National Overview of Public Retirement Plan Risk Sharing & Contingent COLAs

Alex Brown

Research Manager

National Association of State Retirement Administrators

Investments & Pensions Oversight Committee

New Mexico Legislature

November 6, 2019

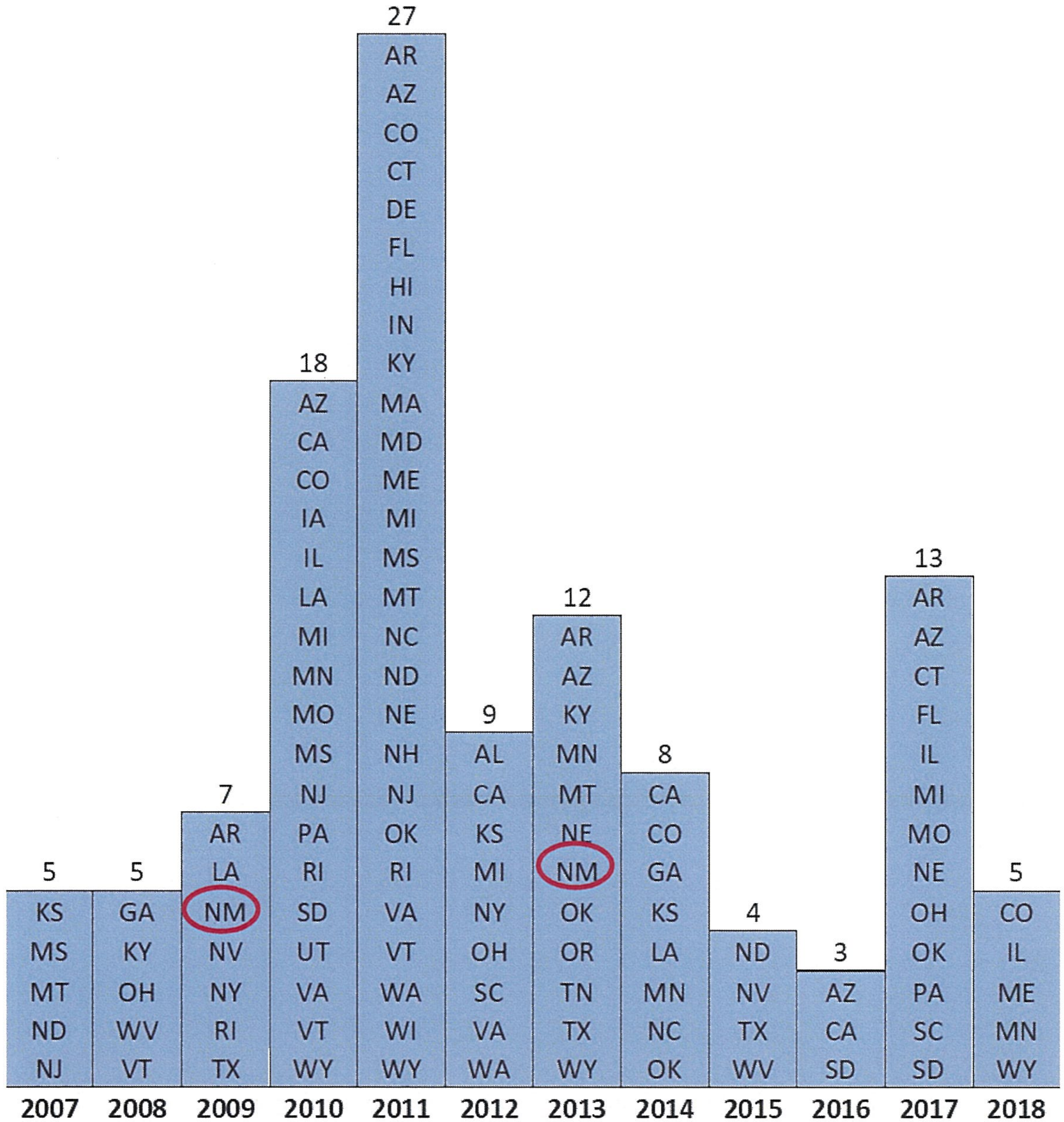
Presentation Overview

- Pension reform overview
- Conceptual discussion of retirement plan risks
- COLA history and purpose
- Examples of performance-based COLAs
- NASRA's position on plan design

2009-Present:
The Era of Public Pension Reform

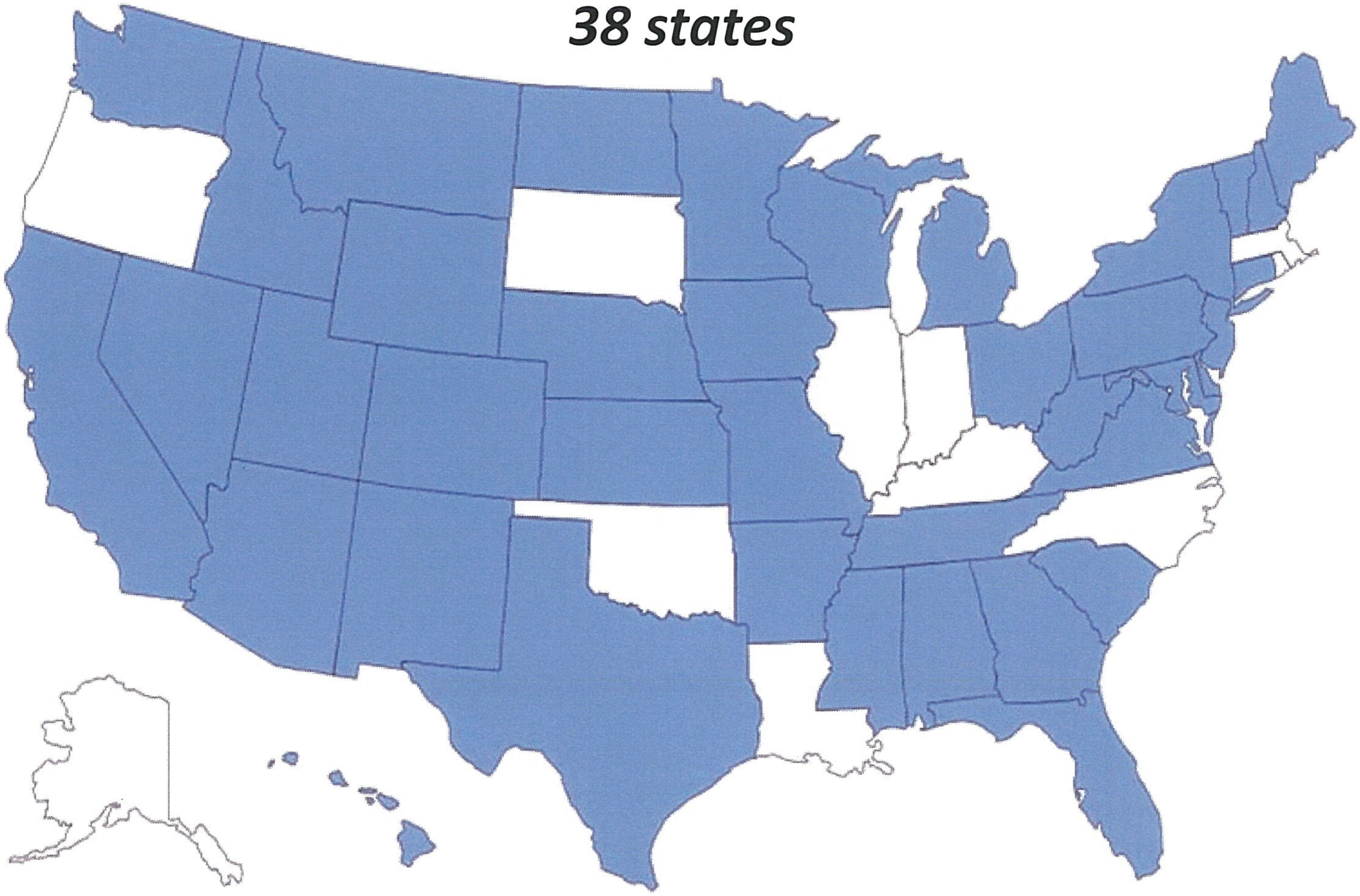
- Nearly every state modified public pension benefits, financing arrangements, or both, since 2010
- Higher contributions
  - Often from employees
  - Usually from employers
- Lower benefits
  - Lower multiplier
  - Higher retirement age
  - More required years of service
  - Reduced, suspended, or eliminated COLAs
- A major theme of reforms has been the establishment of so called risk-sharing plan design features

States Enacting Pension Reform 2007-2018



NASRA, "Significant Reforms to State Retirement Systems"

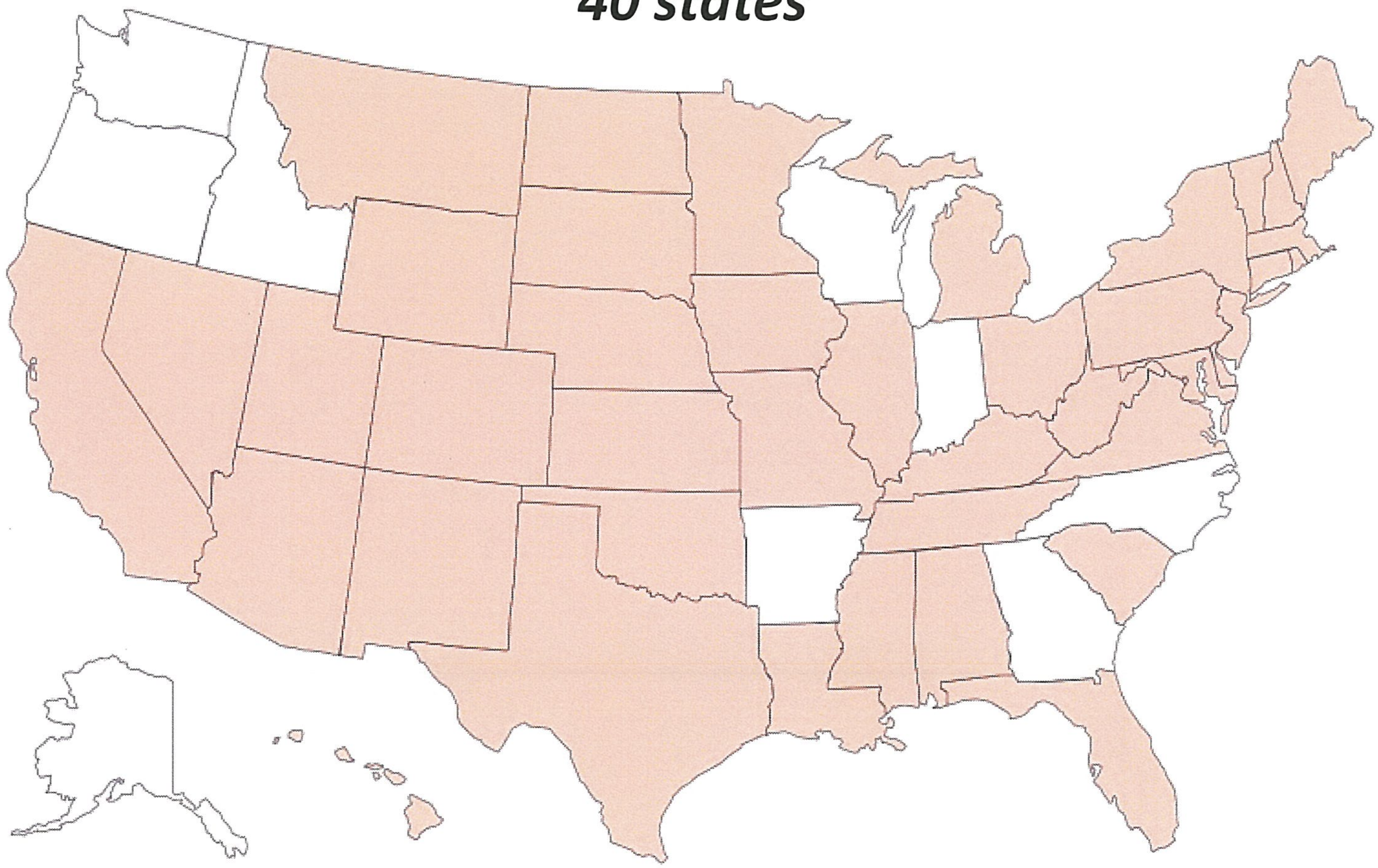
States That Have Increased Employee Contribution Rates, 2009-2018



NASRA, "Significant Reforms to State Retirement Systems"

States That Reduced Pension Benefits, 2009-2018

40 states



NASRA, "Significant Reforms to State Retirement Systems"

Risk Sharing Conceptually

C + I = B + E

Contributions + Investment Earnings
= Benefits + Expenses

- Over time, the revenue into a retirement plan must equal the plan's expenses
- This balance is maintained when the plan's actuarial assumptions are approximately correct over time
- In a traditional defined benefit plan, when this balance is disrupted, employer contribution rates must rise
- Risk-sharing introduces the possibility that employee contributions or benefit levels will be adjusted under certain conditions

Primary Types of Retirement Plan Risk

- Investment risk
  - The risk that investment returns will be less than expected
  - Who is expected to make up the shortfall depends on the plan type and plan design
- Longevity risk
  - The possibility that retirees may live longer than expected
  - Also known as mortality risk
- Inflation risk
  - The risk that inflation will erode the purchasing power of one's retirement benefit
  - The presence or absence of a COLA is consequential

Who Bears Retirement Plan Risk?

- Risk is distributed differently, depending on the plan type and plan design
- In traditional defined contribution plans, employees typically bear all (or most) of the risk
- In traditional defined benefit plans, employers typically bear all (or most) of the risk
- In modern public pension plans:
  - The type and degree of risk-bearing varies
  - Some plans have longstanding risk-sharing features while in others, these features are recently incorporated
  - More risk is being shifted from employers to employees

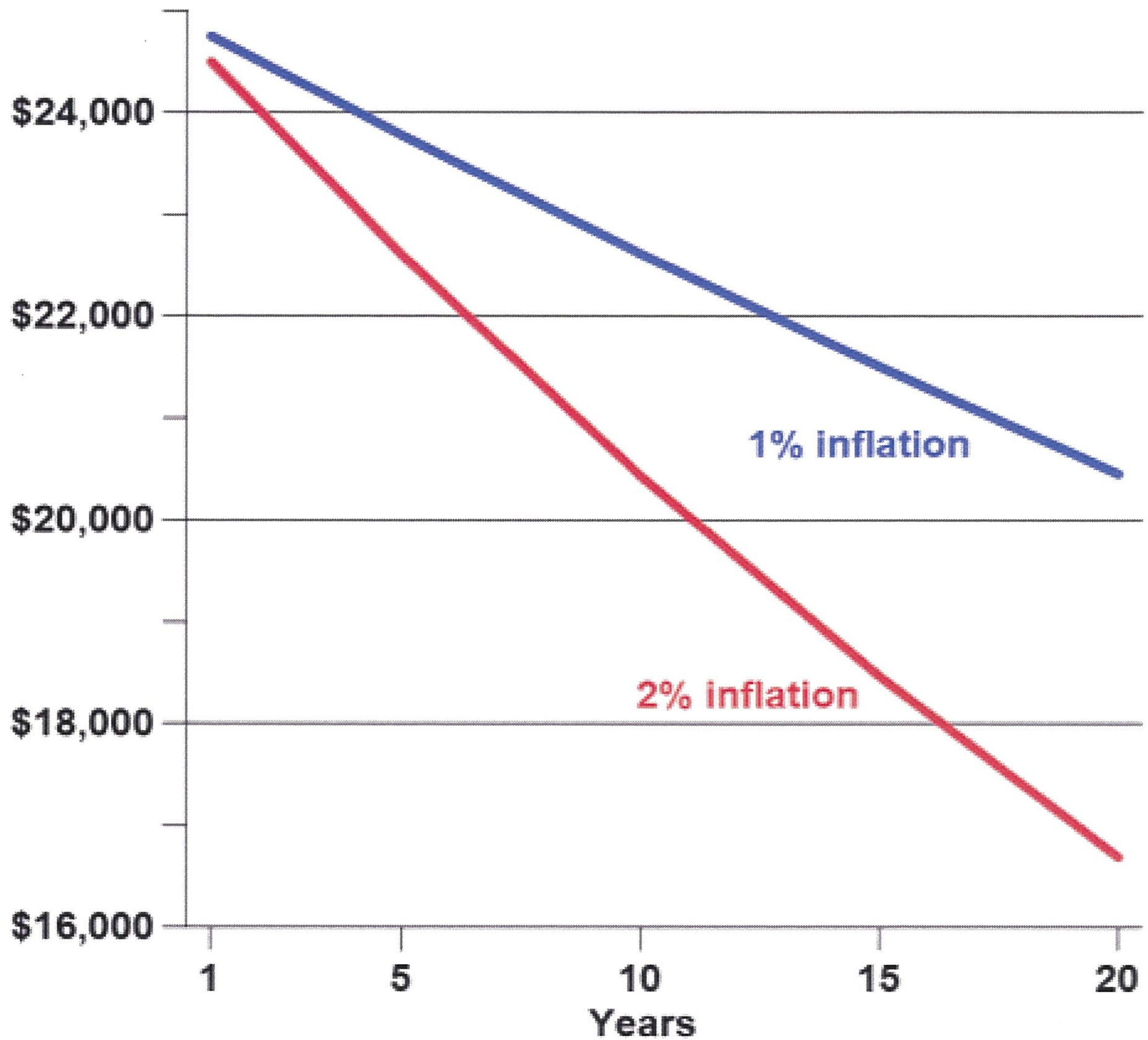
Additional Considerations

- Public pension plans vary in their governance arrangements, legal and statutory frameworks, plan designs, and stakeholder objectives
- Whether or not, and to what degree, risk-sharing elements can be incorporated into a plan's design depends on several factors:
  - The plan's design:
    - Who is required to contribute, and how much?
    - How is the benefit calculated and distributed?
    - Presence or absence of a COLA
  - The ability to change certain plan elements

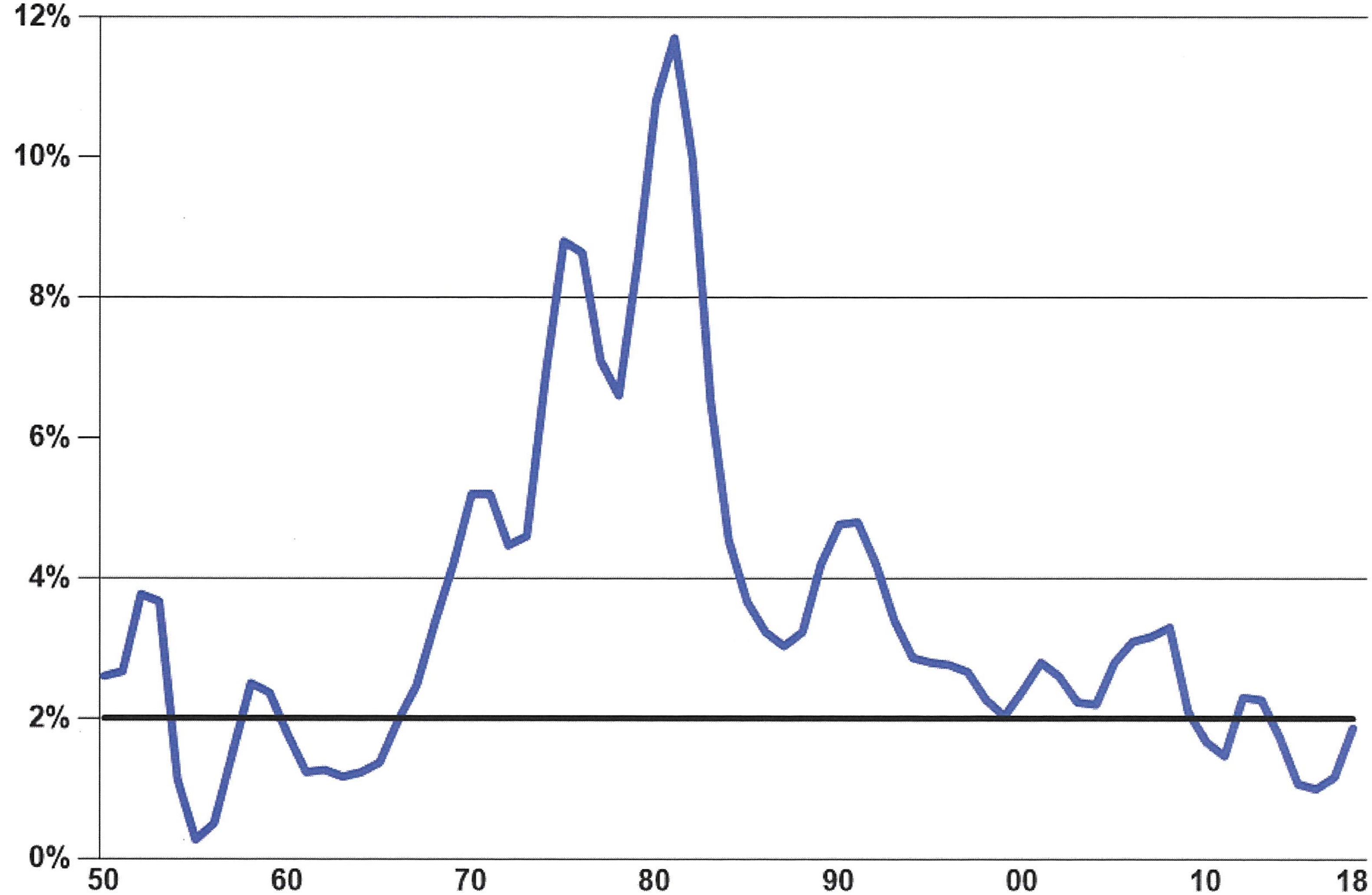
COLA Purpose and History

- A COLA is intended to offset the effects of inflation on a pension benefit
- COLAs for many plans were established in the 1970s and 1980s in response to high inflation
- Most plans provide COLAs on an automatic or ad hoc basis
- Since 2009 many states have reduced, suspended, or eliminated COLAs in an effort to reduce liabilities and costs
- Low inflation in recent years has protected many retirees against the impact of COLA reductions

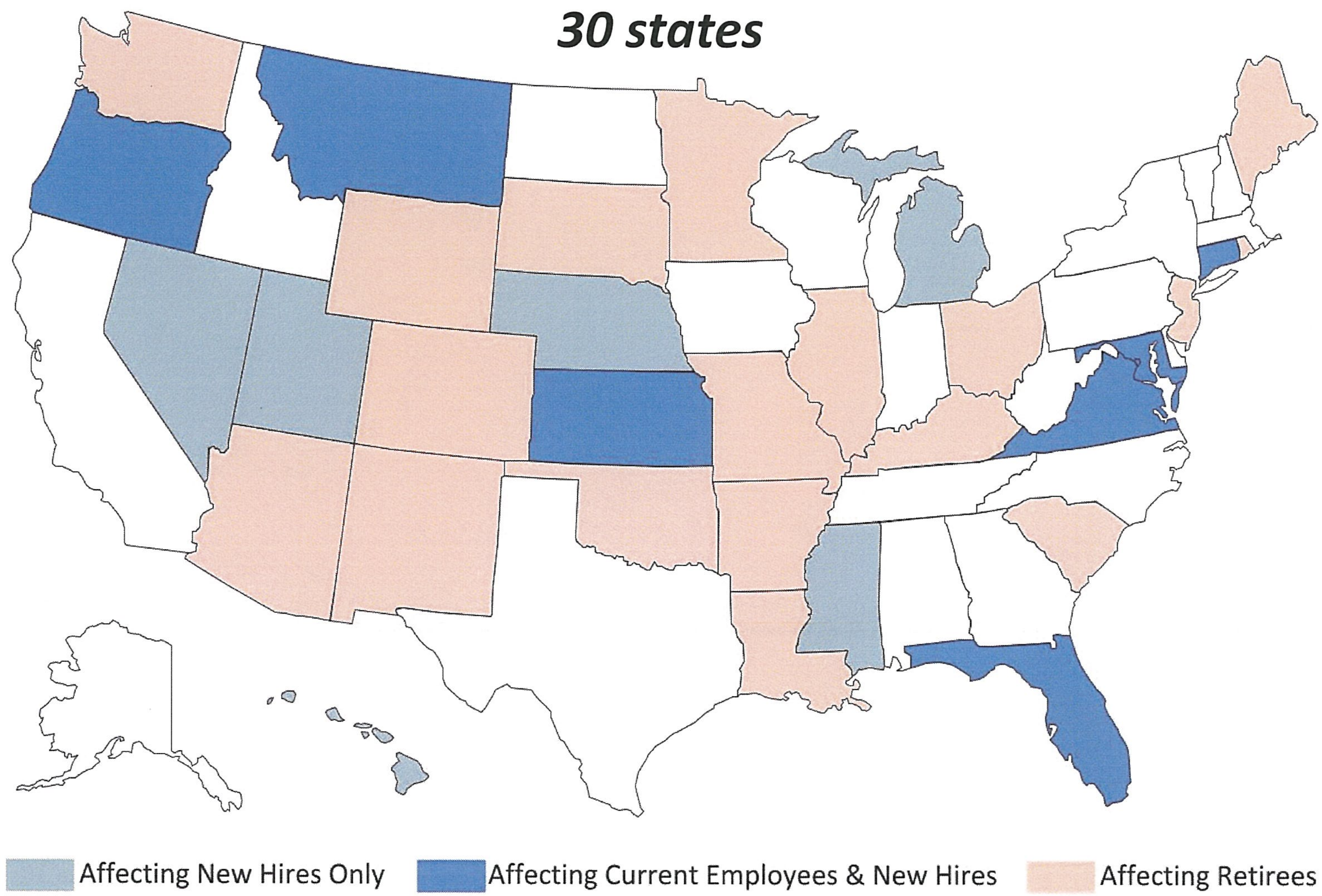
Impact of 20 Years of Inflation on Purchasing Power of $25,000 Benefit



Three-Year Rolling Average Change in CPI-U, 1950-2018



States that Have Made Changes to Cost-of-Living Adjustments, 2009-2018



Contingent or Limited COLAs

- Most plans provide a COLA based on the annual change in CPI, and usually restricted to a specific percentage of the change (i.e. one-half of CPI) or subject to a cap (i.e. not to exceed three percent)
  - In this arrangement retirees bear the risk of inflation above the threshold or cap
  - COLA will not likely be higher than is necessary to protect against inflation
  - If inflation is higher, the COLA will not fully offset the effect of inflation

Contingent or Limited COLAs

- Some plans provide COLAs (or provide larger COLAs) when annual investment earnings exceed an established benchmark (e.g. the plan's assumed rate of investment return)
  - COLAs are paid from investment earnings rather than contributions
  - COLAs may be infrequent and inadequate to preserve purchasing power
  - This arrangement subjects retirees to investment risk as well as inflation risk
- Other limited or contingent COLA features include:
  - Applied only to a portion of the pension benefit
  - Delayed onset or minimum age requirement

Examples of Performance-Based COLAs

- Connecticut Teachers
- Louisiana State Employees and Teachers
- Maryland State Retirement & Pension System
- Employees' Retirement System of Rhode Island
- Statewide public pension plans in Arizona
- Colorado PERA

Connecticut Teachers

- For those hired between 9/92 and 7/1/07, COLA is equal to Social Security COLA with a maximum of:
  - 1.5 percent if investment return is < 8.5 percent
  - 6.0 percent if investment return is > 8.5 percent
- For those hired after 6/30/07, new COLA maximums apply as follows:
  - 1.0 percent if investment return is < 8.5 percent
  - 3.0 percent if investment return is between 8.5 and 11.5 percent
  - 5.0 percent if investment return is > 11.5 percent

Louisiana SERS and TRS

- COLAs are granted if investment returns reach a certain level, limited by inflation and the funded status of the system
- COLA applies only to the first $60,000 of benefits (indexed)
- Minimum COLA eligibility is age 60 if retired for at least one year
- COLAs may be granted only every other year until the system is at least 85 percent funded
- Participants may self-fund an annual COLA of 2.5 percent beginning at age 55 by accepting an actuarially reduced retirement benefit

Louisiana SERS and TRS Funding and Performance Based COLA Matrix

System Funding	System earns at least 8.25%	System earns ARR[1], but not 8.25%	System does not earn ARR
Less than **55%**	None	None	None
At least **55%** but less than **65%**	Lesser of **1.5%** or CPI-U[2]	Lesser of **1.5%** or CPI-U	None
At least **65%** but less than **75%**	Lesser of **2%** or CPI-U	Lesser of **2%** or CPI-U	None
At least **75%** but less than **80%**	Lesser of **2.5%** or CPI-U	Lesser of **2%** or CPI-U	None
At least **80%**	Lesser of **3%** or CPI-U	Lesser of **2%** or CPI-U	Lesser of **2%** or CPI-U

[1]*ARR is the Assumed Rate of Return for the System, currently 7.65% for the 12 month period ending on June 30 of the previous year.*
[2]*CPI-U is the Consumer Price Index – Urban.*

Source: LASERS Member's Guide to Retirement, July 2019

Maryland State
Retirement and Pension System

- For service credit earned after 6/30/11, COLA is automatic, based on CPI, capped at 2.5% or the if the recent calendar year market value rate of return was greater than or equal to the assumed actuarial investment return of 7.45%.
- If that investment return threshold is not met, the COLA is equal to the lesser of 1.0 percent or the increase in CPI.

Rhode Island ERS

- Effective 7/1/15, annual COLA is comprised as the sum of two elements:
  - The lesser of 3.0 percent or the increase in CPI for the previous year and;
  - 50 percent of the 5-year average investment return of the retirement system, less 5.5 percent with a floor of zero and a cap of 4.0 percent
- COLA commences on the later of the third anniversary of retirement or the attainment of Social Security normal retirement age
- COLA is applied to the first $25,855 of benefits (indexed)
- COLA is granted every four years until the plan is at least 80 percent funded

Statewide Plans in Arizona

- Prior to recent changes, the Arizona State Retirement System and Public Safety Personnel Retirement System provided retirees with a Permanent Benefit Increase (PBI) funded with excess investment returns
- 2013 legislation eliminated the AZ SRS PBI for new hires and replaced with an ad hoc COLA subject to legislative approval
- 2016 legislation replaced the AZ PSPRS PBI with a traditional COLA based on regional CPI and capped at different levels depending on date of hire

Shared Risk Elements of Colorado PERA Plan Design Approved in 2018

If the plans' actual contributions are less than 98 percent of the actuarially determined contribution	If the plans' actual contributions are greater than 120 percent of the actuarially determined contribution
ER contributions may be increased by up to 0.5% in a year, with a cap of 2.0% above ER contribution rates in effect in July 2019	ER contributions may be reduced by up to 0.5% in a year, with a floor of ER contribution rates in effect in July 2018
Member contributions are increased by up to 0.5% in a year with a cap of 2.0% above the July 2021 member contribution rate.	Member contribution rates are decreased by up to 0.5% in one year, not to fall below the 2018 member contribution rates.
The COLA is reduced by up to 0.25% in one year, not to fall below a floor of 0.5%	The COLA is increased by up to 0.25% in one year, not to exceed a cap of 2.0%
The state direct distribution payment into the fund is increased by up to $20 million in one year, not to exceed $225 million	The state direct distribution payment into the fund is reduced by up to $20 million in one year, with a floor of $0

NASRA's Position on Plan Design

- Core elements of public pension plan design
  - Mandatory participation
  - Employee-employer cost sharing
  - Assets that are pooled and professionally managed
  - Targeted income replacement
  - Annuitized benefits
  - Survivor and disability benefits
  - Access to a supplemental retirement savings plan

Several of these elements specifically address matters of retirement plan risks

NASRA Resolution 2016-01: Guiding Principles for Public Retirement System Plan Design and Sustainability

Final Thoughts

- How key retirement plan risks are apportioned among plan stakeholders is a consequential element of retirement plan outcomes
- Plans in which all - or most - of the risk falls on one stakeholder or another may lead to adverse outcomes for all stakeholders
- Many plans provide a COLA that is contingent or limited based on external factors, including investment performance and funding level
- The specific elements exposed to risk – and the degree to which they are exposed – varies depending on each plan's circumstances and objectives

Thank you for listening

nasra.org

nasra.org/sharedriskpaper

nasra.org/colabrief

alex@nasra.org

202-624-8461