2014 Lump-Sum Windows

Update on Plan Sponsor Experience

March 2015

Overview

Offering lump-sum windows has become one of the most frequently used pension risk management strategies of the past three years. Windows for terminated vested participants are the most common, but retiree lump-sum windows have been offered as well.

Lump-sum windows first became prevalent in 2012 when a change in the lump-sum calculation under the Pension Protection Act was fully implemented. We reported on our 2012 experience working with plan sponsors in Aon Hewitt's *Pension Settlements through Terminated Vested Lump-Sum Windows*, issued in February 2013.

Plan sponsor interest in lump-sum windows continued in 2013, albeit at slightly lower levels than in 2012. Activity increased in 2014 as a confluence of events—new mortality expectations, increased PBGC premiums, improved funded status, movement in interest rates, extended funding relief, and additional focus on managing pension risk—encouraged many plan sponsors to move forward with lump-sum windows.

We expect plan sponsor interest in lump-sum windows to continue. Aon Hewitt's *2015 Hot Topics in Retirement* survey indicated that 47% of plan sponsors are very or moderately likely to offer a terminated vested (TV) lump-sum window in 2015, and 27% are very or moderately likely to offer a retiree lump-sum window in 2015.

In this paper, we share experience on terminated vested lump-sum windows implemented in 2014 and best practices for plan sponsors looking to implement future lump-sum windows. We close with a brief summary of our experience with related settlement transactions such as cash-out sweeps, repeat lump-sum windows, "reminder" projects, and retiree lump-sum windows.

2014 Experience

We analyzed plan sponsor experience related to 70 terminated vested lump-sum windows implemented during 2014, covering approximately 290,000 participants.

The average lump-sum election rate for these plan sponsors was 58%. Total lump-sum payments in these windows were in excess of $4 billion, with the total lump sums offered exceeding $8 billion.

The 2014 experience reinforced many of the themes shared in previous Aon Hewitt white papers and webinars. In particular:

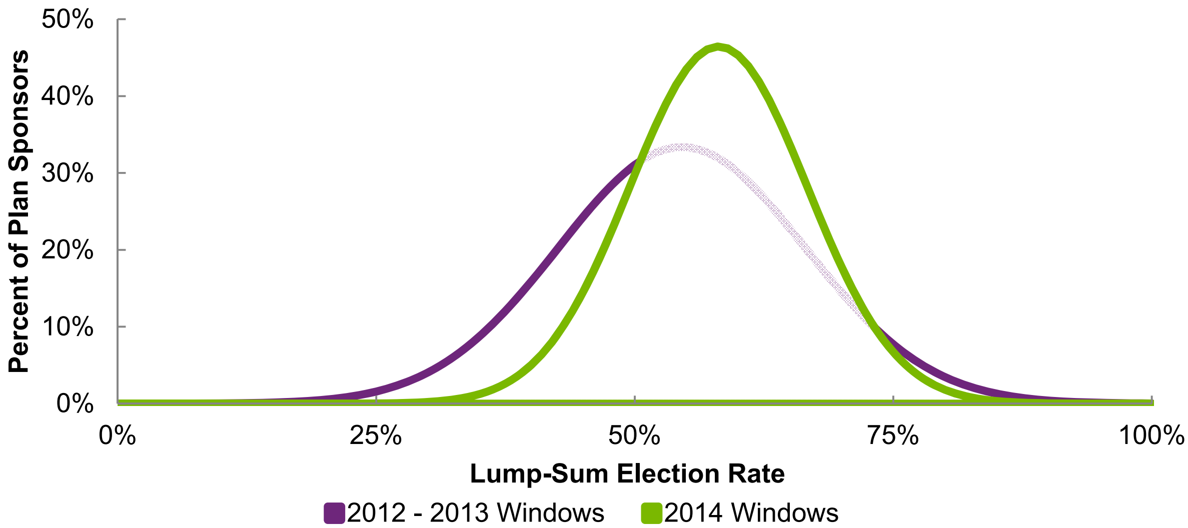
- The average lump-sum election rate was 58%, but individual plan sponsor experience varies widely.
- Lump-sum election rates decrease as the size of the lump sum increases, but other individual demographic data does not appear to be correlated with election percentages.
- Many participants are rolling their lump sums over into IRAs, maintaining the assets within the tax-qualified retirement system.
- Preparation is crucial to a successful lump-sum window.
- Comprehensive and easy-to-understand communications benefit both plan sponsors and plan participants.

Lump-Sum Election Rates

During a window, an eligible terminated vested participant can elect to receive a lump sum, commence an immediate annuity, or defer commencement to a later date.

The average lump-sum election percentage for plan sponsors implementing a lump-sum window in 2014 was 58%. This reflects a modest increase from the average lump-sum election percentage of 55% for plan sponsors implementing windows in 2012 and 2013.

Plan sponsor experience continues to vary between 40% and 70%, with over 80% of plan sponsors falling in this range in 2014.



The increase in lump-sum election rates, as well as the tightening of the distribution in our 2014 experience, coincides with an increase in the number of plan sponsors utilizing best practices. The increase in best practice implementation leads to more successful lump-sum windows.

The remaining participants eligible for lump-sum windows either elected an annuity or deferred their commencement. During 2014, approximately 2% of participants elected an annuity. The majority of participants who elected an annuity were already eligible for immediate commencement of benefits.

On February 26, 2015, the Government Accountability Office (GAO) issued a report titled, "Private Pensions: Participants Need Better Information When Offered Lump Sums That Replace Their Lifetime Benefits."

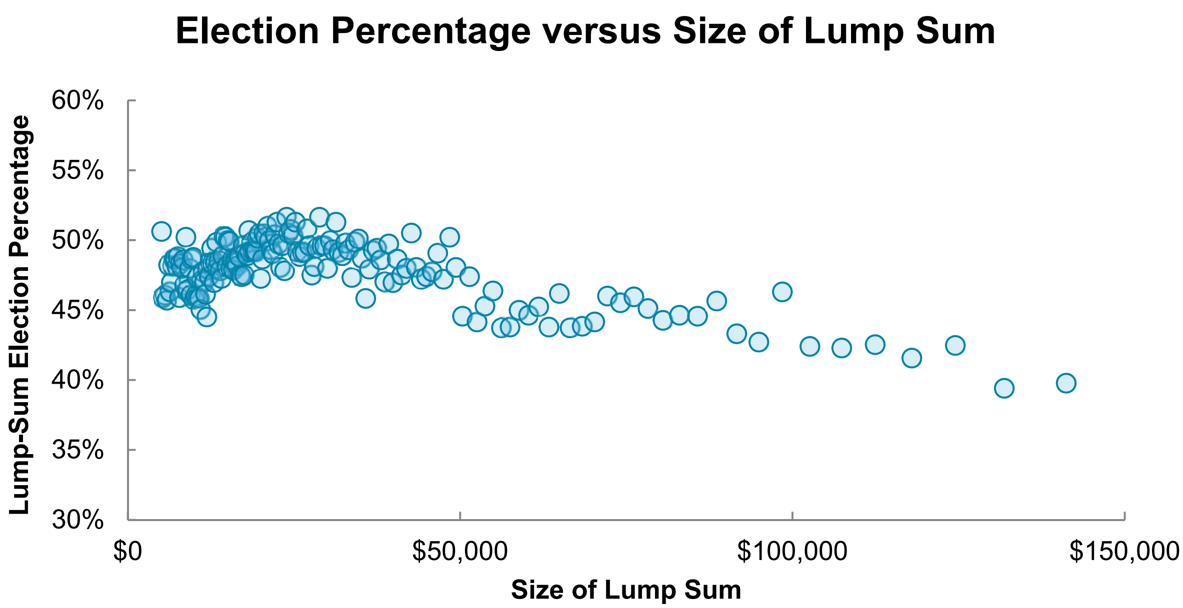
This report reiterated many of the key messages we have been relaying to plan sponsors for the past several years, most notably that participants need to be engaged in the process with clear and robust information in order to empower them to make well-informed decisions.

Plan sponsors implementing a lump-sum window should review the GAO report with counsel and ensure they are providing participants with the necessary information in order to make a lump-sum election.

Dollar-Weighted Lump-Sum Election Rates

The 2014 lump-sum election rate, calculated as a dollar-weighted average for plan sponsors, was 49% (compared to 58% when not weighted by dollar amount).

As can be seen from the chart below, the lump-sum election percentage decreased as the size of the lump sum increased.



Each circle in the above graphic represents the lump-sum election percentage for 1,000 participants with similar lump-sum amounts from $5,000 to $150,000. Over 97% of the participants in our study had a lump-sum benefit of less than $150,000.

Individual Experience

Aside from the impact of lump-sum election amount, there was no meaningful correlation between other demographic variables and the lump-sum election rate. This low level of variability was consistent with our prior findings.

- **Age.** Election rates for participants at different ages were similar, with the exception of large lump sums for retirement-eligible participants. Retirement-eligible participants with a lump sum greater than $75,000 were less likely to elect a lump sum than nonretirement-eligible participants with a lump sum of the same size.
- **Employee type.** Election rates for salaried, hourly nonunion, and hourly union participants were similar. We saw slightly more variability in the lump-sum election rates for these groups compared to our prior study; however, the differences are not statistically significant.
- **Gender.** Election rates for male and female participants were generally the same. The election rate for male participants was 1% higher than the election rate for female participants.
- **Years since termination.** We saw a small decrease in lump-sum election rates as the length of time between the date of termination and the offer date increases.

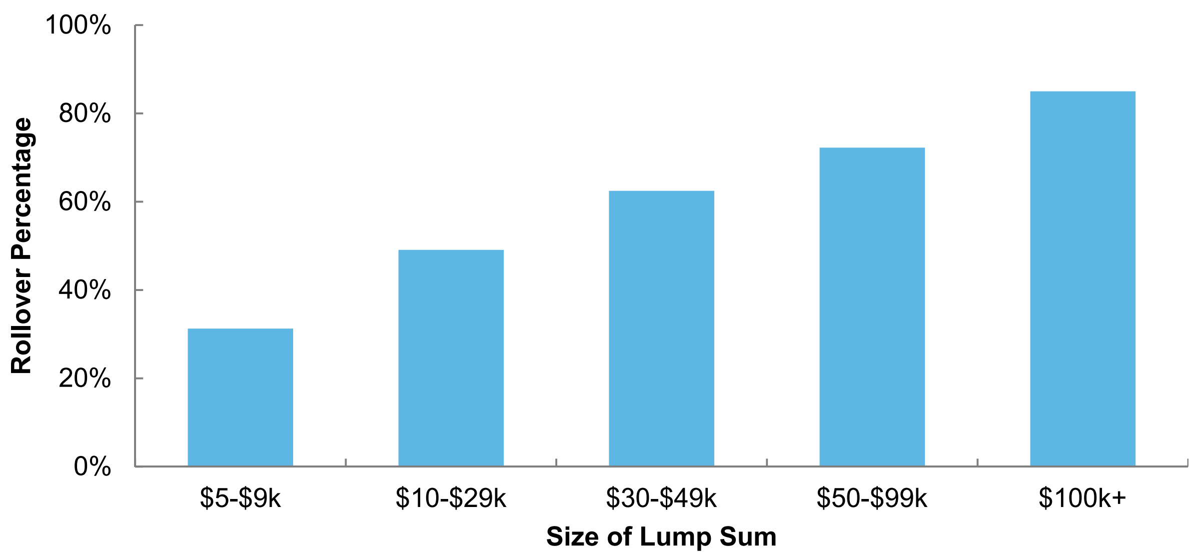
Rollovers

Participants who elect to receive a lump sum are eligible to roll their benefit over to another tax-qualified account such as an IRA or 401(k) plan. Participants who do not roll over their benefit are subject to taxes on the lump sum. Further, participants under age 59½ may be subject to an additional 10% tax on the distribution.

In our 2014 experience, approximately 55% of the participants who elected to receive a lump sum rolled their money directly into a tax-qualified account. Participants who do not elect a direct rollover may also roll the money over into an IRA within 60 days of the distribution, but we are not able to monitor these rollovers.

As shown in the chart below, the rollover percentage increased as the size of the lump sum increased. Overall, approximately 70% of the eligible dollars were rolled over into tax-qualified accounts.

Rollovers as Percentage of Lump Sums



The combination of a lower lump-sum election rate and a higher rollover percentage for participants with large lump sums suggests that participants with larger benefits are more protective of their retirement assets.

Reminder on Best Practices

Electing to receive a lump sum as part of a one-time window is a significant decision for participants. By following best practices, a window can lead to a positive outcome for both plan sponsors and participants. A summary of these best practices is below, divided into two key areas of focus. First is preparation, which is critical for plan sponsors as they put the pieces in place for a successful program. Second is the participant experience, which is truly at the heart of the entire window project. Participants need to be engaged in the process with clear and robust information in order to empower them to make well-informed decisions.

Preparation

Project Management—Project management remains a significant driver of delivering a successful lump-sum window and should take into consideration a number of important areas:

- **Data readiness.** Make an honest assessment of the quality and readiness of the data required to offer terminated vested participants a lump sum.
- **Timing.** Make the decision whether to move forward with a lump-sum window early enough to allow for methodical implementation. Building in adequate time will allow the team to focus on developing and executing a detailed and effective implementation plan.
- **Status updates.** Hold regular status calls so that all stakeholders are well informed and the project stays on track.
- **Reporting.** Report on progress during the window to allow plan sponsors to monitor questions and plan for the resulting liquidity, which can be significant.

Address Search—Address searches remain one of the most important and cost-effective strategies in the implementation of a window. Plan participants cannot make an election without first receiving their packages.

- We recommend completing an address search on all eligible participants, rather than just those with a "known" bad address. This additional step can potentially identify a number of additional address changes, allowing plan sponsors to reach a larger group of eligible participants. Plan sponsors have uncovered a significant number of new addresses using this strategy—more than 20% of the eligible population in some cases.
- We also suggest utilizing a confirmed address search that requests a response from participants to confirm their address. This takes more time, but can also improve the quality of address data.

Despite all these efforts, we believe approximately 5% of the participants eligible for lump-sum windows have a bad address.

Design—Plan sponsors have many design-related decisions to make as part of the lump-sum program, such as defining the eligible group and the methodology for the lump-sum calculation. These decisions will have an impact on the window and should be considered carefully.

Participant Experience

Written Communication—Written communication is the primary method for informing participants of their options and complying with regulations related to electing a pension benefit. The written communication should be structured to accomplish a number of objectives:

- Reestablish a connection with the participants. The terminated vested participants may have left the organization many years ago, or in the case of an acquisition never have worked for the current organization at all.
- Inform the participants of their options and the pros and cons of the choices.
- Focus attention on the choices, deadlines, and election requirements.
- Reassure participants that help is available and provide directions to the call center.
- Remind participants of the deadlines. Participants will sometimes procrastinate or lose track of the paperwork. Reminder post cards and flyers can help focus attention on approaching deadlines.

Call Center—Call center assistance is critical for participants. The call center provides them with a resource to receive unbiased answers to questions related to the lump-sum windows. Some plan sponsors also add financial guidance to the call center in order to provide an additional level of professional and unbiased support to participants.

Other Forms of Communication—We have worked with several plan sponsors to implement outbound reminder phone calls. This is another method of engaging participants in the process and ensuring they consider their options. Plan sponsors in 2014 that included outbound phone calls as part of their process experienced generally higher election rates than plan sponsors that did not. Plan sponsors are continuing to look to other methods of engaging participants in windows with strategies such as web videos, alumni group outreach, or outbound email reminders.

Related Settlement Strategies

The main focus of our paper is terminated vested lump-sum windows. However, a high-level discussion of the following related settlement strategies is included below:

- Cash-out sweeps
- Repeat lump-sum offers
- Lump-sum reminder projects
- Retiree lump-sum windows

Many of the terminated vested lump-sum window best practices discussed above can be applied to these projects.

Cash-Out Sweeps

Plan sponsors can automatically cash out participants with a lump sum of up to $5,000 if the plan document allows. Lump-sum amounts of less than $1,000 may be automatically paid in cash to plan participants. Participants with a lump sum between $1,000 and $5,000 may elect a cash payment or a rollover to an IRA. Participants who do not respond to a cash-out offer must have their payment automatically rolled over to an IRA.

Plan sponsors with an automatic cash-out threshold of less than $5,000 may wish to consider increasing the threshold to $5,000 and running a cash-out sweep. This is a cost-effective project that can force lump-sum payments to participants with high carrying costs in relation to their liability.

Repeat Lump-Sum Offers

Plan sponsors that implemented a lump-sum window in prior years may wish to consider a second offer to participants who declined a lump sum in the first window. There are several issues plan sponsors should consider prior to a repeat offer, including:

- Communication issues—How will participants react to a change in lump-sum amounts?
- Legal issues—Do repeat offers create a "permanent" feature?
- Financial issues—How many will elect the lump sum?

The communication and legal issues referenced above will likely need to be handled on a case-by-case basis. Our limited data suggests that approximately 20% of the targeted participants accept the lump sum during a second offer.

Many plan sponsors that implement a limited lump-sum program (for example, lump sums up to $25,000) may offer a second lump-sum window to participants who were not included in the first window. This is a more straightforward project with many of the same considerations as the first window.

Lump-Sum Reminder Projects

A number of plan sponsors have sent "reminder" mailings to terminated participants who already have a lump sum available. This is different from a traditional lump-sum "window" in that the opportunity to receive the lump sum is available at any time—not just as a one-time event. Lump-sum election percentages for reminder projects have ranged between 20% and 30%. While smaller than the election percentages for terminated vested lump-sum windows, the remaining 70% to 80% of participants may still elect to take a lump sum at a later date.

Plan sponsors with a large population of terminated vested participants with an available lump sum may wish to consider a reminder project. The administrative burden for these projects is much smaller than for a traditional window. No plan amendment is necessary, processes for calculating the lump sum are already well established, and existing election documents do not need to be drafted from scratch.

Retiree Lump-Sum Windows

Plan sponsor interest in retiree lump-sum windows has also increased over the past few years. A review of the issues and considerations associated with a retiree lump-sum program is beyond the scope of this paper.

Information related to lump-sum election rates for retiree programs, derived from public disclosures, is summarized in the table below.

Retiree Lump-Sum Windows (known as of February 2015)

Sponsor	Year	Approximate Number of Participants Offered a Lump Sum	Approximate Number of Retirees Taking Lump Sum
Ford	2012−2013	90,000 (retirees and TVs)	30% (37% including TVs)
General Motors	2012	42,000 (retired after 1997)	30%
TRW Automotive	2012	21,000 (retirees and TVs)	Unknown (50% including TVs)
Johnson Controls	2014	11,000 (retired after 1999)	Not disclosed
NCR	2014	20,000 (retired after 1993)	50%
ADM	2014	10,000	Not disclosed
Alcatel-Lucent	2015	74,000 (retirees and TVs)	Not yet complete

In Closing

Lump-sum windows and related projects continue to be an effective way for plan sponsors to manage risk while offering participants the opportunity to consolidate their retirement savings. A well thought-out program can lead to successful outcomes for both the plan sponsor and participants.

For more information, please contact your Aon Hewitt consultant.

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