TO: Members of the Legislative Commission on Pensions and Retirement

FROM: Lawrence A. Martin, Executive Director

RE: Commission Interim Project: Alternative Retirement Plan Design, Second Consideration
Options Regarding the Design and Establishment of a Potential Hybrid Retirement Plan

DATE: January 7, 2014

Introduction

Since the Commission has been discussing benefit plan design alternatives beginning in 2011, there has been some inclination on the part of members of the Legislative Commission on Pensions and Retirement towards the creation of a hybrid retirement plan to replace in whole or in part the current Minnesota public employee defined benefit retirement coverage.

This memorandum attempts to provide members of the Commission with some starting points should the Commission wish to develop a hybrid retirement plan proposal.

Concept of Hybrid Retirement Plan Coverage

A hybrid retirement plan is a retirement plan design that combines some attributes of defined contribution retirement plans and defined benefit retirement plans.

Defined contribution retirement plans are pension plans that specify the contributions into the plan and leave to be determined, based on the investment performance on the amassed contributions and the commencement date or dates for disbursement of the pension benefit, the amount of the pension benefit. Examples of defined contribution retirement plans are Individual Retirement accounts (IRAs) and 401(k) Retirement Plans.

Defined benefit retirement plans are pension plans that specify the amount of the pension benefit to be disbursed and the earliest age at which that amount, unreduced for early receipt, is payable and leave to be determined periodically the amount of contributions to be obtained over the active plan membership period of a pension plan member.

Potential Goals for Which a Replacement Retirement Plan Could Be Designed

There are at least seven potential goals which, individually or in combination, could be the impetus for seeking to design a replacement retirement plan. The goal or goals for a retirement plan redesign will likely favor one or more of the various potential redesigns.

The seven potential goals for a retirement plan redesign that I have identified are:

(1) Cost Reduction. A redesigned retirement plan could be sought either to reduce the actual total contribution requirement of the retirement plan or of the employer, contribution of the retirement plan;

(2) Reduced Employer/Taxpayer Risk. A redesigned retirement plan could be sought to provide greater stability than the current defined benefit retirement plans in the retirement plan cost to be borne by employers and taxpayers by eliminating in whole or in part investment risks or mortality risks;

(3) Increased Membership Investment Return Possibilities. Although an incentive limited largely to bull market periods, a redesigned retirement plan could be sought to provide retirement plan members with greater opportunities to directly manage and personally benefit from the investment of retirement plan assets;

(4) Increased Pension Portability for Mobile Employees. Recognizing that career employment is less likely to be the norm, for recent and future public employees undefined a redesigned retirement plan could be sought to provide to plan members who are or will be mobile in their employment pursuits to gain portability or greater portability for their past pension coverage;

(5) Provision of Fairer Pension Coverage for All Plan Members. Recognizing that short-service members who do not vest or who do not take a deferred retirement annuity and who do take a refund of member

contributions from a defined benefit plan receive less proportional value in their pension than longer-service plan members, a redesigned retirement plan could have the goal of making the pension value obtained by all plan members more proportional and more fair;

(6) Reduce or Eliminate Individual or Group Pension Value Manipulation Potential. The redesign of a retirement plan could have the goal of reducing or eliminating the potential for manipulation in the defined benefit plan that could benefit an individual, who may have a means to control an element of the retirement plan benefit formula such as salary, or a group, who may be able to successfully lobby for early retirement access or other pension benefit advantage; and

(7) Better Replicate Private Sector Pension Practices. A goal for a redesign of a retirement plan could be to have the private sector retirement plan design practices applicable to many or most taxpayers of a jurisdiction replicated in the public sector benefit practices for that jurisdiction.

Types of Potential Hybrid Retirement Plans

While academic commentators on the topic differ, in attempting to utilize the most generalized distinctions, the Commission staff has identified three types of hybrid pension plans.

The three types of hybrid plans are:

a. Augmented Defined Contribution Plan/Cash Balance Plan. This type of hybrid retirement plan starts with a defined contribution retirement plan and adds to it one defined benefit retirement plan component, which is the guarantee of an investment return rate on the accumulated account balance for each plan member. Under this hybrid plan type, each plan member has an individual account to which member and employer contributions are credited and to which interest at a prescribed rate annually will be credited. The eventual benefit payout is a lump sum benefit, although the account balance could be converted into a monthly benefit annuitized by the plan, with the plan then also assuming a mortality risk as well as an investment risk.

b. Side-by-Side/Combination Hybrid Plan. This type of hybrid retirement plan pairs a defined benefit plan, frequently stripped down from a prior defined benefit plan design, with a defined contribution plan. The combination would have defined benefit plan coverage on covered salary at a reduced rate, funding a reduced benefit accrual rate, and crediting a portion of contributions on covered salary to the defined contribution plan portion. The payout from the defined benefit plan portion is generally in the form of a monthly annuity, although it could be in a lump sum, and the payout from the defined contribution plan portion generally in the form of a lump sum amount, although the lump sum amount could be annuitized on the actuarial reserve basis as the defined benefit plan portion, subjecting the pension plan to a mortality risk.

c. Stacked/Sequential Hybrid Plan. This type of hybrid retirement plan sequences a defined benefit plan with a defined contribution plan, with the defined benefit play portion covering only a portion of the total salary, frequently the initial portion up to a specified amount, and with the defined contribution plan portion funded from any portion of covered salary that was not included in defined benefit plan coverage. The payout from this hybrid plan type would be the same as for the side-by-side/combination hybrid plan type.

Utilization of Hybrids in Other Jurisdictions

Hybrid retirement plans, combining in some fashion elements of defined contribution retirement plans and defined benefit retirement plans, have been utilized both in the private sector and in the public sector in various jurisdictions, thereby providing a precedent for the consideration of the creation of a replacement hybrid retirement plan for some or all Minnesota public employees.

The following indicates the existing hybrid retirement plans in various jurisdictions based on research by the Legislative Commission on Pensions and Retirement:

a. Cash Balance Plans.
   - Montgomery County, Maryland, Guaranteed Retirement Income Plan
   - State of Nebraska
   - Belgium Private Sector Plans
   - Japan Private Sector Plans
   - Switzerland Private Sector Plans
   - United Kingdom Private Sector Plans
   - U. S. A. Private Sector Plans

b. Parallel or Side-by-Side Plans.
- Federal Employees Retirement Program (DB plan with employee-funded Thrift/DC plan)
- State of Georgia ERS (DB plan with employer match of employee voluntary contribution to DC plan)
- State of Indiana PERF & TRF (DB plan with elective employer payment of employee contribution to DC plan)
- State of Michigan PSRS (DB plan with employer match of employee contribution to DC plan)
- State of Minnesota, various employers (DB plan with employer matched employee contribution to Sec. 457 DC plan)
- State of Ohio PERS & TRS (DB plan with employer contribution divided between DB plan and DC plan)
- State of Oregon PERS (employer-funded DB with employer-funded DC plan, with employer option to pay employee)
- State of Pennsylvania 67 County Retirement Plans (employer-funded DB plan and employee-funded DC plan)
- State of Rhode Island RIRSA (DB plan with employee and employer contributions to DC plan)
- State of Washington DRS (employer-funded DB plan and employee-funded DC plan)
- MERF $2 bill & Annuity Plan (employer-funded DB plan and employee-funded DC plan)
- MTRFA $2 bill & Annuity Plan (employer-funded DB plan and employee-funded DC plan)

c. Sequential/Stacked Plans.
- Netherland Private Sector Plans (DB career average salary plans on initial portion of salary with DC plan on additional salary)

d. Other Plans.
- State of Colorado (choice of optional DC plan)
- State of Florida (choice between DB plan or DC plan)
- State of Montana (choice of optional DC plan)
- State of North Dakota (optional DC plan for non-classified employees)
- State of Ohio (optional DC plan for other than police and fire)
- State of South Carolina (optional DC plan for other than police and fire)
- State of Utah (choice between DB plan or DC plan)
- State of Vermont (optional DC plan for State employees)
- University of Minnesota Faculty Retirement Plans (DC plan with DB minimum for some long service professors)

In addition to established hybrid retirement plans outlined above, the creation of hybrids was actively considered in 2012 by at least one U.S. county, three U.S. states, and five Canadian governments, as follows:

Jurisdiction	Type of Hybrid or Alternative Plan Considered
Montgomery County, Maryland	Cash balance, or side-by-side, or stacked hybrid (DC coverage in excess of $50,000)
State of Kansas	Stacked hybrid (DC coverage in excess of $50,000, $31,000, $25,000, or $14,000, with 4% annual increase in cap) or DC plan
State of California	Capped employer contribution to DB plan as a percentage of pay
State of South Carolina	Stacked hybrid (DC coverage in excess of $40,000 threshold)
Dominion of Canada	Proposed creation of Canada Supplementary Pension Plan (DC top-up plan) for private sector employees
Province of Ontario, Canada	Proposed top-up supplemental DC plan
Province of Nova Scotia, Canada	Proposed top-up supplemental DC plan
Province of Alberta, Canada	Proposed top-up supplemental DC plan
Province of British Columbia, Canada	Proposed top-up supplemental DC plan

Alternatives in Creating a Hybrid Retirement Arrangement

1. Alternative Types of Hybrid Retirement Plans Analyzed. Because a cash balance plan is a hybrid only in its most technical sense (i.e., defined contribution plan with guaranteed rate of interest credited to member accounts as its sole defined benefit plan feature) and because a complete shift to a cash balance plan would represent a great shift from the current defined benefit retirement coverage, the presentation of options set forth below is limited to parallel/side-by-side hybrid retirement plan designs or sequential/stacked hybrid retirement plan designs.

2. Potential Creation of a Parallel/Side-by-Side Hybrid Retirement Plan. To create a parallel/side-by-side hybrid retirement plan to replace some of all of the current defined benefit retirement plans in Minnesota, the current defined benefit plan or some significant components of the current defined benefit plan would be retained and a defined contribution plan would be added, with future member and employer contributions split between the defined benefit plan portion and the defined contribution plan portion. The contribution structure would require either that some of the current defined benefit retirement plan components be downsized or eliminated to reduce the actuarial cost of the resulting benefit coverage to create room under the current total contribution rate or that additional member contributions, additional employer contributions, or both be mandated to accommodate the defined contribution portion without underfunding the defined benefit plan portion.

   A defined benefit plan downsizing will not necessarily be easy, since the benefit plan components interplay and interact in sometimes unpredictable ways. Some potential downsizing options are the following:

General Plan Element	Potential Specific Change
Membership	Limit coverage by the defined benefit plan portion to full-time employees or to employees above a certain salary level or a certain number of hours expected to be employed annually.
Benefit accrual rate	Reduce current rate (usually 1.7% per year of final average salary for general employees; 3.0% for public safety employees) to smaller percentage of final average salary rate.
Vesting	Increase minimum service period for non-forfeitable benefit entitlement or reduce the non-forfeitable portion for short-service employees.
Normal retirement age	Increase the age at which an unreduced retirement benefit is payable.
Early retirement age	Increase the age at which a reduced retirement benefit is payable or increase the amount of the benefit reduction per year or month below the normal retirement age.
Service crediting	Credit service on a fractional basis for less than full month employment rather than general current practice of full month credit for any service period.
Salary base for benefit determination	Increase salary base for benefit computation from highest five years average to a longer period, up to career average salary.
Salary crediting	Limit credited salary to base salary or limit salary credit to salary below a set maximum.
Disability coverage	Exclude inactive or deferred members from benefit coverage, require greater extent of disability for benefit entitlement, or limit disability coverage to members who make optional additional member contribution.
Survivor coverage	Reduce the amount of final salary or average salary provided to spouse, to children, or to family in total.
Combined service	Eliminate any augmentation of benefits if the Combined Service Annuity portability provision is used.

   Of all of the potential downsizing, the easiest to accomplish legislatively (i.e., minimum of amended statutes) and the easiest to result in comparable benefit payouts between similar retirement plans would be benefit accrual rate reductions, normal retirement age increases, early retirement age benefit reductions, or shifting to a career average salary base for benefit computations. Although the defined benefit plan component changes can be made in a manner to produce similar or identical benefit payouts for similar employees between retirement plans covering similar employee types, the actuarial savings will not necessarily track as closely since the normal costs of the current similar type retirement plans differ (based on different entry ages, different average service lengths for retirees, and different retirement age experiences) and since the similar retirement plans have different current contribution deficiencies.

3. Potential Creation of a Sequential/Stacked Hybrid Retirement Plan. To create a replacement for some or all of the current Minnesota defined benefit retirement plans using the sequential/stacked hybrid retirement plan approach, a salary breakpoint (i.e., maximum salary for defined benefit plan coverage and threshold salary for defined contribution coverage) would be required to be selected and specified and the amount of the above breakpoint salary contribution rates would be redirected to the defined contribution portion of the hybrid plan. Alternatively, the defined retirement plan portion could be

restricted to base salary amounts, with the defined contribution retirement plan portion utilized for all non-base salary compensation.

To assist in attempting to specify a breakpoint salary, the Commission staff obtained from the various retirement plan administrators a decile breakdown of their membership as of June 30, 2011, indicating the top salary for every 10% of the plan membership of each retirement plan, organized lowest salary to highest salary. That information indicates the following:

FY 2011 Retirement Plan Salary Distribution by Decile

	MSRS-General	PERA-General	TRA	DTRFA	SPTRFA	State Patrol	PERA-P&F	MSRS-Corr.	PERA-Corr.	Judges
Lowest paid 10%	$21,373	$4,652	$7,076	$1,283	$13,312	$55,764	$48,026	$26,271	$9,821	$129,124
11%-20%	32,731	11,336	29,936	5,606	45,615	63,715	56,620	36,180	30,931	129,124
21%-30%	37,625	16,533	40,274	33,868	54,841	67,571	61,964	38,558	40,330	129,124
31%-40%	41,931	21,941	46,822	48,553	61,222	71,230	66,050	40,544	44,049	129,124
41%-50% (Median)	46,134	30,637	52,988	62,587	68,514	74,290	69,900	43,333	47,059	129,124
51%-60%	51,247	39,176	58,537	64,434	73,534	75,632	73,663	46,817	50,476	129,124
61%-70%	57,277	46,373	64,273	66,027	76,998	78,986	77,512	50,008	54,437	129,124
71%-80%	65,351	54,602	70,560	67,983	80,574	83,154	82,666	55,225	59,758	129,124
81%-90%	76,591	68,148	78,704	71,257	83,873	90,733	90,496	63,605	67,000	135,580
91%-100%	391,832	360,000	264,531	159,529	188,511	116,289	149,894	128,381	112,055	160,579
Mean/Avg. Salary	$51,286	$37,040	$53,507	$53,956	$64,714	$76,607	$73,225	$47,572	$49,332	$133,802

The indicated salary figure for each decile is the highest salary for plan members in that decile grouping.

To utilize the breakpoint salary figure approach, once a decision is made on the breakpoint salary figure dividing defined benefit plan coverage from defined contribution plan coverage is made, the question of the amount of member and employee contributions to be assigned to be deposited to the defined contribution plan portion individual accounts needs to be addressed.

The current defined benefit plan contribution rates were established to fund both the cost of the retirement plan coverage provided to active members for future service (i.e., the normal cost and administrative expenses) and the cost of paying off the unfunded actuarial accrued liability for the retirement plan from past liability additions (i.e., amortization contribution or supplemental contribution). In the current defined benefit retirement plans, the employer contribution rate is frequently larger than the member contribution rate because of the need to redress perceived or actual past employer retirement plan underfunding. The contributions to defined benefit retirement plans in excess of the normal cost and administrative expenses of the retirement plan is needed to amortize the retirement plan unfunded actuarial accrued liability in a reasonable period of time. Thus, it would seem that the appropriate course of action in setting the defined contribution plan portion of any hybrid coverage that the employer contribution should not exceed the member contribution (other than for public safety plans, where it would presumably follow the Commission's policy of 60% employer contribution/40% member contribution), with any balance continuing to be retained by the defined benefit plan portion of the hybrid to eliminate any unfunded actuarial accrued liability in a systematic manner. If the member and matching employer contribution exceeds the normal cost rate for the defined benefit plan portion of the hybrid plan, expressed as a percentage of pay, as it is likely to do, logic would indicate that the member should not receive more pension value in the defined contribution plan portion contribution that the member received in the defined benefit plan portion normal cost and administrative expenses.

Implementation Questions

There are four sets of questions about the implementation of a hybrid retirement plan, whether the hybrid plan is a side-by-side hybrid or is a stacked hybrid, relating to which types of Minnesota public employees the hybrid will apply, relating to when and for whom the hybrid would be effective, relating to whether or not a Minnesota defined benefit retirement plan or plans will self-insure the benefit derived from the defined contribution portion of the hybrid retirement plan, and relating to how the administration of the hybrid will be structured:

1. Types of Employees for Hybrid Coverage. The options with respect to the types of Minnesota public employees will be covered by the potential hybrid retirement plan or plans range from the totality of the types of Minnesota public employees to a select portion of the types of Minnesota public employees. Presumably, because of the nature of their employment and the nature of the retirement coverage as secondary, volunteer firefighters would be excluded from any potential hybrid retirement plan coverage.

There are four other types of Minnesota public employees for which an argument for exclusion can be made, which are persons already covered by a defined contribution plan for the entirety of their coverage (i.e., MnSCU teaching personnel, University of Minnesota faculty, local elected officials other than county sheriffs, legislators, and constitutional officers), public safety employees (i.e., members of the State Patrol Retirement Plan and the Public Employees Police and Fire Retirement Plan), correctional employees (i.e., members of MSRS-Correctional and members of PERA-Correctional), and judges.

a. Current defined contribution retirement plan members probably should be excluded because there is unlikely to be any demand for the change and because the probable proponents of the potential hybrid retirement plan likely favor defined contribution retirement coverage over defined benefit retirement coverage in general.

b. Public safety employees lack Social Security coverage, a defined benefit plan type benefit arrangement, for their public safety employment, making them different from general employees who currently have two defined benefit coverages and, if a hybrid plan is established, of which the potential hybrid plan would only change one coverage. Public safety employees also have greater disability or death-in-service requirements than the replacement hybrid plan likely could meet.

c. Correctional employees have similar casualty benefit coverage requirements as public safety employees, but do have Social Security coverage and may be distinguished from any potential public safety employee precedent.

d. Judges have a more robust legal right to their retirement coverage under the Minnesota Constitution under *Sylvestre v. State*, 298 Minn. 142, 214 N.W.2d 667 (1973) and also may argue that any potential hybrid retirement coverage is not well suited for a membership group that enters public service at a relatively late age compared to other groups.

2. Rapidity in Implementing a Hybrid Plan. The options with respect to the effective date of the implementation of the potential hybrid retirement plan range from immediate complete implementation to an extended delayed implementation.

   a. An immediate and total implementation of a potential hybrid retirement plan would undoubtedly constitute an actual benefit reduction for those plan members who are at the normal retirement age or substantially close to the normal retirement age, since the accumulation of any significant account balance in the defined contribution retirement plan portion of any hybrid coverage takes a substantial period of time, with compounding investment performance, to amass its retirement benefit, while the defined benefit retirement plan portion amasses most of its benefit value at the end of a person’s career.

   b. The implementation could be limited to newly employed public employees only, who have no amassed benefit under the current defined benefit retirement plan and who have no legal rights to any particular coverage under current Minnesota Supreme Court decisions, but any savings or other public policy benefit from the retirement plan coverage change would be substantially delayed.

   c. The implementation could be expanded to include, in addition to new public employees, current employees who are not currently vested (i.e., generally under three years of service or five years of service), since these employees likely have not amassed any pension value beyond the refund of member contributions and because these plan members likely (although not assuredly) lack any legal rights to their benefit coverage under the Minnesota Supreme Court’s current view of pension law.

   d. The implementation could be limited to new employees and current employees who affirmatively elect the coverage change, which would avoid any legal challenges (as long as benefit counseling of current employees was sufficient), but elective provisions in pension coverage tend to be utilized by those who calculate that they would receive a benefit from the change (known as the “election against the plan or fund” phenomenon) and could increase the actual total cost of retirement coverage due to that election phenomenon, at least in the short run.

   e. The implementation could be done on a phase-in basis, slowly adding portions of the defined contribution plan portion for selected portions of the existing membership, but a phase-in that would avoid any potentially successful legal challenges could be hard to design and sequence.

3. Payment Form for Defined Contribution Plan Benefit. The question relating to the manner in which the benefit derived from the defined contribution portion of the hybrid retirement plan will be paid and the

role that any defined benefit retirement plan would play if the benefit is permitted to be annuitized. The defined contribution plan portion of a hybrid retirement plan could be paid in a lump sum or in installments, could be annuitized through the purchase of an annuity contract from an outside insurance company, or could be annuitized through a defined benefit retirement plan using the same annuity reserve factor that the plan uses for defined benefit plan annuities and benefits. Current Minnesota defined contribution plans utilize all three approaches:

1) The Public Employees Defined Contribution Retirement Plan pays a lump sum benefit or will transfer the lump sum to an insurance company to purchase an annuity as arranged by the participant.

2) The Minnesota State Colleges and Universities System Individual Retirement Account Plan (MnSCU-IRAP) is administered by TIAA-CREF, a trust under New York state law that functions very much like a traditional insurance company, paying lump sum benefits or annuitizing the lump sum amount in-house.

3) The Unclassified Employees Retirement Program of the Minnesota State Retirement System (MSRS-Unclassified) pays a lump sum benefit or annuitizes account balances through the MSRS General State Employees Retirement Plan (MSRS-General) using the MSRS-General annuity reserve factors.

When a defined benefit retirement plan annuitizes a defined contribution retirement plan account balance, the defined benefit retirement plan takes on both the mortality risk and the post-retirement investment performance risk for the defined contribution plan accumulation. If the choice of annuitizing through a defined benefit plan is an individual choice rather than a generalized requirement, the selection option also introduces the “election against the fund” risk, where individuals who accurately discern that their likely longevity is above average or that the upcoming investment performance opportunities are souring can disproportionately elect the annuitization option and defeat the general risk pooling mechanism of a defined benefit retirement plan, increasing pension costs over what they would be absent the change.

4. <u>Hybrid Retirement Plan Administration</u>. The question with respect to the administrative structure or structures for the potential hybrid retirement plan coverage is whether a separate new hybrid retirement plan will be administered by each current defined benefit retirement plan administration or whether the hybrid retirement plan coverage arrangement will be administered by one plan administrator, either an existing retirement plan administration or some other administration. A new retirement plan arrangement will be more consistently and effectively administered if a single administrator was utilized, but designating only one hybrid plan administrator would mean the eventual end of the current five retirement plan administrations, which could create additional opposition to the potential retirement plan design change.

<u>Conclusion</u>

This memorandum has attempted to assist Commission members in contemplating its options in the consideration for the establishment of a potential hybrid retirement plan by identifying the purposes for a hybrid plan, identifying the types of hybrids, by surveying the experience of various jurisdictions in establishing hybrids, by identifying the broad changes needed in Minnesota retirement law to create a hybrid, and by identifying some implementation questions arising out of a potential change to a hybrid. If additional elaboration on these points is desired by Commission members, the Commission staff is available to respond any request.