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Defined Benefit Pension Plans

Risk Management & Basic Policy

For sponsors of defined benefit pension plans, 2008 was a challenging year with the new rules of the Pension Protection Act taking effect and the steep decline in the equity markets; a harsh reminder that uncertainty and risk are present. There is no doubt that there are financial risks associated with sponsoring a defined benefit plan. Recognizing these risks and setting policies to help manage them is very important. As we put 2008 behind us and look forward to the challenges ahead we thought it would be helpful to outline some basic policy considerations for sponsors of defined benefit pension plans.

Benefits

Perhaps the most fundamental of all policies for a defined benefit plan is the benefit policy. Benefit policy defines not only what the benefits are that are earned but also who earns them and when they are paid. Benefit policy is often the first item that is changed in an attempt to manage risk and minimize financial impact. A reduction in the amount of benefits or later commencements of full benefits are common changes to benefit policy that are often considered.

In recent years, a first step for many plan sponsors has been to freeze participation in the current defined benefit plan so newly hired employees would not earn benefits under the defined benefit plan. This so called "soft freeze" is a palatable solution to rising costs for many employers since it is not perceived as a take away for existing employees. However the sponsor may have to consider what type of replacement plan to provide the new hires, which adds both administrative time and cost. The more extreme measure, or "hard freeze", where benefits are no longer earned in the future for existing employees is often perceived as a take away by employees. Once again a replacement plan may have to be considered. In addition the impact may be greater for mid to late career employees who do not have adequate time to adjust to the change and prepare for retirement.

The replacement plan that many sponsors consider is a defined contribution plan where the employer contribution amount is a percentage of salary which can be budgeted each year without wide fluctuations. The plan will offer a variety of investment choices for these contributions. The risk of poor investment experience lies with the employee and may result in not having adequate income for retirement. There has been much publicized regarding this over the last few months as employees' account balances, tied to the equities markets, have plummeted. There are long term implications of this for both the employer and society as a whole. Conversely the ability to direct investments and

possibly accumulate a large sum of money for retirement or rollover funds upon separation of employment may be attractive to younger or more mobile employees. Understanding the demographics and preferences of your workforce is an important part of determining what type of plan is best for your business. Also reviewing the expected replacement ratios (i.e. the percentage of final salary replaced by the retirement income) from the employer sponsored plan, considering other forms of retirement income for the affected employees and comparing these to national averages is extremely important.

A second option, adopted by many Fortune 100 companies, is a cash balance plan. A cash balance plan is a "hybrid" plan with participant benefits in the form of an account balance (like a defined contribution plan, e.g. 401(k) plan) equal to the sum of cumulative service credits (e.g. 5% of compensation) and interest credits (e.g. 5% annually), but is technically a defined benefit plan because the interest credits are defined in the plan document and guaranteed by the plan itself. Cash Balance plans have more predictable annual expense and contribution requirements-like defined contribution plans-but have most of the advantages that other defined benefit plans have: pooled investment accounts that allow sponsors access to more sophisticated investment advisors, the ability of participants to annuitize a portion of or all of their account balance at retirement from the plan itself, typically lower overall administrative costs, the ability to provide subsidized early retirement benefits (either as a permanent feature or as part of an early retirement window offering) and the ability to provide executive benefits that are usually otherwise offered through non-qualified arrangements. While there was considerable controversy regarding Cash Balance plans earlier in the decade, the Pension Protection Act of 2006 ("PPA") clarified how Cash Balance plans need to be structured to avoid issues of age-discrimination, thereby eliminating much of the risk of lawsuits that existed prior to PPA. Nearly all new defined benefit plans created in the past 5 years have been with a cash balance plan design. Finally, participants in Cash Balance plans in 2008 will enjoy account balances that increased in value...something participants in defined contribution plans will not have, unless they were invested solely in cash or stable value funds.

As annual costs for defined benefit plans have risen, a significant number of plan sponsors have frozen these plans to participation, future accruals or both. Unfortunately this trend may continue as a common reaction to increasing costs. However, whenever possible, we encourage a careful review of benefit policy, alternative options and your organizations goals and objectives before any action.

Funding

In the decades since the Employee Retirement Income Security Act (ERISA) that have led up the Pension Protection Act of 2006, Congress has enacted various pieces of legislation aimed at controlling the amount a plan sponsor is required and allowed to contribute to a defined benefit plan. The funded status of the plan (i.e. how much of plan liabilities are covered by the value of plan assets) has always factored into the determination of these amounts. During positive economic times, when many plans were considered very well funded, legislation was targeted at decreasing the amount that could be contributed and deducted. More recently, legislation has centered on the need to increase the funded status of the plans thereby requiring higher minimum contributions. Under current law, the annual minimum required contribution is a seven year amortization payment to make up the shortfall between liabilities and assets and the cost of providing an accrual for the year (if the plan is not frozen). For those plan sponsors subject to the tax deductibility rules, there may be the ability to contribute up to at least the difference between assets and 150% of the liabilities. These two numbers represent a contribution range each year and may be the basis for the plan sponsor's current funding policy.

A plan sponsor's funding policy should recognize the annual cost of benefits being earned each year for the current employees as well as an allowance for additional amounts due to a mismatch of the past service liabilities and assets. Given the economic condition and downturn in the equities market, we have seen the mismatch grow immensely over this past year. As a result, many plan sponsors are asking how they will be able to make up this amount in such a short time. In response to this crisis, there was some relief provided as part of the Worker, Retiree and Employer Recovery Act signed into law in December of 2008(WRERA). Further detail on [WRERA can be found here.](#)

For an ongoing plan, it is very important that a plan sponsor be able to commit to a funding policy, which is separate from the legislative requirements, but will likely fall within the mandated contribution range each year. This funding policy should always recognize the annual ongoing cost of providing additional accruals each year for the current employees as well as include an allowance for the possible mismatch of plan liabilities and assets. This possible mismatch will vary for each plan sponsor based on the maturity of the plan, expected future cash flows and investment direction.

Investment

A plan sponsor should have an investment policy that attempts to meet the objectives of the plan sponsor; considering tolerance for risk, liquidity requirements of the plan and funding policy. Performance benchmarks should be part of the policy and should be reviewed on a regular basis. The policy should address the failure to meet these benchmarks within a specified time. Perhaps now more than ever, greater attention is being given to the investment policy.

While Harbridge does not act in an investment advisory role, it is important that the actuary and investment advisor communicate and share pertinent information. The actuary makes assumptions about future expected cash flows out of the plan which are the basis for establishing the liability. The funding policy of the plan sponsor with regard to the expected cash flow into the plan should also be discussed with the investment manager.

Understanding as well as planning for these expected cash flows on the investment side is fundamental. Examining options for matching these cash flows to a bond portfolio is also something that should be discussed if there is a desire to minimize the potential for a mismatch of liabilities and assets. As liability driven investing (LDI) carries certain risks, we encourage a discussion with your investment manager of the advantages and disadvantages of such an approach. It can't be denied that the landscape under which plan sponsors are operating has changed dramatically and as such, the long regarded investment policy of 60% equities, 40% bonds and other fixed income should be reviewed.

Conclusion

Risk is present within any financial program and the events of this past year were a harsh reminder of that fact. While risk can not be eliminated, by recognizing areas where we have some control we can manage it more effectively. Defined benefit pension plan sponsors, now more than ever, should review their benefit, funding and investment policies to determine if the objectives that have been established are being met. Upon careful review, a sponsor may determine that objectives have changed and/or policies need to be revised.

For further assistance or any questions, please contact your Harbridge Consultant.

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