June 6, 2019

More Pension Lump Sum Cashout De-risking Activity Expected in 2019

By Amy Gentile

Pension plan sponsors looking for significant cash savings and de-risking opportunities have another favorable environment to pull the participants' lump sum cashout lever this year. But that lever includes several options and considerations. In 2019, the interest rate environment is favorable which gives pension plan sponsors an opportunity to provide lump sum payments to participants while improving the funded status of the plan. So why wait to offer this cashout opportunity when you have this significant benefit staring you right in the face?

Lump Sum Cashouts Defined

A Lump Sum Cashout program occurs when a defined benefit pension plan amends its plan to allow terminated vested participants to take a lump sum payment of their benefit and be cashed out of the plan entirely. The program is typically offered as a one-time window but can also be made a permanent feature of the plan with potentially significant financial impact. Plans generally may offer this type of program only if their IRS funded percentage is at least 80% both before and after the program is implemented.

Many pension plans have offered, or at least considered, Lump Sum Cashout programs over the last several years to minimize their financial risk. Plan sponsors that have implemented these programs have been rewarded with significant cash savings as well as risk reduction.

Advantages of Implementing Lump Sum Cashout Today

1. Favorable Lump Sum Interest Rate Environment

In 2019, the lump sum interest rate environment is favorable for most employers thanks to a significant interest rate increase during 2018 when lump sum interest rates are locked in for 2019 calendar year plans. These higher rates will result in smaller lump sum payments when compared to 2018 (15-20% decrease).

2. Improved Funded Status

Another advantage of the current interest rate environment is that lump sums will be less than most other liability measurements related to the plan. In other words, interest rates used for 2019 calendar year plans to determine accounting liabilities are lower than lump sum rates. Therefore employers will be paying benefits to participants using a value less than the balance sheet entries being carried for those benefits. These lower lump sum payments will then help employers improve the funded status of the plan in addition to de-risking or reducing the future risk. This interest rate arbitrage is not expected to exist in 2020 since defined benefit lump sum interest rates have continued to decrease since the beginning of 2019.

Flat Rate (per participant) + Variable Rate = PBGC Premium

3. PBGC Premium Savings

The most significant benefit of offering a Lump Sum Cashout Program is the Pension Benefit Guaranty Corporation (PBGC) premium savings. The PBGC continues to increase the annual premiums that pension plans are required to pay to protect the benefits of their participants in the pension plan. The per participant portion of the premium (flat rate) is now up to an $80 payment per participant in 2019. This is more than a 200% increase since 2012. The variable rate portion of the premium is up to $43 per $1,000 underfunded which is an increase of almost 500% since 2012. These rates are expected to continue to grow with inflation each year. Therefore it is ideal for pension plan sponsors to reduce their participant count sooner rather than later so they can save on these future premiums. In total, some defined benefit plan sponsors could see annual PBGC premium savings of over $600 for each participant who takes a lump sum distribution.

Can You Offer a Lump Sum Cashout More than Once?

Employers that have previously offered a lump sum cashout to participants should be aware that this doesn't exclude them from pursuing a de-risking program again. In general, as long as plan sponsors wait 3-4 years between similar programs, they can offer the same program to plan participants again. This gives participants who have terminated since the original program an opportunity to take their pension payment. A second round offering also gives participants from the first program a second chance to take a cashout while de-risking the plan for the plan sponsor.

Other Considerations When Planning for a Lump Sum Cashout

There are some concerns that plan sponsors will also want to consider such as:

- Potential increases to contribution requirements;
- One-time accounting charges that could be triggered;
- Potential increase to annuity purchase pricing upon plan termination. Note that a permanent lump sum feature may increase pension plan termination annuity pricing and cause some insurers to decline to bid.

In summary, 2019 is an ideal year given the lump sum interest rates. The current interest rate arbitrage provides pension plan sponsors a low cost opportunity to de-risk the pension plan and save significantly on future PBGC premiums. As with any de-risking opportunity, there are several considerations that should also be discussed. The defined benefit plan's actuary should be consulted so they can properly evaluate the impact of offering such a program.

Some plan sponsors use lump sum cashouts as part of their pension plan termination preparation strategy. This Findley white paper provides tips to map your route to pension plan termination readiness.

Questions? Contact the Findley consultant you normally work with, or contact Amy Gentile at amy.gentile@findley.com, 216.875.1933.