CHAPTER 4

Plan COLA remains unpredictable and is not guaranteed for members

Chapter Summary

There have been three types of WRS COLAs.

Cost-of-living adjustments (COLAs) are provisions to increase retirement benefits that many state retirement systems adopted in the 1970s and 1980s in response to periods of high inflation. The WRS Public Employee Plan (the plan) has offered three types of COLAs in its history: ad hoc flat-rate increases, automatic compounded percentage-of-benefit increases, and currently, "break-even" percentage-of-benefit increases.

Before 1994, the Legislature awarded many ad hoc COLAs to different groups of plan retirees.

In 1996, LSO evaluated WRS' COLA administration covering the 1978-1994 period, during which the Legislature had awarded many ad hoc increases. Usually, these were flat-dollar amounts, multiplied by years of service that permanently increased retiree benefits. The Legislature initially funded these ad hoc adjustments with General Fund appropriations with WRS later absorbing their costs. There was no predictability to this approach and our report criticized the inconsistent and sporadic nature of ad hoc COLAs.

Beginning in 1991, WRS statutes provided an automatic 1% COLA that gradually increased to 3%.

At that point (1996), an automatic 1 percent COLA had also been funded and awarded every year since 1991. With these, retirees received a statutorily set percentage-of-benefit increase and the same increase was pre-funded for active employees each year. WRS maintained that awarding the ad hoc increases diverted funds from these automatic COLAs, which the WRS Board preferred.

We recommended that the Legislature and the WRS Board work together to develop a policy for granting plan COLAs, and that the board identify achievable ways to fund them. In response, WRS initiated a benefit planning process and formalized gradually increasing the statutory automatic COLA to 3 percent as its primary goal, a goal it reached in 2001 and maintained through 2003. This chapter takes up where the earlier LSO report left off and examines how actuarial funding and WRS decisions since 1996 have affected COLA levels.

This report covers a third type of COLA – the "break-even" percentage of benefit increase.

Generally, we found that WRS has continued to pre-fund annual percentage-of-benefit compounded COLAs for all plan members, at levels that seemed predictable for many years but that, more recently, have varied. This happened because of a change in COLA policy proposed by WRS and adopted by the Legislature in 2004. Prompted by the 2000 - 2002 decline in equity markets, this change made the COLA level flexible (determined by the board each year) to keep the plan's annual actuarial costs within the funding available from contributions; this is the standard WRS applies to determine if a COLA is actuarially sound. Thus, WRS uses the COLA as the mechanism to balance the plan's costs with its funding. We identify this as the third type of WRS COLA, the "break-even" percentage-of-benefit increase.

Although pre-funded, the break-even COLA is neither guaranteed nor at a predictable level.

Under the break-even approach, COLAs are neither guaranteed nor at a predictable level. As a result, retirees' benefits are not consistently maintaining any particular level of purchasing power, nor will they in the future under the current COLA policy. Instead, any annual benefit increases are dependent upon the plan's actuarial experience, particularly the plan's investment returns. Although they may look like automatic increases, the board awards these break-even COLAs only if the statutory contribution rate and investment returns will cover their increased costs.

Confusion exists about this latest COLA, and policymakers face more decisions about it.

Despite this fundamental COLA policy change, confusion exists among retirees about why the COLA has become so variable, and there are expectations that it should be higher. The WRS Board has indicated that it plans to request that the Legislature increase the plan contribution rate in order to provide higher COLAs in future years. Our recommendation is that as part of this initiative, the WRS and Legislature should determine whether the plan will provide a guaranteed COLA, or will continue offering the break-even, non-guaranteed COLA. If it is the latter, WRS needs to better communicate that policy so members can plan for having retirement benefits that will not necessarily maintain their purchasing power.

COLA is pre-funded, but not guaranteed

The cost for the plan's COLAs includes amounts for pre-funding them for active members as well as for immediately providing

In theory, pre-funding a COLA means it will be available to active employees when they retire.

increases to current retirees. The idea is that through pre-funding in this manner, the same level of COLA that is awarded to current retirees should be available to active employees when they eventually retire. This approach increases plan costs, since the COLA permanently enhances both current retirees' base benefits and the annual cost of deferred retirement benefits for actives (the normal cost, as explained in the previous chapter). In recent years, the combination of experiencing low investment returns and awarding a COLA has added to the plan's unfunded actuarially accrued liability (UAAL). This has resulted in more of current contributions paying the UAAL amortization payment.

However, this will not necessarily occur with WRS' break-even COLA approach.

However, WRS' particular approach to pre-funding COLAs does not mean currently active employees are guaranteed COLAs of any level when they reach retirement. The portion of the total contribution allocated to pre-fund benefits, including the COLA, for plan members when they retire will not necessarily result in automatic compounded benefit increases actually being paid out at a later date. Rather, all plan retirees, present or future, will receive COLAs of variable amounts *only if* the plan can actuarially fund them in any future year, depending upon the plan's actuarial experience in the previous year. It is essentially a "pay-as-you-go" COLA, guaranteed only to those current retirees who receive the actual benefit increases.

This chapter builds on the last to explain the WRS COLA.

The preceding summary of this chapter's finding likely suffices for those who understand actuarial concepts and how Wyoming statutes direct the WRS Board to operate the plan. However, we perceive a certain level of confusion among many stakeholders, particularly plan retirees, about the plan's COLA. Building upon the preceding chapter's explanation of actuarial funding, the following sections show how the WRS COLA policy and the actuarial process combine to result in a variable COLA.

WRS COLAs must be actuarially sound

Since 1991, the WRS Board has had statutory authority to award compounded COLAs up to a cap that gradually increased through

amendments from 1997 to 2001 – from 1 to 3 percent.[1] The overall caveat in statute is that the system's actuary must first determine that these benefit adjustments are "actuarially sound" (W.S. 9-3-419(b)(v)). Figure 4.1 shows the compounded COLAs granted since 1991 (see Appendix E for COLA history).

Through statutory amendments, the COLA grew from 1% to 3%.

Figure 4.1

WRS Public Employees Plan COLAs
1991 - 2007

1991 - 1996		1997	1998	1999	2000
1%		1.5%	2%	2.5%	2.5%
2001	**2002**	**2003**	**2004**	**2005**	**2006**
3%	3%	3%	2.16%	1.4%	1.05%
2007	Years in color indicate those with break-even COLAs.				
1%					

Source: LSO summary of WRS documents.

For WRS to grant a COLA, the statutory contribution must cover the cost increases it creates

For WRS, "affordable" means cost increases for a COLA cannot cause total actuarial costs to exceed 11.25%.

The WRS Board explains its decisions on the COLA level as being limited to what is "affordable," but the implications of tying COLAs to actuarial soundness are more complex than a conventional understanding of that term. What it means is this: for the board to grant a COLA of any level from zero up to the 3 percent cap, the statutory contribution rate of 11.25 percent of the plan payroll must cover the increased actuarial costs for: 1) benefits attributable to current service (normal cost); and, if the COLA creates or increases a UAAL, 2) a higher amortization payment. Investment returns higher than assumptions will mitigate these cost increases by reducing the UAAL.

Pre-funding a COLA costs much more than increasing the benefits of existing retirees

In determining the cost of a COLA, the actuary assumes the

[1] Statute states that the COLA cannot be higher than the Wyoming cost-of-living index. However, it also authorizes WRS to track the differences when the Wyoming cost-of-living index exceeds the awarded COLA, and when it is actuarially sound to do so, add the accumulated percentage adjustments to future years' COLAs, up to the 3 percent cap. Neither of these conditions has been met since the percentage increase COLA went into effect in 1991. (See W.S. 9-3-419(b)(ii), (iii), and (vi).)

COLA granted in any given year to be the level of COLA that will be granted in all future years for current and future retirees during the pension payment period. Costs for awarding the COLA are computed on the basis of how much funding is necessary to permanently increase current retirees' benefits and also to pre-fund the same increase for active employees.

It costs much more to pre-fund the discounted cost of COLAs for all members of the plan than to increase just current retirees' benefits.

Pre-funding is an efficient way to fund COLAs because projected investment returns decrease the amount that needs to be allocated to fund them in the present. However, it still costs much more to pre-fund the discounted cost of COLAs for all members of the plan – working, inactive, and retired – than it would to increase just current retirees' benefits. For example, as of the January 1, 2007 valuation, providing a 1 percent COLA requires 2.31 percent of covered payroll, or approximately $29.6 million annually. This compares with the non-actuarial, LSO estimate of $2 million it would cost to give just current retirees and beneficiaries a 1 percent increase in their benefits.

Awarding a COLA increases the UAAL because all members' benefits accrue at higher rates.

Further, as shown in Figure 4.2 depicting plan costs for 2007, the UAAL amortization payment accounts for a good deal of the COLA's cost. Without the COLA, the plan would have had a funded ratio of almost 102 percent; instead, with the 1 percent COLA, the funded ratio is 94.4 percent. The UAAL results because of two conditions that make current benefit liabilities with the COLA higher than plan assets. After a COLA is awarded:

- Current retirees' base benefits are now permanently set at a higher level and will continue throughout their retirement.
- Benefits for active members are accruing at a higher level with the inclusion of the COLA.

Increasing the UAAL means the amortization payment requires more of the contribution.

For 2007, the overall effect is that the 11.25 percent contribution rate went from being more than enough to fund members' base benefits (without the COLA), to having to also finance the debt of much of the long-term cost of the added COLA benefit.

The plan would have been more than 100% funded in 2007 if no COLA had been awarded.

Figure 4.2

2007: Difference in plan costs between no COLA and .99% COLA

	0.00% COLA	0.99% COLA
Normal Cost	9.17%	9.73%
UAAL Amortization Cost	(0.39%)	1.36%
Administrative Expenses	0.16%	0.16%
Total Cost	8.94%	11.25%
Total Contribution	11.25%	11.25%
Funding Margin/(Deficit)	2.31%	0
Funded Ratio	**101.8%**	**94.4%**

Source: State of Wyoming Retirement System, Report on Actuarial Valuation as of January 1, 2007, Buck Consultants. Costs are expressed as percentages of the total covered payroll, $1,285,096,152.

Actuarial smoothing determines asset value used in determining COLA affordability

Favorable investment returns are most important to the WRS break-even COLA.

Seeing billions in plan assets and positive WRS investment returns since 2003, retirees and others may assume the plan can afford a higher COLA than those granted in the last few years. Although good investment returns in any given year are most important in determining the actuarial affordability of a COLA, having favorable returns does not necessarily mean a plan can afford a higher COLA. This is in part because the actuarial value of WRS assets is smoothed, as explained in Chapter 3.

COLA is a balancing mechanism to enable board to keep costs within contributions

Neither Wyoming statute nor WRS has specified what "actuarially sound" means.

For decades, statute has stipulated actuarial soundness for any COLA, but neither law nor WRS specified what exactly that meant. From 1991 to 2003 the maximum COLA allowed in statute apparently met that undefined standard, and was awarded. Since 2004, the WRS Board has applied a specific concept of actuarial soundness to the plan: the contribution rate must cover all plan annual actuarial costs.

Because this policy limits the increase in the normal cost and UAAL amortization cost, it has led the board to grant variable and decreasing COLAs. Had plan investment earnings been high

Now, WRS interprets "actuarially sound" as having costs covered by the contribution.

enough to provide a funding margin, the COLAs would have been higher. The COLA determination has been the mechanism used by WRS to balance funding with the volatility of plan experience, primarily that of investment returns lower than assumptions.

WRS Board sought the flexibility to annually set the COLA level

2004 statute change allows WRS to set COLA at any level between 0 and 3%.

In 2004, WRS successfully sought an amendment to the COLA section of the retirement statutes allowing it to set the COLA at levels between 0 and 3 percent. WRS sought this change because the board and the actuary interpreted statute as requiring the board to grant either no COLA or 3 percent, nothing in between.

In 2003, WRS awarded a COLA that now, it would not consider actuarially sound.

Because the statutory contribution would not cover the full cost of providing a 3 percent COLA (the level set in statute), in 2003 the board had to pay for it with plan assets that were essentially obligated for future benefits, or that would serve to cushion against poor plan experience in the future. Using plan assets in this way led the board to conclude it needed flexibility in setting the COLA level. Under the board's current actuarial soundness standard, funding the COLA as it did in 2003 would not be acceptable.

WRS now grants "break-even" COLAs

The break-even approach forces the level of COLA that can be awarded.

As a result of the 2004 statutory change, WRS grants a "break even" COLA, a technique designed by the plan actuary. Under this approach, the actuary does two valuations each year: the primary valuation using a 3 percent COLA (statutory cap) and one with no COLA. As shown in Figure 4.7, the actuary interpolates the results between the two and arrives at a COLA at which the increases in the normal cost and UAAL amortization payment can be covered by the statutory contribution rate. The previous year's investment return, if higher than the assumption, offsets some of the increase in the UAAL, and thus reduces the amortization actuarial cost increase.

Figure 4.7
2007 COLA determination as expressed as a percentage of total covered payroll

	No COLA	3% COLA	.99% COLA[1]
Normal Cost	9.17%	10.99%	9.73%
UAAL Amortization Cost	(0.39%)	5.39%	1.36%
Administrative Expenses	0.16%	0.16%	0.16%
Total Cost	8.94%	16.54%	11.25%
Total Contribution	11.25%	11.25%	11.25%
Funding Margin/(Deficit)	2.31%	(5.29%)	0%
Funded Level	**101.7%**	**80.9%**	**94.4%**

Source: State of Wyoming Retirement System, Report on Actuarial Valuation as of January 1, 2007, Buck Consultants.
[1] Rather than a 0.99 percent increase, the board decided to approve a 1 percent COLA effective July 1, 2007 (FY '08).

For the plan to remain sound, the UAAL must be amortized over a rolling 30-year period. Thus, through the actuarial valuation, the statuary contribution rate determines what an actuarially sound or affordable COLA can be under the plan.

In the late 1990s, WRS set a 3 percent COLA as its primary benefit goal

Now the policy is: the amount of the COLA depends upon what is affordable.

Through this 2004 legislation, the state effectively set a policy that the COLA amount depends upon what the 11.25 percent contribution rate will cover, after all other actuarial experience is taken into consideration. This contrasts with WRS' goal when LSO conducted the 1996 study, which was to provide a 3 percent compounded COLA "to assist retirees in maintaining purchasing power vis-à-vis inflation." Our report criticized WRS for not committing to a time frame for achieving this goal. In response, the next year WRS began a review of all plan benefits for most pension plans in effect at that time. Although the 1996 study had targeted only the plan's COLA administration, WRS took the initiative to engage in a comprehensive review of public pension benefits in the state.

A 3% COLA was an announced and vetted WRS goal in 1999.

From this initiative, WRS devised a Comprehensive Benefit Plan (CBP), which articulated what its different plans' benefit provisions were and what changes, if any, were desired or needed (see Appendix F for the 1999 CBP). By 1999, WRS had set a goal

The plan multiplier was also increased after a WRS planning and review initiative.

to provide the 3 percent COLA in the 2000 - 2004 time period; it achieved this goal in 2001, when the Legislature set 3 percent as the statutory COLA level. In the review process, WRS identified another benefit improvement members wanted, the enhanced multiplier, and the board also endorsed this statutory change in 2001. According to WRS Board minutes, the board intended to review the CBP every two years and consider any proposed changes to the plan based on how they would affect the likelihood of reaching pre-defined goals.

WRS has not updated its Comprehensive Benefit Plan since 2000; retirees still expect a 3 percent COLA

Even though, since the 2004 change in law, there is no statutory obligation for WRS to grant a 3 percent COLA, board members sense that retirees expect this. However, in its struggle to maintain benefits since the 2000 - 2002 contraction of plan assets, the board has effectively retreated from its 3 percent COLA goal and has apparently shelved both its process to update the Comprehensive Benefit Plan, and its strategies to at least every two years, examine retiree COLAs and the extent to which retirees have maintained purchasing power relative to inflation.

WRS may not have adequately communicated the COLA policy change.

Now, some board members consider the lower COLAs that have been awarded not benefit reductions but rather "the COLA(s) specific to (each) year and within the rules and the statute." Trustees acknowledge that perhaps WRS has not communicated well enough that statute gives the board discretion to determine the appropriate COLA.

Value of retirees' benefits diminishes through inflation

WRS benefits do not keep up with the state's inflation rate.

COLAs were generally adopted by retirement systems during the 1970s and 1980s when high inflation significantly eroded retirees' benefits. Thus, the basic objective of COLAs is to help retirement benefits keep pace with inflation, or to at least slow the erosion of retiree benefits caused when the cost of living increases. However, WRS retirees' benefits continue to be eroded by inflation and are increasingly losing ground in their purchasing power relative to the Wyoming Consumer Price Index (WY CPI).

Inflation is measured by the Consumer Price Index

Statutes require that annual COLAs be no more than the Wyoming CPI in the previous year.

Inflation is commonly measured at the national and state government levels by looking at the change in consumer prices for a predefined basket of typical consumer goods and services. This analysis, typically done in quarterly or annual increments, forms the basis for the CPI. Wyoming statute requires that the WRS Board annually "determine" the cost of living increase from the previous calendar year as the percentage change the Department of Administration and Information, Economic Analysis Division finds it to be in the state (W.S. 9-3-419(b)(i)).

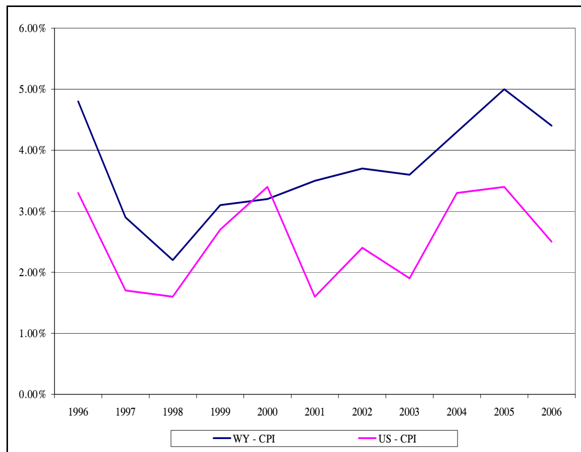
Inflation has been higher in Wyoming than in the nation.

As shown in part A of Figure 4.3, the WY CPI has been higher than the overall U.S. CPI in every year but one (2000) during the last decade. Part B of this figure shows the actual CPI percentages and the practical impact of inflation on a hypothetical $100 since 1995. That $100 has decreased in value and under the WY CPI, is two-thirds ($66) of what it was worth in 1995.

Figure 4.3

Comparison of the value of money, Wyoming CPI and U. S. CPI
1996 - 2006

A



B

Year	WY - CPI	Value of money	U.S. - CPI	Value of money
1995	-----	$100.00	-----	$100.00
1996	4.80%	$95.20	3.30%	$96.70
1997	2.90%	$92.44	1.70%	$95.06
1998	2.20%	$90.41	1.60%	$93.54
1999	3.10%	$87.60	2.70%	$91.01
2000	3.20%	$84.80	3.40%	$87.92
2001	3.50%	$81.83	1.60%	$86.51
2002	3.70%	$78.80	2.40%	$84.43
2003	3.60%	$75.97	1.90%	$82.83
2004	4.30%	$72.70	3.30%	$80.10
2005	5.00%	$69.07	3.40%	$77.37
2006	4.40%	$66.03	2.50%	$75.44

Source: LSO analysis of Wyoming Department of Administration and Information, Economic Analysis Division's data.

Retiree benefits are increasingly losing ground under recently-awarded COLAs

Since 1995, plan COLAs have replaced just over half of retirees' lost purchasing power.

WRS COLAs have steadily decreased since 2003, a period during which the WY CPI has risen by more than 4 percent per year. Figure 4.4 shows the WY CPI and WRS-approved COLAs and what their impact has been when applied to the average plan benefit from 1995, which was $670. Using this average benefit as an example, by 2006 the average retiree would have needed a monthly benefit of $999 to keep up with Wyoming's inflation rate. Instead, because the WRS COLA had replaced roughly half of the purchasing power lost, the average benefit was $838.

Figure 4.4

WY CPI and WRS COLA impact on the 1995 average retiree benefit 1996 – 2006

Calendar Year	WY CPI		WRS COLA		Difference between WY CPI and COLA
1995	-----	$670.00	-----	$670.00	-----
1996	4.80%	$702.16	1.00%	$676.70	3.80%
1997	2.90%	$722.52	1.50%	$686.85	1.40%
1998	2.20%	$738.42	2.00%	$700.59	0.20%
1999	3.10%	$761.31	2.00%	$714.60	1.10%
2000	3.20%	$785.67	2.50%	$732.46	0.70%
2001	3.50%	$813.17	3.00%	$754.44	0.50%
2002	3.70%	$843.26	3.00%	$777.07	0.70%
2003	3.60%	$873.61	3.00%	$800.38	0.60%
2004	4.30%	$911.18	2.16%	$817.67	2.14%
2005	5.00%	$956.74	1.40%	$829.12	3.60%
2006	4.40%	$998.83	1.05%	$837.82	3.35%
$ Increase in benefit	**-----**	**$328.83**	**-----**	**$167.82**	**$161.01**
% Increase in benefit	**-----**	**49.08%**	**-----**	**25.05%**	**24.03%**
Average annual increase	**3.70%**	**-----**	**2.05%**	**-----**	**1.64%**

Source: LSO analysis of WRS and WY Department of Administration and Information, Economic Analysis Division data.

Social Security COLAs protect only a portion of retiree income from inflation

Social Security replaces 30% to 50% of retiree income.

Plan retirees receive a U.S. CPI-indexed COLA for part of their retirement income – that provided by Social Security. A generally accepted guideline is that retirees will need between 60 and 80 percent of net pre-retirement income to maintain their

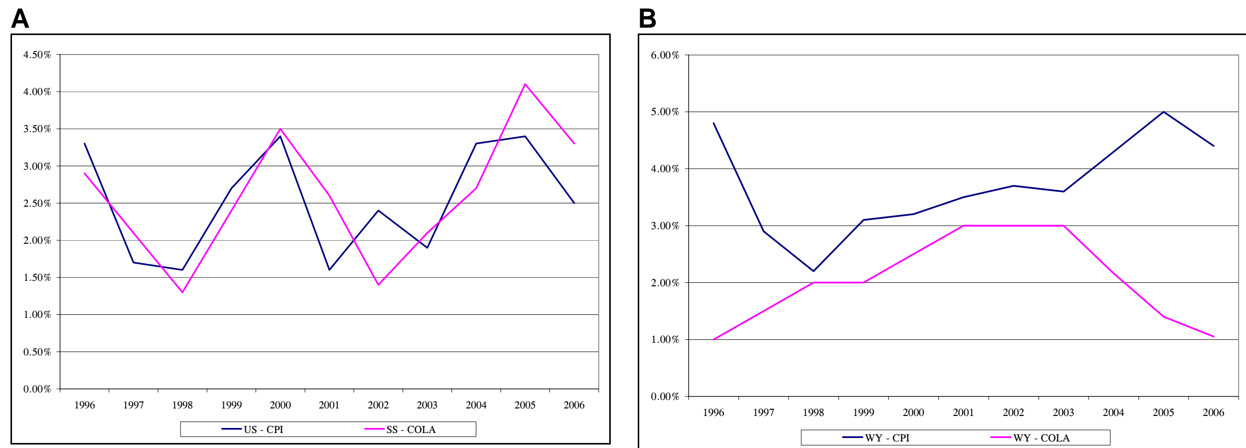
standard of living during retirement. Social Security will likely replace 30 to 50 percent of that, less for higher wage earners and more for lower wage earners. The balance of the funds necessary for retirement income must come from earnings and other assets, such as the WRS pension.

Social Security COLAs have been close to national inflation levels; WRS COLAs have not matched the WY CPI.

The Social Security COLA has kept those benefits generally on par with the U.S. CPI. In an analysis of the WY CPI and the U.S. CPI over the last 20 years, we found that while Wyoming's cost of living has almost doubled (increased by 97 percent), the overall U.S. cost of living has increased less (83 percent). For just the last decade, as shown in Figure 4.5(A), Social Security COLAs have nearly mirrored the U.S. CPI. However, the WRS COLA, shown in Figure 4.5(B), has not reached the WY CPI since 1996.

Figure 4.5

Comparison of Social Security and WRS COLAs to Relevant Cost-of-Living Indices:



Source: LSO analysis of WRS and WY Department of Administration and Information, Economic Analysis Division's data.

Retirees seek direct assistance from the Legislature for health care subsidies

Retirees' health care cost concerns do not affect the WRS Board's decisions.

Although the WRS Board and staff are aware of increasing pressure placed on retirees' fixed incomes by large increases in health care costs, they say retiree health care has not directly affected the board's COLA decisions. Legally, the WRS has no jurisdiction over retiree health care insurance and WRS officials

maintain that retirees' health care issues are not part of the board's role or benefit concerns.

This cost pressure may increase retiree appeals to the Legislature for help.

However, lacking a guaranteed or higher COLA may cause the Legislature to come under pressure as it did in the 1980s and 1990s, to provide ad hoc increases for certain groups of retirees. Some groups are more poorly-situated than others, such as long-time retired members who, because of subsequent multiplier and salary level increases, started retirement with less generous base benefits than more recent retirees.

Some retirees will receive a one-year health care cost subsidy from the state.

Already, the Legislature has awarded a one-year (effective July 1, 2007) health care premium subsidy for retirees under the state's group insurance plan (EGI). The subsidy is essentially an ad hoc increase (paid with General Funds) for the roughly 1,700 retirees of the state, university, and community colleges, and judicial and legislative branches who have maintained their insurance coverage with the state's self-insured plan (5,000 of the retirees from these entities have not). This sub-group of recipients represents approximately 10 percent of all plan retirees.

This subsidy is a higher benefit than a 3% COLA, but it is neither compounded nor assured.

Based on the most recent WRS valuation data, this complete population of retirees averaged 19.8 years of service (under age 65) before retiring. This means the average pre-65 retiree under this subsidy ($11.50 per year of service) will receive $218.50 per month, or $2,622 during the year. Figure 4.6 compares the cost of the retiree health care subsidy to the cost of different COLAs, using average length of service and pension amounts for 2006.

Figure 4.6

CY 2006: Example of health care subsidy compared to 1%, 2%, and 3% COLAs

Retirees under 65		**Health Care Subsidy per Month**	**Retirees under 65** Retirement Benefit		**COLA Amount per Month** 1%	2%	3%
Average years of service	19.83	$218.50	Average	$1,440.67	$14.41	$28.81	$43.22
Retirees over 65		**Health Care Subsidy per Month**	**Retirees over 65** Retirement Benefit		**COLA Amount per Month** 1%	2%	3%
Average years of service	18.04	$103.50	Average	$1,137.37	$11.37	$22.75	$34.12

Source: LSO analysis of WRS data and 2007 Wyoming Session Laws.

Health care subsidy is apart from retirement benefits and is not pre-funded

WRS funds do not pay this health care cost subsidy.

Importantly, this increase is not a part of WRS retirement benefits. As it stands now, the health insurance premium subsidy for retirees will be available only if the Legislature appropriates funding for it year-to-year (a pay-as-you-go strategy). Some other states pre-fund retiree health care insurance subsidies, and the Wyoming Legislature considered doing this in the 2007 Session. Senate File 165, which did not pass, would have established a trust to pre-fund retiree health care through contributions totaling 1 percent of employees' pay. Starting such a trust fund would require the state to track its long-term liabilities, similar to the pension plan, in order to meet a new Governmental Accounting Standards Board (GASB) reporting requirement.

Some other states pre-fund health care benefits.

A sustained health care subsidy could affect retirement levels

Plan members can retire at age 60, but Medicare coverage begins at age 65.

As noted in Chapter 2, WRS offers unreduced retirement benefits for members who have reached age 60; according to the plan's most recent experience study, the average retirement age is 61.03 years. Sixty is a substantially lower age requirement than for federal retiree benefit programs (Social Security and Medicare), but each year about one-third of plan retirees are younger than age 65, the age at which Medicare coverage begins and partially covers health care costs. A widespread belief articulated by one board member is that "everyone wants to retire early and what stands in their way is the cost of health insurance."

"Everyone wants to retire early and what stands in their way is the cost of health insurance."

Actuarially, it is more expensive for the plan if individuals retire at earlier ages, and less expensive if they delay retirement. Additionally, mortality rates have been improving and the actuary expects active employees to have retirement lifetimes of 30 years or more. However, recent national studies predict the early-retirement trend is reversing: aging baby boomers are facing longer lives coupled with rising costs for health care and other services, and thus are staying on the job longer.

Retiring at younger ages is actuarially more expensive.

Since the state's health care subsidy could be offered for only a year, it is neither as expensive nor as sustained as a retirement benefit COLA, which, whether or not compounded, permanently increases base benefits.

WRS Board has not sought to increase the contribution rate to provide a higher COLA

The Legislature must approve any increase in the plan contribution rate.

From our research and analysis, several inter-related reasons appear to have prompted the WRS Board to determine that balancing plan funding by adjusting the COLA was the proper course. Foremost among those is that it has not wanted, and for many years, not needed, to recommend an increase in the statuary contribution rate. As noted in Chapter 3, Wyoming statute directs the board to prepare an annual statement of the required contribution rate which "after approval by the legislature, shall be payable by employers." This has not occurred, and the contribution rate has remained at an employer/employee combined rate of 11.25 percent since 1981.

In most years, the 11.25% contribution rate has been more than enough to pay plan actuarial costs.

In some states, the plan's governing board adjusts the contribution rate to what the annual actuarial valuation indicates, and then moves it on to the legislature for approval. In these cases, the contribution rate is termed to be a floating rate, not fixed, and may be either increased or decreased. But for the WRS Board, changing the contribution rate was not a consideration for many years because until 2003, the 11.25 percent contribution rate was enough to pay plan costs. This was due to extraordinary investment returns from the 1990s. In many of those years, 11.25 percent had been more than enough, creating funding margins (excess contributions) that augmented plan assets and paid for benefit enhancements.

The WRS Board has firmly adhered to the existing statutorily-set contribution rate.

Statements from the WRS 2005 strategic plan up to the most recent newsletter (Spring/summer 2007) convey the board's adherence to the longstanding statutory contribution rate of 11.25 percent (emphasis added by LSO):

WRS presents the contribution rate as an external limitation on benefits.

- "The board's goal is to manage the system in a manner that provides the most affordable benefit package *inside of the statutorily set contribution levels.*" – 2005 Strategic Plan (most recent available).
- "The Board grants COLAs within the constraints of the statutes, which require the Board to pay only what is affordable *given the contribution rates set by law.*"

- "WRS has consistently provided competitive benefits to members when funding margin is available *without the need to increase contribution rates*."

The actuary has suggested increasing the contribution rate to allow a higher COLA.

Even though WRS has never proposed increasing the contribution level, the idea has been suggested by the actuary as an option that would allow a higher COLA. In every year since 2003, as the board has awarded lower and lower amounts, its actuary has presented the board with options to maintain a COLA of 3 percent. These options included: 1) increase contribution levels; 2) decrease base benefits; or 3) achieve better investment returns. The board consistently has chosen to grant break-even COLAs while working to achieve higher returns.

WRS Board has focused upon improving investment returns to fund the plan and provide a higher COLA

Since the market downturn, WRS has struggled to fund higher base benefits.

Funding a COLA within the existing contribution rate worked well during the mid- to late-1990s, when investment returns were high enough to finance the basic plan benefits plus improvements. Since 2003, however, funding the plan with 11.25 percent of total payroll has become more of a challenge for the board. As one trustee explained, "It has been a fight just to provide the benefits we already have. Our predecessors on the board gave us a heavy burden when they increased benefits, not knowing that we would have a downturn in the market in 2000."

A break-even COLA leaves no funding margin to serve as a hedge against future poor returns.

As the previous chapter noted, although plan investments have improved, assets still lag liabilities on an actuarial basis. Since obtaining the flexibility in 2004 to balance plan funding by adjusting the COLA, WRS has been relying upon earning stellar investment returns to finance higher COLAs. Yet recent returns have not been high enough to compensate for the 2000 to 2002 investment losses, and in 2007, the COLA declined to its lowest level since 1996, 1 percent. In addition, awarding a break-even COLA in the 2004 - 2007 period has left no funding margin to build assets that could act as a hedge against future poor investment experience.

WRS Board has wanted to protect the defined benefit plan

The board's primary objective is to preserve the defined benefit plan for all members.

Holding a policy to ensure *employers*' costs stay level (since most of them pay the full contribution), even if it results in lower benefits to retirees, may seem contrary to the board's statutory obligation to act solely in the interest of the retirement system participants and beneficiaries (W.S. 9-3-439(a)(i)). The board's reasoning is that this policy has been the best way to preserve the defined benefit plan for all plan members.

Until now, WRS trustees have kept plan employers' costs (and those of the taxpayers that support those employers) unchanged. They have not initiated a request to the Legislature for an increase in the contribution rate on behalf of plan beneficiaries who would benefit from a larger COLA, nor for one that is guaranteed. Instead, they have determined that keeping contributions level for employers is in the plan participants' best interests, even if this means an inconsistent COLA.

There is a concern that increasing the contribution rate would lead the Legislature to modify the plan's structure.

From board minutes, we learned that trustees have resisted seeking a contribution rate increase because of concerns that doing so would lead the Legislature to infer that the defined benefit plan is not working and possibly change it to a defined contribution plan, as recently happened in Alaska. While the WRS Board strongly believes a defined benefit plan is preferable to the defined contribution model and has passed a resolution stating as much, it recognizes that determination rests with the Legislature.

Other methods of providing COLAs

To be guaranteed, a COLA must be set at a specific level in statute.

For the plan to offer a guaranteed COLA, WRS statutes must require that retirement benefits be adjusted by a specific percentage each year. This would mean the WRS plan actuary automatically includes the cost for a guaranteed COLA when calculating the normal cost for active members. It would also increase the UAAL because past service would be valued higher than it originally was; thus the UAAL amortization payment would increase. To maintain actuarial soundness, the statutory

contribution level must cover these costs, which (unless investment or other experience were to decrease liabilities, increase assets, or both) would require increasing the rate.

A guaranteed COLA would increase the normal cost and UAAL payment cost – thus require a higher contribution rate.

This is how WRS recognized the cost of the COLA from 1991 to 2003; other states pay for guaranteed COLAs in this manner as well. For example, until 2007 Montana's public employees' plan had a 3 percent "guaranteed annual benefit adjustment." However, like all pension plans, Montana's was hurt by the market downturn and found this level of annual increase unsustainable. The legislature reduced it to 1.5 percent for new employees, and temporarily increased the contribution rate to get its UAAL to a sound level.

Other states have been more straightforward in offering "affordable" COLAs.

Some retirement systems fund a COLA on an "as affordable basis" as WRS has done, but they make the affordability determination more transparent. This is done in different ways, such as by setting up separate funds for excess investment returns, or by separating retiree and active employee funds and providing retiree COLAs only if the retiree fund has a surplus. This last approach does not pre-fund COLAs for active employees, nor does it create an inter-generational transfer of funds.

Direct infusions of cash usually go towards reducing UAALs

A cash infusion would provide funding to increase a break-even COLA in the short term.

Wyoming legislators have questioned whether appropriating money directly to the plan would ensure a higher COLA. In response, WRS officials provided an estimate based upon the 2006 plan valuation that it would take a one-time infusion of $823 million into the plan's assets to increase the COLA from approximately 1 to 3 percent.

But adverse actuarial experience could absorb the cash.

Other states have used the cash-infusion approach primarily to pay down large unfunded liabilities, not to finance ongoing benefit enhancements. By paying down the UAAL and lowering the amortization cost, a cash infusion could provide funding flexibility in the short term to increase the COLA. It could also mitigate the plan UAAL increase resulting from public school salary raises that were higher than assumptions. However, since adverse actuarial experience could absorb such an appropriation, it might not be available to fund a continuing obligation.

WRS actuary can present options for providing a COLA

WRS is preparing to request an increase to the contribution rate, but is not considering COLA funding options other than break-even.

The preceding few paragraphs provide at a very basic level what the plan actuary can do with methodological sophistication if requested by the WRS Board and Legislature. It is the business of actuaries to know different methods for providing COLAs, and what it would take for WRS to fund them, based upon the plan's specific characteristics. When WRS comes forward with a request to increase contribution levels, as it appears it is preparing to do later in 2007, the Legislature should expect to see that the board has, with the assistance of its actuary, considered options, combinations of options, and objectives for allocating any increased contributions.

WRS needs to plan for the new era of pension management it faces

WRS has focused upon investment returns and not maintained its benefit planning process.

Between 1997 and 2001, when the 3 percent COLA was achieved, the WRS Board used its Comprehensive Benefit Plan as a platform to explain what benefits were, where they were intended to go, and what were the means for achieving those goals. Along with the steady public input, WRS had clear objectives by which to measure its progress toward implementing plan goals, or to substantiate why it would not endorse proposals for other benefit enhancements. Since 2004 and the change to a break-even COLA, WRS has abandoned its planning process and used only investment returns to measure its progress.

We believe WRS should update its comprehensive benefit plan.

In hindsight, WRS' plan to use investment returns as the primary means to fund benefit enhancements was ideal in the late 1990s, when the market was producing sustained high returns. Yet since 2000, this approach has shown that even with the current market rebound, total dependence upon investment earnings may not be a reliable way to fund a COLA. With differences in expectations among plan members and WRS on what benefits are reasonable versus affordable, plan administration has gotten more complicated. At the very least, we believe an update to the CBP is indicated.

Recommendation: Together, WRS and the Legislature should determine whether the plan will provide a guaranteed COLA, or continue offering the break-even, non-guaranteed COLA.

WRS COLAs were always to be actuarially sound, though the concept was never defined.

The Legislature has a tradition of providing post-retirement benefit increases, first through a series of increases that were clearly ad hoc, and then from 1991 through 2003, through a statutorily-set percentage that appeared to guarantee a certain level of COLA. In fact the COLA during those 14 years was not automatic or guaranteed, although favorable actuarial experience allowed each year's COLA to be exactly what the statutory maximum was. This is because during all the years when statute provided a set percentage benefit adjustment, the over-riding principle in WRS statutes has been whether or not a particular year's COLA would be actuarially sound, even though that concept was never defined.

The 2004 statute change essentially made all COLAs ad hoc, depending upon what is affordable.

Beginning in 2004, however, the WRS Board in effect adopted a specific concept of actuarial soundness: all annual plan costs must be covered by the statutory contribution rate of 11.25 percent. With the statutory change establishing the break-even COLA, the board now had authority to determine the COLA based on whatever amount (within the 3 percent cap) was actuarially sound, or "affordable" with existing contributions. What was not so transparent about this policy change was that it essentially codified the longstanding unwritten policy that COLAs would be ad hoc – what the system could or could not afford for that year – and that they were in no way guaranteed.

In the summer 2007 *WRS Retirement Update*, the board signaled its intent to continue the general policy of providing some sort of benefit increase. It will also undertake a legislative initiative "to increase contribution rates in order to provide retirees greater COLAs in future years." Our understanding is that the board's intention is to continue the break-even COLA policy with any potential increase in the contribution rate.

However, the board's initiative should give stakeholders (the WRS Board, the Legislature, and plan members) an opportunity to help determine whether the COLA will be guaranteed at a minimum level or whether the break-even approach authorized in statute will be maintained. If the former, both that floor and a means to fund it must be agreed upon, whether it be an increase in the contribution rate or some combination of funding options.

If the break-even policy is kept, communication about what it means for the COLA should improve.

If the break-even approach is continued, all should realize that depending upon high investment returns will not guarantee a COLA of any specific level, and active members' contributions may go toward pre-funding a benefit that they may not receive. Further, WRS should improve its communication of this policy so that both retirees and active members can prepare to retire with benefits that are not necessarily intended to grow in any particular proportion to the Wyoming cost-of-living index.

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