

COVENANT PENSION PLAN AND INSURANCE BENEFIT PROGRAM
FINANCIAL CONSIDERATIONS

The Covenant, through its Board of Pensions and Benefits and staff, provides a retirement plan for pastors and missionaries and a medical, prescription drug, dental, life and disability benefit program for pastors, missionaries and church workers. Day-to-day management of these programs is a shared responsibility among the Business Office and Department of the Ordered Ministry.

For Bethany Benefit Services, we collect premiums for health, life, and disability insurance and remit payments to third party administrators or insurance companies. In addition, we administer the financial functions for the Covenant Pension Plan including premium collection, benefit payments, investment of fund assets (asset allocation, investment manager selection and performance evaluation) and actuarial liability management.

Covenant Pension Plan

The Covenant Pension Plan is a defined benefit plan, which covers pastors and missionaries of the Evangelical Covenant Church. Significant advantages of a defined benefit are:

- The Covenant Pensions and Benefits Board, not the participant, assumes responsibility for achieving the needed investment return to pay retirement benefits (through asset allocation; investment manager selection and evaluation; and actuarial valuation).
- Retirees and surviving spouses do not outlive their benefits.
- The plan has an automatic 65% surviving spouse benefit.

The Pension Plan is managed under policies developed by an investment committee and approved by the full board. The fund has policies that assure, among other things, that assets are not invested in companies where a significant portion of the business is the manufacturing or sale of alcohol, tobacco, weapons of war or gambling.

The Covenant Board of Pensions and Benefits and staff use outside experts to advise them in discharging their fiduciary responsibilities. Deloitte & Touche, one of the nation's largest accounting firms, audits the Covenant Pension Fund financial statements annually. Hay Actuarial Consultants, one of the largest actuarial consulting firms and a consultant to many church denominational pension plans, does an annual actuarial valuation and regularly provides actuarial consulting services to the plan. Fund Evaluation Group, a large investment consulting firm to pension plans, endowments and foundations, advises the Covenant Pensions and Benefits Board on investment performance measurement and evaluation, asset allocation, education, and investment manager selection.

We regularly review the investment performance of our managers, our asset allocation across asset classes and potential new asset classes. By asset allocation, we mean what percentage of the overall portfolio is invested in major categories of assets – for example, different types of domestic equities, fixed income, international, absolute return and private equity. We do this in order to develop a return/risk investment profile geared to meet actuarial liabilities (which recognize our pension benefit obligations). We have developed a Pension Investment Model, which allows us to plan for the future under alternate asset and liability scenarios.

At the present time, the plan covers 1,796 individuals, including 953 active pastors and missionaries in the plan, 347 retirees, and 134 surviving spouses. The average ages of those pastors and missionaries covered by the pension plan are actives (47.9 years), retirees (76.2 years) and surviving spouses (81.2 years). The average

years of service for current actives are 11.8 years. The range of ages for retirees is from 63 to 98. The range of ages for surviving spouses is from 45 to 98.

The pension fund's current asset allocation is: large cap domestic equity (35%), small cap domestic equity (16%), international equity (18%), international real estate (2%), absolute return (8%), fixed income (19%), private equity (1%), and timber (1%). Eighteen outside professional investment managers are responsible for investments in the following asset categories:

<u>Asset Class</u>	<u>Manager</u>
Large capitalization growth equity	Fayez Sarofim
Large capitalization growth equity	Marsico Focused Growth
Large capitalization value equity	Barclays Enhanced Value Index
Large capitalization equity	Barclays Enhanced 500 Index
Small capitalization growth equity	Kalmar Investments
Small capitalization value equity	Boston Partners
Private equity	Abbott Capital
Private equity	Northgate Partners
Private equity	Newlin Energy Partners
Timber	Sustainable Woodlands Fund
International equity	EuroPacific Growth
International equity	DFA International Small Cap Value
International equity	DFA Emerging Market Value
Absolute return	Gateway
Absolute return	PIMCO All Asset Fund
Fixed income	Dodge & Cox
Fixed income	PIMCO
International real estate	Cohen & Steers

Each year as we complete our annual asset allocation study, we examine additional asset classes that by adding them to the fund can improve the risk/return profile of the portfolio through either enhanced returns and/or returns less correlated with the rest of the portfolio. Over the last year we have added a large cap growth equity; an international emerging markets; an absolute return; an international realty and a private equity manager.

Of our 18 investment managers, 3 are in separate accounts and 15 in pooled accounts.

The Covenant Pensions and Benefits Board has made increases in minimums (**when investment performance permits**) for both retirees and surviving spouses a high priority as summarized in the table below:

MONTHLY PENSION MINIMUMS

	<u>Retiree</u>	<u>Surviving Spouses</u>
1995	\$480	\$320
2001	\$765	\$575
2007	\$933	\$700
% change 1995-2007	94%	119%

Effective April 1, 2007, the Covenant Board of Pensions and Benefits announced a 6% increase in minimums as well as a 6% increase in across the board retirement benefits.

As a result of salary progression, growth in number of retirees and benefit increases, total benefit payments have increased significantly in recent years:

<u>Year</u>	<u>Benefit Payments</u>	<u>Ratio to 1990</u>
1990	\$1,386,000	
1995	\$2,477,000	1.8x
2000	\$3,938,000	2.8x
2006	\$5,093,000	3.7x

Total benefit payments to retirees and surviving spouses during the last 10 years have been \$39 million!

Over the last 20 years from 1986 to 2006, assets in the plan have increased as follows:

	<u>Assets</u>	<u>% of Total</u>
Assets, December 1986	\$14,200,000	9%
Net contributions (premiums minus benefit payments)	\$23,100,000	15%
Market appreciation	<u>\$114,600,000</u>	76%
Assets, December 2006	\$151,900,000	

This illustrates the importance of prudent investment decisions and strong investment results to the long term financial viability of the Covenant Pension Plan.

In support of the pension plan, board and staff do much analytic work designed to have adequate assets available to pay pension liabilities as they accrue. Each year, with the assistance of our investment consulting advisor (Fund Evaluation Group), we review our pension fund asset allocation. Effective asset allocation can simultaneously improve the risk/return profile and provide appropriate diversification. Investment research indicates that about 90% of portfolio return is attributable to sound asset allocation. Through broad diversification across asset sectors and investment managers, the Covenant Pension Plan seeks portfolio growth consistent with low variability in returns. We carefully manage portfolio risk by monitoring volatility (beta), standard deviation and correlation for the equity portfolios and duration in the fixed income sectors.

During 2006, the plan's investment return was +13.5%. Over the past 20 years, the Covenant Pension Plan annual investment return has averaged 9.4%.

In regularly evaluating investment results on a quarterly basis, we compare both: (a) investment results vs. appropriate investment indices and (b) assets vs. actuarial liabilities.

The Covenant Pension Plan is currently in solid financial position, as of April 30, 2007, with both market value of assets and actuarial value of assets modestly in excess of actuarial liabilities.

Benefit Programs

The Bethany Benefit program for pastors, missionaries and church workers consists of the following:

- Medical PPO coverage through Blue Cross/Blue Shield as a third party administrator.
- Dental indemnity and PPO coverage through Delta Dental.
- Long-term disability (at 60% of pay for disabilities over 90 days) through UNUM.
- \$75,000 of group life insurance coverage through AIG.
- Prescription drug card through Express Scripts.
- An employee assistance program through UNUM.
- Employee paid (optional) long-term care insurance through CNA.

Effective in 2002, any employee covered by our LTD coverage, who goes onto long-term disability, will have their Bethany premiums paid for the next 24 months. Also effective in 2002, any pastor covered by both Bethany and the Covenant Pension Plan, who is on long-term disability, will have their pension premiums paid (at the salary level they were receiving at the time long-term disability began) for as long as they remain on long-term disability. **These long-term disability coverages are of tremendous value to both churches and pastors, in those situations where a pastor is on long-term disability. These coverages are one of the real values of being in the Bethany plan and are not available elsewhere.**

Effective January 1, 2004, our medical insurance administrator/provider network changed to a nationwide Blue Cross/Blue Shield plan. We believe that this change contributed very positively to our good claim results since 2004 through the following:

- Much greater network coverage
- Deeper discounts for medical charges
- Easier filing of claims (especially for retirees)

Effective January 1, 2005, we changed our dental network provider to Delta Dental, the nation's largest dental network. By so doing, we have generated cost savings for both participants and the plan.

Our medical programs (health, dental and prescription drug) rates are based on the experience (which is credible) of **our** Covenant pastors, missionaries and church workers. However, we do negotiate, in combination with many other denominations (consisting of over 250,000 individuals), to get favorable network and administrative costs from Blue Cross/Blue Shield, Delta Dental and Express Scripts.

Following a period of rapidly escalating claims in 1999 and 2000, we have had very good claims experience in recent years. For the year 2007, our medical rates increased 5%. Over the last five years, Bethany has had the following medical rate increases: 8% (2003), 5% (2004), 5% (2005), 0% (2006), and 5% (2007) for a compound annual medical rate increase of 4.6% over the last five years. At the same time, many other group plans were experiencing compounding 10-20% rate increases for each of these five years, for a total 5 year increase in plans in excess of 60%.

At its February 2007 meeting, the Covenant Board of Pensions and Benefits, upon recommendation by staff and with previous review by our health actuaries, declared a June 2007 one month medical premium holiday. As a result, **2007 Bethany medical paid premiums will be 3.3% below the 2005 medical rates of two years ago!** This medical premium holiday will save local Covenant churches over \$800,000 in premium payments during 2007

Not surprisingly, in view of our rate increase situation, we are experiencing enrollment growth.

In our judgment, it is crucial for our ministry, missionaries and local Covenant churches that we continue to have a viable effective Bethany insurance program (especially from a financial perspective) because it enables both pastors and local churches to facilitate movement of Covenant pastors between churches.

Some years ago we learned that the Presbyterian USA denomination was forced to drop denominationally sponsored health insurance. In their announcement they stated:

“... the employees who will be most affected by the termination of the health care plan are those with pre-existing conditions and immediate health concerns such as heart problems or cancer.”

We continue to attempt to manage the Bethany program so that the Covenant hopefully will never find itself in such a difficult situation.

Our health insurance actuaries tell us that high medical inflation trends will continue in the marketplace. Principal drivers for higher medical cost inflation include the following major components:

- an aging work force (which typically incurs more medical treatment)
- improved (and expensive) medical technology
- aggressive diagnosis and preventative treatment
- saturation of managed care cost control, leaving fewer untapped cost savings opportunities

Factors contributing to prescription drug cost increases are:

- direct-to-consumer advertising has created greater demand
- increase of new and innovative drugs in the market
- some new expensive drugs do not generally have lower cost generic alternatives yet available
- the general level of prescribing drugs has been increasing significantly, partially attributable to an aging population and the practice of “defensive medicine.” It has been estimated that only 11% of individuals over 65 are not on at least one prescription medication.

Previously, the Covenant Benefit Board commissioned Hay Associates to review our benefit programs, obtaining input from our pastors and comparing our programs with those of other denominations. Hay concluded that our insurance and retirement programs were at the median (middle) in comparison with other denominational plans.

Conclusion

Managing benefit programs today (given medical trend inflation and the volatility of investment markets) is very demanding. Our study by Hay Associates indicates that our programs are well positioned compared to other denominations.

We are pleased to note that:

For the Covenant Pension Plan:

- Performance continues to be solid
- Assets are in excess of liabilities (which is our goal and many times today is not the situation for various corporate and government pension plans).

and for Bethany:

- In recent years, rate increases have been very low (*further improved by a medical premium holiday for June 2007*)
- Enrollment is growing (which is healthy)
- We continue to have good experience

Currently, both our pension and medical programs are in strong financial shape in providing good benefits to our pastors and missionaries who are called to serve our mission and ministry, both in local churches and across the world!

Dean A. Lundgren, Director of Pensions
May 2007

