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A YEAR TO PIVOT

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Uh-Oh, We're in a Pandemic... Now What?

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By all accounts, 2020 has been an extraordinary year, and the surprises keep on coming. You may remember at the beginning of the year (seems like forever now), we were wishing a happy new year 2020 to family and friends and hoped for a great year. Well, that didn't turn out quite like we expected.

As we all know too well, the effects of the COVID-19 pandemic first hit hard in March 2020. The stock market fell by more than 30% in a matter of just a few weeks and most of the country went into lockdown. At that time, we braced ourselves for the worst, not knowing exactly how things would play out. Many of us expected a repeat of the so-called Great Recession of 2008-2009, or something similar to the technology bubble crash in the early 2000s, or possibly something even worse.

Effects of the Pandemic on the Upcoming Actuarial Valuation

In Florida, most local governmental pension plans perform actuarial valuations on an annual basis, with a valuation date of October 1st (corresponding to the prior fiscal year end). Now that the fiscal year ending September 30, 2020 has passed, we are getting the first glimpse of how the pandemic will impact the different pension plan metrics.

For most pension plans, the investment returns will likely be much better than we had expected back in March. For the fiscal year ending September 30, 2020, the actual rate of return for most pension plans will actually be near or above the assumed rate of return. This is mainly due to a strong rebound of the stock market from its March low. Lower interest rates also helped drive up the investment return on fixed income investments.

In addition, as a result of the pandemic, pension plans may experience gains on the actuarial liability. In particular, salary increases may be less than assumed, more layoffs or terminations than expected may occur, and the number of participants that passed away during the year may be greater than expected. On the other hand, there may be more retirements during the year than expected, more deaths or disabilities in the line of duty than expected, and additional compensation (or "hazard pay") granted to certain employees. The net impact of these factors will vary from plan to plan.

All things considered, the actuarially required contribution developed in the upcoming valuation reports will likely be similar to those developed in the previous year, and the funded ratios will likely show a slight improvement for most plans.

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How will the Pandemic Affect Future Actuarial Valuations?

While plan investments did better than we all expected at the beginning of the pandemic, future plan investment performance may not be as favorable. It will be difficult for the stock market to continue the upward trend it's been on since March, especially considering the higher than usual level of risk and uncertainty that financial markets are currently facing. Also, with interest rates at an all-time low, the great returns in the fixed income market in the past year will be difficult to repeat. At the same time, the economic slow-down caused by the pandemic will likely continue to shrink local governmental revenue sources, putting a strain on the plan sponsors' annual budgets.

If pension contributions make up a large portion of the sponsor's annual budget, it may be in the best interest of both the local government and the pension

plan to work together to plan ahead. As you may know, local governments in Florida are required to fund the actuarially required contribution amount each fiscal year. This has helped most Florida plans maintain much better funded levels and remain more sustainable than in many other parts of the country. However, if local governments struggle to balance budgets together with large and unexpected pension contributions, pension reforms may ultimately be introduced as a way to lower pension costs.

So, what can be done?

Pension boards can work with plan sponsors to better plan for future contribution requirements. Consider the following steps:

1. You can ask your actuary to prepare a forecast showing expected contribution requirements and funded status for the pension plan over the next several years. That should also include stress tests or "what-if" scenarios to better understand the range of variability of future contributions. There may be actions you can take to smooth out future contribution volatility using the knowledge derived from these types of forecasts.

As an example, actuarially required contributions are typically made up in part of a payment on the pension plan's unfunded liability (similar to a mortgage payment on your home loan). For most pension plans, a new amortization base is created each time the assets and liabilities in the actuarial valuation are different than previously expected. The plan sponsor's contribution requirements therefore increase or decrease when new amortization bases are created or when they are fully paid off. Knowing when a scheduled increase or decrease in the contribution requirement is expected to occur can help you eliminate contribution volatility, by either combining different amortization bases, or by strategically implementing desired method or assumption changes at the same time.

2. If the actuarial assumptions haven't been reviewed in a while, it may be good to have your actuary perform an experience study and assumption review sooner rather than later (since the current economic and demographic assumptions used in the actuarial valuation may become out of date). This will help to stabilize contribution requirements in the long term, since the assumptions used in the valuation will line up more closely with expected future experience. The use of updated assumptions may even result in lower contribution requirements.

Knowing the impact of updated assumptions will help the plan sponsor to budget for future contribution requirements, and allow you to time their implementation. This is preferable to updating the assumptions after they become so out of date that they cease to be considered reasonable.

3. If revenues are expected to be more limited in future fiscal years, the sponsor may find it helpful to contribute additional amounts (above the actuarially required contribution) before the real tough times hit. The additional contribution can be set aside in a prepaid contribution reserve and can be used to offset future contribution requirements.

Knowing where the plan is headed and the possible actions the Board can take will help everyone feel more prepared to deal with the ongoing effects of the pandemic. Having an open dialog and working partnership between the pension Board and plan sponsor can help the plan achieve better outcomes.

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erdale, Florida office. He has more than 15 years of actuarial and benefits consulting experience. Nicolas provides actuarial and consulting services to both public and private sector employee retirements systems and OPEB plans. Nicolas's work for his clients includes preparation, supervision, and presentation of actuarial valuations and GASB/FASB accounting disclosures, benefit redesign studies, experience studies, and cash flow projections. He also has significant experience performing modeling studies, including asset/liability studies using deterministic and stochastic approaches. Nicolas has worked for both public sector and middle market private-sector plans.

Dina is a Consultant in GRS' Ft. Lauderdale, Florida office. She has over 10 years of experience working with employee retirement systems and OPEB plans. Her clients include both public and private sector benefit plans. She currently serves clients in Florida. Dina's actuarial experience covers funding and accounting valuations, experience studies, assumption and plan design modeling, and multi-year forecasts of valuation results. Her benefits consulting background includes total reward statements, lump sum payout windows, plan termination work, retirement readiness studies, and development of benefit calculators. ■