Deeper Dive into Retirement Program Implications of COVID-19

April 9, 2020 Webcast

Recap

As employers manage through the crisis, it is critical for them to consider how the retirement plans they sponsor can support their employees develop financial resilience while meeting the company's financial objectives.

Effect of market volatility on pension funded status and employee savings

The month of March brought considerable volatility with equity markets fluctuating daily, interest rates declining and corporate credit spreads widening. In the U.S., we estimate that the average pension funded ratio fell 8% in the first quarter.

In Canada, there were similar declines in equity markets and interest rate conditions from an accounting funded status perspective. However, Canadian plan sponsors should also be keeping an eye on the solvency ratio, which is largely driven by government bonds. With the decline in Canadian bond yields in the first quarter, the solvency position of pension plans has deteriorated. In fact, the solvency ratio for the typical plan would have declined 14% in Q1 2020. Depending on the province, this decline in solvency ratio may also impede the ability of a plan to pay lump sums to terminating members.

The crisis has also had an effect on employee savings. The first quarter brought reductions in account balances from about 15% for employees nearest retirement to over 20% for those just beginning their careers. The market shock increased the time horizon for employees who are nearest to retirement to be financially ready to retire by about half a year for a sample company.

Policy response

In the U.S., the CARES Act provides temporary funding relief for defined benefit plans. Contributions required in 2020 may be delayed until January 1, 2021 with some exceptions. And for defined contribution plans, the CARES Act includes provisions to provide flexibility around short-term financial needs for COVID-19 impacted participants. These include: 1) an increase in the maximum plan loan limit, 2) plan loan repayments after date of enactment and before January 2, 2021 can be deferred for up to one year, 3) tax-favored, penalty-free distributions up to $100,000. For all defined contribution plan participants, 2020 required minimum distributions have been waived.

In Canada, pension reform was introduced over the past couple of years in most jurisdictions, which provided significant funding relief. While there are ongoing discussions with pension regulators about providing relief due to the pandemic, no legislation has been released.

Employer response

Defined benefit plans. Employers sponsoring defined benefit plans are taking the following actions:

- Assess the effect of market volatility and identify near-term priorities (balance sheet, P&L, cashflow, debt covenants).
- Execute near-term opportunities to meet cashflow/cost needs (funding strategies, program design, operational costs).
- Monitor participant behavior, review economic and demographic assumptions.
- Prepare for the future by recognizing that a different path forward may be necessary and revisit defined benefit plan financial management strategy as stability is restored.

These strategies apply to both U.S. and Canadian plan sponsors. In addition, Canadian sponsors are looking to perform off-cycle valuations. In Canada, funding valuations are required every three years. Filing funding valuations earlier than required provides sponsors with contribution certainty and stability, in effect locking in the pre-COVID 19 position of their plan.

Defined contribution plans. Some sponsors of defined contribution and savings plans are taking short-term actions to ease corporate cash flow concerns. For example, they might eliminate, suspend or reduce employer contributions and/or institute a maximum contribution or a maximum matching contribution dollar limit. However, careful consideration should be given when taking such action to avoid unintended consequences or impact to employees' longer-term financial wellbeing.

Employers are also taking actions to support employees' near-term financial needs throughtheir defined contribution and savings plans. In addition to the changes allowed by the CARES Act, sponsors seek to help employees strike the right balance for their situation. It's important to educate employees on implications of withdrawals, loans, and possible sources (such as HSAs). . Employees will want to avoid unintended consequences, as using retirement savings now could negatively affect their longer-term financial wellbeing.

Key retirement elements of workforce reduction programs

An employees' ability to access defined contribution and defined benefit plan dollars depends on the type of workforce reduction program a company implements. Funds in defined contribution plans can be accessed in the case of a layoff, voluntary separation or involuntary separation. Furloughs, because they are temporary, have the most restrictions. However, in the event of a furlough, defined contribution plan dollars can be accessed via hardship withdrawals, loans or in keeping with the provisions allowing penalty - free withdrawals beginning at age 59½.

When it comes to defined benefit plans, access to funds in the event of a layoff, voluntary separation or involuntary separation will depend on the terms of the plan, including the eligibility date and whether a lump sum provision exists. In the case of a furlough, a defined benefit plan will only provide access to funds if the plan allows for in-service distributions starting at age 59½. Such a provision will specify whether there is a lump sum option.

In addition to defined contribution and defined benefit plans, workforce reduction programs also have other compensation and benefits implications. It is important to consider how these design factors, as well as other factors, affect participant engagement.

Rethinking retirement plans

A crisis such as this one should spur plan sponsors to rethink how they create and manage retirement plans. The objective should be to develop financial resilience now and in the future for the benefit of their employees and the company.

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