

Employer Requests to Re-amortize Unfunded Liabilities

1.0 Introduction

PSPRS is required to maintain assets that, combined with future contributions and investment earnings, are sufficient to fund all benefits expected to be paid to members and their beneficiaries and to pay reasonable administrative expenses. This objective requires using actuarial methods and assumptions that are consistent with generally accepted actuarial standards.

PSPRS statute requires that the PSPRS Board of Trustees, in consultation with the actuary retained by PSPRS, establish the actuarially determined amount required to amortize the unfunded accrued liability over a closed period of not more than twenty (20) years. The PSPRS statute, however, permits an employer to make a one-time election to request that the board, exercising its discretion, use a closed amortization period of not more than thirty (30) years if the employer meets certain procedural conditions.

As a result of actuarial principles, lengthening the amortization period beyond the current closed amortization policy adopted by the Board of Trustees will result in increased future contributions for employers. The increased amount can under certain circumstances jeopardize, among other things, the probability of payment of benefits and reasonable administrative expenses and the stability of the PSPRS system.

Accordingly, to facilitate the ability of the PSPRS Board of Trustees to exercise its discretion in a fully informed and appropriate manner and to meet its fiduciary duties, the following information will be relevant in connection with the PSPRS Board of Trustees' considering an employer request to re-amortize unfunded liabilities under A.R.S. §§ 38-843(I) and/or 38-891(M).

Note: A re-amortization for a period longer than twenty (20) years has a potential infirmity under both the United States Constitution and the Arizona Constitution. Ariz. Const. art. II, § 25 (Contract Clause, providing "No ... law impairing the obligation of a contract, shall ever be enacted"); U. S. Const. art. I, § 10, clause 1 (Contract Clause, providing "No State shall ... pass any ... Law impairing the Obligation of Contracts"). That is, the maximum 20-year amortization period was Arizona law when Arizona voters approved the amendment to the Arizona Constitution confirming that membership in the PSPRS plan is a "contractual relationship." Ariz. Const. art. XXIX, § 1(C). As such, there is a risk that a court could conclude that an amortization period longer than twenty (20) years (such as could occur as a result of an employer request under A.R.S. §§ 38-843(I) and/or 38-891(M), which were enacted after the constitutional amendment) impairs that contract and thus is invalid.

An Arizona superior court has ruled that the PSPRS Board's granting such a request for re-amortization is not necessarily a "per se" violation of the Pension Clause of the Arizona Constitution. It should be noted, though, no court has addressed whether such a re-amortization might nevertheless, among other things, (a) violate the Pension Clause of the Arizona Constitution on an "as applied" or some other basis, (b) violate the Contract Clause of the Arizona Constitution, or (c) violate the Contract Clause of the United States Constitution.

Accordingly, even if the PSPRS Board were to deem granting a re-amortization request appropriate after consideration of the conditions and guidelines set forth below, the PSPRS Board may under certain circumstances deem it necessary or appropriate to impose conditions on the re-amortization as described in part III below, for the purpose of mitigating the risk of impairment of the membership contractual relationship. Failure to comply with those conditions could result in, among other things, reverting to the amortization period in effect prior to the employer's request (or some other period deemed appropriate by the PSPRS Board in consultation with the actuary) and/or requiring the employer to restore the diminished contribution amount arising while the longer amortization period was in effect.

2.0 Authority

A.R.S. § 38-843(I)

A.R.S. § 38-891(M)

5.0 Guidelines

Considering the aforementioned, it is in the best interest of an employer requesting re-amortization of unfunded liabilities to have the request accompanied by an analysis of the following conditions and guidelines and by supporting documentation and information. The conditions and guidelines consist of three categories: (5.1) procedural conditions, (5.2) substantive guidelines, and (5.3) substantive conditions.

5.1 Procedural Conditions

By Statute, an employer's request must satisfy certain procedural requirements. Before the Board of Trustees can consider a request for re-amortization, an employer's request must meet the following requirements:

- a. A written request is required for the longer amortization period. The request should also contain the following:
 1. Specific period requested. The requested period must be a closed period of not more than thirty (30) years. [A.R.S. §§ 38-843(I) & 38-891(M)]
 2. The request must specify the actuarial valuation date for which the new amortization period is to begin. The actuarial valuation date chosen must be the PSPRS system's fiscal year end, either immediately before or after the date of the resolution. [A.R.S. §§ 38-843(I)(1) & 38-891(M)(1)]
 3. The request must indicate that it is accompanied by both (a) the resolution and other materials described below, and (b) a memorandum addressing the guidelines set forth herein. A.R.S. §§ 38-843(I)(2) & 38-891(M)(2). The employer may also include with the request any other material that the employer might deem relevant to the request, but the written request should mention and describe the additional material.
 4. The request must be signed by a duly authorized representative of the governing body of the employer.

- b. A resolution requesting the longer amortization period and specifying the actuarial valuation date for which the new amortization period is to begin.
 1. The governing body of the employer must have adopted a resolution (a) requesting the longer amortization period and (b) specifying the actuarial valuation date for which the new amortization period is to begin. [A.R.S. §§ 38-842(I)(1)(1st sentence) & 38-891(M)(1)(1st sentence)]
 2. The actuarial valuation date chosen must be the system's fiscal year end either immediately before or immediately after the date of the resolution. [A.R.S. §§ 38-842(I)(1)(1st sentence) & 38-891(M)(1)(2nd sentence)]

- c. Supporting documentation evidencing compliance and authority.
 - 1. Documentation evidencing, in connection with adoption of the resolution, compliance of the employer's governing body with the Arizona Open Meeting Law and any requirements imposed by the employer's governing documents such as charter, code, and/or ordinance. These materials should include, at a minimum, (a) notice of the meeting at which the resolution was adopted, (b) agenda for the meeting at which the resolution was adopted, and (c) minutes of the meeting at which the resolution was adopted.
 - 2. Incumbency certificate evidencing the office held by the individual signing the request on behalf of the governing body certifying that the individual is the current holder of that office.
- d. A written memo addressing the conditions and guidelines set forth herein.
- e. A copy of the employer's pension funding policy required to be adopted pursuant to A.R.S. § 38-963.01.
- f. The request and other supporting material must be submitted to the PSPRS Administrator. The request may be submitted electronically via email, or hardcopy via mail. It is the responsibility of the employer to ensure the request has been properly submitted. Current contact information for the PSPRS Administrator is as follows:

PSPRS
Attn: Administrator
3010 E. Camelback Rd. #200
Phoenix, AZ 85016

*To submit via email, please contact PSPRS at (602) 255-5575, for the email address of the Administrator.

5.2 Substantive Guidelines

In exercising its discretion and meeting its fiduciary duties with respect to a request for re-amortization, the PSPRS Board is subject to various constitutional and statutory provisions and various actuarial standards. Accordingly, in considering a request for re-amortization, the PSPRS Board will consider the following guidelines, which take into account those provisions.

Those constitutional and statutory provisions and actuarial standards include the following, among others: A.R.S. § 38-848.04(A)(3) (sets forth that the board trustees shall discharge their duties "with the care, skill and caution *under the circumstances then prevailing* that a *prudent person* acting in a like capacity and familiar with those matters would use in the conduct of an activity of like character and purpose") (emphasis added); Ariz. Const. art. XXIX, § 1(D) (mandates that "[p]ublic retirement system benefits shall not be diminished or impaired[.]"); A.R.S. § 38-848.04(B)(3) (sets forth that board trustees shall "*make reasonable efforts to verify facts* relevant to the investment and management of assets of a retirement plan or system.") (emphasis supplied); A.R.S. §§ 38-843(B) and 38-891(A) (both set forth that the closed period for amortization of unfunded liabilities set by the Board takes into account the recommendation of the system's actuary); Actuarial Standard of Practice 51 (ASOP 51) (Assessment and Disclosure of Risk Associated with Measuring Pension Obligations and Determining Pension Plan Obligations); A.R.S. § 38-863 (employer disclosure of funding ratio); A.R.S. § 38-841(B) (sets forth that the system is established to "provide a uniform, consistent and equitable statewide program."); A.R.S. § 38-848.04(A) (sets forth that the board shall act impartially, taking into account any differing interests of members and beneficiaries); Ariz. Const. art. XXIX, § 1(D) (mandates that the system be administered solely in the interests of the members and beneficiaries.); A.R.S. § 38-848.04(A)(1) (the board shall act solely in the interests of members and beneficiaries).

- a. Actuarial and other system resources.
 - 1. As noted above, under the Arizona Constitution and applicable statutes, in determining an amortization period one consideration is the opinion of the system's actuary. In addition, the system's personnel and advisors are familiar with the system, its operations, and its rights and obligations. Accordingly, in reviewing an employer's request, the PSPRS Board may consult with the PSPRS actuary, personnel, and advisors. The employer's request should indicate whether the employer has separately received advice from an actuary in connection with making the request and, if so, provide details regarding that advice.
- b. Special and/or unique perceived risk.
 - 1. In applying generally accepted actuarial principles, the PSPRS Board, actuary, and personnel might perceive certain risks arising from the context in which the request is made, including existing facts and circumstances (as well as reasonably foreseeable consequences and the making of reasonable assumptions). If the requesting employer is aware of such risks, the request should address those risks.
- c. Bond ratings or other debt financing guidelines (operating expenditures, debt ratio, etc.)
 - 1. Alterations in amortization periods can affect pension expenses and unfunded liabilities, which in turn can impact an employer's bond rating or ability to borrow. Information regarding the employer's bond rating and capacity for debt financing is thus material. An employer's request should indicate whether the employer has a bond rating(s) or other financial rating(s) and, if so, the nature of the rating(s).
 - 2. It should be noted that a high bond rating can, on a relative basis, evidence the lack of a pressing need for the relief resulting from lengthening of an amortization period. Conversely, a low bond rating can, on a relative basis, evidence such a pressing need.
- d. Cash flow implications.
 - 1. An employer's cash flow is relevant to the employer's ability to pay required pension contributions. Accordingly, it is important to understand the effect of re-amortization on the employer's cash flow. A request should provide supporting financial statements and other information regarding the employer's historical and projected cash flow.
- e. Funded status, contribution rates, and operating budget affordability.
 - 1. The employer's current funded status is relevant to the question of materiality of a request re-amortization. In addition, an employer's contribution rate and operating budget are pertinent to the prospects for the employer's funded status. While PSPRS maintains data regarding an employer's funded status and contribution rate, the request should (a) confirm the employer's understanding of that status and rate, (b) disclose the employer's funding ratio for each of the employer's eligible groups under the PSPRS system, and (c) provide relevant information regarding the employer's historical and projected operating budget.
- f. Sources of revenue, and limitations on raising revenue.
 - 1. The request should address the taxation and assessment powers and other revenue sources (e.g., user fees) available to the employer.
 - 2. If the employer has undertaken various fiscal measures to address its unfunded liability, those should be addressed by the employer. For example, such measures might comprise, among other things, an increase in taxes, assessments, user fees, or other sources of revenue that will be solely applied to unfunded liabilities, or reduction of operating budget expenditure items to make funds available to apply to unfunded liabilities.

3. The request should also address any legal, practical, or other limitations on the use of those powers and other revenue sources to finance the payment of contributions to the PSPRS system.
- g. Expenditure limitation compliance.
 1. To the extent that an employer is subject to constitutional, statutory, or other expenditure limitations, the request should indicate the existence, extent, and practical effect of those limitations.
 - h. Employer's stated rationale/need for re-amortizing.
 1. Aside from addressing the other itemized guidelines, the employer should explain its reason for requesting the re-amortization, including the need for implementing the change at this time.
 2. For example, if the employer believes that the request is necessitated by an emergency situation (such as a clear and present danger to the employer's ability to pay upcoming contributions to PSPRS), the employer should explain the nature and expected duration of that situation.
 - i. Employer's stated justification for the specific amortization period requested.
 1. The employer should explain the rationale for the requested amortization period and why it is the optimal period (e.g., why 23 years is preferable to 22 or 24 years).
 - j. Special and/or unique circumstances justifying the re-amortization request.
 1. In addition to the guidelines listed above, the employer may provide to the board other information deemed pertinent to the request.
 - k. Magnitude of negative amortization due to re-amortizing.
 1. The general policy of PSPRS is to avoid negative amortization of pension liabilities. Accordingly, the employer should document that the request will not result in negative amortization or, if it will, illustrate the relative immateriality of the negative amortization (or, alternatively, explain the rationale for creating negative amortization of the projected magnitude).
 - l. Effect on intergenerational equity due to the re-amortizing.
 1. The employer's request should also address the effect, if any, that the re-amortization would have on intergenerational equity.
 - m. Input from representatives of the employer's public safety personnel.
 1. In light of the board's statutory fiduciary duty, the employer's request should be accompanied by input from the employer's public safety personnel. The PSPRS Board may itself solicit input from such personnel.

5.3 Substantive Conditions

Due to potential constitutional constraints, an employer should recognize that the effectiveness of any re-amortization may well depend on the re-amortization's being subject to certain conditions. The purpose of the conditions (if any were to be imposed) is to mitigate the risk that a court might otherwise deem the re-amortization to infringe on the membership contractual arrangement. The more pertinent conditions are likely to be, therefore, those that tend to prevent jeopardizing, among other things, the probability of payment of benefits and reasonable administrative expenses and the stability of the PSPRS system.

Any such conditions would be incorporated into a written intergovernmental agreement between the employer and PSPRS.

Accordingly, the employer should address the conditions that it believes are necessary or

appropriate conditions to apply to the re-amortization or otherwise explain why such conditions are not necessary or appropriate. Depending on the circumstances, one or more of the following conditions may or may not be applicable or feasible. On the other hand, the following list of potential conditions is not intended to be exhaustive, and there may be additional or other conditions that might be warranted depending on the circumstances. Accordingly, in its written request, an employer may feel free to suggest additional or alternative conditions.

- a. Diligent pursuit of bond financing or other financing of existing unfunded liabilities.
 1. Some employers have undertaken, or are considering undertaking, bond financing or other financing for their existing unfunded liabilities, thereby alleviating the need for other means of addressing liability for contributions to PSPRS, such as re-amortization.
 2. Factors relevant to such a financing may also be addressed in the request. For example, recent legislation allows fire districts to pledge assets for financing.

- b. Participation in the PSPRS pre-funding plan.
 1. Enacted in 2020, the PSPRS pre-funding plan can enhance the ability of an employer to plan for and pay over to PSPRS the employer's future contribution obligations. See A.R.S. §§ 38-931 to 38-940.

- c. Financial performance covenants or benchmarks, such as average annual budget surplus or other measure.