CARES Act Impact on Defined Benefit Pension Risk

January 2021

DeMarche

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Point of Discussion

01 CARES Act provided temporary lookback relief

02 Funded status of corporate plans has been declining

03 Cash contributions were deferred until 1/1/2021

04 Pension risk transfer costs are declining

05 Pension return assumptions are declining

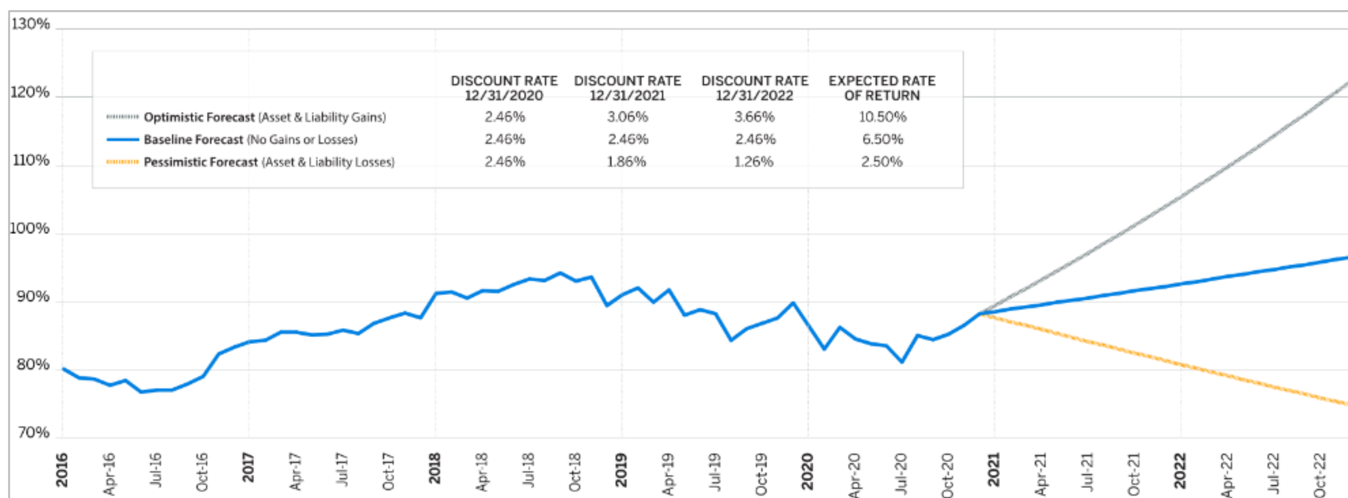
06 Pending HEROES Act may provide future relief

The Coronavirus Aid Relief and Economic Security (CARES) Act is a $2.2 trillion economic stimulus bill that was passed into law on March 27, 2020 in response to the economic fallout of the pandemic in the U.S. A key component of the legislation included immediate relief for defined benefit plan sponsors by providing more time to plan for the future. This paper examines the current condition of these plans across four metrics (funded status, contributions, benefits payments, and asset returns) and pension risk management strategies for the future.

ERISA Funded Status

Under the Cares Act, plan sponsors can rely on their funded status certifications for the 2019 plan year to determine if benefit restrictions for 2020 plan year are applicable. This "lookback year relief" can be particularly impactful for programs with plan years ending in February/March/April, which experienced the brunt of the Covid-19 crisis bear market.

The chart below shows the changes in DB Plan funded status, on a US GAAP accounting basis, for the Milliman 100 Pension Funding Index (December 2020). The chart covers the past five years to provide context for the severity of the situation, combined with forecasts for the future of funded status based on optimistic, baseline and pessimistic forecasts. Note that funded status on an accounting basis does not reflect any interest rate funding relief.



Compounding the stress on funded status is the fact that interest rate relief provisions under current law are scheduled to slowly dissolve starting in plan year 2021 and continuing through 2024.

Zorast Wadia, Principal with Milliman, stated in June 2020[1] :

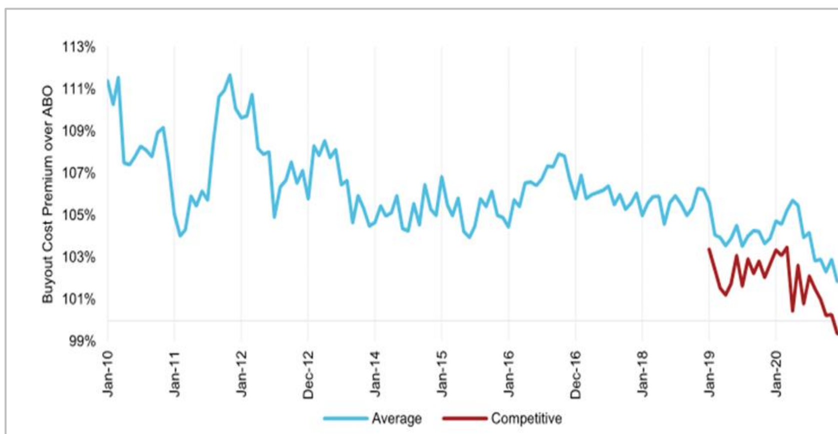
> *"The result will be a lowering of the funding interest rates and a consequent increase in plan liabilities and, in most cases, minimum contribution requirements. The likely effect of funded status losses stemming from the coronavirus economic meltdown will be increased cash contribution requirements for plan sponsors starting in 2022, right in the middle of the interest rate relief erosion. This double whammy could be a serious issue for plan sponsors"*

Cash Contributions

The CARES Act also allowed sponsors to defer all normally required cash contributions in 2020 to January 1, 2021. It also gave sponsors the option to make voluntary contributions if they had free cash flow or their businesses recovered later in the year. This aspect of the CARES Act provided another risk mitigation tool for pension managers. It is important to note that the Act did not extend any deadlines for tax deductibility of contributions. Plan sponsors must resume cash contributions in 2021, unless new legislation is passed, which could be a strain as they navigate the post-COVID market environment.

Benefit Payments

CARES allowed that, if a plan offered an accelerated form of payment like lump sums, and was able to avoid benefit restrictions in 2019, then the exemption could carry over to 2020 regardless of the plan's funded status. Offering lump sum payouts or purchasing annuities from a third party insurance company fall into the category of "pension risk transfer" strategies, which have been popular for some time. As a result of interest rate movements by the Fed, the cost of annuities has fallen sharply according to the Milliman Pension Buyout Index (December 2020) seen on the left.

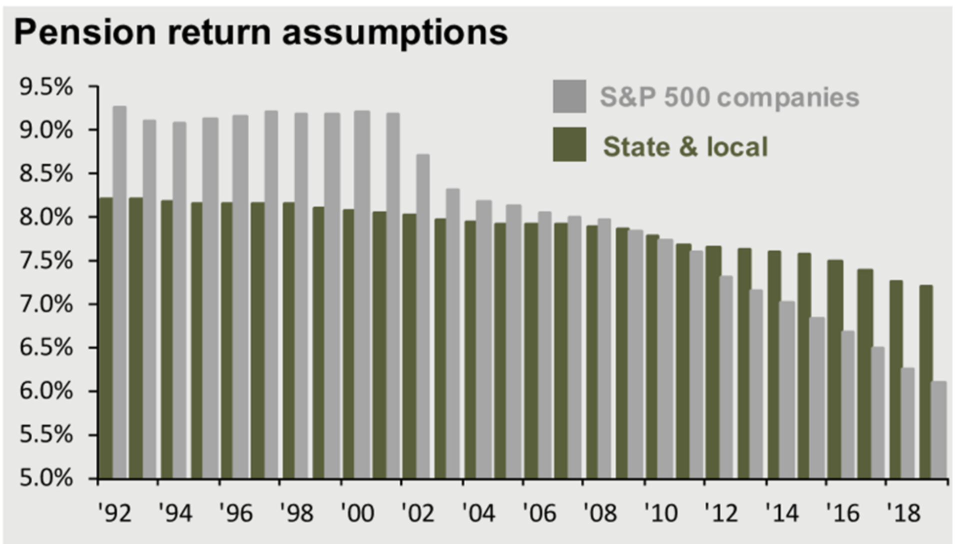


Pensions that have embarked on the de-risking path, which also includes interest rate immunization techniques, such as employing long duration fixed income portfolios, are in a stronger position to manage future uncertainty and market volatility.

Asset Returns

A challenging piece of the puzzle to sort out is what return assumptions to make for the capital markets in the coming years. The Fed's Zero

Interest Rate Policy (ZIRP) has forced downward pressure on yield curves and expected returns of fixed income securities. This also flows through to other rates impacting defined benefit pensions including discount rates used to calculate the present value of the liabilities and plan actuarial return assumptions. It is imperative that plan sponsors take a step back and assess the future for capital market risks and returns and asset allocation strategies as they attempt to manage pension plan risks for their enterprise. Public pensions have yet to fully adjust to the new world of lower expected returns as seen by the chart on the right provided by JPMorgan (December 2020). S&P 500 companies have been much quicker to adjust their pension return assumptions downward versus state & local pensions.



Future Relief

Looking forward, the Health and Economic Recovery Omnibus Emergency Solutions Act (HEROES Act) which has passed in the U.S House of Representatives but has since stalled in the Senate would provide additional support for pensions. Two key provisions include an extension of interest rate smoothing for calculating minimum required distributions and increasing the amortization period from 7 to 15 years for amortizing funding shortfalls.

Conclusion

The CARES Act has provided meaningful support to DB plan sponsors faced with managing pension risk during this historic pandemic, but the relief is temporary. Future relief in the form of the HEROES Act could be on the horizon, but just the same, plan sponsors must actively engage in a serious review of risk mitigation techniques to achieve longer term goals. DeMarche collaborated with Milliman, one of our actuarial partners for client asset liability work, to develop this paper. If your organization is in need of an asset-liability analysis, we would be happy to help you in navigating the new challenges that 2021 will bring.

Put Research To Work

with the DeMarche Team

Thomas C. Woolwine
Vice Chairman
(913) 384-4994

Houston McConnell, CFA
Senior Analyst, Investment Manager Research
(913) 384-4994

Sources Utilized:

- *Milliman*
- *JPMorgan*

1. Wadia, Z. (2020). DB Pension Plans: 10 Considerations in Light of the Coronavirus Crisis of 2020. Retirement Section News, Society of Actuaries.