



Alternative Retirement Plan Designs

Hybrid Plans

By Paul Zorn

Hybrid plans can help governments reallocate retirement costs and risks while continuing to provide sustainable lifetime retirement benefits.

Over the last decade, economic, demographic, and political pressures have led state and local governments to consider alternatives to their traditional defined benefit (DB) pension plans. While a few have switched to defined contribution (DC) plans, others have turned to hybrid approaches that combine DB and DC plan features. Hybrid plans can help governments reallocate retirement costs and risks while continuing to provide sustainable lifetime retirement benefits.

A variety of hybrid plan designs exist, including pension equity plans, floor offset plans, target balance plans, cash balance plans, and combined DB/DC plans. However, only two designs are currently used by state and local governments: combined DB/DC plans and cash balance plans.

THE KINDS OF PLANS

Combined DB/DC Plans. Public-sector hybrid plans are often developed as separate but coordinated DB and DC plans. The DB portion of the benefit is typically funded by the employer, and benefits are based on a modest multiplier (e.g., 1 percent or 1.25 percent of final average salary) times years of service. Retirement eligibility and distribution options are usually similar to those of a DB plan, but might be less generous (e.g., based on a longer

period for determining final average salary or requiring later ages for retirement eligibility). The DC portion is typically based on mandatory minimum employee contributions, although additional voluntary employee contributions might be allowed. Upon retirement, the employee's DC account can be distributed as a lump sum or rolled over. In many cases, the DC account can be converted to an annuity.

Cash Balance Plans. While most public-sector hybrid plans use the combined DB/DC approach, a few are cash balance plans. Under this design, individual accounts are established for employees and credited with a fixed percentage of the employee's pay (e.g., 6 percent). In this respect, they function much like DC plans. Additionally, interest is credited to the individual's account based on a rate established by the plan. Consequently, in this respect, they are like DB plans, since the interest rate is guaranteed. Upon retirement, the accumulated account balance can be paid as a lump sum or converted to an annuity. Public-sector cash balance plans are often funded by both the employer and employees.

ALLOCATING RETIREMENT RISKS AND COSTS

Key retirement risks include investment risk, longevity risk, and inflation risk.

Exhibit I: Allocation of Key Risks in DC, DB, and Hybrid Plans

	DC Plan	DB Plan	Hybrid Plan
Investment Risk	Falls on the employee, since benefits are entirely based on the accumulated DC account balance	Falls on the employer, since investment shortfalls are made up through employer contributions	Falls on the employer for the DB portion of the benefit, and otherwise on the employee
Longevity Risk	Falls on the employee, since the DC account balance must be sufficient to fund benefits over the employee's lifetime	Falls on the employer, although the risk is mitigated by pooling the longevity risk over the group	Falls on the employer for the DB portion of the benefit, and possibly for the DC portion, if the DC benefit is taken as an annuity
Inflation Risk	Falls on the employee, since the DC account balance must be sufficient to maintain purchasing power through retirement	Falls on the employer to the extent that the benefit includes postemployment cost-of-living adjustments	Falls on the employer to the extent that the DB portion of the benefit provides postemployment cost-of-living adjustments

- Investment risk is the risk that investment earnings will fall short of the amount required to pay the benefits.
- Longevity risk is the risk that plan participants will live longer than expected and, therefore, require greater assets at retirement than originally assumed.
- Inflation risk is the risk that price increases will lower the benefit's purchasing power over time.

These risks affect retirement plan costs, since adverse risk experience (e.g., low investment returns) increases benefit costs, while favorable risk experience (e.g., high returns) lowers costs. Exhibit 1 shows how these risks are allocated to employers and employees through DC, DB, and hybrid plan designs.

Generally, the risks fall on the employee in DC plans and on the employer in DB plans, and in hybrid plans, the risks are allocated between the employer and employees. However, in DB plans, investment risk can be reduced through professionally directed asset allocation,

and investment costs can be reduced through negotiated investment management fees. Nevertheless, as a DB plan matures and the size of its fund increases, the investment risk grows in dollar amount and as a percentage of payroll.

There are two kinds of mortality risk — individual mortality risk and population mortality risk. In DC plans, employees must accumulate account balances that are sufficient to pay benefits over each individual employee's retired lifetime (e.g., to their 90s and beyond). In DB plans, the risk to individuals is pooled (i.e., averaged) over plan members. Consequently, DB plans need to fund benefits only over the average life-expectancy of the group (i.e., to their mid-80s). However, to the extent that longevity improves for the DB plan population as a whole, the risk falls on the employer.

Inflation risk falls on the employee in DC plans. In DB plans, pre-retirement inflation risk falls on the employer, to the extent that inflation causes final

average earnings to increase more rapidly than expected, and postemployment inflation risk falls on the employer, to the extent that the plan provides postemployment cost-of-living adjustments (COLAs).

There are other risks as well. For example, laws and regulations could change and add to the complexity of plan administration or potentially reduce benefits. Given recent changes to the rules and regulations regarding cash balance plans as a result of the 2006 Pension Protection Act, governments should consult with legal counsel before adopting hybrid plan designs other than the combined DB/DC type of plan. In addition, attention should be paid to issues regarding age discrimination.

EXAMPLES OF HYBRID PLANS

Hybrid plans have been established in a growing number of states, including Georgia, Hawaii, Michigan, Nebraska, Ohio, Oregon, Texas, Utah, and Washington. Two examples,

below, provide additional details about how the plans are structured. The examples are summarized from *The Evolution of Public Pension Plans: Past, Present and Future*, published by the National Conference on Public Employee Retirement Systems, and have been updated by representatives of the plans.

Municipal Employees' Retirement System of Michigan. In 2006, the Municipal Employees' Retirement System of Michigan (MERS) introduced its hybrid plan, which combines DB and DC components. The hybrid plan is optional for local governments and was designed to help governments control the costs of providing retirement benefits without having to switch to a DC plan. The DB benefit is funded solely by employer contributions. Participating employers can select one of three benefit multipliers: 1 percent, 1.25 percent, or 1.5 percent, which is then applied to three-year average final compensation for employees in the covered group. Once the multiplier is chosen, it cannot be changed. Participants become vested after six years of service and are eligible for retirement benefits at age 60, with no option for early retirement. The plan also provides disability and in-service death benefits, but it does not provide postemployment COLAs. With the sole exception of the choice of multiplier, the defined benefit provisions of the hybrid plan cannot be modified by collective bargaining or employer policy.

The negotiable portions of the DC benefit are employer contributions, vesting schedule, mandatory pre-tax employee contributions (if adopted by the local government), and the DB

to DC conversion option for active employees (at not less than 80 percent or more than 100 percent of the actuarial present value of the accrued benefit). Loans are not recommended but are allowed from the DC program, if adopted by the local government. Employees select investments from a variety of funds offered by the plan's administrator, including the MERS Total Market Fund (i.e., MERS's DB portfolio), offered at a low investment fee. The DC account balance can be taken as a lump sum, rolled over, or paid as an annuity purchased from an insurance carrier.

With the exception of those negotiable items identified above that are within the DB and DC components, no other hybrid plan provisions can be modified.

Texas Municipal Retirement System. The Texas Municipal Retirement System (TMRS) is a modified DB retirement plan that credits annual interest on contributions but does not guarantee an ultimate benefit amount. Created in 1947, TMRS provides retirement benefits to municipalities statewide. Each month, participating municipalities withhold a portion of each employee's salary and deposit it into a TMRS account held for the employee. The amount withheld is 5 percent, 6 percent, or 7 percent of the employee's gross salary, as determined by each local government, although a few municipalities are grandfathered at the 3 percent contribution level. Employer matching credits are set at 100 percent, 150 percent, or 200 percent. Interest is credited annually on the employee's account at a rate determined by the TMRS Board, based on the system's investment

income, with a minimum guaranteed rate of 5 percent.

In most TMRS municipalities, employees are vested after five years of service (although a few governments have elected to maintain 10-year vesting). Employees can retire at age 60 or older with 5 years of service credit (or 10 years for a few governments), or at any age with 20 or 25 years of service credit, depending on their government's option. At retirement, member contributions and interest credits are combined with the municipality's matching funds and other granted credits, and a monthly annuity is calculated based on these amounts and estimated life expectancy. The plan offers a variety of annuity options, including single-life annuities, joint and survivor annuities, and partial lump-sum options, all guaranteeing monthly payments for the retiree's life.

In addition, TMRS offers an optional updated service credit through which municipalities can elect to raise members' monthly benefits to prevent them from being eroded over time. Municipalities can also provide their retirees with COLAs amounting to 30 percent, 50 percent, or 70 percent of the Consumer Price Index, depending on the option elected by the municipality.

Note that under the TMRS plan design, contributions made by employers do not simply match employee contributions, but rather are determined annually by an actuarial valuation. Each employer's contributions reflect the mortality and service experience of employees covered by the fund, rates of return on plan assets, and the demographics of each municipality's workforce.

CONCLUSIONS

State and local government retirement plans have evolved over time as a result of the changing environments in which they operate. These pressures will continue well into the future. However, decisions to change plan design should be made only after careful consideration of the long-term costs and risks.

To provide guidance regarding hybrid plans, the GFOA developed a best practice, *Essential Design Elements of Hybrid Retirement Plans* (the full text of which is available at <http://www.gfoa.org/downloads/HybridPlansFINAL.pdf>). For employers considering hybrid retirement plans, the Best Practice recommends that decision makers consider the following questions:

- What is the role of the hybrid plan in providing retirement benefits? Is it

intended to replace the current DB or DC plan, or will it supplement the current DB or DC plan?

- What purpose is the hybrid plan intended to serve? Is it intended to control employer costs by reallocating retirement risks, or enhance the employer's ability to recruit and retain employees, or some other purpose?
- What are the short-term and long-term costs and/or savings that will likely result from the hybrid plan? This should include not only direct costs but also the total costs of compensation. Decision makers should also consider possible increases in administrative costs due to the more complicated features of hybrid plans.
- Will the resulting hybrid plan comply with the GFOA's Best Practices

for defined benefit and/or defined contribution retirement plans?

- Can the plan be sustained over the long term?

It is also important that changes in plan design be undertaken after careful consideration, professional advice, and legal assistance. Depending on the type of change, it might be advisable to consider some form of grandfathering for employees close to retirement. Furthermore, for hybrid plans other than combined DB/DC type plans, it is imperative to consider whether the hybrid plan or plan features comply with the 2006 Pension Protection Act and related regulations. ■

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