The tide is changing in favor of personal financial conservatism. Gone are the days when participants jump at the chance to get a lump sum of their retirement benefits, invest the money as they wish and feel confident that they can effectively manage their money and maintain their desired lifestyle in retirement. Individual investors are now less optimistic about their ability to withstand market volatility and have scaled back their risk tolerance in light of recent market events.

This behavioral shift underlies the key decision as to whether a lump sum cash-out offer might be the right direction for your pension plan. In an effort to continue de-risking defined benefit (DB) plans, plan sponsors are offering terminated and/or retired participants the opportunity to receive a lump sum cash-out of their benefits in lieu of future annuity payments. The plan sponsor reduces their liability and participants may receive a benefit option they find very appealing. But can this opportunity be “successful” for your plan? While success cannot necessarily be predicted beforehand, this article investigates the reasons why such a strategy is a viable option deserving consideration as you seek to de-risk your pension plan.
Why It Makes Sense

Why is this option gaining favor among plan sponsors now? The Pension Protection Act of 2006 (PPA) changed the required interest rates for calculating lump sums and, in so doing, actually made lump sums more attractive for plan sponsors. Mandated interest rates for calculating lump sums increased under PPA, and those rates are now fully phased in for 2012. These rates result in lower payouts to plan participants and also release a liability closer to that held in the plan’s funding valuation. Paying lump sums in the past resulted in a loss for a pension plan, but that same loss is materially diminished and potentially negligible with the PPA changes. On the reverse side, PPA established a stricter eligibility for paying full lump sums since they can no longer be offered by plans that are less than 80 percent funded.

Now, here comes funding relief to save the day. The Moving Ahead for Progress Act in the 21st Century (MAP-21) revised the rules on how a plan’s funded status is calculated, enabling many plans to exceed the 80 percent threshold and forge ahead with cash-out offers that they may not have otherwise qualified for. This funding relief opens a window during which sponsors may want to take advantage of the boost in their plan’s funded status and offer lump sums while eligible to do so. The window could be temporary as funding relief will be phasing out over the next few years.

In addition to these major legislative changes, some of the other main drivers behind offering lump sum cash-outs to terminated and/or retired plan participants are as follows.

- Under MAP-21, the Pension Benefit Guaranty Corporation (PBGC) will be increasing premiums substantially beginning in 2013 as discussed in our prior guidance linked here. Plan sponsors must pay a flat-rate premium on each individual owed a benefit by the plan. Releasing an individual’s liability through payment of a lump sum benefit also releases the plan sponsor from that annual premium. The example on the left illustrates the potential PBGC premium savings realized for a illustrative plan sponsor.

### EXAMPLE

Suppose you plan to offer a lump sum cash-out to select vested terminated employees and you anticipate that approximately 1,000 such employees will take a lump sum. If said employees were to remain in the plan, PBGC flat-rate premiums would be paid each year in the future for their lifetime assuming they elected an annuity. If they take a lump sum, the example below displays the potential savings a plan sponsor could realize just based on those premiums alone not to mention the risk and volatility associated with keeping their liability in the plan.

| Average Age of Affected Group | 45 |
| Expected Future Lifetime | 40 years |
| Present Value Factor (assuming 5% interest) | 16.92 |
| PBGC Flat Rate Premium (Ignoring Inflation Effects) | $42 per Participant for 2013; $49 per Participant for 2014 and Beyond |
| Estimated PBGC Savings over a Participant’s Lifetime | $822 per Participant |
| **TOTAL SAVINGS** | **$822,000** |
Sponsors de-risk their plan by trading a potentially volatile future cost for a known cost. Offering lifetime coverage subjects a plan sponsor to interest rate risk, investment risk and longevity risk. All of these aspects are removed with respect to those benefits paid out in full.

Cash-outs are the most cost-effective risk transfer option available to plan sponsors because they do not involve buying annuities from an insurer, who will need to recover administrative costs and future risk premiums in any annuity quote they offer.

For plan sponsors ultimately looking to terminate their plan, this could be considered an initial step. Upon plan termination, participants must be offered an annuity. Most plans also offer lump sums since it lowers the cost of the plan termination. Taking this step in advance could make the termination process smoother by reducing the affected population. However, sponsors should note that the participants may be more likely to accept a lump sum as part of a plan termination process rather than as a voluntary cash-out from the plan.

What Stands in the Way

Lump sum cash-outs may not make sense for all plans and sponsors should carefully evaluate the following aspects that could make the process inefficient or cost prohibitive.

- As mentioned above, success is contingent on participants’ willingness to accept the cash-out. Unfortunately, plan sponsors will have to see the process through before they know if it was a worthwhile venture. Undertaking such a project will require significant administrative and communications efforts. Plan sponsors should evaluate the opportunity costs associated with each before proceeding.

- If all lump sum benefits are paid out of corporate assets and the plan is currently underfunded, the plan’s funded status will fall as a result of the transaction. For example, suppose a plan is 82 percent funded with a $100 million liability and $82 million in assets. If a lump sum cash-out results in payments to participants of $15 million and assuming that a similar liability is released, the plan’s new funded status is 79 percent \[\frac{($82 - $15)}{($100 - $15)}\]. Plan sponsors need to closely examine whether this decline in funded status triggers an “at-risk” status, subjects the plan to benefit restrictions or has any other unintended consequences.

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Interest rates are historically low right now, driving up the cost of lump sum benefits. Sponsors could wait for upward movement in the rates to lower the actual payouts. Any such movement would improve the plan’s funded status as well, but keep in mind the timing balance mentioned in the next bullet.

MAP-21 allows plan sponsors to hold a lower liability for minimum funding purposes than the lump sums the participants will receive. If plan funding is a primary concern, there is a delicate timing balance that must be monitored to determine when funding relief creates a funded status high enough to allow lump sums, but also times the distribution so that the liability released is similar to the payouts. Accounting results do not exhibit the differentiation between liabilities and payouts to the same degree. If plan accounting is the primary concern, the cash-out may be better suited to meeting your objectives.

Payment of lump sums could trigger settlement accounting. If your plan has accumulated significant past losses (many plans are in this situation with the recent decline in discount rates), you may be required to recognize a portion of those liabilities immediately in your profit and loss rather than deferring the recognition over time.

Antiselection may occur when participants with a shorter life expectancy elect the lump sum in an attempt to maximize their benefit. On the reverse side, healthier participants may realize that a life annuity is likely more valuable and opt not to take a lump sum. In both respects, this can drive up the plan sponsor’s cost as participants take the avenue most advantageous for their own personal situation. This is especially true if lump sums are offered to a retiree group.
What to Expect of the Process

Does this seem like it would be a valuable initiative for your plan to undertake? Many large companies are gambling that the ultimate financial outcome will be positive for their plan, including General Motors, Ford Motor Company and New York Times Company.¹ Before you follow suit, make sure you investigate and understand the process. Consult your plan advisors well in advance of the intended offer and allow for three to six months to complete the process. The success of your offer will depend heavily on the degree of preparation and the communications strategy you employ.

- Determine who will receive a cash-out offer (vested terms, retirees, date restrictions, etc.)
- Determine window during which lump sums will be offered and can be accepted
- Data clean-up for affected population, including addresses and demographic data necessary for calculations
- Select vendor(s) to assist with communications, calculations, plan administration, call center, etc.
- Develop a communications campaign
- Determine what portion of lump sum cash-outs will be paid for from plan assets
- Restructure investments to provide appropriate liquidity
- Evaluate settlement accounting impact
- Determine whether early retirement subsidies should be incorporated into lump sum values
- Ensure plan is funded well enough to allow for a plan change and/or to offer lump sum benefits
- Perform benefit calculations for all available options
- Amend plan as needed to offer the benefit
- Develop proper forms for benefit elections, taxation, relative values, etc.
- Investigate whether any discrimination issues must be resolved (e.g., top 25 HCE restrictions)

Lump sum cash-outs are gaining momentum, especially with the media coverage of the large companies undertaking such ventures. However, plan sponsors need to recognize that there is growing concern about the ability of participants to make informed choices. Bestowing large amounts of money on participants may prevent the funds from being used for their intended purpose of retirement income. In addition, many question the average participant’s ability to withstand future market volatility. The Pension Rights Center has even called for a halt to such offers for further investigation by Congress.

For now, the lump sum cash-out option is another arrow in a plan sponsor’s quiver deserving attention. The costs and risks associated with keeping participants in the plan may outweigh the benefits in some respects.

If you are interested in further researching the feasibility of this de-risking strategy for your plan, contact your Lockton Retirement Services advisor for assistance.

The “Success” Issue

An important thing to remember is that a lump sum cash-out presents a choice for participants. They cannot be forced into accepting a lump sum unless the value of their lump sum is less than $5,000 and your plan allows for small cash-outs. Participant decisions will be heavily influenced by personal situations and fiscal outlook, thereby making it difficult to predict whether a strategy will be successful in advance. Plan sponsors can reasonably expect anywhere from 30 percent to 50 percent “take up” on cash-out offers assuming a proper communication strategy is employed. Recently, GM announced that only 30 percent of its retirees eligible for a cash-out elected a lump sum.²