VOL. 28, NO. 4 WINTER 2015

BENEFITS LAW JOURNAL

De-risking Your Pension Plan: Do New Regulations Make 2016 the Best Time to Offer Lump-Sum Distributions?

Zorast Wadia

As we approach the 10th anniversary of the passage of the Pension Protection Act of 2006 (PPA), many defined benefit (DB) plan sponsors seeking to de-risk their investment portfolios have had occasion to examine an array of strategies. Coincidentally, 2016 is also a year when one specific option—offering a lump-sum window to vested, terminated employees—stands out as a compelling idea. Next year provides a unique confluence of regulatory and market conditions that may, in fact, prove to be the last time the lump-sum tactic is practical. This article offers a brief review of the rationale for de-risking and the major strategies that DB plan sponsors typically use. Next, it describes how lump-sum windows work, including the major pros and cons for both plan sponsors and employees. The regulatory issues that are the chief reason why 2016 stands out as a ripe year for offering a lump-sum window are summarized. It concludes with a big picture view of how these issues might affect DB plan sponsors' thinking about their fiduciary responsibilities.

Zorast Wadia is a principal and consulting actuary with the New York office of Milliman. Wadia has been working in the retirement benefits field for more than 15 years. He has expertise in actuarial valuations for qualified and nonqualified plans. He also has expertise in the areas of pension plan compliance, design, and risk management. Zorast serves on Milliman's Corporate Strategic Planning Group.

PPA RAISES FOCUS ON FUNDED STATUS RISK

The passage of the PPA resulted in a fundamental conceptual shift for plan sponsors. It separated the valuations of assets and liabilities and made them distinct. Prior to 2006, the liability valuation was intrinsically tied to asset return expectations. Thus, plan sponsors had an incentive to maximize their equity exposures in line with the risk tolerance of the investment program, and then manage risk through asset class diversification.

In the PPA era, liabilities are determined by an Internal Revenue Service (IRS) yield curve. Some plan sponsors no longer perceived a benefit in taking on additional risk in the pursuit of excess returns from equities. Now, instead, they pursue pension de-risking strategies that, generally, take equity risk off the table as the plan's funded status improves. In this case, de-risking means lessening a plan's exposure to investment volatility. De-risking can also mean reducing an organization's pension footprint.

Many of the de-risking techniques are long-term strategies, beginning with plan design changes, such as converting from a traditional plan (based on final average pay) to a hybrid plan (based on career average pay), where there is more of a cost-sharing relationship between employer and employee. Plan sponsors are also using asset/liability matching strategies such as liability-driven investing (LDI), in which assets are invested in a portfolio that matches the duration of the plan's liabilities. Plan sponsors are also using equity tail-risk hedging strategies to manage capital requirements and protect against downside risk.

Along the de-risking spectrum, the most extreme—and expensive-to-implement—techniques are called third-party risk transfers. These include buy-ins, buy-outs, and plan termination. These transfers involve purchasing annuities from an insurance company, which then assumes some, or all, of the pension risk from the plan sponsor. The insurance companies generally charge a high premium—10 to 20 percent of the liabilities assumed—which is why this approach is so expensive.

REASONS FOR OFFERING A LUMP-SUM WINDOW

A lump sum is a risk transfer distribution option offered to participants that allows them to receive their entire vested balance in the retirement plan. This discussion focuses on lump-sum *windows* for terminated vested employees. The window is a relatively short designated period of time (*e.g.*, two or three months) when the offer is valid. By opting in, employees can receive their distribution years, or even decades, before they reach retirement age, which is when annuity payments begin.

Thus, participants may perceive the offer as a windfall, given the potentially earlier start date. However, accepting a lump sum may involve a sacrifice of relative value. Participants will get a relative value statement from the plan sponsor that shows the likely difference in value of the lump sum compared with the annuity. It may show that the participant is giving up 10 to 40 percent of the value of the annuity. But we have to ask ourselves if those numbers convey a specific meaning. Most important, do participants realize they are giving up the security of a lifetime income stream?

These questions are addressed at the end of the article. Right now, we need to spell out the rationale for the lump-sum window from the plan sponsor's perspective. There are several economic benefits to consider.

- **Reduce the pension footprint.** The lump-sum window is a tool for reducing the size, but not the scope, of a DB program. Employees who opt to take the distribution are basically cashed out of the plan. This effectively reduces the size of the plan's liabilities and assets, and the number of participants. Reducing a plan's pension footprint would reduce its unfunded balance sheet liability, thus improving its comparison ratio to market capitalization.

- **Transfer longevity risk.** Reducing the number of terminated vested employees means the plan sponsor no longer has the risk of adverse mortality experience if retired participants live beyond their life expectancies. The longevity risk has been transferred from the plan to those participants.

- **Eliminate PBGC premiums.** When terminated vested employees cash out of the plan, the sponsor no longer has to pay Pension Benefit Guaranty Corporation (PBGC) premiums for them. In general, pension plans may be on the hook for both a mandatory flat-rate premium, per participant, and a variable-rate premium, which is based on the plan's underfunded liability.[1] Flat-dollar premiums have greatly increased since the PPA was enacted. Also, several amendments, notably the Moving Ahead for Progress in the 21st Century Act (MAP-21) in 2012 and the Highway and Transportation Funding Act of 2014 (HATFA), empower PBGC to schedule additional increases. IRS regulations generally allow plan sponsors to unilaterally cash out participants with vested balances up to $5,000. When you consider that the PBGC premiums for each of these participants would range from \$57 to as high as \$475 annually,[2] it's obvious why plan sponsors would prefer to shed this liability.

- **Offer minimum lump sums.** The lump sums that sponsors offer to participants do not need to be any higher than the statutory minimum calculation basis under Internal Revenue Code Section 417(e)(3). In other words, lump sums do not need to reflect any early retirement subsidies that may be present in annuity benefits offered to participants who are retirement-eligible. Thus, participant lump-sum elections can lead to liability gains on the balance sheets of plan sponsors.

- **Gain in accounting liabilities.** There is an accounting benefit that plan sponsors receive whenever they do lump-sum transactions. Here's a simplified explanation of how it works: There is up to a four-month "lookback" at the interest rate that will be used to calculate the exact amount of each participant's lump sum.[3] At the same time, chief financial officers (CFOs) can look at the current interest rates, which will be used to calculate the plan's liabilities. Currently, with interest rates so low, there's a significant differential between them and the generally higher rates used to determine statutory minimum lump sums. As a result, there is an accounting gain every time a lump-sum transaction happens. In basic terms, the plan is releasing more in accounting liabilities than in assets that would be used to pay the lump sum—and that is where the gain comes from.

CONS OF LUMP SUMS

Every strategy has pros and cons, and lump-sum windows are no exception. The arguments against them range from demographics to market risk to administrative complexity.

- **Adverse selection.** Because the value of the lump-sum distribution is significantly less than that of a lifetime annuity, it's reasonable to assume that many people making use of the window have an immediate need for cash. We note, historically, that a major need has been to pay outstanding medical bills. Thus, a less healthy cohort may be drawn to the lump-sum window, leaving healthier people with greater longevity expectations in the plan.

- **Benefit restriction.** This is the flip side of the accounting anomaly that leads to the balance sheet gain described previously. Again, because different indices are used to calculate assets and liabilities, the funding status of a DB plan declines when lump-sum assets are withdrawn. If these withdrawals cause the funded status to slip below the 80 percent threshold, then benefit restrictions kick in. For example, the plan would only be allowed to offer half lump sums instead of full cash-outs. Plans would also be restricted from using credit balances[4] in lieu of cash contributions to satisfy ERISA minimum funding requirements. In this scenario, full PBGC premiums would remain in effect.

- **Opportunity cost.** A successful lump-sum strategy would result in a much smaller pension footprint. But this implies that assets are leaving the program as well as the liabilities. If the capital markets perform well subsequently, the plan sponsors could experience regret that they, in effect, sold assets just before they rallied. For example, plan sponsors that engaged in lump-sum distribution strategies in 2011 missed out on opportunities to earn double-digit returns on their pension plan asset portfolios in 2012 and 2013.

- **Settlement accounting.** A lump-sum window could trigger plan settlement accounting under Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 715-30, which may result in the immediate recognition of previously unrecognized actuarial losses. This action would serve to raise pension expense or lower pension income in the year of the lump-sum distributions. If settlement accounting is a concern, note that lump-sum windows can be structured to avoid them by creating limited lump-sum thresholds.

- **Administrative complexity and expense.** It's actually time-consuming and expensive for a DB plan to design and implement a lump-sum window campaign. Terminated, vested employees may be widely dispersed and difficult to locate. Communications may be ongoing for six months or more, and the recordkeeping must be accurate and compliant. There is also an added cost that the sponsor must bear to design and implement the lump-sum window.

- **Employee dissatisfaction.** The communications campaign described previously will inevitably come to the attention of

> current employees. This can lead to a negative perception—that the employer is treating terminated workers better than those currently engaged. For example, active employees may be perturbed if only terminated vested participants are offered a chance to elect lump-sum distributions.[5]

After weighing the pros and cons, different plan sponsors will certainly come up with different conclusions about the right courses of action for their programs. That said, there are two additional considerations that should factor into their decisions. One is a tactical opportunity that makes lump sums especially compelling in 2016. The other is the need for long-term reflection on the ultimate goals of fiduciaries for their investment programs and their beneficiaries.

LUMP SUMS: A TACTICAL OPPORTUNITY

A golden opportunity—perhaps the last of its kind—for lump-sum windows is coming up in 2016. After that, the window may close for quite some time.

The issue, in brief, stems from a disagreement within the actuarial profession. In October 2014, the Society of Actuaries (SOA) published its updated Mortality Tables Report. The new tables included much more optimistic assumptions about longevity than anything that had come before. If these assumptions are correct, employees would live longer, and the cost of funding their retirement benefits would increase in the 6 to 10 percent range for many plan sponsors.

Many in the actuarial community responded critically to the report, based on the table's construction methodology and conclusions. At the same time, plan sponsors were concerned because the new longevity assumptions would have the effect of increasing funding requirements, pension expense, and PBGC premiums. Implementation of the new SOA mortality tables would also significantly reduce the accounting gains that are one of the key economic benefits associated with lump-sum distributions.

On July 31, 2015, the IRS stepped in and eliminated the controversy—and uncertainty—at least through the end of 2016 with IRS Notice 2015-53. As Milliman stated in its Client Action Bulletin of August 13, 2015:

> *For defined benefit plan sponsors (including multiemployer pension plan trustees)*, the updated tables provide certainty that the [new SOA tables] will not be required for 2016. The use of the IRS's updated tables will have a more modest effect… on actuarial valuation results, including minimum funding, benefit restrictions, lump-sum calculations, and PBGC premiums.

Looking ahead to 2016, plan sponsors know they can benefit from the accounting gain traditionally received from lump-sum transactions. Furthermore, the US Federal Reserve continues to signal that an interest rate increase will take place before the end of 2015, with additional small rate hikes throughout 2016. Moreover, through the first nine months of the year, corporate bond interest rates, which are the benchmark interest rates used to calculate statutory minimum lump sums, are already up about 35 basis points. In fact, plans using a three-month lookback period for interest rates can already lock in this interest rate basis for minimum lump-sum distributions in 2016. The basic math of lump sums means that lump sums due employees will be smaller because of higher benchmark interest rates.

Additionally, it is rumored that, in 2017, the IRS will adopt a new table reflecting longevity improvements, which may be the SOA table[6] or something similar. In other words, plan sponsors considering a lump-sum distribution may want to take advantage of the clearly favorable environment in 2016.

DO FIDUCIARIES PUT THE PLAN FIRST? OR PARTICIPANTS?

Ultimately, the choice of whether to offer participants a lump-sum distribution or not is more than a simple economic or business decision for individuals who play the dual role of fiduciary and plan sponsor. The US Department of Labor has recently released proposed guidance that broadens the definition of a fiduciary; thus, increased scrutiny of fiduciary action is sure to follow. As fiduciaries, individuals have the duty to run the pension fund solely in the best interest of the plan's beneficiaries. On the one hand, in their role as plan sponsor, they are in charge of large pools of assets and tasked with doing what is best for the company; if they see a way to add economic value, they should certainly do that. Part of their fiduciary responsibility to plan participants may be to consider the salient question of whether lump-sum distributions are in the best interest of plan participants. Specifically:

- Is it good and proper to allow people to take lump sums relatively early in their lives and at a potentially lower relative value, rather than requiring them to wait until retirement age when they can receive an annuity?

- Are participants harming themselves in the long run by forgoing the retirement subsidies that may be inherent in annuities?

- How clear should the plan sponsor communication offering lump sums to terminated vested participants be in terms of detailing the plan provisions and assumptions applicable (and even not applicable, for additional voluntary disclosure) that are used to value the lump sums?

- When employee education materials are prepared for participants, do they not always teach the importance of lifetime income? From this perspective, the trend away from DB plans in favor of defined contribution (DC) plans is also a concern.

IRS NOTICE 2015-49 HAS A BIG IMPACT

Lump-sum distributions are another manifestation of this trend away from pensions, and we recently saw the IRS weighing in. Issued in August 2015, Notice 2015-49, "Use of Lump-Sum Payments to Replace Life Income Being Received by Retirees Under Defined Benefit Pension Plans," gives voice to the government's concerns about this practice.

Basically, the IRS was responding to a handful of well-publicized cases from 2012 and 2014 in which companies offered lump sums not only to terminated vested employees but also to *retirees*. General Motors and Verizon were two of the plan sponsors involved; it was controversial at the time. Many practitioners felt that this practice was prohibited. But the companies' ERISA attorneys appealed to the IRS, asking for private letter rulings. The IRS granted permission for the lump-sum distributions under specific circumstances.

However, when the news got out, some plan sponsors interpreted these IRS rulings as broadly sanctioning distributions to retirees. IRS Notice 2015-49 clarifies that the private letter rulings were exceptions. It argues that replacing an annuity with a lump sum "undermines the intent" of the regulations prohibiting changes after annuity payments begin.

This makes a lot of sense when you think about it on an individual level. We're talking about retirees who have grown used to living on a fixed income. Suddenly a letter comes in the mail offering a relatively enormous amount of cash. What a temptation! Yet accepting the offer could have adverse consequences down the road for people who are not skilled at managing money or who may underestimate their spending needs over a longer-than-expected retirement. The aforementioned adverse consequences are by no coincidence also directly applicable for terminated, vested employees who elect lump-sum distributions in lieu of annuities.

When it comes to de-risking, there is no one answer that's right for every situation. The fact that the window for lump sums may close after 2016 argues for prompt action. At the same time, we expect the IRS to issue more definitive guidance in the near future, so more cautious programs may want to wait and see. One thing that's clear is that there are other de-risking options, including plan design modifications, LDI, and volatility management or risk hedging strategies, which provide significant benefits—without the controversy.

NOTES

1. This would be measured without respect to interest rate relief afforded under HATFA, which was signed in August 2014. HATFA extended the interest rate funding relief under MAP-21 as applicable to minimum required contribution calculations under IRC § 430. However, calculations for the PBGC variable-rate premium are not affected by the interest rates used for funding relief.

2. *See http://www.pbgc.gov/prac/prem/premium-rates.html,* last accessed Nov. 4, 2015. The cap per participant on the variable-rate premium is $418 for plan years beginning in 2015.

3. It is possible to change the "lookback" month for purposes of the lump-sum window to a basis other than what is used for *de minimis* lump sums, already defined for a plan.

4. Credit balances referred to here were carryover balances prior to 2008 and prefunding balances after 2007. They were created because of contributions in excess of the IRC § 430 minimum contribution requirements.

5. To avoid employee morale issues, plan sponsors can decide to amend their plans to include a permanent lump-sum feature. However, one downside of this is that insurance carriers will require that a lump-sum option be reflected in its annuity purchase price, thus increasing the cost of a plan termination, should that decision be initiated in the future.

6. We note that the SOA recently released an updated projection scale on October 8, 2015. The effects of this latest table and projection scale are yet to be analyzed, but initial indications are that the liability impact would be milder compared with the table released in the 2014 SOA report.