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[S&P: Houston's Preliminary Pension Plan: Panacea Or Prolonged Predicament?]

DALLAS (S&P Global Ratings) Sept. 15, 2016–S&P Global Ratings believes that the pension reform framework described in a statement by mayor of Houston, Texas yesterday is a step in the right direction for the city. The city's efforts to come to an agreement, even if preliminary, that includes improved funding discipline, more conservative assumptions, and benefit reform demonstrates management's efforts at improving the retirement system's sustainability and is no small feat. However, we also recognize that there is a long road ahead before negotiations are finalized and the full impact of the proposal can be fully evaluated.

We downgraded the city to AA/Negative in March 2016 based in part on our opinion of its 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. The framework announced by the mayor, which is still preliminary and subject to additional negotiations, lays out a set of agreed-to goals without details about how these would be achieved. Although some elements of the proposed plan point to greater conservatism in assumptions, others bring along increased risk, and none are free of implementation risk.

In our view, the more conservative measures include the adoption of a 30-year closed end amortization; a reduction in the assumed rate of return to 7%; improved funding discipline; and reduction of one-third of the liability through cost containment measures related to changes in benefits. We understand the Mayor's plan also calls for an additional $1 billion of pension obligation bonds (POBs) which could add some risk. From a credit perspective, issuing POBs increases leverage and fixed costs. The decision to utilize debt
for this purpose is tantamount to deficit financing–funding an operating expenditure with bonds. The POB bond proceeds would need to provide a return equivalent to the assumed rate of return (7%) plus the cost of borrowing the funds for the pension funding to keep track with assumptions. This is particularly important as a trend of lackluster investment returns, together with forecasts of lower expected market returns over the next 10 years, has brought on renewed calls from some financial economists for lower rate-of-return and discount rate assumptions (see our report, "U.S. State Pensions: Weak Market Returns Will Contribute To Rise In Expense," published Sept. 12, 2016).

Additionally for Houston, which has a front-loaded debt service schedule, we would have to evaluate how this issuance would play into its ability to meet future capital needs and if it will be structured in a way that provides reduced pension funding early on in exchange for higher, less sustainable contributions in the future. Even measures that reflect increased conservatism are not without risk. For example, we view full funding of actuarially determined contributions as positive, but that practice could place significant stress on the city's budget and be difficult to execute should investment returns fall short of assumptions or savings not materialize as expected. We understand this plan is nascent and that the final elements are still subject to substantial negotiations. Furthermore, like any pension reform effort, this one could be subject to litigation, which could delay or derail implementation. Ultimately, the impact of this proposal will rest on the mix of elements that make their way to an adopted and final plan, what level of savings they provide, and on the city’s ability to execute the plan once adopted.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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