Navigating Your Way Through Market Turbulence

Turbulent market conditions are undoubtedly causing concern for you and your employees regardless of whether you are a for-profit or a non-profit organization. These uncertain times can create a lot of questions and concerns, particularly around your retirement program.

As such, we believe it's important to take an in-depth look at each of the retirement plan alternatives one by one, to help you understand how the market may be affecting your retirement plan(s) along with actions you — as a plan sponsor — may want or need to take as you review your retirement program. We have organized this paper into the following, easy to read sections:

- **Defined Benefit Plans**
- **Defined Contribution Plans**
- **Employee Stock Ownership Plans**
- **Nonqualified Deferred Compensation Plans**

Within each applicable section is a summary of action items to consider regarding your retirement plan(s).

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Defined Benefit (DB) Plans

Action Items to Consider

- Talk to your actuary
- Assess impact of market value volatility with regard to:
  - Plan funding
  - Accounting
  - Pension Benefit Guaranty Corporation (PBGC) premiums
- Evaluate plan design

A defined benefit plan is an employee benefit pension plan that defines the benefit an employee is expected to receive at retirement. As a plan sponsor, you assume the investment risk for this type of plan and must ensure that the assets held under the plan will meet the liabilities (benefit obligations) the plan provides. Your employees, in turn, receive a benefit from you without making any contribution, investment decisions or assuming any investment risk for the benefit provided. This makes a DB plan more complicated for you, but allows more peace of mind to your employees benefiting under the plan.

If you manage a DB plan, the volatile market conditions have likely caused you concern. It has been recently reported, through various studies and articles, that DB plans have had a decrease in their equity value holdings with the economic downturn. While your first concern may be the impact this will have on the required contributions to your DB plan, there are other effects. As a defined benefit plan sponsor, it's important to keep the following items in mind:

DB Plan Funding

For most of you, the amount required to fund your DB plan will increase. The Pension Protection Act (PPA), in addition to defining funding rules, also placed benefit restrictions on DB plans based on the plan's benefit restriction funding ratio, also known as the adjusted funding target attainment percentage (AFTAP). Depending upon the funding status of the plan, the following may apply to your defined benefit plan:

- **Credit Balances:** Credit balances may be created if you contributed more than the minimum funding in the past. Creating a credit balance is generally a good thing, allowing sponsors to manage their cash flows. A credit balance built in an earlier year can generally be used instead of paying cash to meet funding requirements in a later year. But, a credit balance needs to be managed so it does not trigger any reporting or benefit restrictions.

  Almost all funding ratios are based on assets reduced by credit balances (generally unless the plan is at least 94 percent funded in 2009). So, having a credit balance may cause your plan to look less funded than it is. That can trigger participant notices, or even benefit restrictions, if a plan is less than 80 percent funded using reduced assets.

  But, you can always offset the problem by using the credit balance to improve the testing ratios.

- **Lump Sum Benefit Restrictions:** Some DB plans allow participants to take lump sum distributions. In order to allow participants to take the full amount of any lump sum distribution, the DB plan must be funded to at least 80 percent, not including credit balances. If the plan is at least 60 percent funded, a partial benefit can be paid as a lump sum. Once funding falls below 60 percent, no lump sum amounts can be paid. With the downturn in the market, more plans will likely fall into this category. Please work closely with your actuary, or consider using tools provided by your service provider to help estimate your 2009 funding requirements.

- **Highly Paid Restrictions:** If your DB plan is not funded at 110 percent of current liabilities, then current or former highly compensated employees (HCE) who are among the top 25 most highly paid employees in the current or any prior year, would face restrictions on lump sum payments or annuity purchases/guarantees. However, an individual facing this restriction can choose among other distribution options to receive their benefit. If your plan falls in this category, talk to your Financial Professional or service provider regarding the distribution options available to a HCE.

- **Benefit Accrual Restrictions:** Due to an anticipated decline in funded status, there will be some DB plans which will be required to freeze benefit accruals. PPA requires future accruals to be frozen if the defined benefit plan is funded below 60 percent (using assets reduced by credit balances). Unless your DB plan provides otherwise, the accruals and the accelerated payments resume prospectively at the date the plan's funded status recovers. You should work closely with your actuary, or consider using tools provided by your service provider to help estimate your 2009 funding requirements.

General Restrictions

If AFTAP is	Less than 60%	60% but less than 80%
Benefit Accrual	Frozen	Unaffected
Accelerated/Lump Sum Benefits	Prohibited (no amount in excess of monthly life annuities may be paid from the plan).	Allowed up to 50% of the benefit otherwise payable, but not more than the PBGC maximum benefit for the year*. Remainder may be paid in a life annuity form.

*The Pension Benefit Guarantee (PBGC) maximum benefit is adjusted for payment age. The accelerated payment can only be paid once to a participant during a consecutive period of restrictions.

Impact on Accounting

Asset losses caused by the market downturn are offset against any decreases in liabilities due to the increase in corporate bond interest rates. The difference between assets and liabilities will appear on your corporate balance sheet and income statement. The net effect of the market value and the interest rates will also impact your pension expense. Based on this, you should review what the impact will be on your accounting and review any loan covenants as well, for unintended consequences of any reduction in accounting ratios that may apply.

PBGC Premiums

Most DB plan sponsors are required to pay PBGC premiums. These premiums protect the pensions in private DB plans. A portion of the annual premium is based upon the funded status of your DB plan. If your DB plan is underfunded the variable rate premium is $9 for every $1,000 in underfunding. It is not possible to say whether premiums will increase or decrease in 2009. While the market value of DB plan assets have declined for almost all plans, the liabilities have also declined as the corporate bond interest rates used for measuring them have been increasing. For details on premium rates, refer to www.PBGC.gov.

There are a number of issues you, as a DB plan sponsor, may need to consider when planning your budgets for the 2009 plan year. In doing so, it's best to work closely with your actuary, or you may want to consider using any applicable tools provided by your service provider to help estimate your 2009 funding requirements and the impact market value volatility may have on your DB plan.

Plan Design

With the current market conditions, it may be a good opportunity to evaluate your entire retirement program (defined benefit, 401(k), 403(b), non-qualified, etc.) to determine if it is meeting your objectives. It should work for you both from a budgetary perspective as well as from a human resources perspective. Your service provider may also have plan design consultants and actuaries who can assist you with this evaluation and offer solutions for your defined benefit plan as well as your entire retirement program. Some design issues to consider for your DB plan include:

- **Review** of plan provisions to determine if any cost savings can be identified by reducing or removing some optional benefits.
- **Redesign** formula/benefit (e.g., enhance or reduce current formula, convert to cash balance design, etc.)
- **Schedule** a temporary freeze in benefits (e.g., 1-2 years) to reduce short-term funding requirements. This is similar to the concept of eliminating a 401(k) match during difficult times. It does require a plan amendment and there are timing considerations.
- **Consider** closing the plan to new entrants or possibly freezing benefits for all or a portion of your employees permanently.

Defined Contribution (DC) Plans

A defined contribution plan (e.g., 401(k), 403(b), profit sharing and/or money purchase plan) is a type of retirement savings vehicle that is based on contributions — typically pre-tax dollars — made either by an employee or employer (or both) into individual participant accounts. The benefits to be received depend upon the accumulated value of these contributions and their potential earnings.

If you sponsor a DC plan, the recent market volatility likely has your employees watching their retirement account values plummet. At the same time, you are likely to be re-evaluating your plan's investment option offerings and addressing your employees' concerns regarding the safety and security of the retirement plan's assets.

There are a number of issues you, as a DC plan sponsor, may want to consider in reaction to the volatile financial markets. The items listed throughout this section can help guide you through some of your responsibilities.

Action Items to Consider

- Review fiduciary responsibilities and procedures
- Participant communications
- Evaluate plan design

Fiduciary and Investment Option Considerations

One key fiduciary responsibility is the selection and monitoring of the investment options offered under your retirement plan. This is an opportune time for you, as a plan sponsor, to meet with a Financial Professional to make sure your retirement plan offers diversification of investment options based on the various asset classes, styles and managers for your employees.

While not required by ERISA, now may also be a good time to establish an investment policy statement or review a current statement, if one exists. If you have not done so already, you may also want to form or regroup an investment committee to monitor the investment options under your retirement plan. Your investment review may include examination of the following areas:

- **Evaluate** each investment option against the original selection criteria to ensure it still continues to meet the plan's objectives.
- **Compare** each investment option's performance, returns, and risks relative to its peer universe and benchmark index over the long term.
- **Analyze** the qualitative elements of each manager's investment process.
- **Evaluate** the investment option's fees for reasonableness.

- **Outline** your committee's decision-making process related to the plan's investment option offerings, including the criteria for decisions and the proper documentation of actions taken to help mitigate litigation risk.

If you need help establishing a formal fiduciary program, contact your Financial Professional, tax or legal counsel. Your service provider may also be able to help you understand your obligations through various tools and services. For example, they can assist you with the investment review process or help you understand your overall fiduciary responsibilities.

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Participant Education

One important aspect of running a successful retirement plan is educating your employees. The volatile market conditions likely have given rise to many questions and concerns from your employees. These questions and concerns may include how the recent financial crisis will affect the safety and security of retirement savings as well as how they should be investing during these turbulent times. Knowing their risk tolerance and grasping the importance of a long-term investment strategy can help answer their questions and move them closer to reaching their goals.

You may also want to consider the information and tools your participants need to better understand their investment options and to emphasize the long-term approach toward retirement planning. Your service provider or Financial Professional may offer a variety of employee communications to help address a wide range of topics.

Plan Design

The severe market downturn could also affect your retirement plan design in several ways. It may be necessary to revisit your retirement plan objectives, along with any budgetary concerns, to determine if any changes should be implemented to your plan. Your service provider may have plan design consultants who can assist you with this evaluation and offer solutions for your DC plan as well as your entire retirement program. Some design issues to consider include:

- **Review** your employer contribution obligations (employer match, employer profit sharing, etc.), as listed per your retirement plan document, to determine your contribution requirements for the current year, as well as future years, and decide if any changes are warranted and/or possible.

- **Evaluate** whether annuity distribution options would be a good fit for your retirement plan. Annuity distribution options can provide a guaranteed stream of payments which some plan participants may prefer over investing a lump sum amount at retirement on their own.
- **Consider** how your retirement plan allows participants to access account balances for financial emergencies. Having a loan program or making in-service withdrawals (e.g., hardship, 59½ withdrawals) available may provide plan participants with a sense of security if such emergencies were ever to come up. Now may be the time to communicate your plan's withdrawal options to participants and explain that, if utilized, it may have a financial impact on their ability to meet their retirement goals.
- **Determine** how any workforce changes can impact your retirement plan. If you are considering reducing your number of employees, closing a division, or reducing the work schedule of employees due to the current economic conditions, you will want to review the impact these changes will have on your plan (e.g., a potential decrease to salary deferrals, plan compliance nondiscrimination testing, partial plan termination, etc.).

Employee Stock Ownership Plans (ESOPs)

An Employee Stock Ownership Plan (ESOP) is a type of DC plan which makes the employees of a company the beneficial owners of stock in that company. For a DC plan to be designated as an ESOP, the plan is required to primarily invest in the stock of that company, and the plan document must be written to designate the plan as an ESOP.

It is difficult to know for sure how the current economy may impact an individual company. Some companies may feel a greater impact than others. In anticipation of tightening of credit, reduced cash flow availability and potential decreases in the fair market value of ESOP shares, it is advisable for you to begin exploring how these difficult economic times can impact you as an ESOP company. The following are a few areas that could be reviewed to help determine possible exposure, and to implement proactive steps to avoid potential issues. You should contact your ESOP consultant for additional assistance if your company and associated ESOP anticipate a tightening of cash flow and/or a decrease in fair market value.

Action Items to Consider

- Review plan for possible exposure
- Provide participant communications
- Talk to your valuation firm (privately held companies)
- Seek input from your ESOP consultant

With the current state of the public market, you may have an opportunity to demonstrate the benefit your ESOP may have by comparing company stock performance to the public market volatility.

Employee Communications

Now more than ever, it is important to communicate proactively with your ESOP participants. Helping participants understand the valuation process, especially how events outside the company's control can impact value, is an important step in reassuring participants in these troubling times. With the current state of the public market, you may have an opportunity to demonstrate the benefit your ESOP may have by comparing company stock performance to the public market volatility. Generally, your ESOP consultant can assist in the preparation of tailored participant communications.

Distribution Policy and Repurchase Obligation

This is a good time to revisit your distribution policy and repurchase obligation projections. In the event of a tightening of cash flow, you may need to implement a delay in distribution timing or pay a portion or all distributions in installments. At the same time, it will be important to update the repurchase obligation study to incorporate any changes to the distribution policy, as well as stock and employee growth projections and turnover assumptions. There are also some typical distribution policy decision points that you may wish to revisit, such as any segregation process (conversion of former employees out of company stock and into other investment options).

Decrease in Fair Market Value Impacting Common Plan Operations

A decrease in fair market value can impact various areas of plan operation. Using dividends, or S corporation earnings distributions, on allocated shares to repay the ESOP loan may become problematic. Employer contributions, such as matching contributions, which are satisfied based on the fair market value of shares released from the loan suspense account should be reviewed to determine the impact of any expected decrease in fair market value.

Decreases in Workforce

Any significant anticipated decrease in workforce should be examined to determine the impact on plan operations, such as deduction limits and plan compliance coverage testing.

S Corporation Anti-abuse Testing

The synthetic equity associated with a nonqualified deferred compensation plan, for which the benefit is not based on company stock value, is determined by dividing the present value of the arrangement by the fair market value of company stock. A decrease in the fair market value of company stock can significantly increase the number of synthetic equity shares that are associated with such an arrangement. It is important to proactively review the current synthetic equity structures to determine how they may be impacted by a decrease in the fair market value of company stock. Reductions in workforce may also significantly impact this test. When it comes to S corporation anti-abuse testing, early action is crucial and prevention is key, as there may not be a correction path.

Nonqualified Deferred Compensation (NQDC) Plans

Many employers sponsor a nonqualified deferred compensation plan to supplement qualified plan benefits for key employees. NQDC plans allow your key employees the opportunity to defer compensation in addition to any salary deferrals made to a qualified plan. NQDC plans provide benefits that would not otherwise be allowed under a qualified plan and permit the employer to provide other discretionary contributions to recruit, retain and reward your key employees. While there are other nonqualified deferred compensation arrangements (such as stock appreciation rights or certain equity compensation awards), the focus of this section is limited to the above description.

Due to recent economic events, it is advisable for you to review the financing of your NQDC plan. The following are items to consider in your review:

Action Items to Consider

- Assess financing
- Examine legislative developments
- Monitor defined benefit funding

Assess Financing

NQDC Plans are unfunded contractual obligations to pay promised benefits to key employees in the future. As a plan sponsor, you can choose to:

- Leave the obligation unfinanced, or
- Informally finance the future obligation

You are not required to set aside or reserve corporate assets to match future obligations. However, many times employers informally finance future obligations with corporate-owned life insurance or taxable

corporate investments, such as mutual funds. In these turbulent market times, you should reassess the current financing strategy to help ensure it still meets your objectives. Your Financial Professional and service provider can work with you to help you determine an appropriate financing strategy for your goals and needs.

Examine Legislative Developments

One important piece of legislation as a result of recent market instability is the Emergency Economic Stabilization Act (EESA) of 2008. Two aspects of EESA which may impact your NQDC plan are:

- **Troubled Asset Relief Program:** The Act has directed the Treasury Department to develop a program to buy troubled assets related to mortgages. Companies who participate in the program must limit executive compensation and golden parachute provisions. Some NQDC plans have golden parachute provisions and should be evaluated if your company benefits from the troubled asset program.
- **Code Section 457A:** In addition to the executive compensation restrictions listed above, EESA also added Code Section 457A which generally prohibits individuals from deferring in a nonqualified plan maintained by a "tax indifferent" foreign entity outside U.S. jurisdiction. If 457A applies, any affected employee will need to pay tax when the nonqualified deferred compensation vests and not when payment is made. Additional guidance is still needed on this topic. However, you should begin to evaluate whether you fit within the covered classes under the law. If you are uncertain if your plan falls under this category, discuss the issue with your legal advisor.

Monitor Defined Benefit Funding Status

If you sponsor a DB plan, you must closely coordinate the financing of your NQDC plan with the valuation of your defined benefit plan. If your qualified DB plan is at risk, then assets may not be transferred or set aside for purposes of the nonqualified deferred compensation plan without subjecting your senior executive employees to the risk of taxation and a penalty tax and interest. If you sponsor a DB plan, you should review the 2008 funding status to determine if your plan is considered at risk for the 2009 plan year. If your defined benefit plan is at risk, contact your tax or legal advisor before transferring, setting aside or distributing assets attributable to a NQDC plan or before transferring assets to or from the Rabbi Trust, as there is currently very limited guidance surrounding these rules.

Conclusion

During turbulent market conditions, it is more important than ever for you to continue to monitor and evaluate the impact on the various aspects of your retirement plans. We've discussed a number of changes for retirement plans that may be needed to help meet your retirement plan objectives. However, meeting these objectives requires action on your part. Acting on retirement plan changes may take some time, so you'll need to plan accordingly. Board approval may be required or a committee consensus may need to be obtained before any changes can be made. **It is important that you begin looking at your retirement plans now so you are prepared for any decisions or changes you may need to make in the near future.** As stated in the beginning of this paper, employer-sponsored retirement programs remain one of the most efficient and effective ways for Americans to save for a more secure retirement. They remain a significant part of an overall benefit package that can help you compete for high performing employees, so it is worthwhile for you to review your retirement plans along with your business strategies.

Regardless of the decision you make or the plan design you have, your Financial Professional and service provider are able to help evaluate your alternatives so you can make informed decisions related to these difficult economic issues. You may also want to contact your actuary or retirement plan consultant, tax or legal counsel to assist you through the impact of market volatility as it relates to your organization's retirement plan benefits.

For more information, please contact your Financial Professional, or a representative of The Principal®.

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