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A HYB SOLUT

Defined benefit funding pressures and the untested liabilities associated with defined contribution plans are prompting some plan sponsors to revisit the concept of a hybrid plan.

By Steve Gendron

Could hybrid plans be the solution for today's beleaguered pension plan sponsors? In a recent informal poll of Canadian pension and benefit executives, almost 25% said that if they were starting fresh today, they would choose a hybrid pension plan over any other plan design.

Pension plans combining the characteristics of both defined benefit (DB) and defined contribution (DC) plans have been around for many years. In fact, they're quite common among some plan sponsors, such as universities. In the past, they may have been dismissed as too complex for plan sponsors trying to steer their way through the legislative quagmire—but this may be changing.

WHAT ARE THEY?

Hybrid plans come in many shapes and sizes. They include combination plans where the benefit is the sum of the pensions from separate and distinct DB and DC components. They also include "greater of" plan designs where the DB pension is compared to the DC pension and the member receives the larger of the two. Here are some of the more common hybrid plan designs currently in use among Canadian plan sponsors:

Combination (or stacked) plans – In this type of plan, a DC benefit is stacked onto a core DB pension. The amount paid on termination, death or retirement is the sum of the amount earned under the core DB plan and the account balance under the DC component.

A typical combination plan might include a core DB pension: 1% times highest average five-year earnings times pensionable service.

It can also include an additional DC benefit: member optional contributions of 4% of pensionable salary plus matching employer contributions of 50% of member contributions. In this example, a member earning $70,000 would have a $9,900 pension adjustment (PA): $5,700 relating to the DB provision and $4,200 relating to the DC provision. Of course, under current tax law, the higher the core DB formula, the less room there is for DC contributions and vice versa. For higher income earners, it may be necessary to limit DC or recognize members' earnings only up to a certain dollar limit under the DB component to leave some DC contribution room.

The typical approach for these arrangements is to have the DB pension funded solely by the plan sponsor, with the DC contribution pension funded by optional member contributions with or without some type of sponsor match.

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Choice and lifecycle plans – These plans resemble combination plans in that the final benefit is the sum of the pensions from two separate components. The choice plan allows members to choose between a DB pension and a DC pension. This may be a one-time choice at enrollment, or the plan may allow one switch during the member's career or unlimited switches at regular anniversary dates.

Lifecycle plans are designed to maximize the benefit value at every age level. This typically translates into providing the member with a DC pension for an initial period of service or to a specified age and a DB pension thereafter. This allows the plan sponsor to provide higher termination values in the earlier years of service and younger ages when termination rates are highest.

"Greater of" plans – They offer members the greater of the pension that can be purchased by their DC account or a minimum DB pension—sometimes referred to as a "floor" or guaranteed pension.

For most terminating members, the value of the DC account will be larger than the value of the DB pension, provided investment returns are in the 6% per annum range (or greater). When a member qualifies for early retirement, the reverse is generally true. But it's not uncommon for the DC account to overtake the DB pension if members delay their retirement to their mid-60s or later, when early retirement subsidies have evaporated.

When the DB floor applies, member and sponsor accounts are converted to the DB pool to pay benefits, much like any other DB plan. If the floor doesn't apply, member and sponsor accounts are transferred to the member by locked-in transfer to a financial institution outside the plan, or converted to a monthly lifetime annuity inside the plan. The latter option is a perk that is not available under DC plans that do not contain risk or asset sharing aspects. However, unlike other DC plans, members typically do not have direct investment control over their own or the sponsor's contributions. Member and sponsor accounts are usually invested in a fund selected by the sponsor so as not to underwrite aggressive investment risks.

Pension adjustments for "greater of" type plans are calculated in the same fashion as the benefit: the greater of the pension adjustment for the DC or DB pension.

Cash balance plans – Canadian cash balance plans are an offshoot of the traditional DB plan. They are more common in the U.S., but due to PA requirements and minimum and maximum restrictions on the "cash balance," their popularity in Canada is low.

A cash balance plan is, essentially, a DB plan that tries to mimic the early value-building qualities of a DC plan. It provides improved termination benefits, but retains the fundamental DB characteristics at retirement. Typically, these plans do not allow for member contributions, and in order to maintain the same relative sponsor cost, must provide a trade-off of some ancillary benefits at retirement for enhanced termination benefits.

Unlike the traditional DB plan, the basic benefit in a cash balance plan is a lump sum amount—determined by a formula—rather than a monthly pension amount. The formula itself can be based on final average earnings, age and service, or age plus service.

Under Canadian cash balance plans, each member has a notional account to which notional contributions and interest is credited (a notional account is a book-keeping account only—no actual funds are set aside for the member per se). On leaving the plan, the accumulated notional balance is paid as a locked-in transfer, or an underlying DB pension is available in lieu of the lump sum transfer.

The plan must therefore have an explicit underlying DB formula to satisfy Canada Revenue Agency's requirement for a determinable PA. In addition, the defined lump sum amount cannot be less than the minimum transfer value of the underlying defined benefit, determined in accordance with provincial pension legislation, and cannot exceed the maximum value of the underlying defined benefit, in accordance with tax rules. For these reasons, this type of design has not been popular in Canada.

Flexible pension plans – Flexible pension plans have been created over the last decade to address certain inefficiencies

under Canadian tax rules, in particular the calculation of the PA. Like other hybrid plans, flexible plans contain both a DB and DC component. Members are permitted to make optional contributions to a DC account, but these contributions are not included in the calculation of a member's PA.

At termination or retirement, the accumulated account balance is used to purchase ancillary benefits on the DB provision. These might include a smaller early retirement reduction, bridge benefits, longer guarantee periods or improved survivor benefits and cost-of-living increases. The beauty of the flexible design concept is that members are able to decide if they want to make optional contributions and how those contributions will be used, while at the same time not increasing their pension adjustment.

The potential downside of flexible plans is the risk of accumulating assets in the DC account that exceed the value of ancillary benefits a member can purchase. In this case, the member runs the risk of forfeiting those excess assets—a risk that must be clearly communicated from the outset.

There are two types of flexible pension plans. Under a traditional flexible plan, the DC account is an "add-on" to the base DB formula. Newer hybrid flexible plans typically pay a pension based on the DB formula less the amount of pension provided by the member's DC account. The difference between the two is in the upper limit of member contributions. Under the traditional flexible design, member contributions are limited to the lesser of 9% of pay or $1,000 plus 70% of the member's pension adjustment; under the hybrid, flexible design contribution are limited to the annual DB pension adjustment.

PROS AND CONS

Hybrid plans have certain advantages over traditional DB and DC contribution plans. At the same time, hybrid plans may not be right for every plan sponsor. Here are some of the pros and cons:

Typically, DC plans provide more value at younger ages, while DB plans provide increased value once a member is eligible for early retirement. Most hybrid designs attempt to provide larger values for younger, mobile members through the DC component and more stable, predictable values for older members through the DB component.

The positives are numerous. First of all, hybrid plans allow members to benefit in potential upside investment returns under the DC component if superior investment returns are realized. In addition to the potential upside, members have downside investment protection through the underlying DB provision. This also mitigates some of the annuity purchase risk associated with pure DC plans.

Hybrid plans provide members increased flexibility and choice. Some even allow members to tailor their pension to meet their personal expectations for career

duration and retirement age.

Unlike pure DB plans, hybrid plans provide individual members with a visible account balance which they can see growing over time. The account balance is an attractive feature of DC plans because it is easily understood by members. There is also the element of predictability. Hybrid plans generally offer a more predictable benefit than straight DB or DC plans.

As for pension expense volatility, they are able to limit it to a degree by using DC concepts that are not subject to pension accounting volatilities. Flexible pension plans also permit member optional contributions which are deductible for personal tax purposes but do not affect the calculation of a member's PA. This improves the efficiency of certain DB plans which don't provide all the ancillary benefits contemplated in the pension adjustment's "9" factor.

There are negatives associated with hybrids. DB and DC plans are difficult enough to communicate on their own and combining the two poses a serious communication challenge that plan sponsors must be willing to face head on. If plan members don't understand their hybrid plan, many of the advantages will be wasted on them.

Certain hybrid designs require coordination of the DB and DC provisions to comply with maximum pension adjustment rules. This may prohibit full recognition of a member's earnings or require a cap on the contributions allowed to the DC component—or both. As well, some hybrid designs may allow members a very limited DC investment choice. This ensures that member investment risk is not totally underwritten by the plan sponsor. As for the administration of hybrid plans, the process is more complex than with standard plans and may require more time and resources.

Hybrid plans may not be appropriate for every organization. Plans design should always be driven by business needs, culture and goals, and not industry trends. Some questions plans sponsors should consider before adopting a hybrid design include:

1. Do we have diverse member retirement needs and do we want to be flexible in meeting those needs?

2. Are we concerned about providing adequate termination benefits and do we want to sacrifice some retirement benefit value for termination value?

3. How big an issue is member investment risk?

4. Is adequacy of pensions at retirement a concern?

5. Are we willing to make member communication a top priority?

If the answer to all these questions is "yes," a hybrid plan may be the answer. **BC**

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