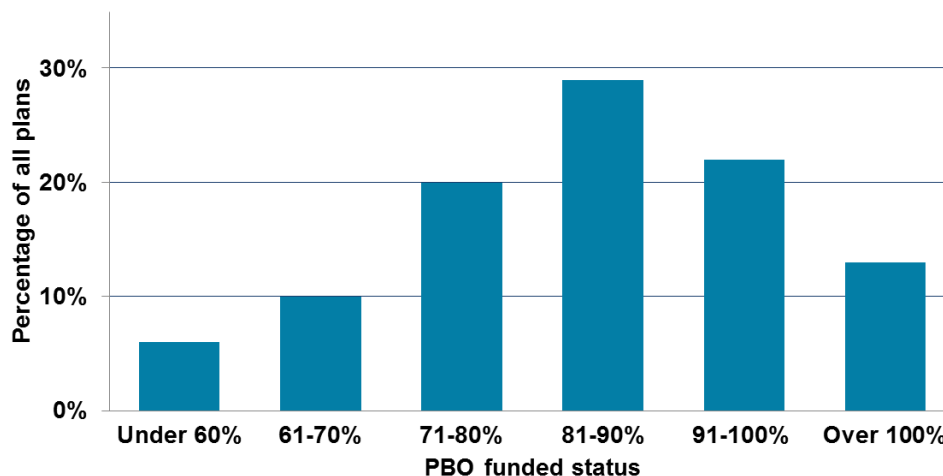


Institutional Group

# Lump Sum Term-Vested Payouts – Is Now the Time?

After a difficult five years overseeing pensions, plan sponsors in the U.S. and Canada are finding pension funding levels the healthiest they have been since 2007. The favorable markets of the past two years, combined with a rise in discount rates, have pushed the majority of pension funded levels to above 81% on a Projected Benefit Obligation (PBO) basis (see Chart 1). Many pension committees, seeking to avoid the roller-coaster ride of pension surplus and deficit of the last ten years, are actively seeking options to reduce the relative liability of the pension plan itself. One of the options being considered by plan sponsors is a lump sum payout of terminated-vested (term-vested) participants. This perspective considers how this fits into overall pension de-risking strategies and how recent changes in pension management could impact plan sponsors choosing this option.

*(Chart 1) – Funded status of pension plans from 820 U.S. and Canadian publicly-traded companies*



**NOTE:** Numbers are based on year-end 2013 financial results for 820 publicly-traded companies with assets over \$20 million. Companies in financial services industry are excluded.

Source: SEC filings, CapIQ

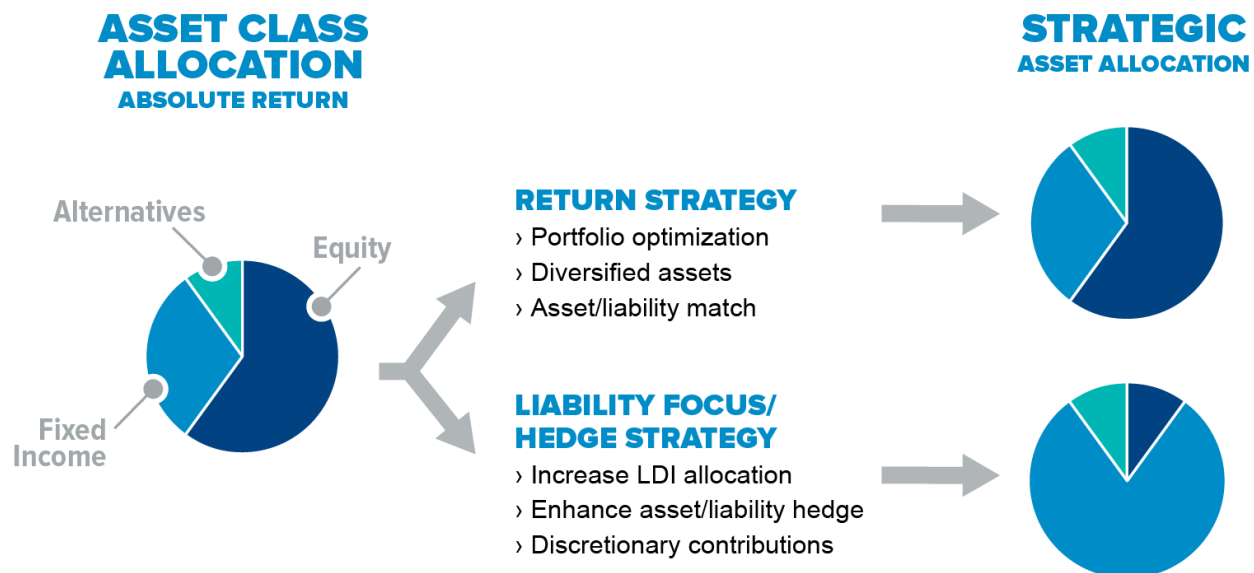
## Reasons plan sponsors are electing term-vested payouts

In recent years, some corporate pension plan sponsors have reduced the size of the terminated-vested (term-vested) population within the plan through lump sum distributions – commonly referred to as Lump Sum Term Vest (LSTV) projects. Primarily, the reasoning behind this was driven by a few specific factors:

- › **Rising PBGC premiums** – The increase in both flat rate and variable rate premiums being charged by the Pension Benefits Guaranty Corporation (PBGC) have added to the administrative costs on a per participant basis. These rates will be indexed to inflation moving forward, so plan sponsors could incur additional increases as expected inflation begins.
- › **Legislative changes** – Another influencing factor has been some of the benefits provided by the Pension Protection Act of 2006 (PPA) and subsequently The Highway and Transportation Funding Act of 2014 or House Bill H.R. 5021 (see [“Update on Pension Funding Relief in 2014”](#)). This legislation has changed the measuring of the lump sum discount rate from being based on a 30-year treasury-rate to one that uses investment grade corporate bonds. The result has reduced the impact of paying out lump sums significantly. Now the lump sum amount will closely mirror the ERISA funding valuation, allowing a dollar-for-dollar reduction in both the pension liability and the pension assets.
- › **Changes to mortality tables** – Anticipated modifications to the mortality tables used to determine the pension liability could increase the total liability by as much as 5-8%. These changes are expected to start impacting liability measures in 2016 or 2017. Choosing a term-vested payout now could avoid that impact.

## Factor investment strategies when considering LSTV projects

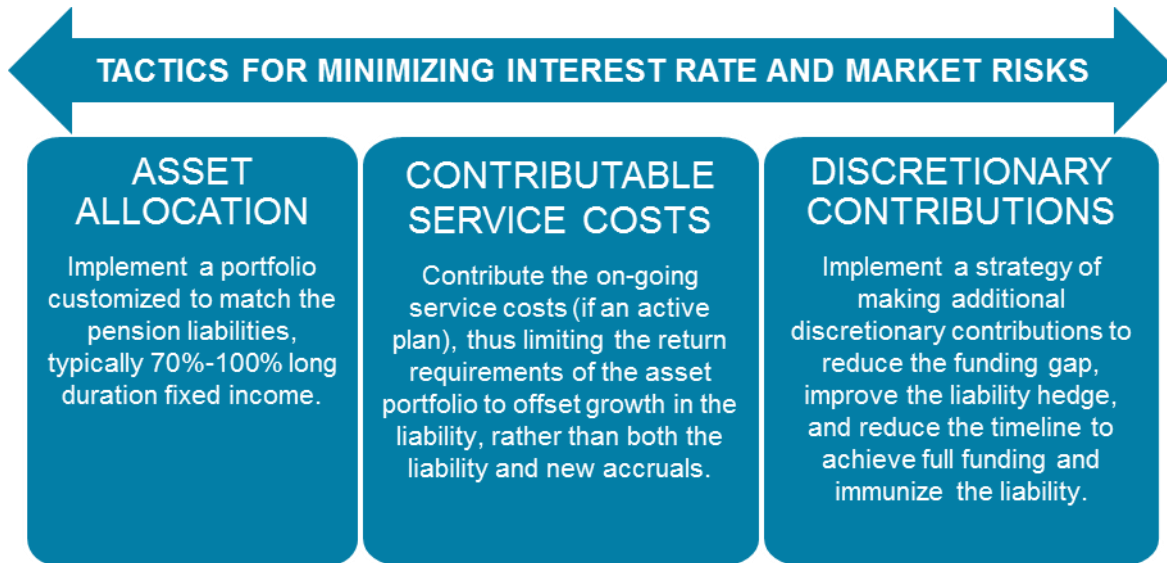
In general, there are two high-level philosophies which organizations hold concerning investing the pension assets – a “Return Strategy” or a “Liability Focus/Hedge Strategy.” The most common philosophy for investing pension assets is a “Return Strategy,” supported by the median asset allocation being approximately 52% equities, 35% fixed income, and 13% alternatives.<sup>1</sup> This strategy accelerates corporate investments into a pool of capital market assets, particularly under the restrictions associated with a pension account. The other philosophy is a “Liability Focus/Hedge Strategy,” where assets are invested as a hedge for the legacy pension liability. The goal behind this philosophy is to hedge liability, reduce surplus volatility and contribution uncertainty, and reduce the tail risk associated with significant underfunding scenarios in a specific time period. The graphic below illustrates the two.



<sup>1</sup> Standard and Poor's Capital IQ

## Impact of an LSTV project on liability focused strategies

For a pension plan sponsor implementing a de-risking strategy, this approach offers some incremental benefits. Plan sponsors seeking to immunize the liabilities can deploy several tactics that are designed to minimize both interest rate and market risk from their pension plan, and create a level of cost certainty around the defined benefit pension:



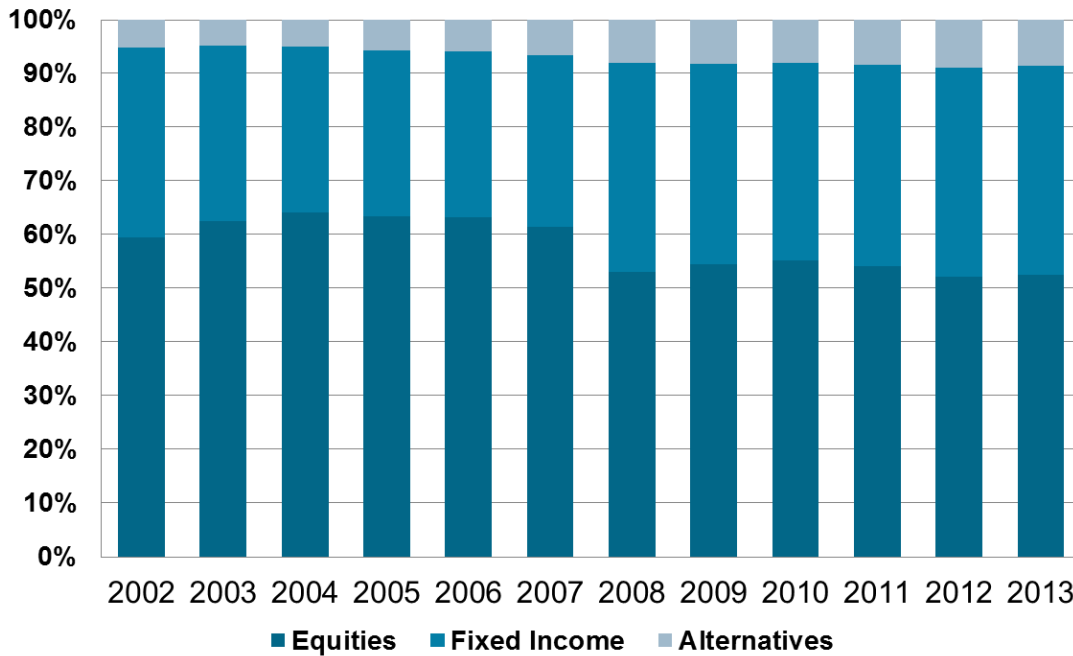
In this context, an LSTV is supportive of this de-risking strategy by reducing the liability and the associated costs of servicing the term-vested population. Under this approach, the plan sponsors will amend their pension plan to add lump sum distributions as a form of payment. The plan sponsor then proactively contacts a targeted population of the term-vested employees (for example those with term-vested amounts of less than \$50,000) with an offer of a lump sum. Participants then have the option to do one of the following three things:

- 1. Take cash in a lump sum** – Participants tend to either take the cash or roll the proceeds into a qualified retirement account. According to industry averages, this option is usually chosen by about half of the participants, and proceeds are used equally to either get cash or roll into a qualified account.
- 2. Receive an annuity payment** – Participants do not tend to choose this option as industry averages show a very small percentage who typically choose this (less than 5%).
- 3. Do nothing** – Industry averages show that about half of the participants tend not to respond to the offer and remain in the plan.

## Impact of an LSTV project on return seeking strategies

While an LSTV is supportive of a de-risking investment strategy, this is not the approach currently being employed by most pension plans. The current asset allocation continues to overweight return seeking assets, while limiting the allocation to duration matching fixed income. At the end of 2013, the average asset allocation was similar to what it had been at the end of 2012 (despite the significant increase in funded status) with a median equity allocation of 52%.

(Chart 2) – Median asset allocations for pensions from 820 U.S. and Canadian publicly-traded companies



**NOTE:** Numbers are based on year-end 2013 financial results for 820 publicly-traded companies with assets over \$20 million. Companies in financial services industry are excluded.

Source: SEC filings, CapIQ

Pension plans employing this strategy are implicitly pursuing an alternative approach to managing pension assets. Rather than match the pension liabilities, they are seeking asset returns in excess of the liabilities, in an effort to reduce the long-term “cost” of supporting the pension. This strategy may also reflect an anticipation of a rise in interest rates, and concerns over the impact of this rise on fixed income assets. This return-oriented strategy is the dominant approach in the U.S., implemented in one form or another, by most plans domestically. Under this approach, more assets are going to be more valuable than less assets – the more money available to the plan sponsor, the greater the earnings potential of those funds above the targeted liability. The combination of a spread differential between the projected liability cost and the expected return, over a period of time, should benefit the plan sponsor.

On that basis it would potentially be less attractive to return assets to the pensioners on a dollar for dollar basis, thus removing the opportunity of the plan sponsor to earn the incrementally higher returns over time.

## Opportunity cost of term-vested cash-out

Given that the majority of plan sponsors' philosophy around pension investing continues to be a "Return Strategy," analysis was conducted by SEI's Institutional Group to review the impact of an LSTV project on plans with this asset allocation. The analysis looked at a sample plan with the following assumptions:

- › \$255M in plan assets; \$300M in PBO liability.
- › Assets are invested in a diversified portfolio of 60% equities, 30% medium duration fixed income, and 10% alternatives, including private equity, structured credit, and hedge funds.
- › Expected return is 8.0%; Current PBO rate of annual increase is 4.5%.

Assuming the above remains constant, the projected results over a five year period can be compared as follows:

### (Example 1A) – Base case

<b><u>Base case</u></b>	<b><u>Starting value</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Assets</b>	<b>255.0</b>	<b>275.4</b>	<b>297.4</b>	<b>321.2</b>	<b>346.9</b>	<b>374.7</b>
<b>Liabilities</b>	<b>300.0</b>	<b>313.5</b>	<b>327.6</b>	<b>342.4</b>	<b>357.8</b>	<b>373.9</b>
<b>Funded status</b>	<b>85.0%</b>	<b>87.8%</b>	<b>90.8%</b>	<b>93.8%</b>	<b>97.0%</b>	<b>100.2%</b>
<b>Funding gap</b>	<b>45.0</b>	<b>38.1</b>	<b>30.2</b>	<b>21.1</b>	<b>10.8</b>	<b>(0.8)</b>

Next, the analysis assumes there is \$40 million of term-vested liabilities the plan sponsor wants to offer lump sums. Assuming the industry average is true and 50% take the lump sum (and that the lump sum amount matches the PBO liability level), the revised projection will be similar to the base case above, but with both the assets and liabilities reduced by \$20 million:

### (Example 1B) – Lump pay \$20 million in term-vested

<b><u>Term-vested</u></b>	<b><u>Starting value</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Assets</b>	<b>235.0</b>	<b>253.8</b>	<b>274.1</b>	<b>296.0</b>	<b>319.7</b>	<b>345.3</b>
<b>Liabilities</b>	<b>280.0</b>	<b>292.6</b>	<b>305.8</b>	<b>319.5</b>	<b>333.9</b>	<b>348.9</b>
<b>Funded status</b>	<b>83.9%</b>	<b>86.7%</b>	<b>89.6%</b>	<b>92.6%</b>	<b>95.8%</b>	<b>99.0%</b>
<b>Funding gap</b>	<b>45.0</b>	<b>38.8</b>	<b>31.7</b>	<b>23.5</b>	<b>14.2</b>	<b>3.6</b>
<b>Vs. Base case</b>	<b>0.0</b>	<b>0.7</b>	<b>1.5</b>	<b>2.4</b>	<b>3.4</b>	<b>4.5</b>

Comparing the two strategies indicates the plan sponsor benefits by about \$4.5 million to retain the assets over the next five years rather than conduct a LSTV project. This is driven by the spread between projected assets and liabilities over five years. However, there are additional factors that will likely reduce the costs associated with the term-vested payout option.

## Increasing PBGC premium costs

PBGC premiums are scheduled to rise from \$46 per person to \$57 per person over the next three years. Assuming the average lump sum amount is \$20,000 and there are 1,000 term-vest participants being cashed out, the annualized costs per year of PBGC premiums saved would range from \$46,000 per year to \$57,000 per year. While these are meaningful savings, and likely understate the full administrative savings associated with this strategy, they will likely not offset significantly the median investment returns on the assets if retained. In addition, there are significant actuarial and administrative costs associated with implementing a lump sum payout. These include “scrubbing” compensation data, drafting communications, and responding to participant questions. These costs can be \$100-\$200 per participant or more, offsetting a significant portion of projected PBGC premium savings through the LSTV project.

## Revised mortality tables

An anticipated increase in mortality tables will also reduce the projected gains associated with retaining the assets and liabilities. It has been almost 15 years since the last mortality study was completed for pension plans, so not surprisingly the new one will increase projected life expectancies and thus the benefit obligations. This impact potentially could be significant. According to the Society of Actuaries’ exposure draft of the updated mortality tables, plan sponsors could see a 5-8% increase in liabilities on a PBO basis.<sup>2</sup> Applying a 6% rise in liability assumptions three years out, term-vested payouts will reduce the potential benefits of maintaining the assets under management for five years by one-third or more, depending on the magnitude of the increase in liability.

*(Example 2) – 6% increase in PBO liability due to change in mortality assumptions in year 3*

<b><u>Base case</u></b>	<b><u>Starting value</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Assets</b>	255.0	275.4	297.4	321.2	346.9	374.7
<b>Liabilities</b>	300.0	313.5	327.6	362.4	378.3	395.3
<b>Funded status</b>	85.0%	87.8%	90.8%	88.7%	91.7%	94.8%
<b>Funding gap</b>	45.0	38.1	30.2	40.8	31.4	20.6

<b><u>Term-vested</u></b>	<b><u>Starting value</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Assets</b>	235.0	253.8	274.1	296.0	319.7	345.3
<b>Liabilities</b>	280.0	292.6	305.8	337.9	353.1	369.0
<b>Funded status</b>	83.9%	86.7%	89.6%	87.6%	90.6%	93.6%
<b>Funding gap</b>	45.0	38.8	31.7	41.8	33.4	23.7
<b>vs. Base case</b>	0.0	0.7	1.5	1.1	2.0	3.0

<sup>2</sup> Society of Actuaries RP-2014 Mortality Tables Exposure Draft (February 2014)

However, this is a one-time increase in projected liabilities as compared to an on-going spread differential between projected returns on liabilities versus interest on the pension liability. Under median projections, a pension plan anticipating favorable returns over the PBO liability would still benefit by retaining assets under management rather than paying out lump sums. This approach will also be enhanced should interest rates increase, reducing the PBO liability and offsetting some or all of the anticipated changes to the mortality tables. Using the same assumptions outlined in *Example 2*, the analysis looked at the impact a 1% increase in discount rates would have. The below graphics show that increase would more than neutralize the increase in mortality assumptions, thus further supporting the case for retaining assets under management.

**(Example 3) – 1% increase in discount rates in year 2 (6% increase in PBO liability due to change in mortality assumptions in year 3)**

<b><u>Base case</u></b>	<b><u>Starting value</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Assets</b>	<b>255.0</b>	<b>275.4</b>	<b>297.4</b>	<b>321.2</b>	<b>346.9</b>	<b>374.7</b>
<b>Liabilities</b>	<b>300.0</b>	<b>313.5</b>	<b>290.0</b>	<b>320.4</b>	<b>334.9</b>	<b>349.9</b>
<b>Funded status</b>	<b>85.0%</b>	<b>87.8%</b>	<b>102.6%</b>	<b>100.2%</b>	<b>103.6%</b>	<b>107.1%</b>
<b>Funding gap</b>	<b>45.0</b>	<b>38.1</b>	<b>(7.4)</b>	<b>(0.8)</b>	<b>(12.1)</b>	<b>(24.8)</b>

<b><u>Term-vested</u></b>	<b><u>Starting value</u></b>	<b><u>Year 1</u></b>	<b><u>Year 2</u></b>	<b><u>Year 3</u></b>	<b><u>Year 4</u></b>	<b><u>Year 5</u></b>
<b>Assets</b>	<b>235.0</b>	<b>253.8</b>	<b>274.1</b>	<b>296.0</b>	<b>319.7</b>	<b>345.3</b>
<b>Liabilities</b>	<b>280.0</b>	<b>292.6</b>	<b>270.7</b>	<b>299.1</b>	<b>312.5</b>	<b>326.6</b>
<b>Funded Status</b>	<b>83.9%</b>	<b>86.7%</b>	<b>101.3%</b>	<b>99.0%</b>	<b>102.3%</b>	<b>105.7%</b>
<b>Funding gap</b>	<b>45.0</b>	<b>38.8</b>	<b>(3.4)</b>	<b>3.0</b>	<b>(7.2)</b>	<b>(18.7)</b>
<b>vs. Base case</b>	<b>0.0</b>	<b>0.7</b>	<b>4.0</b>	<b>3.8</b>	<b>4.9</b>	<b>6.1</b>

One other important aspect to consider is the pension plan always retains the option of offering lump sum distributions in the future. Should the sponsor strategy change to a general de-risking strategy, paying out term-vested participants can be implemented as one of multiple approaches to mitigate risk within the pension plan.

## Conclusion

While lumping out term-vested plan participants is perhaps the lowest cost strategy for reducing pension plan risk, it is one component of an overall de-risking strategy. Pension committees should approach the pension problem in a holistic fashion, and engage in practices that support their current plan for dealing with the pension problem. While the analysis above is fairly simplistic, it illustrates the challenges of applying multiple pension strategies. A plan engaged in an asset optimization strategy is to some degree undermining its own strategy by reducing assets under management, and giving up the potential for positive investment returns. This is particularly the case for plan sponsors delaying de-risking strategies based on anticipated increase in interest rates. Under the current low interest rate environment, costs of settling benefits now may turn out to be relatively high.

## About the author



*Tom Harvey serves as a Director for the Advice Team within SEI's Institutional Group. In his role, he is responsible for delivering on-going strategic advice to SEI's institutional clients, which include corporations, healthcare organizations, multiemployer plans, public pension plans and nonprofit organizations.*

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