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

M. Elizabeth Reich
Chief Financial Officer

[Attachment]

T.C. Broadnax, City Manager
Chris Caso, City Attorney
Mark Swann, City Auditor
Bilierae Johnson, City Secretary
Preston Robinson, Administrative Judge
Kimberly Bizor 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
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1 May 2020

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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.

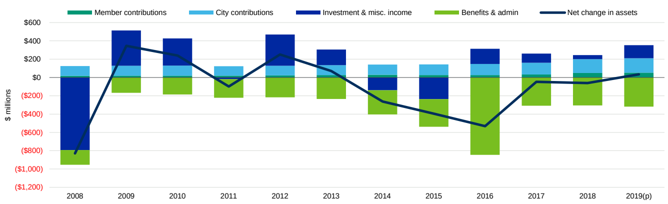
Pensions are a significant credit challenge for Dallas. While the DPFP is one of the city's two pension systems, it accounts for roughly two-thirds of Dallas' adjusted net pension liability (ANPL). As of its fiscal 2019 (ended 30 September 2019) reporting and based on a 4.22% discount rate, Dallas' ANPL 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

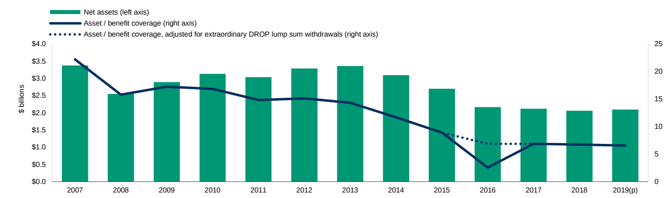
Cash flow of Dallas' Police & Fire Pension System has improved since heavy withdrawals in 2016…



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 DPFP 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 DPFP's assets.

In addition to numerous other benefit changes and higher city contributions that have helped to stabilize the DPFP, 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 DPFP 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 DPFP 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 DPFP 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.

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