Defined Benefit Plans

A Critical Element in Employee Retirement Planning

Christian Brothers Services

Executive Summary

Employers today face a myriad of retirement funding options as they try to provide a safe and secure retirement benefit for employees. The number of choices available, combined with a fluctuating economy and budget limitations, can make finding a solution even more difficult for employers. For many organizations, the Christian Brothers Employee Retirement Plan (CBERP) is the solution they are seeking. The CBERP is a defined benefit plan that is both practical and appropriate for employers trying to meet their employee needs without unduly taxing their budget. At the same time, the CBERP protects participating employees from risks to their retirements associated with fluctuating markets.

What is a Defined Benefit Plan?

A defined benefit plan is an employer-funded source of retirement income from which employees are provided a fixed, monthly payment throughout their retirement. An employee does not normally contribute any money to a defined benefit plan but relies on the employer to fund the plan appropriately.

Businesses in the corporate sector have been moving away from defined benefit plans over the past 20 years. One reason for this is the Employee Retirement Income Security Act (ERISA), a federal law that regulates pension plans in private industry and imposes detailed requirements on various aspects of plan administration, including participation, vesting, benefit accrual, and funding. The legislation related to plan funding is particularly stringent for plan sponsors.

Advantages of the Christian Brothers Employee Retirement Plan

- "Church plans" such as the CBERP are not required to comply with ERISA regulations
- Although the CBERP voluntarily complies with many aspects of ERISA, including funding the benefits promised to employees, we tend to apply those rules that support the best interests of employees and employers
- Employers are offered several contribution rates, allowing them to select the one that best suits their retirement budget
- The employee receives a solid foundation for retirement that is not market dependent, allowing him or her to plan for retirement income with greater certainty

Challenges Associated with the Christian Brothers Employee Retirement Plan

- Employer assumes the financial risks associated with the Plan
- Maintaining a healthy funded status during significant market downturns

Board Actions to Confront these Challenges

Over the last few years the Pension Board has taken steps to improve the funded status of the Plan and reduce the underfunding in the Plan caused by the recent market losses that have affected all investments. These steps have included reducing the interest rate used in the actuarial valuation, elimination of the Golden Rule of 90 provision for new participants, and changing the Normal Retirement Date for new participants.

Investment Strategies to Reduce the Underfunding

With a market value of assets in the CBERP exceeding $1.3 billion—significantly more than most other church plans covering Catholic institutions—the Board has the opportunity to invest in alternative investment strategies, such as real estate, private equity, and other non-traditional strategies. The investment strategy provides more diversification which over time provides better returns with less risk.

Conclusion

The CBERP is a vital benefit to employees who have served and will serve the Catholic Church. The CBERP has provided retirement security for employees for over 50 years and will continue to do so into the foreseeable future.

Retirement Income Sources

Most retirement experts agree that an employee's retirement income should stem from a variety of sources, including but not limited to the following:

- **Christian Brothers Employee Retirement Plan (CBERP)**, which is an employer-funded defined benefit plan
- **Christian Brothers Retirement Savings 403(b) Plan (CBRSP)**, which is a defined contribution plan that allows an employee to save for retirement and personal savings accounts
- **Social Security Benefits**, which are funded by employee and employer

A combination of these vehicles can help ensure retirement income stability even if one element in the group fails to deliver as expected. For example, if a poor economy reduces the rate of return for employee retirement savings, the CBERP and Social Security can still generate significant retirement income. With the potential shortfalls projected with Social Security benefits, employer- and employee-funded plans will be essential to make up any shortfall.

Unfortunately, you may have heard that many employers are shying away from employer-funded options such as defined benefit plans, considering them too onerous and outdated. With pressure to reduce expenses, a number of organizations have eliminated or frozen existing defined benefit plans in order to save money.

We believe there are several advantages to offering a defined benefit plan as well as several disadvantages to freezing one. It is important to be aware that the CBERP has unique advantages over other types of defined benefit plans. Organizations should fully understand and appreciate the distinctions of this type of vehicle before making any long-lasting decisions.

- Freezing a defined benefit plan does not change the employer's obligation to fully fund the plan
- Eliminating a defined benefit plan may be detrimental to the long-term retirement security of employees
- An employer matching defined contribution plan only may not provide adequate benefits
- Future Social Security benefits may be uncertain

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What is a Defined Benefit Plan?

A defined benefit plan is an employer-funded source of retirement income from which employees are provided a fixed, monthly payment throughout their retirement. Unlike other retirement plans, including defined contribution plans, an employee does not normally contribute any money to a defined benefit plan but relies on the employer to fund the plan appropriately. Employers assume all the investment risks and thus protect their employees from unstable market performance.

Over the past 20 years, defined benefit plans have been losing favor with many businesses in the corporate sector. The Employee Retirement Income Security Act (ERISA)—a federal law that regulates pension plans in private industry and subsequent legislation have imposed detailed requirements on various aspects of plan administration, including participation, vesting, benefit accrual, and funding. Legislation related to plan funding is particularly stringent for plan sponsors. The law precludes a corporation from contributing to a defined benefit plan when the plan is significantly overfunded and mandates a minimum contribution when the plan is not. As a result, corporations cannot contribute "extra" money to a pension plan during economically fruitful times to anticipate economic downturns. Conversely, in challenging times, corporations are forced to make a minimum contribution to the plan—sometimes to the tune of millions of dollars. Rather than face the volatility inherent in pension plans, corporations are contemplating freezing or terminating these retirement vehicles.

Fortunately, "church plans" such as the CBERP are not required to comply with ERISA regulations. While the CBERP does voluntarily comply with many aspects of the ERISA, we tend to apply those rules that support the best interests of employees and employers.

For example, employers with a church plan must fund the benefits promised to employees but are not subject to the more stringent rules requiring funding in difficult times and no funding in good times. In the CBERP, we offer several employer contribution rates and the employer can select the one that best suits their retirement budget. The contribution rate does not have wide year-to-year variances that other defined benefit plans encounter when trying to satisfy the regulatory minimum contribution guidelines.

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Advantages of the Christian Brothers Employee Retirement Plan

As previously mentioned, by participating in the CBERP, a defined benefit plan, employees are protected from risks associated with fluctuating markets. Since employers assume the investment risk, employees will receive a defined monetary payment at retirement regardless of investment returns. This gives an employee a solid foundation for retirement that is not market dependent, allowing the employee to plan for retirement income with greater certainty.

The CBERP also shields employees from longevity risks. The CBERP pays the employee each month for the length of his or her lifetime, regardless of how long the individual may live, thus securing income across retirement. In addition, the Plan allows the participant to elect a benefit option at retirement that provides for the continuation of payments for a spouse or other designated beneficiary in the event of the employee's death.

Contrast this with a defined contribution plan which provides funds only until the account is depleted. Even if an individual has been able to save as much as $200,000 in his or her defined contribution plan, he or she may run out of money before passing away. If the employee lives until age 90, for example, the money needs to provide 25 years of retirement income, which could exceed the number of years the employee worked.

Organizations should note that the government is encouraging defined contribution plans to provide an annuity option to offer greater retirement income security, essentially making the defined contribution plan "act" like a defined benefit plan. However, purchasing an annuity is substantially more expensive through the defined contribution plan than providing this benefit in a defined benefit plan.

In addition to protecting employees from investment and mortality risks, the CBERP removes the burden of financial decision-making and investment monitoring from employees, allowing for professional management that better controls investment performance over the life of the plan. Studies show that investment results from professionally managed defined benefit plans outstrip those of managed defined contribution plans, benefitting both the employer and employee. Since the CBERP is a multiple employer plan the total assets are significantly greater than individual plans. This allows the Plan to incorporate more diverse investment vehicles, such as alternative investments and real estate, which could yield potentially higher investment returns with less risk. Most defined contribution plans have more limited investment options. Due to its larger asset values, the CBERP meets the breakpoints of investment managers which lower investment costs.

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Challenges Associated with the Christian Brothers Employee Retirement Plan

Despite the advantages, there are challenges for the CBERP. One of the most significant challenges is the fact that the employer assumes the financial risks associated with the Plan. We have identified this as a benefit to the employee, but this can present a challenge for the employer. A participating employer needs to fund the Plan on a continuing basis. When the Great Recession occurred in 2007-08, employers needed to continue to make contributions into the CBERP in the midst of other financial challenges. Many employers that offered solely a defined contribution plan, such as a 403(b) or 401(k) plan, could choose to suspend their employer matching or discretionary contribution. All this did was shift the burden from the employer to the employee – most likely at a time when they were ill-equipped to take on the burden. Employers are generally better equipped than employees to weather long-term downturns in the market, helping to ensure the prospects of retirement for their employees.

The greatest challenge to the Plan is maintaining a healthy funded status. This can be difficult in significant market downturns, such as what occurred in 2007-08. The Plan was overfunded (i.e. more than 100 percent) as of the July 1, 2007 actuarial report, but suffered a significant downturn the following year due to negative investment returns – which affected all investments, not just those of the CBERP. A fact that is typically overlooked is that during this period employees participating in a defined contribution plan had their account balance diminish to the point that his/her targeted retirement date would need to be pushed out into the future. Neither the defined benefit plan nor the defined contribution plan is immune to market downturns. For the defined benefit plan, the investment loss needs to be made up over time but the participant's benefit is protected. The Board has taken a number of steps to reduce the underfunding in the Plan caused by the market losses.

Board Actions to Confront these Challenges

While the CBERP has its challenges, they are not insurmountable. Over the last few years the Board has taken steps to improve the funded status of the Plan. Unfortunately these changes will take time to fully alleviate the funding challenge. The following are some of actions the Pension Board has enacted over the last few years:

- July 1, 2010: Reduced the interest rate used in the actuarial valuation from 8 percent to 7.5 percent
- July 1, 2012: Eliminated the Golden Rule of 90 provision for new participants
- July 1, 2012: Changed the Normal Retirement Date for new participants to mirror that of Social Security
- July 1, 2012: Adopted the PPA mortality table
- July 1, 2013: Changed the salary assumption from 4.5 percent to 3.0 percent
- July 1, 2014: Required employers to increase their funding or reduce their benefit formula prospectively
- July 1, 2015: Implemented a withdrawal liability

While the CBERP has its challenges, they are not insurmountable. Over the last few years the Board has taken steps to improve the funded status of the Plan.

The changes in interest, mortality and salary increases are not plan changes which affect benefit accrual. Rather these changes value the liabilities on a more conservative basis. In making these changes, the actuaries not only looked at what other church plans were doing, but also reviewed the actual experiences for the Plan. For example, the investment return for the Plan over the last 25 years was 9.4 percent annually. This is the real investment return over that period of time. While short term investment performance may vary, the actuaries, along with the investment consultant, believe achieving a 7.5 percent investment return over a longer period of time is reasonable. The change in the mortality table used was also a more conservative approach for valuing the liabilities for the Plan. These more conservative assumptions initially increased the unfunded status of the Plan on an actuarial basis but will likely limit future increases in the unfunded status since experience is expected to more closely match the revised assumptions.

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- The greatest challenge to the Plan is maintaining a healthy funded status. This can be difficult in significant market downturns, such as what occurred in 2007-08
- Neither the defined benefit plan nor the defined contribution plan is immune to market downturns

The market value of CBERP assets exceeds $1.3 billion. Most other church plans covering Catholic institutions have significantly lower assets.

The actual Plan changes relating to the elimination of the subsidized early retirement benefit (Golden Rule of 90) and changing the Normal Retirement Date for new hires, along with the changes in the benefit formula and corresponding contribution rate have reduced the normal costs (i.e. the cost for benefits accruing over a one year period.) These changes are expected to eliminate further erosion in the funded status assuming the actuarial assumptions of the Plan are met. Ultimately eliminating the underfunded amount that has already occurred due to market losses can only be achieved through market gains. The Pension Board, in working with the investment consultant, has developed an investment strategy to reduce the underfunding status over time.

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- The Pension Board, in working with the investment consultant, has developed an investment strategy to reduce the underfunding status over time

Investment Strategies to Reduce the Underfunding

Historically the CBERP had the traditional split between equities and fixed income. This had served the Plan well for a long period. Over the years, the Pension Board commissioned the investment consultant and actuaries to perform stochastic forecasts using Monte Carlo simulations to project the funded status into the future. The Board requested and reviewed such a forecast at their spring meeting in 2007. The study showed that even under bad circumstances the Plan would be in a well-funded, albeit slightly underfunded position into the foreseeable future. It is important to understand that dramatic changes occur when you have significant market events such as the Great Recession. The study did not assume a loss of more than three standard deviations. When the studies were run a few years later the picture was not as rosy. The Board determined that the traditional investment strategy made up solely of equities and fixed income created undo risk. Many retirement plans have a significantly higher ratio of retirees to active participants which forces them to invest in more conservative investments, such as fixed income. In this interest rate environment, it is difficult to achieve significant investment returns with that strategy. In comparison to multi-employer plans, the ratio of inactive participants to active participants significantly exceeds other multi employer plans. The good news is that the CBERP does not face this dilemma and can continue to invest in return seeking funds. Another positive for the CBERP is that the market value of CBERP assets exceeds $1.3 billion. Most other church plans covering Catholic institutions have significantly lower assets. This level of assets provides the Board with the opportunity to invest in alternative investment strategies, such as real estate, private equity, and other non-traditional strategies. The investment strategy can be more diversified which over time provides better returns with less risk. Plans with lower asset values are somewhat hamstrung from investing in these types of securities due to minimum asset requirements and locks on withdrawals.

- The good news is that the CBERP does not face the dilemma of inactive participants significantly exceeding active participants and can continue to invest in return seeking funds
- The level of CBERP assets provides the Board with the opportunity to invest in alternative investment strategies, such as real estate, private equity, and other non-traditional strategies

The CBERP removes the burden of financial decision-making and investment monitoring from employees, allowing for professional management that better controls investment performance over the life of the plan.

Over the last few years the Pension Board has diversified the portfolio in the following manner:

Change	Rationale
(2010) Increased relative foreign equity allocation and broadened active non-US equity allocation to include emerging markets	Increase foreign diversification and opportunity set for active management
(2011) Conservative, core real estate allocation	Alternative to fixed income; slightly increase expected return at comparable overall risk
(2014) Broadened international index fund to include small cap stocks	Marginally increase returns and diversification by including foreign small cap stocks
(2015) Allocation to GMO Benchmark-Free Fund	Add diversification and flexibility to investment program in low-returning environment; outperform a 60/40 mix of stocks and bonds over time
(2016) Initiated allocation to Private Equity	Outperform public market stocks over time, while adding diversification
(2016) Allianz Structured Alpha	Deliver returns in excess of S&P

The Future

The more proactive an organization is in designing and maintaining a defined benefit plan, the better the plan is able to weather changing market pressures. As detailed above, the Pension Board has made significant plan design changes over the years. At this point in time, the Pension Board is not planning on making any significant changes in the plan design. The Board is monitoring how the changes already made are affecting the funding of the Plan. The Board will make future changes if needs arise. The Board is considering establishing trigger points—such as a certain funded percentage—that would launch a change in plan design. This would allow the Board to respond quickly to changes before they negatively impact the ability to support the plan.

Conclusion

The most important attribute in determining the success of the CBERP is the commitment of the Pension Board to understand its obligations and monitor plan performance. The Board has affirmed that they have no intention of terminating or freezing the CBERP. The Plan is a vital benefit to employees who have served and will serve the Catholic Church. The CBERP has protected employees for over 50 years and will continue to do so into the foreseeable future.

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