Time to offer a lump sum distribution window in your Corporate Pension Plan?

While some plan sponsors have opted for this strategy over the past few years, others have not offered a lump sum distribution window because of higher lump sum payouts at a time of historically low interest rates. However, with interest rates at persistently low levels with no clear end in sight and PBGC premium rates skyrocketing, corporate pension plan sponsors should consider offering a lump sum window to terminated vested plan participants who have not reached retirement age.

A History of Rising Costs

Corporate pension plans have faced rising and variable costs for several years due to low interest rates, increasing PBGC premiums, and investment return volatility. Some plan sponsors have addressed this, in part, by purchasing annuities for a segment of the population, such as retirees, and/or offering a one-time lump sum opportunity to terminated vested participants. The justification for these programs has been the desire to downsize the pension plan and lower pension cost volatility. However, because the interest rates required for determining lump sums have been at historically low levels, such approaches effectively lock in those low yields on that portion of their plan assets, foregoing potentially higher investment returns. In addition, while eliminating the number of plan participants through lump sum payouts has slightly lowered PBGC premiums because of the headcount reduction, the unfunded liability has remained unchanged when lump sums are paid, resulting in unreduced PBGC variable rate premiums.

PBGC Premium Changes

Over the past several years, PBGC premiums have skyrocketed for single employer pension plans, most recently as part of the Bipartisan Budget Act of 2015[1]. Our November 2015 article entitled "The Bipartisan Budget Act of 2015: Impact on Single Employer Pension Plans" describes the PBGC premium derivation and projected increases due to the higher rates enacted in the law. The per participant rate, which was $57 in 2015, will be $80 in 2019 and indexed with wage increases thereafter. The variable rate premium, which was $24 in 2015, is projected to be over $43 in 2019 per $1,000 of underfunding[2].

For all but very well-funded plans, the variable rate premium is the largest portion of the total premium and, based on the same level of unfunded liability, is projected to increase over 80% from 2015 to 2019. However, there is a variable rate per participant premium cap that is based on the headcount of the plan. This cap was $418 per participant in 2015, increasing to $500 in 2016 and indexed thereafter (projected to be $538 in 2019). Because the variable rate cap is projected to increase at a much smaller rate than the uncapped variable rate premium, more and more plans will see the

[1] Bipartisan Budget Act of 2015 enacted November 2, 2015
[2] For illustration purposes, we have assumed that a 2.5% per year annual wage increase for projecting PBGC premiums.

variable rate per participant premium cap applying in the future. Since this cap is not based on the level of underfunding, additional contributions to the plan would not lower the PBGC variable rate premiums if this cap applies, but lowering the headcount, such as through lump sum windows, would lower both the variable rate premium and the per participant premium.

The Impact of a Lump Sum Window on PBGC Premiums

In the following example, the pension plan has $25 million in assets and $18 million in liabilities on a PBGC premium basis, resulting in $7 million of unfunded liability. There are 450 total plan participants, of which 70 are terminated vested. The plan sponsor offers a lump sum window to all 70 terminated vested participants, 50 of which accept the offer and take lump sum distributions.

		Projected 2017 PBGC Premiums	
		Without Lump Sum Window	*With* Lump Sum Window
1.	Unfunded Liability	$7,000,000	$7,000,000
2.	Variable Rate Premium per $1000 Underfunding	$33.75	$33.75
3.	Variable Rate Premium Before (1) X (2); rounded	$237,000	$237,000
4.	Variable Rate Premium Cap ($512.50 X Headcount)	$230,625	$205,000
5.	Final Variable Rate Premium (Lesser of (3) or (4))	$230,625	$205,000
	Participant Headcount	450	400
	Per Participant Premium Rate	$69	$69
6.	Per Participant Premium	$31,050	$27,600
	Total PBGC Premium (5) + (6)	$261,675	$232,600

In this example, paying out lump sums to 50 terminated vested participants reduces the PBGC premium by $29,075. While the Unfunded Liability remains unchanged due to the variable rate premium cap, the headcount reduction reduces both the per participant premium and the variable premium.

Optimal Threshold Method

The potential downside to paying lump sums now is the plan is effectively locking in a rate of return on those lump sums of 4% to 4.25% compared to a potentially higher long-term return on plan assets. Because of this, there may be an optimal threshold on the level of lump sums to offer. For example, offering lump sums to those with values under a certain threshold, such as $30,000, may offer the best balance of PBGC premium and other savings relative to potential investment opportunity cost. Each situation would need to be reviewed carefully for an optimal balance.

Conclusion

Besides potential savings through PBGC premium reductions, offering a lump sum window to terminated vested participants ultimately saves in plan administrative costs and reduces the size of the plan, thus reducing pension risk. In addition, anticipated statutory mortality table changes expected as early as 2017 are likely to increase lump sum payouts, which suggests considering this approach prior to implementation of the new tables.

We would be happy to assist you with evaluating the potential benefits of a lump sum window program for your pension plans. We would need to obtain some easily available, basic information to get started.