PENSION TRENDS

BY INDEPENDENT ACTUARIES, INC.

IndependentActuaries.com

May 2024

Defined Benefit Plan Risk– Part 1

(This is part 1 of a 2 part series on Defined Benefit Plan Risk)

Risk can be a scary word. We tend to associate the term with worst case scenarios. In actuality, we take risks every day and the outcomes can be positive or negative. The key to living with risk is understanding **what** risks you are taking on, knowing what **level** you are willing to accept, and how to **manage** the ones you take. Think about driving a car, what roads you take, and what speeds you travel. Think about where you invest your money and what funds/stocks you choose. All these decisions assume some level of risk and incorporate your own risk tolerance.

As you decide which type of retirement plan to sponsor, similar discussions about risk should be addressed. Every future financial obligation has some associated risks. That is unavoidable. As actuaries, we are trained in risk management. While some of the risks inherent in retirement plans are out of our control, we can help educate our clients to make informed decisions in the face of these risks.

We see a combination of investment and contribution risk come up with our small business clients. Most often, the motivation for adopting a defined benefit plan with this sector is to maximize tax deductions. Understanding how contributions and investment return impact future deduction opportunities goes a long way to mitigate these risks.

Defined benefit plans indirectly assume future investment returns on plan assets. If investment returns are higher than those assumed, generally the required and deductible contributions to the plan decrease and the plan's funded status is higher. Conversely, lower actual returns will generally increase the required and deductible contributions to the plan and decrease the plan's funded status. This is defined as **Investment Risk**, the potential that investment returns will be different than expected.

Plan assets should be invested in a prudent manner with an awareness of how fluctuation in investment return impacts future contribution requirements. Either of the situations in the paragraph above may be beneficial depending on your goals. Lower investment returns in one year can trade off with the opportunity for higher levels of deductible contributions. Alternatively, higher investment returns can mean you can receive the same size benefit at retirement without putting as much money into the plan.

There is also a risk that actual contributions will impact future required contributions or that future required contributions are higher than expected. This is called **Contribution Risk**. If the required contributions are the only amounts funded, the plan may not be able to pay the full amount of benefits when due. Alternatively, if contributions are funded at the maximum tax deductible range, the plan may risk being overfunded when you are ready to retire and excise taxes may be due on any excess assets. This risk can be reduced by reflecting your future goals for the plan in your funding policy. For example, if you plan on retiring and terminating the plan in the next few years, overfunding the plan today may not be prudent since there are restrictions on excess assets in a pension plan.

Each situation is unique – there is not any one investment/funding strategy that works for everyone. We can work with you and your advisors to understand the consequences of your particular strategy.

To subscribe to our Pension Trends newsletter, visit IndependentActuaries.com and submit your email address. Or you can send an email to KristenMeredith@indact.com

To read previous issues of Pension Trends, visit our Pension Trends Archive at:

www.independentactuaries.com/resources/general-resources/pension-trends-newsletter/pension-trends-archive/

Author Profile:

This article was written by Sara Ark, FSA, EA, MAAA and Shannon Hatfield, FSA, EA, MAAA. Sara's specialties include small company-sponsored defined benefit plans, cash balance plans, and financial accounting. Shannon's specialties include plan design, administration, and accounting for public and private sector defined benefit plans and OPEB plans.

© 2024 by Independent Actuaries, Inc.
All Rights Reserved

INDEPENDENT ACTUARIES, INC.

5 Centerpointe Dr, Ste 520
Lake Oswego, OR 97035
Phone: 503.520.0848
Fax: 503.520.1147
IndependentActuaries.com

email:
info@indact.com