Approved: March 2, 2000
Date

MINUTES OF THE HOUSE KANSAS 2000 SELECT COMMITTEE.

The meeting was called to order by Chairperson Kenny Wilk at 1:30 p.m. on January 25, 2000 in Room 526-S of the Capitol.

All members were present except: Representative Susan Wagle - excused

Committee staff present:
Alan Conroy, Legislative Research Department
Julian Efird, Legislative Research Department
Gordon Self, Revisor of Statutes
Janet Mosser, Committee Secretary

Conferees appearing before the committee:
Julian Efird, Legislative Research Department

Others attending: See attached list.

Chairperson Wilk explained to the committee that the series of briefings planned for the remainder of the week are in preparation for the Chair's intent to take up the defined contribution retirement issue next week.

Julian Efird, Legislative Research Department, was recognized and reviewed the December 1999 Report of the Joint Committee on Pensions, Investments, and Benefits to the 2000 Kansas Legislature (Attachment 1).

Questions and discussion followed. Meredith Williams, Executive Secretary, Kansas Public Employees Retirement System, was recognized and assisted in answering questions.

Chairperson Wilk adjourned the meeting at 2:25 p.m.

The next meeting is scheduled for January 26, 2000.

Unless specifically noted, the individual remarks recorded herein have not been transcribed verbatim. Individual remarks as reported herein have not been submitted to the individuals appearing before the committee for editing or corrections.

KANSAS 2000 SELECT COMMITTEE GUEST LIST

DATE: 1-25-00

NAME	TITLE	REPRESENTING
Roger Franzke		KGC
Jan P. Hagin	Intern	Rep. Troy Findley
Valerie Ritter		WSU Classified Senate
Dennis Phillips	Sec.	Kansas State Council of Fire Fighters
Les Hughes		D of A Personnel
D. Helen Roether	Office Manager	Emporia State Univ.
Sharon Horn	Keyboard Opr. III	Emporia State Univ.
Janet Rees		Emporia State Univ
Krista Gaspeich	Staff	DOA/DPS
Leland Breedlove	KI	KPERS
Meredith Williams	[illegible]	KPERS
Jack Hawn	~~KPERS~~	KPERS
Sharon Avery		SEAK
Judy Dillard		WSU Classified Senate
Tom VELTMAN	PRESIDENT	WSU CLASSIFIED SENATE
DAVE JOHNSON		EMPORIA STATE UNIVERSITY
Thomas O[illegible]		Emporia State University
William D Sloyer		Emporia State University
Janet Florene		AFSCME Local 3371
Martin Flame		AFSCME LOCAL 3371
Douglas CUSHENBERY		Emporia State Univ.
Ray Rodriguez		Emporia State Univ.
[illegible]		" "
Ron Gaches		Fidelity Investments

KANSAS 2000 SELECT COMMITTEE GUEST LIST

DATE: 1-25-00

NAME	TITLE	REPRESENTING
Larry F. Rosenquist		ESU (AFSCME 1357)
Steven R. Sisson		ESU (AFSCME 1357)
TERRY BOWER		ESU
Eldon E. Hinck		E.S.U.
FLOYD D. CROSS		E.S.U.
ANDY SANCHEZ		K.A.P.E.
Steve Parsons		KGC
Larry Mateer		ESU
Randy Umholtz		ESU Lebo Ks.
Craig Grant		KNEA
Pat Lehman		KSFA

Report of the Joint Committee on Pensions, Investments, and Benefits to the 2000 Kansas Legislature

CHAIRPERSON: Representative Tim Carmody

VICE-CHAIRPERSON: Senator Dave Kerr

OTHER MEMBERS: Senators Jim Barone, Marge Petty, Don Steffes, and Robert Tyson; Representatives Ray Cox, Geraldine Flaharty, Vaughn L. Flora, Cindy Hermes, Al Lane, Clark Shultz, and Gwen Welshimer

STUDY TOPIC

School district employer contributions to Sec. 403(b) deferred compensation plans for school employees

December 1999

Kansas 2000 Select Committee
Meeting Date 1-25-00
Attachment 1

JOINT COMMITTEE ON PENSIONS, INVESTMENTS, AND BENEFITS*

CONCLUSIONS AND RECOMMENDATIONS

The Joint Committee considered three proposals during the 1999 Interim and conducted other studies relative to its statutory changes of monitoring the Kansas Public Employees Retirement System (KPERS). In regard to the topic of school district employer contributions to section 403(b) deferred compensation plans for school employees, the Joint Committee recommends permissive legislation authorizing school boards to provide an employer match with the school district intending to pay the cost out of the local general fund budget. In regard to the topic of defined contribution plans, the Joint Committee recommends continued study of this subject. In regard to the topic of Kansas Police and Firemen's (KP&F) Retirement System membership for certain state employees with law enforcement duties and the definition of law enforcement officer, the Chairperson appointed a subcommittee to continue study of the definition issue during the 2000 Legislature and to report back to the Joint Committee. In studying the statutory topics, the Joint Committee reviewed KPERS post-retirement benefits, investments, actuarial valuation report, and annual audit. The annual financial and compliance audit of KPERS contained no significant findings or recommendations relative to KPERS accounting procedures and internal controls.

BACKGROUND

The Joint Committee on Pensions, Investments, and Benefits is directed by statute to monitor, review, and make recommendations relative to investment policies and objectives formulated by the Kansas Public Employees Retirement System (KPERS) Board of Trustees; to review and make recommendations related to KPERS benefits; and to consider and make recommendations on the confirmation of members nominated by the Governor to serve on the KPERS Board of Trustees. In carrying out these statutory duties, the Joint Committee generally identifies several different topics for interim study. Other topics may be assigned by the Legislature or Legislative Coordinating Council (LCC).

The 1999 Legislature accelerated the due date for actuarial valuations of school districts and community colleges with early retirement incentive plans (ERIPs). The reports are due to be submitted by January 1, 2000, to the Joint Committee. Three years ago these reports were collected for the first time and the Joint Committee reviewed the results. Legislation concerning these ERIPs passed last session and placed a one-year moratorium on establishment of any new plans.

* Proposed legislation not available at time of publication.

For the 1999 Interim, the LCC assigned one study topic to the Joint Committee:

- school district employer contributions to Sec. 403(b) deferred compensation plans for school employees.

The Joint Committee in its 1998 report to the Legislature recommended two topics be continued for study during the 1999 interim:

- defined contribution plans; and

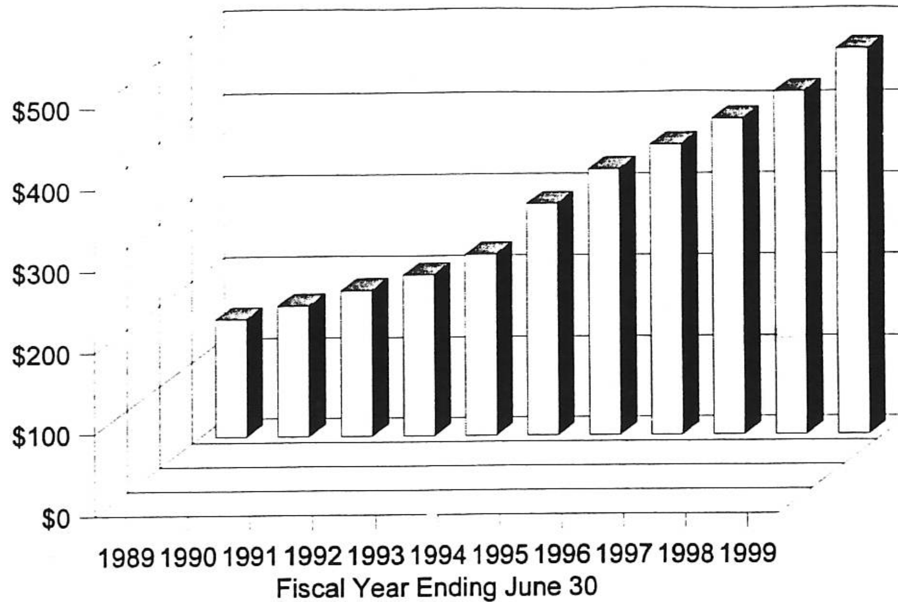
- KP&F membership for state employees with law enforcement duties and the definition of law enforcement officer.

The Joint Committee met on October 12, November 10, and December 12, 1999. The minutes and attachments for all meetings are available in the Division of Legislative Administrative Services.

COMMITTEE ACTIVITIES

Post-Retirement Benefits

The number of retired KPERS members increased from 38,243 in FY 1989 to 51,643 on July 1, 1999. Benefits paid to retirants and their beneficiaries increased from $145.2 million in FY 1989 to $472.5 million in FY 1999. The average monthly benefit amount increased from $316 to $759 between FY 1989 and FY 1999. The increase in the number of retired members and the higher average monthly post-retirement benefits resulted in the growth in annual payments from FY 1989 to FY 1999 as shown in the following chart. Of particular note is the increase reflected first in FY 1994 following substantial enhancement in benefit calculations for retirees after July 1, 1993, and post-retirement adjustments for members retired prior to that date. An almost $52 million jump occurred in FY 1994 annual payments after the 1993 Legislature provided enhancement of retirements of benefits for both retirees and those eligible to retire beginning in FY 1994.



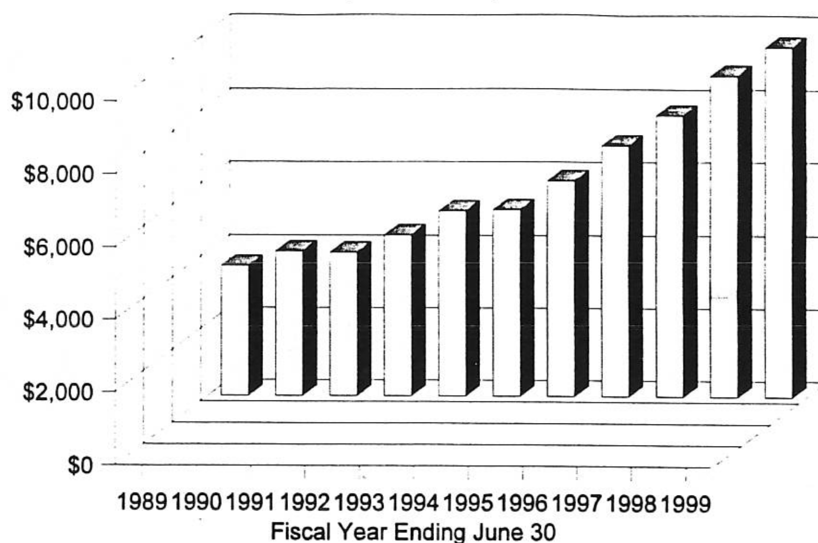
KPERS Investments

News from the KPERS administrators for the plan year that ended June 30, 1999, has been good. Earnings reported in FY 1999 indicate that investments had an overall annual rate of return equal to 11.2 percent. The investment portfolio grew in value to almost $9.6 billion on June 30, 1999, compared with a year earlier when the Fund's investments were valued at $8.8 billion. Investment performance for the last ten fiscal years has helped increase the KPERS net asset value from $3.6 billion in FY 1989. Growth of 14.0 percent was achieved for the latest three years, and 15.7 percent for the latest five years.

The KPERS Board of Trustees adopted a new investment policy to guide the relative proportion of the portfolio that is allocated to different types of investments. Previously, the allocation of KPERS assets was based on a policy adopted January 28, 1994, and continued until July 16, 1998. The new target allocation policy was adopted by the KPERS Board of Trustees on July 17, 1998.

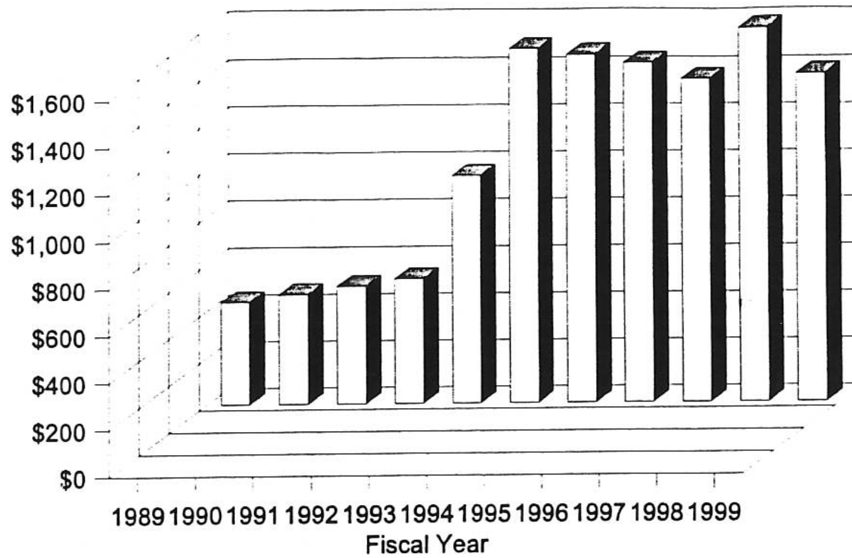
KPERS Net Asset Value of Investments

(In Millions)



Actuarial Valuation

The KPERS actuary presented the annual system valuation report for the fiscal year ending June 30, 1999. The actuarial report determined, based upon the KPERS Board of Trustee's adopted assumptions and the methodology employed by the actuary, that the unfunded actuarial liability as of June 30, 1999, was $1.397 billion. The unfunded actuarial liability (UAL) for all plans decreased from $1.591 billion as of June 30, 1998, according to the annual valuations. The following chart shows an 11-year period portraying the relationship of KPERS actuarial assets to actuarial liabilities, based on the actuarial valuations as of June 30 of prior years, which is expressed as the difference between resources available and resources needed to pay future benefits to retired members.



An asset valuation method, approved in 1994 by the KPERS Board of Trustees, is used to smooth the effect of market fluctuations in order to lessen the year-to-year changes in employer contribution rates. The actuarial value of assets is equal to the expected asset value based on an assumed earnings rate of 8.0 percent, plus one-third of the difference between the actual market value and the expected asset value. Unrecognized gains or losses from prior years also are considered. The other two-thirds of the current difference is taken into account in subsequent years when future valuations are performed. This asset valuation method tends to influence the amount of investment gain reported by the actuary. The following table shows the reasons for the decrease in UAL between June 30, 1998, and June 30, 1999:

		In Millions
UAL as of June 30, 1998	$	1,591
Investment gain		(369)
Refinement in data/procedures		21
Liability loss from actual experience		46
Effect of employer contribution/time lag		78
Expected increase due to amortization method		30
UAL as of June 30, 1999	$	1,591

1-6

When discussing the UAL, the KPERS actuary indicated that it might be helpful to apportion the total amount of liability among the different KPERS plans. The following table shows the liability for the different plans:

	In Millions					
	Judges	KP&F	State/ School	Local	TIAA	Total
UAL as of June 30, 1999	$8.1	$317.4	$972.6	$76.0	$23.3	$1,397.4

This year's actuarial report provides additional information on the status of the unfunded liability. The KPERS actuary pointed out that an evaluation of the unfunded actuarial liability on a pure dollar basis may not provide a complete analysis since only the difference between the assets and liabilities are reflected. Another way to evaluate the unfunded actuarial liability and the progress made in funding it is to track the funded status (the ratio of the actuarial value of assets to the actuarial liability) and to evaluate the UAL as a percentage of covered payroll as shown in the following table.

	1994	1995	1996	1997	1998	1999
Funded Ratio	77.0%	78.8%	81.0%	83.3%	83.0%	86.0%
UAL*	$1,505	$1,481	$1,444	$1,376	$1,591	$1,397
UAL as Percentage Of Payroll	43.2%	39.3%	36.6%	33.5%	37.2%	31.2%

* In millions

Also presented were multi-year projections of employer contribution rates for KPERS State/School and KPERS Local. The State/School rate is projected to peak at 5.30 percent in FY 2005 and the local rate to peak at 3.50 percent in calendar year 2003. The current employer contribution rate for State/School is 4.19 percent in FY 2000 and the current rate for local is 3.22 percent beginning January 2000.

KP&F Membership

The Joint Committee reviewed the KP&F Retirement System's, requests of certain state agencies for expanded employee membership in KP&F, statements from representatives requesting KP&F membership, and the definition of police officer.

The Assistant to the Secretary of Administration for Employee Relations presented background information on the issue of KP&F membership relative to labor negotiation activities. It was noted that the following employees and agencies are included in memoranda of agreements that seek KP&F affiliation: enforcement agents, Kansas Racing and Gaming Commission; enforcement agents, Kansas Lottery; enforcement agents, Division of Alcoholic Beverage Control; fire investigators, State Fire Marshal; securities special investigators, Office of the Securities Commissioner; and Capitol Police, Kansas Highway Patrol. It also was noted that tentative agreements have been reached with nine bargaining units at state correctional facilities for corrections officers.

The following representatives appeared on behalf of certain employee groups: Lt. Colonel Terry Maple, Assistant Superintendent, Kansas Highway Patrol, urged the Committee to recommend that Capitol Police officers with full police powers be granted membership in KP&F. William Harper, Supervisor, Fire Investigation Division, State Fire Marshal, asked the Committee to recommend that fire investigators be granted membership in KP&F. Charles E. Simmons, Secretary of Corrections, noted that two proposals are included in the FY 2001 budget request in the enhanced services level: the first proposal includes placing both correctional officers and parole officers under KP&F, and an alternative proposal includes enrolling parole officers in the special KPERS–Corrections Group A. Todd Gilbert, President, American Federation of State, County, Municipal Employees (AFSCME) Local 3371, reviewed some of the rationale for adding state corrections officers to KP&F. Leonard Garrett, Chief Executive Steward, AFSCME Local 3371, cited other reasons for adding corrections officers to KP&F.

Jack Hawn, KPERS Deputy Executive Secretary, explained the FY 2002 fiscal impact on all KP&F employers if the large group of correctional staff were included. Mr. Hawn cited a cost increase of $3.8 million that would result in an employer rate hike for both state and local agencies paying KP&F contributions due to the change in composition of the membership associated with adding state corrections employees. He said that, alternatively, the cost increase could be apportioned exclusively to the Department of Corrections.

The Committee reviewed the issue of who should be eligible for KP&F membership. The Revisor's Office staff explained the statutory definition in KSA 74-4952(12) for certain public safety positions identified as "police, policeman, or policemen" who are eligible for membership in the KP&F retirement system. It was noted that legislative changes to KSA 74-4952(12) in 1998 eliminated part of the definition that read "in support of" and added the requirement for law enforcement training. The Revisor's Office staff pointed out that some public safety positions, such as emergency medical service technicians, are included in KP&F by KSA 74-4954a. The Kansas Bureau of Investigation agents, Highway Patrol troopers, and university police officers are included in KP&F by statutory provisions, not by definition in KSA 74-4952(12).

KPERS Litigation

Through the process of litigation, KPERS has recovered $27.65 million, the KPERS Executive Secretary reported. A total of $16.89 million has been spent in conjunction with that litigation. A net recovery of $10.77 million has been realized and deposited into the KPERS Fund. A representative of the KPERS Litigation Group appeared at the October meeting and explained the losses associated with direct placements and real estate investments for which KPERS is seeking redress through litigation. It was noted that one trial was scheduled to begin January 10, 2000, and that a number of other state court trials had been stayed pending appeals. Final briefs in the appeals were scheduled for October of 1999, and decisions in those cases were anticipated to be delivered in early 2000 by the Court of Appeals.

Qualified Plan Status

The Retirement System has received an Internal Revenue Service (IRS) determination letter announcing that KPERS is considered a qualified plan. The IRS determination letter is in response to KPERS submission of various plan documents and a request for an IRS ruling that the plan design meets all qualified-plan requirements under section 401(a) of the Internal Revenue Code.

The IRS determination letter assures KPERS members and participating employers that they are entitled to the various tax advantages associated with qualified-plan status. These advantages include federal tax deferral of retirement contributions, federal tax deferral on interest and benefit accruals, and complete federal tax exemption on the fund's investment earnings. The IRS stresses the importance of both designing and also administering a plan in compliance with section 401(a) requirements. The responsibility for addressing future design and administration issues will reside with the KPERS Board of Trustees and staff.

Plan Design Considerations

KPERS consulting attorneys provided background information on federal compliance issues for governmental retirement plans. Five principal points were emphasized:

- Every plan for post-retirement compensation should try to achieve the most preferred tax status under the Internal Revenue Code available that will meet the employers' and members' needs.
- Employers should consider the impact of pension plan benefits on employment patterns.
- It's not an all-or-nothing proposition in that an employer can sponsor more than one type of plan to benefit employees' different needs.
- A defined benefit plan can be modified to include defined contribution-like features without giving up the advantages of a defined benefit plan.
- For qualified defined contribution plans, 457 plans, and employer funded 403(b) plans, large plan sponsors may be able to negotiate advantageous investment programs.

A comparative review was provided of the characteristics for defined benefit plans, defined contribution plans, and hybrid plans (see **Supplement 1** to this report).

A comparison of governmental retirement plans under the Internal Revenue Code also was provided (see **Supplement 2** to this report).

The KPERS consulting attorneys stressed that there were three approaches to making changes in current retirement plans: a tiered option that allows only new hires to participate in a new plan; a layered option that adds a new plan for all members while maintaining the old plan in some form; and an election that allows members to choose a new plan, or to remain in the old plan.

For both the 457 plans and 403(b) plans in which an employer match might be considered, the KPERS consulting attorneys recommended creating a 401(a) plan into which the employer contribution would be placed. Oklahoma, Indiana, Missouri, and South Carolina use a parallel 401(a) plan for the employer match in order to maximize the amount an employee can put into the regular 457 or 403(b) plan.

Alternative Plan Designs

School District Plans. The Joint Committee reviewed the proposal assigned by the LCC concerning section 403(b) tax sheltered annuity or custodial accounts for school district employees and the possible need for permissive legislation authorizing employer matching contributions.

The Vice President for Retirement Plans, Security Benefit Group of Companies, summarized the reasons why 403(b) matching

programs had been adopted in other states and the need for permissive legislation to authorize employer contributions in Kansas. Minnesota has passed authorizing legislation. Several different types of plans were described.

The Assistant Superintendent for USD 233, Olathe told why legislation is needed to allow school districts to match employee contributions to 403(b) tax sheltered annuities. It was pointed out that 26 percent of the USD 233 employees currently participate in a tax shelter plan and that an employer match would increase the number of participants. Different advantages for providing an employer match were described.

Members of the Joint Committee asked how the proposal related to the school district early retirement incentive plans. The Security Benefit representative said that in Minnesota the 403(b) employer match was designed to keep employees working longer for the districts and to counter early retirements. The Assistant Superintendent indicated that the two concepts would serve different purposes and that each would be useful to school districts and their employees in meeting various needs.

State Deferred Compensation Plan. The State of Kansas offers a Section 457 deferred compensation plan that allows maximum annual deferral of 25 percent of adjusted gross earnings, not to exceed a maximum of $8,000. The plan is intended to supplement the KPERS defined benefits and is referred to as a voluntary program in which state employees may choose to participate. There are 13,470 plan accounts, with 9,451 active participants making periodic contributions. The average annual contribution is $2,250. Approximately 26,000 state employees are eligible to participate in the Section 457 plan.

Aetna Life Insurance and Annuity Company administers the plan under contract with the Director of Personnel Services who is statutorily responsible for plan administration. Assets totaled $318,639,821 on December 31, 1998. The plan offers 37 different investment options, including products from Aetna, Fidelity, Janus, T. Rowe Price, Scudder, and Oppenheimer. Since the plan is self-directed by participants, assets may be shifted among different investments that include variable annuity options, with many of the choices represented by different mutual funds.

Within the deferred compensation plan, there is an option for certain statutorily defined state employees who elect not to participate in KPERS, and instead may opt for an 8.0 percent contribution by the state into the deferred compensation account. There are approximately 65 state employees who participate year-round in this 8.0 percent program. A number of part-time employees of the Legislature also participate in this program, but only work four months during the session.

Defined Contribution Plans. Jack Gaumnitz, a retired professor of business, made remarks to the Committee about his experience as a Regents employee who was covered by TIAA-CREF, a defined contribution plan for unclassified staff and faculty. He listed a number of advantages of defined contribution over defined benefit plans. The principal advantage was individual choice. Other advantages cited by Mr. Gaumnitz included quicker vesting, portability, individual portfolio consideration, risk management, and enhanced flexibility.

The Committee asked about the cost of individual investing and the fees charged by investment agents. Mr. Gaumnitz cited no-load mutual funds and other reduced-cost methods of direct investing when individuals choose to manage their own portfolio investments. He indicated that the rate of return for individuals could be much higher than

KPERS because individuals would tailor investments to their needs and that more emphasis could be placed on stocks that tend to earn higher rates of return over time than real estate or fixed income options in which KPERS invests.

Bills Proposing Alternative Plan Designs

The Joint Committee also reviewed legislation recommended for introduction during the 1999 Session by the Kansas Select 2000 Committee and the Subcommittee on Retirement Benefits. Five bill drafts that correspond to the subcommittee's recommendations were examined.

Proposal No. 1. This bill would authorize the State of Kansas and other governmental employers to participate in matching programs. It would permit the state and local governments to provide up to a 1.0 percent match for Section 457 plans, and the school districts and community colleges to contribute up to a 1.0 percent match for Section 403(b) plans.

Proposal No. 2. The bill would establish a pension equity option for all KPERS members. The account value either would be paid at retirement in a lump sum or converted to a monthly benefit paid in equal installments. The traditional KPERS calculated retirement benefit would be available if a member did not select the pension equity option. Members of KP&F and the Judges retirement systems would not be eligible for participation.

Proposal Nos. 3, 4, and 5. These bills have certain common elements. A defined contribution plan alternative to the traditional KPERS defined benefit plan would be established. Any KPERS member electing to change plans would have years of service and salary levels frozen for calculating retirement benefits, but no assets would be transferred to the new plan. Future retirement benefits would come from the traditional KPERS plan and from the new alternative plan if the new alternative plan were selected. Both the employer and employee would contribute 4.0 percent to the new plan. Vesting would occur in two years. Death and disability benefits comparable to KPERS levels would be provided. The KPERS Board of Trustees would administer the new plan. Members of KP&F and the Judges retirement systems would not be eligible for participation.

Proposal No. 3. This bill would make a defined contribution plan available to nonjudicial employees in the judicial branch. Present employees would be offered a one-time option of transferring to the new plan, or remaining in the current KPERS plan. Newly hired employees would have the same option as present members to elect either the traditional KPERS plan or to opt into the new plan.

Proposal No. 4. The bill would make a defined contribution plan available to all unclassified employees in the executive, judicial, and legislative branches. Present employees would be offered a one-time option of transferring to the new plan, or remaining in the current KPERS plan. Newly hired employees would have the same option as present members to elect either the traditional KPERS plan or to opt into the new plan.

Proposal No. 5. This bill would make a defined contribution plan available to all employees covered by KPERS in the executive, judicial, and legislative branches. Present employees would be offered a one-time option of transferring to the new plan, or remaining in the current KPERS plan. Newly hired employees would be covered by the defined contribution plan and will not have the option of choosing the traditional KPERS plan.

Conclusions and Recommendations

The Joint Committee considered three proposals during the 1999 Interim and conducted other studies relative to its statutory changes of monitoring the KPERS operations.

- In regard to the topic of school district employer contributions to section 403(b) deferred compensation plans for school employees, the Joint Committee recommends permissive legislation authorizing school boards to provide an employer match with the school district intending to pay the cost out of the local general fund budget.

- In regard to the topic of defined contribution plans, the Joint Committee recommends continued study of this subject. It is anticipated that the House Select 2000 Committee will review the five bills considered by the Joint Committee during the 1999 interim. No recommendations were adopted by the Joint Committee regarding the five bills.

- In regard to the topic of KP&F Retirement System membership for certain state employees with law enforcement duties and the definition of law enforcement officer, the Chairperson appointed a subcommittee to continue study of the definition issue during the 2000 Legislature. It is anticipated that the subcommittee will meet early in the session and that the Joint Committee may receive the subcommittee report when that group's study is completed.

- In studying the statutory topics, the Joint Committee reviewed KPERS post-retirement benefits, investments, and actuarial valuation report. The annual financial and compliance audit of KPERS also was reviewed. There were no significant findings or recommendations, no material weaknesses in internal controls, and no exceptions in compliance with finance-related laws and regulations.

Supplement 1

Features of Defined Benefit Plans, Defined Contribution Plans, and Hybrid Plans*

Introduction

The Employee Retirement Income Security Act ("ERISA") introduced extensive federal regulation of private retirement plans. The purpose of the legislation was to protect the interests of participants and their beneficiaries by mandating certain minimum vesting, funding, and disclosure requirements on plan sponsors, from which governmental plans are generally exempt. However, certain federal regulations are still a fact of life for governmental plans primarily through the Internal Revenue Service ("IRS") administration of the qualification requirements of the Internal Revenue Code ("Code"). Employee pension benefit plans are divided into two general categories: defined benefit plans and defined contribution plans. In deciding which type of plan is most appropriate for a given employee, the objectives of these plans must be considered in light of the workforce, the employer environment, and the employee preferences. Additionally, "hybrid plans" also can be designed where features of both defined benefit and defined contribution plans are synthesized. Before launching into the issues associated with potential hybrid combinations, however, an informed policymaker must have a working knowledge of the critical elements of "defined benefit" and "defined contribution" plans, as well as a general understanding of their respective features or characteristics.

Critical Elements

Defined Benefit Plans. A defined benefit plan is a retirement program that provides the employee with a specific benefit at retirement. This plan calculates a benefit based on a formula, often a percentage of final average pay multiplied by the years of service. Benefits are payable as an annuity for the lifetime of the member, possibly continuing for the lifetime of his or her beneficiary. The retirement plan typically funds the cost of providing these benefits through a combination of employee contributions, employer contributions, and investment return.

Defined Contribution Plans. A defined contribution plan is a retirement program where members each have an individual account (or accounts) that accumulates employee contributions, employer contributions, and investment return. At termination of employment or retirement, the retirement benefit is solely determined by the account balance. Payment options often include lump sums as well as annuities which are limited by the account balances at the time of the annuity purchase. Defined contribution plans also are known as "individual account" plans.

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* Source: Ice, Miller, Donadio, and Ryan, Indianapolis, Indiana

Hybrid Plans. A number of public retirement plans have implemented hybrid plans—plans that combine features of both defined benefit and defined contribution plans. Sometimes public policymakers create for one group of employees two separate plans, which combine to provide the features of a defined benefit and a defined contribution plan. On the other hand, some policy makers have opted for the creation of a single hybrid plan, which has the desired features of both defined benefit and defined contribution plans. Finally, some policy makers have just added to a defined benefit plan certain features of a defined contribution plan. Some of the hybrid plans are of recent vintage, but some have been in place for decades.

Each type of program has its own characteristics. By comparing these characteristics to the objectives and working environment of the employees, the most appropriate type of plan can be selected. If some characteristics of each are desirable or necessary, a hybrid program can be designed. Regardless of which plan ultimately proves to be most attractive to employees and employers, it is vital that the plan is "qualified" under Section 401(a) of the Code.

Defined Benefit Plans, Defined Contribution Plans, and Hybrid Plans: A Comparison of Features and Characteristics*

	Defined Benefit Plan	Defined Contribution Plan	Hybrid Plan
Normal Retirement	Employees earn a fixed benefit based on a formula. Thus, the benefit at normal retirement is easily determined if you know the individual's average salary and years of service. Benefit formulas based on final average salary automatically adjust for pre-retirement inflation. Highly sophisticated benefit formulas that address specific circumstances (such as past service or part-time employment) also can be designed.	An employee's benefit is equal to his vested account balance at retirement. For an employee with many years of service, that account balance could be substantial. However, depending on investment earnings, it may or may not keep pace with pre-retirement salary inflation. For an employee with only a few years of service or low pay, the account balance could be minimal. There is no guarantee of what the account balance will produce in terms of monthly benefit.	A hybrid plan can be designed a number of ways, but one approach would be to have a fixed benefit based on a formula, to accomplish the protection and certainty of a defined benefit plan. A hybrid plan could have some incremental benefit based on an account value. In addition, a hybrid plan could add distribution options in the form of a lump sum as to all or part of the member's accrued benefit.
Early Retirement	Employees earn a fixed formula benefit. In many plans, the normal retirement benefit is reduced for the number of years the employee is retiring early. Often the fund is subsidizing that employee's early retirement.	An employee's early retirement benefit is equal to his account balance at early retirement. There is no reduction for earlier age, nor is there an ability to "subsidize" a greater value benefit. The balance is simply whatever it is at the point of early retirement. There can be no "subsidization" of early retirements.	A hybrid plan can be designed to continue the early retirement subsidy concepts. If the employer wants plan design changes to be neutral in terms of effect on retirement pattern, this would probably be the desired approach.
Post-Retirement Increases	A defined benefit plan can provide for post-retirement increases—Cost of Living Adjustments ("COLAs"). This type of increase can provide significant protection from post-retirement inflation.	A defined contribution plan cannot provide for a post-retirement increase as such. The defined contribution account would continue to grow in value post-retirement if there is favorable investment performance. This would produce more in-	A hybrid plan can continue any COLA design in place. It also can allow a separate invested account designed to provide post-retirement investment direction and market appreciation.

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* Source: Ice, Miller, Donadio, and Ryan, Indianapolis, Indiana

Defined Benefit Plan	Defined Contribution Plan	Hybrid Plan
	come to the participant over time, which may offset the impact of inflation. However, the account also could suffer investment losses and thus produce less income over time.	
Death and Disability Benefits (Insurance-Type Benefits)		
A defined benefit plan can provide for a fixed formula death benefit. For example, many governmental plans provide a non-actuarially reduced allowance for disability. Defined benefit plans also can provide minimum benefits, or additional benefits for line-of-duty or occupational death and disabilities.	A defined contribution plan may pay the employee's account balance at the employee's death or disability. There is no minimum benefit and no additional benefits for line-of-duty events. Death and disability protection can be provided through insurance coverage.	A hybrid plan can continue fixed formula death and disability benefits. It also can provide minimum benefits and line-of-duty/occupational death and disability. Separate insurance coverage to replicate those benefits would not be necessary.
Investment Direction		
Generally, in defined benefit plans, employees have no investment direction, and assets are centrally managed. Some funds have authorized investment direction of a portion of the fund.	Defined contribution plans are not required to offer employees investment choices. However, most defined contribution plans do provide some element of choice in investment options.	A hybrid plan can provide for employee investment direction on some portion of the benefit, generally expressed as the employee contribution account. A hybrid plan typically would not contain employee investment direction for the entire benefit, thereby providing a limited degree of exposure to the economic markets, while also providing a limited degree of protection against economic downturns.
Vesting and Accruals		
Defined benefit plans often provide no benefits for short term employees. Most defined benefit plans are directed at the long-term employee. However, benefit design within the defined benefit plan can address this issue.	Defined contribution plans may use the same vesting schedule as defined benefit plans. However, defined contribution plans may provide for immediate vesting of all contributions and earnings. The short-term employee frequently will end up with more in a defined contribution plan.	A hybrid plan can use the same vesting schedule as either type of plan. However, it can provide for accelerated vesting of certain amounts if desired.

Defined Benefit Plan	Defined Contribution Plan	Hybrid Plan
Portability		
A defined benefit plan may afford limited portability. However, recent innovations in this area can provide significant portability in a number of situations. For example, "service purchases" and "rollovers" (into qualified plans or IRAs) allow greater portability.	Defined contribution plans generally provide portable benefits. However, because of federal law restrictions, there are limitations on portability between various types of plans (tax sheltered annuities, deferred compensation plans and qualified plans). Defined contribution plans do not accommodate service purchase concepts.	Portability can be enhanced by certain design features. Hybrid plans can still include service purchase concepts. Some federal law restrictions apply.
Benefit Increases		
A well-funded mature defined benefit plan could pay for some benefit increases through favorable actuarial experience. In all other cases, benefit increases would be paid by increased employer, employee, or employer and employee contribution obligations.	The only way to increase benefits is to increase account balances—by increased contributions or by increased investment performance.	A hybrid plan can be designed to allow maturation to a well funded plan. This would allow favorable actuarial experience to pay for benefit increases. Any portion of the hybrid plan based strictly on account balances would still be wholly dependent on those balances for its increases.
Employee Understanding		
It is usually easy to understand the ultimate benefit, but not the current value in a defined benefit plan. However, employees can be told the benefit formula and can be coached to be able to estimate their monthly benefit. It is difficult to understand the value of the benefit at younger ages.	Defined contribution plans are usually the easier plan to understand. That is, it is relatively easy to understand the account balance "today." The ultimate benefit available, however, is impossible to predict with certainty.	A hybrid plan can provide communication and education on both the ultimate benefit and the current benefit.
Tax Treatment		
Defined benefit plan distributions are treated as ordinary income, with a 10 percent penalty for early distribution, unless rolled into an IRA. There are basis recovery rules that also apply.	Defined contribution plans receive the same tax treatment as other qualified plans.	Hybrid plans receive the same treatment as other qualified plans.

	Defined Benefit Plan	Defined Contribution Plan	Hybrid Plan
Other Features	A defined benefit plan generally provides no in-service distributions or access. For example, hardship distributions are impermissible. Loans are seldom permissible.	A defined contribution plan may permit various kinds of in-service access, such as loans, hardship distributions, and in-service withdrawals at certain ages, subject to code restrictions. Such plans do afford more design flexibility in this regard. However, consideration must be given to the objectives of the plan and the significant administrative costs and difficulties associated with this type of provision.	A hybrid plan can provide some design flexibility, although it would be very uncommon to provide in-service access. Generally, plan sponsors simply do not find that this fits their objectives.
Administrative Cost	A defined benefit plan generally requires actuarial valuations, accounting functions, and investment management fees. It also may require record-keeping for employee contributions and service credit. However, overall, most fundamental benefit structures are relatively easy to administer.	A defined contribution plan is sometimes thought of as an "easier" or less expensive plan to administer. Any such plan generally requires accounting functions and investment management fees. However, numerous investment choices, various kinds of payment options, and other features can result in a much more difficult and expensive plan to administer. Those types of features can result in additional investment costs, accounting or record-keeping costs, and administrative fees.	We often see a hybrid plan looking primarily like a defined benefit plan in terms of administration, with certain additional expenses due to investment options or accounting needs. Generally, however, these plans do not have the highest end costs that some defined contribution plans have.
Financial Commitment of Employer	In a defined benefit plan, the employer is generally required to project the ultimate benefits in the plan and fund, in advance, to meet these benefit commitments. To the extent that past service is credited under the plan, a past service liability results. Therefore, the employer is committed not only to fund for future service benefits, but also to amortize the "mortgage" for past services. In the event that the pen-	In contrast, defined contribution plans are by definition always fully funded. The employer or employee satisfies its obligation on a year-by-year basis, by contributing the amount specified by the plan's formula. If the plan should terminate, each member's benefit, which is the amount in his account, is fully funded and there is no future liability for the employer.	Financial commitment depends on structural elements. Generally, hybrid plans are structured as defined benefit plans. A hybrid plan can contain a portion based on a fixed benefit commitment, plus a portion based on a fixed contribution commitment.

Defined Benefit Plan	Defined Contribution Plan	Hybrid Plan
sion plan is terminated, if assets are not sufficient to meet the liability for promised benefits, the employer may be liable to satisfy the unfunded obligations.		
Investment Risk		
The risk of investment performance is on the employers in a defined benefit plan. If the value of the portfolio goes down, the employers must contribute more to cover that decline in value. If the value goes up and the plan earns more than the actuarial assumptions (net experience gains), the employers will need to contribute less to fund the benefits. In either case, employee benefits remain the same. Employer contribution rates for many defined benefit plans have declined in recent years due in part to favorable investment experience.	The risk of investment performance is on the employees in a defined contribution plan. If the value of the portfolio goes down, the contribution rate does not vary and the employee's benefits go down. If the value goes up, the employees' benefits are greater and the employers or employees will contribute the same.	Allocation of risk depends on structural elements. The hybrid plan can "split" risk allocation so some component is borne by employees and some is borne by employers.
Cash Flow		
This point is closely related to the prior one. A defined plan must fund the benefits being accrued in some manner. However, if the plan achieves "maturity," favorable investment performance and actuarial experience can pay for some of the benefits, reducing or eliminating the cash flow of employer dollars into the plan. This can best be demonstrated by a "fully mature" well-funded situation, where employer contribution requirements have been generally declining over recent years, while benefits continue to accrue at the same rate. An "immature" poorly-funded plan can experience wide fluctuations in contribution demands.	A defined contribution plan can never "pay for itself" on an on-going basis. It will always require contributions. All favorable investment performance goes directly to employee accounts. In an employer-funded plan, the defined level of employer contributions must be made each year, so there is no time when the investment performance and experience would reduce or eliminate the cash flow of employer dollars into the plan.	If defined benefit elements are funded primarily (or exclusively) by employer contributions, cash flow requirements for a hybrid will be like a defined benefit plan. Conversely, if defined contribution elements are funded by employee, then the employer cash flow will not be affected.

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Unfunded Liability

A defined benefit plan can accrue an unfunded liability by the promise of a benefit for which funding is currently unavailable or inadequate. However, funding schedules can be put in place to amortize unfunded liabilities.

No unfunded liabilities can exist because the employee's benefit is only what is in the employee's account.

Unfunded liability can occur in defined benefit aspects of hybrid plans. Depending on structure, a hybrid plan may mitigate or eliminate unfunded liability potential.

Supplement 2

SNAPSHOT COMPARISON OF GOVERNMENTAL RETIREMENT PLANS UNDER INTERNAL REVENUE CODE*

Code Section	Taxation	Contribution Limits	Benefit Limits	Distribution Forms
401(a) Defined Benefit	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	Employee contributions limited to lesser of $30,000 or 25% compensation	$135,000 per year, but can pay more through QEBA	• Rollovers to IRA or qualified plan • Lifetime annuity guaranteed by fund • Lump sum available • Disability benefits • Death benefits • Health benefits account
401(a) Defined Contribution	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	Lesser of $30,000 or 25% compensation for employees and employer contribution	N/A	• Rollovers to IRA or qualified plan • Lump sum • Periodic payments available • Guaranteed lifetime benefit available through commercial annuity • Health benefits account
401(a) Hybrid Plan	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	Contribution limits will apply to defined contribution-like features	Generally structured to use defined benefit limits	• Rollovers to IRA or qualified plan • Lifetime annuity guaranteed by fund • Lump sum available • Disability Benefits • Death Benefits • Health Benefits Account
403(b) Tax Sheltered Annuity	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	• $10,500 on voluntary employee contribution (salary reduction) • Lesser of $30,000 or 25% compensation for employee and employer contribution • Maximum exclusion allowance for employee and employer contribution	N/A	• Rollovers to IRA or 403(b) plan • Lump sum • Periodic payments • Guaranteed lifetime benefits available through commercial annuity • Can add periodic payments
457(b) Deferred Compensation Plan	• No income taxation until benefits paid • No FICA taxation on employer contributions or on benefits	$8,000 or 33 1/3% of includible compensation for employer and employee contribution	N/A	• Transfers to other 457 plans • Lump sum • Periodic payments • Guaranteed lifetime benefits available through commercial annuity

* **Source**: Ice, Miller, Donadio, and Ryan, Indianapolis, Indiana.