

# Pension risk management: COVID-19 FAQs

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The rapid spread of coronavirus across the globe has ushered in a new era of economic uncertainty and, with it, uncertainty for sponsors of defined benefit (DB) pension plans. Market volatility has led many plan sponsors to ask a variety of questions. We hope the following FAQs help you thoughtfully consider the potential effects that market volatility resulting from COVID-19 can have on your plan.

## Questions—and answers

Like all retirement plans, DB pension plans achieve their long-term goals when plan sponsors and investment committees, who decide the path of pension funding and benefit design, put current market conditions in perspective.

### Q&A 1: Will market volatility spawned by COVID-19 impact my participants' benefits?

This is a very complex question as it depends on a number of variables. Pension plans typically fall into one of the following categories.

1. **Traditional:** This type of pension plan defines benefits as an annuity dependent on an employee's pay and/or service while working for the plan sponsor. Aside from the impact of COVID-19 on employment, market volatility does not directly affect the amount of benefits provided under this type of plan. However, volatility may affect the availability of optional forms that accelerate payment (i.e., lump sums) if the plan's funded status drops below 80%.
2. **Hybrid:** This type of pension plan typically defines benefits as a notional account balance (also known as a "cash balance" plan). In general, market volatility (even outside of COVID-19) will affect participant benefits over the long run, but the effect is dependent on plan design. The component of a cash balance plan that relates to stock and bond market changes is called an "interest credit." Thus, how the interest credit is calculated influences whether COVID-19 will have an impact and over what period of time.
  - a. **Fixed:** These plans define the growth in account balances as a fixed percentage. Thus, benefits determined under these plans are not directly affected by market volatility.
  - b. **Bond-based:** These plans define the growth in account balances based on the yield of a variety of bond indices (most commonly, the 30-year treasury). Thus, the long-

term impact of COVID-19 will be muted when compared to market-based plans described below and dependent on the long-term path of the bond index underlying the plan's definition of interest credit.

- c. **Market-based:** These plans define the growth in account balances based on the change in the value of the underlying trust. These plans have the highest chance of impact from COVID-19 for the types of pension plans described in this article, but the ultimate impact on participants will depend on several factors:
  - Asset allocation of trust (i.e., share of stocks versus bonds).
  - Depth and duration of any global recession that may result from COVID-19.
  - Timing of retirement – If an employee does not expect to retire for many years, the impact of COVID-19 will likely be less than that of an employee planning to retire soon under this specific type of cash balance plan.

Under U.S. law, plans governed by ERISA may not pay cash balance lump sums less than the accumulated value of "pay credits." Thus, there is a "floor" under account balances that may mitigate the short-term impact of COVID-19 for employees retiring soon.

Another type of hybrid plan is a "variable annuity plan." These plans will likely experience a similar impact as market-based plans above, depending on design. However, they do not typically have a "floor" benefit and thus present additional downside risk to participants if markets remain depressed for a lengthy period.

Pension plans are commonly offered in conjunction with a defined contribution plan (i.e., 401(k)), which will feel the impact of market volatility. Thus, today's market climate puts a spotlight on the need for regular contact between participants and financial advisers to stay on track for retirement.

More broadly speaking, ERISA may impose restrictions on lump sums and other benefit changes when the plan's funded status drops below key thresholds (80% and 60%, or 100% in certain bankruptcy situations). Thus, aside from the impact of market volatility on the amount of a participant's benefit, plans may be required to restrict certain options (i.e., lump sums) under the plan until the plan's funded status improves or may be required to freeze benefit accruals if the funded status falls below 60%. Under the CARES Act, the federal government provides short-term relief for sponsors during 2020 to mitigate the impact of benefit restrictions.

In the event of plan sponsor bankruptcy, participant benefits are insured by the Pension Benefit Guaranty Corporation (PBGC) up to certain thresholds for PBGC-covered plans.

### **Q&A 2: How does market volatility spawned by COVID-19 affect my plan's financial health?**

Similar to the first question, the answer depends on a number of variables. Plan sponsors follow a variety of metrics when determining their plan's "financial health," but the most common are funded status, required contributions, and accounting expense.

Over the long term, the impact of market volatility resulting from COVID-19 will be highly dependent on the depth and duration of any potential global recession and, more importantly, the speed of recovery. In addition, the plan's asset allocation will affect the impact of COVID-19 over both the short and long term.

Under U.S. law and accounting standards, single employer plan sponsors determine funded status based on corporate bond yields, not governmental bond yields. During the height of the most recent market volatility, credit spreads widened considerably, leading to higher discount rates for plans. All else equal, plan liabilities will decrease when a higher discount rate is reflected. Thus, while assets are declining, liabilities, in the short term, may be declining also. Sponsors should pay close attention to changes in corporate bond yields to evaluate whether the plan is experiencing an offsetting effect on their funded status from rising corporate bond yields.

Plans that have valuation dates in the short term (April through July) have the highest likelihood of seeing adverse effects from COVID-19 market volatility. Plans that value their assets and liabilities on January 1, the most common date for single employer U.S. pension plans, have more time to benefit from any future improvement in the markets.

As always, regular communication between your plan actuary and investment consultant will help you understand whether changes are needed to contribution schedules or asset allocation. If your plan has adopted investment policies that

reduce asset liability mismatch, commonly referred to as "liability driven investing" or simply "LDI," your plan will likely weather market volatility better than non-LDI plans, all else being equal.

### **Q&A 3: If I was planning to terminate my pension plan in the next two years, how will current market volatility affect my plan's path-to-termination?**

Most plans that are on a path-to-termination adjust their asset allocation toward higher percentages of investments that mirror changes in the underlying plan liability (also known as "liability driven investment" or "LDI") as funded status improves. If the plan is fully funded and 100% invested in fixed income that tracks changes in the plan's liability, then the impact of COVID-19 market volatility on plan termination will likely be muted.

If the plan is underfunded or contains significant asset liability mismatch, plan sponsors may need to reassess their plan termination timing to determine the most cost-effective path to termination under current market conditions.

In order to terminate a pension plan, the sponsor must purchase a group annuity contract from an insurer to settle liabilities for any participants who do not take a lump sum (including ongoing retirees). Insurers invest across the fixed income risk spectrum (including government bonds – yields at all-time lows) as well in real estate and equities (limited). Regular discussion with your plan actuary can prepare you for changes in the estimated cost of purchasing a group annuity contract to complete your plan termination.

## **Conclusion**

While these FAQs were written from the perspective of single employer plan sponsors in the U.S., several of the concepts, especially in the first question, also apply to other plan types (governmental and multi-employer). The best way to make informed decisions about how to manage your pension plan in today's market climate is through consultation with your plan's advisers. Many sponsors will look to projections and sensitivity testing as a way to model the impact of different strategies to mitigate market volatility. For those who are able, they may even consider using additional capital to take advantage of market volatility to improve the plan's long-term funded status.

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