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Can Texas Local Governments Afford Their Pension Obligations?

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Can Texas Local Governments Afford Their Pension Obligations?

For the vast majority of local Texas issuers, pension pressures will remain manageable compared with those of peers across the country. Although Texas issuers typically have very weak debt and contingent liability profiles, this is often attributable to local governments having high overall net debt as a percent of market value, rather than large pension obligations.

In general, local Texas governments continue to experience steady gains in market value and economic activity, which equate to growing revenue streams and stable-and-strong available reserve positions. Healthy reserves and greater financial flexibility will allow issuers to address long-term pension pressures. Overall, S&P Global Ratings believes Texas local governments have relatively low pension costs and participate in pension plans that are well funded.

Key Takeaways

- We do not anticipate any sectorwide pension pressure on issuers in the region in the near to medium term.
- Most Texas local governments participate in pension plans that are well funded.
- Strong economies and financial performance, coupled with low pension costs over the medium term, enable local issuers to meet their actuarially determined contribution (ADC) requirements without significant budgetary pressure.
- Some exceptions exist, particularly with large cities or single-employer plans.

Local Retirement Systems In Texas

Nearly all Texas local governments participate in one of three pension plans: the Texas Municipal Retirement System (TMRS), the Texas County and District Retirement System (TCDRS), or the Teachers Retirement System (TRS). Overall, these plans report healthy funded ratios, and while some plans use somewhat optimistic assumptions which could downplay expected costs (see "Local Government Pension And Other Postemployment Benefits Analysis: A Closer Look," published Nov. 8, 2017, on RatingsDirect), we do not believe that most local governments will face significant challenges or budgetary stress given currently relatively low-cost requirements. Although some large pension challenges do exist for municipalities in the state, the majority of those are linked to single-employer plans that are unique to specific localities. Historically many local Texas issuers have made 100% of their ADC without seeing a material increase in carrying costs, which we view as a credit strength. Furthermore, generally favorable statewide demographics and additional oversight by the Texas Pension Review Board provide further support for credit stability (see "Everything's Bigger In Texas, Including Potential Pressure To Fund Pension Benefits," published Feb. 8, 2018, on RatingsDirect). We do not anticipate any sectorwide pension pressure on issuers that participate in TMRS, TCDRS, or TRS in the near term.

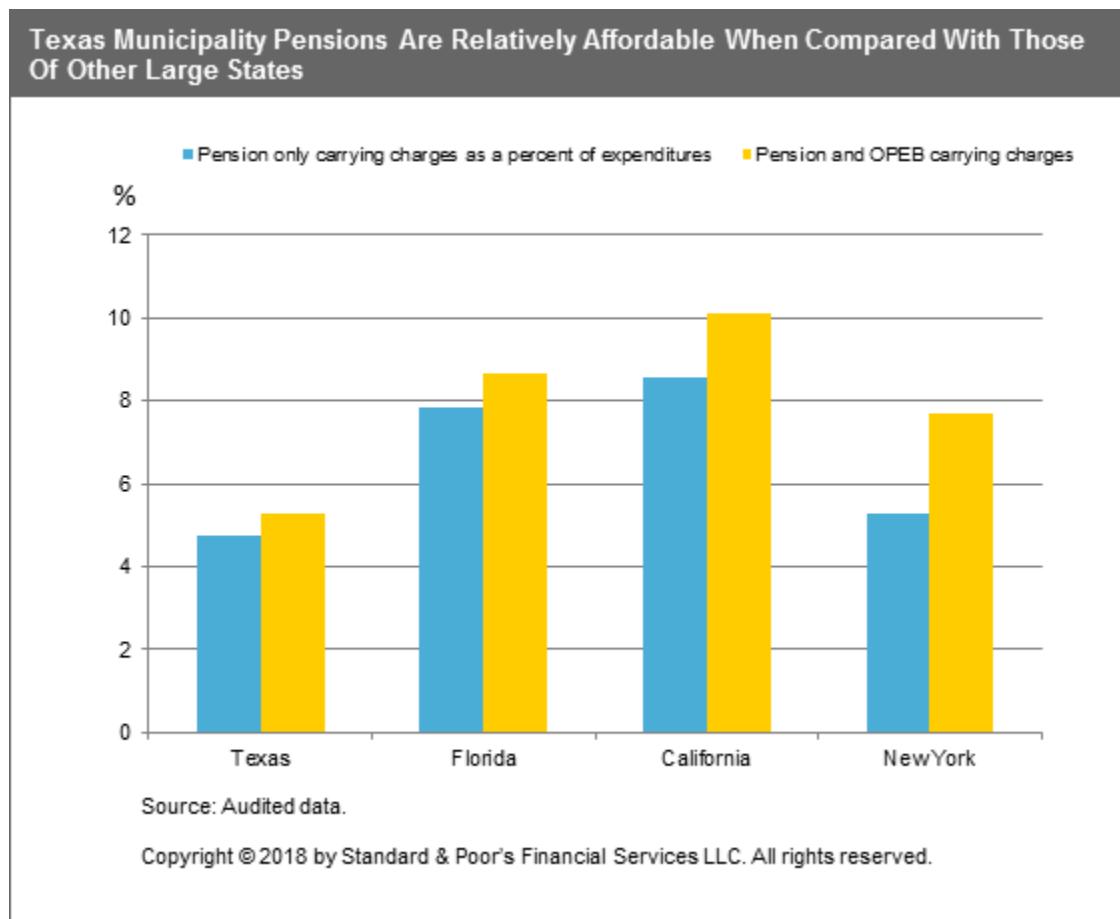
Texas Municipal Retirement System

Established in 1947, the TMRS is an agent multiple-employer retirement system. The plan provides retirement, disability and survivor benefits for employees of 866 municipalities in the state. Unlike the state's Employee Retirement System (ERS), TMRS does not receive contributions from the State of Texas. Municipalities may join voluntarily and include their own retirement plans and autonomy over benefits offered within the framework of the TMRS Act. Municipalities independently fund the plans along with their employees, as well as any investment earnings.

We believe the overall health of the system reflects reasonable assumptions, including a relatively conservative 6.75% assumed long-term rate of return. The plan also maintains an amortization policy that limits the amortization methods used by the individual cities. The assumed discount rate of 6.75% was decreased from 7.0% in the previous year (2015). Although the actual money weighted investment return of 7.55% in December 2016 exceeded the assumed rate, the plan experienced relatively weak returns, in our view, of 0.08% and 5.85% in the previous two years.

Generally, Texas municipalities have not faced significant challenges meeting ADC levels for the pension plan, nor do we anticipate any widespread pressure in the near-term. Pension carrying charges for Texas local governments average about 4.75% of operating expenditures, which is relatively low when compared with the same averages for cities in other large states like Florida and California, which are at 7.84% and 8.54% respectively.

Chart 1



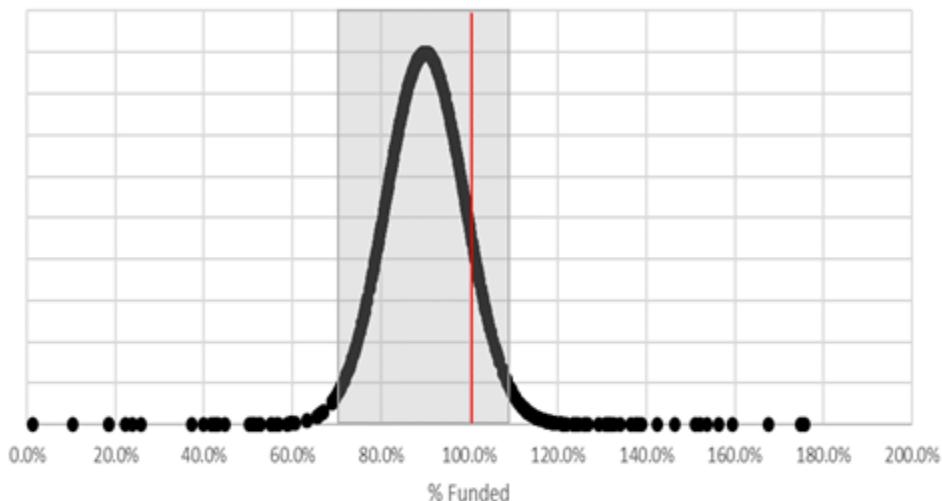
The Relative Strength Of Plans' Funded Status Is A Credit Positive

The funded status of most municipalities participating in TMRS remains relatively strong. As an agent multiple employer plan, the individual municipal funded ratio varies across participants.

As illustrated in chart 2 below, the actuarial funded ratios of pension plans for a good portion of Texas municipalities in TMRS is above 80%. There are even a handful that record an actuarial funded ratio above 100%. The actuarial funded ratio provides a general view of relative funded ratios, although we use the Governmental Accounting Standards Board (GASB) funded ratio (based on the fiduciary net position as a percent of the total pension liability) when analyzing individual municipality credit. An actuarial funded ratio in excess of 100% represents a high likelihood of a net pension asset reported in the city's financial statements. We understand the city's number of active versus inactive employees and amortization periods can vary significantly. While a handful of municipalities in the plan have actuarial funded ratios below 50%, a relatively small number of employees or relatively short amortization periods (below 10 years) indicate the risks are manageable.

Chart 2

Funded Ratios Distribution For TMRS-Participating Municipalities



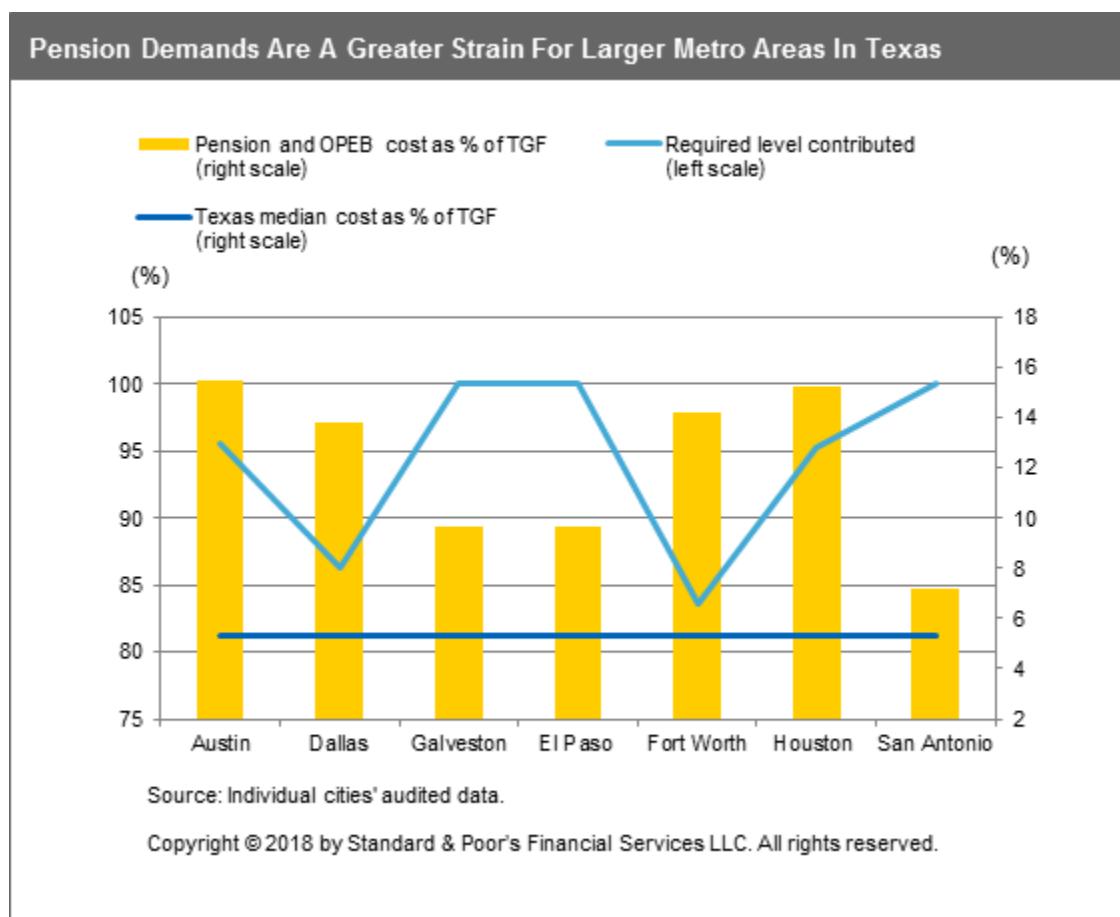
Source: TMRS Dec. 31, 2016 actuarial valuation. Chart depicts actuarial funded ratios for entire universe of Texas municipalities in TMRS.

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Individual City Plans

Most Texas cities are members of TMRS, but 17 cities also have single-employer plans that are enabled by either Texas statute or by city ordinances. These plans include those for certain employees of some of the state's largest metro areas including Austin, Dallas, El Paso, Fort Worth, Galveston, Houston, and San Antonio. In the summer of 2017, Dallas ('AA-') and Houston ('AA') enacted significant pension reforms to address the growing unfunded liabilities of the respective plans. The reforms include increases in city and employee contributions as well as benefit reductions. The effect of these single-employer plans on the cities is unique, as each plan has its own specific framework, benefits, contribution requirements and set of assumptions that present varying degrees of stress to the local governments.

Chart 3



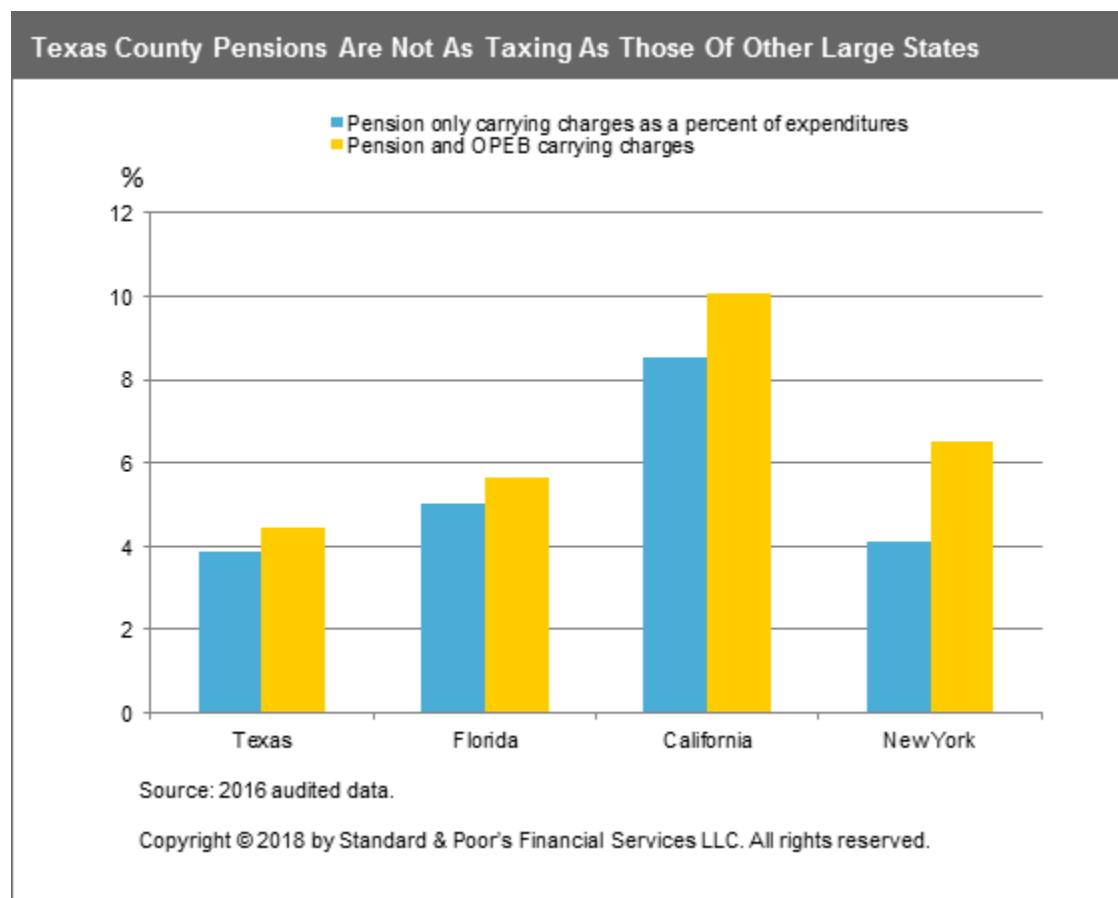
Texas County And District Retirement System

The TCDRS was established in 1967 and is an agent multiple-employer retirement system that provides retirement, disability and survivor benefits to 701 counties and districts, including water, hospital, appraisal and emergency service districts. Similar to TMRS, TCDRS does not receive funding from the state. Each employer plan is funded

independently by the county or district, its employees, and any investment earnings the plan's assets may accumulate. As an agent multiple employer plan, the actuarial funded ratio varies across individual participants. As of Dec. 31, 2016, the plan's system-wide aggregate funded ratio, on an actuarial basis, was at nearly 90%, which suggests a relatively healthy position overall under GASB standards. While TCDRS uses a relatively high assumed 8% rate of return, it also uses a closed amortization schedule with a relatively short 15-year amortization period to determine its required contribution rates. Participating counties and districts are required to pay 100% of their ADC every year. Employers can make additional contributions and have the ability to adjust their benefits annually to address their independent operational and financial priorities. TCDRS is a savings-based plan.

Similar to cities, counties and districts that have voluntarily joined TCDRS have not had significant challenges meeting pension contribution requirements. Strong reserve positions have allowed Texas counties and districts to increase pension expenditures without putting a significant near-term strain on budgets or liquidity. Given the individual nature of the plans, each plan and the local government's ability to meet funding requirements is unique. However, we don't anticipate any widespread challenges in the state.

Chart 4

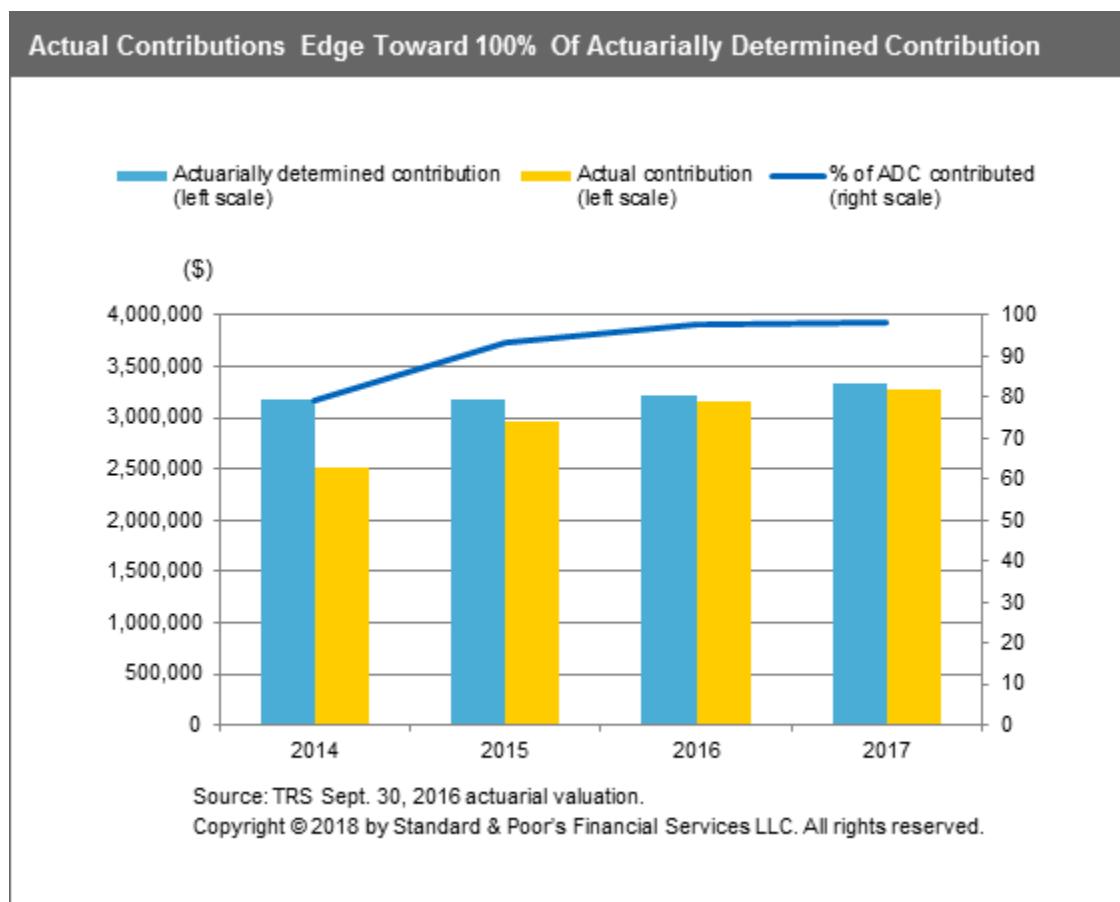


Teachers Retirement System

The TRS, a cost-sharing multiple-employer retirement system, was created in 1936 for the benefit of public school teachers, other public school employees, and certain higher-education personnel. TRS is Texas' largest public retirement system, in both membership and assets. While the plan is considered well-funded, with a funded ratio of 82.17% as of the Aug. 31, 2017, comprehensive annual financial report (CAFR), several of the plan's assumptions and methodologies, including the statutory contribution requirements, are considered optimistic in our view.

With a discount rate of 8.0%, TRS' assumed rate of return is higher than the national average of 7.5% and necessitates what we consider aggressive investment strategies ("Everything's Bigger In Texas, Including Potential Pressure To Fund Pension Benefits,"). In addition, contributions to the plan are statutorily determined amounts as a level percent of pay although, actual contributions have approximated actuarially determined amounts over the past four years (see chart 4). The plan's calculated amortization period of 34 years exceeds its targeted amortization of 30 years. This extended amortization, combined with the contributions based on a level percent of pay, means that the amortization payments are not sufficient to cover all of the interest charges on the unfunded portion of the liability for the first 14 years, or until the funding period reaches approximately 20 years. This is likely to lead to further growth of the net pension liability if the plan doesn't experience favorable performance compared with assumptions (such as assets outperforming the 8.0% assumed rate of return).

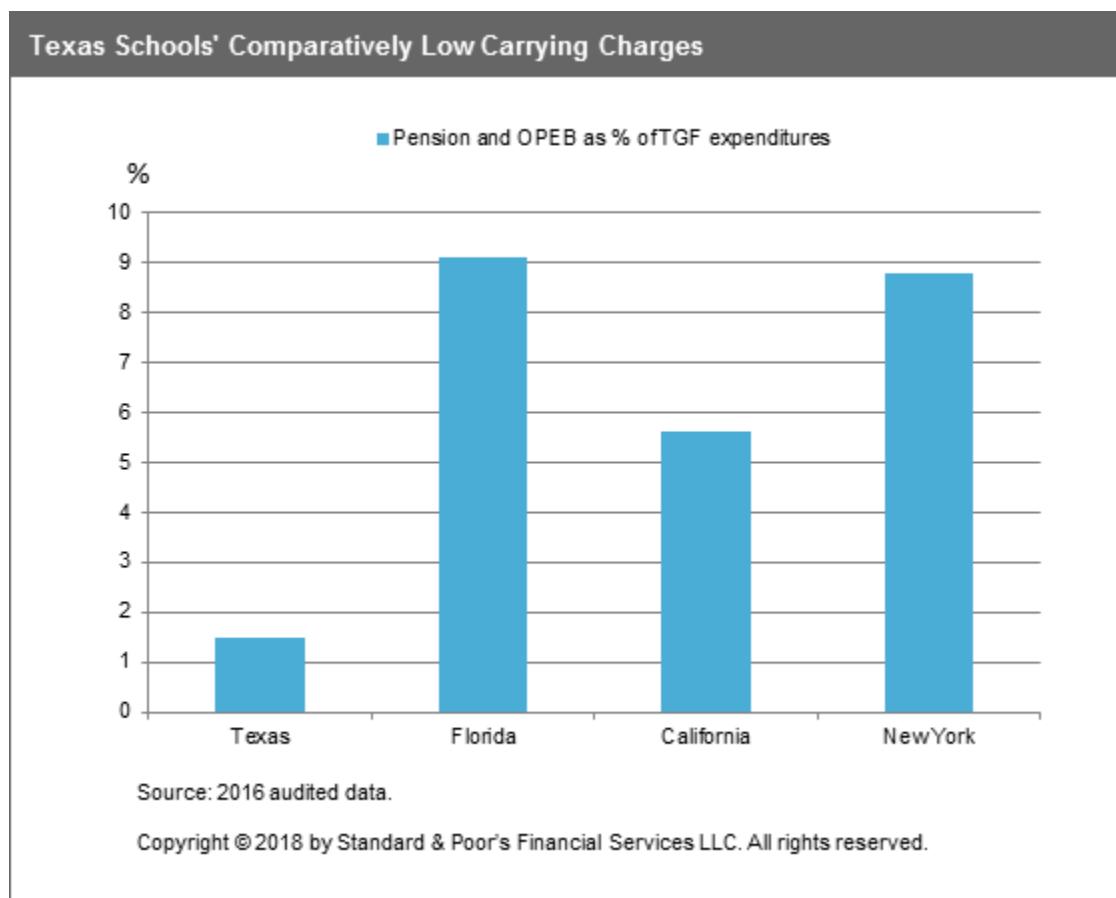
Chart 5



The State Is Unlikely To Place Further Pension Burden On Districts

Despite these shortcomings, we do not believe Texas school districts are facing significant pension-related budget stress. Districts generally feature low pension and other postemployment benefit carrying charges, with a median annual cost equal to 1.53% of total governmental funds expenditures. These low costs are largely attributable to the special funding situation that exists, whereby the state (as a non-employer contributing entity) pays a large portion of the plan's annual contributions. The state is required to contribute at a rate equal to the employer's rate, less certain adjustments (salaries funded by federal sources, during a member's first 90 days of employment, and for employees earning above the statutory minimum salary). While the state could shift some of this burden to the school districts, we believe this is unlikely given it would require an amendment to the state constitution.

Chart 6



Dipa Patel and Lauren Carter contributed research to this article.

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