

What are Hybrid Retirement Plans



A QUICK-REFERENCE GUIDE



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The term *hybrid retirement plan* has a wide range of meanings. The U.S. Department of the Treasury, for example, considers most state and local pension plans to be hybrids because both employees and employers contribute to them.

But when state and local officials talk about hybrid plans, they generally mean that their governments offer some combination of a defined benefit (DB) and defined contribution (DC) plan or a single plan that includes elements of both. Under these plans, when eligible employees retire, they receive a specific benefit that incorporates features of both a DB-type pension as well as a DC-type retirement benefit. The latter is based on the contributions made by the employer and/or employee into the employee's individual retirement account, along with the investment return realized over the life of the account.¹ Many public employers also offer an opportunity for employees to save for retirement through a voluntary supplemental deferred compensation plan.

Public employee retirement packages are not limited to the traditional employer-provided pension or individual-based retirement accounts. Today there are more options than ever, with a range of features, blends of investment risk, and sources of funding. Each of the plans below has certain advantages and disadvantages, and each offers a different distribution of investment risk responsibility between the employer and employee.

Defined Benefit plan (DB) with Defined Contribution (DC) features: These plans, although not usually considered true hybrids, include a combination of an employer-provided DB pension plan with a separate DC plan such as a 457, 403(b), 401(a), or (to a limited extent) 401(k).²

Defined Contribution plan (DC) with Defined Benefit (DB) features: DC plans, such as a 457, 403(b), 401(a) or (to a limited extent) 401(k), exist only as cash

"A **defined benefit** plan promises a specified monthly benefit at retirement. The plan may state this promised benefit as an exact dollar amount...Or, more commonly, it may calculate a benefit through a plan formula that considers such factors as salary and service."

"A **defined contribution** plan, on the other hand, does not promise a specific amount of benefits at retirement. In these plans, the employee or the employer (or both) contribute to the employee's individual account under the plan, sometimes at a set rate...These contributions generally are invested on the employee's behalf. The employee will ultimately receive the balance in their account, which is based on contributions plus or minus investment gains or losses."

Source: <http://www.dol.gov/dol/topic/retirement/typesofplans.htm>

balances upon retirement with no guaranteed rate of return and are subject to fluctuations due to market volatility. To help mitigate an individual's risk that he or she might outlive his or her money, some DC plans now offer holders the opportunity to purchase annuity contracts or allow DC funds to be annuitized through the plan sponsor's DB plan.³

Cash Balance Plans: In this type of defined benefit plan, employers guarantee an annual rate of return on a "notional" account into which the employer, the employee, or both contribute. The account must, at a minimum, meet the guaranteed rate, which may be a set percentage or some multiple of an indicator, such as the yield on a Treasury bill.⁴ At retirement, the employee can withdraw the funds through an annuity or in one lump sum. Because a cash balance plan is a defined benefit plan, the employer is ultimately responsible to fund the plan so that the benefit obligation (i.e., the sum of the participant notional accounts), is funded.

Pension Equity Plans: Pension equity plans operate like traditional pension plans that base the cash value of defined benefits on a formula that typically accounts for years of service, age, and some averaging of salary. Typically, an employee earns “points” each year, multiplied by salary. For instance, in a plan that awards 5 percent of salary each year, after 20 years a plan participant would have accumulated 100 points (or 100 percent) of final average salary, or an account balance

of one year’s final average salary. However, unlike a traditional pension plan, which may be accessible only after a period of 20, 25, or 30 years of service, pension equity plans have a current cash value. An employee can receive the account balance as either an annuity or lump sum payment upon separation, regardless of years employed.⁵ Pension equity plans provide employees the benefits of DB plans with the flexibility usually found in DC plans when they change employers or careers.

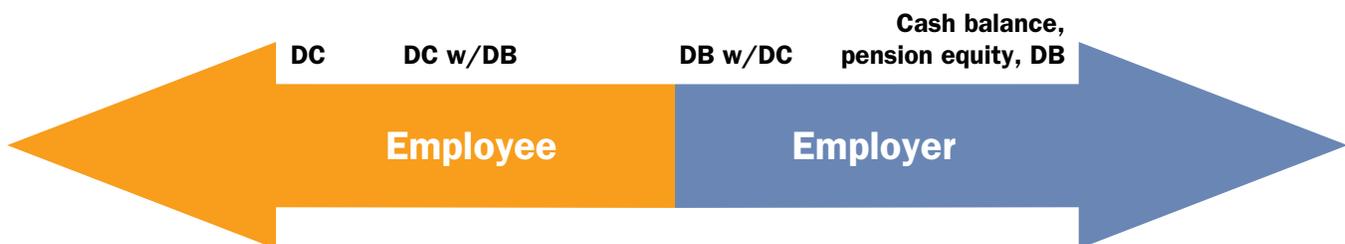
Table 1. Overview of the Benefits, Risks, and Responsibility of Different Employer Sponsored Retirement Plans

| Plan Feature | DB | DC | Cash Balance | Pension Equity | DB with DC | DC with DB |
|--|---------------------------------------|--|---------------------------------------|---------------------------------------|--|--|
| Funding Source | Employer and employee | Employee* (possible employer contribution) | Employer and employee | Employer and employee | Employer and employee | Employee* (possible employer contribution) |
| Portable to new employer | No | Yes | Yes | Yes | Some | Yes |
| Responsibility for investment risk | Employer | Employee | Employer (until separation) | Employer (until separation) | Employer and employee | Employee and annuity provider |
| Rate of return for employee during service | Guaranteed for employee contributions | Variable | Guaranteed for employee contributions | Guaranteed for employee contributions | Mixed | Variable |
| Accrual of benefits | Back loaded, toward end of career | Front loaded, toward start of career | Even | Even | Part even and part back loaded, toward end of career | Front loaded, toward start of career |
| Potential to outlive funds | No | Yes, unless annuity purchased | No, if annuity selected | No, if annuity selected | No, if service requirement met | No, if annuity purchased |

Sources: Robert L. Clark, John J. Haley, and Sylvester J. Schieber, “Adopting Hybrid Pension Plans: Financial and Communications Issues,” *Benefits Quarterly*, First Quarter 2001, pp. 7–17, and author contributions

* Employee contributions that are “picked up” under section 414(h) of the Internal Revenue Code are treated as employer contributions for federal tax purposes.

Figure 1. Spectrum of Investment Risk Associated with Different Employer Sponsored Retirement Plan



State and Local Government Examples

The State of Washington

<http://www.drs.wa.gov/>

In the 1990s and early 2000s, the State of Washington was one of the first states to offer the choice of a defined benefit plan with a defined contribution feature for a range of public employees. The 401(a) plan gives state, education, and local government employees access to two separate retirement components—a defined benefit and a defined contribution account. The defined contribution account consists of individual employee accounts that generate retirement income from employee contributions to the account (contribution levels determined by the employee), along with performance on investments. Employees have the ability to decide on the mix of investments or can invest in an investment portfolio that is managed by the Washington State Investment Board. Also, upon retirement, retirees can elect to take payments from their defined contribution account in installments, lump sums, or rollovers, or have them transferred to lifetime annuity payments.

The other component is the defined benefit plan. The defined benefit portion is funded by employer contributions held in trust, with investments managed by the Washington State Investment Board. When the employees retire, they can begin receiving monthly payments equal to 1 percent times the number of years of service times the monthly average of the 60 highest-paid consecutive service credit months. These payments are adjusted every July 1 for cost of living, which follows the Consumer Price Index, up to a maximum of 3 percent adjustment per year. While there are some early retirement options, the normal retirement age for the plan is 65 years of age with 10 years of service or age 65 with five years of service if at least 12 of those months were earned after the age of 44.⁶

The State of Georgia

<http://www.ers.ga.gov/>

As of the beginning of 2009, the State of Georgia provides a hybrid retirement plan for all new state employees. The plan includes a 401(k) DC plan along with a traditional DB pension plan. For the 401(k) portion, employees are automatically enrolled in the plan with

a default 1 percent employee contribution rate. The state offers a 100 percent match for the first 1 percent of employee contribution and matches 50 percent of employees' contributions up to 5 percent of their salaries. Employees may leave their account funds in a default lifecycle fund, shift to their choice of a combination of 13 available investment options (bonds, equities, real estate, and others), or transfer to a self-directed brokerage account. Normal retirement age is 60 with at least 10 years of service, or any age with 30 years of service. At retirement, employee options include taking a lump sum payment from their 401(k) accounts, taking a partial lump sum, taking payments for a set period of time, receiving payments based on the employee's or his/her spouse's life expectancy, or purchasing an annuity. After 10 years of service, employees also become eligible to receive benefits from a DB plan upon retirement. Employees are required to contribute 1.25 percent of their salaries to the DB plan and, when retired, will receive monthly payments equal to 1 percent times the number of years of service times the average of the 24 highest consecutive months of salary while a member of the retirement system.⁷

The State of Ohio

<https://www.strsoh.org/>

Between 2000 and 2002, the State of Ohio began offering a combined plan for teachers. In this plan, the employees contribute 10 percent of their annual salaries to a DC account and their employer contributes 14 percent of salary to the DB portion of the plan. For the DC account, participants have the option of allocating all or portions of the account funds among seven investment choices, including money market funds, bonds, a mix of equity funds, and real estate. Members are eligible for normal retirement at age 60 with at least five years of service. At this time or later, employees can begin to collect retirement benefits, which are paid separately from the DB and DC accounts. The DB benefit they receive is determined by 1 percent times the number of years of service times the average of the three highest years of earnings. Participants have the option of taking a partial lump sum payment at retirement and then receiving reduced lifetime monthly DB payments. At retirement, the DC account balance reflects member contributions plus gains or losses on investment choices, and can be withdrawn as an annuity or lump-sum payment.⁸

Endnotes

- 1 Employee Benefits Security Administration, U.S. Department of Labor – <http://www.dol.gov/ebsa/>
- 2 Essential Design Elements of Hybrid Retirement Plans (2008), Government Finance Officers Association – <http://www.gfoa.org/downloads/HybridPlansFINAL.pdf>
- 3 Essential Design Elements of Hybrid Retirement Plans (2008), Government Finance Officers Association – <http://www.gfoa.org/downloads/HybridPlansFINAL.pdf>
- 4 Private Pensions: Information on Cash Balance Pension Plans, U.S. Government Accountability Office – <http://www.gao.gov/new.items/d0642.pdf>
- 5 What is a Pension Equity Plan? (by L. Bernard Green), U.S. Bureau of Labor Statistics, U.S. Department of Labor – <http://www.bls.gov/opub/cwc/cm20031016ar01p1.htm>
- 6 Public Employees' Retirement System Plan 3, Washington State Department of Retirement Systems – <http://www.drs.wa.gov/member/handbooks/pers/plan-3/default.htm>
- 7 State Employees' Pension & Savings Plan, Employees' Retirement System of Georgia – http://www.ers.ga.gov/plans/ers/gseps/formspubs/GSEPS_PlanOverview_FINAL4.pdf
- 8 Understanding Your STRS Ohio Benefits – Plan Summary, State Teachers Retirement System of Ohio – <https://www.strsoh.org/pdfs/brochures/20-101.pdf>

From the National Conference of State Legislatures:
<http://www.ncsl.org/LinkClick.aspx?fileticket=yGsmFhwoq7E%3D&tabid=18511>

From the Government Finance Officers Association:
<http://www.gfoa.org/downloads/HybridPlansFINAL.pdf>

From the National Association of State Retirement Administrators: <http://www.nasra.org/resources/Hybrid%20Grid.pdf>

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