



## BEST PRACTICE

### **Essential Design Elements of Hybrid Retirement Plans (2008) (CORBA)**

**Background.** In its Best Practice (BP), *Developing a Policy for Retirement Plan Design Options* (2007), the Government Finance Officers Association (GFOA) recommends that public sector employers or plan sponsors have a policy statement that will guide their plan design decisions. Once a pension plan design decision has been made, GFOA members can refer to this BP on *Essential Design Elements of Hybrid Retirement Plans* to review the essential elements of offering a hybrid retirement plan or incorporating a hybrid feature.

Separate best practices have been adopted for the *Essential Design Elements of Defined Benefit Retirement Plans* and the *Essential Design Elements of Defined Contribution Retirement Plans*. These best practices should be consulted accordingly.

The emergence of hybrid plans in recent years, offering a combination of defined benefit and defined contribution plan features shows how the public retirement benefits environment is changing. Hybrid plans may be offered as a primary, optional or supplemental plan.

#### **(A) Hybrid Account Balance Plans**

There are a growing number of hybrid plans that express future retirement benefits as account balances. The key difference between defined contribution plans and hybrid plans is that defined contribution plans establish an actual funded account for each participant, which contains employer and employee contributions and investment gains and losses, while hybrid plans establish “accounting” or notational accounts for each participant. The participant’s balance in a hybrid plan continues to grow throughout employment, and the benefit is defined by the current value of the account.

The most common hybrid account balance plans are:

1. **Cash Balance Plans** - In cash balance plans, the employer sets aside a percentage of an employee’s salary each period and the balance set aside earns interest at a set rate. In other words, the employer promises to make a contribution to an account, usually with a specified percentage of pay (also referred to as a credit to the employee’s account), and to credit the account with interest, usually a specified rate of return or a rate based on the yield of a particular benchmark. The employer invests the funds, retaining all investment income and bearing all the risks. The plans generally provide participants the option of receiving their vested account balances as an annuity or as a lump-sum.
2. **Pension Equity Plans** – In a pension equity plan, the balance in the employees’ account equals a given percentage of the employees’ final average salary for each year of service. Some plans increase the percentage with additional years of service. Pension equity plans have various flexible features, which should be analyzed before a plan is selected. The plans generally provide participants the option of receiving their vested account balances as an annuity or as a lump-sum.

**(B) Plans with Hybrid Features**

1. Defined Benefit Plan (DB) with Defined Contribution (DC) features - Public sector plans have options under section 401(a) of the IRC to add a defined contribution feature to a defined benefit plan. There are several variations of DB plans with defined contribution features. Some of these are referred to as blended plans or combination plans. Although not considered a traditional hybrid plan or feature, another common approach is to simply offer a defined benefit plan and a separate voluntary defined contribution plan such as a 457, 403(b) or 401(k) plan.
2. Defined Contribution Plan (DC) with Defined Benefit (DB) features – Defined contribution plans may seek ways to allow members to manage the risk of outliving their money. This could include the purchase of an annuity contract, or allowing a transfer out of the DC plan into an appropriate DB plan where the employee can annuitize this transferring DC balance.

**Recommendation.** Should an employer choose to provide a hybrid retirement benefit plan, the GFOA recommends that retirement system administrators and finance professionals consider the following before adopting hybrid plans or combining hybrid features with defined benefit or defined contribution plans:

1. Whether the hybrid plan will serve as the primary income replacement vehicle or will a hybrid feature be added to supplement a defined benefit or defined contribution plan.
2. Whether the plan will replace a current defined benefit plan or defined contribution plan, become part of a blended plan, or be offered as an alternative to all employees or to new employees at the time of hire.
3. The purpose of the hybrid plan; is the hybrid plan intended to:
  - (a) Reduce the employer’s cost by utilizing hybrid plan cost control features including how investment risk is allocated between the employer and employee.
  - (b) Enhance the employer’s ability to recruit and retain employees, including older employees and/or younger more mobile employees, by offering retirement plans providing:
    - 1) predictable and/or guaranteed benefits, including adequate disability, survivor benefits and other ancillary benefits.
    - 2) portable benefits upon termination or retirement.
    - 3) benefits which are easily communicated to the participant.
4. Whether the hybrid plan or feature under consideration achieves the employer’s stated purpose for changing, supplementing or replacing the current plan.
5. Whether there are projected short and long-term costs and/or savings of changing the plan or feature and will the plan or feature be sustainable long-term. Evaluation of costs and/or savings should include not only direct pension costs but also an estimate of the impact on other benefits and on total compensation costs. Consideration should also be given to the possible increased cost of administering additional plans or more complex plan features. For example, does the internal plan staff have the knowledge and skills to administer a hybrid plan or will additional consulting services be required?
6. Plan conversions or implementing new plans should be undertaken with competent professional advice and assistance. Conversion of a defined benefit plan to a hybrid plan should be undertaken with careful consideration and with legal assistance. Consider whether the hybrid plan or plan feature complies with

the Pension Protection Act of 2006 and its implementing regulations. Particular attention should be paid to issues regarding age discrimination.

7. Whether the relevant plan or features comply with GFOA Recommended Practices for Defined Benefit and/or Defined Contribution Retirement Plans, as appropriate.

## **References**

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Approved by the GFOA's Executive Board, February 22, 2008.