How are COLAs Calculated?

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Today's Presentation

- COLAs Overview
- DRS COLA Calculations
- COLA Considerations
- Key Takeaways
- Next Steps

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What Is a COLA?

- A Cost-Of-Living Adjustment (COLA) is an increase to the pension benefit of a retiree or beneficiary intended to assist with rising costs due to inflation
  - May be tied to inflation (CPI), service, fixed percentage
  - May be one-time or annually recurring
- Most plans provide a CPI-based COLA
- Exception is PERS 1 and TRS 1 plans which provide
  - Alternate minimum and basic minimum benefits increase of ~3% annually
  - Optional COLA for purchase provides a Plans 2/3 style COLA

Which Plans Are Eligible for COLAs?

- All DRS administered retirement plans include a COLA, except the Judges Retirement Plan
- However, types of COLAs available to retirees vary by Plan/System and eligibility requirements

DRS COLA Eligible Retirement Plans	JRS
	LEOFF Plans 1/2
	PSERS
	PERS Plan 1
	PERS Plans 2/3
	SERS Plans 2/3
	TRS Plan 1
	TRS Plans 2/3
	WSPRS Plans 1/2

Recent 2021 COLA Recipients by Type

Plan(s)	COLA Type	Estimated Headcounts
Plans 2/3*	CPI Capped COLA	123,000
PERS/TRS Plans 1**	Minimum Benefit COLAs	17,000
LEOFF 1	CPI Uncapped COLA	7,000

**Includes all Plans 2/3 retirement plans, Judicial, and WSPRS 1.*

***OSA estimates approximately 56,000 PERS/TRS 1 retirees may be eligible for ad hoc COLAs.*

Source: Summarized data from 2021 COLAs data provided by DRS.

What Is a CPI?

- The Bureau of Labor Statistics gathers data on prices
- Produces multiple price indices, such as the
  - Consumer Price Index (CPI)
  - Producer Price Index
  - Different indices for regions across the country
- CPI measures the average cost of a basket of goods in a certain area
  - Choice of goods in the “basket” typically changes once a decade
- COLAs for Washington plans use “Seattle area” CPI

Who Determines COLAs?

- Retirement plan statutes prescribe COLAs
- COLA calculation is defined in law
  - Does not allow exercise of discretion
  - Determined by arithmetic, not an agency decision
- DRS performs the calculation and adjusts payments
- OSA only provides a courtesy check of the calculation
  - Yearly COLA letters from OSA simply confirm the arithmetic is correct

How Are COLAs Calculated?

- COLAs are based on percent changes in the CPI
- DRS compares CPI for prior years
- Simplified calculation

$$\frac{\text{2021 CPI}}{\text{2020 CPI}} - 1 = \text{2022 COLA}$$

- Actual COLAs depend on the plan design

Example with Real Numbers: LEOFF 1

- 2020 CPI = 826.0
- 2021 CPI = 865.2

2021 change in CPI = (865.2 ÷ 826.0) - 1 = 4.75%

2022 LEOFF 1 COLA = 4.75%

- Note
  - Members must be retired at least one full year before receiving a COLA
  - LEOFF 1 COLAs are paid in April

Example with Real Numbers: Plans 2/3

- 2020 CPI = 826.0
- 2021 CPI = 865.2

2021 change in CPI = (865.2 ÷ 826.0) - 1 = 4.75%

2022 Plan 2/3 COLA = 3.00% (1.75%* banked)

- Note
  - Members must be retired at least one full year before receiving a COLA
  - Plan 2/3 COLAs are paid in July

**Simplified example: Determining banked amount is not as simple as subtracting percentages.*

What Does "COLA Banking" Mean?

- When the percent change in CPI exceeds 3%, the amount above 3% is held (banked) for a later year
- The balance will be held for future year(s) when the change in CPI is below 3%
- Plans 2/3 retirees are expected to receive the full COLA over time (based on current inflation assumptions)

COLA Banking Examples

Example 1*					
Year	Increase in CPI	Excess Above 3% Added to Bank	Applied to COLA From Bank	Total Remaining in Bank	Total COLA
1	4%	1%	**	**	3%
2	2%	0%	1%	0%	3%

Simplified example: Determining banked amount is not as simple as subtracting percentages.

***First year there is no balance in the bank.*

Example 2*					
Year	Increase in CPI	Excess Above 3% Added to Bank	Applied to COLA From Bank	Total Remaining in Bank	Total COLA
1	4%	1%	**	1%	3%
2	4%	1%	0%	2%	3%
3	2%	0%	1%	1%	3%
4	1%	0%	1%	0%	2%

Simplified example: Determining banked amount is not as simple as subtracting percentages.

***First year there is no balance in the bank.*

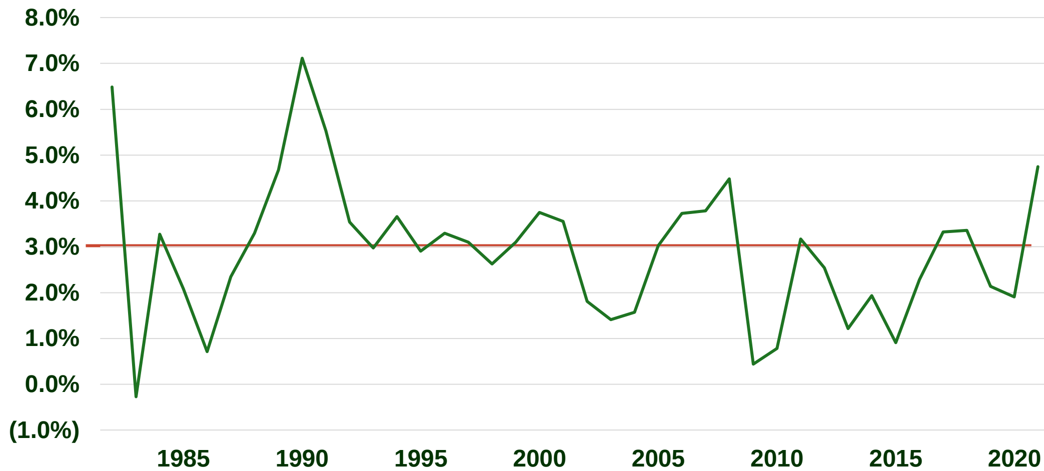
COLAs Don’t Represent Current Experience

- Higher prices in shelter or food, for example, and changes in the economy today are not immediately reflected
- COLA calculations are a look-back over the prior two years, so there is a lag in current inflation experience compared to the applied increase
- Not an up-to-date or real-time measure
  - Based on inflation measured several months prior to the first payment
  - May not be the same measure of inflation as reported in the media
- Caps may temporarily limit increases in periods of higher inflation

Personal Experience Varies

- Average “basket” may not be reflective of your basket or your region
- Does the average retiree in rural Washington spend the same as the average “Urban Wage Earner and Clerical Worker” in the Seattle area?

Historical Inflation According to BLS



Note: Prior to 2018, CPI was based on Seattle-Tacoma-Bremerton.

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COLA Plan Experience Varies

- COLAs have changed over time
- Ad Hoc COLAs for Plans 1*
  - 2018 1.5% with $62.50 cap
  - 2020 3% with $62.50 cap
  - 2022 3% with $110 cap

**Only applies to retirees not eligible for minimum benefits.*

COLA Type	COLA Applies to
Base COLA	Judicial LEOFF Plans 1 and 2 PSERS Plan 2 PERS Plans 2 and 3 SERS Plans 2 and 3 TRS Plans 2 and 3 WSPRS Plans 1 and 2
Uniform COLA *(Removed May 2011)*	TRS Plan 1 PERS Plan 1
Basic Minimum COLA	TRS Plan 1 PERS Plan 1
Alternate Minimum Benefit	TRS Plan 1 PERS Plan 1
Age 65 COLA	TRS Plan 1 PERS Plan 1
Optional COLA	TRS Plan 1 PERS Plan 1

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Plans 1 Recap

- LEOFF 1 Only COLA
  - LEOFF 1 members receive the full CPI change from prior years
  - This is referred to as a “fully indexed” COLA so if the percent change in CPI is 4%, annuitants receive 4%
  - If inflation is negative this may result in a pension decrease

- PERS/TRS Plans 1 Only COLA
  - COLAs available to Plans 1 include
    - Basic minimum, Alternate minimum, Optional COLA for purchase
  - May be granted ad hoc COLAs if passed by the legislature
  - Majority of retirees do not receive regular COLAs on the basic or alternate minimums

Plans 2/3 Only COLA Recap

- Members of the Plans 2/3 receive full change in CPI from prior years, not to exceed **3% per year**
- Members of Plans 2/3 are eligible for “banking COLAs”
- This means if the change in CPI is 2%, eligible retirees receive 2%
- If the change in CPI is 4%, they receive 3%
  - The extra 1% is held, or “banked” for future years
- Retirees may lose purchasing power if inflation averages above 3% for a prolonged time period

Key Takeaways

- Retirement system and plan designs vary
- COLAs are provided to many retirees in different forms
- CPI-based COLAs lag market experience and do not represent a real-time response to inflation

Next Steps

- Educational presentation today providing a foundation for COLAs and how they are calculated
- The Committee may discuss this issue and revisit this topic during Executive Committee
- The Executive Committee may decide to
  - Request a briefing to review recent ad hoc and automatic COLA fiscal notes to help inform any next steps
  - Study a particular aspect of COLA policy this interim
  - Take no action

Thank You

The Select Committee on Pension Policy is staffed by the Office of the State Actuary.

Questions? Contact us:

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Additional Resources

- See DRS website for more information
  - Includes the Plans 1 minimum COLA, optional COLA, and others
- Recent OSA actuarial fiscal notes
  - Annual Automatic CPI-based COLA: SB 5698 (did not pass)
  - One-time permanent 3% COLA with cap on July 1, 2022: SB 5676 (enacted)
- See BLS website for additional information
  - Includes CPI reports and related publications and announcements

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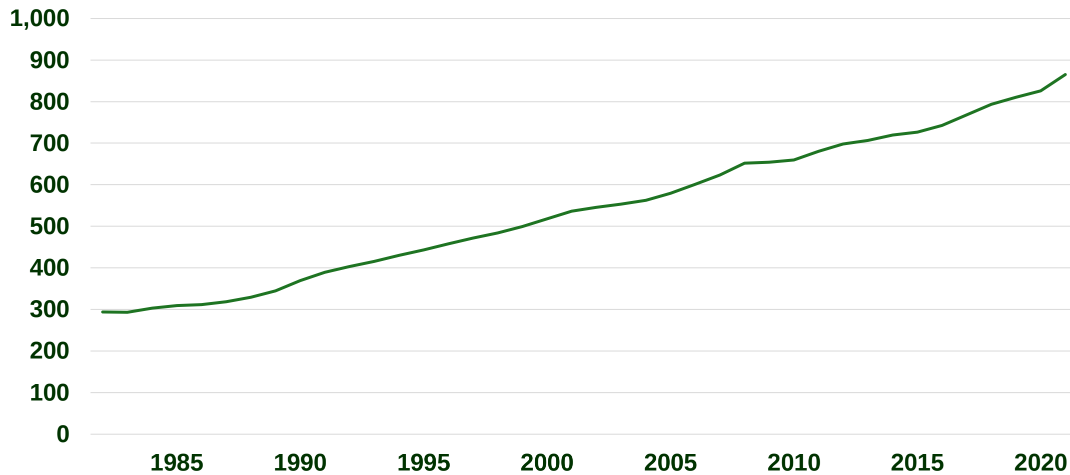
Appendix: CPI Index Trend



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