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Via Webcamera

Good morning. My name is Hank Kim and I am executive director and counsel of the National Conference on Public Employee Retirement Systems (NCPERS). I would like to thank Chairman Lepak and Vice Chairman Boatman for their leadership in calling this important hearing. I also want to thank Representative Frix for his work on the much-needed Cost of Living Adjustment legislation that took effect in July.

I am pleased to speak on behalf of NCPERS, the largest trade association for public sector pension funds. We represent more than 500 funds throughout the United States and Canada, including Oklahoma's firefighters, law enforcement, and police retirement systems. Through our members, we are the voice of seven million retirees and nearly 15 million active public servants — including but not limited to public safety personnel, teachers, judiciary employees, elected officials, and general employees.

Before I dive in, I want to congratulate lawmakers for giving bipartisan support in both chambers of the legislature to the Representative Frix's COLA legislation, which took effect in July.

For the first time in 12 years, retired workers are getting a raise to offset cost-of-living increases. The increase is 2% of the monthly pension amount for workers who have been retired at least two years, and 4% for those who have been retired at least five years. Throughout the process, careful consideration was given to the pension plans' ability to absorb the COLA.

Today, I have been asked to describe the parameters other states and localities use to grant COLAs. Answering this question is an important step toward equity for Oklahoma's hard-working public servants. The matter deserves careful and prompt consideration so that this state's retired workers don't have to go another 12 years before an adjustment their pension pay is made.

The purpose of a COLA, after all, is to offset cost-of-living increases. No one wants to see the value of a public pension eroded. But that is exactly what happens when big gaps develop between adjustments. During the 12 years that Oklahoma's public servants went without a COLA, their cost of living rose 19.5%, according to the Bureau of Labor Statistics.[1] In effect, the lack of a COLA over this period reduced the value pensions paid to retirees by nearly 20 cents on the dollar.

The bottom line about COLA practices is that they are all over the map. Most public pensions at one time or another provide a COLA.

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[1] https://protectpensions.org/news/cost-living-adjustment-state-pensioners-becomes-law/

However, there is wide variation from one pension system to another in how COLAs are calculated and approved.

One key difference is whether COLAs are awarded automatically, meaning they are triggered by specific circumstances in the pension plan, or whether they are approved on an ad-hoc basis. Maybe a simpler way of describing this is whether the COLA is built into the pension plan, or isn't. When it is built in, there are variations in how COLAs work.

Another key is one of those variations: Are COLA increases applied in a simple or compound manner? Over the long term, compounding produces larger pension checks for retirees. There are other differences, but we will start with these two and discuss them in greater detail before we move on.

Oklahoma, of course, currently takes the ad-hoc approach, and this puts the state in a minority. In all, 29% of public pension plans offered ad hoc COLAs, meaning specific action had to be taken by a plan sponsor or legislature to agree on or authorize a COLA, according to 2019 data from NCPERS. By contrast, more than half of plans—54%--offered an automatic COLA.[2]

What I really want to underscore is that there are many, many ways to configure any COLA adjustments. I'll start with an example of how one pension system—the city of Chattanooga, Tennessee fire and police—structured and then restructured its automatic COLA.

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[2]https://www.ncpers.org/files/2019%20NCPERS%20Public%20Retirement%20Systems%20Study%20Report%20Final_M.pdf

Chattanooga had a 3% annual, flat-rate COLA in effect for a number of years. It as unadjusted for inflation as measured by the Consumer Price Index, or CPI. In 2007, when the annual rate of inflation was 3.8% in 2008, a 3% CPI wasn't enough to help retirees keep up. But when consumer prices deflated to the tune of 0.4% in 2009, an automatic 3% adjustment looked awfully generous.[3] There was a serious cost issue, and there was also a significant optics issue for the city.

When they retooled the formulae, they did a few things differently. First, they set the CPI adjustment to a maximum of 3%--but they limited the COLA until the pension funds' funding level reached 80%. And they skipped the COLA one year.

This is still an automatic approach to pension COLA adjustments, but it's not a cookie-cutter approach.

To provide another example of the automatic approach, let's look at the San Antonio Fire Employees pension fund. It provides an adjustment equal to 75% of CPI. Can they go higher than 75%? Yes, they can, but to do so they need to go to the state.

Now, what's an example—outside of Oklahoma--of the ad-hoc approach? DeKalb County, Georgia, which makes up part of metro Atlanta, provides a good case study. When they awarded on in 2019 for the first time in 14 years, it was 2%. Over time, they have looked at many options, including regressive measures such as a flat dollar amount of $50 across the board for anyone whose benefits total $5,000 or less a month. The bottom

[3] https://www.usinflationcalculator.com/inflation/historical-inflation-rates/

line is that the change is one-time only, and there is no promise of further increases down the road.

As I mentioned earlier, another major design decision in creating a COLA is whether they increase simply, or in a compound manner.

Under a simple COLA benefit, each year's increase is calculated based on the employee's original benefit when they retired. Under a compound COLA arrangement, the annual benefit increase is calculated based upon the original benefit as well as any prior benefit increases. Or a hybrid approach may be used, where the calculation is "simple" until the retiree reaches a certain age, and then begins compounding. The financial advantage to retirees of compounding begins small, but grow wider as the years continue.

COLAs, as I've mentioned, come in endless shades and varieties, and one common variable is for the amount of the adjustment to be contingent on other factors being met, such as the pension fund attaining a certain funding level.

What are some of the other approaches we see? COLAs can be **performance-based**, so that funding levels or investment performance impact the amount available for a COLA. **Delayed-onset or minimum age requirements** may be imposed so that COLAs don't kick in immediately. COLAs may be awarded on a **limited benefit basis**, covering only a portion of a retiree's annual benefit rather than the full amount. These are just some of the variations out there.

Some best practices do seem to be emerging. In conversations with the actuarial community, these are some ideas that come up:

1. Avoid flat rates. They're a crude instrument, because depending on the economy's performance, they are almost certain to end up being out of sync with inflation. It's important not to lock yourself in to an inflexible rate that isn't responsive to economic conditions.
2. Don't just set a floating rate—set a maximum, too. It is not prudent to leave the rate open-ended. The best practice is to determine a percentage that you think you want to provide, link it in some way to the Consumer Price Index, and make the resulting percentage a maximum.
3. Set up the funding. This is the most important point. When you promise an increase, the best practice is to put in the budget and fund for it. A COLA is a permanent increase in your cost structure, and you need to build it into your income stream.

In short, there is truly no single, magic formula for calculating and administering COLAs. But as I've just noted, there are some important rules of thumb. Today's historically low interest rate levels have spurred some plans to think about adjusting or even eliminating COLA formulas.

Our inability to accurate predict the direction of the economy makes it prudent, in my view, to have a sufficiently flexible approach to COLAs. The fine art of benefit design and financing should be and can be carefully calibrated to economic realities of a given community. Putting a carefully considered COLA formulation in place now, when interest rates are low, can position a pension system to weather the normal ups and down of the marketplace.

This has, of course, been a high-level and general overview. Now, when inflation is very low, is time to think prudently about designing a COLA approach that can weather all storms.

On behalf of NCPERS, I wish to thank the committee for giving us the opportunity to present our expertise on this important retirement security issue. NCPERS stands ready to assist you with facts, research, and expertise as you delve into policy discussions on retirement security. We invite this body to contact us should you need additional information.