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Consultant Spotlight

Advantages Of Lump Sum Windows

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For defined benefit pension (DB) plans, lump sum windows continue to be a popular way to lower plan costs and reduce volatility. In 2008, plan sponsors were hit by a double whammy when their plan investments tanked and low interest rates caused pension liabilities to skyrocket. Even though recent funding relief legislation, such as the **Moving Ahead for Progress in the 21st Century Act**, has made life easier for plan sponsors, the fear of another 2008 has caused employers to look for other solutions to "de-risk" their DB plans. And because many plan sponsors have frozen their DB plans and are hoping to terminate them down the road, they do not like surprise market fluctuations that suddenly raise plan contribution levels.

Enter the lump sum window

By offering lump sums to certain participants during a temporary window of time, plan sponsors are able to do a "controlled burn" of their pension liabilities. Not only can a lump sum window reduce volatility caused by fluctuating interest rates, it also reduces the insurance premiums paid to the **Pension Benefit Guaranty Corporation**, which currently range between $64 and $564 per participant each year. Also, unlike a lump sum option that is permanent, a window does not lock a plan sponsor into offering a lump sum option at plan termination, which can affect annuity purchase pricing.

Typically, lump sums are offered to plan participants who are stuck in limbo because they no longer work for the company, but they have not yet started to receive pension payments. The plan actuary can help identify the eligible group in order to meet a certain financial target or to avoid a "settlement" under financial accounting rules, which would occur if total lump sum payments during the year exceed the plan's service cost plus interest cost (as determined by the actuary).

Three things are necessary to make a lump sum window successful: communication, communication, communication. In addition to the required legal notices informing participants of their rights, you should do your best to create a package that is eye-catching (not many people read their mail after it goes in the trash) and easy to read (if it reads like stereo instructions, people will jump to the election forms and make up their own rules). The communication should spell out the pros and cons of taking a lump sum so that the participant can make an informed decision. The last thing anyone wants is for a well-intended offer to turn into a class action because participants were misled.

It takes time to create a good communication package, and usually there will be several people who want to take a whack at the piñata, including legal counsel. Just know that clear communication up front will reduce the number of questions and follow-up on the back end.

Another thing to keep in mind is that people who are in limbo do not always tell you when they move, so it is a good idea to do an address search before sending out the lump sum offer. Hardly any plan participants are psychic, so if the offer does not reach them in the mail, they probably will not reply.

Plan participants tend to like the idea of receiving lump sums, so a window is often seen as a win-win. It makes the pension more portable by giving participants the ability to roll it into an IRA or another qualified plan. If the pension is small (but not small enough to cash out under normal plan rules), the lump sum provides a payment that someone can actually use instead of being forced to take small monthly payments for life.

Acceptance rates for lump sums tend to be between 20- 40%, depending on the group that is offered lump sums. This can reduce plan liabilities significantly and, in a volatile economy, the lower the liability, the easier it is for the plan to maintain its funded status.

There are several actuarial and administrative firms that have expertise in managing lump sum window offerings. If a plan sponsor is looking for ways to protect the DB plan from market volatility and reduce administrative expenses, a lump sum window can be very effective.

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