HOUSTON POLICE OFFICERS' PENSION SYSTEM

FUNDING POLICY

SECTION 4000

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4000 Introduction

4000.01 This funding policy outlines a formal long-term strategy for financing the pension obligations accruing under the Houston Police Officers' Pension System with the goal of achieving a funded ratio that is equal to or greater than 100%, as required by Texas Government Code §802.2011.

4000.02 This policy is limited by the authority granted to the board of trustees under Article 6243g-4 ***(governing statute)***. Therefore, this document creates a framework for proactively managing risks by outlining how the board will approach future changes to benefit and contributions levels under different conditions. In the event this policy conflicts with any statutory language, the statute shall prevail.

4001 Funding Priorities

4001.01 The primary funding priorities are to:

1. Ensure the security of accrued benefits by making certain contributions and assets are sufficient to pay benefits when due.
2. Limit the volatility of contribution rates for both the members of ***the Houston Police Officers' Pension System*** and ***the City of Houston, Texas***, consistent with other funding objectives.
3. Ensure that each generation of members and employers incurs the cost of benefits for the employees who provide services to them, rather than deferring those costs to future members and employers;
4. Provide a reasonable margin for adverse experience to help offset risks.
5. Continue progress of systematic reduction of the Unfunded Actuarial Accrued Liability.

4002 Funding Objectives

4002.01 The system's funding objectives are:

- A funded ratio of 100% or more within 31 years as of July 1, 2017.
- A fully funded system with no unfunded liabilities.

4003 Actuarial Methods

4003.01 The board has adopted the following actuarial methods for purposes of actuarial valuations and the determination of the benchmark Actuarially Determined Contribution:

I. Cost Method

The Ultimate Entry Age Normal method.

II. Asset Smoothing

The actuarial value of assets recognizes 20% of the difference (typically referred to as "five year smoothing") between the market value of assets and the expected actuarial value of assets, based upon the assumed valuation rate of return of 7.00% per annum.

III. Amortization Policy

The amortization rate is determined as a level percentage of active member payroll. It is the amount required to amortize the unfunded actuarial accrued liability (UAAL) over a closed period using the process of "laddering".

The UAAL as of June 30, 2016, as restated in the "Final Initial Risk Sharing Valuation Study as of July 1, 2016" (RSVS Study), which was dated September 28, 2017, is the initial base and is amortized over a closed 30-year period beginning FY2018. Each future valuation will establish either a liability gain layer or a liability loss layer. These layers will represent unexpected increases/decreases in the unfunded actuarial accrued liability (after subtracting out any remaining Legacy Liability or any remaining prior years' liability layers). New loss layers will be amortized over a 30-year period, while new gain layers will be amortized over the remaining amortization period as of one year after the valuation date of the largest remaining loss layer (will typically be the legacy liability). The amortization of all layers will begin one year after the valuation date using a level percentage of payroll amortization method.

4004 Actuarial Assumptions Guidelines

4004.01 At least once every four years, the pension system actuary at the direction of the pension system shall conduct an actuarial experience study in accordance with actuarial standards of practice. The actuarial experience study required by this subsection must be completed not later than September 30 of the year in which the study is required to be conducted.

4004.02 Except as otherwise expressly provided by the governing statute, actuarial assumptions and methods used in the preparation of a risk sharing valuation study, other than the initial risk sharing valuation study, shall be based on the results of the most recent actuarial experience study.

4005 Actuarially Determined Contribution Benchmark

4005.01 The governing statute established a "corridor midpoint" which is the projected city contribution rate specified for each fiscal year for 31 years in the initial risk sharing valuation study under Section 9B of the governing statute and serves as the System's Actuarially Determined Benchmark. The city contribution rate will change from year to year based on annual risk sharing valuation studies and is generally, subject to the Risk Sharing Mechanism described below, in the range of the "corridor" which is five percentage points plus or minus the corridor midpoint.

4006 Consideration of Plan Modifications

4006.01 Guidelines for Future Reductions in Benefits or Increase in Contributions

A. Guidelines for future benefit reductions are governed by the Risk-Sharing Mechanism described below.

4006.02 Guidelines for Future Increase in Benefits or Reduction in Contributions

A. Guidelines for future increase in benefits or reduction in contributions are governed by the Risk-Sharing Mechanism described below

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4007 Risk-Sharing Mechanisms

The board has determined that the key risk facing the system is when actual experience diverges from actuarial assumptions. The following methods for sharing risk between the members and the city are included in the governing statute:

4007.01 Falling Costs Scenarios

If the estimated city contribution rate is lower than the corridor midpoint then:

- If the funded ratio is less than 90 percent, the city contribution rate for the fiscal year equals the corridor midpoint;
- If the funded ratio is equal to or greater than 90 percent and the city contribution is less than minimum contribution rate then the following adjustments shall be applied sequentially to the extent required to increase the estimated city contribution rate to equal the minimum contribution rate:
    - First, adjust the actuarial value of assets equal to the current market value of assets, if making the adjustment causes the city contribution rate to increase;
    - Second, under a written agreement between the city and the board entered into under Section 27 of this article not later than April 30 before the first day of the next fiscal year, reduce the assumed rate of return
    - third, under a written agreement between the city and the board entered into under Section 27 of this article no later than April 30 before the first day of the next fiscal year, prospectively restore all or part of any benefit reductions or reduce increased employee contributions, in each case made after the year 2017 effective date;
- If the funded ratio is equal to or greater than 100 percent
    - all existing liability layers, including the legacy liability, are considered fully amortized and paid
    - the applicable fiscal year is the payoff year for the legacy liability
    - for each fiscal year subsequent to the applicable fiscal year, the corridor midpoint shall be determined by a written agreement between the City and the Board;
- If the funded ratio is greater than 100 percent, then in a written agreement between the city and the pension system under Section 27 of the governing statute, the pension system may reduce member contributions or increase pension benefits if, as a result of the action:
    - the funded ratio is not less than 100 percent and
    - the city contribution rate is not more than the minimum contribution rate.

4007.02 Rising Costs Scenarios

- If the city contribution is greater to or equal to the corridor midpoint

- If the estimated city contribution rate is less than or equal to the maximum contribution rate for the corresponding fiscal year, the estimated city contribution rate is the city contribution rate;
- If the estimated city contribution rate is greater than the maximum contribution rate the following adjustments shall be applied sequentially to the extent required to decrease the estimated city contribution rate to equal the corridor midpoint:
    - Adjust the payoff year of the legacy liability to a payoff year not later than 30 years from the first day of the fiscal year beginning 12 months after the date of the risk sharing valuation study in which the liability loss layer is first recognized;
    - adjust the actuarial value of assets to the current market value of assets, if making the adjustment causes the city contribution rate to decrease,
- If the city contribution rate after adjustment detailed above is greater than the third quarter line, then the city contribution rate equals the third quarter line rate and the following adjustments are made:
    - The city and the board shall enter into a written agreement under Section 27 of the governing article to increase member contributions and make other benefits or plan changes not otherwise prohibited by applicable federal law or regulations.
    - If an agreement is not reached by April 30 before the first day of the next fiscal year, to the extent necessary to set the city contribution rate equal to the third quarter line, the board shall increase member contributions and decrease cost-of-living adjustments and/or increase the normal retirement age

- If the city contribution rate remains greater than the corridor midpoint in the third fiscal year after adjustments are made in accordance with the above sections, then the city contribution rate must be set at the corridor midpoint by:
    - Adjusting the actuarial value of assets to equal the current market value of assets, if making the adjustment causes the city contribution rate to decrease; and
    - Under a written agreement between the city and the board, increase member contributions and make other benefits or plan changes not otherwise prohibited by applicable federal law or regulations.
        - If agreement is not reached by April 30 before the first day of the next fiscal year, the board, to the extent necessary to set the city contribution rate equal to the corridor midpoint, shall increase member

contributions and decrease cost-of-living adjustments and/or increase the normal retirement age.

Below is a visual depiction.

{ Scenario 4 }

Maximum Contribution Rate[1]

{ Scenario 3 } 3rd Quarter Line[2]

Corridor Midpoint[3]

{ Scenario 1 }

Minimum Contribution Rate[4]

{ Scenario 2 }

FALLING COSTS		**RISING COSTS**	
Scenario 1: Inside Corridor – between Midpoint and Minimum	Scenario 2: Outside Corridor – below Minimum	Scenario 3: Inside Corridor – between Midpoint and Maximum	Scenario 4: Outside Corridor – above Maximum
• City Contribution Rate between Minimum and Midpoint **• Return to Midpoint If System <90% funded**	**• City Contribution Rate below Minimum** **• Implement prescribed remedies to increase City Contribution to Minimum**	**• City Contribution Rate between Midpoint and Maximum** **• City pays City Contribution Rate with no adjustments**	**• City Contribution Rate above Maximum** **• Implement prescribed remedies to decrease City Contribution to Midpoint**

[1] Maximum contribution rate - the rate equal to the corridor midpoint plus 5%.
[2] Third Quarter Line - corridor midpoint plus 2.5 %.
[3] Corridor Midpoint - the projected city contribution rate specified for each fiscal year for 31 years.
[4] Minimum contribution rate - the rate equal to the corridor midpoint minus 5%.

4008 Review of Funding Policy

4008.01 This policy may be amended from time-to-time to reflect changes in other board policies, emerging best practices for public defined benefit pension plans, prevailing opinions of future board members, and suggested changes by system stakeholders. Suggested changes to the policy may be submitted to the board in writing for consideration at future meetings.