



Responding to the COVID-19 Crisis

Plan sponsors have time to take strategic steps to help mitigate some of the risk inherent in these unprecedented circumstances.

BY ZORAST WADIA

As of this writing in late March 2020, we are in the midst of a crisis unlike any other in our history. The COVID-19 pandemic has caused economies worldwide to shut down voluntarily. At present, the severity and duration of the disease are unknown; the same is true of the impact on the economies of the U.S. and our global partners. The effect on pension plans will certainly be negative.

However, Congress responded quickly by passing the CARES Act, which provides a record-shattering \$2 trillion in stimulus—including some immediate relief for plan sponsors.

Despite the continued uncertainty, we can offer helpful guidelines for corporate pension plan sponsors based on past experience and the market data that is already in the books through the first quarter of 2020. Specifically, we will address the likely impacts on

pension expense and funded status. We will also discuss the impact of the CARES Act on required cash contributions in calendar year 2020. Moreover, we'll also point out some red flags to watch for over the next few years. Finally, we'll detail strategic steps plan sponsors can begin taking now to help mitigate some of the risks in these unprecedented circumstances.

GOOD NEWS: 2020 OBLIGATIONS BASED ON 2019'S NUMBERS

The first quarter of 2020 has been grim for financial markets, with the S&P 500 Index declining nearly 20% and the yield on 10-year Treasury bills falling below 1%. Fortunately, this has absolutely no impact on pension plan obligations or reporting in 2020 for calendar year plan and fiscal years.

Cash requirements for underfunded plans with calendar year plan years are based on the valuation results as of Jan. 1, 2019. They are paid as quarterly installments that the IRS views as a safe harbor amount. So plan sponsors can rest assured that cash projections for the current year will not be affected by recent market events. Furthermore, with the enactment of the CARES Act, all cash contribution requirements for the 2020 calendar year have been delayed to Jan. 1, 2021. This gives plan sponsors the ability to voluntarily make cash contributions during 2020 should they have free cash flow on hand.

Now let's look at the impact on the plan sponsor's P&L. These calculations are based on the full calendar year 2019—a period of mixed results but, again, excluding the current market decline.

Investment returns were strong in 2019, with assets increasing on average 15.7% as measured by the Milliman 100 Pension Funding Index (PFI). At the same time, discount rates fell around 110 basis points to historic lows, resulting in liabilities increasing by 17.4% across the PFI.

These key inputs interact in different ways when calculating the four principal components of pension

expense. Generally speaking, service cost would have increased due to the lower discount rate. Counterintuitively, interest expense could actually have decreased, particularly for plans with low duration in the 7-to-10-year range. Expected return on assets would be higher due to market appreciation during the year—though tempered perhaps by lower capital market expectations for 2020. Finally, most plans have loss amortizations on their books, and these losses would have likely increased relative to 2019 P&L due to the discount rate declines.

The net result is that pension expense would likely have increased for most plans, except those with very short duration, which might actually have experienced an improvement. Funded status declined in 2019 as the increase in liabilities outpaced asset growth. All told, these changes are moderate and well within the normal range of experience. Thus, the backward-looking nature of pension accounting buys plan sponsors valuable time to prepare for obligations that will begin to come due in 2021.

POTENTIAL PROBLEMS IN 2021 AND BEYOND

With the passage of the CARES Act, including \$2 trillion in stimulus plus \$4 trillion in liquidity available from the Fed, it's reasonable to expect that the U.S. economy will make it through this crisis. But will asset prices regain the levels of Jan. 1, 2020? And will the discount rate rise enough to take some pressure off of liability valuations? Right now, it appears likely that pension expense and funded ratios will take a hit in 2020.

To make matters worse, additional difficulties are lurking several years ahead as the interest rate smoothing relief, which was introduced in the 2012 MAP-21 bill and extended in the 2014 HATFA bill, is scheduled to phase out between 2021 and 2024. Currently, smoothing effectively mutes the impact of discount rate declines on the calculation of required cash

contributions. Starting in 2021, the phase-out would increase the cost of cash contributions significantly each year, possibly even doubling required cash contributions by 2024.

This implies that the losses occurring in 2020, should they persist through the end of the year, will impact the cash contribution calculation in 2022—at the exact time that half the benefit of the discount rate smoothing corridor is set to expire. This is a serious concern. In fact, industry associations are already discussing with Congress the need for further pension reform beyond the CARES Act provisions related to defined benefit plans. Proposals under discussion include extending the current interest rate smoothing provision, deferring extraordinary losses, and freezing PBGC premiums.

WHAT PLAN SPONSORS CAN DO TODAY

A proactive approach for plan sponsors would start with a review of funding projections over the next 5 years, or longer if possible. This would reflect the full widening of the interest rate smoothing corridor, revealing the full extent of changes to the cash contribution from 2019 to 2024. In addition, plan sponsors could also address optimal contribution deferral and funding strategies in light of the passage of the CARES Act. The plan review should also include best- and worst-case scenarios for market returns so you can model potential impacts on the P&L. And it may be necessary to consider how retirement plans can be better leveraged to deal with demographic changes resulting from the COVID-19 pandemic.

Addressing an increase in the cash requirement is straightforward: The sooner you can put in additional contributions the better. However, with the economic downturn experienced in the first quarter of 2020, many plan sponsors' organizations may be planning other uses of cash. All this could signal consideration of future

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plan de-risking strategies once the immediate crisis is under control.

In conclusion, the key point is not to panic, *because you have plenty of time to plan*. Under existing rules, cash contributions based on this year's market results would not be affected until 2022. Now, the CARES Act provides relief from any contributions due this year. It is essential to use this window to make workable plans to fund your contributions requirements over the next 5 years—at a minimum. Based on recent history and comments from key legislators, a second wave of relief from the current, historically low interest rate scenario could already be in the works. Nevertheless, it's best to be prepared for the possibility of challenging times for pension plans over the next several years. **PC**

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