## COLAs: Advantages and Disadvantages of Selected Designs

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<th>Feature(s)</th>
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| **Current TMRS-CPI-based**      | 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 prefunded 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**     | 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**         | 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**                   | 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)**                       | 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**            | 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 |