COLAs: Advantages and Disadvantages of Selected Designs

COLA Design	Feature(s)	Examples	Advantages	Disadvantages
Current TMRS-CPI-based (3/29/12 meeting)	Repeating: 30%, 50% or 70% of CPI-U	TMRS	• May be provided when judged affordable by governing entity • Maintains retiree's purchasing power • Repeating COLA rates are stable, but more costly than ad hocs in short term • In long-term, UAAL decreases and funded ratio improves • Initial COLA or increase in CPI percent results in large benefit increases for the year adopted; also the longer retired, higher the increase	• Can be costly • Costly to restart if turned off • Repeating COLA rates higher than ad hocs in short-term, because ad-hoc COLAs are not prefunded • A reduction in COLA CPI percent results in lower or no increase until the cumulative increase exceeds current benefit; also, the longer retired, the longer the wait until another increase will be realized
	Ad-Hoc: 30%, 50% or 70% of CPI-U	TMRS	• Can be adopted when deemed affordable • In the short-term, ad hoc COLA costs are lower than repeating COLA	• May be infrequent and may not be a consistent inflation hedge • Generally, not included in ARC and not prefunded • In long-term, repeated ad-hoc COLAs create "stacking effect" which results in increasing costs • Cumulative contributions are ultimately higher since Ad-hoc COLAs are not pre-funded In the long-term, and exceed those for repeating COLAs • Generally, funded ratio declines with each adoption while UAAL increases over time

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Investment Earnings (3/29/2012 meeting)	COLA provided when annual investment earnings exceed an established benchmark	Arizona Rhode Island	• COLA provided specifically from investment earnings instead of contributions • Spreads risk between employer and retirees • Dampens growth of plan liabilities when returns are low	• COLA not guaranteed • COLA may be infrequent or lower increase than expected if returns are below benchmark • May not be sufficient to sustain purchasing power • Lowers the effective investment return and may increase future contributions or lead to a lower funded status • If assets don't keep up with liabilities, contributions have to increase to fund benefits
Reserve Account (3/29/2012 meeting)	COLA ("Dividend) provided from funds held in a separate reserve account. The value of the account equals the value of monthly pension benefits; dividend is paid if investments return a surplus to account	Wisconsin (WRS)	• Dividend provided specifically from investment earnings instead of contributions • Spreads risk between employer and retirees • Dampens growth of plan liabilities when returns are low; provides an additional benefit when returns are high • If negative dividends, a "floor" can be established that prevents a person's pension from being reduced to an amount lower than the person's original pension benefit	• Dividends are not guaranteed and may actually be reduced if account falls below the value of pension liabilities • Dividends may actually be "negative" if the account falls below the value of pension liabilities ("clawback") • Retirees not guaranteed purchasing power protection • Lowers the effective investment return and may increase future contributions or lead to a lower funded status • May be infrequent and not a consistent hedge against inflation

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Self-Funded Annuity Option (3/29/2012 meeting)	Allows a retiring employee the option to “self fund” a fixed rate COLA as an optional form of payment. Lower monthly annuity payments provided with promise of a guaranteed future annual COLAs at a fixed rate.	Louisiana (TRSL) Nebraska	• Cost-benefit can be pre-determined for each employee • Useful option if employee does not have social security since purchasing power is negatively impacted by absence of a COLA • For employer, employee bears costs • Feasible option for cities that do not have a COLA	• Member may have to work longer to obtain the desired monthly benefit and “self fund” their guaranteed COLA • Administration may be complex, especially for agent-based plans, and when benefits are employer and employee-based • For employee, they bear all costs
Fixed Rate (Flat-Rate) (5/3/2012 meeting)	May be provided either on an ad hoc or repeating basis at a flat rate or at some proportion of CPI (e.g. 3%), with or without a CAP	TCDRS	• Employer may be able to control plan costs better • Protects against some or all of purchasing power loss • Ability to adopt can be based on level of CPI • Repeating COLAs are included in ARC, so they are pre-funded	• May not protect purchasing power during periods of high inflation if not tied to CPI
Additional Employee Contributions (5/3/2012 meeting)	Employees are allowed to contribute additional funds which would be used to fund a COLA or keep current benefit level		• Employees could be more certain to receive a COLA after retirement	• Federal tax law may prevent this type of arrangement if the additional employee contributions are voluntary • Due to cash balance nature of TMRS plan, 1% increase in member rate does not correlate to a 1% decrease in employer rate (i.e. leakage)

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Funded Status (5/3/2012 meeting)	COLA can be granted when funded status is over an agreed upon threshold	Arizona New Jersey Oklahoma Rhode Island Wyoming	• Plans would always have to meet a threshold before COLAs granted • Projected COLA above funded level threshold would be included in ARC and pre-funded • Spreads plan funding risks over employers and retirees • Dampens growth of plan liabilities when the plan's funded status is low or not improving	• When returns are less than expected over a period, retirees may not receive a COLA • COLA may not be sufficient to fully protect retiree's purchasing power