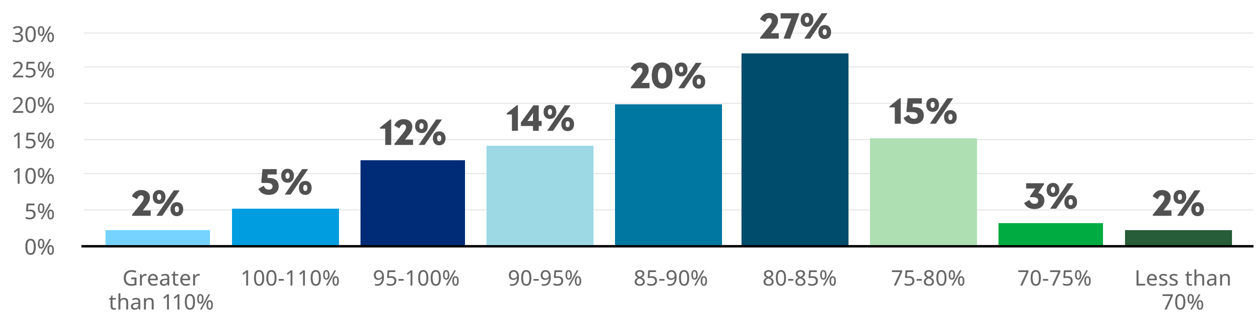
Expanding funding options

Under the American Rescue Plan Act (ARPA), companies have more funding options for their defined-benefit pension plans. For most DB plans, the legislation lowers the minimum contribution amounts required from companies. The contribution amounts are also insulated from market fluctuations, meaning that companies can better predict future contributions over the next several years. For the CFO, the funding relief offers flexibility to explore other funding goals, such as building to a future funded percentage where their DB plan could be terminated. Or, for companies with DB plans that are already well-funded, CFOs could find opportunities to shift part of the annual allocation to other areas of priority in the company.

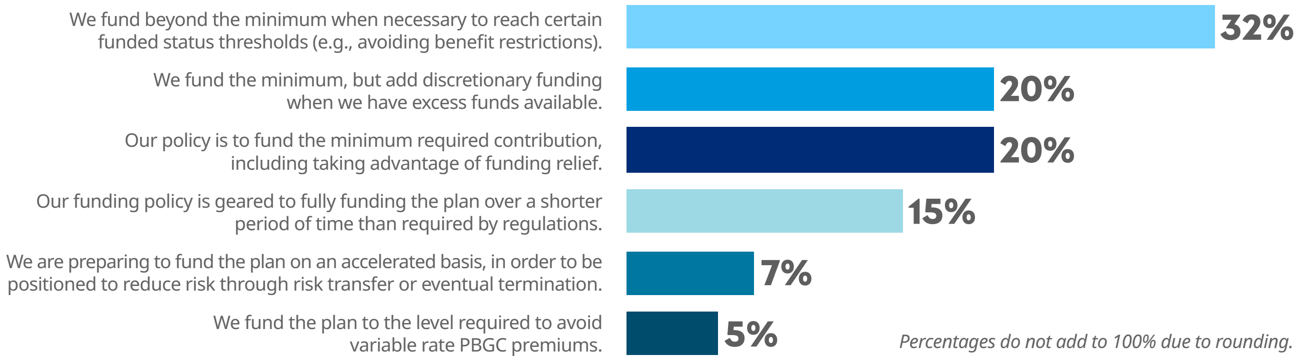
The CFO Research survey of 201 executives showed companies are primed to make changes to their DB plans and they're planning to take advantage of the funding relief legislation. To avoid potential pitfalls, plan sponsors will have to consider their long-term objectives before adopting new funding strategies. Fully adopting pension funding relief will delay contribution requirements, and offer flexibility to save cash for several years, but that may come with an increase in Pension Benefit Guaranty Corporation (PBGC) fees – which in part are based on the funding level of the plan – and may lead to significantly larger contributions over the long-term. On the other hand, if the strategy targets a specific funding level – like plan termination -- the funding could be more volatile as market conditions change. We expect most employers will take a balanced review of the business case considerations of funding relief with long term objectives in mind, while others may be eager to immediately take advantage of the opportunity to contribute less. All in all, the flexibility offered with relief is welcomed by plan sponsors.

The funded ratios reported by the surveyed executives skewed lower than prior survey results. Through the first quarter of 2021 we have seen equities at new highs, and increases in interest rates that improved most plans' funded status. Most companies on the whole still have more work to do in shoring up their DB plans, and the funding relief in the new legislation may have an impact on the pace and time horizon of getting there. The largest percentage of the survey respondents, 26%, reported their DB plans have current funded ratios (plan assets divided by projected benefit obligation) of 80% to 85%, with 19% in the 85% to 95% range and 15% in the 75% to 80% range. Nearly three quarters of the respondents, 73%, fell into ranges between 75% and 95%. During 2020, we saw the funded status of a typical plan decrease by 10% through March, and end the year down 3%, and then increase 10% through the first quarter of 2021. This illustrates the inherent volatility in a typical plan, and the challenge that many plan sponsors are focused on addressing.

What is the current funded ratio on an accounting basis (i.e., PBO/plan assets) of your organization's largest DB plan?



Which of the following statements best characterizes your organization's approach to funding its pension plan?



Percentages do not add to 100% due to rounding.

What motivates companies to fund their plans? According to the survey, the most popular funding approach—cited by 32% of the respondents-- is to fund to a threshold to avoid PBGC filings or participant notices. Tied for second-most popular, both at 20%, were: 1. Fund the minimum required contribution and take advantage of funding relief, and 2. Fund the minimum, but add discretionary funding when excess funds are available. As a slight departure from prior survey's results, only 15% say they are geared to fully fund the plan over a shorter time period than the regulations stipulate. This is down from 29% in 2019 and points to higher needs for cash in other parts of the business.

The survey also indicated that most of the reasons for modifying pension funding policy have to do with risk transfer goals. And eight out of 10 of the surveyed executives said they had either increased or were considering increasing contributions to avoid PBGC premiums. Taken as whole, the top motivating factors described by the surveyed executives indicate more of a short-term outlook on funding, probably by the financial challenges of 2020 presented by COVID-19.

For Ralph Balestriere, CFO of Red Wing Shoe Co., interviewed as part of the survey project, the motivating factors for increasing the funded ratios for the three qualified DB plans at his company were mainly to hit an 80% level mandated by the funds' charter and then to ultimately reach 100% so the company could exit the plans, which are all frozen to new entrants. Red Wing Shoe is a privately held footwear company based in Minnesota. The funded ratios for the three plans rose to 100%, 100% and 78%, up from about 70% for all three in 2010. "We were in tough shape," Balestriere says.

Whether by the fund charter or avoiding PBGC premiums, CFOs have many options for funding policy for their plans. The new funding relief delivered by ARPA will give flexibility to meet their needs.

To what extent are future PBGC premium costs affecting your organization's contribution policy?