NASRA Issue Brief:
State Hybrid Retirement Plans

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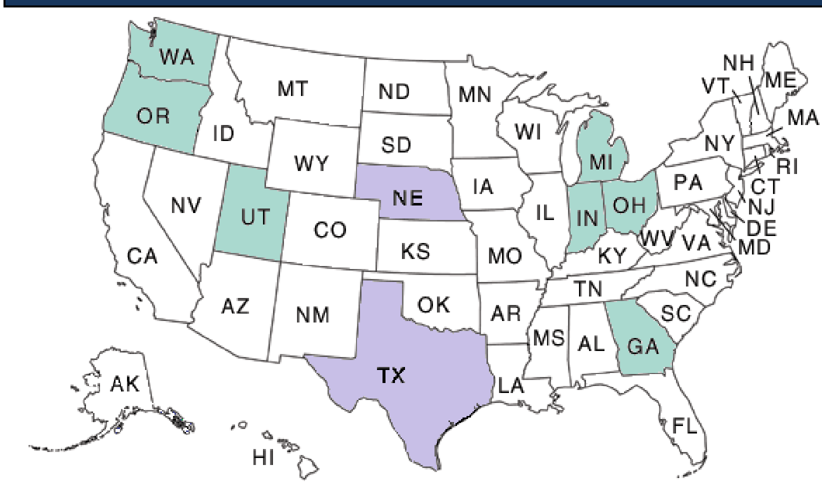
Hybrid plans have been in place in public sector retirement systems for decades. Currently, this plan design is receiving increased attention as states find that closing a traditional defined benefit pension plan to new employees could increase—rather than reduce—costs,[1] and that providing only a 401(k)-type plan does not meet retirement security, human resource, or fiscal needs. While most states made the decision to retain their defined benefit plan by modifying required employer and employee contributions, restructuring benefits, or both,[2] some have also looked to so-called "hybrid" plans that combine elements of traditional pensions and individual account plans.

This brief examines two types of hybrid plans in use in the public sector. The first is a cash balance plan, which marries elements of traditional pensions and individual accounts into a single plan (see Table 1). The second combines a smaller traditional defined benefit (DB) pension 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 retirement plan elements 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] a factor identified as a major cause of the nation's growing retirement insecurity. By contrast, for nearly all employees of state and local government, retirement plan participation is mandatory.

Figure 1: States that administer cash balance and DB+DC hybrid plans as a mandatory or optional primary retirement benefit for broad classes of employees



State hybrid plans are no exception, as employee participation remains mandatory in these programs. The Georgia Employees' Retirement System (ERS) hybrid plan has a mandatory DB component. Its DC component has a default employee contribution of 1 percent with a matching employer contribution. However, employees may elect to increase or decrease participation or to opt out of the DC component altogether.

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.

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] In the wake of the Great Recession, many states have increased employees' required contributions.[5]

Hybrid plans also typically employ a shared financing approach to retirement benefits. State hybrid 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.

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. There are no required employee contributions to the DC component, but employers match the first 1 percent of salary and one-half of the next 4 percent of salary voluntarily contributed by the employee.

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.

Pooled Assets

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

Assets for cash balance plans are pooled and invested by professionals and guaranteed annual returns are provided to plan participants. DB+DC plans pool assets in the DB component and management of assets in the DC component varies. Most plans provide a range of risk-based investment options: some are mutual funds available to the general public and others are maintained by the retirement system and available only to plan participants. Assets in the Oregon DC component are pooled and invested in a fund similar to the DB plan fund; similarly, Washington provides an option for employees to invest their DC assets in a fund that emulates the DB plan fund.

Required Lifetime Benefit Payouts

An overarching objective of retirement plans is to provide income insurance in old age. Longevity risk is the danger that a participant could outlive their retirement assets. 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 distributing longevity risk across participants.

The two statewide hybrid cash balance plans in Texas require accounts to be paid in the form of a lifetime benefit, although employees may elect to receive a small portion of their benefit as a partial lump sum upon retirement. The Nebraska hybrid cash balance plan gives employees the option of receiving a lifetime benefit payout on some or all of their account balance, or to instead receive any portion of their retirement benefit as a lump sum.

DB+DC plans generally require the DB portion of the plan to be paid in the form of a lifetime benefit. The DC portion, however, generally 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 also account for the presence or absence of income from Social Security.

Benefits that provide for a form of insurance regarding death or disability are an important feature in the public sector, particularly as many jobs involve hazardous conditions. Most plans in the public sector—whether traditional or hybrid—integrate survivor and disability benefits into the pension, which is generally the most cost-effective way to do so.

Conclusion

The information in the tables below illustrates how states are using various combinations of retirement plan design to achieve their retirement plan objectives. This diversity in plan design reflects the fact that a one-size-fits-all solution does not meet different states' human resource needs and fiscal conditions and frameworks. The critical factor in evaluating a retirement plan is the extent to which the plan contains the core elements of public pension plan design known to promote retirement security: 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.[8]

See Also

National Association of State Retirement Administrators, Resolution 2010-01: *Guiding Principles for Retirement Security and Plan Sustainability*, http://www.nasra.org/resolutions.htm#201001

National Conference of State Legislators, State Defined Contribution and Hybrid Pension Plans, http://www.nasra.org/resources/NCSL_DC_Hybrid.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

Contact

Keith Brainard, Research Director
National Association of State Retirement Administrators
keithb@nasra.org
www.nasra.org

[1] Wikipension, "Costs of Switching from a DB to a DC Plan," http://www.wikipension.com/index.php?title=Studies_and_reports#State_Studies
[2] NASRA,"Selected Approved Changes to State Public Pensions to Restore or Preserve Plan Sustainability," http://www.nasra.org/resolutions.htm#200701
[3] U.S. Department of Labor, Bureau of Labor Statistics, Retirement Benefits: Access, participation and take-up rates, March 2011, http://www.bls.gov/news.release/ebs2.t01.htm
[4] Public Fund Survey, www.publicfundsurvey.org
[5] NASRA, "Selected Approved Changes," supra
[6] Employers are also required to contribute an additional five percent of salary 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 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 Hybrid Plans: Cash Balance

	Nebraska County and State	Texas Municipal	Texas County and District
Year plan approved	2002	1947	1967
Employee groups affected	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 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
Contributions	State EEs contribute 4.8%, county EEs contribute 4.5% State contributes 156% of EE rate; counties contribute 150% of EE rate	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
Rate of return applied to cash balances	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	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' unfunded liabilities and accumulated in a reserve account to offset future losses
Benefit payment options	Rollover, lump sum or annuity	Annuity with or without a partial lump sum, depending on EE election	Annuity based on final savings balance and ER matching with or without a partial lump sum, depending on EE election
Info online	www.npers.ne.gov	www.tmrs.com/down/pubs/tmrs_facts.pdf	http://www.tcdrs.org

* EE = employee; ER = employer

Table 2: Overview of Hybrid Plans: Smaller Defined Benefit + Defined Contribution (DB+DC)								
	Georgia Employees' RS	**Indiana Public RS**	**Michigan Public Schools RS**	**Ohio Public Employees' RS**	**Ohio State Teachers' RS**	**Oregon PERS**	**Washington Dept of RS**	**Utah RS**
Year plan approved	2008	1955	2010	2002	2001	2003	1996	2010
Employee groups affected	Mandatory for new hires since 2009; optional for those hired before 2009 (EE* may opt-out of DC component within 90 days)	Mandatory except for EE hired after 2011 who may elect a DC plan only	Mandatory for all new hires after 06/30/2010	Optional for new hires and non-vested workers since 12/31/02	Optional for new hires and non-vested workers since 2001	Mandatory for all EEs (existing and new) since 2004	Optional for most employee groups	Mandatory for new hires as of 07/01/2011, but EEs can elect DC-only plan
Defined Benefit Portion								
DB benefit formula (having met age/service requirements)	1.0% x years of service x final average salary = annual benefit	1.1% x years of service x final average salary = annual benefit	1.5% x years of service x final average salary = annual benefit	1.0% 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	1.0% x years of service x final average salary = annual benefit	Varies depending upon date of hire and which one of three DB plans EE is enrolled	1.0% 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*: 2.0% x years of service x final average salary = annual benefit
DB plan contributions	EE contributes 1.25% and ER* contributes remainder	ER funds the DB benefit	EE contributes on a graduated scale based on pay; ER contributes remainder	ER funds DB benefit	ER funds DB benefit	ER funds DB benefit	ER funds DB benefit	ER pays up to 10% of pay, 12% for public safety (+ 5% to amortize the DB unfunded liability) EEs only pay into DB if the normal cost of the plan exceeds maximum ER contribution
Defined Contribution Portion								
Employer DC plan contributions	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%	None	ER contributes 1% of salary	None	None	None	None	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

Table 2: Overview of Hybrid Plans: Smaller Defined Benefit + Defined Contribution (DB+DC)

	Georgia Employees' RS	Indiana Public RS	Michigan Public Schools RS	Ohio Public Employees' RS	Ohio State Teachers' RS	Oregon PERS	Washington Dept of RS	Utah RS
Employee DC plan contributions	EE auto enroll at 1.0% of salary contribution but may vary contribution rate up or down	3.0% of salary	2.0% of salary	10.0% of salary	10.0% of salary	6.0% of salary	5% to 15% of salary depending on EE	EE contributions optional
DC plan investment options	12 options ranging from conservative to aggressive, plus 5 lifecycle funds	7 options ranging from conservative to aggressive, and 10 target date funds, all administered by the retirement system	Choice of active and passive investment options, target date funds, and a brokerage window	16 OPERS-sponsored funds including core and target date funds, plus a brokerage window	8 options ranging from conservative to aggressive including a guaranteed return option	All DC plan contributions are invested in a single, pooled fund that mirrors the DB plan fund	Either the total allocation portfolio, which mirrors DB plan fund, or 7 self-directed funds ranging from conservative to aggressive, plus target date funds	12 risk-based options
Default DC plan investment options	Lifecycle funds based on age	The Guaranteed Fund, which earns a fixed rate established annually by the Board	Target Retirement Fund that matches the year the participant will be eligible to retire	Target Date Fund closest to the year the participant turns 65	Money market fund	DB plan fund	Target Date Funds	Medium Horizon Fund, which features a diversified investment portfolio
DC plan withdrawal options	Rollover, annuity, lump sum, partial lump sum, installments	Annuity, rollover, partial lump sum and annuity, deferral until age 70½	Lump sum, consolidation from other plans, direct rollover to an IRA, periodic distribution	Annuity, including partial lump sum option plan; deferral until age 70½	Annuity including partial lump sum lump sum, or rollover	Lump sum payment or in installments over a 5-, 10-, 15-, or 20-year period or the EE's anticipated lifespan	Lump sum, direct rollover, scheduled payments, personalized payment schedule, and annuity purchase	After 4-year vesting period: lump sum, partial balance, periodic distribution, direct rollover, direct rollover to an IRA
Info online	www.ers.ga.gov	www.in.gov/inprs/index.htm	https://stateofmi.ingplans.com/eportal/welcome.do	http://www.opers.org	http://www.strsoh.org	http://www.oregon.gov/PERS	http://www.drs.wa.gov (go to “my plan 3 account”)	http://www.urs.org

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