

# THE AMERICAN RESCUE PLAN ACT BRINGS RELIEF AND HIGHLIGHTS CHALLENGES FOR US PENSION PLAN SPONSORS



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The American Rescue Plan Act (ARPA) was signed into law on March 11, 2021, and included a variety of plan sponsor–friendly changes to single-employer and multiemployer pension plans, but no real help for public sector plans. The corporate world is receiving additional funding relief, while the poorest-funded multiemployer plans are receiving a much-needed rescue. Ultimately, ARPA may change the future landscape of US pension plans, which may prompt plan sponsors to modify their investment strategies to achieve plan objectives. Its impact will vary greatly, both by plan type and individual plan circumstances.

## SINGLE-EMPLOYER PLANS

While ARPA's impact will differ based on the funded status of each plan, it also highlights the age-old interconnection between contribution policy and investment strategy.

- **FOR WELL-FUNDED PLANS, ARPA CHANGES VERY LITTLE**, as these plans were not required to pay minimum required contributions in the first place. We don't anticipate these plans will change their investment strategies, which likely will be centered on duration-matched fixed income.
- **FOR UNDERFUNDED PLANS, ARPA WILL SIGNIFICANTLY REDUCE FUTURE CONTRIBUTION REQUIREMENTS**, potentially causing a shift between reliance on employer contributions and investment returns to achieve fully funded status. Some plans may reduce reliance on growth assets, given that the benefits of moving into riskier strategies to reduce contributions is now less. On the other hand, if plans were relying on contributions to improve funded status and are now no longer budgeting to make these contributions, then more growth-oriented strategies would ultimately have to be implemented in the asset portfolio to achieve similar full funding.
- **MANY PLANS (INCLUDING THOSE THAT ARE FAIRLY WELL FUNDED) SHOULD DEFINE A CONTRIBUTION POLICY**, as it is likely that mark-to-market funded status may deteriorate if contributions won't flow into these plans, especially if there are benefit accruals. If plan sponsors are not careful and take too long of a "contribution holiday," they may be surprised by significant contribution requirements in the future, once the funding relief begins to wear away. Plan sponsors in this situation should begin considering a contribution policy in line with their objectives and budgetary constraints.

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- **MANY PLANS WILL HAVE TO RE-EVALUATE PORTFOLIO LIQUIDITY**, as lower future contributions mean greater reliance on the investment portfolio for liquidity needs, mainly to fund benefit payments and administrative expenses but also any capital calls.

## SUMMARY OF MAJOR ARPA CHANGES FOR SINGLE-EMPLOYER PLANS

ARPA's single-employer plan funding relief has four main components, the first being the largest:

- 1. EXTENSION OF THE INTEREST RATE SMOOTHING CORRIDOR.** This corridor refers to the minimum interest rate that can be employed to value the liability used for determining contribution requirements (Funding Target). It was 90% in 2020 and was scheduled to decrease to 85% in 2021 (meaning that the interest rates could not be lower than 85% of the 25-year average of rates). ARPA increased the percentage to 95% retroactively to 2020 and maintains this percentage until 2026, when it will begin decreasing by 5% per year until it reaches 70%. Plan sponsors should see approximately a 50 to 75 basis point (bp) increase in their discount rates used for funding purposes.
- 2. AN ULTIMATE FLOOR OF 5% FOR THE 25-YEAR AVERAGE RATES.** This means that, from now on, the interest rate used for funding cannot be less than the corridor percentage multiplied by 5% (4.75% through 2025, decreasing to 3.5% in 2029 and beyond).
- 3. PRIOR SHORTFALL (UNDERFUNDING) BASES HAVE BEEN ELIMINATED.** These bases were set up each year the plan was underfunded under the Funding Target basis and were previously amortized over seven years.
- 4. FUTURE SHORTFALL BASES WILL BE AMORTIZED OVER 15 YEARS.** The extended amortization generally implies that underfunded plans will be expected to become fully funded over 15 years.

## MULTIEMPLOYER PLANS

While ARPA provides a variety of relief measures, the largest is the rescue of the worst-funded plans. Overall, the major impact is that the lifeline for these plans has been extended by at least 30 years. From an investment perspective, this may mean more assets will begin flowing into investment-grade bonds, although probably not enough to move the market—keep in mind the US Federal Reserve is purchasing \$120 billion in bonds a month. One of the restrictions to receiving these funds relates to the “allocation of plan assets,” potentially meaning these plans will not be able to change how they are currently invested. Thus, we may have to wait and see if ARPA results in any significant changes to these plans’ strategies, potentially after additional guidance from the Pension Benefit Guaranty Corporation (PBGC) or US Department of Labor.

Many of ARPA's possible implications have not been fully defined yet, and the PBGC may issue guidance on certain provisions in the future. These measures could include addressing the impact on the actuarial discount rate. Even though the original asset allocation of the plans receiving ARPA relief may not be modified, the addition of investment-grade bonds into the portfolio may impact the actuarial discount rate for the plan, since it is ultimately tied to the plan's asset allocation. The addition of investment-grade bonds into the portfolio would lower the expected return of the entire portfolio. This, in turn, may prompt plan sponsors to lower the discount rate, which would increase the liability and lower funded status.

Another potential outcome could relate to more aggressive risk taking. Some plans may consider increasing the risk of their investment strategy, knowing that if the strategy fails, the plans will have the backstop provided by ARPA, which allows them to certify as Critical and Declining through 2022, and receive the relief funds. This “Hail Mary” option may be contemplated by plans that are on the cusp of this status and may feel abandoned by the current relief measures.

#### **SUMMARY OF MAJOR ARPA CHANGES FOR MULTIEMPLOYER PLANS**

- Plans that were projected to go insolvent in the near future (Critical and Declining Status), had benefits suspended under the Multiemployer Pension Reform Act of 2014, and some others are going to receive enough money to pay for benefits for the next 30 years. Overall, this is projected to be around \$86 billion in total. The money will be received as a lump sum and has to be invested in investment-grade bonds.
- Changes to Pension Protection Act rules including:
  - Delay of certifying as endangered or critical status;
  - Extension of periods for rehabilitation, or for funding improvement plans;
  - Additional amortization periods of losses; and
  - PBGC premium increases, starting in 2031 (from \$31 to \$51 per participant, indexed to inflation)

#### **PUBLIC SECTOR PLANS**

The law makes it clear than any funds going to state and local governments cannot be used for their respective pension plans. While money is certainly “fungible,” we don’t anticipate significant changes to these plans in terms of contribution or funding strategy.

#### **CONCLUSION**

While ARPA brings significant funding relief to many single-employer defined benefit plans, it also introduces additional complexity in achieving plan sponsor objectives. For some, the desire to further rely on growth assets to reduce contribution requirements may now be reduced. For many others, there is still a need to “ultimately pay the piper.” Whether this payment comes from higher contribution requirements down the road or leaning on the plan’s investment portfolio until then, the need to improve funded status should be addressed. For others, the relief provided by ARPA may be irrelevant as funded status has improved so much that required contributions may be a distant memory. Many of these plans have already taken the necessary steps to de-risk their portfolio, have codified their policies, and are now looking forward to achieving their objectives. No matter where plans fall along this spectrum, however, the investment strategy must be tailored to the plan objectives and requirements.

The relief for multiemployer plans can only be considered a rescue of the poorest-funded plans. There are certainly strings attached, and we will have to wait some time before the ultimate impact is known. The relief also highlights the dichotomy between plans that have been managed well and those that have not. We can certainly imagine some strong feelings from plans not receiving the relief funds, as they seem to have been entirely excluded from the relief measures.

One thing is for certain: regulatory changes have and will result in changes to the US-defined benefit system for years to come. ■

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