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De-risking Corporate Pension Plans Is Getting Tougher

After making great strides to improve DB funded ratios, increased market volatility and delayed contributions may reverse that momentum.

Corporate defined benefit (DB) pension plans have made great progress in de-risking their portfolios and nudging them toward fully funded status in recent years. But those advances are in trouble.

Increased market volatility from the coronavirus crisis could harm cash-strapped companies' retirement programs. And one double-edged sword is the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which has furnished short-term liquidity relief. It allows plan sponsors to delay 2020 contributions to the next calendar year. Taking this step, though, risks unwelcome side effects.

A contributions delay could result in weaker future funded ratios for companies that elect to take advantage of the relief, which means that companies eventually seeking to offload pension funds from their balance sheets will find it that much more difficult to do. Investors are already entering the second half of the year wary of continued market volatility and low discount rates that will hinder investment returns.

Until the end of the fiscal year, it will be unclear which businesses have elected to take advantage of the funding holiday, although analysts say many are mulling the option. “I think there’ll be a delay in recognizing the broad impact that this might have,” said Theresa Roy, product specialist at Income Research + Management.

Headwinds

Earning back losses may inspire some corporate pension plans to take on more risk in their asset allocation, a reversal of the liability-driven investing (LDI) techniques they’ve been using to de-risk portfolios, Roy said.

In recent years, corporate pension plans have been moving toward more conservative portfolios. In 2018, fixed income counted for 43% of plan assets, compared with 30% for stocks. By comparison, just four years prior, in 2014, the two asset classes were even, about 39% each, according to a 2019 report from Conning. Last year, 88% of S&P 500 company plans used LDI, according to a survey by Goldman Sachs Asset Management.

But in 2020, the pandemic pummeled the aggregate funded status of corporate DB pension plans. In May, the funded ratio for the 100 largest corporate pension plans fell to 84%, down 5.8 percentage points for the calendar year, according to a June report from the consulting firm Milliman. Despite strong investment gains in May, the deficit swelled to $306 billion from $289 billion at the end of April because of lower discount rates. Rates had fallen another 50 basis points (bps) this year.

Volatility also remains in the equities market, and the threat that skittish investors will prompt another market dive is large. While the S&P 500 finished the second quarter up 20%, in its best rally in more than two decades, many market observers aren’t resting easy. They’re concerned that frothy markets propped up by the Federal Reserve could tank in the second half of the year.

Earnings and revenue are expected to take a shellacking, certainly in the performance reports that are about to be released for the second quarter—and beyond. That’s not a good harbinger for contributions to plans. “Corporate

America is doing far less well than the stock market suggests," said Constantijn W.A. Panis, principal at Advanced Analytical Consulting Group.

All this creates a lot of uncertainty for institutional investors. But it may especially hurt DB plans in sectors that are hardest hit by the pandemic, such as the automobile and health care industry.

A number of hospitals, for example, are under great financial pressure to treat COVID-19, meaning the cost of caring for patients, as well as spending for extra personal protective measures and equipment, has skyrocketed, according to a report by the American Hospital Association. Many nonprofit health care systems have also had to defer elected surgeries for patients, meaning a significant source of their cash flow was also interrupted.
"All these coupled together may encourage a sponsor to consider having a riskier asset allocation going forward just so that they can try to earn out of their deficit," said Income Research + Management's Roy, who believes it could be a longer-term shift.

But other experts say this may not be the case. Plan sponsors wary about continued volatility in the markets may want to stick with more conservative allocations, given that portfolios with more equities and alternatives lost a disproportionate amount of money in March. "That's sort of fresh in folks' minds," said Wendy Towber, credit analyst at S&P Global Ratings.

It's also important that pension plans maintain a long-term investment perspective and not make any rash decisions based on what happened in March, since they're not expected to hit their assumed return every single year.

Coming Up
Situations differ, of course, from plan to plan. How the pandemic will impact pension plans will depend on a variety of different factors, including whether pension plans actually decide to delay their contributions. Another factor is what the percentage of the contributions will be relative to the budget. Anywhere above 8% to 10% of expenditures, including the other post-employment benefits is

good. Other considerations include who's setting the pension guidance: the actuary or the plan's investment board, which may be more flexible.

Coming up, investors are also watching how future fiscal relief will shape how the coronavirus will continue to impact funded ratios. While the CARES Act allowed plans to delay contributions, another $3 trillion fiscal aid package currently is languishing in the US Senate that includes other forms of relief. The package for single employer retirement plans includes extending amortization periods for funding shortfalls to 15 years from seven years.

Given these challenges going forward, funded statuses are expected to weaken for many systems. In coming months, we'll know the extent of the damage.

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