

Before the Pension Protection Act (PPA), trustees were concerned with avoiding short-term funding deficiency (credit balance equals zero) while ensuring their plans met long-term objectives. Now, trustees are strongly encouraged to monitor their plans' funded status to avoid having their plans be considered "endangered" or "critical." The key for multiemployer plan trustees is to move away from traditional asset management models to a new model focused on dynamic asset management aligned with the goals of plan management.

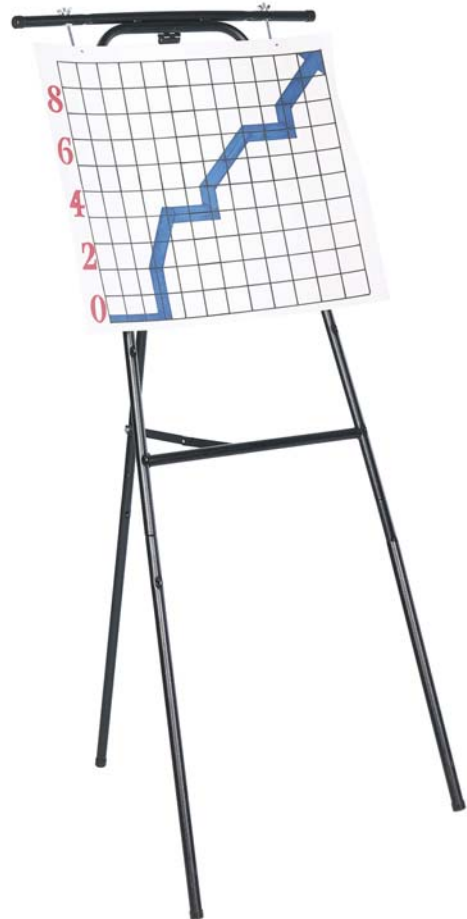
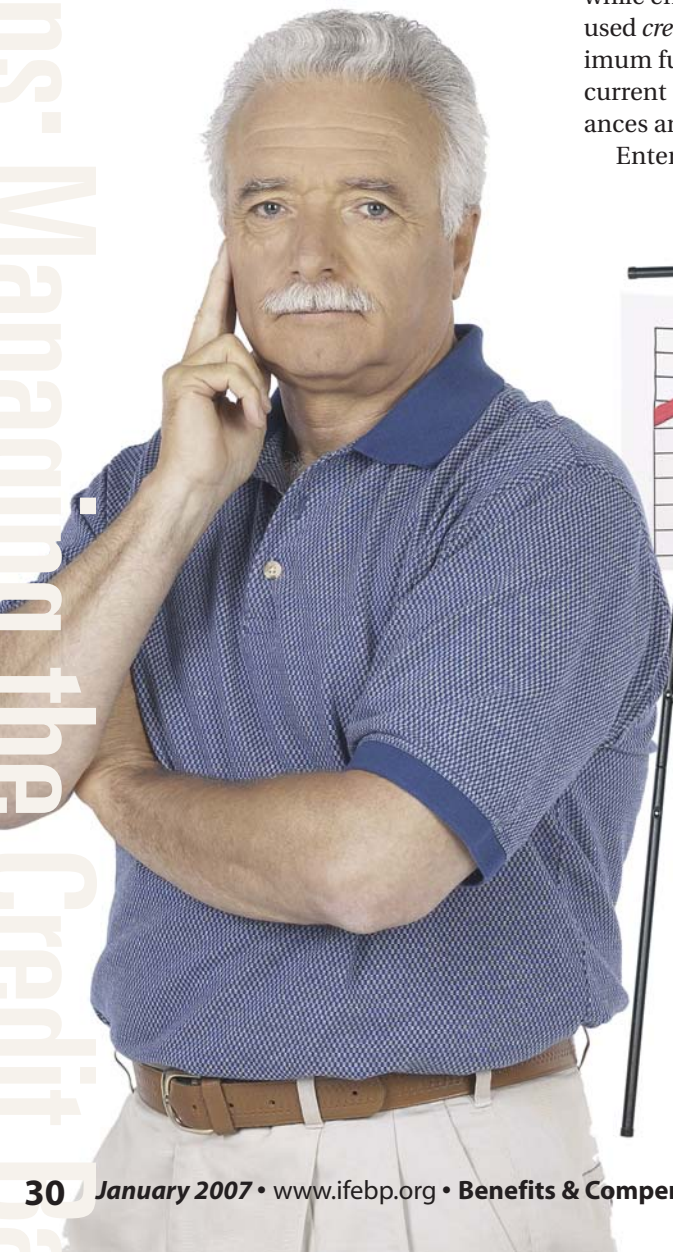
Multiemployer Plans: Managing the Credit Balance

by Jeffrey Sparling

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For multiemployer pension trustees, the recently passed funding reform adds to the complexities inherent in pension plan management. Prior to reform, trustees concerned themselves with avoiding a short-term funding deficiency while ensuring the plan met long-term funding objectives. In recent years, funds have used *credit balances* (the aggregate amount of contributions made in excess of the minimum funding requirements) to meet minimum funding requirements because their current contribution rates were insufficient to do so. Therefore, once these credit balances are depleted, funds experience a funding deficiency.

Enter the Pension Protection Act (PPA), and trustees are now strongly encouraged



to also monitor their plan's funded status to avoid being labeled "endangered" or "critical." Placement in one of these categories results in significant restrictions on the plan, requiring the creation of a strategy to get out of these categories, and new disclosures to members. The criteria for reaching endangered or critical status is based on a combination of a funding deficiency in the near term and/or funded status below a certain threshold.

This added complexity and increased scrutiny of funding status creates an environment that demands trustees effectively budget for market volatility. The key for multiemployer plan trustees is to move away from traditional asset allocation and investment models to a new model focused on dynamic asset management aligned with the goals of plan management.

The Traditional Model: What Went Wrong

Many of the plans in trouble today were overfunded and increased benefits during the 1990s. The change in fortune these plans later experienced can primarily be attributed to inadequately diversified portfolios and the misguidance of the pre-reform regulatory environment. These two factors were further amplified by the fact that the traditional plan management model was not dynamic enough to enable trustees to effectively forecast the impact these factors would have on plans.

Until recently, a common characteristic of multiemployer plan portfolios was an asset allocation of 50-70% in domestic equities, with the remainder of the assets invested in bonds. During the late 1990s, funds with this asset allocation experienced tremendous growth. However, the concentration of fund assets in these asset classes also led to large declines in value when the domestic equity market began to falter. The plans could have better controlled the volatility if they had increased diversification and integrated other asset classes such as hedge funds, international equities or real estate into their portfolios.

The volatility experienced by these plans highlighted the misguidance that prereform regulation offered. When the domestic equity markets were flourishing and plans were enjoying substantial returns on their investments, regular participant contributions caused plans to be more than 100% funded. As a result, trustees were ob-

ligated to increase plan benefits to ensure that participant contributions would remain tax-deductible. These increases were also used to offset investment gains. In addition, plans were locked into increased liabilities (amortized over a 30-year period) well after they had fully amortized the impact of their investment gains (amortized over a 15-year period). Recognizing this misguidance, PPA now permits plans to be up to 140% funded, and the amortization period for plan changes has been reduced to 15 years in order to match the period for gain/loss amortization. However, and unfortunately for many plans, these changes have come too late to be of any assistance in the short term.

The two issues discussed above had significant negative impacts on previously healthy plans. The impact was actually worse than expected because trustees and their advisors could not accurately forecast the effects of such circumstances on the plan. With this view, some plans actually continued to increase benefits into the early 2000s. The traditional model for managing multiemployer plans was not integrated enough to allow trustees to forecast these misadventures. With responsibilities traditionally spread across actuaries, consultants, investment managers and trustees, it is very difficult to take a holistic view of the pension plan. A more integrated approach would have allowed for better forecasting which would have identified a declining credit balance. This would have allowed for trustees to take a more cautious and strategic approach when increasing benefits.

Case Study: Poor Management of Market Volatility Can Put Plan at Risk

For example, look at a historically strong and overfunded multiemployer plan with over 1,500 participants. During the late 1990s, the plan was over 100% funded. Based on its funding status, the plan contributions required by the Employee Retirement Income Security Act (ERISA) were less than the plan's negotiated contributions. Trustees continued to grow the plan and often were required to increase benefits for participants to ensure that their contributions were tax-deductible, resulting in increased overall liabilities of the plan.

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Between 2001 and 2004, poor financial markets resulted in a significant decrease in the plan's assets. The decrease in assets, coupled with higher liabilities, created a funding gap that began to raise the plan's minimum contribution. The plan's credit balance was used to offset the growing gap between the minimum contributions and negotiated contributions. However, the gap was understated due to favorable actuarial smoothing rules, which allowed the use of asset values based on averages from the bull market five years earlier. As a result of the perceived smaller funding gap, minimum contributions remained low and the credit balance was not significantly drawn down. In addition, trustees actually increased benefits in 2003 because their current model for management did not forecast the potential problems they were yet to experience.

Today, the plan is in significant trouble. As market volatility persisted, the benefits of smoothing decreased, funding levels dropped significantly and the plan's credit balance has eroded. In retrospect, the plan management model failed to alert trustees because it did not budget for market volatility. Last year, trustees were forced to cut benefits by 85% because of market volatility that caused a significant decrease in assets. This benefit reduction then caused a strain on recruiting new members. To make matters worse, the plan's actuary assumed the plan would meet the assumption rate for 2006 and instructed trustees to increase benefits to about half of what they had previously been. Although typical practice is to use this standard assumption, the investment management strategy was not changed to align with this goal. Recently, when the actuary revisited this case and realized the plan might not meet the return assumption, he recommended that the trustees retract their promise to plan participants to increase benefits.

New Rules Mean Multiemployer Plan Trustees Need a New Approach

The above case study points out a significant shortcoming in the traditional approach to multiemployer plan management—It is not designed to manage both short-term funding deficiencies and long-term funded status objectives. During positive markets, plans would, on average be able to meet aggressive actuarial as-

sumption rates (7% to 8%), with limited use of credit balances. More recently, the persistence of market volatility and the disappearance of the turn-of-the-century bull markets have created a significant shortfall of expected contributions, resulting in projected funding deficiencies. Actuaries are instructing plans to make significant changes (contribution increases and/or cuts in benefits) before their credit balances go to zero and cause a funding deficiency. Additionally, recently passed pension reform has added to the complexity by requiring the ongoing management of funded status.

Multiemployer plan trustees have truly entered a new world when it comes to plan management. Ongoing concern about funding deficiencies has led to the need to better manage credit balances, and multiemployer plans are now required to monitor their funded status on an annual basis. The traditional management approach does not meet either of these requirements and multiemployer trustees should consider a new approach to plan management in the following key areas.

Credit Balances and Funding Deficiencies

Multiemployer trustees can no longer afford to manage funding deficiencies by relying on returns to meet a specified actuarial assumption. The new approach should be to focus on forecasting the credit balance and determining the short-term risks that need to be addressed. For example, if forecasting suggests that a funding deficiency is a short-term possibility, trustees might want to consider that stable returns are more important than meeting an assumed return for a given year.

There are two types of forecasting—deterministic and stochastic. *Deterministic forecasting* is based on specific inputs and does not take into account random variation. Rather, it provides a fixed and precisely reproducible result. Thus, trustees can forecast their plan's credit balance by determining specific estimates for inputs such as participant hours, contribution rates and return on investments over a period of years. This gives trustees the ability to perform stress tests on certain conditions to determine the impact that a change in inputs will have on the health of their fund. For example, if a local union was between projects and knew that participant hours

would be less than the actuarial assumption, it would be aware that it might need to take corrective action to offset the reduction in participant hours.

Stochastic forecasting is a statistical process that uses probability and random variables to predict a range of probable investment performances. A stochastic forecast involves running thousands of economic scenarios (yield curve changes, interest rate changes and different inflationary environments) to come up with a probability range of investment returns. These investment returns can then be used to forecast the probability that certain health measures (for example, credit balance, funded status) will fall within a given range. For example, trustees using stochastic forecasting can determine the probability that they will be successful in avoiding a funding deficiency given their current asset allocation. Both types of forecasting are critical because they help trustees understand the impact of factors within their control on the overall health of the plan.

Funded Status

Multiemployer trustees can no longer afford to follow traditional asset allocation strategies and expect that approach to yield returns that are consistently aligned with funding needs. The new approach requires new and unique asset allocation strategies, such as alternative asset classes, that can effectively budget for market volatility while providing long-term growth. Trustees must be focused on funded status thresholds and how they can protect the plan from "endangered" or "critical" status. For example, if a plan is in danger of falling below the 80% funding threshold and being categorized as "endangered," trustees might want to consider an asset allocation that sacrifices some return to protect downside.

If plans are underfunded, traditional asset allocation models become even more detrimental and plan trustees need to adopt an approach that enables the ongoing and dynamic management of the plan. Take the scenario of a plan that is 65% funded and has already decreased benefits and increased contributions so that it can reach a funded status target of 80% within ten years. The fund already has a fully diversified global portfolio consisting of 55% equities and 45% bonds. The expected return for this portfolio is

7.5% and standard deviation (risk) is 10.6%, which would put the plan on pace for the target goal.

However, actively managing the plan allows the consideration of new investment products. By allocating a portion of the fund's assets to hedge fund of funds and private equity investment classes, the fund will improve its expected return to 8.2% and lower its standard deviation to 10.5%. Therefore, by adding alternative investment classes, this fund is able to boost its expected return without adding additional risk. This additional return will help the fund reach funding targets quicker than the expected ten years.

Stochastic models have shown that once this fund reaches its 80% funded status, it would benefit from lowering its equity allocation and therefore its exposure to risk. Active changes to the asset allocation will benefit the funded status of the plan and make the plan less likely to once again fall below this critical funded status threshold.

Conclusion

In the “new” world, multiemployer plans can no longer afford to continue to

implement the traditional model for plan management. Moving forward, trustees can and should build long-term strategies for managing funding deficiencies and funded status by integrating all plan management functions. This will allow for ongoing management with dynamic asset allocation strategies that will change as certain goals are met.

By designing an asset allocation strategy that integrates and aligns numerous components of the plan—such as contribution requirements, future contribution expectations, credit balance and overall liabilities—trustees can develop a

strategy to control the ongoing volatility. This will allow for the protection of the credit balance and long-term prosperity of the plan. **B&C**

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