

Memorandum



CITY OF DALLAS

DATE May 1, 2020

TO Honorable Mayor and Council Members

SUBJECT **Moody's Investors Service Recognizes Dallas Police & Fire Pension System
Federal Appeals Court Ruling as 'Credit Positive' - INFORMATION**

Today, Moody's Investors Service (Moody's) released a brief Issuer Comment article regarding the credit positive impact of the Fifth US Circuit Court of Appeals ruling upholding certain changes to the Dallas Police & Fire Pension System's (DPFP) Deferred Retirement Option Plan (DROP). Moody's considers the ruling a credit positive to the City of Dallas in that, "it provides near certainty that the removal of participants' lump-sum withdrawal options in 2017 was permissible, eliminating a potential liquidity risk for the system and ultimately the city's budget." According to Moody's report, "pensions are a significant credit challenge for Dallas," and "had the court ruled differently, DPFP participants could have resumed large withdrawals from the pension system, potentially threatening the system's near-term solvency."

Previously, the DPFP board of trustees ended lump-sum DROP benefit withdrawals starting in 2017 and in March 2018, a lower federal court ruled that the decision was permissible in response to a lawsuit filed by several DPFP plan participants. Following an appeal, the case was elevated to the Supreme Court of Texas for review. Moody's notes that, "Texas' highest court ruled that the changes were permissible under the Texas Constitution, and the federal appeals court similarly ruled that the action by the DPFP board did not violate the US Constitution."

This article is not a rating change from Moody's but reflects the positive impact of the federal appeals court ruling and prudent benefit changes that have helped stabilize the DPFP in an especially challenging time for municipal governments. Please let me know if you need additional information.

M. Elizabeth Reich
Chief Financial Officer

[Attachment]

T.C. Broadnax, City Manager
Chris Caso, City Attorney
Mark Swann, City Auditor
Biliera Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizzor Tolbert, Chief of Staff to the City Manager
Majed A. Al-Ghafry, Assistant City Manager

Jon Fortune, Assistant City Manager
Joey Zapata, Assistant City Manager
Nadia Chandler Hardy, Assistant City Manager
Dr. Eric A. Johnson, Chief of Economic Development & Neighborhood Services
Laila Alequresh, Chief Innovation Officer
M. Elizabeth (Liz) Cedillo-Pereira, Chief of Equity and Inclusion
Directors and Assistant Directors

ISSUER COMMENT

1 May 2020

 Rate this Research

Contacts

Thomas Aaron +1.312.706.9967
VP-Sr Credit Officer
 thomas.aaron@moodys.com

Denise Rappmund +1.214.979.6865
VP-Senior Analyst
 denise.rappmund@moodys.com

CLIENT SERVICES

Americas 1-212-553-1653

Asia Pacific 852-3551-3077

Japan 81-3-5408-4100

EMEA 44-20-7772-5454

Dallas (City of) TX

Federal appeals court hands City of Dallas another win on pension changes

On 27 April, the Fifth US Circuit Court of Appeals upheld certain changes to the Dallas Police & Fire Pension System's (DPFP) Deferred Retirement Option Plan (DROP). The ruling is credit positive for the [City of Dallas](#) (A1 stable) because it provides near certainty that the removal of participants' lump-sum withdrawal options in 2017 was permissible, eliminating a potential liquidity risk for the system and ultimately the city's budget.

Had the court ruled differently, DPFP participants could have resumed large withdrawals from the pension system, potentially threatening the system's near-term solvency. The DPFP previously faced a solvency crisis because many large lump-sum withdrawals by participants from their DROP accounts followed investment losses in real estate and other alternative asset classes in 2014 and 2015.

A renewed threat to the DPFP's near-term solvency could have forced the city to prop up the system's asset base with unexpectedly high contributions at a particularly inopportune time, given the budget challenge that Dallas – like all local governments – faces because of the coronavirus-driven economic downturn. With the federal appeals court confirming the halt to lump-sum withdrawals was permissible, the risk of near-term insolvency is now almost certainly eliminated. The chances that the plaintiffs can successfully appeal to the US Supreme Court are exceptionally low, should they make an attempt.

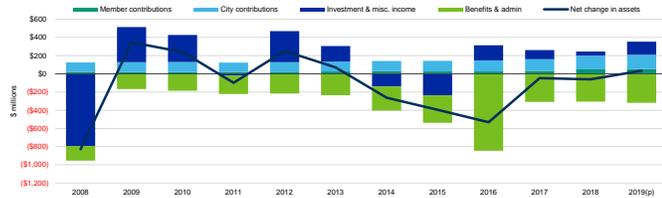
Pensions are a significant credit challenge for Dallas. While the DPFP is one of the city's two pension systems, it accounts for roughly two-thirds of Dallas' adjusted net pension liability (ANPL). As of its fiscal 2019 (ended 30 September 2019) reporting and based on a 4.22% discount rate, Dallas' ANPL was \$6.2 billion, 394% of its revenue. Its reported net pension liability, based on a weighted-average 6.73% discount rate, was \$3.8 billion. In fiscal 2019, pension contributions consumed around 12% of the city's operating revenue.

On a long-term funding basis, the lump-sum benefit withdrawals are neutral to the pension system and the city's unfunded pension liability because total liabilities fall by an amount commensurate with each withdrawal. On a near-term basis, however, heavy withdrawals would pose a threat to the DPFP's solvency, in part because the system struggles to unwind its heavy asset allocation to real assets and other alternatives.

While [2020 market volatility](#) has the potential to present a new challenge, the system's annual cash flow and asset base have nonetheless stabilized in recent years, in large part because of higher contributions and benefit changes, including the halt of lump-sum DROP withdrawals. The system's net cash flows were close to zero in 2017, 2018 and 2019, a significant improvement from the heavy declines in 2014 through 2016 (see Exhibit 1). As a

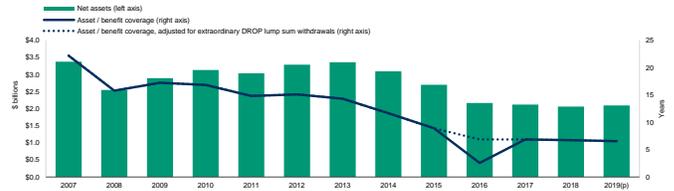
result, the system's asset base and the size of assets compared with benefit outflows, which we call "asset/benefit coverage," have significantly stabilized (see Exhibit 2).

Exhibit 1
Cash flow of Dallas' Police & Fire Pension System has improved since heavy withdrawals in 2016...



2019 results are preliminary.
 Source: Dallas Police & Fire Pension System financial reports

Exhibit 2
...and the system's asset position has stabilized as a result



Source: Dallas Police & Fire Pension System financial reports

DROP programs generally allow employees to continue working at the end of their careers and concurrently receive pension benefits rather than credit for additional service time. Rather than being sent to employees, however, the payments accumulate in a DROP account held by the pension system (often credited with interest) that can be taken as a lump sum or as a supplement to normal retirement benefits when employees stop working. The DFPF DROP program offered very high rates of guaranteed interest, ranging from 6% to 10% annually from 2008 to 2017, and allowed on-demand lump-sum withdrawals by DROP participants. At their peak in 2016, DROP accounts were more than half of the DFPF's assets.

In addition to numerous other benefit changes and higher city contributions that have helped to stabilize the DFPF, its board of trustees ended lump-sum benefit withdrawals starting in 2017. Since then, participants in the system must collect their DROP balances in the form of annuities. Several DFPF participants filed a lawsuit in federal court seeking to have their lump-sum DROP withdrawal option reinstated. In March 2018, a lower federal court ruled that the elimination of the lump-sum withdrawal feature was permissible because it did not impair DROP benefits but, rather, just altered the timing of their distribution.

After receiving the plaintiffs' appeal, the federal appeals court asked the Supreme Court of Texas to review whether the DFPF board of trustees violated the state's constitution when it altered the method by which participants could withdraw their DROP balances. Texas' highest court ruled that the changes were permissible under the Texas Constitution, and the federal appeals court similarly ruled that the action by the DFPF board did not violate the US Constitution. In March 2019 and in a separate case, the Supreme Court of Texas also decided that reductions to the interest rate applied to DROP account balances was permissible.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

© 2020 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND/OR ITS CREDIT RATINGS AFFILIATES ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND MATERIALS, PRODUCTS, SERVICES AND INFORMATION PUBLISHED BY MOODY'S (COLLECTIVELY, "PUBLICATIONS") MAY INCLUDE SUCH CURRENT OPINIONS. MOODY'S INVESTORS SERVICE DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT OR IMPAIRMENT. SEE MOODY'S RATING SYMBOLS AND DEFINITIONS PUBLICATION FOR INFORMATION ON THE TYPES OF CONTRACTUAL FINANCIAL OBLIGATIONS ADDRESSED BY MOODY'S INVESTORS SERVICE CREDIT RATINGS. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS, NON-CREDIT ASSESSMENTS ("ASSESSMENTS"), AND OTHER OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. AND/OR ITS AFFILIATES. MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS DO NOT COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS, ASSESSMENTS AND OTHER OPINIONS AND PUBLISHES ITS PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS, AND PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS OR PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER. ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

MOODY'S CREDIT RATINGS, ASSESSMENTS, OTHER OPINIONS AND PUBLICATIONS ARE NOT INTENDED FOR USE BY ANY PERSON AS A BENCHMARK AS THAT TERM IS DEFINED FOR REGULATORY PURPOSES AND MUST NOT BE USED IN ANY WAY THAT COULD RESULT IN THEM BEING CONSIDERED A BENCHMARK.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing its Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY CREDIT RATING, ASSESSMENT, OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any credit rating, agreed to pay to Moody's Investors Service, Inc. for credit ratings opinions and services rendered by it fees ranging from \$1,000 to approximately \$2,700,000. MCO and Moody's investors Service also maintain policies and procedures to address the independence of Moody's Investors Service credit ratings and credit rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold credit ratings from Moody's Investors Service and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

Additional terms for Australia only: Any publication into Australia of this document is pursuant to the Australian Financial Services License of MOODY'S affiliate, Moody's Investors Service Pty Limited ABN 61 003 399 657AFSL 336969 and/or Moody's Analytics Australia Pty Ltd ABN 94 105 136 972 AFSL 383569 (as applicable). This document is intended to be provided only to "wholesale clients" within the meaning of section 761G of the Corporations Act 2001. By continuing to access this document from within Australia, you represent to MOODY'S that you are, or are accessing the document as a representative of, a "wholesale client" and that neither you nor the entity you represent will directly or indirectly disseminate this document or its contents to "retail clients" within the meaning of section 761G of the Corporations Act 2001. MOODY'S credit rating is an opinion as to the creditworthiness of a debt obligation of the issuer, not on the equity securities of the issuer or any form of security that is available to retail investors.

Additional terms for Japan only: Moody's Japan K.K. ("MJKK") is a wholly-owned credit rating agency subsidiary of Moody's Group Japan G.K., which is wholly-owned by Moody's Overseas Holdings Inc., a wholly-owned subsidiary of MCO. Moody's SF Japan K.K. ("MSFJ") is a wholly-owned credit rating agency subsidiary of MJKK. MSFJ is not a Nationally Recognized Statistical Rating Organization ("NRSRO"). Therefore, credit ratings assigned by MSFJ are Non-NRSRO Credit Ratings. Non-NRSRO Credit Ratings are assigned by an entity that is not a NRSRO and, consequently, the rated obligation will not qualify for certain types of treatment under U.S. laws. MJKK and MSFJ are credit rating agencies registered with the Japan Financial Services Agency and their registration numbers are FSA Commissioner (Ratings) No. 2 and 3 respectively.

MJKK or MSFJ (as applicable) hereby disclose that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by MJKK or MSFJ (as applicable) have, prior to assignment of any credit rating, agreed to pay to MJKK or MSFJ (as applicable) for credit ratings opinions and services rendered by it fees ranging from JPY125,000 to approximately JPY250,000,000.

MJKK and MSFJ also maintain policies and procedures to address Japanese regulatory requirements.