

# PENSION PLAN DESIGN: DEFINED BENEFIT, DEFINED CONTRIBUTION, AND HYBRID PLANS

## INTRODUCTION

HJ 8 (2021), assigned to the State Administration and Veterans' Affairs (SAVA) Interim Committee, calls for an interim study of the financial stability of Montana's defined benefit public employee retirement systems and the development of a long-term strategic approach to funding the systems. This briefing paper provides information about the different types of pension plans and serves as a primer for the panel discussion at the March 24, 2022, SAVA meeting.

## TYPES OF PENSION PLANS

There are three major types of retirement plans in the public sector: defined benefit (DB), defined contribution (DC), and hybrid plans. There is no universal answer as to what is considered the optimal retirement plan structure, as this varies based on the needs and objectives of the plan sponsor and population covered, and the legal and regulatory environment of the state or municipality. According to the U.S. Bureau of Labor Statistics, as of March 2021, 75% of state and local workers in the U.S. participated in defined benefit plans and 18% participated in defined contribution plans.

## DEFINED BENEFIT PLANS

- A defined benefit (DB) plan is an employer-sponsored retirement plan that provides a specific monthly benefit at retirement. The employee's salary and length of service determine the retirement benefit.
- DB plan funds typically include a combination of employer contributions, employee contributions, and investments earnings. Actuarial valuation results determine recommendations for contribution rates.
- Public pension assets are put into a pooled trust fund and are managed by professionals at the state level. The pooled trust fund assets are invested to pre-fund the cost of pension benefits, providing economies of scale that lower fees and increase returns. Retirees receive set monthly installments rather than a lump sum and the benefit is guaranteed for the rest of their life.
- Investment performance does not affect the value of a DB plan benefit but may affect or cap cost-of-living adjustments.
- The typical DB plan places some responsibility and risk on both the employer and employee.
- DB plans are the most prevalent plan design in the public sector.

## DEFINED CONTRIBUTION PLANS

- A defined contribution (DC) plan is an employer-sponsored retirement savings vehicle that accumulates savings based on contributions to an employee's individual retirement account. DC plans do not promise a specific retirement benefit.

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- In a DC plan, the employee, employer, or both contribute to the plan. The contribution amount is typically a certain percentage of the employee's salary.
- DC plans typically do not pool assets, and instead, employees have a range of investment options to manage individually. The employee receives the balance in their account upon retirement. The 401(k) plan is the most popular form of DC plan.
- Employees assume the investment and longevity risks in DC plans. Employers fulfill their annual obligations as their contributions are made but may face some uncertainty about timely retirements if investment returns drop close to an employee's retirement date and the employee decides to delay.
- Many states offer employees a DC plan as a supplemental retirement savings plan or as an optional alternative to the DB plan. Three states – Alaska, Michigan, and Oklahoma – and the District of Columbia offer only a DC plan on a statewide basis for broad employee groups.

## HYBRID PLANS

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- Hybrid pension plans combine elements of both DB and DC plans. The most common government-sponsored hybrid plan types are combination plans and cash balance plans.
- Combination plans feature a DB component that is typically more modest than a traditional DB plan combined with a mandatory DC plan. Eleven states offer combination hybrid plans, either optional or compulsory.
- Cash balance plans combine elements of traditional pensions with individual savings accounts into a single plan. Employers generally guarantee an annual rate of return on an account the employer, employee, or both contribute. Five states offer cash balance hybrid plans: California, Kansas, Kentucky, Nebraska, and Texas.
- Core elements of all hybrid plans include mandatory participation, shared financing and risk among employers and employees, pooled assets, and required lifetime benefit payouts.

## MONTANA'S PENSION PLANS

Most of Montana's statewide public employee retirement systems originated as local government and school district plans. Over time, local jurisdictions opted to join the state's plans or to combine their local plans into one statewide plan. The first statewide system, the Teachers' Retirement Systems (TRS), was formed in 1937. The state's largest plan, the Public Employee Retirement System (PERS), was created in 1945 with the Public Employees Retirement Law. The most recent plan, the PERS Defined Contribution Plan (PERS-DC), was formed in 1999.

There are now 11 public employee retirement systems in Montana – 9 DB plans and 2 DC plans. These systems cover nearly all state and local government employees and school district employees. In addition, many state employees are eligible to join the optional supplemental 457(b) Deferred Compensation Plan.

Retirement fund assets, including contributions and investment earnings, are protected trust funds under the Montana Constitution. In addition, Montana's constitution provides that retirement system funds may not be diverted or encumbered for any other purpose (Article VIII, Section 15).

As of June 30, 2021, Montana's defined benefit retirement plans covered more than 54,000 active public employees and 46,000 retirees and benefit recipients – approximately 1 in every 10 Montanans – and involved more than \$14.5 billion in investment assets and nearly \$17.4 billion in liabilities.

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**MONTANA'S DEFINED BENEFIT PLANS**

PLAN NAME	YEAR ESTABLISHED	ACTIVE MEMBERS*	BENEFIT RECIPIENTS*	ACTUARIAL VALUE OF ASSETS*
Teachers' Retirement System (TRS)	1937	19,161	16,985	\$4.6B
Public Employees' Retirement System (PERS)	1945	29,028	24,403	\$6.5B
Highway Patrol Officers' Retirement System (HPORS)	1945	244	356	\$168M
Game Wardens' and Peace Officers' Retirement System (GWPORS)	1963	1,023	420	\$247M
Volunteer Firefighters' Compensation Act (VFCA)	1965	2,031	1,531	\$45M
Judges' Retirement System (JRS)	1967	57	73	\$120M
Sheriffs' Retirement System (SRS)	1974	1,495	805	\$438M
Municipal Police Officers' Retirement System (MPORS)	1974	823	910	\$516M
Firefighters' Unified Retirement System (FURS)	1981	734	692	\$555M

**MONTANA'S DEFINED CONTRIBUTION PLANS**

PLAN NAME	YEAR ESTABLISHED	ACTIVE MEMBERS	BENEFIT RECIPIENTS	MARKET VALUE OF ASSETS
Montana University System Retirement Program (MUS-RP)**	1987	6,637	3,664	\$979M
Public Employees' Retirement System Defined Contribution Retirement Plan (PERS-DC)***	1999	4,765	2,215	\$409M

\*Information from MPERA and TRS actuarial valuations dated June 30, 2021.

\*\*MUS information from TIAA as of 03/10/2022.

\*\*\*PERS-DC information from MPERA as of June 30, 2021.

## SOURCES

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