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NewsLetter

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Multiemployer Defined Benefit Plans in a Time of Crisis: Keeping a Long-Term Perspective

The dramatic price declines and increased volatility experienced throughout worldwide capital markets in 2008 is having, and is likely to continue to have, a significant negative effect on defined benefit plans. This *NewsLetter* discusses the consequences of these developments and emphasizes the importance of keeping a long-term perspective as multiemployer plan trustees grapple with current conditions and look ahead to developing solutions to cope with the effect on their plans.

Losses, the Recovery Challenge and Implications

There were very limited opportunities to achieve a positive rate of return in the market during 2008, as shown in the table below. For an illustration of the magnitude of asset losses that have occurred and are continuing — and what it will take to recover from them — consider a plan that experienced a decline in asset value of 25 percent during 2008, from $700 million as of December 31, 2007 to $525 million by December 31, 2008. To get back to $700 million, assets would have to grow by 33 percent (*not* 25 percent).[1] From an actuarial perspective, recovering from these negative

[1] It will always take a greater percentage gain to offset a loss because the starting point is now a much smaller number.

2008 Returns for Selected Equity and Fixed-Income Indices

Equity Indices		Fixed-Income Indices	
Standard & Poor's 500	−37.0%	Barclays Capital Aggregate	5.2%
Russell 3000	−37.3%	Barclays Capital Government/Credit	5.7%
Russell 1000	−37.6%	Barclays Capital Intermediate Government/Credit	5.1%
Russell 1000 Growth	−38.4%	Barclays Capital Long-Term Government/Credit	8.4%
Russell 1000 Value	−36.9%	Barclays Capital Government	12.4%
Russell 2000	−33.8%	Barclays Capital Credit	−3.1%
Russell 2000 Growth	−38.5%	Barclays Capital Mortgage	8.3%
Russell 2000 Value	−28.9%	ML High-Yield Master II	−26.4%
MSCI EAFE (net)	−43.4%	Citigroup Non-U.S. WGBI (unhedged)	10.1%
MSCI ACWI ex-U.S. (net)	−45.5%	Citigroup Three-Month T-Bill	1.8%
MSCI EM (net)	−53.3%		

This table was created by Segal Advisors, The Segal Company's SEC-registered investment consulting affiliate. For more information about investment performance, see Segal Advisors' quarterly publication *Synopsis*, which is available on the Segal Advisors Web site: www.segaladvisors.com

In March 2009, The Segal Company will be conducting complimentary seminars across the country that will focus on current issues for multiemployer retirement plans. The seminars will be held in the following cities: Boston, Chicago, New York, Oakland and Washington, DC. To register to attend one of these seminars, visit the following page of Segal's Web site: www.segalco.com/me_seminar.cfm

Segal's Web site has been redesigned to include a new look and feel, improved navigation and interactive features. Please visit the site — www.segalco.com — and register to receive future issues of Segal's *NewsLetter* and other publications of interest to trustees of multiemployer plans and the professionals who serve them.

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rates of return will be even more challenging, given that each fund is expected to earn an assumed rate of return each year and typically uses an asset valuation method that gradually recognizes market value fluctuations. However, by law, the actuarial value of assets must be within 120 percent of the market value. The magnitude of the market losses has mitigated some of the impact of the gradual recognition. Even if the market has a relatively significant recovery in 2009, a fund's investment performance would have to exceed the assumed rate of return by more than the amount by which the 2008 rate of return fell short of the assumed rate to "offset" the damage done in 2008.

Expectations formulated when the initial actuarial certifications required by the Pension Protection Act of 2006 (PPA'06) were completed[2] have likely changed because of what happened in the market, especially in the fourth quarter of 2008. The market downturn will have an adverse effect on the next PPA'06 certifications for virtually all plans. This is true even though the actuarial value of assets, rather than the market value of assets, is used to determine the PPA'06 funded percentage of a plan. The actuarial value of assets is usually measured based on a gradual recognition of market value fluctuations. Unless and until there are market gains to offset the losses that have occurred in 2008, the actuarial value of assets will also decline over time. Even if there are extraordinary investment gains in future years, those gains, like the 2008 losses, will be recognized gradually.

Plans in the green zone in 2008 may find themselves in the yellow zone or red zone in 2009. Even plans that remain in the green zone in 2009 are likely to find themselves closer to one or both of the triggers for yellow zone status, and may be facing loss of green zone status at some point in the near future unless there is a significant market recovery in 2009. Plans already in the yellow zone or red zone will likely be confronted with a worsening situation, perhaps affecting the ability to pay benefits.

Time is the key element. Because of the somewhat gradual recognition of market losses through the actuarial smoothing techniques applied to the value of plan assets, multiemployer plans have some time — perhaps to have contribution rates or benefit levels adjusted or to allow the market to recover — to help moderate the problems related to losses in market value.

PPA'06 Compliance Relief

In recognition of the magnitude of the difficulties facing pension plan sponsors due to 2008 market conditions, a special session of Congress passed emergency pension relief just before the end of 2008: the Worker, Retiree and Employer Recovery Act of 2008 (WRERA).[3] The law, which was signed by the President on December 23, 2008, allows trustees of multiemployer plans to elect a

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one-year freeze in their plans' zone status. (Most plans' status would stay at the 2008 level; for plans with plan years that began in the last quarter of 2008, the frozen status would be based on the plans' situation at the end of 2007.) Certifications of actual 2009 zone status will still be required for plans that officially freeze their zone status. Plans that are officially in the red or yellow zone for 2008 or 2009 (after taking the freeze into account) can extend their funding improvement and rehabilitation periods by three years. For many plans, the choice of which relief measure to elect can be a difficult one.[4]

At the time this *NewsLetter* went to press, the prospects for additional, broader pension relief were uncertain. Legislation had not yet been introduced in the new Congress.

Understanding Future Implications: Projections

The first 2009 certifications will not be due until the end of March for calendar-year plans (*i.e.*, by the end of the first 90 days of the plan year). Projections, beyond those required for 2009 certification, can provide helpful information to trustees. For example, these projections could assist the bargaining parties in establishing appropriate contribution rates when a collective bargaining agreement renews before a Funding Improvement Plan or Rehabilitation Plan is established.

[2] PPA'06 requires trustees of multiemployer plans to review projections of the plans' financial status at least annually in order to identify emerging funding challenges so they can be addressed effectively. If the actuary's projections, reported in a certification, reveal an emerging funding problem, a plan is classified as being in either "endangered status" (colloquially referred to as being in the yellow zone) or "critical status" (nicknamed the red zone). Plans with funding status that is neither endangered nor critical are considered to be in the green zone. According to Segal's Fall 2008 *Updated Survey of Plans' Actual Zone Status* (http://www.segalco.com/publications/surveysandstudies/fall08zones.pdf), 80 percent of surveyed plans were in the green zone, 12 percent were in the yellow zone and 8 percent were in the red zone.

[3] The multiemployer relief in the WRERA responded to the initiative of leaders in the multiemployer community and the Multiemployer Pension Coalition of unions, employers and funds, led by the National Coordinating Committee for Multiemployer Plans, which played a central role in pressing for the special multiemployer rules in PPA'06.

[4] For details on the key multiemployer provisions of the WRERA, see Segal's December 2008 *Bulletin*, "Pension Relief Bill's Provisions Affecting Multiemployer Plans": http://www.segalco.com/publications/bulletins/dec08pensionrelief.pdf

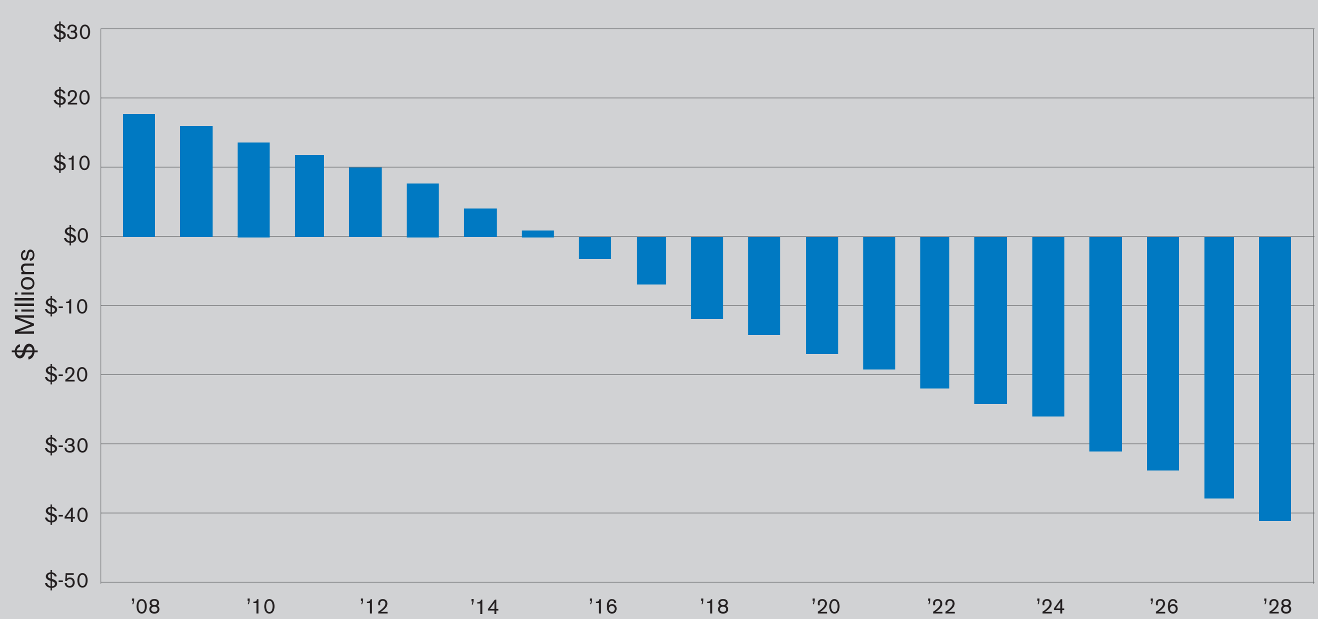
There are two types of projection techniques. A deterministic projection is one that is based on a single set of assumptions, produces one result and is often used to measure the effect on one aspect of a plan (*e.g.*, Scheduled Cost[5]) when something else is changed (*e.g.*, a plan provision or a contribution rate). Stochastic modeling, which is sometimes referred to as Monte Carlo simulation, consists of many different deterministic projections where all assumptions about the future are held constant except for the investment return.

Using deterministic projection techniques, as PPA'06 requires, or the more robust techniques of stochastic modeling, can measure the effect of market volatility and decline for a particular plan, taking into account its design and demographic characteristics. Because the only sources of a multiemployer pension plan's income are contributions and the investment earnings on plan assets, measuring how a plan has been affected by recent market conditions is key. Analyzing how contribution requirements change under various scenarios (*e.g.*, market fluctuations and different levels of employment) can be viewed as one way to examine a plan's risk profile. Such analysis provides insight to the trustees about how the cost of the plan will react to differing sources and levels of stress imposed on it. Although final investment results for the 2008 year may not yet be available, using some estimate of year-end results, will allow for a preliminary assessment of the various measurements critical to PPA'06 or any others of importance to the trustees. As noted above, even if a plan is projected to remain in the green zone for 2009, these projections may provide an "early warning" of a change in zone status that is projected to occur in the near future.

Graph 1 below is a sample output of a deterministic projection. It shows how one plan's credit balance is projected to change over time. Consistent with this modeling technique, there is a single value for the credit balance in each future year shown in the graph. A deterministic projection answers questions in the form of "if X happens or changes, then Y results." It does *not*, however, give any indication of the likelihood of this outcome.

[5] Scheduled Cost is Segal's mechanism of evaluating the long-term sufficiency of a plan's contribution levels to support the plan of benefits into the future.

Graph 1: Sample Deterministic Credit Balance Projection



Source: The Segal Company.

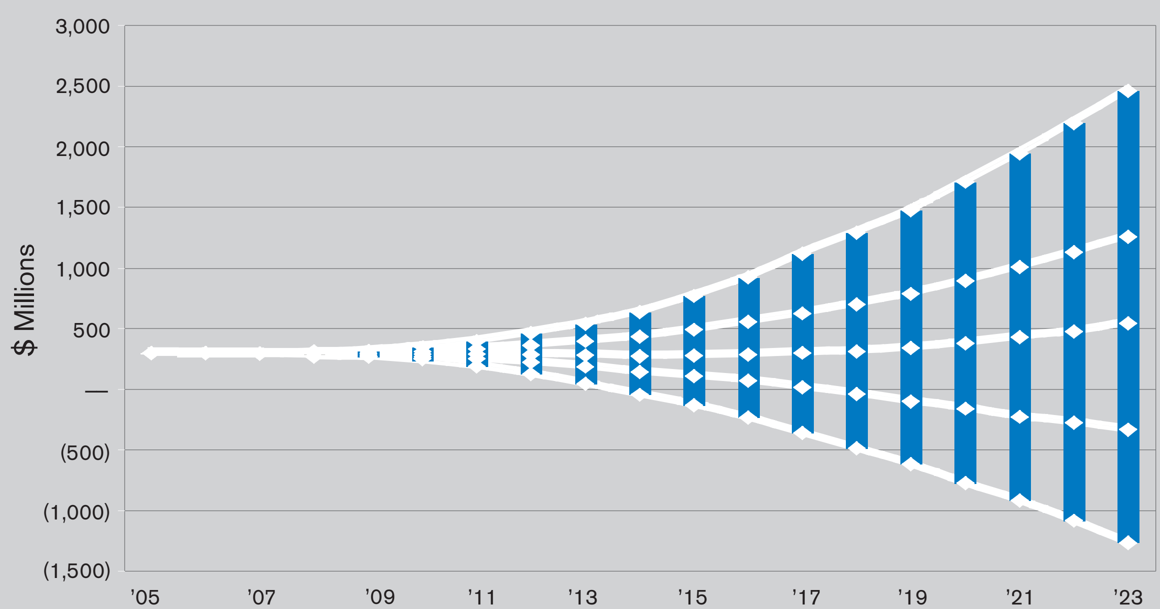
> "Although projections are not guarantees of how the future will play out, modeling possible outcomes can assist trustees in understanding the relative impact of various changes, bringing clarity to their goals and objectives and, ultimately, helping with both short- and long-term planning."

Graph 2 below, which also shows a projection of a credit balance (for a different plan), is based on stochastic modeling. It shows a range of values for each future year instead of a single value. The top line shows how the credit balance would change over time for the best 5 percent of investment return outcomes over that period of time. Similarly, the middle line represents how the credit balance would change for the "middle" of the possible outcomes (*i.e.*, 50 percent of the outcomes are expected to be better and 50 percent will be worse). The bottom line shows how the credit balance would change taking into account up to 95 percent of all the possible outcomes. For some plans, the advantage of the stochastic modeling technique is the perspective gained by an analysis of the range of possible outcomes and their associated probabilities. This type of projection answers questions in the form of "what is the likelihood of certain outcomes under certain assumptions?"

Future industry activity, primarily as it pertains to future contribution income, is also a critical component of the projections required by PPA'06. As the law requires, insight into that aspect of the plan's operation must come from the trustees. Current, and projected, economic conditions may have a detrimental effect, perhaps only in the short term, on the contribution income for many plans. This will be an important factor to consider when undertaking projections.

Regardless of the projection technique used, it is important to remember that any projection is an estimate of future events based on assumptions. Although projections are not guarantees of how the future will play out, modeling possible outcomes can assist trustees in understanding the relative impact of various changes, bringing clarity

Graph 2: Sample Stochastic Credit Balance Projection



Note: The text above this graph explains how to interpret it.

Source: The Segal Company.

to their goals and objectives and, ultimately, helping with both short- and long-term planning.

Next Steps in General

In addition to undertaking projections, trustees of multiemployer pension plans may want to review the following, as part of their long-term planning process:

- ***The Options under the WRERA to Freeze the Plan's Zone Status at the 2008 Level and/or to Elect Three Additional Years for Remedial Plans under PPA'06*** As with any choice, there are advantages and disadvantages. Whether freezing the zone status is helpful or not is a decision that each board of trustees will have to make based on the facts and circumstances of their particular plan. Projections can help with this decision-making.
- ***Collective Bargaining Agreements*** Knowing when collective bargaining agreements expire, or when longer-term agreements provide for contribution rate increases, will be important as trustees chart a course for the future. These dates, which can have implications regarding the official beginning of a Funding Improvement or Rehabilitation Period, indicate when additional money may be available to plans.
- ***Temporary Sources of Contribution Income*** Many multiemployer pension plans operate in conjunction with related health plans. Some have companion defined contribution plans. A possible source of temporary funding for pension plans may be available through a prospective reallocation of contributions from one of the related plans. However, making this happen could, in fact, require a significant amount of discussion by many interested parties.
- ***The Actuarial Asset Valuation Method Employed*** Because the actuarial value of assets plays such a key role in the new PPA'06 measurements, a review of the methodology employed to gradually reflect market value may be in order to assure trustee comfort with the approach used.
- ***The Plan Design*** A significant advantage that defined benefit plans have over defined contribution plans is time to recover from actuarial losses due to a bad investment climate, or other adverse experience, without an immediate effect on benefits. However, if these losses are severe enough or occur for a sustained period of time, and the bargaining parties do not negotiate contribution rates at a level adequate to fund the existing plan of benefits, it may be necessary to lower benefits.
- ***Industry Outlook*** Care should be taken when performing projections, especially as it pertains to assumptions about future employment levels. Given the dramatic downturn in the economy in general, projecting employment levels into the future by using averages over the past few years may prove to be unrealistically optimistic. At the very least, analyzing a few different scenarios of differing employment levels will provide insight into the regulatory requirements of a plan, and how they can be affected by changing employment patterns.
- ***Awareness of Participant Response*** Although this *NewsLetter* focuses on the more technical aspects of how to deal with the current environment, trustees may also want to pay attention to the needs of plan participants. Active participants, as well as retirees, will no doubt have questions and fears about the impact of the recent market downturn on the pension plan. The text box below discusses crisis communications.

Crisis Communications

All Americans are concerned about the recession. Plan sponsors may want to consider crisis communications to keep participants informed about how the troubled economy is affecting their pension plan and what the trustees are doing in response.

PPA'06 requires that participants in red-zone and yellow-zone plans be formally notified of that fact and receive information about the plan's Rehabilitation Plan or Funding Improvement Plan. Those "required" communications could be expanded to include references to current conditions or a separate communication piece dedicated to current conditions could be created. Some trustees of green zone plans have also opted to keep participants informed of the plan's status.

Trustees of many funds have also opted to send targeted communications to specific audiences, including retirees, to reassure them that their benefits are not affected by PPA'06 (*e.g.*, their plan's funding status, Rehabilitation/Funding Improvement Plans).

As ERISA requires, all plan communications should be written in clear, easy-to-understand language.

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Steps for Red-Zone Plans

As required by the plan stewardship rules that PPA'06 introduced, trustees of red-zone plans are now developing Rehabilitation Plans to stabilize the plan's finances by the end of the Rehabilitation Period. In addition to increasing contributions, eliminating ancillary benefits and reducing future benefit accruals, corrective measures for red-zone plans may include the elimination of "adjustable" benefits. These are primarily early retirement subsidies (*e.g.*, unreduced benefits, such as service pensions, or slightly reduced benefits at early retirement ages) along with prospective benefit accrual reductions. Because PPA'06 defines certain target levels that will need to be achieved and the time period over which that improvement must occur, Rehabilitation Plans that were completed in 2008 almost certainly will need to be revised.

Trustees of red-zone plans that elect to temporarily freeze the plans' zone status, as allowed by the WRERA, would not have to update the Rehabilitation Plan or the contribution and benefit schedules in 2009. Trustees of red-zone plans will also need to decide whether to add an extra three years to their Rehabilitation Plan. This decision is complicated by the fact that many plans' recovery from critical status could take longer than an extended 13-year period. Modeling can be helpful as trustees consider this option.

Steps for Yellow-Zone Plans

In accordance with the rules introduced by PPA'06, trustees of yellow-zone plans are now developing Funding Improvement Plans. Corrective measures for yellow-zone plans are limited to prospective benefit accrual reductions, elimination of non-protected benefits and/or increasing contribution levels. Trustees of yellow-zone plans that elect to temporarily freeze the plans' zone status would not have to update the Funding Improvement Plan or the contribution and benefit schedules in 2009.

Steps for Green-Zone Plans

Plans fortunate enough to be in the green zone for 2009 without taking into account legislative relief to rely upon a 2008 certification may still require corrective measures in the near future. Regardless, Segal believes that establishing funding parameters is still essential because of the serious consequences of falling out of the green zone.[6] A long-term perspective is just as essential for trustees of green-zone plans as for those in the other two zones.

Conclusion

Whether plan design or contribution rate changes are being considered, looking at these options through the PPA'06 "lens" involves more time, a greater level of detail and consideration of how the changes can affect the position of the plan, as that financial and actuarial condition is now defined and measured by PPA'06.

With all of the volatility in the market, it is important to receive frequent updates on a plan's investment performance and to consider modeling of the PPA'06 measurements well in advance of the deadlines outlined in the law. While early analysis is not likely to dramatically change the eventual outcomes, prompt identification of the likely results maximizes the amount of time for a full consideration of all possible options.

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To discuss solutions for coping with the effect of current conditions on your plan, and for more information about how projections can help, contact your Segal Company benefits consultant or one of the following experts:

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[6] For more information about funding parameters, see Segal's September 2008 *NewsLetter*, "Does Green Mean Go? Trustee Decision-Making in the Post-PPA'06 Era": http://www.segalco.com/publications/newsletters/sept2008.pdf

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