The Dallas Public Pension Crisis:
A Warning for Cities Across Texas

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Our core objective is to improve the lives of individuals by strengthening our social, governmental, and economic systems.

Introduction

Dallas is in the midst of a financial crisis. The city's public pension debt has doubled in less than two years due to inadequate funding, irresponsible benefit enhancements, and poor investment decisions. The total unfunded liability is now at least $4 billion—and the plans do not have enough money to pay for nearly half of the retirement benefits workers have already earned.

The problems with the city's largest pension fund, the Dallas Police and Fire Pension System, are particularly acute. The plan, which is supposed to protect the retirement security of law enforcement officers and first responders, is nearly bankrupt and could run out of cash for benefit payments in the near future.

The most immediate issue is the recent "run on the bank." In the past six months, police officers and firefighters have withdrawn hundreds of millions of dollars in savings from the Deferred Retirement Option Program (DROP), a savings account provided to members of the police and fire fund when they reach retirement eligibility. There are urgent problems with DROP, but it won't be enough to focus on those issues alone.

The city must also address a number of underlying structural flaws in order to improve the pension system's financial stability and protect workers and taxpayers. These problems include the police and fire fund's broken governance structure, inadequate funding, and misguided investment practices.

One egregious example of how the plan has been mismanaged is the reckless decisions made by the police and fire fund's former leadership, who invested more than half of its assets in real estate, including high-risk properties such as luxury homes in Hawaii and a resort and vineyard in Napa, California. The city made less than it expected on these investments, which led to a nearly $1 billion investment shortfall, hundreds of millions of dollars in asset devaluations, and a reported Federal Bureau of Investigation (FBI) review.

The issues facing the police and fire fund alone present a serious threat to the city's fiscal health. However, these problems have been compounded by the fact that the Employees' Retirement Fund is also facing funding challenges. The plan, which serves municipal workers, holds more than $900 million in debt. Recently, it has failed to meet its investment return targets, and the city has not paid enough into the system to make up the difference, which has caused the unfunded liability to grow.

Now faced with the question of how to deal with ballooning pension costs, there are few options. The city's pension debt is already more than three times the general fund revenue, and the only way to balance the books will be to raise taxes, freeze or reduce wages and benefits for public workers, or cut programs and services.

It is clear that Dallas is in serious financial trouble. The city is at a tipping point. If local leaders do not take immediate steps to address the problem, there could be disastrous consequences.

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Although there are solutions that can help to put the city on a path to financial sustainability, officials don't have the tools they need to negotiate changes to the police and fire plan at the local level. The plan, like 12 other pension funds in Texas, is under the control of the state legislature. This creates problematic delays and means that elected representatives who may know little about the city's finances are making decisions that have a significant impact on those who live and work in the community.

In order to truly fix the pension problems, city leaders must obtain local control of the police and fire fund, take steps to stabilize DROP, and develop a plan to pay down the pension debt held by both plans. The crisis in Dallas should serve as a warning to cities across Texas, especially those with plans under state control, including Fort Worth, Houston, San Antonio, Austin, and El Paso. In a short time, Dallas' fiscal health has taken a serious turn for the worse, and dedicated public servants and taxpayers are likely to pay a hefty price.

History of the Police and Fire Fund

Although the municipal employees' retirement plan is nearly $1 billion in debt, the largest threat to the city's finances is the significant funding challenges facing the police and fire pension fund. In 2014, the Dallas police and fire plan reported that it was more than 75 percent funded, but just two years later, the funded ratio plummeted to 45 percent. Without meaningful reforms, the plan is projected to run out of money in 15 years or less.

Table 1. By 2015, Dallas' Pension Plans Faced Serious Funding Challenges

Plan	Pension Debt (in Millions)	Funded Ratio	Share of Total Shortfall	ADC* (in Millions)	Actual Contribution (in Millions)	Percent of ADC Contributed
Dallas Pension Plans	**$4,225**	**58.2%**	**100.0%**	**$220**	**$168**	**76.3%**
Employees' Retirement Fund of the City of Dallas	$935	77.4%	22.1%	$65	$51	78.5%
Dallas Police and Fire Pension System – Combined	$3,267	45.1%	77.3%	$153	$115	74.9%
Dallas Police and Fire Pension System – Supplemental	$23	45.8%	0.5%	$2	$2	100.0%

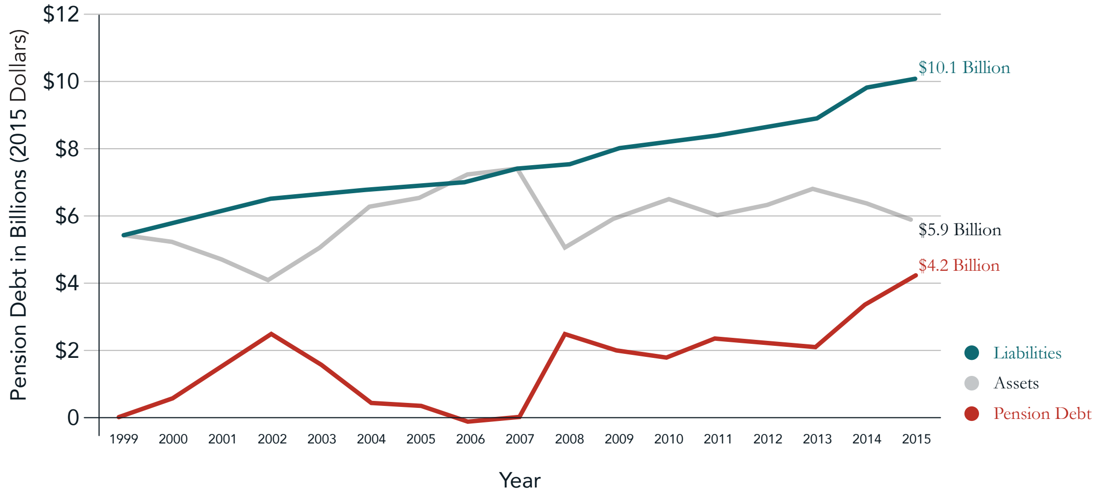
Dallas General Fund Revenue	**$1,150 Million**

Source: Authors' calculations; Employees' Retirement Fund and Police and Fire Pension System comprehensive annual financial reports; Employees' Retirement Fund and Police and Fire Pension System actuarial valuation reports; and "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board. *Actuarially Determined Contribution (ADC).

The acute funding issues can be traced back to several factors, including a series of bad investments made by the plan's former leadership. The former plan administrator, Richard Tettamant, transferred more than 50 percent of the portfolio into hard-to-value private equity and real estate investments in an effort to earn high returns. The big bets on Hawaiian estates, a California resort and vineyard, an infamous Dallas skyscraper known as the Museum Tower, and other properties failed to pay off. While other financial funds made double-digit gains during the bull market that followed the Great Recession, the police and fire plan posted average returns that were nearly a percentage point below its expected rate of return of 7.25 percent.

In 2011, as the plan began to rack up debt from its investment shortfalls, officials at the Nasher Sculpture Center noticed that a reflective glare from the nearby Museum Tower was causing damage to the center's sculpture garden. A protracted debate between the pension board and representatives of the center about how to fix the problem followed—often playing out in reports published by the local media.

Graph 1. Dallas' Pension Debt Doubled Between 2013 and 2015



Source: Authors' calculations; Employees' Retirement Fund and Police and Fire Pension System comprehensive annual financial reports; Employees' Retirement Fund and Police and Fire Pension System actuarial valuation reports; "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board; and Bureau of Labor Statistics. Note: Adjusted for inflation.

The public dispute led to increased scrutiny of the plan by local and city officials. Investigative media reports soon revealed that members of the fund's board and employees spent nearly $1 million on trips to Europe, the United Arab Emirates, and other places. News outlets also reported that the fund launched a fake social media campaign to make it appear as if the public supported the Museum Tower in the argument over the glare.

Local leaders launched their own inquiry into the fund's investments, but it took several years to uncover the true extent of the plan's underfunding, given that the city did not have local control of its own pension fund and therefore had limited information about the plan managers' actions. After the pension board voted to remove Tettamant in 2014, the plan's new managers conducted an extensive review of its portfolio. They found that the former leadership had overvalued the fund's assets and used accounting gimmicks to hide millions of dollars in debt. The review resulted in hundreds of millions of dollars in write-downs of its real estate holdings, which drew the attention of federal investigators. Earlier this year, the FBI raided the offices of the former outside advisory firm, investigating "multiple breaches" of fiduciary responsibilities.[1]

At the same time that the former plan managers' alleged misconduct came to light, it also became clear that the plan had failed to account for several cost drivers when calculating the amount the city should pay into the pension system. In other words, although Dallas made

1 Michael Granberry. (Sept. 25, 2016). "Fights, fantasy fixes and the FBI: Museum Tower and Nasher still at odds over glare after five years." *Dallas Morning News*. Retrieved from http://www.dallasnews.com/arts/museums/2016/09/25/fights-fantasy-fixes-fbi-museum-tower-nasher-still-odds-glare-five-years

payments to the police and fire fund, its contributions were not enough to cover the true cost of workers' benefits and the plan's debt. This further exacerbated the problems caused by its investment shortfalls.

The most significant miscalculation was that DROP, which was created to help the police and fire departments retain experienced employees, proved to be much more expensive than officials originally anticipated. The program is intended to be an incentive for experienced employees to keep them in the workforce and offers workers who are eligible to retire a guaranteed investment return in exchange for deferring their pension benefits. Employees can choose to withdraw their savings immediately upon retirement or leave them in the fund in perpetuity. When an employee *does* withdraw the funds in his or her account, the savings and guaranteed investment returns are paid out as a lump sum in addition to the individual's monthly annuity benefit.

These types of accounts can be sustainable if designed properly. However, the program in Dallas became a serious financial liability after several significant enhancements were made. During the late 1990s, the plan increased its guaranteed interest rates, setting levels between 8 and 10 percent, and expanded eligibility requirements. Then in 2001, members of the police and fire plan made further amendments to the investment rate provision by tying the rate to the 10-year average of the police and fire pension system's returns. State statute allows the members to unilaterally increase benefits through a two-thirds majority vote, and the members were able to make these changes without the approval of city officials or taxpayers.

The result was that returns remained high even during years in which the market did not perform well. This created significant problems during the Great Recession, when plan members kept earning returns of 9.75 and 10 percent based on the fund's prior strong performance. The guaranteed interest rate and the pension plan's actual returns have continued to diverge in recent years, which has put the fund even deeper in the hole.

The grave miscalculations regarding the police and fire plan's governance, funding, and investment policies are now threatening its financial stability. Amid concerns about the fund's solvency and potential changes that would make it more difficult for retirees to access their DROP balances, public safety workers have withdrawn or requested more than $300 million from DROP accounts in the last several months.

More than 50 percent of the plan's total remaining assets are attributable to DROP accounts. Given that the plan is severely underfunded and a considerable amount of its other capital is invested in illiquid assets such as real estate and private equity funds, it could face a severe cash-flow problem in the near future if the run continues.

While Dallas must take immediate steps to stabilize DROP, much more is needed to address the police and fire fund's underlying issues. In particular, there are two structural problems that will cause the debt to continue to grow.

First, as the plan's funded ratio decreased over the past few years, Dallas' actuarially determined contribution—or the amount that is needed to pay down the debt and cover benefits for current employees—has skyrocketed to an unprecedented 79 percent of payroll. However, state statute caps the city's contribution level at 28.5 percent of payroll, which is less than half of what it should now be paying given the enormous unfunded liability. If Dallas keeps failing to make adequate payments into the pension system, the debt will increase dramatically.

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Second, the debt will balloon if the plan misses its investment targets and the city fails to make up the difference. This is important to consider given that the police and fire fund's expected rate of return is almost three times greater than the risk-free rate of return. In other words, Dallas is betting on returns it is very unlikely to achieve.

The Current Situation

Even under the best-case scenario, Dallas' pension debt will have serious consequences for workers and taxpayers. Put simply, rising pension costs will affect the city's ability to recruit and retain workers and provide public services. It could also undercut the region's long-term economic growth. Dallas will have less money to devote to police and fire departments, libraries, parks, and other programs. There will be less discretionary funding to invest in infrastructure improvements that could help to attract new residents and employers. And it will be more difficult for the city to put money aside in order to weather economic downturns or to deal with financial emergencies.

The budget crunch also presents a considerable risk to the city's other pension plan, the Employees' Retirement Fund, which currently holds more than $900 million in pension debt and is only 77 percent funded. Although the plan is in a better financial position than the police and fire fund, it faces many of the same structural problems.

Between 2010 and 2015, Dallas contributed *at least* $74 million less than the amount it needed to pay in order to maintain the fiscal health of the employees' fund. Like making the minimum payments on a credit card, this only means that it will cost much more to pay off the debt in the long run. Indeed, during the same period, the city's actuarially determined contributions nearly doubled.

The underfunding, coupled with the fact that the fund is banking on investment returns of 8 percent, a figure that it is unlikely to achieve over either the short or long term, have put the employees' plan on shaky ground. Without reform, the debt is projected to grow, placing municipal workers' retirement security at risk.

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The bottom line is that the pension debt held by both the employees' plan and the police and fire fund will impact the city for years to come. Left with few options to balance the budget and cover rising pension costs, taxpayers could face tax hikes, while police officers, firefighters, and other public servants could face wage and benefit reductions.

Graph 2. Pension Debt is 3.5 Times Greater than General Fund Revenue

Source: Authors' calculations; Employees' Retirement Fund and Police and Fire Pension System comprehensive annual financial reports; Employees' Retirement Fund and Police and Fire Pension System actuarial valuation reports; and "Guide to Public Retirement Systems in Texas" by the Texas Pension Review Board.

Indeed, police and fire pension plan officials are considering requesting a $1 billion cash payment from the city, which would require Dallas to raise taxes or cut services.[2] Members of both pension plans may also face benefit cuts. Administrators of the employees' plan have proposed capping annual Cost of Living Adjustments, increasing the age at which members reach retirement eligibility, and reducing benefit levels for new employees.

Members of the police and fire fund are considering changes that would increase the amount they contribute to pensions, cap annual Cost of Living Adjustments, reduce the guaranteed interest rate offered to DROP members, and limit the amount of time workers can participate in DROP to 10 years. However, these changes alone will not be enough to solve the problems with the police and fire plan, and the plan's actuaries estimate that the changes will only push back, by a few years, the date at which it is expected to run out of money.

Dallas cannot afford to make incremental fixes, especially given that the pension debt is already causing serious problems. At a recent public meeting, the police and fire pension board announced that it will seek more than $36 million from the city to cover its operations costs. The request came as Fitch Ratings and Moody's Investors Service downgraded the city's credit rating for the second year in a row, citing the pension debt as the primary reason for the downgrades.

2 Tristan Hallman. (Oct. 21, 2016). "Dallas Police and Fire Pension benefit cuts will only be the beginning of solution for 'big, hairy mess.'" *Dallas Morning News*. http://www.dallasnews.com/news/news/2016/10/20/dallas-police-fire-pension-benefit-cuts-will-beginning-solution-big-hairy-mess

While the issues in Dallas would be challenging for any city, they come at a particularly difficult time for the local community after the tragic July shooting in which five local law enforcement officers lost their lives. As the city seeks to identify ways to protect its dedicated emergency personnel, it must take into account the fact that, left unchecked, pension debt will become a tremendous burden for the police and fire departments.

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Solutions

There is no easy fix for Dallas' pension problems. Any viable solution will require shared sacrifice between workers, taxpayers, and the government. Therefore, it is important that local leaders engage all stakeholders in developing a fair plan to pay down the pension debt and to create a sustainable retirement system going forward. Furthermore, any reform plan must address both the immediate challenges and systemic issues.

In the short term, plan managers must find a reasonable way to limit withdrawals from the police and fire DROP so that the fund does not experience a massive cash flow problem. If withdrawals continue at the current rate or accelerate, they will affect the plan's ability to make benefit payments. The pension board has yet to take meaningful action to address this problem and is currently relying on plan members' goodwill to keep the fund solvent, which is jeopardizing workers' retirement security.

While stabilizing DROP is important, much more is needed to truly solve Dallas' pension problems. One serious obstacle to improving the system is the fact that local leaders do not have all of the tools they need to develop comprehensive, balanced reforms. Although the municipal employee retirement fund is codified under a city ordinance that allows local leaders to negotiate directly with workers, the city's ability to enact changes to the police and fire fund at the local level is limited because the plan is controlled by the state. Under this arrangement, local leaders must seek legislative approval to make changes to the plan, such as increasing the city's contribution rate or adjusting benefits.

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In order to address the systemic flaws and prevent problems from arising again in the future, Dallas must obtain local control of its police and fire plan. This would give the city the authority to change the plan's governance structure and design, ensuring its long-term sustainability. The city would also have the flexibility it needs to respond to changing economic or demographic trends.

Once policymakers have local control of the pension system, the city and plan managers must make fundamental reforms to its funding and investment policies so as to protect the retirement security of public workers.

1. First, the city must adopt a better funding policy. It must make adequate funding non-negotiable and should commit to paying down its current unfunded liabilities in 30 years or less. Going forward, it should commit to paying down any new debt in 20 years or less, as recommended by the Society of Actuaries Blue Ribbon Panel on Pension Funding. The city should also require that the plans use more conservative assumptions for calculating annual contributions to ensure that the payments cover the full costs of workers' benefits.

2. Second, plan managers must establish prudent investment policies that take into account market risk as well as the city's ability to make up for investment shortfalls. These policies should also set appropriate limits on asset allocation and fees.

3. Third, the city should consider enrolling new workers in plans that are simpler and easier to manage, like a Defined Contribution or Cash Balance plan. Both types of plans can be designed to place workers on a path to a secure retirement while also protecting the city's financial interests.

Local leaders should also work with state legislators to ensure that other communities do not find themselves facing the same critical pension challenges. Texas has failed to hold its local governments accountable for making responsible retirement payments, and by their own estimates, municipal governments across the state owe $18 billion in pension debt for retirement benefits workers have already earned.

This debt presents a serious financial problem that could damage the state's long-term economic health. State leaders should learn from Dallas' mistakes and enact reforms that will set non-negotiable minimum annual funding requirements for cities, strengthen plan reporting requirements, and simplify the regulatory environment for municipal plans.

The pension challenges facing cities across Texas are urgent, but they can also be solved. City leaders in Dallas and in other communities, in partnership with state leaders, must take action now. They must the address the crisis in Dallas and the looming problems in other areas of the state before they become too big to fix.