



ALLOWING ADVANCE PAYMENT OF UNFUNDED ACCRUED LIABILITIES BY SERS EMPLOYERS

Overview

In a previous SERS white paper, we explored several fundamental practices for public pension funding, such as full payment of the Actuarially Required Contribution (ARC), the institution of a dedicated funding policy, and more. From a practical standpoint, such elements can be viewed as pieces of a puzzle, that, when fit together appropriately, can provide a clear, full picture of a financially sound, well-run public pension fund.

In this white paper our ongoing conversation focuses on another potential piece to the pension funding puzzle, one that could have benefits not only to SERS, but also to the Commonwealth and participating employers that fit within the legislative guidelines established under Act 2019-105. The following overview is intended to both educate readers and encourage additional exploration and discussion about solutions to the public pension funding puzzle.

On November 27, 2019, Governor Wolf signed House Bill 1982 into law as Act 2019-105. The law creates a mechanism that allows eligible employers to enter into an agreement with the State Employees' Retirement Board to make a one-time lump sum payment of 75% to 100% of their respective unfunded accrued liability (UAL).

Such a prefunding agreement offers significant potential benefits to SERS, the eligible employer, and the Commonwealth.

For SERS:

- **The Significant Infusion of Additional Cash.** This cash can be invested, providing additional returns to the fund. It can be used to increase liquidity in the fund, providing SERS with greater flexibility in meeting the system's benefit obligations, particularly in uncertain economic environments. Along with more assets under management, SERS investment costs can be spread over a larger base, thereby creating increased efficiencies. Additionally, the infusion of cash would immediately help pay down a portion of the fund's UAL and increase SERS' funded ratio. This reduces stress on the fund and could result in more flexibility in regard to investment decisions.

For the Commonwealth:

- **Better Credit Ratings.** Typically, an improved financial status for the fund can mean better credit ratings. Industry studies have shown that for both Standard & Poor's and Moody's, state government credit ratings correlate closely to state pension funding ratios. In other words, the more reliable the funding and the better the funded ratio, the greater likelihood for a higher credit rating.

For the Eligible Employer:

- **Flexibility in Operating Budgets.** Employers who have the wherewithal to prepay their UAL potentially can realize annual budget savings for operations and other investments.

It is important to note that the prefunding agreement plan **creates no new liability for Pennsylvania taxpayers.** Essentially, the proposal offers a Win-Win-Win scenario for everyone.

How it Works

In order to initiate a prefunding agreement, an eligible employer would approach SERS with an expression of interest in entering into a mutual contract. It is not an undertaking that SERS would be able to initiate unilaterally. Act 105 permits SERS to charge an eligible employer for the payment of fees and costs incurred by the Board in connection with the prefunding agreement.

SERS' actuaries will calculate the portion of the unfunded accrued liability that an eligible employer is liable for based on SERS' most recent Valuation Report. The employer can enter into an agreement with the State Employees' Retirement Board ("Board") to make a lump sum payment of 75% to 100% of that amount.

Eligible employers will receive credits against their future contributions that will be recognized by an annual setoff. With limited exceptions, this schedule of credits is fixed once it is set. The lump sum payment covers only liabilities accrued as of the date of the calculation. Future changes in liability, whether gains or losses, will attach to the employer as if the advance payment was not made.

Window of Limitation: Agreements must be entered into by December 31, 2024, and the lump sum payments must be made by May 1, 2025.

Other Key Points:

Eligibility: Act 105 defines "Eligible Employer" as all SERS-covered employers except:

- Pennsylvania Turnpike Commission
- Delaware River Port Authority
- Port Authority Transit Corporation
- Philadelphia Regional Port Authority
- Delaware River Joint Toll Bridge Commission
- State Public School Building Authority
- Department of General Services
- State Highway and Bridge Authority
- Delaware Valley Regional Planning Commission
- Delaware River Basin Commission
- Susquehanna River Basin Commission
- Any separate independent public corporation created by statute, not including any municipal or quasi-municipal corporation.

Lump-Sum Payment Calculations: Lump sum payments will be based on an employer's share of SERS' UAL in the most recent actuarial valuation. If all SERS-covered employers could, and did, simultaneously make a lump sum payment of 100% of their calculated share of UAL, then SERS would be fully-funded. A lump sum advance payment will result in a credit for the employer against future employer contributions that will be recognized by an annual setoff.

A lump sum advance payment of accrued liability contributions will become part of the general assets of the State Employees' Retirement Fund. It will not be segregated or separately managed for the employer who made the payment. An employer will receive only a ledger entry of future setoffs of actual contributions. Once money is paid to SERS, it cannot be refunded to the employer except through recognition as a setoff against actual contributions.

Prohibition on Pension Obligation Bonds: Section 13 of Act 2010-120 prohibits SERS employers that are executive agencies or independent agencies under the Procurement Code from issuing pension obligation bonds. While most SERS employers are executive agencies or independent agencies under the Procurement Code, Penn State (the first employer to express interest under Act 105) is not.

The reality is that most employers are unlikely to have sufficient excess funds available to make the required lump sum payment. Thus, the pension bond prohibition will, in practice, prevent many eligible employers from taking advantage of Act 105.

Continuing Responsibility for Future UAL: Any SERS employer prepaying its UAL will continue to be liable for future changes in its portion of the UAL, regardless of why the UAL increases or decreases. Future changes in the UAL resulting from recognition of investment gains or losses under the 5-year smoothing process, changes in actuarial assumptions, actual experience differing from expected experience, legislative changes, changes resulting from litigation, or any other reasons, will be applied to an employer's future contribution rate and actual contributions.

The Penn State Experience

On March 19, 2020, the Penn State Board of Trustees approved a proposal for the university to increase its borrowing authorization by approximately \$1.1 billion.

University officials noted that the administration had been exploring opportunities to control costs, and Act 2019-105 provided a novel way to achieve significant savings as they sought to develop a solution to Penn State's own pension funding puzzle. The additional authority allowed Penn State to incur debt so that it could tender a lump sum prepayment of the university's UAL, thereby reducing its future annual employer contribution obligations to SERS.

Following a successful bond issuance, Penn State submitted to SERS a payment of \$1.06 billion that was received on Thursday, April 30, 2020. In return for this payment, the university is scheduled to receive an annual credit of nearly \$93.3 million for payments to SERS beginning in the 2020-21 fiscal year.

Overall, the university estimates net savings of more than \$37 million annually over the next 20 years, net of debt service, to fully fund its continuing pension obligations to SERS in future years.

Meanwhile, the SERS fund will benefit immediately from the infusion of an additional \$1.06 billion that will be deployed on behalf of SERS members in accordance with the SERS Defined Benefit Plan Investment Policy Statement.

Looking to the Future

According to a university official, annual budget savings will help Penn State in its ongoing efforts to promote access and affordability, while the prepayment should help boost SERS' funded status by an estimated 2.0%.

Act 2019-105 was a creative initiative enabled by legislators and the Wolf Administration to help solve part of the pension funding puzzle in a way that could benefit SERS, the Commonwealth, and employers that meet a certain standard.

We at SERS welcome the opportunity to discuss our experience with Act 2019-105 with our colleagues in the legislature and the administration. Our goal is to continue to build a secure future for our members and participants who rely on us to help them work through their own retirement puzzles.