NASRA Issue Brief:
State Hybrid Retirement Plans

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Although hybrid plans have been in place in public sector retirement systems for decades, this plan design has received increased attention in recent years. This new focus occurs as states find that closing their traditional pension plan to future (and, in some cases, existing) employees could increase—rather than reduce—costs,[1] and that providing only a 401(k)-type plan does not meet important retirement security, human resource, or fiscal objectives. While most states have chosen to retain their defined benefit (DB) plan by modifying required employer and employee contributions, restructuring benefits, or both,[2] some also have looked to so-called "hybrid" plans that combine elements of traditional pensions and individual account plans.

Although a hybrid retirement plan may take one of many forms, this brief examines two broad types in use in the public sector. The first is a cash balance plan, which marries elements of traditional pensions with individual accounts into a single plan (see Table 1). The second type combines a smaller traditional DB plan with an individual defined contribution (DC) retirement savings account, referred to in this brief as a "DB+DC plan" (see Table 2). Despite variability among these plans, most contain the core features known to promote retirement security: mandatory participation, shared financing between employers and employees, pooled assets invested by professionals, a benefit that cannot be outlived, and survivor and disability protections.

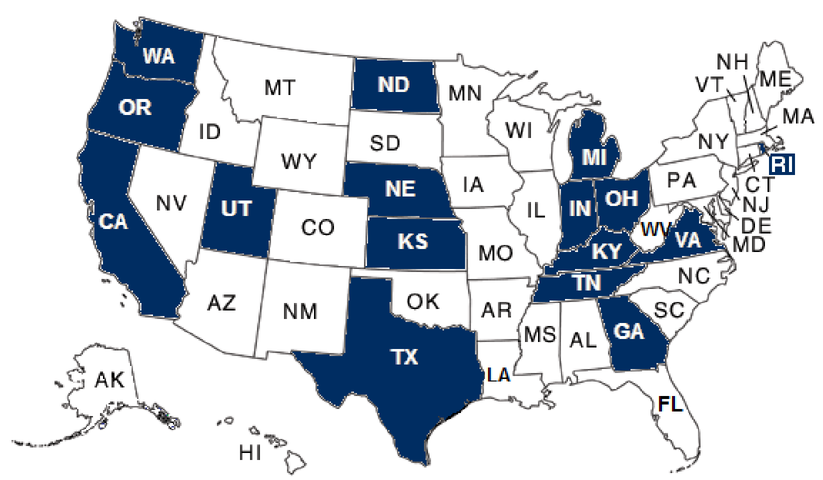
Mandatory Participation

In the private sector, just one-half of the workforce participates in an employer-sponsored retirement plan,[3] widely recognized as a major factor contributing to the nation's retirement insecurity. By contrast, for nearly all employees of state and local government, retirement plan participation is mandatory.

Employee participation remains mandatory in state hybrid plans. One partial exception is the Georgia Employees' Retirement System (ERS), which administers a hybrid plan for many of its members. Participation in the DB component of the plan is mandatory, and participants may elect to not participate in the DC component (although the vast majority have not exercised this election).

Most public employees also have access to a supplemental, voluntary individual retirement savings plan, such as a 401(k), 403(b) or 457 plan. In addition to mandatory participation in the primary plan, some public employers automatically enroll new hires in supplemental retirement savings plans, and participants may opt-out at any time.

Figure 1: States that administer CB or DB+DC plans as a mandatory or optional primary retirement benefit for groups of general or K-12 educational employees



Shared Financing among Employers and Employees

Nearly all traditional pensions in the public sector require employees to contribute toward the cost of their retirement benefit,[4] and in the wake of the 2008-09 market decline and the Great Recession, many states have increased employees' required contributions.[5]

Hybrid plans also typically employ a shared financing approach to retirement benefits. State cash balance plans, which feature accruals on employee accounts (cash balances), are funded with mandatory contributions from both employees and employers.

DB+DC plans vary regarding the level to which employees and employers are required to contribute toward the DB and DC components. As examples, for the hybrid plans in Indiana, Ohio, Oregon, and Washington, the employer finances the DB component, and the DC component is funded by mandatory employee contributions (ranging from 3 percent to 15 percent of salary). The Michigan Public Schools hybrid plan requires employees to contribute to the DB component on a graduated scale based on pay, and employers finance the remainder; employees are also required to make a mandatory 2-percent-of-salary contribution to the DC component, which employers match at a 50 percent rate.

The Georgia ERS hybrid requires employees to contribute 1.25 percent of salary to the DB component, with the remainder financed by the employer. Employees are automatically enrolled in the DC component at 1% of salary, but may opt out or contribute more. Employers match the first 1 percent of salary and one-half of the next 4 percent of salary voluntarily contributed by the employee to the DC plan.

The Utah retirement system requires employers to contribute 10 percent of salary (12 percent for public safety) toward the DB plan's cost.[6] If the cost is less than the employer's 10 percent contribution rate, the difference goes into employees' individual 401(k) savings account. If the cost of the DB plan exceeds the employer's 10 percent contribution rate, employees must contribute the difference to the DB plan. In either instance, employees may elect to make additional contributions to the 401(k) plan. (Employers in Utah must also contribute five percent of pay to the Utah Retirement System to amortize the unfunded pension liability.)

North Dakota PEP

North Dakota offers most of its workers an optional hybrid retirement plan designed to provide greater portability.

Known as "PEP" —Portability Enhancement Program— North Dakota PERS participants can vest in the employer's portion of the defined benefit plan by participating in a supplemental deferred compensation account, funding a benefit that is more portable than the traditional defined benefit plan and similar to a defined contribution plan.

Pooled Assets

Retirement assets that are pooled and invested by professionals offer important advantages over individual, self-directed accounts. Combined portfolios have a longer investment horizon, which allows them to be better diversified and to sustain greater market volatility. In addition, the professional asset management and lower administrative and investment costs in pooled arrangements result in higher investment returns.

As with traditional pension plan assets, cash balance plan assets are pooled, invested by professionals, and guarantee annual returns to plan participants. Likewise, DB+DC plans pool assets in the DB component; the manner in which DC plan assets are managed varies. Most plans provide a range of risk-based investment options: some are retail mutual funds and others are maintained by the retirement system and available only to plan participants. Assets in the Oregon DC component, for example, are pooled and invested in a fund similar to the DB plan fund; participants do not have a choice regarding how their DC plan assets are managed. Similarly, Washington State provides an option for employees to invest their DC assets in a fund that emulates the DB plan fund.

Required Lifetime Benefit Payouts

A core objective of retirement plans is to provide lifetime income insurance. A major threat to lifetime income is known as longevity risk, which is the danger of exhausting assets before death. Ensuring lifetime income can be accomplished in part by pooling longevity risk, i.e., distributing that risk among many plan participants. The alternative is an arrangement, embodied in defined contribution plans, in which longevity risk is borne by individuals.

Most public sector plans require some or all of the pension benefit to be paid in the form of an annuity – installments over one's retired lifetime – rather than allowing benefits to be distributed in a lump sum. This not only better ensures participants will not exhaust retirement assets, but it also reduces costs by allowing retirement assets to be invested as part of the trust over a longer period, and by funding for average longevity rather than the maximum longevity.

As examples, the two statewide cash balance plans in Texas require participant accounts to be paid in the form of a lifetime benefit; county and district employees may elect to receive 100% of their benefit as a partial lump sum upon retirement. The Nebraska cash balance plan gives employees the option of receiving a lifetime benefit payout on any portion of their account balance, and to receive any portion of their retirement benefit as a lump sum.

DB+DC plans normally require the DB portion of the plan to be paid in the form of a lifetime annuity. The DC portion, however, usually may be paid out in various forms including a lifetime benefit, a lump sum or partial lump sum of the account balance, or installments over a certain term (e.g., 5, 10, 15 or 20 years).

Social Security, Disability and Survivor Benefits

Approximately 25 percent of state and local government employees do not participate in Social Security.[7] While most public sector retirement plan designs seek to replace a targeted percentage of income, they often also reflect the presence or absence of income from Social Security.

Benefits that provide income insurance in the event of death or disability are an important feature among public sector employers, particularly for jobs that involve hazardous conditions. Most public sector retirement plans—whether traditional or hybrid—include survivor and disability benefits, which is a cost-effective method for sponsoring these benefits.

Conclusion

Nearly every state has made changes in recent years to the retirement plans.[8] While DB plans remain the prevailing model, cash balance and DB+DC plans have been in place for many years in some states, and are new in others. The diversity in public sector plan design reflects the fact that a one-size-fits-all solution does not meet public employer human resource and fiscal objectives. Like defined benefit plans, cash balance and DB+DC plans in the public sector vary from one jurisdiction to the next, and no single design will address the cost and risk factors of every state or local government.

A key factor in evaluating a retirement plan is the extent to which it contains the core elements known to best meet human resource and retirement policy objectives of state and local governments: mandatory participation, shared financing, pooled investments, benefit adequacy, and lifetime benefit payouts. These features are a proven means of delivering income security in retirement, retaining qualified workers who perform essential public services, and providing an important source of economic stability to every city, town, and state across the country.[9]

Most public retirement systems seek to provide a benefit that meets these objectives while balancing risk between employees and employer units. The information in the tables below illustrates the degree to which states are using various cash balance and DB+DC designs to achieve these objectives.

See Also

National Association of State Retirement Administrators, Resolution 2010-01: *Guiding Principles for Retirement Security and Plan Sustainability*, http://www.nasra.org/resolutions#RESOLUTION 2010-01

National Association of State Retirement Administrators Issue Brief: Shared-Risk Arrangements, http://www.nasra.org/sharedriskbrief

National Conference of State Legislators, State Defined Contribution and Hybrid Pension Plans, http://www.ncsl.org/Portals/1/Documents/employ/StateDC-%20HybridRetirementPlans2010.pdf

National Institute on Retirement Security, *A Better Bang for the Buck: The Economic Efficiencies of Pensions*, 2008, http://www.nirsonline.org/index.php?option=com_content&task=view&id=121&Itemid=48

National Institute on Retirement Security, *Decisions, Decisions: Retirement Plan Choices for Public Employees and Employers*, 2011, http://www.nirsonline.org/storage/nirs/documents/Decisions%20Decisions/final_decisions_decisions_report.pdf

National Institute on Retirement Security, *Look Before You Leap: The Unintended Consequences of Pension Freezes*, 2008, http://www.nirsonline.org/index.php?option=com_content&task=view&id=173&Itemid=49

U.S. Department of Labor, Bureau of Labor Statistics, *National Compensation Survey: Employee Benefits in States and Local Government in the U.S.*, March 2011, http://www.bls.gov/ncs/ebs/benefits/2011/ownership/govt/table02a.pdf

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[1] NASRA, "Costs of Switching from a DB to a DC Plan," http://www.nasra.org/switching

[2] NASRA, "Selected Approved Changes to State Public Pensions to Restore or Preserve Plan Sustainability," http://www.nasra.org/resolutions#RESOLUTION 2010-01

[3] U.S. Department of Labor, Bureau of Labor Statistics, Retirement Benefits: Access, Participation and Take-Up Rates, July 2013, http://www.bls.gov/news.release/pdf/ebs2.pdf

[4] Public Fund Survey, www.publicfundsurvey.org

[5] NASRA, "Selected Approved Changes," supra

[6] Employers are also required to contribute an actuarially determined rate each year to amortize the DB plan unfunded liability

[7] U.S. Government Accountability Office, "Social Security: Issues Regarding the Coverage of Public Employees," 2007, http://finance.senate.gov/imo/media/doc/1110607testmn1.pdf

[8] National Conference of State Legislatures, "State Retirement Legislation," http://www.ncsl.org/documents/employ/Basic-Presentation-July2012.pdf

[9] National Institute on Retirement Security, *Pensionomics: Measuring the Economic Impact of State & Local Pension Plans,* 2009, http://www.nirsonline.org/index.php?option=com_content&task=view&id=189&Itemid=48

Table 1: Overview of Cash Balance Hybrid Plans						
	TX Municipal	**TX County and District**	**CA State Teachers**	**NE County and State**	**KS PERS**	**KY RS**
Year plan approved	1947	1967	1995 for the Cash Balance Benefit Program, 2000 for the Defined Benefit Supplement	2002	2012	2013
Employee groups affected	Mandatory for EEs of 800+ cities that have elected to participate in the TMRS	Mandatory for EEs of 600+ counties and special districts that have elected to participate in the TCDRS	The Cash Balance Benefit Program is optional for part-time and adjunct educational workers; the Defined Benefit Supplement is a cash balance plan provided to full-time educators	Mandatory for county and state EEs* hired after 2002 and those hired previously who elected to switch from the DC plan	Mandatory for EEs of state and local government, including education employees, hired after 1/1/15	Mandatory for new state and local EEs, judges, and legislators who become members on or after January 1, 2014
Contributions	EEs pay 5%, 6%, or 7%, depending on ER* election ER pays 100%, 150%, or 200% of EE rate, also depending on ER election, and adjusted based on unfunded liability	EEs pay 4%, 5%, 6%, or 7% depending on ER election ERs pay normal cost plus amount to amortize the unfunded liability within a 20-year closed period	EEs in the Cash Balance Benefit Program typically pay approximately 4% of earnings, depending on local bargaining agreements; Defined Benefit Supplement EEs contributed 2% from 2001-2010 Beginning in 2011, ER and EEcontributions to the Defined Benefit Supplement are 8% each on compensation in excess of one-year of service credit ER must contribute at least 4% for Cash Balance Benefit participants and the combined EE/ER rate must be at least 8%	State EEs contribute 4.8%, county EEs contribute 4.5% State contributes 156% of EE rate; counties contribute 150% of EE rate	EEs contribute 6% ER contributes between 3-6% depending on how long the member has been employed	EEs contribute 5%; public safety EEs contribute 8% State contributes 4%; , 7.5% for public safety EEs

	TX Municipal	TX County and District	CA State Teachers	NE County and State	KS PERS	KY RS
Rate of return applied to cash balances	5% (set by statute): The TMRS Board determines the allocation of any excess amounts; the board is authorized to distribute such amounts a) to reduce cities' unfunded liabilities; b) to EEs' individual accounts, and/or c) to a reserve to help offset future investment losses	7% (set by statute): Used to reduce ERs' Members' accounts receive an annual interest credit of 7% as specified by statute	Guaranteed minimum interest rate is based on 30-year U.S. Treasury bonds for the period from March to February immediately prior to the plan year (3% for plan year 2013-14)	Based on the federal mid-term rate plus 1.5%: When the mid-term rate falls below 3.5%, EEs receive a 5% minimum credit rate When favorable returns combine with an actuarial surplus, the governing board may approve a dividend payment to EE accounts	Members are guaranteed an annual rate of return of 5.25% on their accounts	Employee accounts are guaranteed 4% annual return; accounts also receive 75% of all returns above 4%
Benefit payment options	Annuity with or without a partial lump sum, depending on EE election	LIfetime annuity based on EE final savings account balance, less any EE-elected partial lump-sum payment, plus ER matching	Lump-sum and/or monthly lifetime annuity or period certain monthly annuity	Retiring participants may annuitize any portion of their cash balance and take a lump sum of any remainder. Members electing an annuity may also elect to take a reduced benefit with an automatic annual COLA	Retiring participants may annuitize their cash balance and may elect to take up to 30 percent as a lump sum. Participants may also elect to use a portion of their balance to fund an auto-COLA	Member may choose annuity payments, a payment option calculated as the actuarial equivalent of the life annuity, or a refund of the accumulated account balance
Info online	www.tmrs.com/down/pubs/tmrs_facts.pdf	http://www.tcdrs.org	http://www.calstrs.com/sites/main/files/file-attachments/basics_cash_balance_plan.pdf	www.npers.ne.gov	http://www.kpers.org	https://kyret.ky.gov/images/uploads/news/Summary_of_Senate_Bill_2_changes.pdf

* EE = employee; ER = employer

Table 2: Overview of Defined Benefit + Defined Contribution (DB+DC) Hybrid Plans											
	IN Public RS	**WA Dept of RS**	**OH State Teachers' RS**	**OH Public Employees' RS**	**OR PERS**	**GA Employees' RS**	**MI Public Schools RS**	**UT RS**	**RI ERS**	**VA RS**	**TN Consolidated Retirement System**
Year plan approved	1955	1996	2001	2002	2003	2008	2010	2010	2011	2012	2013
Employee groups affected	Mandatory except for EE hired after 2011 who may elect a DC plan only	Optional for most employee groups	Optional for new hires and non-vested workers since 2001	Optional for new hires and non-vested workers since 12/31/02	Mandatory for all EEs (existing and new) since 2004	Mandatory for new hires since 2009; optional for those hired before 2009 (EE* may opt-out of DC component within 90 days)	Mandatory for all new hires after 06/30/2010	Mandatory for new hires as of 07/01/2011; all EEs may elect DC-only plan	Mandatory for existing members of ERS as of July 1, 2012, as well as new hires (except judges and some public safety members)	Mandatory for most state and local employees, educational employees, and judges, hired on or after 1/1/14 – excluding state police and other law enforcement officers	Mandatory for new state and higher education employees and teachers hired after July 1, 2014; optional for local government entities
Defined Benefit Portion											
DB benefit formula (having met age/service requirements)	1.1% x years of service x final average salary = annual benefit	1% x years of service x final average salary = annual benefit	1% x years of service x final average salary = annual benefit	1% x up to 30 years of service x final average salary + 1.25% x years in excess of 30 x final average salary = annual benefit	Varies depending upon date of hire and which of 3 DB plans EE is enrolled in	1% x years of service x final average salary = annual benefit	1.5% x years of service x final average salary = annual benefit	1.5% x years of service x final average salary = annual benefit For public safety: 2% x years of service x final average salary = annual benefit	1% x years of service x final average salary = annual benefit	1% x years of service x final average salary = annual benefit	1% x years of service x final average salary (maximum annual pension benefit of $80,000, indexed by CPI)

	IN Public RS	WA Dept of RS	OH State Teachers' RS	OH Public Employees' RS	OR PERS	GA Employees' RS	MI Public Schools RS	UT RS	RI ERS	VA RS	TN Consolidated Retirement System
DB plan contributions	ER funds the DB benefit	ER funds DB benefit	ER funds DB benefit	ER funds DB benefit	ER funds DB benefit	EE contributes 1.25% and ER contributes the remainder of the annual actuarially determined contribution rate	EE contributes on a graduated scale based on pay; ER contributes remainder	ER pays up to 10% of pay, 12% for public safety (+ 5% to amortize the DB unfunded liability). EEs pay into DB only if the normal cost of the plan exceeds maximum ER contribution	State EEs and teachers contribute 3.75% to the DB plan; municipal EEs contribute 1% or 2% based on COLA election; municipal police and fire contribute 7 or 8% based on COLA election. ER contributions to the DB plan remain unchanged	EE contributes 4% to the DB plan ER contributes an actuarially determined amount to fund the DB benefit (less employer DC contributions)	EE contributes 5% to the DB plan ER contributes 4%
Defined Contribution Portion											
Employer DC plan contributions	None	None	None	None	None	100% ER match on EE's 1st 1% of salary and 50% match on next 4% of salary for a maximum ER contribution of 3%	ER contributes 1% of salary	ER contributes 10% (12% for public safety); if DB cost is more, EE must pay but if less, the difference is applied to EE's DC account	ER contributes 1% to the DC plan for state and local EEs and teachers; 3% for municipal police and fire EEs not covered by Social Security	Mandatory ER contributions of 1% - increases with EE contributions up to 3.5% maximum	ER contributes 5% to the DC plan

	IN Public RS	WA Dept of RS	OH State Teachers' RS	OH Public Employees' RS	OR PERS	GA Employees' RS	MI Public Schools RS	UT RS	RI ERS	VA RS	TN Consolidated Retirement System
Employee DC plan contributions	3% of salary	5% to 15% of salary depending on EE	10% of salary	10% of salary	6% of salary	EE auto enroll at 1% of salary contribution but may vary contribution rate up or down; participants may opt-out of the DC plan within 90 days of their date of hire	2% of salary	EE contributions optional	State and local EEs and teachers contribute 5% to the DC plan; 3% for municipal police and fire EEs not covered by Social Security	EEs may contribute up to 5% to the DC plan (1% minimum)	EEs contribute 2%, with opt-out feature
DC plan investment options	7 options ranging from conservative to aggressive, and 10 target date funds, all administered by the retirement system	Either the total allocation portfolio, which mirrors DB plan fund, or 7 self-directed funds ranging from conservative to aggressive, plus target date funds	8 STRS Ohio-sponsored options ranging from conservative to aggressive plus a guaranteed return option and target date funds	16 OPERS-sponsored funds including core and target date funds, plus a brokerage window	All DC plan contributions are invested in a single, pooled fund that mirrors the DB plan fund	16 options ranging from conservative to aggressive, plus 5 lifecycle funds	Choice of active and passive investment options, target date funds, and a brokerage window	12 risk-based options	12 target date funds and 10 funds ranging from conservative to aggressive	11 options ranging from conservative to aggressive, plus 10 target date funds.	11 target date funds and 15 options ranging from conservative to aggressive

	IN Public RS	WA Dept of RS	OH State Teachers' RS	OH Public Employees' RS	OR PERS	GA Employees' RS	MI Public Schools RS	UT RS	RI ERS	VA RS	TN Consolidated Retirement System
Default DC plan investment options	The Guaranteed Fund, which earns a fixed rate established annually by the Board	Target Date Funds	Earliest target date fund	Target Date Fund closest to the year the participant turns 65	DB plan fund	Lifecycle funds based on age	Target Retirement Fund that matches the year the participant will be eligible to retire	Medium Horizon Fund, which features a diversified investment portfolio	Age appropriate Target Retirement Fund	Target Date Funds based on the participant's age at enrollment	Age appropriate Target Date portfolio
DC plan withdrawal options	Annuity, rollover, partial lump sum and annuity, deferral until age 70½	Lump sum, direct rollover, scheduled payments, personalized payment schedule, and annuity purchase	Annuity including partial lump sum, lump sum or rollover	Annuity, including partial lump sum option plan; deferral until age 70½	Lump sum payment or in installments over a 5-, 10-, 15-, or 20-year period or the EE's anticipated lifespan	Rollover, annuity, lump sum, partial lump sum, installments	Lump sum, consolidation from other plans, direct rollover to an IRA, periodic distribution	After 4-year vesting period: lump sum, partial balance, periodic distribution, direct rollover, direct rollover to an IRA	Lifetime annuity, lump-sum distribution, or distribution in installments (rolling assets into an IRA or leaving assets in the plan)	Depend on the circumstances at termination; DB/DC combo plan requires coordination between the two components with respect to termination options	Lump sum, periodic payments, minimum required distributions, or annuity; beneficiaries may use a combination of more than one payment method
Info online	www.in.gov/inprs/index.htm	http://www.drs.wa.gov (Go to "my plan 3 account")	http://www.strsoh.org	http://www.opers.org	http://www.oregon.gov/PERS	www.ers.ga.gov	https://stateofmi.ingplans.com/eportal/welcome.do	http://www.urs.org	https://www.ersri.org/public/documentation/FINAL_RIRSAGuide_January2012.pdf	http://www.varetire.org/employers/member-benefits/hybrid-plan/index.asp	http://treasury.tn.gov/tcrs/PDFs/HybridPlanSummarySheet.pdf