

Managing the 'Demise' of the Defined Benefit Plan

**With Special Guest:
Rob Tremper
Mohawk Paper Mills**

Lynda Sandersen
Bellwether Consulting LLC





Traditional Defined Benefit Plans

- ▶ ERISA qualified plan that provides a specified benefit level at retirement
- ▶ Employer guarantees benefit for each employee
- ▶ Employer bears investment risk
- ▶ Subject to mandatory insurance coverage by PBGC
- ▶ Minimum funding standards apply
- ▶ Employer contributions are tax deductible when made

A promise by an employer to make a specific stream of payments to an employee upon retirement



Pension Liability = Long Bond

Parallel Concepts, Different Names

Pension Plan

Plan Sponsor
Employee
Service Cost
Interest Cost
Plan Assets
Benefit Payment
Lump Sum Payment
Service Life
Funded Ratio
Discount Rate
ERISA
Plan Termination
PBGC

Bond

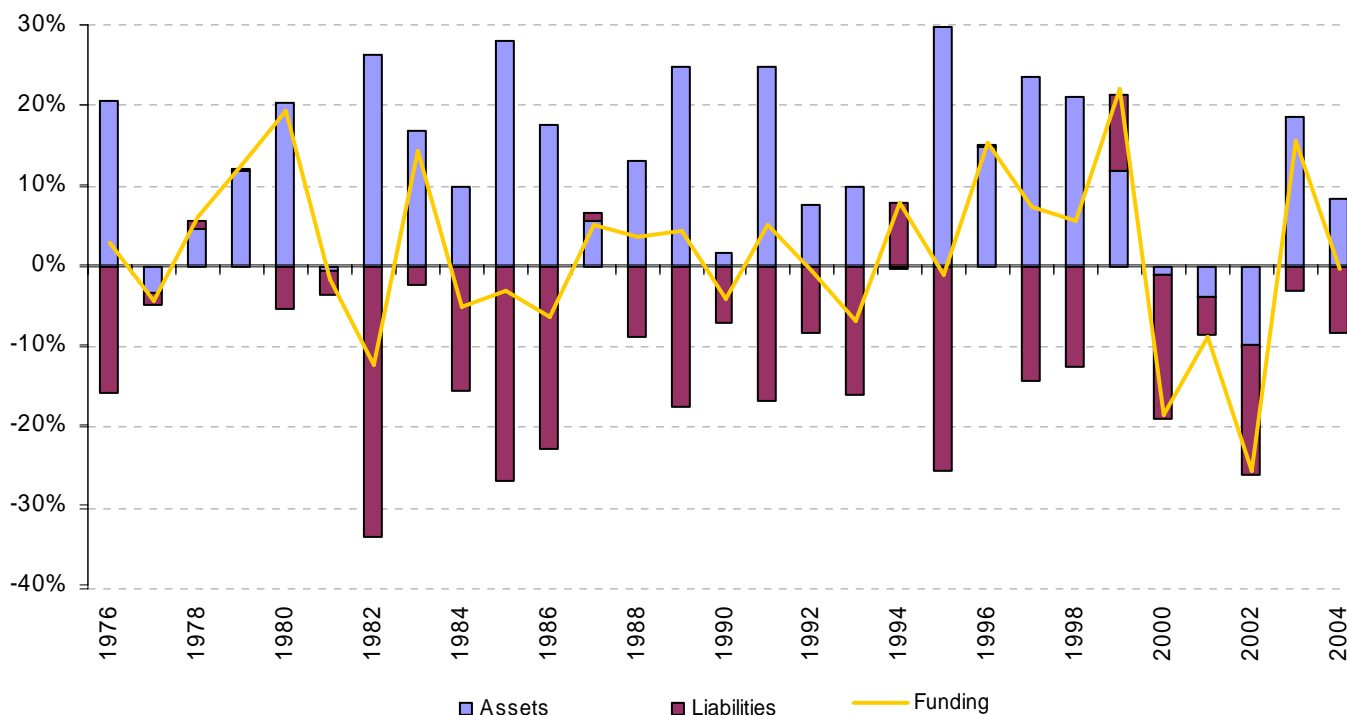
Issuer
Bondholder
More Bonds
Amortization
Sinking Fund
Redemption
Put
Duration/Maturity
Credit Risk
Market Interest Rate
Covenants
Call
Credit Enhancement



What Happened?

► Pension Crisis – The Financial Story

- Plan assets fell sharply as the stock market collapsed
- Plan liabilities rose sharply because interest rates declined
- Funding for many plans collapsed, requiring plan sponsors to book losses and increase cash contributions





Traditional Defined Benefit Plans

Advantages:

- ▶ Benefits are guaranteed by employer and PBGC
- ▶ Employer guarantee removes investment risk from employee
- ▶ Provides adequate retirement benefits for all employees regardless of age at plan entry



Disadvantages:

- ▶ Employer assumes risk of bad investment results
- ▶ Employer is subject to recurring annual funding obligation regardless of whether, in a given year, a profit is made
- ▶ More administratively complex and costly than qualified defined contribution plans (Requires actuarial services, minimum funding requirements, PBGC guarantee)
- ▶ Details can be difficult to communicate to employees



Traditional Defined Benefit Plans

Biggest Disadvantage to an Employer:

- ▶ Volatile funding and accounting based on asset and liability fluctuations.

Difficult for employer to accurately predict future funding requirements, making planning very difficult



- ▶ Keep the traditional Defined Benefit plan, but match investments to liability
- ▶ “Replace” the Defined Benefit plan
 - ▶ Cash Balance
 - ▶ Money Purchase
 - ▶ Profit Sharing
 - ▶ Target/Age-Weighted
 - ▶ 401(k)



A Case Study



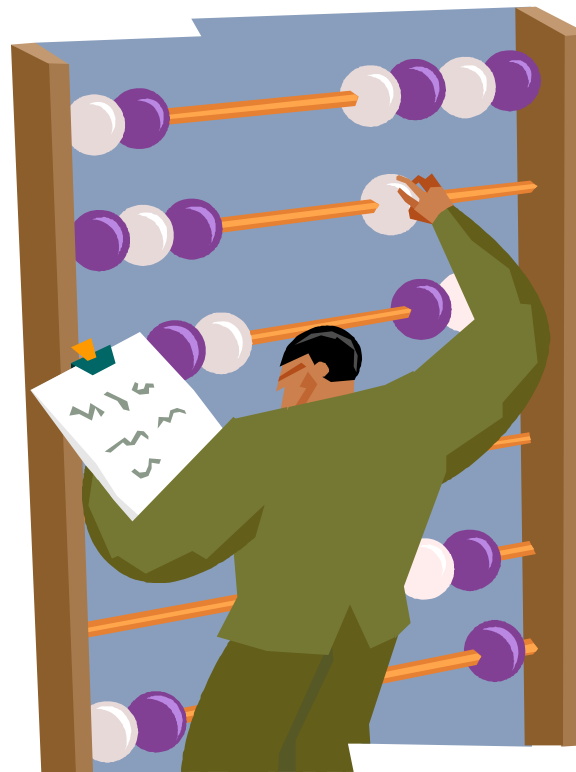


Replacement Alternatives

► Cash Balance Plan

Qualified plan that provides for annual employer credits at a specified rate to *hypothetical individual accounts* that are set up for each plan participant

- The hypothetical accounts are liabilities, not assets
- All assets are pooled in a single fund and back all liabilities
- Employer guarantees service credits AND minimum rate of return on each participant's account



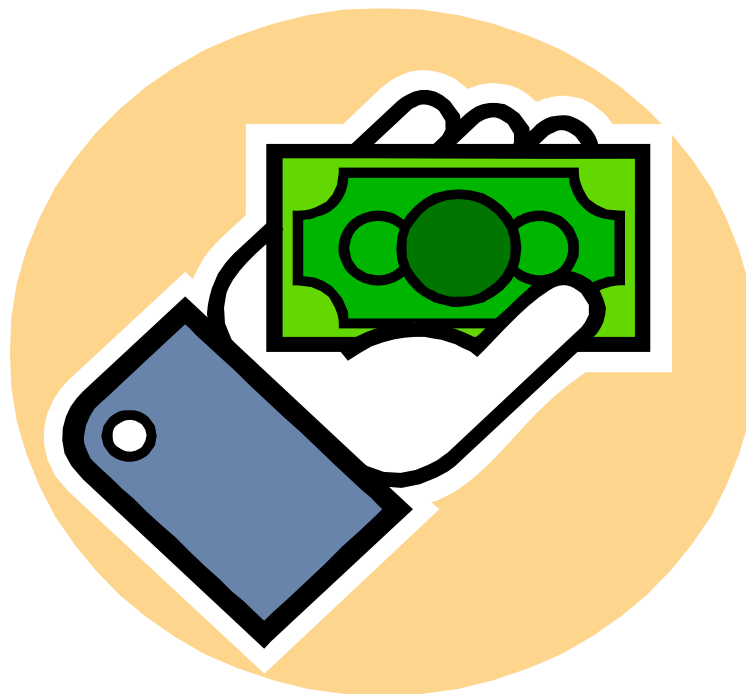


Replacement Alternatives

▶ Money Purchase Plan

Qualified defined contribution plan that requires *mandatory employer contributions* to individual employee accounts

- ▶ Employer makes annual contributions to each account under a nondiscriminatory contribution formula





Replacement Alternatives

▶ Profit Sharing Plan

Qualified defined contribution plan with flexible employer contribution provisions to individual employee accounts

- ▶ Employer's annual contribution can be purely discretionary, or based on a formula usually relating to annual profits





Replacement Alternatives

- ▶ Target / Age-Weighted Benefit Plan
Qualified defined contribution plan that allows higher contribution levels (as a percentage of compensation) for older plan entrants
 - ▶ Formula for annual employer contributions based on employee's compensation and age on entering the plan



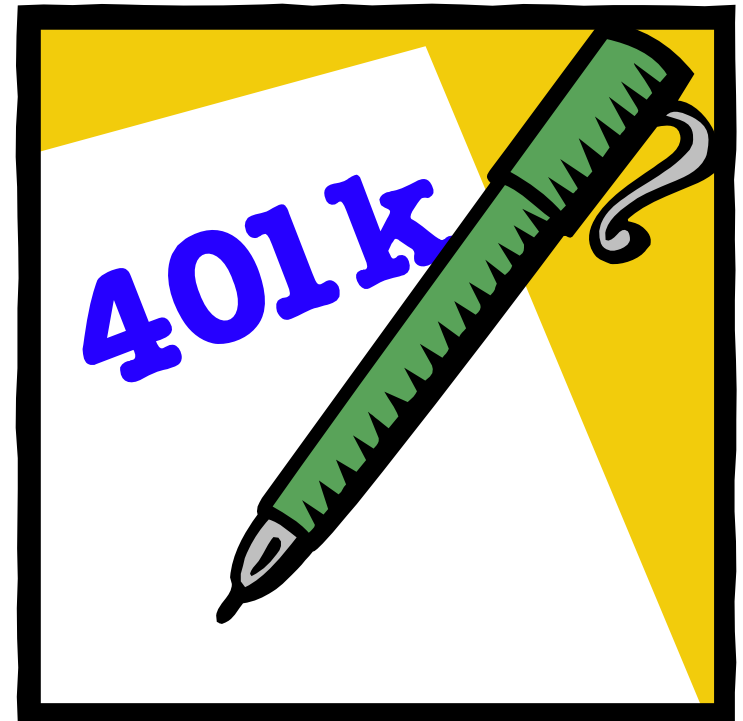


Replacement Alternatives

▶ 401(k) Plan

Qualified defined contribution plan that allows for *employer matching contributions* to individual employee accounts that accumulate employee contributions

- ▶ Can be set up as discretionary, which allows for the match amount to change from year to year





Caution

- ▶ Transition from a traditional defined benefit plan can adversely affect older workers.
 - ▶ Traditional pension benefits accrue much more quickly as employees near retirement age.
 - ▶ Age discrimination is often a focal point for objection to a transition, and can give rise to litigation.
 - ▶ The issue can be addressed by “age weighting” the funding formula or providing transition credits for older employees.





Retaining the Benefits of DB

- ▶ Participation Automatic
- ▶ Funding Consistency & Sufficiency
- ▶ Asset Allocation Strategy & Rebalancing
- ▶ Investment Oversight Professional Advice

How do you encourage good behavior?



Encouraging Good Behavior

- ▶ Give them Something for Nothing
 - ▶ Employer Contribution = “Free” money
 - ▶ Structure to encourage the highest contribution rate possible
 - 50% of first 6% of deferrals, instead of 100% of first 3%



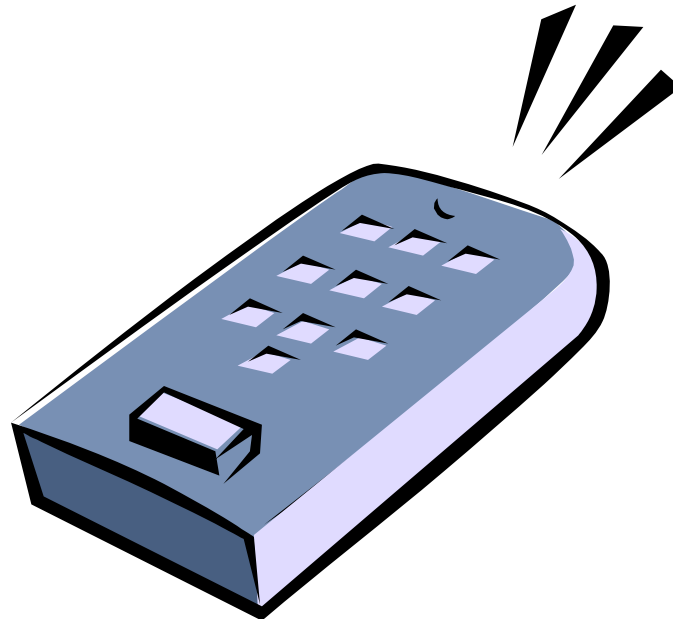


Encouraging Good Behavior

▶ Make it Automatic

▶ Takes advantage of inertia

- Enrollment
- Deferral increases for employee contributions
- Automatically managed

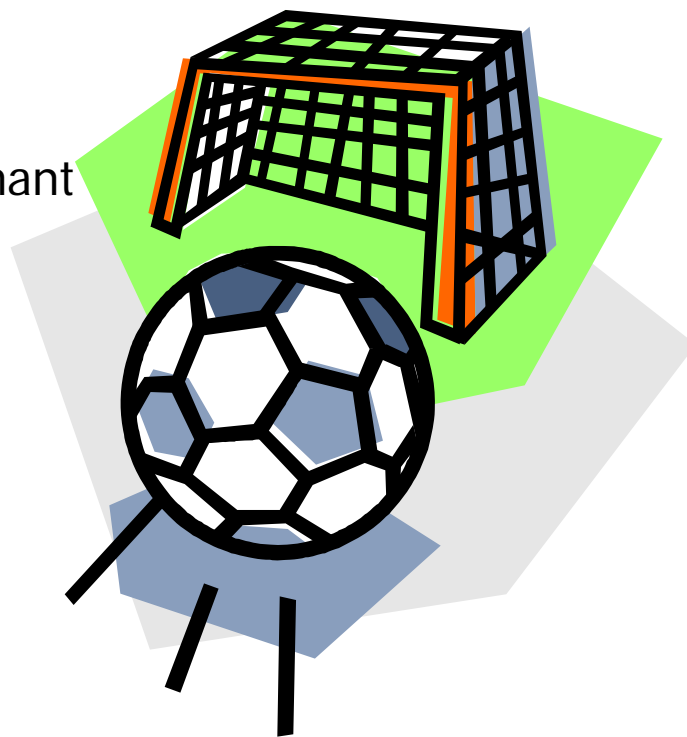




Encouraging Good Behavior

▶ Go for the Goal

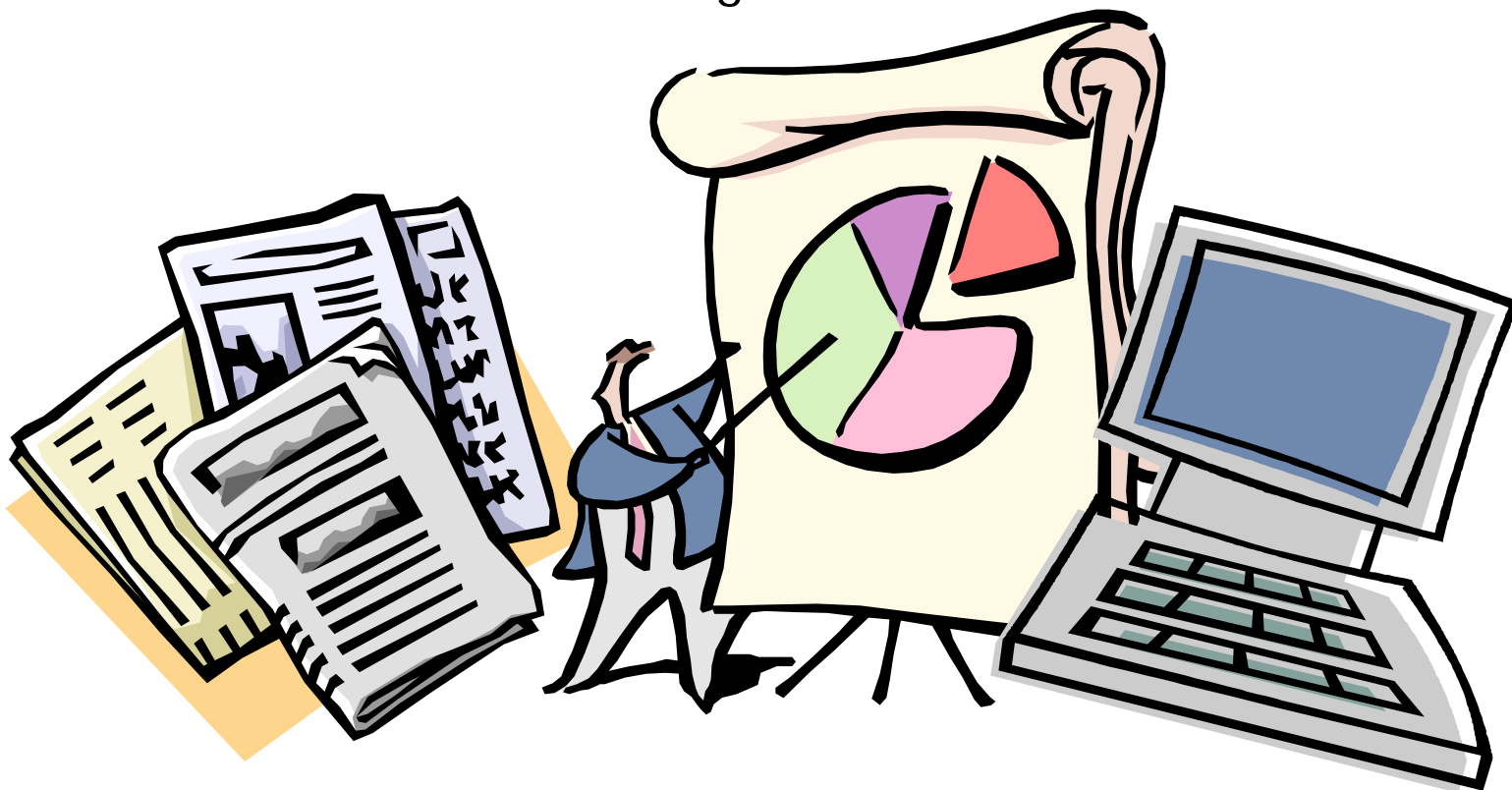
- ▶ Needs analysis and goal setting
- ▶ Lifestyle or Target Maturity funds
 - Automatically adjust allocation to more conservative mix as target date is approached
- ▶ Encourage smart diversification
 - Asset allocation important determinant of portfolio performance





Encouraging Good Behavior

- ▶ Communicate, communicate, communicate... and educate!
 - ▶ Multi-media
 - ▶ Model to aid decision-making



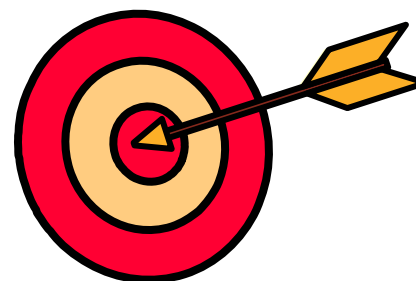


Good Behavior



▶ Start saving early

▶ Set goals



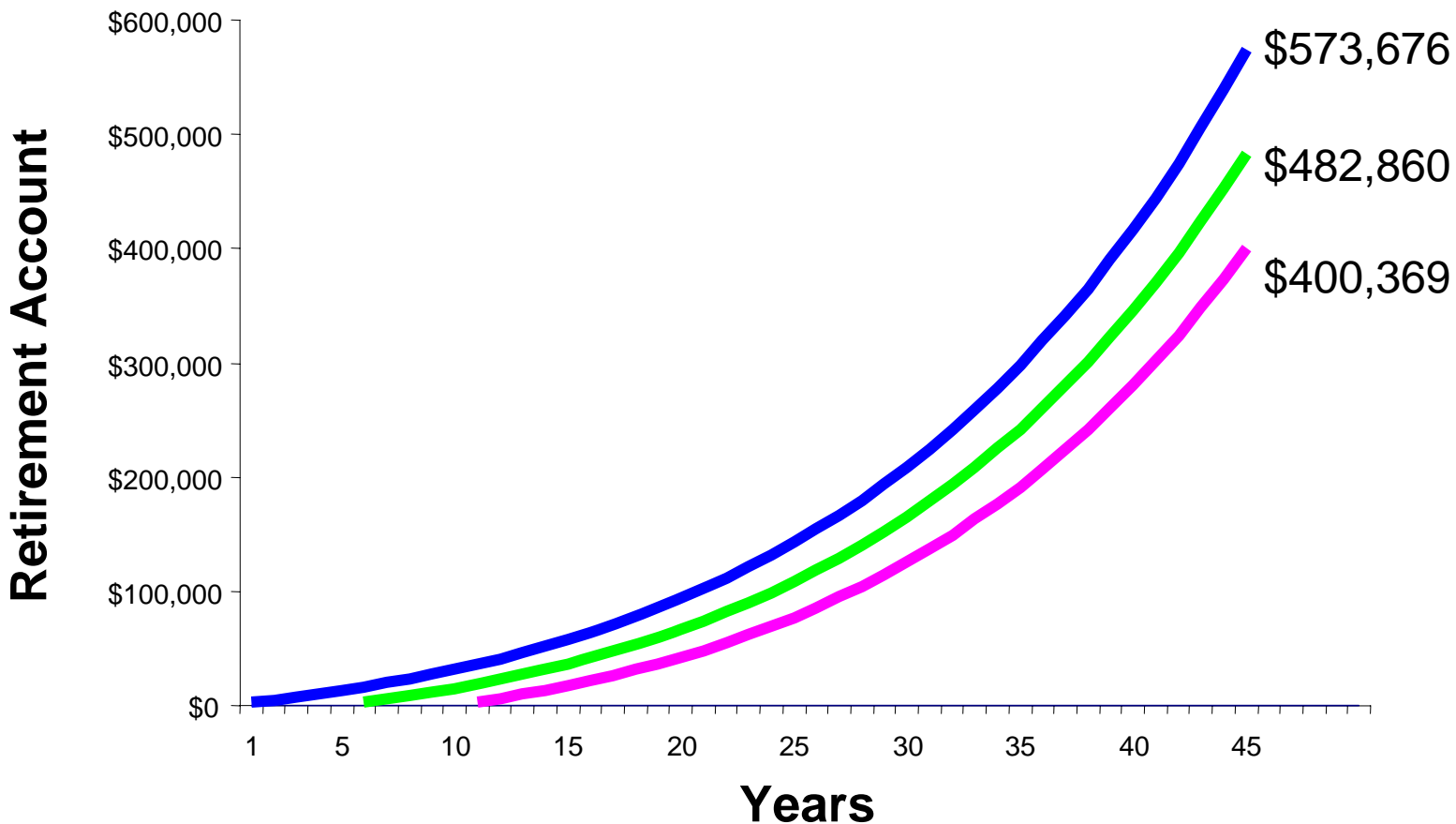
▶ Focus on asset allocation

▶ Take a whole portfolio view





It Really Makes a Difference



Assumptions: \$35,000 salary in year 1
3% employee deferral
5% investment return

3% annual salary increases (\$128,500 in year 45)
100% employer match on first 3% of employee deferral

Bellwether Consulting LLC is an SEC-registered investment adviser.

We focus on providing investment advice to retirement plan sponsors and other institutional investors, including investment policy formulation, asset allocation and asset-liability studies, investment manager selection, performance monitoring, and independent fiduciary support.

Please feel free to call for more information, or visit our website at www.bellwetherconsulting.net



Bellwether Consulting LLC • PO Box 140 • Montclair, NJ 07042-0140
Tel: 646.205.9346 • www.bellwetherconsulting.net