compounded average. At the 7% goal, compounding raises the DROP rate from 4.5% to 5.25%. It looks to me like the relationship is arithmetical, so really just means the factor is really 75%. The section also establishes a new floor of 2.5%. This gives some idea what the pension thinks about its future earning potential.

- Section 14(l) – This section limits DROP participation to 20 years.

- Section 15(a) – Reduces work-related disability from 55% of final pay to 45% for member hired after 2004.

- Section 15(b) - Reduces non-work-related disability from 27.5% of final pay to 22.5% for member hired after 2004. Also, eliminates 10-year service requirement.

- Section 15(m) – Board can approve disability pension even if injury was incurred during the commission of a felony. This is ridiculous.

- Section 15(p) – Subjects person who fraudulently receives disability to "civil and criminal prosecution." This language is too general to be enforced, but fraud is probably already covered by other criminal statutes.

- Section 15 generally cleans up the disability procedures.

- Section 16 – This section deals with the rights of survivors. Changes are minimal. I had heard the survivor rights might be reduced to 80%, but I don't see that in this draft. Personally, I don't favor that change for existing members, but if we don't get DC plans for new employees that should be changed for new employees.

- Section 16A – This cleans up the DROP beneficiary designation provisions. I don't see any problems with the changes.

- Section 17(i) – This section allows members that are rehired to "buy back" years they were not employed. This is a completely new section and using several undefined terms. I cannot tell from reading this how this would work or what the financial impact is.

- Section 25 – There are massive changes to this section that appear to IRS qualification related and have no impact on the pension plan costs or debt.

- Section 27 – This section grants the City and the pension board sweeping powers to change the pension plan, including <u>increasing</u> benefits. This may be limited by some of the qualifying language that works Sections 9 and 9A but should nonetheless be deleted or significantly and explicated limited to protect the changes made in this bill.

- Section 29 – This section deals with the issue confidentiality, although there are other provisions sprinkled throughout the bill that touch on this subject as well. As a general proposition, we need to start from scratch on this issue. Originally, these provisions were enacted to keep the individual accounts of members from begin public information. I think that fundamental premise needs to be reconsidered. Certainly, the salaries of public employees is public information so why is this form of their compensation not? But even we accept the basic premise, it is clear that pension plans have used this exemption to obfuscate the amount of the members' benefits and the corresponding cost.

- Section 29?? – At the end of the bill there is another "Section 29" that abrogates any agreements entered between the City and pension board prior to the effective date. That is appropriate but it contains a troubling exception "except as expressly agreed to in writing by the city and the board." This is too broad and should be deleted or significantly and explicated limited to protect the changes made in this bill.