Guide to Church Retirement Plans | Issue 3

The Bulletin:

This chapter of the series explores the ***benefit security*** of a "church plan" and how to determine whether or not a plan is on track to pay benefits that were promised to participants.

Funding policy

Every pension plan should have a funding policy, including church plans. A good funding policy will consider short-term and long-term obligations and be based on sound methods and assumptions. Having a successful pension plan with *benefit security* depends on the plan sponsor monitoring the funded status and also making regular contributions to the plan.

In general, church plans are not subject to many of the same rules and requirements as corporate pension plans. Church plans are not subject to minimum funding requirements, Pension Benefit Guaranty Corporation (PBGC) premiums, and other regulations. However, the church pension plan is still a promise to employees to provide a meaningful benefit in retirement and should be monitored to make sure it is on track. Besides plan design and investment strategy, the funding policy is a major element of ensuring the plan's *benefit security* and a successful pension plan.

For many corporate pension plans, the funding policy is mandated by the Internal Revenue Service (IRS). The IRS minimum required contribution has evolved over time including the Pension Protection Act, but church plans are not subject to these rules. All pension plans should have a funding policy that is reviewed regularly by the plan sponsor and retirement committee to confirm it meets certain standards. A stable pension plan will fund for benefits that are earned by participants while the participant is working for the employer.

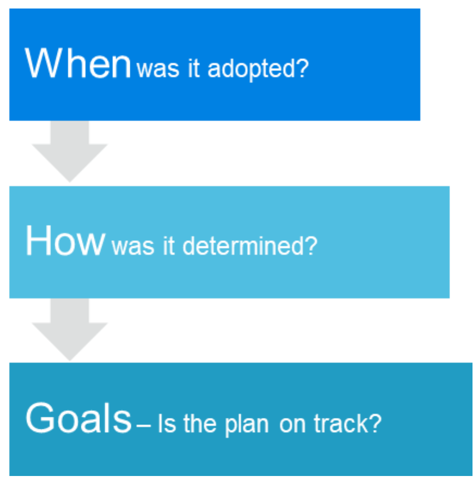
Has the funding policy been checked lately?

So, what is the plan's current funding policy? A lot may have changed since the funding policy was adopted—updated mortality tables, lower interest rates, and rising costs in other employee benefits offered by the employer, to name a few.

Consider the following:

- When was the current funding policy adopted?
- How was it determined?
- What were the goals at the time it was adopted and is the plan on track?
- Do the employees make any contributions to the plan?

FIGURE 1: FUNDING POLICY CONSIDERATIONS



When the funding policy was adopted, was the goal to be fully funded by a certain point in time? Or was a funding policy calculated using a split of costs between employer and employee? If so, a plan sponsor should regularly monitor the progress the plan is making under the funding policy.

What are some ways to calculate our contribution?

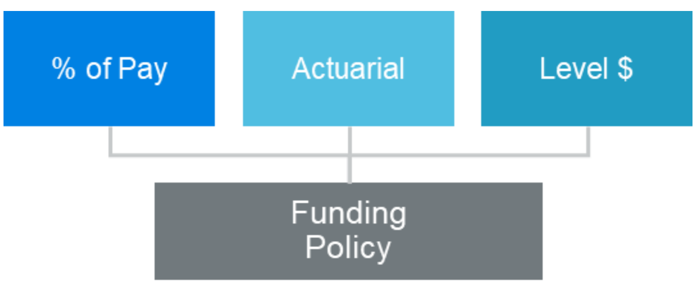
If the plan sponsor decides it is time to make a change, understand that funding policies come in all shapes and sizes. Some of the more common funding policies are:

- Percentage of payroll
  - Employer contributes 6.5% of covered payroll to the plan.
  - Pros: easy to predict and budget each year
  - Cons: should be checked regularly to make sure the plan is on track

- Level dollar amount
  - Employer contributes $500 per active participant per year to the plan.
  - Pros: easy to predict and budget each year
  - Cons: should be checked regularly to make sure the plan is on track
- Set dollar amount recalculated periodically
  - Employer contributes $500,000 in 2020, 2021, and 2022 to the plan. New calculation to be determined in 2023.
  - Pros: locks in the pension contribution for several years to ease budgeting
  - Cons: could cause large swings when the funding policy contribution is redetermined if the plan has experienced major changes like retirements, large salary increases, asset gains and losses
- Calculation based on annual actuarial valuation
  - Employer contributes normal cost plus amortization of unfunded liability to the plan.
  - Pros: most accurate way to stay on track since changes are reflected immediately
  - Cons: administrative work to collect new data and produce valuation each year

The last example is usually the preferred method, but also has the most variability from year to year. And it seemingly hits the plan sponsor the hardest after a tough year in the market.

FIGURE 2: COMMON FUNDING POLICIES

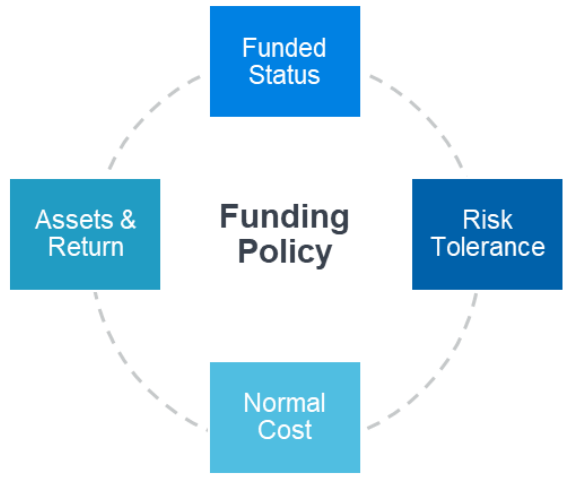


Is it time to make a change?

If a plan sponsor feels it is time to consider a change to the funding policy, they should ask themselves these questions:

- What is the funded status of the plan? A plan that is 70% funded will have different objectives than a plan that is 95% funded.
- Is the plan frozen or ongoing? Will the funding policy need to account for current accruals or only benefits that have already been earned?
- How much of the contribution covers the benefits earned during the year (normal cost)?
- When is the current funding policy expected to fully fund the liability?
- How are the assets invested and is the investment return assumption reasonable?
- Are the other actuarial assumptions reasonable?

FIGURE 3: COMPONENTS OF FUNDING POLICY



Other Considerations

While reviewing or developing the funding policy, plan sponsors should also consider preparing for unanticipated changes in their plan and funded status. If the plan demographics change significantly or investment returns are atypical, the funding policy should be revisited.

Actuarial valuations rely heavily on assumptions like expected investment return, salary scale, turnover rates, retirement rates, and the mortality assumption. Actuarial experience studies should be considered regularly to make sure the funding policy remains valid. Additionally, if assets are valued on a smoothed basis rather than market value, the plan sponsor should remain vigilant of upcoming changes to the funded status due to deferred investment gains and losses.

Despite a plan sponsor's best efforts sometimes pension plans need to change, for better or worse. A sound funding policy will consider conditions that must be met to adopt benefit changes, including benefit increases or decreases, or cost-of-living adjustments. These steps can be added to the funding policy to address these plan changes considerations.

Conclusion

Plan sponsors may go through this exercise and determine their funding policies are adequate. Others may determine that a change in either method or amount of contribution is warranted. Given favorable asset returns over the past 10 years, many plan sponsors expected to have shored up their pension shortfalls, but that has not necessarily been the case. Although not popular, a change in funding policy could be the answer to provide more *benefit security* to plan participants.

Your Milliman actuary

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For more information about The Bulletin series, see prior articles here.

Do you have a question about your defined benefit pension plan? Write to us at thebulletin@milliman.com.