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May 31, 2001

Mr. Aristotle L. Hutras
Director
Ohio Retirement Study Council
88 East Broad Street, Suite 1175
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Re: House Bill 157 – Draft amendment providing compounded COLAs

Dear Aris:

As requested, we will discuss the draft amendment to House Bill 157, “HB 157”, that would allow the Board of each Retirement System to change from a “simple” COLA, as is provided by current law, to a “compounded” COLA. Such a change would be allowed if the Board determined, based on a report from the system’s actuary, that COLAs could be compounded “without significant additional liability to the system”.

“Simple” vs. “Compounded” COLA Adjustments

Under current law, COLA adjustments are made on what is called a “simple” basis. This means that the additional COLA benefit is calculated by applying the COLA rate to the initial benefit at retirement instead of the retiree’s current benefit (the initial benefit plus all COLA adjustments made to date). Since the rate of CPI increase is calculated on a “compounded” basis, applying the COLA rate in the way required by current law has the effect of providing less than a full adjustment for inflation even when the rate of inflation is less than the 3% cap. Moreover it provides less than a 3% increase in a retiree’s current income after they have been retired for a number of years.

The draft amendment would modify the current COLA provision to provide adjustments on a compounded basis. We will refer to this draft amendment as the “Compounding Amendment”. This Compounding Amendment would provide for compounding on a prospective basis, i.e., future COLA adjustments would be added to the base for calculating future COLA adjustments, “if, based on the actuary’s report, the board determines that an annually increased base can be used without significant additional liability to the system”. Such a change, once adopted, would continue indefinitely.

Of the 62 statewide retirement systems included in the Public Pension Coordination Council’s 1999 PENDAT database, 39 provide a compounded COLA and 23 provide a

simple COLA. Among those systems providing a compounding COLA, 13 provide a fixed rate and 26 provide an adjustment based on the CPI. Among those systems with a simple COLA, 7 provide a fixed rate and 16 provide an adjustment based on the CPI.

Last year we roughly estimated the impact of changing from a simple to a compounded COLA on the costs of pension benefits. In preparing those estimates, we assumed that past and future COLA adjustments would be added to the base for calculating future COLA adjustments. Thus those earlier estimates reflected a somewhat more expensive transition to compounded COLAs than the Compounding Amendment. But those estimates provide a rough frame of reference for considering the significance of changing from simple to compounded COLAs.

Those estimates indicated that such a change would increase the normal costs by approximately 4% to 6% and the actuarial liabilities by approximately 5% to 11%. The estimates are summarized in the following table. Note that we assumed that the OP&F current and future surviving spouse's benefits of \$550 per month (the January 1, 1999 level), which increase each year by the COLA adjustment, would also change to be increased on a compounded basis. We also assumed that the COLA increases under HPRS would continue to be delayed as under the current plan.

	HPRS	PERS- State	PERS- Local	PERS- LE	OP&F	SERS	STRS
Normal Cost for Pension Benefits with:							
Simple COLAs	25.0%	14.7%	14.7%	19.9%	20.0%	13.8%	15.1%
Compounded COLAs	26.5	15.3	15.3	20.9	21.2	14.3	15.8
% Increase	6%	4%	4%	5%	6%	4%	5%
Actuarial Liabilities (<i>in billions</i>) for Pension Benefits with:							
Simple COLAs	\$0.53	\$15.28	\$22.01	\$1.29	\$8.45	\$7.53	\$52.39
Compounded COLAs	0.57	16.13	22.15	1.36	9.42	7.90	55.31
% Increase	8%	6%	5%	5%	11%	5%	6%

Last year we also roughly estimated the impact on the funding period of the Ohio Retirement Systems if the COLA was changed from a simple to a compounded basis. At that time, none of the systems could afford this change within the 30-year funding period limitation in SB 82 when the benefit increase legislation enacted during 2000 was reflected in the estimate. In the chart below, we summarized the estimated increase in the employer contribution rate allocated to pension benefits needed to bring the funding period within the 30-year funding requirements of SB 82.

Additional contributions required if Compounded COLAs were adopted

	HPRS	PERS- State	PERS- Local	PERS- LE	OP&F	SERS	STRS
Increase in ER Rate	2.00%	0.80%	0.75%	2.30%	5.70%	1.55%	0.75%

Meaning of “significant additional liability”

It is somewhat difficult to anticipate what is meant by “significant additional liability” in the Compounding Amendment. We believe that, if the legislature wishes to grant to the Boards of the Retirement Systems the authority to move from simple to compounded COLAs, it would be desirable to specify more clearly the criteria that should be considered by the Boards in determining whether such a change is possible. For example, the amendment might provide that a Board could provide compounded COLAs only if such a change, if permanent, would not jeopardize the ability of the System to either:

- comply with the requirements of SB 82; or,
- continue to provide health care benefits to retirees.

As drafted, the Compounding Amendment would provide that a decision by a Board to provide compounded COLAs would be a permanent change – the base for all future COLA adjustments would include all COLA adjustments subsequent to the change from simple COLAs. It would be prudent to provide that a Board could revert back to simple COLAs if adverse subsequent experience jeopardizes the System’s ability to comply with the requirements of SB 82 or to continue to provide health care benefits.

Uniformity among the Systems

The Legislature and the ORSC should consider the appropriate public policy regarding any changes in the COLA. Any changes granted to the retirees of one retirement system may create pressure for making a similar change in the other retirement systems. If, for example, one or more systems change to a compounded COLA but others do not, pressure may develop for similar changes to be made to the other retirement systems even though they may significantly increase the cost of those systems.

Health Insurance

The Legislature and the ORSC may want to consider the possible desirability of the Retirement Boards allocating more of the employer contribution rate to providing health insurance benefits instead of COLAs. The COLA adjustments tend to benefit the higher paid and longer service members relatively more than other members (since they will

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have higher benefits and thus larger COLA increases) but a significant portion of the increased benefit will be lost due to both Federal and State taxes. Health insurance benefits are of equal value to both the high and low paid employees and are not subject to income tax.

Summary

Based on the estimates we prepared last year, providing COLAs on a “compounded basis” would significantly increase the actuarial liabilities of the systems and would probably require increased contributions from either employers or members to avoid violating the requirements of SB 82.

Please let us know if you have any questions or if you need any additional information.

Sincerely,

William A. Reimert

Katherine A. Warren

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