



HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN
Financial Statements and Required Supplementary Information
December 31, 2016 and 2015
(With Independent Auditors' Report Thereon)

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

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KPMG LLP
811 Main Street
Houston, TX 77002

Independent Auditors' Report

The Board of Trustees
Harris County Hospital District, dba Harris Health System:

We have audited the accompanying statements of fiduciary net position of the Harris County Hospital District Pension Plan (the Plan) as of December 31, 2016 and 2015, and the related statements of changes in fiduciary net position for the years then ended and the notes to the financial statements.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with U.S. generally accepted accounting principles; this includes the design, implementation, and maintenance of internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error.

Auditors' Responsibility

Our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditors' judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. Accordingly, we express no such opinion. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of significant accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements referred to above present fairly, in all material respects, the Harris County Hospital District Pension Plan's fiduciary net position as of December 31, 2016 and 2015, and the changes in fiduciary net position for the years then ended, in accordance with U.S. generally accepted accounting principles.

Emphasis of Matters

As discussed in note 2 to the financial statements, the Plan implemented the provisions of Government Accounting Standards Board Statement No. 72, *Fair Value Measurement and Application*, for the year ended December 31, 2016. Our opinion is not modified with respect to this matter.



Other Matters

Required Supplementary Information

U.S. generally accepted accounting principles require that the management's discussion and analysis and the schedule of changes in net pension liability and related ratios, the schedule of investment returns, the schedule of employer contributions, and the notes to required supplementary information on pages 3–5, 22–25 be presented to supplement the basic financial statements. Such information, although not a part of the basic financial statements, is required by the Governmental Accounting Standards Board who considers it to be an essential part of financial reporting for placing the basic financial statements in an appropriate operational, economic, or historical context. We have applied certain limited procedures to the required supplementary information in accordance with auditing standards generally accepted in the United States of America, which consisted of inquiries of management about the methods of preparing the information and comparing the information for consistency with management's responses to our inquiries, the basic financial statements, and other knowledge we obtained during our audit of the basic financial statements. We do not express an opinion or provide any assurance on the information because the limited procedures do not provide us with sufficient evidence to express an opinion or provide any assurance.

KPMG LLP

Houston, Texas
June 29, 2017

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Management's Discussion and Analysis (Unaudited)

December 31, 2016 and 2015

As management of the Harris County Hospital District, d/b/a Harris Health System (the System), we offer readers of the Harris County Hospital District Pension Plan (the Plan) financial statements, this narrative overview and analysis of the financial activities of the Plan for the years ended December 31, 2016 and 2015.

Financial Highlights

Net position of the Plan as of December 31, 2016, 2015, and 2014 were \$594,401,173, \$564,716,739, and \$584,261,265, respectively. These net assets are restricted for use for the payment of future employee pension benefits.

The Plan's net position available for benefits increased \$29,684,434 for the year ended December 31, 2016. Net position decreased \$19,544,526 and increased \$31,614,823 for the years ended December 31, 2015 and 2014, respectively.

Contributions to the Plan are made solely by the employer, the System, as determined by the Plan's actuaries based on future obligations and required funding to meet those obligations. These contributions totaled \$32,693,266, \$31,758,544, and \$31,292,164 for the years ended December 31, 2016, 2015, and 2014, respectively.

The Plan's total investment income (loss) in 2016, 2015, and 2014 was \$39,528,831, (\$4,891,065), and \$37,067,888, yielding a total return on investment of 6.6%, (0.8)%, and 6.8%, respectively. Investment income consists of interest, dividend income, and net appreciation (depreciation) in the fair value of investments. The net appreciation in fair value on investments in 2014 reflected more stabilized market conditions as compared to 2015. In 2015, the Plan's fund performance reflected waning equity market momentum and a rise in volatility, and in 2016, global and U.S. economic activity firmed. A detail of the asset allocation for the years ended December 31, 2016, 2015, and 2014 was as follows:

	2016	2015	2014
Domestic equities (common stock)	37%	52%	52%
International equities (common collective trust and mutual fund)	25	18	17
Fixed income investment (common collective trust, mutual fund, and fixed income securities)	33	30	31
Hedge funds (common collective trust)	5	—	—
Total	100%	100%	100%

Benefit payments are the primary expense of the Plan. Such payments totaled \$40,177,655, \$44,023,057, and \$34,443,693 for the years ended December 31, 2016, 2015, and 2014, respectively. Calendar 2016 payments included \$420,827 in lump-sum payouts to 120 terminated vested participants. Calendar 2015 payments included \$5,931,488 in lump-sum payouts to 368 participants.

Other expenses of the Plan include administrative and investment expenses, which totaled \$2,360,108, \$2,388,948, and \$2,301,536 for the years ended December 31, 2016, 2015, and 2014, respectively.

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Management's Discussion and Analysis (Unaudited)

December 31, 2016 and 2015

Overview of the Financial Statements

Our discussion and analysis is intended to serve as an introduction to the Plan's basic financial statements. The Plan's financial statements are composed of financial statements and notes to the financial statements. The financial statements consist of two statements: (1) statements of fiduciary net position and (2) statements of changes in fiduciary net position. These statements present information on all the Plan's assets and liabilities with the difference between the two reported as net position restricted for pensions. Over time, increases or decreases in net position restricted for pensions may serve as a useful indicator of whether the financial position of the Plan is improving or deteriorating. The statements of changes in fiduciary net position present information showing how the Plan's net position restricted for pensions changed during the year. The notes provide additional information that is essential to a full understanding of the data provided in the financial statements.

Investment Policy

The Plan's investment policy requires the Plan to maintain target asset allocation and ranges for the total fund. The asset allocation and ranges are as follows:

	Target	Range
Domestic equities	35%	23–47%
International equities	25	18–32
Fixed income investments	35	23–47
Hedge funds	5	3–7
Total	100%	

The Plan's investment policy was adhered to during the years ended December 31, 2016, 2015, and 2014.

Fiduciary Net Position

	2016	2015	2014
Cash	\$ 2,834	—	12,810
Common stocks	213,391,279	284,301,375	294,298,880
Mutual funds	205,053,791	125,068,078	144,302,037
Common collective trust	83,144,599	53,196,480	135,613,263
Fixed income securities	84,385,114	88,238,574	—
Short-term investments	17,882,843	17,002,973	10,179,183
Accrued income and other	2,643,383	1,312,693	656,981
	606,503,843	569,120,173	585,063,154
Accrued expenses and other	(12,102,670)	(4,403,434)	(801,889)
Net position restricted for pensions	\$ 594,401,173	564,716,739	584,261,265

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Management's Discussion and Analysis (Unaudited)

December 31, 2016 and 2015

Changes in Fiduciary Net Position

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Beginning balance	\$ 564,716,739	584,261,265	552,646,442
Contributions	32,693,266	31,758,544	31,292,164
Investment income	39,528,931	(4,891,065)	37,067,888
Deductions	<u>(42,537,763)</u>	<u>(46,412,005)</u>	<u>(36,745,229)</u>
	<u>\$ 594,401,173</u>	<u>564,716,739</u>	<u>584,261,265</u>

Request for Information

This financial report is designed to provide a general overview of the Plan's finances. Questions concerning any of the information provided should be addressed to the Harris County Hospital District, d/b/a Harris Health System, Attn. Benefits Department, 2525 Holly Hall, Houston, TX 77054.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Statements of Fiduciary Net Position

December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Assets:		
Cash	\$ 2,834	—
Investments – at fair value:		
Fixed income securities	84,385,114	88,238,574
Mutual funds:		
Fixed income	114,234,624	75,953,344
International equity	90,819,167	49,114,734
Common stock	213,391,279	284,301,375
Common collective trust:		
International equity	54,651,693	53,196,480
Multistrategy	28,492,906	—
Short-term investments	<u>17,882,843</u>	<u>17,002,973</u>
Total investments	<u>603,857,626</u>	<u>567,807,480</u>
Receivables:		
Accrued investment income	558,897	606,340
Sales not yet settled	<u>2,084,486</u>	<u>706,353</u>
Total receivables	<u>2,643,383</u>	<u>1,312,693</u>
Total assets	<u>606,503,843</u>	<u>569,120,173</u>
Liabilities:		
Cash overdraft	—	287
Accrued administrative expenses	557,926	557,139
Payables for securities purchased	<u>11,544,744</u>	<u>3,846,008</u>
Total liabilities	<u>12,102,670</u>	<u>4,403,434</u>
Net position restricted for pensions	<u>\$ 594,401,173</u>	<u>564,716,739</u>

See accompanying notes to financial statements.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Statements of Changes in Fiduciary Net Position

Years ended December 31, 2016 and 2015

	<u>2016</u>	<u>2015</u>
Employer contributions	\$ 32,693,266	31,758,544
Investment income:		
Net appreciation (depreciation) in fair value of investments	<u>27,641,231</u>	<u>(14,407,013)</u>
Net appreciation (depreciation) in fair value of investments	<u>27,641,231</u>	<u>(14,407,013)</u>
Other investment income:		
Interest	1,817,803	629,240
Dividends	10,029,185	8,744,713
Other	<u>40,712</u>	<u>141,995</u>
Total other investment income	<u>11,887,700</u>	<u>9,515,948</u>
Net investment income (loss)	<u>39,528,931</u>	<u>(4,891,065)</u>
Benefits paid directly to participants	40,177,655	44,023,057
Administrative expenses	<u>2,360,108</u>	<u>2,388,948</u>
Total deductions	<u>42,537,763</u>	<u>46,412,005</u>
Net increase (decrease) in net position	29,684,434	(19,544,526)
Net position restricted for pensions:		
Beginning of year	<u>564,716,739</u>	<u>584,261,265</u>
End of year	\$ <u><u>594,401,173</u></u>	<u><u>564,716,739</u></u>

See accompanying notes to financial statements.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

(1) Description of Plan

The following description of the Harris County Hospital District Pension Plan (the Plan) provides only general information. Participants should refer to the summary plan description for more complete information, a copy of which is available from the Harris County Hospital District, d/b/a Harris Health System (the System).

(a) General

The Plan is a noncontributory, single-employer defined-benefit pension plan covering all full-time employees of the System who meet the Plan's service requirements. As a governmental plan, it is exempt from the reporting and disclosure requirements of the Employee Retirement Income Security Act of 1974 and follows the reporting requirements as dictated by the Governmental Accounting Standards Board (GASB).

In October 2006, the System Board of Trustees (Trustees) amended the Plan to close enrollment to new hires effective January 1, 2007. The amended plan offers employees hired prior to January 1, 2007, a choice to either (1) continue with their current pension plan or (2) elect to participate in the System's enhanced 401(k) retirement savings plan with a match, effective July 2007, of up to 5% of participant's compensation provided by the System. All new hires and rehires after December 31, 2006 are only eligible for the System's 401(k) retirement savings plan with a match up to 5%.

The Plan is administered by an administrative committee (the Committee) appointed by the Trustees of the System. The Committee comprises nine members who are responsible for administering the Plan under the terms that are established. The Trustees, as authorized in the plan document, approves amendments to the Plan. State Street (the Trustee) serves as trustee and custodian for the Plan.

(b) Pension Benefits

Active employees with one or more years of service, who meet eligibility requirements are entitled to a monthly pension payment beginning at normal retirement age (65) equal to the benefit accrued based on compensation and years of service. The Plan permits early retirement at ages 55 to 64, provided 10 years of service has been completed. If employees terminate after 5 years of service, they retain the right to vested benefits. Participants become 100% vested in their accrued benefits after 5 years of service. Each participant shall have a monthly benefit payable for life that is equal to the greater of (a) the number of years of service multiplied by 1.5% of the average monthly compensation (average base compensation received in the five highest consecutive calendar years out of the 10 complete calendar years prior to retirement) or (b) the accrued monthly retirement benefit determined as of January 1, 1989, plus the number of years of future service earned after January 1, 1989, multiplied by 1.5% of the average monthly compensation, subject to a minimum equal to the benefit earned under the Plan prior to the adoption of the sixth amendment as of September 30, 1991 (applies to nonhighly compensated employees only). Monthly benefit payments are subject to a minimum based on the number of years of service multiplied by \$6 and a maximum provision permitted to be paid under Section 415 of the Internal Revenue Code (the Code). Participants may also elect to receive their benefits in other optional forms.

If the present value of a terminating participant's vested benefit is \$1,000 or less, the benefit will automatically be paid in a lump sum.

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Notes to Financial Statements

December 31, 2016 and 2015

During 2016, the Plan made lump-sum payments of \$420, 827 to 120 participants. During 2015, the Plan offered a window lump-sum payment option to terminated vested participants who terminated employment before March 31, 2015. A total of 368 terminated vested participants accepted a lump-sum payment option totaling \$5,931,488.

(c) Death and Disability Benefits

If an active employee dies, a benefit equal to one-half of the normal pension benefit will be due to the spouse of the participant if the participant has attained 10 years of service. The beneficiary of a deceased retired participant is entitled to a lump-sum payment of \$5,000. If a participant becomes disabled, the participant will be paid 55% of his/her average monthly compensation, less 64% of the monthly primary social security benefit at the time of disability. Disability benefits will be paid during the participant's disability or until retirement age is reached, whichever is shorter.

(d) Plan Membership

Membership of the Plan consisted of the following as of January 1, 2016 and 2015, respectively:

	<u>2016</u>	<u>2015</u>
Inactive plan members or beneficiaries currently receiving benefits	\$ 2,888	2,774
Inactive plan members entitled to but not yet receiving benefits	1,450	1,702
Active plan members	<u>2,668</u>	<u>2,966</u>
Total	<u>\$ 7,006</u>	<u>7,442</u>

(2) Summary of Significant Accounting Policies

(a) Basis of Accounting

The accompanying financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America (GAAP). The Plan is maintained on the accrual basis of accounting. The Plan applies the GASB pronouncements applicable to benefit plan accounting and reporting.

(b) Use of Estimates

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and changes therein, disclosure of contingent assets and liabilities, and the actuarial present value of accumulated plan benefits and changes therein at the date of the financial statements. Actual results could differ from those estimates.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

(c) Risks and Uncertainties

The Plan utilizes various investment securities, including U.S. government securities, corporate debt instruments, mutual funds, corporate stocks, and common collective trust funds. Investment securities, in general, are exposed to various risks, such as interest rate, credit risk, and overall market volatility risks. Due to the level of risk associated with certain investment securities, it is reasonably possible that changes in the values of investment securities will occur in the near term and that such changes could materially affect the amounts reported in the financial statements.

The actuarial present value of accumulated plan benefits is calculated based on economic and demographic assumptions, including investment return rates, inflation rates, salary increases, retirement ages, and mortality rates. Due to uncertainties inherent in the estimations and assumptions processes, it is at least reasonably possible that changes in these estimates and assumptions in the near term would be material to the financial statements.

(d) Investment Valuation and Income Recognition

Investments are stated at fair value. Shares of mutual funds are valued at quoted market prices, which represent the net asset value of shares held by the Plan at year-end. Common stock is valued at quoted market prices. Units of common collective trust funds are stated at fair value as determined by the issuer of the fund based on the fair value of the underlying investments.

Purchases and sales of securities are recorded on a trade-date basis. Interest income is recorded on the accrual basis. Dividends, including dividends paid by common collective trusts, are recorded on the ex-dividend date. Net appreciations include the Plan's gains and losses on investments bought and sold as well as held during the year.

Management fees and operating expenses charged to the Plan for investments in the mutual funds are deducted from income earned on a daily basis and are not separately reflected. Consequently, management fees and operating expenses are reflected as a reduction of investment return for such investments.

(e) Administrative Expenses

All administrative expenses incurred in the operation of the Plan are paid by the Plan as provided in the Plan document. The plan sponsor provides accounting and certain other administrative services to the Plan at no charge.

(f) Payment of Benefits

Benefit payments to participants are recorded upon distribution.

(g) Contributions

Contributions to provide benefits under the Plan are made solely by the System. The System makes annual contributions based on an actuarial valuation of the Plan. The actuarial recommended contribution includes normal cost, plus amortization of the expected unfunded liability, if any.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

(h) Newly Adopted Accounting Pronouncement

GASB Statement No. 72 – *Fair Value Measurement and Application*. The statement provides guidance for applying fair value to certain investments and disclosures related to all fair value measurements. The requirements of this statement are effective for financial statements for reporting periods beginning after June 15, 2015. All applicable provisions have been included in the Plan's financial statements as of December 31, 2016.

GASB Statement No. 79 – *Certain External Investment Pools and Pool Participants*. This statement established specific financial reporting criteria used to determine whether a qualifying external investment pool may elect to use an amortized cost exception to fair value measurement. The statement also establishes additional note disclosure for qualifying external investment pools. The requirements of this statement are effective for financial statements for reporting periods beginning after June 15, 2015. All applicable provisions have been included in the Plan's financial statements as of December 31, 2016.

(3) Investments

The fair value of investments as of December 31, 2016 and 2015 is presented in the following table:

	<u>2016</u>	<u>2015</u>
Common stocks	\$ 213,391,279	284,301,375
Mutual funds	205,053,791	125,068,078
Common collective trusts	83,144,599	53,196,480
Fixed income	84,385,114	88,238,574
Short-term investments	<u>17,882,843</u>	<u>17,002,973</u>
Total	<u>\$ 603,857,626</u>	<u>567,807,480</u>

The Plan categorizes its fair value measurements within the fair value hierarchy established by generally accepted accounting principles. The hierarchy is based on the valuation inputs used to measure fair value of the assets. Level 1 are quoted prices in an active market for identical assets, Level 2 are significant other observable inputs, and Level 3 are significant unobservable inputs.

The mutual funds held by the Plan are actively traded and valued at the daily closing price as reported by the fund and are disclosed as investments in Registered Investment Companies. The common collective trusts held by the Plan are valued at net asset value of the respective investments as a practical expedient to estimate fair value. This practical expedient would not be used if it is determined to be probable that the investment will be sold for an amount different from the reported net asset value.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

The following is a summary of the hierarchy of the fair value of investments of the Plan as of December 31, 2016 (in thousands):

	2016 Fair value		
	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	December 31, 2016 Total
Investments by fair value level:			
Debt securities:			
U.S. Treasury securities	\$ —	44,066	44,066
Asset backed	—	4,394	4,394
Commercial mortgage-backed securities	—	5,726	5,726
Corporate bonds	—	20,260	20,260
Mortgages	—	9,582	9,582
Municipals	—	357	357
Fixed income mutual funds	114,235	—	114,235
Total debt securities	<u>114,235</u>	<u>84,385</u>	<u>198,620</u>
Equity securities:			
Domestic	213,391	—	213,391
International	90,819	—	90,819
Total equity securities	304,210	—	304,210
Short-term investment funds	—	17,883	17,883
Total investments by fair value level	<u>\$ 418,445</u>	<u>102,268</u>	<u>520,713</u>
Investments measured at the net asset value (NAV):			
Common collective trusts			54,652
Hedge funds – multistrategy			<u>28,493</u>
Total investments measured at NAV			<u>83,145</u>
Total investments measured at fair value			<u>\$ 603,858</u>

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Notes to Financial Statements

December 31, 2016 and 2015

The following is a summary of the hierarchy of the fair value of investments of the Plan as of December 31, 2015 (in thousands):

	2015 Fair value		
	Quoted prices in active markets for identical assets (Level 1)	Significant other observable inputs (Level 2)	December 31, 2015 Total
Investments by fair value level:			
Debt securities:			
U.S. Treasury securities	\$ —	47,474	47,474
Asset backed	—	2,502	2,502
Agencies	—	5,953	5,953
Commercial mortgage-backed securities	—	3,047	3,047
Collateralized mortgage obligations	—	4,166	4,166
Corporate bonds	—	18,262	18,262
Mortgages	—	6,694	6,694
Municipals	—	141	141
Fixed income mutual funds	75,953	—	75,953
Total debt securities	<u>75,953</u>	<u>88,239</u>	<u>164,192</u>
Equity securities:			
Domestic	284,301	—	284,301
International	49,115	—	49,115
Total equity securities	<u>333,416</u>	<u>—</u>	<u>333,416</u>
Short-term investment funds	—	17,003	17,003
Total investments by fair value level	<u>\$ 409,369</u>	<u>105,242</u>	<u>514,611</u>
Investments measured at the net asset value (NAV):			
Common collective trusts			53,196
Hedge funds – multistrategy			<u>—</u>
Total investments measured at NAV			<u>53,196</u>
Total investments measured at fair value			<u>\$ 567,807</u>

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Notes to Financial Statements

December 31, 2016 and 2015

Investments measured at the NAV (in thousands)

	<u>Fair value</u>	<u>Unfunded commitments</u>	<u>Redemption frequency (if currently eligible)</u>	<u>Redemption notice period</u>
Common collective trust	\$ 54,652	None	Daily	None
Multistrategy hedge funds	<u>28,493</u>	None	Monthly	95 days
Total investments measured at the NAV	\$ <u><u>83,145</u></u>			

For assets that are measured at NAV per share, the valuation provided by the fund manager is used. All partnerships provide audited financial statements, along with unaudited quarterly reports.

Common collective trust – The trust’s investment objective is to seek long-term capital appreciation above the MSCI All Country World Ex-U.S. Investable Market Index (net), by investing at least 80% of its total assets in a diversified portfolio of common stocks and in securities convertible into, exchangeable for or having the right to buy such common stocks that issued by companies of all sizes domiciled outside the United States.

Multistrategy hedge funds – This type invests in hedge funds that pursue multiple strategies to diversify risks and reduce volatility, primarily through limited partnerships. The fund is organized by investing substantially all assets through a master feeder structure and may use a wide range of investment strategies.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

During the plan years ended December 31, 2016 and 2015, the Plan's investments (including investments bought, sold, and held during the plan year) appreciated (depreciated) in value by \$27,641,231 and by (\$14,407,013) respectively, as follows:

	<u>2016</u>	<u>2015</u>
Common stocks	\$ 27,461,290	(8,131,357)
Mutual funds	272,341	(6,565,692)
Common collective trusts	<u>(92,400)</u>	<u>290,036</u>
Total	<u>\$ 27,641,231</u>	<u>(14,407,013)</u>

During the years ended December 31, 2016 and 2015, interest and dividends earned on the Plan's investments amounted to \$11,846,988 and \$9,373,953, respectively.

(4) Investment Risk Disclosures

(a) Investment Policy

Substantially all of the Plan's investments are held by the Trustee. The Committee authorizes various portfolio managers to manage investments within the guidelines of the Plan's statement of investment policy (the Policy) set forth by the Committee. The Policy mandates a diversified portfolio, which includes investments in common collective trusts, fixed income securities, and equity securities. GAAP requires disclosure of common deposit and investment risks, including credit risk, concentration of credit risk, custodial credit risk, interest rate risk, and foreign currency risk of investments.

The Policy in regard to the allocation of invested assets is established and may be amended by the System's Board of Trustees by a majority vote of its members. It is the policy of the Plan Board to pursue an investment strategy that reduces risk through the prudent diversification of the portfolio across a broad selection of distinct asset classes. The Policy discourages the use of cash equivalents, except for liquidity purposes and aims to refrain from dramatically shifting asset class allocations over short time spans. The following was the Board of Trustee's adopted asset allocation as of December 31, 2016 and 2015:

<u>Asset class</u>	<u>2016 Target allocation</u>	<u>2015 Target allocation</u>
International equity	25%	18%
Fixed income	35	32
Domestic equity	35	50
Hedge funds	<u>5</u>	<u>—</u>
	<u>100%</u>	<u>100%</u>

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

(b) Money-Weighted Rate of Return

For the years ended December 31, 2016 and 2015, the annual money-weighted rate of return on pension plan investments, net of pension investment expenses, was 6.65% and (1.19)%, respectively. The money-weighted rate of return expresses investment performance, net of investment expense, adjusted for the changing amounts actually invested.

(c) Credit Risk and Concentration of Credit Risk

Credit risk is the risk that an issuer of an investment will not fulfill its obligation to the holder of the investment. The Policy establishes minimum acceptable credit ratings for certain investment instruments. Fixed income investment managers are expected to invest in a well-diversified mix of debt instruments, including U.S. Treasury, agency, mortgage-backed, asset-backed, corporate, Eurodollar, and Yankee issue. The Core Plus Fixed Income Investment manager may also invest in derivative instruments such as options, future contracts, or swap agreements. With the exception of the U.S. Treasury and its agencies, no more than five percent (5%) of the market value of the portfolio should be invested in the securities of a single issuer. No more than fifteen percent (15%) of the Fixed Income Investment Manager's portion of the Plan or one hundred twenty percent (120%) of the benchmark's allocation, whichever is greater, shall be rated less than "A" quality. Bonds of foreign issuers are permitted to comprise up to thirty percent (30%) of a Fixed Income Investment Manager's portfolio. The duration of the portfolio is expected to be within fifty percent (50%) of the index's duration. Guidelines for diversification and risk tolerance are detailed within the Policy. Additionally, the Policy includes specific investment strategies for fund groups that address each group's investment options and describes the priorities for suitable investments. GAAP does not require disclosure of U.S. government obligations explicitly guaranteed. As of December 31, 2016 and 2015, below are the Plan's fixed income investments, excluding U.S. government obligations, at fair value:

Security type	2016		2015	
	Fair value	Quality	Fair value	Quality
Fixed income securities:				
Asset backed	\$ 4,394,216	AAA	\$ 2,501,811	AAA
Agencies	—		5,953,511	AAA
Commercial mortgage-backed securities	5,725,705	AAA	3,047,353	AAA
Collateralized mortgage obligations	—		4,165,670	AAA
Mortgages	9,582,440	AA+	6,693,514	AA+
Corporate	20,259,586	A-	18,261,540	A
Municipal	356,922	AA+	141,291	AAA
Mutual funds	114,234,624	BBB+	75,953,344	A
Total	\$ <u>154,553,493</u>		\$ <u>116,718,034</u>	

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

Concentration of credit risk is the risk of loss attributed to the magnitude of an investment in a single issuer. The System mitigates these risks by emphasizing the importance of a diversified portfolio. All funds must be sufficiently diversified to eliminate the risk of loss resulting from overconcentration of assets in a specific maturity, a specific issuer, or a specific class of securities. In particular, no more than 5% of an equity portfolio may be invested in a single company without consent of the Committee. Holdings in any one industry or sector are not to exceed 30% of the portfolio market value. No more than 20% of the portfolio may be invested in cash equivalents and fixed income securities with fixed income securities not exceeding 15%. Concentration by issuer for other investment instruments is limited to 5%. The Policy does specify that acceptable investment instruments must have high-quality credit ratings and, consequently, risk is minimal.

As of December 31, 2016 and 2015, the Plan did not hold more than 5% of assets in any single issuer other than mutual funds, U.S. government obligations, common collective trust funds, or obligations of U.S. government chartered entities.

The Plan maintained no investments in derivatives as of December 31, 2016 or 2015.

(d) Custodial Credit Risk

Custodial credit risk for deposits is the risk that, in the event of failure of a depository financial institution, the Plan will not be able to recover its deposits or will not be able to recover collateral securities that are in possession of an outside party. The custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to a transaction, the Plan will not be able to recover the value of its investment or collateral securities that are in possession of another party.

The Plan does not have a formal policy for custodial credit risk. As of December 31, 2016 and 2015, all investments are held in a nominee name of the custodian for the benefit of the Plan.

(e) Interest Rate Risk

All investments carry the risk that changes in market interest rates will adversely affect the fair value of an investment. Generally, the longer the maturity of an investment, the greater is the sensitivity of its fair market value to changes in market interest rates. The Plan does not have a formal investment policy that limits investment maturities as a means of managing its exposure to fair value losses arising from changing interest rates. Interest rate risk is limited by the short-term nature of the investments.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

As of December 31, 2016 and 2015, the Plan had the following investments in its fixed income accounts:

Security type	2016		2015	
	Fair value	Weighted average maturity in years	Fair value	Weighted average maturity in years
Fixed income securities:				
Asset backed Agencies	\$ 4,394,216	5.27	\$ 2,501,811	4.69
Commercial mortgage-backed Collateralized mortgage obligations	5,725,705	5.64	3,047,353	3.30
Mortgages	—		4,165,670	0.98
Corporate	9,582,440	4.63	6,693,514	5.62
Municipal	20,259,586	5.09	18,261,540	4.80
U.S. Treasury	356,922	7.42	141,291	11.33
Mutual funds	44,066,245	4.37	47,473,882	3.79
	114,234,624	6.68	75,953,344	5.45
Total	\$ 198,619,738		\$ 164,191,916	

(f) Foreign Currency Risk

Foreign currency risk is the risk that fluctuations in the exchange rate will adversely affect the value of investments denominated in a currency other than the U.S. dollar.

The Plan holds investments in common collective trust funds and mutual funds that are invested in international equities. These investments are denominated in U.S. dollars and accounted for at fair value. The Plan has no exposure to foreign currency fluctuations.

(5) Net Pension Liability of the System

The components of the net pension liability of the System as of December 31, 2016 and 2015 were as follows (in thousands):

	2016	2015
Total pension liability	\$ 828,711	806,323
Plan fiduciary net position	594,401	564,717
System net pension liability	\$ 234,310	241,606
Plan fiduciary net position as a percentage of the total pension liability	71.72%	70.04%

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

(a) Actuarial Assumptions

The total pension liability was determined by an actuarial valuation as of December 31, 2016 and 2015, using the following actuarial assumptions, applied to all periods included in the measurement:

Actuarial cost method	Entry age normal
Inflation	3.0%
Postretirement benefit increase	
Investment rate of return – net of expenses	7.5
Projected salary increases (ultimate rate)	4.0
Cost of living adjustment	—
Assumed retirement age	Various retirement age rates were assumed for ages 55 through 70
Mortality rates:	Healthy: RP-2014 bottom quartile mortality tables with generational mortality improvement projected after 2014 with 50% of Scale MP-2014
	Disabled: RP-2014 Disability Mortality Table
	Mortality Improvement: The mortality table for healthy lives includes fully generational mortality improvement projected after year 2014 using 50% of Scale MP-2014

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

The long-term expected rate of return on pension plan investments was determined using a building-block method in which best-estimate ranges of expected future real rates of return (expected returns, net of pension plan investment expense and inflation) are developed for each major asset class. These ranges are combined to produce the long-term expected rate of return by weighting the expected future real rates of return by the target asset allocation percentage and by adding expected inflation. Best estimates of arithmetic real rates of return for each major asset class included in the Plan's target asset allocation as of December 31, 2016 and 2015 (see the discussion of the Plan's investment policy) are summarized in the following table:

Asset class:	Expected real rate of return
Domestic equity – large cap	9.13%
Domestic equity – small cap	10.15
International equity	9.33
Fixed income	6.54
Hedge funds	10.55

(b) Discount Rate

The discount rate used to measure the total pension liability was 7.5%. The projection of cash flows used to determine the discount rate assumed that employer contributions will be made at rates equal to the actuarially determined contribution rates. Based on those assumptions, the pension plan's fiduciary net position was projected to be available to make all projected future benefit payments of current plan members. Therefore, the long-term expected rate of return on pension plan investments was applied to all periods of projected benefit payments to determine the total pension liability.

The foregoing actuarial assumptions are based on the presumption that the Plan will continue. If the Plan were to terminate, different actuarial assumptions and other factors might be applicable in determining the actuarial present value of accumulated plan benefits.

(c) Sensitivity of the Net Pension Liability to Changes in the Discount Rate

The following represents the net pension liability calculated using the stated discount rate, as well as what the net pension liability would be if it were calculated using a discount rate that is one percentage point lower or one percentage point higher than the current rate:

System net pension liability	1% Decrease (6.5%)	Current discount rate (7.5%)	1% Increase (8.5%)
		(In thousands)	
December 31, 2016	\$ 331,517	234,310	151,651
December 31, 2015	338,477	241,606	159,418

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Financial Statements

December 31, 2016 and 2015

(6) Income Tax Status

The Internal Revenue Service (IRS) has determined and informed the System by a letter dated June 10, 2014, that the Plan and related trust were designed in accordance with applicable regulations of the Code. Since receiving the determination letter, the Plan has been amended; however, the System and Plan management believe that the Plan is currently designed and operated in compliance with the applicable requirements of the Code and that the Plan and related trust continue to be tax-exempt.

Therefore, no provision for income taxes has been included in the Plan's financial statements.

The Plan is subject to routine audits by the IRS; however, there are currently no audits for any tax periods in progress.

(7) Plan Termination

Although it has not expressed any intention to do so, the System has the right under the Plan, in certain circumstances, to discontinue contributions to the Plan and to terminate the Plan. In the event that the Plan is terminated, the net assets of the Plan will be allocated generally to provide the following benefits in the order indicated:

- Benefits due to participants who have reached the age of 65 and to beneficiaries of deceased participants
- Benefits due to participants qualified for early retirement, as defined by the Plan
- Benefits due to other participants in proportion to the actuarial value of their accumulated benefits

In the event the assets are not sufficient to carry out any of the foregoing purposes in full, the allocations to the accounts of individuals thereunder shall be made in the proportion that the assets available bear to the assets required to carry out the purpose in full.

**REQUIRED SUPPLEMENTARY INFORMATION
(UNAUDITED)**

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Required Supplementary Information
Schedule of Changes in Net Pension Liability and Related
Ratios – Last 10 Fiscal Years (which may be built prospectively)

Years ended December 31, 2016, 2015, and 2014

(Dollar amounts in thousands)

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Total pension liability:			
Service cost	\$ 7,232	7,795	8,642
Interest	59,397	57,482	52,342
Changes of benefit terms:			
Difference between expected and actual experience	(4,063)	4,637	(1,909)
Changes of assumptions	—	—	40,689
Benefit payments	<u>(40,178)</u>	<u>(44,023)</u>	<u>(34,444)</u>
Net change in total pension liability	22,388	25,891	65,320
Total pension liability – beginning	<u>806,323</u>	<u>780,432</u>	<u>715,112</u>
Total pension liability – ending	<u>828,711</u>	<u>806,323</u>	<u>780,432</u>
Plan fiduciary net position:			
Contributions – employer	32,693	31,759	31,292
Net investment income	39,529	(4,891)	37,068
Benefit payments	(40,178)	(44,023)	(34,444)
Administrative expense	<u>(2,360)</u>	<u>(2,389)</u>	<u>(2,301)</u>
Net change in plan fiduciary net position	29,684	(19,544)	31,615
Plan fiduciary net position – beginning	<u>564,717</u>	<u>584,261</u>	<u>552,646</u>
Plan fiduciary net position – ending	<u>594,401</u>	<u>564,717</u>	<u>584,261</u>
System net pension liability – ending	\$ <u>234,310</u>	<u>241,606</u>	<u>196,171</u>
Plan fiduciary net position as a percentage of the total pension liability	71.72%	70.04%	74.86%
Covered-employee payroll	\$ 182,060	197,360	210,728
System net pension liability as a percentage of covered-employee payroll	128.70%	122.42%	93.09%

Notes to schedule:

Changes of assumptions – In 2014, amounts reported as changes of assumptions resulted primarily from adjustments to assumed life expectancies as a result of adopting the RP-2014 bottom quartile mortality tables with generational mortality improvement projected after 2014 with 50% of Scale MP-2014 for purposes of developing mortality rates. See note 2(i).

This schedule is presented to illustrate the requirement to show information for 10 fiscal years. However, until a full 10-year trend is compiled, the System will present information for those years for which information is available.

See accompanying independent auditors' report.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Required Supplementary Information
Schedule of Investment Returns – Last 10 Fiscal Years
(which may be built prospectively) – Unaudited

Years ended December 31, 2016, 2015, and 2014

	<u>2016</u>	<u>2015</u>	<u>2014</u>
Annual money-weighted rate of return, net of investment expense	6.65%	(1.19)%	6.35%

This schedule is presented to illustrate the requirement to show information for 10 years. However, until a full 10-year trend is compiled, the Plan will present information for those years for which information is available.

See accompanying independent auditors' report.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Required Supplementary Information
 Schedule of Employer Contributions – Unaudited

Year ended December 31, 2016

(Dollar amounts in thousands)

	<u>Actuarially determined contribution</u>	<u>Actual annual contribution</u>	<u>Contribution deficiency (excess)</u>	<u>Covered employee payroll</u>	<u>Contributions as a% of covered payroll</u>
Plan year ended:					
December 31, 2007	\$ 18,233	18,233	100%	\$ 246,400	7%
December 31, 2008	17,800	17,800	100	257,521	7
December 31, 2009	27,538	27,538	100	255,127	11
December 31, 2010	25,219	25,219	100	250,454	10
December 31, 2011	23,657	23,657	100	241,076	10
December 31, 2012	27,486	27,486	100	229,056	12
December 31, 2013	33,959	33,959	100	220,398	15
December 31, 2014	31,292	31,292	100	210,728	15
December 31, 2015	31,759	31,759	100	197,360	16
December 31, 2016	32,693	32,693	100	182,060	18

See accompanying independent auditors' report.

HARRIS COUNTY HOSPITAL DISTRICT PENSION PLAN

Notes to Required Supplementary Information – Unaudited

Year ended December 31, 2016

The information on the required supplementary information was computed as part of the actuarial valuations at the dates indicated.

Additional information as of the latest actuarial valuation is as follows:

Valuation date	December 31, 2016
Actuarial cost method	Entry age normal
Amortization method	Level dollar amortization of unfunded liabilities
Asset valuation method	Market value
Inflation	3.0%
Salary increase (ultimate rate)	4.0
Investment rate of return	7.5
Mortality	Healthy: RP-2014 bottom quartile mortality tables with generational mortality improvement projected after 2014 with 50% of Scale MP-2014 Disabled: RP-2014 Disability Mortality Table Mortality Improvement: The mortality table for healthy lives includes fully generational mortality improvement projected after year 2014 using 50% of Scale MP-2014.

See accompanying independent auditors' report.