Time to Consider the Appropriateness of COLAs Tuesday October 3, 2023 10:30am – 11:35am

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Why COLAs?

- To offset or reduce the effects of inflation on fixed pension income benefits.
- If you are covered by social security, you will have some sort of inflation protection from your Social Security Primary Insurance Amount.
- Collective Bargaining Agreements.
- Plan design objectives.

Why COLAs?

- To maintain or restore purchasing power lost due to inflation.
- May depend on the financial condition of the plan or the employer.

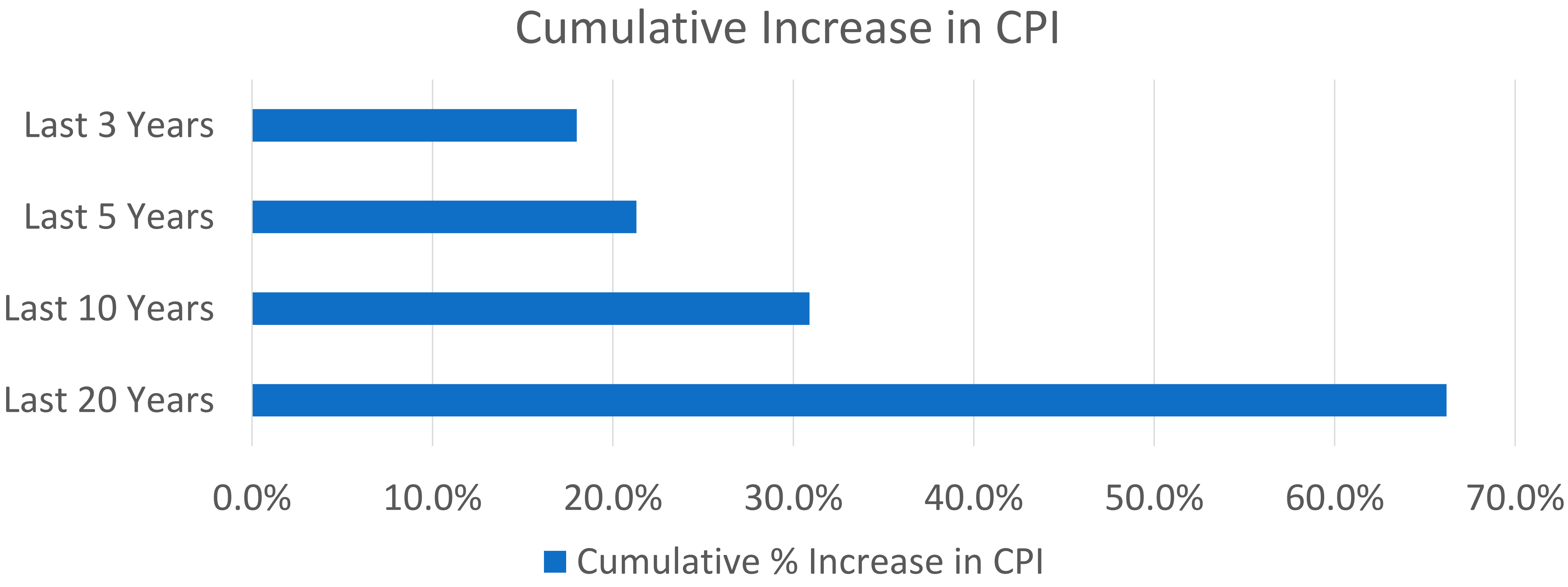
Why Now?

- After 20 years of mild to moderate inflation, the pandemic was a primary driver of a surge in inflation over the last 3 years.
- Even 2% annual inflation can wipe out one-third of a pension benefit’s purchasing power after 20 years of retirement.

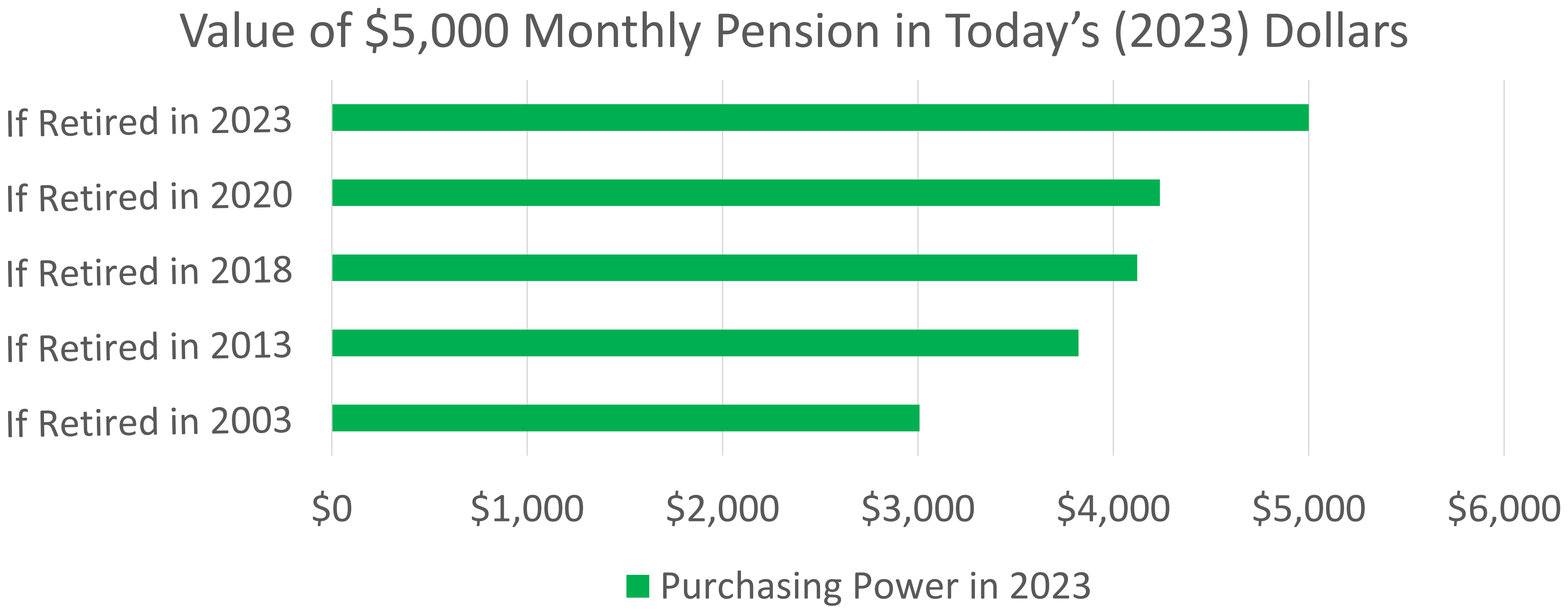
Why Now?

- Many revenue sources for employers increase during periods of higher inflation, so budgets may have expanded versus projections.
- Cost of implementing or changing a COLA will determine the appetite and ability to consider alterations in COLA plan provisions.

Recent Increases in CPI



Decrease in Purchasing Power



To Die with Dignity

I don’t understand how a cemetery can raise it’s funeral prices and blame it on the cost of living.

Types of COLAs

- Periodic (Recurring)
  - COLA’s could be applied annually or at any other interval (e.g., every “X” years, or at ages 65, 70, 75,…).
- Ad hoc
  - One-time COLA for all retirees meeting certain criteria.
- Limited Benefit Basis
  - Applying COLA only to first $X,XXX of pension benefit.

Features of COLAs

- Fixed vs. Variable (inflation/performance-based)
- Percentage-based vs. Dollar-based
- Simple vs. Compound
- Immediate vs. Deferred
- Permanent vs. Temporary
- Caps / Floors (annual and/or lifetime)

Periodic COLAs

Date	Monthly Benefit Amount		COLA
	Annually	Biannually	
10/1/2024	$1,000.00	$1,000.00	
10/1/2025	$1,020.00	$1,000.00	2%/0%
10/1/2026	$1,040.40	$1,020.00	2%/2%
10/1/2027	$1,061.21	$1,020.00	2%/0%
10/1/2028	$1,082.43	$1,040.40	2%/2%
10/1/2029	$1,104.08	$1,040.40	2%/0%
10/1/2030	$1,126.16	$1,061.21	2%/2%

Period/interval can be anything: annually, biennially, every 3rd year, every 5th year.

Timing can be based on years since retirement or attainment of different ages (e.g., 65, 70, 75,…).

Fixed vs. Variable COLAs

Date	Monthly Benefit Amount		Var. COLA
	Fixed 2% COLA	Variable	
10/1/2024	$1,000.00	$1,000.00	
10/1/2025	$1,020.00	$1,018.00	1.8%
10/1/2026	$1,040.40	$1,044.47	2.6%
10/1/2027	$1,061.21	$1,084.16	3.8%
10/1/2028	$1,082.43	$1,101.50	1.6%
10/1/2029	$1,104.08	$1,136.75	3.2%
10/1/2030	$1,126.16	$1,164.03	2.4%

If the objective is to retain purchasing power, variable inflation-based COLAs do the best job of meeting that goal, although they are unpredictable and typically more expensive.

Variable performance-based COLAs are tied to the plan's performance or gain/loss.

Variable COLAs

- Inflation-based variable COLAs are usually tied to an index (e.g., CPI-U, CPI-W).
  - Could be 100% of increase in inflation, as measured by the index, or any other percentage (such as 50% or 75%).
  - Could have an annual cap (such as 3%).

Variable COLAs

- Performance-based variable COLAs can be linked to investment performance, such as:

Investment Return	Annual COLA
Less than 0%	0.0%
0% to 4%	0.5%
4% to 8%	1.0%
8% to 12%	1.5%
12% to 16%	2.0%
16% or Higher	2.5%

Percentage-Based vs. Flat Dollar

Date	Monthly Benefit Amount		COLA
	Percentage-Based COLA	Flat-Dollar Based COLA	
10/1/2024	$1,000.00	$1,000.00	
10/1/2025	$1,020.00	$1,025.00	2%/$25
10/1/2026	$1,040.40	$1,050.00	2%/$25
10/1/2027	$1,061.21	$1,075.00	2%/$25
10/1/2028	$1,082.43	$1,100.00	2%/$25
10/1/2029	$1,104.08	$1,125.00	2%/$25

If the objective is to retain more purchasing power for lower-income retirees, then a flat dollar COLA may be well-suited to meet this objective.

Flat dollar-based COLAs are typically less expensive than percentage-based.

Simple vs. Compound COLAs

Date	Monthly Benefit Amount		COLA
	Compound	Simple	
10/1/2024	$1,000.00	$1,000.00	
10/1/2025	$1,020.00	$1,020.00	2%
10/1/2026	$1,040.40	$1,040.00	2%
10/1/2027	$1,061.21	$1,060.00	2%
10/1/2028	$1,082.43	$1,080.00	2%
10/1/2029	$1,104.08	$1,100.00	2%
10/1/2030	$1,126.16	$1,120.00	2%

Simple COLAs apply the same dollar increase each period (based on a % of the initial pension benefit).

Compound COLAs are a better representation of how inflation operates in the economy, although they are a little more expensive than simple COLAs.

Immediate vs. Deferred COLAs

- COLAs can either start immediately after retirement or be deferred (to a stated age or for a stated number of years after retirement, or some combination).
  - Primary purpose is to reduce cost impact.
  - May make sense to at least defer the COLA while participating in a DROP, as salary increases during DROP participation provide some inflation protection.

Immediate vs. Deferred COLAs

- The longer the COLA delay, the less expensive it will be.
  - COLAs can be deferred for 5 years, 10 years, or longer – this reduces Plan costs and provides a boost to purchasing power after other sources of income (such as from a sunset career or part-time job) cease.
- COLAs can also be deferred to an age (e.g., 60, 65, 70).
- Could also combine age and service (e.g., deferred to age 60 or 65, with at least a 5-year delay).

3-Year vs. 5-Year Deferred COLA

Date	Monthly Benefit Amount		COLA
	3-Year Deferral	5-Year Deferral	
10/1/2024	$1,000.00	$1,000.00	
10/1/2025	$1,000.00	$1,000.00	0%/0%
10/1/2026	$1,000.00	$1,000.00	0%/0%
10/1/2027	$1,020.00	$1,000.00	2%/0%
10/1/2028	$1,040.40	$1,000.00	2%/0%
10/1/2029	$1,061.21	$1,020.00	2%/2%
10/1/2030	$1,082.43	$1,040.40	2%/2%

Permanent vs. Temporary COLAs

- COLAs can be permanent (applying periodically for life) or temporary (applying for X years or from ages Y to Z – e.g., from age 55 to 65).
- Temporary COLAs are usually less expensive than permanent COLAs.
- Temporary COLAs can help bridge gaps by applying until eligibility for other benefits, such as Social Security, Medicare, post-ret health/VEBA benefits, etc.

Temporary COLAs

- Temporary COLAs can have same COLA features as Permanent (Lifetime) COLAs.
  - Could be fixed or variable during temporary period.
  - Could be percentage-based or dollar-based.
  - Could be deferred (5 or 10 years or to a certain age, then applied annually for 10 years).
  - Could be compound or simple COLAs.

Caps and Floors with COLAs

- COLA Caps and Floors are more commonly used with variable (inflation-based) COLAs.
  - An annual COLA cap could be something like 3% to limit increases (and Plan costs) when inflation is high.
  - An annual COLA floor (such as 1%) could apply when inflation is very low to help offset the effect of capped increases in years when inflation exceeds the cap.

Caps and Floors with COLAs

- Lifetime Caps
  - No further COLA increases once benefits have increased by a total of X% (e.g., 50%) or by a total of $X,XXX per month since retirement.
  - Lifetime Caps help reduce the cost of COLAs.
  - They essentially turn permanent COLAs into temporary COLAs for those who live the longest (ceasing once the lifetime cap is reached).

Other COLA Types: Ad hoc COLAs

- "Ad hoc COLAs" are one-time benefit increases given to retirees who have not received periodic COLAs, to help restore at least a portion of lost purchasing power since retirement.
- During periods of favorable experience or budget surpluses, or after several years of inflation without any COLAs for retirees, an ad hoc COLA could be considered.

Ad hoc COLAs

- An ad hoc COLA can be designed in many ways:
  - A fixed percentage increase (or a fixed percentage per year retired, up to a % cap).
  - A fixed dollar increase (or a fixed amount per year retired, up to a $ cap).
  - A restoration of all or a percentage (such as 50%) of lost purchasing power since retirement.

Ad hoc COLAs

- An ad hoc COLA can be applied in many ways:
  - Only to retirees over a certain age (e.g., 65 or 70).
  - Only to retirees who had at least X years of credited service at retirement (e.g., at least 20 years).
  - Only to retirees who have been retired for at least X years (e.g., those who retired 5+ or 10+ years ago).
  - Some combination of the above.

Ad hoc COLAs

- A one-time ad hoc COLA will not increase a Plan's cost/liability until it is implemented. It should then be funded over a shorter amortization period than other plan amendment bases because the changes only apply to retirees.
  - Unfunded liabilities attributable only to retirees should be amortized over no more than 10-15 years.

Ad hoc COLAs

- If a pattern emerges of granting ad hoc COLAs every few years (say, every 3 to 5 years), then they essentially become periodic COLAs; it will then become advisable to incorporate an assumption for future ad hoc COLAs into the Plan cost/liability.
  - ➢ This is required to be done for GASB 67/68 purposes once a pattern of ad hoc COLAs emerges (once they are deemed to be "substantively automatic").

Limited Benefit Basis COLAs

- COLAs that are applied to the first $X,XXX of monthly benefit payments (this can be indexed to maintain intergenerational equity). E.g., COLAs only apply to first $2,500 of monthly payments.
- All other features should be defined (fixed or variable, percentage or dollar based, deferred, temporary, simple or compound, caps, etc.).

Limited Benefit Basis COLAs

- Career service proration can be incorporated into limited benefit basis COLAs.
  - For instance, if COLAs are applied to the first $2,500 of the monthly benefit, this could be prorated based on actual years of service divided by 25; e.g., a retiree with 20 years of service would receive a COLA on the first $2,000 of their monthly benefit (=$2,500 * 20 / 25).

Inexpensive COLA Options

- COLAs could be provided through a reduced Optional Form of Payment irrevocably elected at retirement, which could either be combined with other (joint survivorship) options or restricted to specific options.
  - E.g., Initial monthly benefit could be actuarially reduced (by 15% to 20%) in exchange for a lifetime 2% annual COLA.

Inexpensive COLA Options

- COLAs could also be elected by employees upon being hired in exchange for accepting a lower benefit multiplier AND/OR a higher employee contribution rate (to offset the cost of the COLA).
- These types of COLA Options carry some adverse selection risks (if employees/retirees with longer life expectancies elect the COLA Options).

Scaling

- Every type of COLA can be scaled to suit your needs, objectives, and available funding resources.
- Think in terms of a zero entry pool -- if the stakeholders for your fund believe there is a need for a COLA or a need to increase an existing COLA provision, it can be scaled to be as small or as large as desired or as the Plan sponsor can afford.

Scaling

- Small COLAs are usually considered as being too small to make a meaningful difference; however, an elderly retiree or beneficiary may assign a meaningful value to any amount, even if it just improves their emotional well being.

Examples for Cost Comparison

- 1%, 2% or 3% Fixed Annual Compound COLAs
- 3% Fixed Annual Simple COLA
- 3% Fixed Annual Compound COLA Deferred 5 Years or 10 Years
- CPI-Based Variable Annual Compound COLA with +50% Lifetime Increase Cap
- Temporary 3% Annual Compound COLA for 10 Years (Ages 55-65 or First 10 Years If Retire>55)

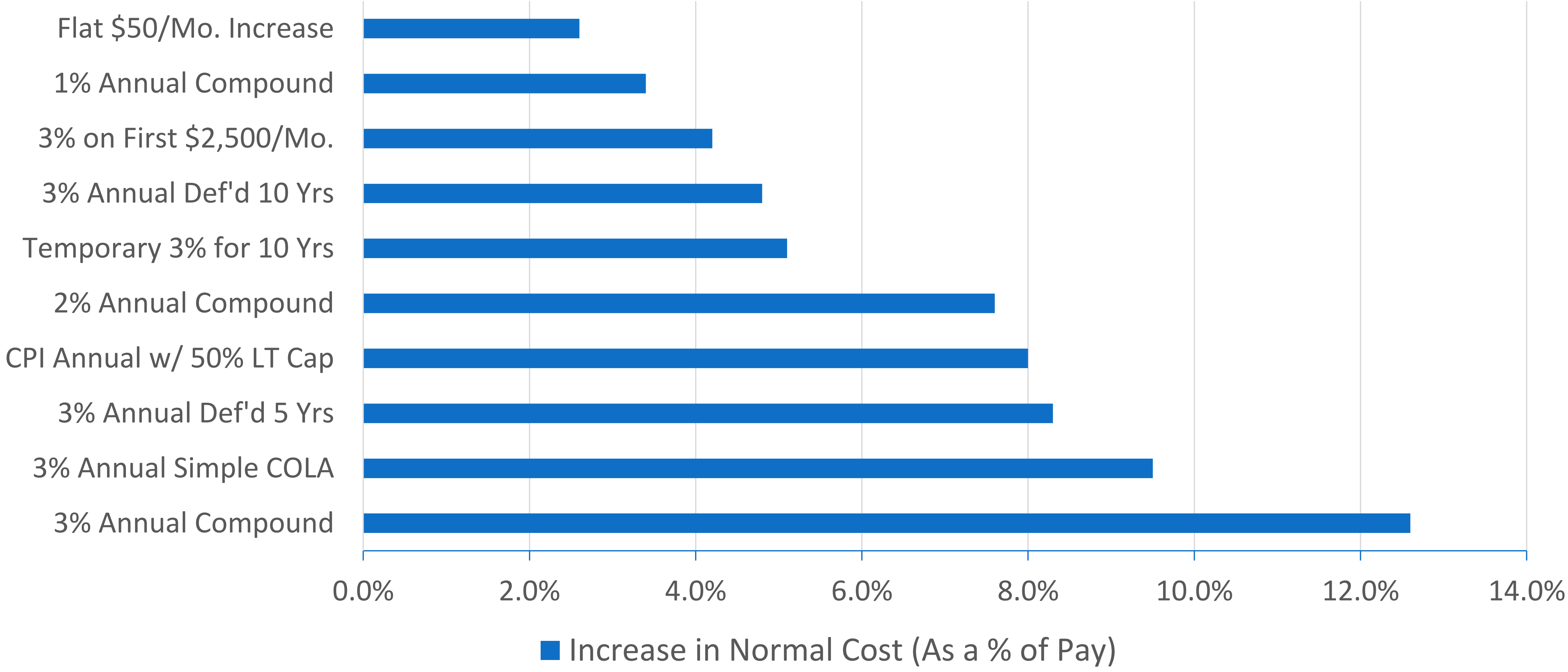
Examples for Cost Comparison

- Limited Benefit Basis 3% Annual Compound COLA Applicable to First $2,500/Month of Pension Benefit
- Fixed Dollar-Based Annual COLA of +$50/Month

Cost Comparison of COLAs

COLA Example	% Increase in Normal Cost	Increase in Normal Cost as % of Pay
1% Immediate Fixed Annual Compound COLA	+11.0%	+3.4%
2% Immediate Fixed Annual Compound COLA	+24.2%	+7.6%
3% Immediate Fixed Annual Compound COLA	+40.1%	+12.6%
3% Immediate Fixed Annual Simple COLA	+30.2%	+9.5%
3% Fixed Annual Compound COLA Deferred 5 Years	+26.6%	+8.3%
3% Fixed Annual Compound COLA Deferred 10 Years	+15.4%	+4.8%
CPI-Based Variable Compound COLA w/ 50% Lifetime Cap	+25.7%	+8.0%
Temp. Fixed 3% Annual Compound COLA (55-65 or 10Yrs)	+16.3%	+5.1%
Limited Benefit Basis 3% Annual COLA on First $2500/Mo.	+13.5%	+4.2%
Fixed Dollar-Based Immediate COLA of $50/Mo. Each Year	+8.4%	+2.6%

Cost Comparison of COLAs



Drafting Ordinance Language and Impact Statements for COLAs

- Examples are paramount to make sure all parties understand what is being agreed upon.
- Examples will aid in both the proper costing and the effective administration.

Drafting Ordinance Language and Impact Statements for COLAs

- Depending on the type of COLA, the plan's funding policy may need to be updated.
- Be clear who is eligible and who is not.
  - E.g., actives (hired on or after a specific date), vested terminated members, retired members, and/or beneficiaries.