SOCIETY OF ACTUARIES

Aging and Retirement

Effects of Ephemeral Mass Unemployment

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Effects of Ephemeral Mass Unemployment

Introduction

Many effects of the COVID-19 pandemic on American retirement savings may be predicted and addressed by analogy or reference to past crises.

The economy contracted suddenly and precipitously as the coronavirus spread across the globe. Such drops can, for example, leave defined benefit pension plans severely and unexpectedly underfunded, due to the simultaneous decline in plan asset values and prevailing interest rates. In the past, Congress has responded with funding relief legislation,[2] and it has done so again in response to the COVID-19 pandemic.[3]

Loss of childcare, unemployment, increased healthcare costs, and the need to take care of sick or elderly family members, among other factors, have recently left many Americans short of cash. Liquidity crises are not new, and the response to them, while not routinized, is familiar. For example, rules regarding hardship distributions and plan loans may be relaxed.[4] In response to the COVID-19 pandemic, Congress has again followed this path.[5]

There are plenty of other familiar challenges for which policy makers may or may not offer medicine. When the economy suffers, so too does the average 401(k) plan balance. Among other things, this may cause some employees to postpone retirement. And a lack of liquidity may cause individuals to withdraw money from retirement accounts (regardless of penalties) or to save less for retirement prospectively. Those lost savings may or may not be made up later.

These and countless other challenges and their attendant effects on the retirement system are, in general terms, well-known.

By many accounts, the current pandemic will be at least somewhat shorter-lived than the major multi-year economic contractions in the past. This prospect offers the tantalizing hope that this crisis will have a relatively small impact on retirement savings. While the economy has suffered, it may well recover quickly because there were no systemic failures. Hopefully workers will be unemployed for only a matter of months before they are rehired, and losses in defined benefit (DB) and defined contribution (DC) plans may be relatively insignificant (or at least less significant than during past, sustained, periods of economic contraction).

One might say the same about liquidity issues. Many individuals may need plan loans and penalty-free withdrawals now, but perhaps it won't take very much money to tide them over until this passes. Once employees return to work, those amounts may be replenished. This might be particularly true given the generous, though temporary, supplemental unemployment benefits offered under the CARES Act.[6]

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[2] *See e.g.*, Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010, Pub. L. No. 111–192.

[3] *See* CARES Act, Pub. L. No. 116–136.

[4] *See e.g.*, Disaster Tax Relief and Airport and Airway Extension Act of 2017, Pub. L. No. 115–63.

[5] *See* CARES Act, Pub. L. No. 116–136.

[6] *See id*.

However, there are some more subtle impacts of mass unemployment on retirement security, even if that period of unemployment is short. These effects may be felt for decades even if the economy recovers and workers are rehired quickly. Below I offer a few examples.

Lump Sums

When employers temporarily reduce their workforces, many former employees, with small balances, may be required to accept lump-sum payments from tax-qualified retirement plans,[7] and many more former employees, with larger balances, will choose such payments.[8] For a multitude of reasons, workers who receive such lump sums may use these funds for something other than retirement savings. And even workers who choose to save such payments may not do so as efficiently as they would have done, within their employer-sponsored retirement plan.

Employers may seek to mitigate some of these losses to the retirement system by amending their plans to allow former employees with small balances to leave money in their plans. But this would create burdensome administrative costs that many plans will probably not choose, voluntarily, to accept. Employers may also work to better facilitate rollovers to other tax-qualified vehicles, such as IRAs. When former employees are rehired, employers may amend plans, where necessary, to accept rollovers from these stop-gap vehicles. But even with these mitigation efforts, significant additional leakage from the retirement system can be expected.

Automatic Escalation Features

Many DC plans (*e.g.*, 401(k)s) include automatic contribution features where, unless an employee affirmatively "opts out," he will automatically contribute a portion of his wages (*e.g.*, 3%) to a plan.[9] The plan may also offer an automatic escalation feature providing that this contribution rate will increase automatically over time (*e.g.*, by 1% every year), unless the employee elects otherwise.[10] Once an employee has participated for a number of years, his contribution rate may have escalated significantly, often up to a cap set by the plan.[11] As a result, the employee largely funds his retirement during the later years.

Depending on how they are structured, many plans may not treat rehires differently from new hires.[12] Thus, many workers who rely on automatic plan contributions may experience a very short period of unemployment and, on rehire, end up saving, for another escalation period, at a much lower rate than if their service had been uninterrupted (again, unless the employee elects otherwise).

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[7] *See e.g.*, VANGUARD, HOW AMERICA SAVES 2019 (2019) (During 2018, only 3% of Vanguard's DC plans permitted deferrals within the plan of balances less than $1,000 and only 17% of plans permitted balances of $1,000 or more (but less than $5,000) to remain in the plan.).

[8] *See e.g.*, *id*. (During 2018, one-third of Vanguard's DC plan participants "terminating employment . . . took a cash distribution.").

[9] *See e.g.*, *id*. (At year-end 2018, Vanguard reported that 48% of its DC plans had adopted automatic enrollment and that 66% of all new plan entrants were enrolled through this mechanism.).

[10] *See e.g.*, *id*. (At year-end 2018, Vanguard reported that "[t]wo-thirds of automatic enrollment plans have implemented automatic annual deferral rate increases.").

[11] *See e.g.*, *id*.

[12] For example, compare the relative flexibility of eligible automatic contribution arrangements under Section 414(w) of the Internal Revenue Code with the more restrictive rules for qualified automatic contribution arrangements under Section 401(k)(13) of the Internal Revenue Code.

Proactive employers may amend their plans, to the extent permitted by law, to automatically restore the rate of employee contributions to pre-separation levels. But many employers will not take this step unless Congress enacts new legislation requiring them to do so. Accordingly, many employees may end up contributing significantly less to their retirement plans.

Defined Benefit Plan Legacy Formulas

Over the last several decades, fewer and fewer workers have participated in traditional DB plans.[13] Many employers have transitioned from generous and predictable traditional DB plans to less generous and/or less predictable account-based plans. Some such employers have closed existing traditional defined benefit offerings to new participants, while maintaining those offerings for existing participants.[14] Some employers may have offered elections where employees choose to continue participating in a legacy DB plan or to transition, prospectively, to a new plan or formula.

While plan rehire rules vary greatly across the market, many employers enroll rehires, even those who once participated in legacy DB plans, in new active plans. Accordingly, even a short but large-scale unemployment event will unexpectedly force many employees, who expected to continue participating in traditional legacy plans, into less generous and/or less predictable account-based plans. The transition from an old plan to a new one may have a major impact on the retirement planning of such employees. And the more backloaded a particular legacy plan, the more acutely employees will feel this effect.[15]

Employers may enact amendments allowing rehires who were terminated temporarily, on account of COVID-19, to return, to the extent permitted by law, to their legacy plans. However, if these plans are significantly more generous than those offered to new hires, many struggling employers may choose, in the absence of legislation mandating the contrary, not to integrate returning employees back into their old plans. The impact of this phenomenon on affected participants may be profound.

Conclusion

Some of the effects of the COVID-19 pandemic on the retirement system may resemble the effects of past economic downturns. Previously developed mitigation proposals may be dusted off and put to good use today. And it is possible that the public health crisis will be resolved quickly enough that many of the normal impacts of economic turmoil on the retirement system will be manageable. On the other hand, the nature of a mass unemployment event—even one that is fleeting—could have a subtle but meaningful and long-term impact on the American retirement system.

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[13] *See* EMP. BENEFITS SEC. ADMIN., U.S. DEP'T OF LABOR, PRIVATE PENSION PLAN BULLETIN HISTORICAL TABLES AND GRAPHS 1975-2017 (2019).

[14] This may be known to some as a "soft freeze."

[15] In the broadest sense, "backloading" refers to the highly regulated practice of awarding richer benefits in later years of service.

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