Client Action Bulletin

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Plan termination and de-risking strategies under the American Rescue Plan Act of 2021

The American Rescue Plan Act 2021 (ARPA ’21) provides relief for defined benefit (DB) pension plans by effecting changes to the Internal Revenue Code and allowing for optional retroactive application dates. How does this new funding relief affect a plan sponsor’s decision to terminate or de-risk its single employer DB plans?

Despite bond yields at historic lows, the fourth quarter of 2020 saw its second-highest quarter on record for the LIMRA Secure Retirement Institute’s survey of insurers (and highest since 2015) for pension risk transfer activity. The increase in activity was partly due to strategies that reduce plan liabilities through annuity purchases. This helped to minimize rising plan liabilities due to declining interest rates. In addition, many plan sponsors were motivated by the expectation that the plan’s 2021 Pension Benefit Guaranty Corporation (PBGC) premium would be significantly higher without de-risking a segment of the plan.

The passage of the American Rescue Plan Act of 2021 helps employers sponsoring single employer defined benefit plans that may have struggled to meet the minimum required contributions under Internal Revenue Code (IRC) §430 in 2020 due to the effects of the global pandemic on their business and their employees. ARPA ’21 provides flexibility to plan sponsors by designating longer amortization periods and by resetting their DB plan deficits using modified higher interest rates to calculate the actuarial liabilities.

Lower cash contributions and longer amortization periods

ARPA ’21 sets all existing shortfall amortization bases to zero in the plan year in which the plan sponsor elects to apply the provisions of the new law. In addition, the amortization period is extended to 15 years from seven years. These changes will almost assuredly result in lower minimum required contributions for those who take full advantage of the relief. For more information, please see the Milliman Client Action Bulletin.

DB plans currently on the path to termination

Single employer DB plans that are on the path to termination may be tempted by the new funding relief, but likely have an alternative funding schedule or plan to fully fund their expected termination liability, which has not changed under ARPA ’21. **Interest rates used to calculate lump sums and annuity placements that are needed for plan termination are not affected by ARPA ’21 and remain at current low levels.** However, with strong investment results over the past couple of years, plan sponsors may have made further progress toward funding their plan termination liabilities.

DB plans working toward plan termination that are using a glide path or dynamic liability-driven investment (LDI) strategy should also see minimal impacts from ARPA ’21, because the actual investments are moving in tandem with current interest rates instead of the modified rates under pension relief. These plans should also remain steadfast toward their goals of ultimate termination and not change any funding strategies in most circumstances.

The expectation is the annuity purchase and de-risking market will remain strong given that these plans were projected to purchase annuities in the next few years. ARPA ’21 should have a negligible impact on their strategies.

DB plans considering de-risking

The interest in the de-risking market has been robust through the global pandemic. Increases in PBGC premiums and rising Accounting Standards Codification No. 715 (ASC 715) accounting liabilities due to low discount rates have driven plan sponsors to reduce their liabilities through lump sum offerings and annuity placements.

The disconnect between the IRC §430 Funding Target and ASC 715 accounting liabilities is expected to grow with ARPA ’21 enactment. Many plan sponsors considering de-risking opportunities are motivated by reducing their balance sheet liabilities. While higher Internal Revenue Service (IRS) funding percentages will show up on IRS Form 5500 filings and U.S. Department of Labor (DOL) Annual Funding Notices, the impetus to reduce the balance sheet obligation will remain strong.

The impact on PBGC premiums is still unknown at this time. **For plans that fund the minimum required contributions, the expectation is that higher PBGC premiums are likely because funded status for the PBGC measurement will decline**. Plan sponsors have historically looked at PBGC premium savings as a motivation for de-risking, and the expectation is this will continue with ARPA ’21 changes. Absent further clarification published by the PBGC, plan sponsors could expect their premiums to continue to increase if funding levels are reduced through a change in strategy due to ARPA ’21. On the other hand, any federal tax policy changes could influence what corporations do with their free cash flow. Should corporate tax rates escalate as a means for paying for the ARPA ’21 stimulus package, plan sponsors may decide to increase their contribution funding, which could lower future PBGC premium expenses.

De-risking through a traditional buy-out annuity purchase lowers the headcount and PBGC liability, which in turn lowers PBGC premiums. Although the reduction in plan assets will likely be higher than the reduction in actuarial liability, sponsors could realize long-term PBGC premium savings and will be motivated to de-risk their plan. For pension plans affected by the PBGC variable-rate premium cap (currently $582 per participant for 2021), the reduction in headcount through an annuity purchase buy-out or other de-risking strategy can be even more impactful, because each participant removed from the plan could result in further PBGC savings.

Other de-risking considerations

Although some DB plan sponsors may have contemplated de-risking opportunities, many have been discouraged by the costs or impacts to their plans. Those that have taken advantage used pension risk transfers of a subset of participants, particularly retirees in payment status, where the plan sponsor may monitor the market for an opportunity to minimize the cost of these premiums and offload the liability without a loss of funded status using tools like the Milliman Pension Buyout Index. While many plan sponsors may look at higher rates as a signal to act, there can be opportunities even when the bond yields are low.

IRC §436 benefit restrictions are expected to be less of a concern to most DB plan sponsors. The use of higher interest rates under ARPA ’21 will result in higher adjusted funding target attainment percentages (AFTAPs). Many plan sponsors have a goal of avoiding benefit restrictions for a multitude of reasons. Avoiding the administrative headache of sending benefit restriction notices and limiting the plan’s ability to offer accelerated forms of payments such as lump sums is a motivation for many. As long as the plan’s AFTAP is above 80%, lump sum benefit restrictions are not of concern. With the interest rate relief offered in ARPA ’21, some plan sponsors will have larger cushions to de-risk portions of their plans and still remain above 80%, so plans can continue to function normally.

Besides future interest rate and investment results, plan sponsors should also consider how they may react to a change in corporate tax laws as noted earlier. Significant pension relief was enacted in 2012’s Moving Ahead for Progress in the 21st Century Act (MAP-21) and resulted in many sponsors making additional pension plan contributions to increase their deductions and avoid higher corporate taxes. The enactment of the Tax Cuts and Jobs Act of 2017 (TCJA) spurred additional contribution and tax policy actions. Plan sponsor contributions accelerated at the end of 2017 when corporate tax deductibility laws were scheduled to decrease in 2018. If a plan sponsor is considering alternatives for uses of free cash flow, making additional contributions to their DB plans for de-risking purposes may be a good strategy.

What this means for plan sponsors

Due to the ability for plan sponsor to adopt the different ARPA ’21 relief provisions with separate effective dates, and the range of effective date choices including retroactive application, analysis and the decision process could be quite complex. For those on the path to plan termination, ARPA ’21 should have minimal impacts. For other sponsors considering de-risking, careful consideration and analysis should be performed to understand the risks and to optimize funding and investment strategies. The relief offered by ARPA ’21 will allow the funding flexibility for many plan sponsors to get their DB plans back on track toward their funded status goals, and de-risking will continue to be a topic fresh on the minds of many plan sponsors in 2021 and beyond.

Further technical guidance is expected and necessary from the IRS and possibly from the PBGC. As noted above, ASC 715 measurements are not affected, but any change in the plan sponsor’s funding pattern or funding policy will ultimately affect funded status on any measurement.

Milliman will continue analyzing, as quickly as possible, the different areas in which ARPA ’21 will affect plan sponsors.

For more information on how this legislation may impact your single employer pension plan(s), please contact your Milliman consultant.

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