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RETIREMENT PLAN STRATEGIES

De-risking pensions—emerging opportunity through lump sum cash-outs under the Pension Protection Act of 2006

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Table of contents

Executive summary

Historically, few pension plans have provided a full lump sum option to terminating plan participants. The reason for this is quite clear. In the past, Internal Revenue Code rules that dictated the interest rate basis for paying pension benefits in the form of a single lump sum were quite unfavorable for the plan, resulting in cash–outs that were significantly higher than the liability calculated for plan funding and accounting purposes. As a result, paying benefits in the form of a single lump sum has historically been viewed as too expensive, leading to an excessive erosion of plan–funded status.

In 2006, the Pension Protection Act (PPA) was enacted to bring forth broad changes to the U.S. pension system. While most of these changes were intended to secure pension funding levels, thereby protecting benefits for millions of American workers, one key but often overlooked change of the PPA was the favorable restructuring of rules for paying out pension benefits in the form of a lump sum.

Under PPA, pension plan sponsors have been provided an attractive risk transfer opportunity, specifically the:

- Ability to amend plans to allow full lump sum distributions on a favorable interest rate basis
- Use of high–quality corporate bonds as the interest rate basis instead of the more conservative U.S. Treasury rates used before PPA (higher allowable interest rates result in lower lump sum cash–outs)
- Allowance to use the new basis on all past service benefits as well as future accruals (i.e., no protection of the old lump sum basis for past accruals unless the plan sponsor chooses to provide such protections as a plan subsidy)

From a strategic perspective, the new lump sum rules under PPA provide most plan sponsors with a cost–effective benefit risk transfer strategy for both active and frozen plans. In fact, once fully transitioned into law, the new rules provide perhaps the most cost–effective and easily administered risk transfer strategy available to plan sponsors, given that most already have a process in place for administering lump sums on a small cash–out basis.

Prudential Retirement® conducted market research by interviewing chief financial officers and Heads of Human Resources to gain a better understanding of plan sponsor knowledge and acceptance of various forms of pension risk management and risk transfer techniques. With regard to this lump sum risk transfer opportunity, we have learned that, while there is an accelerating rate of acceptance for adding lump sum provisions to pension plans, many sponsors have yet to explore the financial advantages despite the fact that the new rules will be in full effect starting with the 2012 plan year.

These revised rules provide an attractive risk transfer opportunity for many plan sponsors starting in 2012, but there are many important issues to consider before a sponsor moves forward, such as:

- Reaching internal philosophical consensus on offering pension benefits in the form of a lump sum
- Planning and execution that is required in 2011 for starting to pay lump sum distributions in 2012
- Analysis of lump sum interest rates in absolute terms and relative to the funding and accounting discount rates
- For frozen plans, determining if lump sums should be offered as soon as possible or deferred to plan termination
- Whether to start with lump sum payments for terminated vested participants only, offer to terminating active employees, or both
- Assessing the impact on funded status including cash funding, balance sheet and settlement accounting issues
- Whether or not to include early retirement subsidies as part of the lump sum option
- Assessing the impact that the lump sum option could have on liquidity needs and asset allocation policy
- Identifying employee communication requirements and strategies
- Identifying administrative and Pension Benefit Guaranty Corporation (PBGC) cost savings through headcount reductions
- Determining incremental costs to amend plan documents and administrative procedures

By allowing full lump sums, a plan sponsor essentially transfers legacy plan costs to terminating and retiring participants. As a result, the residual plan focuses more of its long–term costs and asset efficiency on current employees, much like the trend toward other cash– and account–based employee benefit programs.

For any plan sponsor that does not currently offer full lump sums as an optional form of payment, the next several months are an ideal time to engage the plan actuary and investment strategist to address this attractive plan de–risking and downsizing opportunity provided under PPA. Over the next few years, we expect many plan sponsors will be utilizing the full lump sum option as a tool to manage the size of active plans as well as to minimize frozen plan costs heading into a plan termination. However, there are a few caveats and considerations to work through before deciding how and when to move forward. The remainder of this paper will explore and discuss these plan sponsor considerations.

Lump sum analysis and considerations

The PPA shifted the lump sum basis from one that used a discount rate based on 30–year U.S. Treasury rates to one that uses investment–grade corporate bonds as the interest rate proxy. This shift included a five–year phase–in that is complete with lump sum distributions starting in the 2012 plan year. However, the timing for performing a detailed financial analysis can be earlier than 2012. Specifically, since pension plans have the option to use lump sum interest rates up to five months prior to the plan year of actual distribution, this is an ideal time to assess whether or not the current interest rate environment is ideal for making plan changes effective January 1, 2012 for calendar–year plans.

Depending on the differences (i.e., spread) in the interest rates between U.S. Treasuries and investment–grade corporate bonds at any given point in time, the new basis under PPA can potentially reduce individual lump sums by 5–25% depending on the age of the participant. While lower lump sums are obviously not advantageous for individual participants, the new laws do enable more assets to be left in the plan to cover benefits for the entire plan population. Additionally, the lower lump sum distributions are more closely aligned with the plan's ongoing liability measures in annuity form for plan funding and accounting purposes.

By virtue of closely aligning the lump sum basis with the ongoing liability basis, PPA essentially created a cost–effective "de–risking" strategy for the plan sponsor. In other words, expanding the plan's lump sum policy is more cost effective than other risk transfer options available in the annuity market. The reason is that annuities purchased in the insurance market require more conservative interest rate assumptions to account for properly insuring the investment, longevity and early retirement risks being absorbed by the insurance company. However, cost is certainly not the only driver behind plan sponsors moving to the lump sum option. Through the widespread and expanded use of 401(k) plans and Individual Retirement Accounts ("IRAs") as primary retirement vehicles, along with increasing investment savvy of plan participants with large sums of money, plan sponsors now recognize the growing plan participant demand for the lump sum option.

To take advantage of the lump sum opportunity plan sponsors should consider offering full lump sums on the PPA basis to some or all non–retired participants. This could be accomplished in whole or in phases. Generally, the first step towards a broader lump sum policy is to consider offering full lump sums to existing vested terminated participants.

As an example, with one of our plan sponsors, Prudential Retirement estimated that if all 1,500 vested terminated participants were cashed out with lump sums in 2012, the total payout would be in the ballpark of $40 million. On the contrary, if PPA had not changed the underlying lump sum basis, we estimated that the lump sum cash–out liability for this vested terminated population would be roughly $10 million higher. The estimated $40 million was based on applicable corporate bond rate levels in April 2011, which produced an effective rate of about 5.9% for the vested terminated population. Note, however, that the actual rates used for this plan would not be set until the end of the year preceding the lump sum distributions, and would change with each plan year.

While the lump sum interest rate basis is designed to more closely mirror the ERISA funding valuation rate under PPA, the two bases will usually vary since the ERISA funding rate can incorporate one–month spot rates or 24–month smoothing of bond rates, whereas the new lump sum basis incorporates the one–month spot segment rates similar to the funding rules without smoothing.

Also note that plan sponsors have the option to choose lump sum interest rates that change annually, quarterly or monthly based on the "stability period" adopted by the plan. While most plans have annual stability periods, these optional plan features are another source of variability with interest rates for lump sum, funding, and accounting purposes.

That notwithstanding, assuming interest rate levels don't change too much or too rapidly, the lump sum cash–out rates will now be quite similar to the ERISA funding– and accounting–based interest rates. In our example, the 5.9% used as a proxy for lump sums for the vested terminated population in 2012 is also a good proxy for the funding valuation rate for 2012. In our example, this means that the $40 million potentially paid out to vested terminated participants would be close to a dollar–for–dollar payout with the underlying liability in the ERISA valuation for 2012, and in turn, because of the carrying costs with recordkeeping fees and insurance premiums paid to the PBGC, represents a long–term cost savings through the lump sum cash–out mechanism.

On the other hand, paying out $40 million from plan assets for a plan with less than $150 million in total assets is sure to raise many additional financial and operational issues. We will next explore several of these key considerations.

Benefits philosophy

Historically, plan sponsors have varied considerably in their philosophies toward benefits policy. At the extremes were a high degree of paternalism, which fostered pensions fully funded by the plan sponsor and available only in annuity form, and employee responsibility and self service, which fostered cash– and account–based benefits. The new realities of global business have certainly favored the latter, and yet the consequences of inadequate personal savings, which include unwanted delayed retirements, will have a profound impact on workforce management trends for years to come.

For those uncertain about the long–term consequences of providing pension benefits in the form of a single lump sum, the following should be considered in the context of the plan sponsor's benefits philosophy:

- Is the plan sponsor comfortable with transferring investment risk and longevity risk from the defined benefit plan to its participants, and therefore leaving retirement adequacy in the hands of each participant?
- Should an expanded lump sum policy be permanent and on–going, or only available for a limited period of time (e.g., a "window" for the first three months of 2012)? If permanent and on–going, then active employees will also have the opportunity to elect full lump sums when they terminate employment. This will influence and impact each participant's timing decision for retirement as well as mid–career employment changes, so sponsors should carefully consider workforce management issues, as once an ongoing lump sum option has been added it cannot be taken away.
- Does the plan sponsor want to preserve early retirement subsidies in the determination of lump sum values? For new lump sum cash–out offerings, a plan sponsor can generally offer the lump sum on the subsidized early retirement amount or on an unsubsidized, discounted, present–value basis from the plan's Normal Retirement Date (the latter allows the plan to minimize the lump sum cost for those who elect that option at early retirement ages).
- Deciding whether or not to include early retirement subsidies in the lump sum option is a critical decision between the individual paternalistic view and overall plan cost savings effort.
- Does the plan sponsor want to impose a ceiling on lump sums (e.g., $10,000 or $25,000 maximum, etc.)? Some plans have offered partial lump sums as a means to dampen the potential lump sum payout, but at the same time this creates extra administrative costs for communicating and managing multiple forms of payout to each individual. Today, most plan sponsors are considering an "all or nothing" approach to lump sums.
- How should the plan sponsor handle current retirees? In general, we believe that retirees receiving benefits in annuity

form should continue to be paid benefits in the same annuity form. For starters, the difference between U.S. GAAP liability and annuity buyout pricing for retirees is lower than that for actives and deferred participants. Therefore, it is not as costly to buy a group annuity for retirees. Second, and more important, any cost savings gained by those retirees who elect a lump sum would likely be lost in the pricing for those who continue with an annuity because the insurer would need to account for anti–selection and longer life expectancies in the price of the remaining close–out annuity. There are also practical and fiduciary risks to consider with retirees. For example, is a 90–year–old really capable of making a decision to switch from monthly income to a lump sum that could be quickly depleted?

Funding issues

As attractive as it seems to fully pay out benefits in lump sum form on essentially a dollar–for–dollar basis as compared to the ERISA funding liability, several key funding issues need to be considered as follows:

- Even if the amount of funding liability released through a lump sum cash–out equals the amount of the lump sum distributed, sponsors of underfunded pension plans will experience a decrease in the funded status of the plan. To demonstrate this effect, assume that as of January 1, 2012, a plan has assets of $135 million and liabilities of $150 million. This plan is 90% funded ($135M ÷ $150M). If $40 million is taken from both assets and liabilities, the plan's funded status would drop to approximately 86% [($135 – $40) ÷ ($150 – $40)].
- If a plan's actual funded status prior to an adoption of a full lump sum policy is something closer to 80%, then adding a full lump sum feature would likely drop the funded status below 80%. After dropping below 80% funded, the PPA imposes a partial lump sum restriction, accelerates funding requirements through "at–risk" status, and could impose other restrictions like credit balance waivers.
- There is an opportunity cost when $40 million leaves the plan. If assets are assumed to earn 7.5% or more over the long–term and liabilities are valued based on a long–term 6% corporate bond proxy, then the net annual "cost" due to the lower asset base will be approximately $600,000 (= $40 million x 1.5%)—before reflecting the savings from reduced plan administration and PBGC costs.

There is a delicate balance between offering full lump sums and the net effect those cash–outs could have on triggering restrictions to additional lump sums. A heightened awareness and management of funded status issues around the key trigger points of 60%, 80% and 100% funding levels can help mitigate unwanted results. An integrated risk management approach between the sponsor, the actuary and the investment strategist is the best approach for managing these risks.

Asset allocation

A pension plan that never previously paid out lump sums beyond the $5,000 small cash–out threshold can face a myriad of asset allocation and liquidity planning issues. Some of those that need to be addressed up front are:

- Most plans without full lump sum options have investment policies with small allocations to cash and other liquid assets. In many cases those plans have less than 3% earmarked to highly liquid assets. The plan's actuary and investment strategist should work together to assess annual expected cash payouts based on plan demographics.
- In our previous example, the potential for $40 million in short–term distributions can disturb a plan sponsor's liability hedging strategy and growth portfolios. The split among fixed income, equity and cash/cash equivalents will likely need to be reassessed in light of a full lump sum cash–out option.

- Following a large lump sum payout initiative, the duration of the remaining plan liabilities will most likely decrease if most vested terminated participants take a lump sum cash–out. As a result, the remaining plan will consist of a lower level of assets and liabilities with a shorter duration, which should make the plan easier to manage from an overall asset/liability risk management perspective.

For any plan sponsor that decides to adopt a full lump sum cash–out option for the first time, the Investment Policy Statement should be reviewed and revised to reflect these new asset allocation considerations.

Administrative costs and communication issues

Plan sponsors utilize one of two basic models to administer their pension benefits: an outsourced model supported by a third party vendor or an in–sourced model supported by internal staff. With either approach, a myriad of issues need to be addressed with the parties involved when offering full lump sum cash–outs, as follows:

- Legal costs to amend plan documents, Summary Plan Descriptions and Participant Notices and Elections (we recommend all plan sponsors seek advice from legal counsel regarding plan changes)
- Changes to Relative Value Disclosures for plans with early retirement subsidies where those subsidies do not apply to the lump sum option
- Service agreements should reflect reductions to per–head plan administration fees on a timely basis, especially for ongoing plans that might offer lump sums in batch to vested terminated participants
- Reductions to annual per–head and variable rate insurance premiums to the PBGC, which are typically paid from plan assets, should be included as long–term cost savings in the cost/benefit analysis supporting the decision to offer full lump sums
- Lump sum restrictions for the top 25 highly paid executives while the plan remains below 110% funded

Additionally,

- Expanding the lump sum policy will require a special one–time communication campaign addressed to existing vested terminated participants and their spouses, and potentially to active participants as well
- Communications should address the advantages of a direct rollover in lieu of cash receipt. These communications should be carefully crafted so the sponsor is not perceived as encouraging the lump sum over the annuity options
- Damage control may be required for recent retirees who will regret not having the opportunity to elect a lump sum

If most active and vested terminated participants elect a cash–out at the time of termination or retirement, annual PBGC premiums and other administrative fees will decrease. We estimate that the present value of savings from these variable costs may approach \$2,000 to \$3,000 per participant when it comes to being paid out immediately vs. remaining in the plan for decades. More lump sums mean fewer plan participants, which translates to lower variable costs and smaller plan size. In turn, a smaller plan means lower magnitude of risk and less financial disruption the plan imposes on the sponsor.

Accounting issues

Under U.S. GAAP accounting, when total plan lump sum distributions during a year exceed Service Cost (i.e., the cost of benefits accruing during the year) plus Interest Cost (i.e., the increase in the value of past service liability due to the passage of time), settlement accounting is triggered. Since frozen plans have a zero Service Cost, it is not difficult for a new lump sum provision to trigger settlement accounting for many of today's plans. While settlement accounting is manageable for most plan sponsors under most conditions, those with significantly underfunded plans with considerable deferred actuarial losses will be impacted most through an accelerated recognition of those deferred costs. Plan sponsors should consult with their actuary to assess the likelihood and impact of settlement accounting under Accounting Standard Codification ("ACS") No. 715.

Additionally, by adjusting the plan's asset allocation in the context of a lump sum provision and liquidity needs, the plan sponsor may need to revise its Expected Long–Term Rate of Return on Plan Assets. A change in asset allocation that dictates a lowering of this assumption will likely increase the plan's Net Periodic Pension Expense.

Timing issues

Since PPA fully transitions the new lump sum basis starting with payouts in 2012, with the underlying interest rates determined in 2011, many plan sponsors are only a short time away from knowing whether or not the bond markets will make this opportunity favorable for 2012. This makes 2011 an ideal time to start exploring the benefits of adopting a full lump sum provision under PPA rules. Some additional timing considerations are as follows:

- Sweeping the vested terminated population, if desired, will require an extensive batch calculation, lump sum solicitation, and "claims processing" exercise that may span several months which could commence in 2011

- Interest rate trends (as well as the full phase–in of PPA changes) will most likely make cash–outs starting in 2012 less expensive than cash–outs made before the end of 2011

- If lump sum cash–outs are desired in early 2012, sponsors should plan for at least a three–month lead time for the approval process, communications planning and roll–out, and calculation/solicitation/processing

- A drop in interest rates will increase lump sum amounts. Waiting until late–2011 for a go/no–go decision will give plan sponsors the opportunity to assess the trend of rates that will underlie 2012 lump sum distributions. If rates take an unfavorable turn during the planning and approval phase, plan sponsors will have the opportunity to defer the lump sum rollout for at least another year when rates could become more favorable.

- The possibility of future interest rate increases might also cause plan sponsors to study the potential advantages and risks of delaying the implementation of a lump sum option beyond 2012. However, it is important to note that the lump sum and ERISA funding rates will generally move in the same direction. Therefore, as rising interest rates will tend to improve the funded status of the plan they will also result in lower lump sum payouts.

- Pension plans subject to collective bargaining may take extra time for adopting a new lump sum provision depending on the term of the current Collective Bargaining Agreement and the degree to which the union will want to negotiate terms and options associated with the lump sum provision.

After these issues are thoroughly reviewed many plan sponsors may wish to start the implementation process. It is recommended that the interest rate trends and asset performance (drivers of the plan's funded status and cash–out rates) be closely monitored in tandem to determine the optimal environment in which to proceed with payouts under the new lump sum provision.

Next steps

By allowing full lump sums, a plan sponsor essentially transfers legacy plan costs following employee terminations and retirements to the plan participants. As a result, the residual plan focuses more of its long–term costs and asset efficiency on current employees much like the trend toward other cash– and account–based employee benefit programs.

For any plan sponsor that does not currently offer full lump sum cash–outs as an optional form of payment, the next several months are an ideal time to engage the plan actuary and investment strategist on this tremendous plan de–risking and downsizing opportunity provided under the Pension Protection Act of 2006. While some plan sponsors may currently be restricted from paying lump sums based on other PPA benefit restrictions rules, those funded well above the 80% threshold will find PPA lump sums to be the most cost–effective and easily administered risk transfer strategy at their disposal.

For sponsors of frozen pension plans looking for a cost–effective exit strategy to guide them to and through the plan termination process, the lump sum option should be viewed as a primary cost containment lever within that strategy, thus paving the way for a cost–effective terminal annuity at plan termination.

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For help or answers to questions on assessing your lump sum options and opportunities under the Pension Protection Act, please contact your Prudential Retirement Actuary or one of our Consulting Actuaries below:

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