

# ALERUS Retirement Report

## Managing Retirement Plan Costs in a Recession

In light of the downturn in the economy, some employers may be considering ways to reduce overhead. Modifying the 401(k) benefit for employees may be one means to do so, but it creates some unforeseen consequences.



John Jeffrey, J.D.,  
Corporate Counsel  
Alerus Financial

Generally, employers are concerned about the obvious relationship between the loss of a benefit and employee morale and productivity. In addition to these common sense concerns, employers should keep in mind a number of technical considerations.

Here is a short check list of items to consider:

**1. Timing:** The Internal Revenue Code controls the timing of an employer plan amendment that eliminates or cuts back a benefit. Plans can be modified if the amendment occurs before the beginning of the plan year. However, once an employee accrues a right to a benefit, the employer cannot change the rules.

So the question is always, “*Has the employee accrued the right?*” There are three common situations to consider:

- a. **The benefit has not accrued because of allocation criteria.** Some plans require employees to be employed on the last day of the plan year and/or work 1,000 hours in order to receive the benefit. If a plan modification occurs prior to the employee reaching the benefit accrual benchmark, then a change is permitted. Because of the allocation criteria, the employee never accrued the right to the benefit and there is no cutback.

*For example, assume Company A’s plan includes a 50% match contribution for employees who work at least 1,000 hours during the year. It makes its match annually at year end. In March, the company decides that it cannot afford the match amount for 2009. Since none of its employees have yet worked 1,000 hours by March, no one has accrued the right to the benefit. The employer may amend the plan and notify employees that the match will not occur for 2009.*

- b. **The change is only prospective.** Even if the plan does not have accrual criteria, the employer may still modify the benefit going forward. The employer pays the benefit up to the date of accrual, provides notice of a change and then changes the benefit for the balance of the year.

Assume the same facts as above, except that Company A’s plan has no hourly or last day requirement for its match contribution. In March 2009, it decides to terminate the match effective May 1, 2009; amends its plan and communicates the change to employees. It must still make the match for the period January through April. However, there is no cutback after May 1, since the benefit accrued only up to that date.

- c. **The contribution is a “Safe Harbor.”** In a Safe Harbor plan, the employee’s right to the benefit depends upon the type of contribution the employer has elected to meet its Safe Harbor obligation. If the employer makes the 3% non-elective profit sharing contribution, it can only modify the plan for the coming year. If the employer uses the match formula, it may modify the plan mid-year provided that it gives employees at least 30 days notice of the change.

**2. Limits on Highly Compensated Employees’ 401(k) Deferrals:** The Tax Code ties the maximum rate of Highly Compensated Employees (HCEs) 401(k) deferrals to usage by rank-and-file employees known as “Non-Highly Compensated Employees or “NHCE.” In general, the HCEs cannot defer more than the lesser of two times or two percentage points more than the average deferral rate for the NHCE group. The exception to this rule is a “Safe Harbor” plan.

In a non-Safe Harbor plan, if the employer reduces or eliminates a match, then often NHCEs will defer less. As the average NHCE deferral rate declines, HCEs will often be capped on their ability to make 401(k) deferrals.

CONTINUED ON PAGE 2

### IN THIS ISSUE

>

- Managing Retirement Plan Costs in a Recession
- Investment Update

*CONTINUED FROM PAGE 1*

In a Safe Harbor plan, the employer has elected to make either a 3% profit sharing contribution or a Safe Harbor match. In exchange, the Tax Code permits HCEs to defer up to the annual maximum with no ties to the NHCE's deferral rate. If the employer eliminates its safe harbor contribution, then HCEs face limits on their 401(k) deferral and match amounts.

**3. Required Contributions to a "Top Heavy" Plan.** The Internal Revenue Code defines a plan as "top heavy" if Key Employees (generally defined as employees who have greater than 5% ownership and certain officers) own 60% or more of plan assets. If the plan is top heavy and used by Key Employees, the employer must make a 3% profit sharing contribution to all eligible employees. Because of this obligation, employers often make a 3% Safe Harbor contribution. It fulfills the top heavy requirement plus allows HCEs to make the annual maximum 401(k) deferrals.

If an employer with a top heavy plan eliminates a Safe Harbor election, it may not result in cost savings. The plan would still be subject to the top heavy rule and the required 3% company contribution.

**4. Responsibility for Plan Costs:** Department of Labor guidance permits an employer to have plan administration and investment costs paid by participants. Employers are not required to shoulder these fees. Depending upon the nature of the fee, they may be passed through to participant accounts and either pro-rated or paid on a per capita basis. Often the cost to the individual participant is relatively small.

*For example, assume that Company A's plan has \$5 million of assets and currently incurs a \$10,000 annual accounting fee for its large plan audit. It could have this fee paid by plan participants. If the fee is prorated based upon plan assets, each participant will only pay 0.2% of his/her account balance. On a \$25,000 account, that amounts to \$50.*

**5. Match Rules:** Although eliminating a match is one cost saving alternative, an employer has two less drastic approaches.

- a. **Change the formula:** An employer may either reduce the rate of match or the amount of the deferrals matched. In either case, it will save employer contributions, but still give the employee incentives to save. For example, assume Employer has a current match of 50% on the first 6% of employee 401(k) deferrals. The employer may either reduce the match rate from 50% to 25% or reduce the amount of deferrals matched, i.e. from 6% to 4% or any combination thereof.
- b. **Make the match discretionary on an annual basis:** Rather than eliminating a match prospectively, an employer could change the match to an annual contribution made after the close of the plan year. This change allows the employer to assess the profitability for the year and then choose whether to make a match. If the employer decides that it can afford the match, it

may dictate the match formula at that time. This approach permits the employer to reward its employees if business does not take the anticipated downturn.

**6. Profit Sharing Criteria:** In order to reduce company costs, an employer could reduce the number of individuals who receive a profit sharing contribution in one of two ways.

- a. **Last Day/1000 Hour Requirement.** A plan may avoid making profit sharing contributions to employees who are not employed on the last day of the plan year or who do not work at least 1,000 hours. Depending upon turnover rate and certain coverage rules, this change in plan design could eliminate an employer's obligation to make a contribution for terminated or part time employees.
- b. **Designate Classes.** If a plan passes certain discrimination tests, it may designate separate classes of employees for profit sharing purposes and thereby use profit sharing contributions more effectively.

*For example, assume that Company A has two divisions, B & C. Division B had a profitable year, Division C struggled. If the plan placed employees of each division into a separate allocation category, then (subject to discrimination testing) the company could make a profit sharing contribution for employees of Division B and no contribution for employees of Division C.*

**7. Forfeitures to Offset Company Contributions:** A forfeiture occurs when an employee terminates work and is not fully vested. Plan terms control the application of the forfeited portion of the participant's account. The Internal Revenue Code permits employers to use plan forfeitures to offset future company contributions. This change will directly improve the company's bottom line.

*For example, Company A currently has \$10,000 per year in forfeitures resulting from employee turnover. Its annual match contribution is \$80,000. The employer changes the plan design so that forfeitures offset company contributions. Now the company's annual match obligation is reduced to \$70,000. Forfeitures cover the remaining \$10,000 obligation.*

Companies should assess the costs and benefits associated with their retirement plans regardless of the state of the economy, but hard times make the issue more apparent. In addition to the usual considerations of employee morale and productivity, employers should consider unforeseen technical aspects of changing the benefit structure. Otherwise, they may solve one problem only to create another.

At Alerus Retirement Solutions, we pride ourselves on our ability to offer suggestions on practical ways to make your retirement benefit work better for your company. If you should have questions regarding modification of your plan, feel free to contact us. We would welcome the opportunity to visit with you.

## Investment Update - Winter 2009



*Sunil Swami,  
Chief Investment Officer  
Alerus Financial*

### **Equities: Investors bid good riddance to 2008**

For equity investors, 2008 was one of the worst years in stock market history. The Dow Jones Industrial Average fell 33.8%, its worst annual performance since 1931 and its third worst performance in over 100 years. The broad Standard & Poor's 500-stock index fared worse (down 38.5% for 2008). U.S. stocks lost over \$8 trillion in market value from their

peak in October 2007. There was no place to hide as every sector ended the year in negative territory. Financials at the epicenter of the credit storm fared the worst (down over 50% for the year), while healthcare stocks did the best (down about 25%).

As U.S. housing prices began to fall in 2007, homeowners began defaulting on their mortgages at rates significantly greater than in the past. Highly leveraged financial companies that held these mortgages and mortgage-backed securities such as investment banks, commercial banks and insurance companies saw their market values rapidly disappear. Lehman Brothers filed for bankruptcy, J. P. Morgan bought Bear Stearns and Washington Mutual, Bank of America bought Merrill Lynch and Countrywide Financial and Wells Fargo bought Wachovia. The U.S. government had to step in and buy Fannie Mae, Freddie Mac and AIG.

With banks and non-banking financial institutions saddled with bad debt, there was widespread fear that the nation's financial system would implode. Stocks fell precipitously in the summer of 2008 forcing the U.S. Treasury and Congress to step in and pass a \$700 billion Troubled Asset Relief Program to inject capital into the banking system. The Federal Reserve cut the fed-funds interest rate from 4.25% to a range between 0% and 0.25%. These and other actions taken by the U.S. government and governments around the world appeared to have calmed investor fears. Stocks recovered almost 20% of their value since they bottomed in November 2008.

Consumers, responding to declining home values and equity investments, pulled back their spending. The U.S. economy, as well as, the global economy, went into one of the worst recessions since the Great Depression. Homebuilders and automobile companies were the hardest hit. Fearing bankruptcy, General Motors, Chrysler and Ford appealed to Congress for a bailout. However, there were

some bright spots. As consumers sought value, Wal-Mart and McDonald's prospered and their stocks ended up for the year. Biotechnology companies were unaffected by the financial meltdown or the spending slow-down—Amgen and Genentech's stocks ended up for the year.

The credit crisis, which originated in the U.S., did not spare a single international market. The Dow Jones World Index, excluding the U.S., fared worse than domestic markets (falling 46%). Adding to their woes, investors fled local currencies and sought safety in the U.S. dollar. European banks also held the same mortgages as their American counterparts and suffered a similar fate. In the U.K., Royal Bank of Scotland is now controlled by the government and stock values of large financial institutions such as UBS are down over 70% to 80% from their peaks. The Dow Jones Stoxx index of Europe's 600 largest companies fell 46% in 2008. Iceland, a haven for leveraged finance, was the worst performer (down 92.6%).

In Asia, Japan's Nikkei Stock Average was down 42.1%, its worst performance ever. In dollar terms, however, the index fell only 29.3% as investors unwound their risky carry trades using low interest rates in Japan to borrow yen and invest in other countries and currencies. When the credit crisis began in the U.S. many analysts believed that emerging markets could "decouple" from the developed world. This proved to be incorrect and the MSCI Emerging Markets Index fell 54.5%, faring worse than U.S. markets. As consumer demand in the West declined, export oriented economies such as Japan and China suffered the consequences. In China, the Shanghai Composite Index dropped 65.4%. As China went down so did the demand for commodities—thus hurting commodity-exporting countries like Brazil, Australia and Russia.

### **Bonds: U.S. Treasurys "A friend in need is a friend indeed"**

My finance professor at Sloan School of Management at M.I.T. used to say, "Buy securities in your portfolios that will hold their values and may even appreciate as other asset values collapse around you—a friend in need is a friend indeed." In times of crisis, U.S. Treasurys have held up well and they did so again in 2008 (rising 14%). Long-term Treasurys did better (up 24%) as the yield on the 10-year Treasury note dropped from over 4.03% (down to 2.25%).

Beyond Treasurys and bonds backed either by the U.S. government or government-backed agencies, there was no place to hide. Even municipal bonds dropped 2.5% as many municipalities felt the impact of lower real estate taxes and rising unemployment. Other sectors did worse. Bonds backed by home-equity, where the credit crisis began, fell over 30% and securities backed by sub-prime mortgages, auto loans and

*CONTINUED ON PAGE 4*

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credit cards fell 21%. Non-investment grade corporate bonds fell 26%, making it the worst year in history for this market. Investment grade corporate bonds fell 7% as spreads rose from 2% over comparable Treasury bonds to over 6%.

Credit markets remained closed for issuers most of the year. According to Thompson Reuters, U.S. investment grade issuance fell 35%, high-yield issuance fell 73% and mortgage-bond issuance fell over 80% in 2008. When Lehman Brothers filed for bankruptcy the commercial paper market for short-term loans froze until the Federal Reserve introduced programs to provide liquidity to money market funds and to buy paper directly from companies.

#### **Commodities: A roller-coaster ride**

The Federal Reserve began cutting interest rates in the fall of 2007 to counter the impact of defaulting sub-prime mortgages. The dollar fell and commodities, which are priced in dollars, rose sharply in the first half of 2008. Investors saw commodities as an alternative to stocks and were optimistic that demand from China and India would not be impacted by the credit crisis in the U.S. Crude oil began the year below \$100/barrel and peaked at \$145/barrel in July of 2008. Other commodities such as corn, soybeans and copper also reached their all-time highs. Gold crossed \$1,000 a troy ounce.

The second half of 2008 was a complete turnaround. Consumers, responding to high gasoline prices, rising home foreclosures, higher unemployment and a drop in the value of their investments, began driving fewer miles. As asset prices fell, banks and hedge funds that had rushed into commodities were forced to sell to reduce leverage and meet margin calls. The financial crisis had spread to the rest of the world tipping the global economy into a recession. Commodity prices fell and swiftly wiped out multi-year gains. The Dow Jones AIG Commodity Index dropped 37% for 2008. Oil went from \$100/barrel to \$44.6/barrel at year-end. Copper lost 54% and corn was down 11%.

#### **Real Estate: In the eye of the storm**

The credit crisis began when house prices stopped rising and began to fall in 2006. In 2007, problems appeared to be contained among sub-prime borrowers in formerly high-flying markets such as Miami, Phoenix and California. In 2008 the full brunt of the crisis unfolded as one-in-ten borrowers faced foreclosure or were delinquent on their loans. According to the S&P/Case-Shiller index which tracks home values in 20 cities, house prices fell 23% from their peak in 2006 through October 2008. Lending standards tightened and the mortgage market froze as originations dropped by 50%.

Commercial real estate did not face the over-supply problems of residential markets and held up well through the first half of the year. However, as credit became unavailable property owners could not refinance loans when they came due and were forced to sell in a market where all asset prices were falling. The Dow Jones REIT Index, which tracks publicly traded real estate companies, fell more than 38% in 2008. As consumers cut back on their spending, investors began pricing its impact on retailers and, subsequently, owners of mall properties. As unemployment rose, investors anticipated falling office rents.

#### **2009: A year of healing but will the animal spirits return?**

Paul Krugman, Nobel-prize winning economist, said recently, "Economists agree that government spending on defense during World War II ended the Great Depression. However, no one can adequately explain why the post-war economy did not fall back into a recession." Today, central bankers around the world have cut interest rates and infused massive liquidity into the financial system. In the U.S., the Federal Reserve expanded its balance sheet up to \$800 billion in excess reserves to buy commercial paper and even mortgages. The Obama administration is expected to spend up to \$1 trillion on government programs. The Chinese government has announced a \$525 billion stimulus program. Other countries have followed through with their own spending plans. These actions have already improved investor sentiment. Credit spreads have narrowed and stocks have recovered a bit. But the larger question is, how will the government extricate itself from all this lending and investment activity? Will the private economy function normally when governments stop bailing it out? We are in uncharted territory and investors will soon find out.

Meanwhile, it is expected that house prices will continue to fall and consumers will spend less and save more. Since consumer spending represents 70% of the U.S. economy, we expect this recession to continue through the end of 2009. The Federal Reserve is expected to keep rates low as long as is needed. In this environment, we prefer bonds—particularly government-backed agencies, mortgages and some high quality corporate bonds. As government programs begin to take effect, the economy should recover later in the year and into 2010. Riskier assets, such as high-yield corporate bonds, real estate, commodities and stocks, are likely to bottom out in the second half of 2009 in anticipation of better times in 2010. This recovery scenario assumes that the government will allow failed business models and excess capacity to be taken out. If it does not, the recovery might take much longer.