



Aging and Retirement

# Defined Contribution Plans, Emergency Funds and COVID-19: Challenges for Plan Sponsors and Participants



July 2020



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## Challenges for Plan Sponsors and Participants

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# Defined Contribution Plans, Emergency Funds and COVID-19

## Challenges for Plan Sponsors and Participants

### Section 1: Introduction

As part of its ongoing effort to provide useful information on COVID-19, the Society of Actuaries (SOA) recently launched a series of reports exploring the impact of COVID-19 on retirement risks. The first report in this series, [\*Impact of COVID-19 on Retirement Risks\*](#), released in April 2020, was informed, in part, by online conversations of the listserv the SOA maintains for its Committee on Post-Retirement Needs and Risks and the Aging and Retirement Strategic Research Program. The listserv is comprised of professionals involved in retirement security issues from a wide variety of disciplines and perspectives, including actuaries, economists, attorneys, financial advisers, benefit plan sponsors, demographers, academics, and policy researchers, among others. Other reports in this series may be found at: [SOA COVID-19 Research](#).

This report is based on a follow-up conversation among actuaries from the SOA Retirement Section Council and the Retirement Section Defined Contribution Initiative Project Oversight Group. The actuaries that participated are currently working with plan sponsors of defined contribution plans in the United States and Canada. This report summarizes observations raised during the conversation about the current issues being discussed with clients to deal with immediate concerns as well as broader considerations about defined contribution plans, emergency funds and financial wellness. Its primary purpose is to assist retirement actuaries and plan sponsors and to stimulate further thinking and inform readers on how COVID-19 may reshape retirement in the future.

The context for this report series is not only to address the impact that the emergence of COVID-19 has on retirement risks, but also to reflect the environment that existed before COVID-19. Some key points about that environment include the aging population and the trend away from employers bearing nearly all of the risk for employee benefit plans. There has been a major move away from traditional defined benefit pension plans in the private sector, so that most active employee benefit retirement programs are defined contribution plans. In spite of this trend, many employees are not covered by an employer sponsored retirement program. Although defined contribution plans can potentially provide employees the means for retirement security, many employees are not well equipped to manage the risks associated with defined contribution plans, especially the longevity risk.

In addition, many individuals have only limited emergency funds, or they lack having an emergency fund altogether. The situation is especially acute for lower-income workers. An April 2020 study by the Pew Research Center<sup>1</sup> found that only about one-in-four (23%) of lower-income workers say they have rainy day funds set aside that would cover their expenses for three months in case of an emergency such as job loss, sickness or an economic downturn. Previous SOA research<sup>2</sup> conducted before the COVID-19 pandemic also

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<sup>1</sup> [About Half of Lower-Income Americans Report Household Job or Wage Loss Due to COVID-19](#), Pew Research Center, April 2020. Lower-income adults are defined as those surveyed individuals with incomes less than 2/3 of the median income of adults surveyed.

<sup>2</sup> [Financial Perspectives on Aging and Retirement Across the Generations](#), October 2018

showed that only about 34% of Millennials can afford to cover an unexpected expense of \$1,000 from general savings.

This report is divided by the major topics that were raised and provides a synthesis of the discussion.

The authors would like to thank the discussants and reviewers for their participation and guidance. The discussants and reviewers were Joel Albers, Craig Blumenfeld, Grace Barbieri, Julie Curtis, Lee Gold, Drew Luchies, Anna Rappaport, Rob Reiskytl, Julian Robinson, Ruth Schau, Mark Shemtob, Sue Simon, Todd Tauzer, Lisa Ullman, and Zorast Wadia.

## Section 2: Background on COVID-19 and U.S. and Canadian Defined Contribution Plans

The recent market downturns have caused most defined contribution plan account balances to decline despite market rebounds since March 2020. Participants who remain actively employed and have many years before retirement may be able to adjust future contributions or planned retirement age, accordingly. The impact of investment performance may be compounded as some plan sponsors may lower contributions in the current economic environment, including reducing or suspending matching contributions or other non-matching contributions to improve corporate cash flow. In addition, if employees delay retirement, employers will need to manage workforce changes.

People vary greatly in their financial position – some have no savings or emergency fund and are more “financially fragile.” Others with ample savings may have more flexibility in dealing with changes in their circumstances. For people with little savings but some defined contribution account balances, the defined contribution account balance may be viewed as a source of funds to use in an emergency. To generate enough cash to pay bills, these people may be forced to realize recent market losses on funds withdrawn from their defined contribution account. While access to retirement funds may seem attractive, it also increases the risk of insufficient retirement funds when a participant is ready to retire.

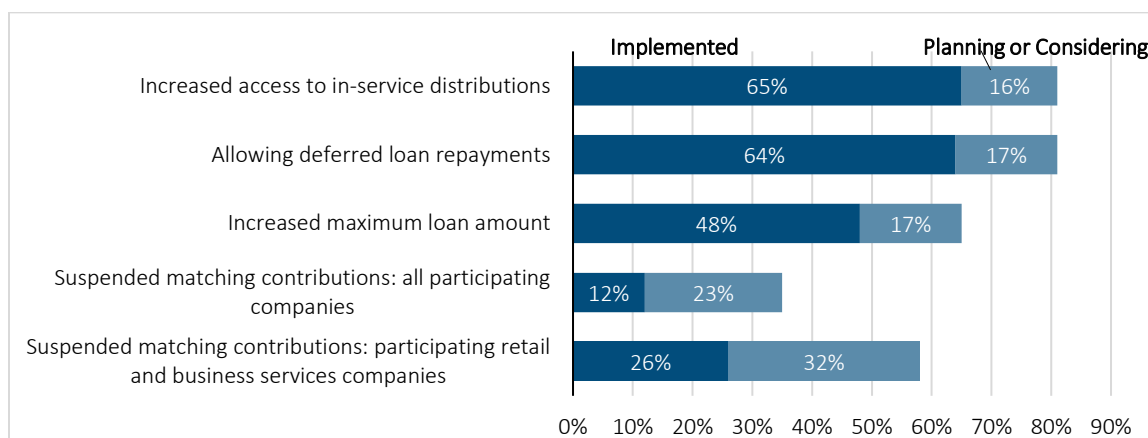
On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security (CARES) Act was signed into law. The CARES Act represents an over \$2 trillion economic relief package to provide aid from the public health and economic impacts of COVID-19. A feature of the CARES Act is to enable larger distributions and loans for those impacted by COVID-19, thereby granting access to 401(k) savings to deal with a financial emergency. Much of the SOA discussion included thoughts about how the CARES Act and the economic environment will factor into defined contribution plan modifications that would be adopted in either the short-term or long-term.

Canada also issued a large aid package in response to COVID-19, but little was done on the defined contribution side to allow access to funds. The main change by the regulators was to allow for full suspension of contributions to defined contribution Registered Pension Plans. Certain savings and retirement products are already easily accessed (TFSA, Registered Retirement Savings Plans with tax consequences), others can be accessed in financial hardship (e.g. Locked-in Retirement Accounts) and others cannot be accessed (e.g. defined contribution Registered Pension Plans).

Willis Towers Watson conducted a pulse survey of employers during the week of April 20, 2020, about changes related to COVID-19 and their 401(k) plans. More than 800 employers with a total of 12 million employees participated. In general, more employers have eased restrictions to accessing 401(k) funds than have suspended or are considering suspending matching contributions. However, a markedly greater

proportion of retail and business services companies, which have especially suffered during COVID-19, have implemented or are considering suspending matching contributions.<sup>3</sup>

**Figure 1**  
**PERCENTAGE OF EMPLOYERS MAKING 401(K) PLAN CHANGES**



Data source: Willis Towers Watson

The near-term concerns for actuaries working with defined contribution plan sponsors can be summarized by several immediate questions:

- Which changes in distribution options permitted by the CARES Act should be adopted?
- How will employer contributions to the plan need to change?
- Should a new approach be adopted to support emergency funds?
- Do participants have a reasonable range of investment options and tools to make decisions in volatile markets?

There are longer term issues such as benefit adequacy and retirement readiness, but generally those issues will not be revisited in the short term.

### Section 3: CARES Act Distributions

- The CARES Act permits COVID-19 related withdrawals up to \$100,000 or 100% of the participant's vested account balance during 2020 for participants who meet the criteria for establishing hardship due to the coronavirus. In addition, plan loans taken between March 23, 2020 and September 22, 2020 up to \$100,000 or 100% of the vested account balance are also permitted for individuals who meet the criteria for coronavirus hardship. Payments on existing loans are also permitted to be deferred one-year through a one-year extension of the loan repayment period. Adoption of these changes is at the plan sponsor's discretion. Plan sponsors may accept the

<sup>3</sup> Willis Towers Watson. (2020, May 4). "Amid COVID-19, More Employers are Easing Access to 401(k) Assets than Cutting Matching Contributions." Press Release. <https://www.willistowerswatson.com/en-US/News/2020/05/amid-COVID-19-more-employers-are-easing-access-to-401k-assets-than-cutting-matching-contributions>

employee's self-certification that they meet the requirements for a coronavirus hardship distribution (withdrawal or loan).

- Hardship withdrawals would ordinarily trigger a 10% excise tax penalty if taken before age 59 ½. The CARES Act waives the tax penalty for those meeting the coronavirus distribution requirements. In addition, participants are permitted to spread the taxable income related to the distribution over three years or pay the amount back and avoid taxation.
- Plan loans do not trigger taxation or tax penalties when initiated or during repayment. Participants will have to carefully evaluate the loan versus withdrawal option. Plan loans instill a discipline for repayment of the loan to the account. However, upon termination of employment, many employees default on their defined contribution plan loans, and loan defaults are treated as a distribution, triggering taxation and the tax penalty if under age 59 ½.
- Adoption of the CARES Act distribution provisions varies, although some recordkeepers are reporting up to 70% of clients offering these options to their participants. This may reflect a philosophy that the client should not determine whether their employees need the money; allowing those with a true need to access the funds. The increased access to funds may ultimately lead plan sponsors to explore different plan structures in the future which segregate employer-funded account balances from the employee funded account balance, and perhaps allowing access to the employee-funded portion but not the employer-funded for loans and distributions.
- Some aspects of the CARES Act distribution provisions are less clear leading to different interpretations. One area where there was a lack of clarity is the availability of coronavirus-related distributions when a spouse experiences a job loss. Based on additional guidance from the IRS in Notice 2020-50, eligibility was expanded to include financial hardship as a result of the individual's spouse.
- Retirees who need to take distributions from their retirement account balance to fulfill federal required minimum distribution (RMD) requirements may be forced to recognize recent market losses. To address this, the CARES Act allows plans to waive RMDs for 2020.

## Section 4: Employer Contributions

- The business hardships experienced with the COVID-19 pandemic are leading many U.S. employers to implement or consider suspension or reductions in employer contributions. It's unclear whether these changes will be short term or permanent. Recordkeepers that the discussion participants work with report 10-15% of employers have suspended contributions with 15-30% considering doing so. A recent survey by the Plan Sponsor Council of America<sup>4</sup> reported that nearly 90 percent of plan sponsors are making no changes to employer contributions at this time. Five percent have suspended matching contributions, and fewer than one percent have suspended non-matching (profit-sharing) contributions. Three percent of plan sponsors are considering options but have not made a decision at this time.
- Similar steps have been taken or are being considered in Canada. The tax authorities have facilitated suspensions by changing certain tax laws.
- Plan design varies by industry and among employers for both nonelective and/or matching contributions. Some plans provide employer discretion over the contributions, while others do

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<sup>4</sup> CARES Act and COVID-19 Impact on Retirement Plans, Snapshot Survey - June follow-up, Plan Sponsor Council of America, [https://www.pasca.org/research/cares\\_snapshot2](https://www.pasca.org/research/cares_snapshot2)

not. The speed and ease of implementing contribution changes will thus vary by plan design. Funding flexibility is available for plan sponsors of defined benefit pension plans. Perhaps the current crisis will foster discussion of further flexibility in plan sponsor contributions for defined contribution plans.

- Changes in employer contributions can be complex for safe harbor plans as a loss of safe harbor status could lead to challenges in passing nondiscrimination testing requirements that would not apply for a safe harbor plan. IRS Notice 2020-52 provides welcome COVID-19 related relief for midyear changes adopted during March 13, 2020 through August 31, 2020.
- Temporary pay cuts implemented by some employers will also trigger lower employer contribution amounts as the percentage of pay employer contribution is applied to a lower amount of pay.

## Section 5: Emergency Funds

- The need for the special distribution rules under the CARES Act highlights the lack of financial preparedness among many employees. Increased focus on support for emergency funds is expected, especially offering a tax-favored option for employee contributions to an emergency fund.
- More employers are requesting guidance from financial wellness advisors on how to best address the need for emergency funds among their workforce. Some employers are offering educational content either as a standalone topic or as part of a broader financial wellness series. More progressive employers often are either actively enrolling employees in direct deposit to savings accounts through either a bank or credit union as part of a bank-at-work program or to a sidecar account associated with the retirement plan (these arrangements are less common). Since a lack of emergency savings has increased the potential of early distributions from retirement plans, there is greater importance because of financial strains from COVID-19 to have foundational cash reserves as a fundamental resource of any financially well household.
- A more holistic view of employee financial wellness could ultimately lead to a flexible plan design that includes employee emergency funds, employee retirement funds, and employer retirement funds. Employer matching contributions could apply to both emergency fund and retirement fund employee contributions but remain in an employer-funded retirement account. Any emergency funds not drawn upon before retirement could be consolidated with the employee retirement funds upon retirement. A maximum dollar amount of employee contributions to the emergency fund on a tax-favored status could help gain acceptance for this among policymakers.
- In Canada, Registered Retirement Savings Plans may be accessed for emergency funds with potential limitations if the employer sponsors the arrangement. Also, in the case of financial hardship, Locked-in Retirement Accounts may be accessed. In both cases, funds that are withdrawn will be included as income in the year of receipt.
- Canada has a Tax-Free Savings Account (TFSA) that allows individuals to save and invest after tax money to be distributed tax free. Contributions (up to \$6,000 in 2020) to a TFSA are not deductible for income tax purposes. Generally, interest, dividends, or capital gains earned on investments in a TFSA are not taxable—either while held in the account or when withdrawn. Other countries also have programs that offer more flexible accounts for emergency needs.

## Section 6: Implications for Investment Options

- Many plan participants have called recordkeepers, primarily due to concern with declines in asset values rather than requesting access to funds. Sometimes, participants can react out of fear and make rash decisions. The call center personnel may help ease these fears, helping participants take a long-term view.
- Target date funds (TDFs) are a common Qualified Default Investment Alternative (QDIA). In general, target date funds have an asset allocation glidepath that reduces the equity/growth asset exposure over time while increasing the bond/fixed income allocation. There are many variations between TDF series. In particular, some TDF glidepaths reduce the equity/growth allocation **to** retirement (the target date) and then keep it constant. Other TDF glidepaths continue reducing the equity/growth path **through** retirement, some as long as 30 years post retirement. Through retirement TDFs typically have a higher equity/growth allocation at retirement. It's possible that plan sponsors will revisit their plan's TDF series following the crisis.
- With the passage of the SECURE Act in December 2019 and the subsequent market turmoil brought on by the COVID-19 pandemic, it is possible that there will be greater interest in lifetime income options within retirement plans. Newer TDFs which incorporate lifetime income options are gaining market share.

## Section 7: Short and Long-term Ramifications on Retirement Readiness

- The overall impact of COVID-19 on retirement readiness will depend upon how retirement account balances recover from depressed asset values, reduced employee and employer contributions, as well as the distributions through withdrawals or loans and associated loan defaults that may occur. Individuals who experience a prolonged job loss and self-employed individuals who experience a decline in their business will face greater challenges.
- A recent paper from Aon<sup>5</sup> illustrates how the market downturn related to COVID-19 may impact representative employees at various ages, showing how a representative older worker may be more negatively impacted than a representative younger worker. If the negative market returns of the first quarter of 2020 hold for the rest of the year, and asset returns go back to expected levels in future years, a representative 60-year old participant may experience decreased retirement readiness of about 1.3 times their projected final pay at age 67. If the assumptions in this paper hold true, participants such as this representative employee have three primary strategies to adjust for the additional shortfall:
  - Save an additional 5% of pay every year until age 67 retirement; or
  - Defer retirement by one year (to age 68); or
  - Reduce their standard of living in retirement by an additional 9%
- Behavioral economics principles also demonstrate that participants do not always act in their own best financial interests. It's possible that future plan designs will help better protect participants during retirement by encouraging the use of lifetime income options.
- Prolonged periods of unemployment will not only cause retirement savings to suffer, but clearly will increase the financial fragility of many. The Pew study cited earlier found that about four-in-ten Americans frequently worry about paying their bills or saving for retirement. These worries

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<sup>5</sup> "Retirement Readiness During Times of Instability, Insights from Aon's *The Real Deal* Research, June 2020." <https://retirement-investment-insights.aon.com/defined-benefit/aon-retirement-readiness-during-times-of-instability-article>

- may not necessarily be connected to the coronavirus outbreak. U.S. adults actually show *less* concern now about the amount of debt they have, their health care costs, paying their bills and being able to save enough for retirement than they did when asked some of the same questions in a September 2019 survey<sup>6</sup>, well before the start of the pandemic. Previous SOA research<sup>7</sup> conducted before the COVID-19 pandemic also showed that Millennials are the most financially fragile generation with 26% having high financial fragility, 35% moderate, and 39% low fragility.
- In addition to the risk that retirement savings will not be adequate at retirement, many challenges remain for retirees to manage the distribution of their savings over the retirement period. Very little focus has historically been provided to this challenge. Although the SECURE Act provisions providing fiduciary protection for plan sponsors that offer lifetime income options within the employer retirement savings plan may provide better options in the future, potentially as defaults, more needs to be done.

## Section 8: Conclusion

COVID-19 will almost certainly have long lasting ramifications for retirement plans and financial security for individuals. The prevalence of defined contribution plans as primary retirement vehicles, especially in the private sector, has transferred many of the risks of retirement security on individual employees. The pandemic has caused massive unemployment including permanent job losses in many cases, asset losses, and declines in contributions that jeopardize retirement security for all individuals. Financial fragility has also been highlighted with the lack of emergency funds leading to increases in debt and the likelihood of individual bankruptcies. Recovery is anticipated to take a long time for many individuals.

It is too early to predict with certainty the changes that will likely follow. Open questions include:

- Is defined contribution a satisfactory design for a primary retirement vehicle? What changes are needed to make it better?
- What new or different risk sharing designs might achieve a better balance of risk between plan sponsor and participant while providing more risk pooling for the participant?
- Have the default options traditionally offered worked out well? How might they change? Will default options be added for the payout or decumulation phase?
- Will target date funds change and what new investment options might emerge?
- How should a defined contribution plan sponsor think about benefit adequacy? Will the focus turn from savings for wealth accumulation to income replacement?
- Will tax-favored or employer sponsored emergency fund plan options become more prevalent?
- Will coverage for employees not eligible for a defined contribution plan, many working for small employers, expand due to state sponsored programs or the SECURE Act provisions for pooled employer plans?

This report has provided perspectives as of late June 2020 and raised many issues to contemplate in the face of COVID-19 as the situation evolves. It has also signaled the importance of reevaluating the best ways to plan for and

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<sup>6</sup> Most Americans Say the Current Economy Is Helping the Rich, Hurting the Poor and Middle Class, Pew Research Center, September 2019

<sup>7</sup> [Financial Fragility Across the Generations](#), February 2019. The SOA research provides insights into financial fragility and who is most likely to be fragile. The researchers developed an index based on a combination of each individual's feelings about financial management and their responses to some financial questions. They then divided the population into three groups with regard to fragility.

manage retirement risks in the future. With the COVID-19 situation rapidly evolving, the SOA is monitoring it closely and continuing to provide research communications that further explore the impact of this pandemic.

## About The Society of Actuaries

With roots dating back to 1889, the [Society of Actuaries](#) (SOA) is the world's largest actuarial professional organizations with more than 31,000 members. Through research and education, the SOA's mission is to advance actuarial knowledge and to enhance the ability of actuaries to provide expert advice and relevant solutions for financial, business and societal challenges. The SOA's vision is for actuaries to be the leading professionals in the measurement and management of risk.

The SOA supports actuaries and advances knowledge through research and education. As part of its work, the SOA seeks to inform public policy development and public understanding through research. The SOA aspires to be a trusted source of objective, data-driven research and analysis with an actuarial perspective for its members, industry, policymakers and the public. This distinct perspective comes from the SOA as an association of actuaries, who have a rigorous formal education and direct experience as practitioners as they perform applied research. The SOA also welcomes the opportunity to partner with other organizations in our work where appropriate.

The SOA has a history of working with public policymakers and regulators in developing historical experience studies and projection techniques as well as individual reports on health care, retirement and other topics. The SOA's research is intended to aid the work of policymakers and regulators and follow certain core principles:

**Objectivity:** The SOA's research informs and provides analysis that can be relied upon by other individuals or organizations involved in public policy discussions. The SOA does not take advocacy positions or lobby specific policy proposals.

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**Relevance:** The SOA provides timely research on public policy issues. Our research advances actuarial knowledge while providing critical insights on key policy issues, and thereby provides value to stakeholders and decision makers.

**Quantification:** The SOA leverages the diverse skill sets of actuaries to provide research and findings that are driven by the best available data and methods. Actuaries use detailed modeling to analyze financial risk and provide distinct insight and quantification. Further, actuarial standards require transparency and the disclosure of the assumptions and analytic approach underlying the work.

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