



Managing Your Defined Benefit Plan in Today's Investment Environment

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Faced with the complex new funding rules for defined benefit plans, many credit unions have found themselves considering a choice between offering employee retirement benefit security and plan cost containment. Some have been forced to terminate their defined benefit plans in order to control costs, in turn jeopardizing their ability to retain talented, long-term employees.

As the deadline for compliance with Pension Protection Act (PPA) regulations approaches, perhaps this dilemma is one you and your own board of directors are confronting. But plan termination as a response to prohibitive funding costs can be avoided. Instead, plan design modification, combined with a shift in investment strategy, can help control plan costs and meet funding requirements.

Defined Benefit Plans—Critical to the Success of any Financial Institution

Defined benefit plans remain one of the best ways to attract and retain a talented workforce—critical to the success of any financial institution. Despite the decline in the share of workers that defined benefit plans now cover, these plans are likely to remain a major source of income for many retired workers and their families well into the future. Today, defined benefit plans remain one of the most significant assets that many employees own. No other retirement program provides a predictable and secure benefit for life. In times of market volatility in particular, the need for defined benefit plans becomes more apparent than ever.

Defined Benefit Plan Investing

But while the investment environment has a direct effect on funding requirements, pension investing is not an arbitrary process of chasing market returns. Pension investing is more a process of matching assets to liabilities, with the ultimate objective being to pay retirement income. With that in mind, a plan's investment policy should be structured to invest plan assets in such a way that will meet those benefit obligations.

Common sense—yes, common practice—no. Most pension funds' primary investment objective is to maximize total return over time at an appropriate level of risk. But pension assets and liabilities must be viewed collectively. That is why the singular focus that drives our investment policy is to ensure that plan assets are invested to guarantee that benefits are secure. Rather than take a maximum total return approach, a sound pension investment strategy should correlate asset returns to liability costs, the goal being to "meet or beat" liabilities while minimizing the volatility of pension costs—no easy feat in the post-PPA world.

Pension funds generally have a long-term time horizon. The investment objectives outlined in the plan's investment policy statement set the guidelines for the plan's investment manager in

choosing investments appropriate for the plan. Within the guidelines of the plan's investment policy, pension funds strive to achieve the highest level of return in order to lower the cost of the pension obligation. That being the case, why wouldn't an investment manager pursue a high risk, aggressive growth investment strategy? Pursuing an aggressive growth investment strategy can result in dramatic swings in the value of a pension portfolio—and can wreak havoc on contribution requirements. Pension funds typically include not only equity investments, but also fixed income, which becomes a significant part of the pension asset allocation process in meeting its liabilities. For example, for retired lives bonds can be structured so as to produce cash flows from interest and principal to meet future benefits.

Changes to Investment Strategies Resulting from the Pension Protection Act

The framework for investing pension assets changed significantly with the implementation of the PPA. Plans will determine their funded status by applying the metrics prescribed by the PPA, some of which we set forth below. Actuarial valuation results will be tied to current capital market returns and volatility, and especially to changes in long term interest rates. The PPA focuses on plan funding ratios (assets divided by liabilities). The PPA considers plans "at risk" that are below 80% funded (have a funding ratio below 80%), and imposes payout restrictions on such plans. Pension plans are therefore expected to shift from focusing on maximizing asset returns to minimizing funding ratio volatility, with a move toward liability driven investing. Although the PPA legislation went into effect for most plans in 2008, many defined benefit pension plans may not have yet reviewed the investment implications of the PPA, or decided on how to update their investment plan.

Under the PPA, small changes in interest rates can also have a significant impact on a plan's funding ratio. Minimizing volatility of contributions is expected to be a primary investment objective for many plans. Plans can no longer focus only on asset driven benchmarks, such as the Russell 3000 Index, a total stock market index. Asset classes which have a high correlation to liabilities, such as long term bonds, will become key plan performance benchmarks.

Funding Status

Under the PPA, two factors impact the funding status of a defined benefit plan: First, the duration (i.e. interest rate sensitivity) of the liabilities. Changes in interest rates result in changing liability values. And second, the degree to which asset values move in line with, outperform, or underperform, the changing liability values. Asset classes which may have been lower risk before the PPA, in an asset focused environment, are higher risk investments under liability driven investing. Duration mismatches with the liabilities create increased risk for previously low risk asset classes. Long-duration bonds become the "risk neutral" benchmark as they come closest to matching the duration of the liabilities. A 3-month T-bill that was a "safe" investment in a traditional asset only environment might not be an efficient investment when considering liabilities payable over 80 years in the future. In the post-PPA environment, longer duration bonds (which more closely match the duration of the liabilities) are a lower risk investment than shorter term securities that do not match the interest rate sensitivity of the liabilities.

Under the PPA, strategies that mitigate interest rate exposure, such as duration/cash flow matching, and interest rate swap overlays, will receive greater attention. Plans will seek to

minimize contribution volatility with adjustments to their fixed income oriented investments. Plans will also focus on how the assets they manage change in value with changes in liabilities caused by changes in the PPA yield curve. Small changes in interest rates can have a significant impact on liabilities, assets, the plan's funding ratio and contribution requirements. Using the long term bond as a benchmark, many defined benefit plans will seek to apply investment strategies that reduce the fluctuations in the funding ratio caused by even small changes in interest rates.

Control Costs, Meet Funding Requirements and Determine Your Best Investment Strategy

If PPA regulations requiring that plan assets and liabilities be viewed together for pension investment strategy purposes have you left you and your board of directors feeling uneasy, Pentegra Retirement Services can help you successfully meet these challenges. We are intimately familiar with this approach: it is the investment strategy we have had in place for over six decades.

The Pentegra Defined Benefit Plan for Financial Institutions' investment strategy is geared to payment of benefits and risk management, and not to leveraging excessive returns. This strategy has enabled us to maintain our stability despite record market volatility and is the critical factor in keeping plan costs down and our customers' funding ratios up.

As the leading provider of retirement plans to community based financial institutions for over 65 years, Pentegra can help you assess the current pension investment environment and evaluate your alternatives. Our expert consultants can meet with you and your board of directors to lay out the cost benefits of each plan option so you can feel confident you are taking the optimal steps to preserve one of your most significant employee benefits while minimizing PPA-driven costs.

Experience the Pentegra Difference

Founded in 1943 by the Federal Home Loan Banks to manage a pension program for their employees, today Pentegra manages more than 1,000 retirement plans and over \$5 billion in plan assets for financial institutions nationwide. Our extensive experience in providing industry specific retirement plan solutions, together with our consulting and technical expertise, make Pentegra uniquely suited to help you effectively manage the challenges created by the PPA. Pentegra is a NAFCU Preferred Partner for qualified retirement plans.

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