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Houston pension liability has doubled since 2008 to $3.9 billion

Report from Rice's Kinder Institute provides overview of Houston pensions and options for reform

HOUSTON – (Aug. 9, 2016) – Houston's pension liability has doubled since 2008 to $3.9 billion and is likely to continue to increase if no action is taken, according to a new report from Rice University's Kinder Institute for Urban Research.

The report, "The Houston Pension Question: How the City's Pension Liability Grew and the Options for Reform," was designed to provide the public and policymakers with an overview of the current financial state of Houston's pensions, an explanation of why the city's unfunded liabilities are growing and insights on potential options for reform. The report also puts Houston's pension situation in a national context and is available online at http://www.kinder.rice.edu.

History and overview of current system

The city of Houston currently contributes approximately $350 million per year to three pension funds combined, but it is not enough to stop the growth in unfunded liability, according to the report.

"Houston currently faces an increasing unfunded liability for its employee pensions totaling $3.9 billion, as of 2015," said Bill Fulton, director of the Kinder Institute. "This number is up from $212 million in 1992. If the system remains unchanged, this unfunded liability is expected to keep growing."

Fulton added, "We respect the difficult task that the city and the pension boards are facing. We feel this report speaks for itself and encourage all parties to use it as a resource for constructive dialogue. We also encourage the city and the pension boards to work toward a long-term solution."

All three of Houston's pension systems – the Houston Police Officers' Pension System (HPOPS), which includes 21 percent of city employees; the Houston Firefighters' Relief and Retirement Fund (HFRRF), which includes 16 percent of city employees, and the Houston Municipal Employee Pension System (HMEPS), which includes 63 percent of city employees – are currently underfunded, according to the report. HPOPS is funded at 81 percent and HFRRF is funded at 92 percent (as of 2013), though both of these funding levels are favorable compared to the national average, which is 74 percent for large state and local plans. HMEPS is funded at 54 percent, well below the national average. This underfunding is the result of several trends, including annual payments below the amount required to maintain steady funding levels and assumed rates of investment returns that are higher than the national average and higher than recent experience.

The report said that each pension plan will require a separate set of solutions because of the different sources of their underfunding. The problems with the municipal employees pension fund are a result of the long-term unfunded liability, while the cost of the police and fire plans is driven by the relatively high annual cost of providing pensions.

Options for reform

The report outlined four options for reform.

1) **Increase city's financial commitment to the pension systems.**
   This option would meet current obligations and pay down the unfunded liability. However, this would require the city to increase its revenue or divert funds from other uses, which could affect the city's ability to provide other public services.

2) **Require larger employee contributions.**
   In Houston, HMEPS members contribute 2.8 percent of their salary – nearly 5 fewer percentage points than the national average (7.6 percent individual contributions) with regard to employee contributions. HFRRF and HPOPS pay 9 percent and 9.3 percent, respectively (close to the national average of 9.6 percent). Increasing HMEPS contributions to the national average would help. However, without an increase in wages, this amounts to a decrease in employee compensation and may reduce the quality of worker the city can attract.

3) **Switch to a defined contribution system or "hybrid" defined benefit-defined contribution system for new hires.**
   This change would shift the financial risk from the employer to the employee for newly hired workers. At the time this change occurs, existing employees are typically legally protected to continue with the original defined benefit plan. This option may be attractive to short-term or younger workers, since the benefits associated with defined contribution plans accrue evenly over a worker's career and are more portable. However, switching to a defined contribution system does not address the previous unfunded liability.

4) **Reduce benefits for current employees.**
   Although cities are usually legally prohibited from cutting benefits for current and former employees, there is flexibility with annual Cost of Living Adjustments (COLA). A reduction in COLA can immediately reduce the unfunded liability. While this can reduce financial obligations over time, it is a decrease in compensation to employers and could mean that retiree income loses ground to inflation over time. Changes to the Deferred Retirement Option Program (DROP), which allows retirement-eligible employees to claim pension benefits while continuing to work, would likely result in smaller savings but could be part of an overall solution.

Houston's system in a national context

According to Fulton, Houston’s pension benefits can be described as being “on the high side of normal” and the city’s current pension liability is not out of line with other large cities nationally. But all cities face a growing unfunded liability problem.

"Houston is not alone as it works to rein in pension costs," Fulton said. "Across the country, cities have taken a range of steps to deal with the rising costs of worker retirement benefits."

The report focuses on five other cities – Phoenix; Jacksonville, Fla.; San Diego; Baltimore; and Fort Lauderdale, Fla. – and highlights the steps they have taken to handle the same challenge Houston faces. The report notes that while it is unlikely that Houston would adopt the same exact reform package as any of the five other cities, the case studies are meant to foster conversation about the desirability and effect of different reforms in Houston.

"These cities were chosen for their geographic and political diversity, as well as the variety of different techniques they employed as they all sought to address the same basic challenge," Fulton said.

1) **Phoenix**
   The city of Phoenix is addressing its pension issue with an increase in employee contributions and an adjustment in the pension plan that includes a hybrid option with a traditional pension and the incorporation of a defined contribution plan. The unfunded liability should be paid off by 2040.

2) **Jacksonville**
   The city of Jacksonville is addressing its pension issue with an increase in employee contributions, a reduction in pension benefits and an acceleration of the city's payment toward the unfunded liability. By 2046, the unfunded liability should be paid off.

3) **San Diego**
   The city of San Diego is addressing its pension issue with a reduction in pension benefits and the introduction of a 401K retirement plan for new hires. While this does not shrink the existing liability, it slows its growth as new employees are on a different plan. In addition, the city has committed to making increased payments to ensure the unfunded liability should be paid off by 2045.

4) **Baltimore**
   The city of Baltimore is addressing its pension issue with a reduction in pension benefits, the introduction of a 401K hybrid retirement plan and increased employee contributions. The unfunded liability should be paid off by 2039.

5) **Fort Lauderdale**
   The city of Fort Lauderdale is addressing its pension issue with the introduction of a 401K retirement plan. While this does not shrink the existing liability, it slows its growth as new employees are on a different plan. The city also introduced a $146.4 million pension bond to pay down the city's unfunded pension liability. The unfunded pension liability should be paid off by 2042.

Fulton said that while there is no "magic solution" to Houston's pension problems, a resolution will likely require a multifaceted approach involving both the city and its workers.

"Ultimately, a pension solution will require a combination of revenue sources, revised assumptions and reforms so that Houston can put the questions of pension finances to rest once and for all," he said.

The Kinder Institute's report was based on an analysis commissioned by the Center for Retirement Research (CRR) at Boston College and led by Jean-Pierre Aubry, associate director of state and local research at the CCR. In addition, the report draws upon a background paper prepared by John Diamond, the Edward A. and Hermena Hancock Kelly Fellow in Public Finance at Rice's Baker Institute for Public Policy. The findings are based on an analysis of financial data about the pension plans from 1993 to 2014 (1993 is the first year for which complete data is available on all three of Houston's plans). The Kinder Institute report also draws on data from the CRR's Public Plans Database, a collection of information for 109 large state-run and 128 large locally-run pension systems around the country.

The report was undertaken at the request of the Kinder Foundation, Houston Endowment, The Brown Foundation Inc. and The Wortham Foundation Inc.

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Rice University's Kinder Institute for Urban Research is a "think and do" tank that advances understanding of the challenges facing Houston and other urban centers through research, policy analysis and public outreach. By collaborating with civic and political leaders, the Kinder Institute aims to help Houston and other cities.

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