May 2021

TAKING STOCK: TAFT-HARTLEY/ MULTI-EMPLOYER PENSION PLANS AWAIT ARPA 2.0

Michael D. Cairns, Partner, Taft-Hartley

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The American Rescue Plan Act (ARPA) of 2021 provides much-needed respite to our Taft-Hartley/ Multi-Employer clients with distressed pension plans.

The $86 billion relief package, which comes following prior failed legislative attempts, aims to provide benefit payments for 30 years—through 2051—for eligible plans, with no repayment requirements. These payments are to be provided in a lump sum amount and the assets are to be managed in a segregated pool, distinct from the current plan assets. While the ARPA, in its present form, is certainly well-intentioned and a promising start, we believe it requires further clarification and/or modification if it is to succeed in its goal of helping troubled pension plans achieve solvency.

As presently written, the separate pool of assets is to be invested in high-grade bonds and other yet-to-be-determined investments, with expected returns of 5.65% — the level of investment income required to ensure the benefit payments last over the proposed 30-year period. The legislation, which is yet to be ratified, uses this 5.65% interest rate to determine the amount of financial assistance; it is calculated as the Pension Protection Act (2006) third-segment rate, an average of long-term yields on high-quality corporate bonds, plus 2%.

However, our forecasts for investment-grade bonds indicate a 2.1% expected return over the next 10 years and a 3.2% expected return over the next 30 years for the U.S. Aggregate Bond asset class; and a 3.1% expected return over the next 10 years and a 4.4% expected return over the next 30 years for long credit. Both expected returns are a far cry from the intended 5.65% return expectation for the financial assistance program, which will be administered by the Pension Benefit Guaranty Corporation (PBGC). The "+2%" included in the investment assumption might be recognizing current low rates, but any transition to higher rates would produce losses in a bond portfolio, so there is no way to invest the segregated pool without taking significant basis risk.

We have conveyed these facts and concerns to Michael Scott, the executive director of the National Coordinating Committee for Multiemployer Plans (NCCMP), an industry group. Specifically, in the review we prepared for the NCCMP, we outlined the following two options for consideration:

1. The interest rate used in the financial assistance calculation should be modified to a more reasonable return expectation based on current yields if the lump sum assets are expected to fulfill 30 years of benefit payments as intended and only investment-grade bonds are used for the financial assistance assets; or

2. Allow for the use of asset class exposures outside of investment-grade bonds, such as public equities, lower-rated corporate debt, and certain private markets assets, for instance, private debt, private infrastructure and private open-end real estate. To that end, we prepared asset allocation scenarios for the NCCMP showing how a 5.65% return could be achieved, particularly over the prospective 30-year period, and all asset allocations to achieve this expected return mandated utilization of asset classes outside of investment-grade bonds.

Taft-Hartley/Multi-Employer pension plans meeting one of these four qualifying requirements will be eligible for financial aid:

i. The plan is in critical and declining status for plan years 2020 through 2022

ii. A suspension of benefits has been approved

iii. The plan is in critical status with a modified funding percentage less than 40% and a ratio of active-to-inactive participants less than 2/3

iv. The plan became insolvent after December 16, 2014, and has remained insolvent since, and has not been terminated

Along with input from other investment, legal and actuarial firms, the NCCMP has prepared a detailed analysis of the initial ARPA legislation with suggestions for the necessary clarifications for the PBGC to review. Further guidance from the PBGC is expected within the next four months and we are optimistic that our concerns around the initial legislation will be addressed. Should the final regulation allow asset classes outside investment-grade-rated securities, our clients can count on our asset allocation and research capabilities to help the segregated assets achieve their intended return target on a risk-adjusted basis.

Additionally, it is yet to be determined if the financial assistance assets will be considered part of a plan's assets overall and if Title I of ERISA, specifically the "duty to diversify to avoid large losses," will be applied. One thought is that if the segregated assets are to be largely invested in fixed-income investments, it would allow the current non-segregated plan assets to be invested in a more aggressive manner, that is, with higher exposures to public and private equities, especially considering the muted return expectations for investments overall over the next 10- and 30-years. If the new segregated assets are considered to be a part of the plan's overall assets, the diversification requirement under Title I would be met. Again, we are awaiting further clarification on this matter in the final PBGC guidance slated to be issued.

Our hope is that the PBGC carefully considers the proposed changes/modifications to make the ARPA achieve its full potential. We encourage our clients to discuss the eligibility requirements, as well as other provisions—the Temporary Funding Relief and PBGC premium increases—contained within ARPA with their actuary or legal counsel. Meanwhile, we will keep our Taft-Hartley/ Multi-Employer clients updated on any new information that comes forth and provide our counsel as needed. Please don't hesitate to contact your NEPC consultant to discuss any aspect of the ARPA.

IMPORTANT DISCLOSURES

Past performance is no guarantee of future results.

All investments carry some level of risk. Diversification and other asset allocation techniques do not ensure profit or protect against losses.

The information in this report has been obtained from sources NEPC believes to be reliable. While NEPC has exercised reasonable professional care in preparing this report, we cannot guarantee the accuracy of all source information contained within.

The opinions presented herein represent the good faith views of NEPC as of the date of this report and are subject to change at any time.

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