



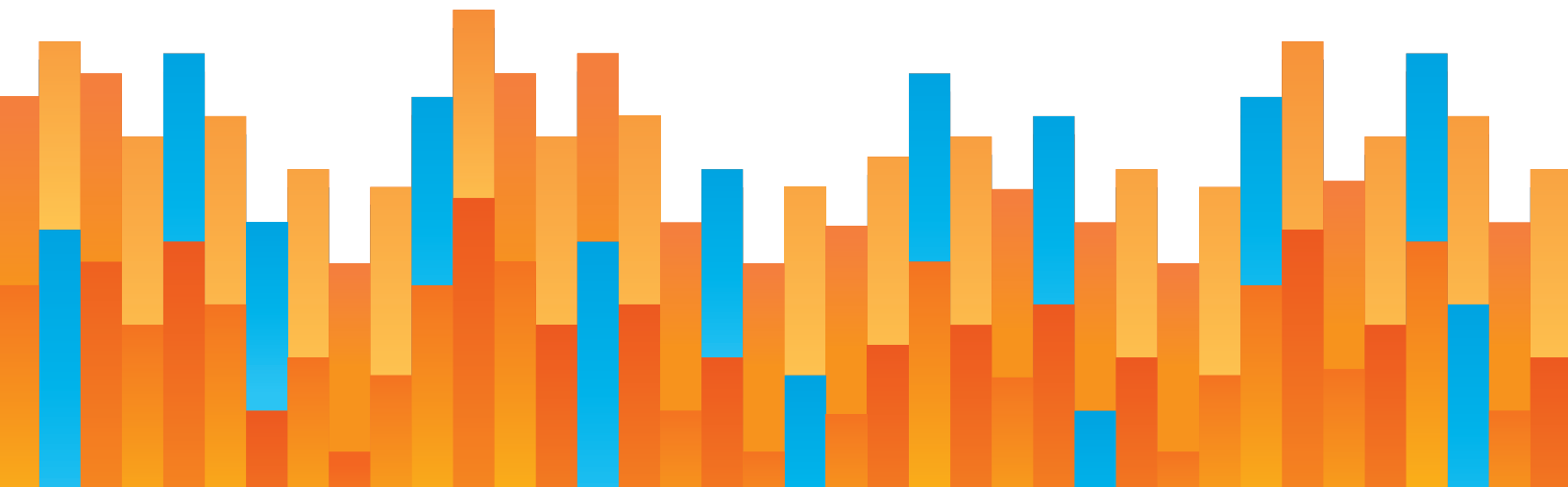
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Gold Standard in Public Retirement System Design Series—No. 4

BEST PRACTICES IN HYBRID RETIREMENT PLAN DESIGN

by Ryan Frost

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The “Gold Standard in Public Retirement System Design Series” reviews the best practices of state-level public pensions and provides a design framework for states that are struggling under a burden of post-employment benefit debt. This fourth entry in the Gold Standard series looks at best practices for integrating cost-of-living adjustments (COLAs) into public pensions. This analysis examines how public plan sponsors can best design and implement COLAs in public pension plans.

Gold Standard Brief #1: Best Practices in Incorporating Risk Sharing into Public Sector Defined Benefit Pension System Design

Gold Standard Brief #2: Best Practices in the Design and Utilization of Public Sector Defined Contribution Plans

Gold Standard Brief #3: Best Practices in Cost-of-Living Adjustment Designs in Public Pension Systems

Gold Standard Brief #4: Best Practices in Hybrid Retirement Plan Design

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PART 1

INTRODUCTION

The hybrid retirement pension plan design, a design that typically combines a guaranteed benefit and 401(k) style individual retirement account, has seen ever-increasing interest from public sector employers in the United States since the market downturns of the late 2000s. Although hybrid retirement plans have been around for decades—notably one of the first adopters being the Federal Employee’s Retirement System—most stakeholders know relatively little about their purpose and possible structure.

A hybrid plan’s goals are no different than any other retirement benefit design’s goals: to provide adequate benefits to workers at an affordable cost to them and their employers. Yet hybrid plans are also beginning to help answer a political question in the wake of the stock market volatility in the last 20 years: What is the appropriate level of risk that employers should shoulder to provide retirement benefits to their employees? The viability of future traditional defined benefit pension plans may depend on a common outlook on this question from both employers and participants.

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The recent shift toward offering hybrid plans to newly hired government employees suggests that governmental employers may be changing their perceptions of the balance of financial risk between employees and employers and whether governments should put greater risk of investment returns on employees by distancing from the traditional defined benefit pension.

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The recent shift toward offering hybrid plans to newly hired government employees suggests that governmental employers may be changing their perceptions of the balance of financial risk between employees and employers and whether governments should put greater risk of investment returns on employees by distancing from the traditional defined benefit pension. Employee and labor associations on the other hand, often have extreme—whether fair or not—biases against the 401(k)-style defined contribution retirement plans typical in the private sector. The hybrid retirement plan offers policymakers and stakeholders a potential compromise between the two opposing viewpoints, potentially offering a “best of both worlds” blended approach.

PART 2

UNDERSTANDING THE HYBRID RETIREMENT PLAN DESIGN

2.1

WHAT IS A HYBRID RETIREMENT PLAN DESIGN?

At its most basic definition, a hybrid retirement plan typically refers to a plan design that combines elements of the traditional defined benefit (DB) pension structure with a defined contribution (DC) plan (also known as an individual savings plan). However, instead of a larger benefit being fully guaranteed by the employer based on a years-of-service and final-average-salary formula—as is the case with a traditional pension—the hybrid aims to provide an employer risk-reduced guaranteed benefit alongside a (typically) employee-sponsored defined contribution account. This structure is often referred to as a “side-by-side” DB/DC hybrid, since employer and employee contributions flow into both accounts simultaneously.

The DB portion, in most cases, will look exactly like every other standard full-DB plan in the country apart from one distinction: the accrual rate (or multiplier) used to calculate the benefit is generally cut by around half. This means the guaranteed benefit will be about 50% of the standard full-DB plan since it is being combined with a DC component to form a complete retirement plan. This benefit design affects employers positively by significantly

reducing forward-looking financial risk since the legally guaranteed benefit is roughly half that of a traditional pension.



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The DC portion involves many factors, including how much is contributed into the DC account over the member's career, the investment earnings on those contributions, and the member's decision at retirement either to annuitize the dollars in their DC account or to pull them out as a lump sum. The goal of policymakers is to ensure this portion of the plan is an adequate source of retirement benefits, alongside the part that will provide guaranteed pension payments.

Employer and employee contributions to a hybrid vary state to state and at the federal level; notably, most newly hired federal employees have participated in a side-by-side hybrid since 1984. For most hybrids, the employers fund the DB plan, while the employees fund their DC accounts. In other cases, what may be the better option moving forward is to have the cost shared between employers and employees in both the DB and DC portions.¹

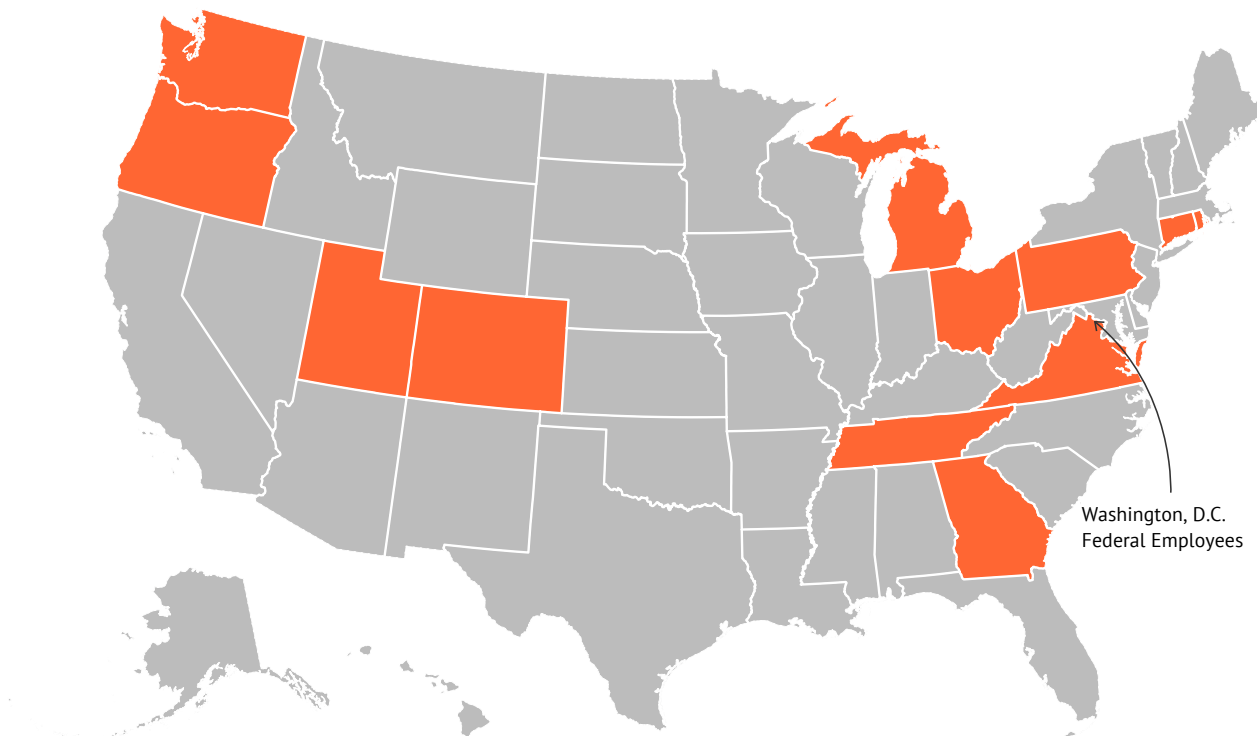
A less common hybrid plan design is the stacked hybrid, whereby a DB plan is the primary benefit up to a specified income level, and the DC account takes over for any income above that threshold. New Jersey was the most recent state to offer a stacked hybrid, offering the DB portion up to the first \$40,000 in income, and covering any additional income with a supplementary cash balance plan.²

¹ See section 4.9 for more discussion.

² Zachary Christensen, "New Jersey Senate President Rolls Out Important Path to Pension Reform Progress." May 2019. <https://reason.org/commentary/new-jersey-senate-president-rolls-out-important-path-to-pension-reform-progress/> - :-:text=Namely%2C%20it%20creates%20a%20new%20%E2%80%9Cstacked%20hybrid%E2%80%9D%20pension,the%20retirement%20age%20of%20new%20workers%20to%2067.

The following chart shows how many states have adopted a hybrid design for at least one of their statewide pension systems. At the turn of the century, there were only two places you could find hybrid plans: Washington and Washington, D.C. This chart shows how quickly this design has started to make its way into the pension design conversation.

FIGURE 1: HYBRID PLANS ACROSS THE STATES



2.2

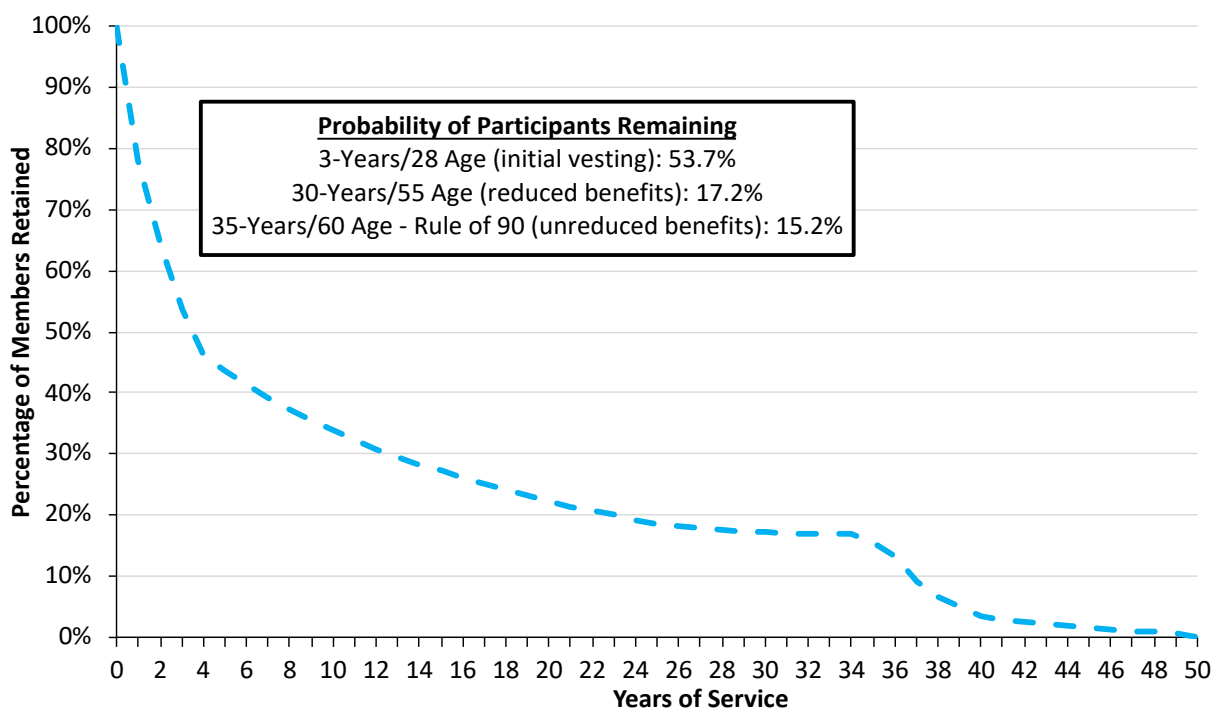
PORTABILITY

The modern public workforce is different than it used to be. Not only does the hybrid design benefit employers by offering reduced risk, but employees also benefit greatly because the average worker does not stay long enough in one job for a full pension to be optimal. In this way, hybrid plans balance the benefit for all stakeholders. Rather than going all-in on employer risk (DB) or all-in on employee risk (DC), the hybrid shares that risk and the rewards during periods of market surges, while appealing to a wider range of workers by not favoring career workers at the expense of more-mobile employees.

out in the Urban study become net contributors to the plan, thus subsidizing employees that do stick around for the long haul, and who generally see a surge in net present value of accrued benefits toward the end of a full career.

Figure 2 shows the probability of an average member, hired at age 25, remaining in the North Dakota Public Employee’s Retirement System (NDPERS). Our analysis shows that 46% of new NDPERS members leave before three years of service, therefore missing the vesting requirement and forfeiting all contributions made by employers on their behalf. Another 20% of new employees who are still working after three years will leave before 10 years of service. All in all, just 17% of new members will work long enough to qualify for reduced benefits.

FIGURE 2: PROBABILITY OF MEMBERS REMAINING IN NDPERS



Source: Pension Integrity Project analysis of NDPERS reports and CAFRs.

For non-career employees, a hybrid is a far better choice than a traditional pension, because hybrids allow the DC portion of the benefit to go with the employee when they change careers, while a traditional DB member who changes jobs must choose to either leave their contributions in the plan to earn a miniscule interest rate, or pull their

contributions (often forfeiting any employer contributions made on the employee's behalf) and start their retirement savings over in another plan.

2.3

SHARED RISK

Hybrid design begins with the following risk considerations for employers and employees:

- What are the costs and predictability of those costs for employers?
- What risks will be placed on employees?

Hybrid plan costs are much more predictable for both public employees and employers because the DB portion of the hybrid is generally around half the size of a full pension. The DC portion is designed to effectively cover the other half of the benefit. This means the employer and employees would be responsible for covering far less in unexpected costs if the pension underperforms in asset returns or plan assumptions are not met. For hybrids that share costs equally in the DB portion between employees and employers, this also reduces the employer's risk that future pay raises for employees would be eaten up by increases in required contribution rates caused by unexpected costs, which is quite common in full DB plans.

Where could unexpected costs come from? These risks generally fall into four categories, and any deviations from expectations in these risks will lead to the plan not properly pricing out its benefits when setting contribution rates:

- Investment risk: the risk that a plan's investment target will fall short in any given year.
- Longevity risk: the risk that retirees will live longer (on average) than is expected and will consequently collect more pension payments than were originally accounted for.
- Contribution risk: the possibility that actual future payments into the pension system deviate from what was expected.
- Plan maturity/design risk: the design of the pension plan itself is unsustainable, especially as the nation's general population ages.⁵

⁵ Ryan Frost, "Best Practices in Incorporating Risk Sharing into Defined Benefit Pension Plans." November 2020. <https://reason.org/wp-content/uploads/best-practices-in-incorporating-risk-sharing-in-defined-benefit-plans.pdf>

For the DC portion, costs are predetermined at whatever percentage the plan stakeholders decide to set their contribution rates to. These costs do not fluctuate with the stock market, making them incredibly appealing to employers. Fluctuations will only occur if a member decides to contribute more, or less, to their DC accounts. These benefits do not rely on actuarial assumptions, and market volatility affects only the individual's personal account—thus all future investment and longevity risk is on the employee.

PART 3

HYBRID DESIGN: DEFINED BENEFIT PORTION

One of the risk-reduction benefits of swapping a traditional pension plan for a hybrid is that the DB portion in the new design can look nearly identical to the current plan, apart from one key change—the accrual rate, or multiplier used to calculate the amount of guaranteed benefit. Almost all public defined benefit plans in the U.S. offer a multiplier between 2.0% and 2.5%, while almost every hybrid plan’s DB portion offers a multiplier between 1.0% and 1.5%. If a member works a full career, their benefit should be comparable to what they would have received under a full pension plan. If that were the only change made for most underfunded plans—swapping to a risk-managed hybrid and offering a lower multiplier in the DB portion—that would instantly put many of them on a path toward significantly reducing the magnitude of unexpected costs in the future.

3.1

AVOIDING TRANSITION “COSTS” (E.G., CONTINUING TO PAY DOWN LEGACY PENSION DEBT)

When considering a change to a hybrid plan, the key is to avoid adding to legacy costs. Amortizing legacy debt should be the number one financial focus in swapping a current full pension plan for a hybrid. Many pension-reform opponents argue that “transition costs” are

why the legacy pension should stay open to new hires. They claim that because employers are going to start contributing toward a new retirement plan for new hires, less money will be contributed to the legacy pension plan to pay off current unfunded liabilities.

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But this would be a consequence of bad policy design and not an inherent result of switching to a new retirement plan for new hires. The question of transition costs is entirely a political—not an accounting or actuarial—question. It is up to legislators and state departments to determine how they want to pay down unfunded liabilities. Legacy unfunded pension liabilities cost what they cost, reform or not. Reform does not make your current pensions more expensive since those are formula-driven benefits. Public pensions are not Ponzi schemes and, by design, pension contributions under a prudent funding policy are not affected by whether or not there are new entrants every year.

The simplest answer to the transition-cost argument requires employers to continue to pay down their share of the legacy unfunded liabilities as if the new members entering the hybrid were still in the legacy DB plan. This takes legacy debt off the backs of new members, who had no part in creating those unfunded liabilities and thus should not have to bear the brunt of paying more of their salary to shore up poor decision-making in the past.

3.2

DEFINED BENEFIT STRUCTURE

Other design specifics should somewhat model current public sector design and best practices. These include offering a pre-funded cost of living adjustment, which prevents inflation during retirement from adversely impacting pension benefits. Another best practice would distinguish between public safety members and non-public safety members by offering retirement age eligibility around 63-67 and 53-57, respectively. Retirement eligibility age significantly affects the value of pension benefits, as the earlier a member retires, the more benefits they will draw, and the higher required contributions will be needed during their working careers.

For more information on proper defined benefit plan design, please see our Gold Standard Series brief “Best Practices in Incorporating Risk Sharing Into Defined Benefit Plans.”⁶

⁶ Ibid.

PART 4

HYBRID DESIGN: DEFINED CONTRIBUTION PORTION

Because DB plans and their design are well understood in the public sector, the design of the DC portion often requires more attention.

4.1

BENEFIT ADEQUACY

First and foremost, employee and employer contributions to the DC portion must be sufficient for benefit adequacy. Whether the DC portion is funded by just the employees, or a split between them and employers, contributions must be enough that after a 30-year career of investment returns, and then combined with the DB portion's benefit, the member is able to reach at least a 60% income replacement ratio. The income replacement ratio represents the percentage of a person's working income needed during their retirement years to retain a steady standard of living. If 30% of a member's replacement ratio is provided by the DB portion (1% multiplier x 30 years of service), that means 30% needs to come from the DC.

4.2

INVESTMENT OPTIONS

The member needs to have a wide array of investment options at their disposal. Some states do not offer any investment vehicles for their members and leave them to invest at their own peril. While self-directed investment should always be an option, plans at the very least should offer target-date options as well. A target-date fund is an investment vehicle that will automatically balance the participant's investment portfolio from high-risk/high-reward to low-risk/low-reward options when nearing retirement. Also, since many hybrid plans are in states with legacy DB plans, one option could invest in or alongside those DB funds. Both Washington State and Oregon provide this option to their hybrid members, in which their yearly investment returns match the overall portfolio's returns.



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4.3

ANNUITIES

Lastly, to truly provide lifetime income, the DC portion must offer a way for members to annuitize their DC assets at retirement. The biggest threat retirees in DC plans face is longevity risk, which is the risk that they will run out of money prior to death. Lifetime income provides the employee with a predictable income stream for their entire lives after retirement. This lifetime income can be offered in many ways, but the most common is through offering to annuitize the member's DC assets at retirement, either through a private third-party vendor, or in some cases, by the pension plan itself offering its members an annuity. The biggest risk employees will face in purchasing an annuity is timing due to

various economic conditions. Depending on the purchase rate at the time a member retires, the annuity could be quite costly for the employee.⁷



Annuities are relatively simple to administer but carry with them either high levels of risk to the sponsor, or poor returns to the member based on the agreed-upon annuitization rate.



An annuity is a guaranteed income stream that an employee purchases at retirement, typically through a lump-sum cash purchase or direct rollover from another savings vehicle (such as a deferred compensation plan). Annuities are relatively simple to administer but carry with them either high levels of risk to the sponsor, or poor returns to the member based on the agreed-upon annuitization rate. This rate is the interest rate that is used to convert a member's DC account balance into an annuity. A higher interest rate means the member will receive higher monthly payments from the annuity.

Washington State, for example, offers an annuitization rate at the defined benefit portion's assumed rate of return (ARR), which is astronomically higher than what is offered by external vendors. However, the state is taking almost all the risk that the plan's current assumed rate of return will be accurate over the retiree's lifetime. If the ARR assumption for the DB portion is lowered in the future, the state will lose money on each annuity sold prior to the lowering of that assumption.

Plans that have been in the DC business for a long time, such as the Teachers Insurance and Annuity Association of America-College Retirement Equities Fund (TIAA-CREF), have recognized this risk and begun to offer variable annuities to their members. This means that the member could take their DC contributions and invest them into annuities themselves, rather than into the most common investment vehicle, target-date funds. By pre-investing into the annuity, essentially paying for it while working, the timing risk is essentially removed.

⁷ Richard Hiller, "Defined Contribution Retirement Plans Can Offer A Variety of Options for Secure Retirement Income," December 2020. <https://reason.org/commentary/defined-contribution-retirement-plans-can-offer-a-variety-of-options-for-secure-retirement-income/>

PART 5

HYBRID PLANS ACROSS THE STATES

5.1 FEDERAL EMPLOYEES RETIREMENT

The Federal Employees Retirement System (FERS) hybrid was created in the mid-1980s to solve two problems. First, Social Security was undergoing a major cash-flow crisis, and creating a new plan for federal employees that allowed them to participate in Social Security would partially alleviate that crisis. Second, the federal plan employees were in at the time—the Civil Service Retirement System (CSRS)—was not sustainable and had never been fully funded by employer and employee contributions, as shown by its total unfunded liability of \$968.1 billion in 2017.⁸

Retirement income for new federal employees hired after 1986 comes from the three components of retirement security’s “three-legged stool”: Social Security, a defined benefit (DB) pension, and individual defined contribution (DC) retirement savings. A new, more affordable annuity was offered under FERS—one that was fully funded by the sum of employee and employer contributions and interest earned by Treasury bonds—and the DC account became known as the Thrift Savings Plan. Both the Social Security and Thrift

⁸ Congressional Research Service, “Federal Employees’ Retirement System: Budget and Trust Fund Issues,” December 13, 2019. <https://fas.org/sgp/crs/misc/RL30023.pdf>

Savings Plan dollars can follow the employee to new employment at any time if they so choose.

5.2

WASHINGTON STATE PUBLIC EMPLOYEES AND TEACHERS RETIREMENT SYSTEMS

Introducing hybrid plans for Washington's teachers and state employees in the late 1990s is one of the more interesting and under-documented stories in the history of public pensions. Washington State has long been ahead of its peers when it comes to reform. In 1977, plans for all new statewide public employees, teachers, police officers, and firefighters closed. In replacement, the state offered new hires in the respective employee groups a 50/50 cost-shared defined benefit, aimed at keeping benefits and costs in check over the long term. These plans were called "Plan 2s."

New teachers were the first group offered a hybrid plan in 1995, with new public employees following four years later in 1999. Historically, risk-cautious employers and legislators have pushed hybrid plans to even the share of market risks with employees. In contrast, members wanting to access the bigger investment returns the markets were offering in the 1990s pushed Washington's hybrid offerings. The Plan 2s were well funded at the time (and still are), eliminating the push for plan reforms from employers and legislators looking to pare down risk.

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Washington's hybrids were modeled after and function similarly to the Federal Employees Retirement System, using a 1% multiplier in the DB funded by employers, and a minimum 5% contribution from employees to fund the DC. After a 30-year career, members would earn 30% of their highest 60 consecutive months of earnings per year in retirement in the DB. For the DC, Washington offers hybrid members the option to purchase an annuity

directly from the plan itself. The DC annuity and the DB benefit could then be combined in one monthly check for retirees.

5.3

TENNESSEE CONSOLIDATED

When new state Treasurer David Lillard took office in 2009, he proclaimed that, due to the additional hundreds of millions of dollars in required contributions, the system “... was not on a sustainable path.”⁹ Alongside all other pension systems, Tennessee’s investments had suffered losses during the Great Recession, and its annual required pension payments were climbing. Tennessee is one of the few states that have consistently made the required contributions to their pension plans, and it was unwilling to change that course. In 2013, the Tennessee Department of Treasury passed TCA 8-36 part 9, which introduced a hybrid plan for Tennessee’s state employees, higher education employees, and certified teachers.

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Employers and employees must contribute to both the DB and DC components of the hybrid. Employers are on the hook for a mandatory 4%/5% split and employees must pay a 5%/2% to the DB/DC respectively. The DB component has a 1% multiplier and the plan caps the maximum annual DB benefit at \$80k per year. For a 30-year career, the member would need a final average salary of \$240k per year for this cap to affect them. Most likely, this was included to pare down the pension benefits of college head coaches and other high-earning collegiate positions.

⁹ Mike Reicher, “As Kentucky pension battle rages on, here’s why Tennessee government workers are secure.” January 2019. <https://www.tennessean.com/story/news/2019/01/01/kentucky-pension-battle-rages-why-tennessee-government-workers-secure/2378623002/>

5.4

OREGON PERS

The Oregon Retirement System has modified its pension benefit structure twice in the past 25 years. The latest change, which occurred in 2003, put all new hires into a DB/DC hybrid plan: the Oregon Public Service Retirement Plan (OPSRP). The DB portion of the hybrid is fully funded by employers, while the DC portion is funded by a 6% employee contribution rate. Historically, this 6% was “picked-up” by Oregon employers, making the entire hybrid plan employer-funded. This pick-up has recently begun to phase out over the past year to reduce employer costs and foster cost-sharing principles.¹⁰

Introducing OPSRP increased the retirement age from 60 to 65 and dropped the benefit multiplier from 1.67% to 1.50%. OPSRP was designed to have the DB pension provide approximately 45% of a member’s final average salary at retirement (for general service members with a 30-year career), and the DC portion—the Individual Account Program (IAP)—to provide an extra estimated 15%-20% of a member’s final average salary.¹¹ Under this plan, both benefits together net a career employee an income replacement ratio of roughly 60%-65%.

Oregon’s hybrid has not gone without controversy in the past couple of years. Last August, the Oregon Supreme Court upheld SB 1049’s 2019 patchwork set of reforms aimed at lowering the burden on employers’ contribution obligations. The ruling validated that the plan could take employee contributions away from their individual savings account (DC component of their hybrid), which was solely funded by employees, and toss them into a fund that would offset the DB component’s required contributions from employers. Here’s what Reason Foundation had to say at the time regarding this decision:¹²

It is understood that reforms rarely spare everyone from some degree of pain, but the policy of directly taking contributions from the employee’s DC to backfill employer obligations in the DB is particularly harmful. The policy ultimately destroys the entire concept of a hybrid retirement plan with two equally important designs— in this case, a

¹⁰ Ken Rocco and Paul Siebert, “2019-2021 Budgeted PERS Contribution Rates for State Government.” August 2018. <https://www.oregonlegislature.gov/lfo/Documents/2018-3%20Budgeted%20PERS%20Contribution%20Rates.pdf>

¹¹ Kevin Olineck, “PERS By The Numbers,” December 2019. <https://www.oregon.gov/pers/Documents/General-Information/PERS-by-the-Numbers.pdf>

¹² Len Gilroy and Ryan Frost, August 2020. <https://reason.org/commentary/oregon-supreme-court-ruling-has-major-implications-for-retirement-security-and-hybrid-plan-design/>

blend of a DB pension and a DC plan—feeding into one overall benefit, as it renders the DC portion of the benefit stream subservient to the DB plan when it’s not healthy (which is likely perpetual). Under this law, when the DB plan is significantly underfunded (less than 90 percent) the employee’s DC contributions are used to backfill the rising costs of the DB benefit, even as the DB benefit amount remains constant. In short, the DB benefit isn’t changing or improving, it’s just that employees now have to sacrifice funds from their DC account to make up for an apparently broken promise from the employers to fully fund the guaranteed return (pension) portion of their benefit by poaching from the variable (DC) benefit. Even worse, Oregon’s hybrid was somewhat weak to begin with due to the fact that up until this year there was only one DC investment option allowed (an allocation to a target-date fund, as opposed to individual mutual funds).

This ruling will be something to look toward if other states begin to see rising costs in their hybrid systems.

5.5

VIRGINIA RETIREMENT SYSTEMS

Act 702 of 2012 introduced a hybrid plan for all classifications of new hires in Virginia’s public pensions post-2013, except for police officers. The plan includes mandatory DB and DC contributions from employees and employers.

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Prior to introducing the hybrid, Virginia had seen rapid increases in both required contributions and unfunded liabilities, sitting at a combined \$21.9 billion in debt from the PERS and TRS plans by 2012.

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Prior to introducing the hybrid, Virginia had seen rapid increases in both required contributions and unfunded liabilities, sitting at a combined \$21.9 billion in debt from the PERS and TRS plans by 2012. According to the system’s actuarial valuation, between 2011 and 2012 alone, the PERS plan and the TRS plan added \$1.2 billion and \$2 billion, respectively, in unfunded liabilities. Just six years after reforms, the system had already slashed over \$5 billion in unfunded liabilities from its books.

Virginia's hybrid plan benefits function similarly to the federal plan and to other states. The DB multiplier was set at 1% of the highest 60 consecutive months of salary. Employees, however, do have a statutory commitment to contribute 4% of pay to the DB part of the hybrid, which differentiates the plan from some others on this list. Also, the employee's DC contributions will be at least partially matched by employers. This shared contribution to each portion of the hybrid may have been a forward-thinking design, as the prior section about the Oregon pension system alludes to.

5.6

GEORGIA ERS

To reduce future costs in the \$4 billion underfunded plan, in 2008 the legislature passed Senate Bill 328, which closed the Georgia Employees Retirement System defined benefit plan and put all new hires after January 1, 2009 into the Georgia State Employees' Pension and Savings Plan (GSEPS)—a hybrid plan.

According to a 2019 analysis from the Georgia Department of Audits and Accounts Performance Audit Division, the state's unfunded liability would have been \$67 million higher without the change in design for new hires.¹³

5.7

UTAH RETIREMENT SYSTEMS

Utah had one of the best-funded pension systems in the country going into the 2008 market downturn. After the downturn, the state pension fund had lost about 22% of its value almost overnight. Former Utah State Senator Dan Liljenquist spoke with Reason in 2013, stating:

It was the biggest loss we've ever sustained as a system. As we started looking at it, we realized that even though we were well-funded, that the 22 percent loss in value actually opened up a 30 percent gap in our pension funding ratio—our funding ratio dropped from about 100 percent in 2007 to a projected 70 percent by 2013—even though we had paid

¹³ Greg Griffin and Leslie McGuire, "Special Examination Report No. 18-11." January 2019. https://gsra.memberclicks.net/assets/18-11_SE_State_Retirement.pdf - :~:text=Employee%20Retirement%20System%20(ERS)%20To%20reduce%20costs,%20the,employees%20hired%20on%20or%20after%20January%201,%202009.

every penny that the actuary had asked us to over the previous several decades. So one market crash opened up a 30 percent gap in our pension funding ratio.¹⁴

Following the 2009 recession, contribution rates for the Utah Retirement System (URS) were projected to spike and remain high for the next two decades. The Utah Legislature responded to these projected higher rates in 2010 by passing Senate Bill 63, which was sponsored by Dan Liljenquist. For all newly hired employees (post July 1, 2011), employer contributions were capped at 10% of pay (12% for public safety), and all employees had the choice to opt into a hybrid plan or a DC plan. As of 2015, about 80% of all newly hired employees chose the hybrid over the DC.¹⁵ One unique feature of this hybrid plan is that employees only contribute to the plan if the normal cost of the plan exceeds 10% (or 12% for public safety personnel). Thus, whenever required contributions exceed 10% for general employees, or 12% for public safety, that excess amount would be fully borne by employees. When the cost of the hybrid is less than 10%/12%, the employees receive the difference into a supplemental account, such as a 457 individual retirement account.

5.8

RHODE ISLAND ERS

Rhode Island passed major pension-reform legislation in 2011, championed by new Biden appointee Gina Raimondo, who at the time was the state's treasurer. Treasurer Raimondo had released a report earlier in 2011 called *Truth in Numbers*,¹⁶ which highlighted the risks and losses accompanied by setting actuarial assumptions, namely the expected return on investments, at an unrealistically high percentage for too long.

At the time of passage, Rhode Island was ranked (by funded percentage) second worst of all state-level pension funds, holding over \$6.8 billion in unfunded liabilities—a mountain of debt for a state with only one million residents.¹⁷ Contributions to the plan were already

¹⁴ Leonard Gilroy, "Closing the Gap: Designing and Implementing Pension Reform in Utah." September 2013. <https://reason.org/commentary/utah-pension-reform/>

¹⁵ Jennifer Erin Brown and Matt Larrabee, "Decisions, Decisions: An Update on Retirement Plan Choices for Public Employees and Employers." August 2017. <https://www.nirsonline.org/reports/decisions-decisions-an-update-on-retirement-plan-choices-for-public-employees-and-employers/>

¹⁶ Office of the General Treasurer Gina M. Raimondo, "Truth in Numbers: The Security and Sustainability of Rhode Island's Retirement System," June 2011, www.law.yale.edu/documents/pdf/cbl/RI_TIN-WEB-06-1-11.pdf.

¹⁷ The Pew Center on the States, "The Widening Gap," June 18, 2012, www.pewstates.org/research/data-visualizations/the-widening-gap-85899377237

eating up 10% of all tax revenues and were forecasted to reach 20% of all revenues by 2018.¹⁸

The reform's changes included a cost-of-living adjustment suspension, an increase in retirement age, a change to the way the plan amortized its debt, and the introduction of the states' first hybrid plan. The hybrid's DC portion required a 5% minimum contribution from employees, while the DB portion was funded by both employers and employees.

5.9

PENNSYLVANIA STATE AND PUBLIC SCHOOL EMPLOYEES

Senate Bill 1 of 2017 was a major landmark in public pension reform. Pennsylvania had been on one of the worst debt trajectories of any state. It had gone from a \$20 billion surplus in 2001 to having over \$61 billion in pension debt by 2015.



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With the hybrid reforms, taxpayers were estimated to save \$5 billion to \$12 billion in expected costs, mostly due to the 50% reduction in guaranteed benefits. New members were auto-enrolled in the hybrid, although they could choose to enter a full DC plan as well. Current members had three options: stay in the legacy DB, enter the new hybrid, or enter the full DC.

The DB portion of the hybrid receives both employee and employer contributions, and any debt will require additional contributions from both. Employees contribute a total of 8.25%, while employers contribute 5% into the DB portion, and 3.25% into the DC portion. The multiplier in the new hybrid is 1.25%.

¹⁸ Raimondo, "Truth in Numbers."

5.10

MICHIGAN PUBLIC SCHOOL EMPLOYEES RETIREMENT SYSTEM (MPERS)

Michigan has quite a history with pension reform, as they were the first state to put their public employees into a full DC plan in the late 90s. The year 2017 also saw some major changes to MPERS by auto-enrolling all new hires into a new DC plan, but also allowing employees to opt-in to a risk-managed DB/DC hybrid plan instead if they chose.

Like many other pension systems in America, MPERS faces a mountain of unfunded liabilities and future of growing contribution rates. At the turn of the millennium the Michigan teachers plan was reported to be fully funded, but as of the end of last year (June 2016) the plan's funded ratio was below 60% with \$29.1 billion in unfunded liabilities. Our analysis of the MPERS valuation reports found that two-thirds of the debt accrual came from underperforming assets over the past decade and a half. For the past few decades MPERS has assumed an 8% rate of return on assets. However, the 20-year average return has actually been 7.2%. The 15-year average is even worse at 6.5%, while the 10-year return has been just 5.8%.¹⁹

The DC plan starts out at a minimum 10% total contribution rate, with auto-escalators to 14% within four years. The hybrid plan had risk sharing built into it from the ground up, with a 7% employer rate paired with a 3% employee rate for new hires. All normal costs and any potential debt payments in the hybrid have full cost sharing between employee and employer, the assumed rate of return is capped at a 6%, and any future debt must be amortized over a 10-year, level-dollar, layered basis. Level-dollar amortization means the plan expects to pay the same dollar amount each year of the schedule, rather than being tied to a salary growth assumption wherein plans pay less in the early years of the schedule due to assumed increases in plan payroll.

Layered amortization comes into play when the plan experiences additional actuarial losses while paying off the current unfunded actuarial liability (UAL). In this case, the plan will not combine these new losses with the old UAL. Instead, it will create a separate 10-year closed amortization schedule for this new debt to be paid off, therefore not affecting its payment or schedule on the old debt. Michigan passed a law to have MPERS transition down to a 0% payroll growth assumption, getting the plan effectively to level dollar on its

¹⁹ Leonard Gilroy, Anthony Randazzo, and Daniel Takash, "Michigan Adopts Most Innovative Teacher Pension Reform in the Nation." June 2017. <https://reason.org/commentary/michigan-adopts-most-innovative-teacher-pension-reform-in-the-nation/>

legacy debt as well. Another unique feature closes the plan should its funded ratio drop below 85% for two years in a row, until that status improves, and all new hires will be put into the existing DC plan during that period.

5.11

COLORADO FIRE AND POLICE PENSION ASSOCIATION

Colorado introduced its first hybrid plan in 2003 by passing Senate bill 03-057. This bill offered members in the current local or statewide “money purchase DC plans” access to a plan with a guaranteed benefit component. It also allowed new members the option to enter this new hybrid, or into the existing statewide full DB plan. At the time of passage, the existing DB plan was 114% funded, pointing to existing confidence in the legislature opening a hybrid option for its DC membership.

5.12

CONNECTICUT STATE EMPLOYEES RETIREMENT SYSTEM

Connecticut State Employees Retirement System (SERS) was just 43% funded in 2017 when reforms were finally made to address the plan’s growing unfunded liabilities. The State Employees Bargaining Agent Coalition (SEBAC) struck a deal with the state legislature to increase employee contributions, revise the cost-of-living adjustment (COLA), and move all new hires to a hybrid plan.

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The increased contributions were to partially shore up the difference in cost sharing between employees and employers, while the COLA change fixed it to increases in the consumer price index (CPI), rather than being an automatic year-over-year adjustment regardless of inflationary changes.

The new hybrid was not without its issues however, in that it is barely a hybrid at all. While the DB portion had its multiplier reduced to 1.3%, the required contributions to the DC portion were a measly 2%, 1% from the employee and 1% from the employer. This minimum contribution requirement will never make up the difference in lost benefits by swapping from the legacy DB plan.

5.13**OHIO PUBLIC EMPLOYEES & TEACHERS**

Pension design changes between 2001-2003 allowed members in both the Ohio public employees and teachers plans a choice to join either the traditional defined benefit plan, the defined contribution plan, or a combined (hybrid) plan.

The new hybrid lowers the guaranteed benefit by offering a 1% multiplier. As of the most recent actuarial valuations, only 2% of public employees are in the hybrid, and only 4% of teachers are in the hybrid.

PART 6

CONCLUSION

A hybrid retirement plan's goals are no different than any other pension benefit design's goals: to provide adequate benefits to workers at an affordable cost to them and their employers.

As with the design of any pension system, the quality of a hybrid plan comes down to how it is structured. A well-designed hybrid strikes a proper balance of risk between employees and employers, while putting career-long employees on a secure path to retirement and granting non-career members the flexibility they need to get the most out of their retirement contributions. Intelligently designing the DC portion of the benefit is crucial, as generally half of the hybrid employee's retirement benefits will be paid out of their accumulated assets. When designing the DC, policymakers need to ensure proper contributions are being made by employees (and sometimes employers), grant a wide array of investment options, and offer annuities to guarantee lifetime income.

Although the path to an adequate retirement benefit may look different from a traditional pension, intelligently designed hybrids have nonetheless shown to provide relatively similar pension benefit accruals for employees—at a much lower risk to the states and local governments who provide them.

ABOUT THE AUTHOR

Ryan Frost is a policy analyst at Reason Foundation's Pension Integrity Project.

Prior to joining Reason, Frost spent seven years as the senior research and policy manager for the Washington State Police and Fire Plan (LEOFF 2), a plan that is nationally recognized for its exceptional funding level. Frost conducted multiple pension studies for the Washington State Legislature. He also drafted and testified on six pieces of adopted legislation affecting LEOFF 2 members, including a first-of-its-kind annuity-rollover provision for defined-benefit plans.

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