Take the Money and Run?

*Understanding Participant Behavior in Lump Sum Cashout Windows*

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In 2014 many plan sponsors offered vested terminated participants (VTs) the option of electing a lump sum distribution in lieu of waiting until retirement to collect their pension benefit. These offers provide participants the opportunity to manage their retirement assets to suit their individual needs. For sponsors these offers are excellent pension risk management opportunities that result in lower plan liabilities, better balance sheet control, and lower participant counts that translate into lower PBGC premiums and plan administration costs. The continuing rise in PBGC premiums and the eventual incorporation of new mortality tables into lump sum calculation regulations make these offers attractive for 2015 and likely 2016.

These offers do create some peril for sponsors and their VTs. The VTs must be given the option of taking their distributions in cash; they cannot be compelled to roll over their lump sum to an IRA or another qualified plan. Sponsors set up these plans to provide for their employees' retirement not to fund mid-life needs. This issue prompted a Government Accountability Office (GAO) report that recommended more information be given to participants that are allowed to elect a lump sum benefit. The GAO is concerned that participants don’t really understand the deferred monthly income they are giving up in order to get the immediate lump sum. This article explores several lessons we can learn from participant behavior when offered a lump sum cashout. Understanding the behavior of VTs will help sponsors make better decisions on whether to make these offers and how to communicate with their VTs.

P-Solve and Nyhart combined forces and aggregated data from 18 cashout windows representing close to 3,500 lives. The good news is that most VTs rollover their cashouts. However, many near retirees are taking the money and running!
What does the data show?

Just over half (51%) of the VTs elected to take a lump sum. Only 1% took the immediate annuity benefit which also must be included with these offers. All of these annuity takers were over age 50. Sponsors can expect “take rates” of between 40% and 60% on these offers and do not need to worry about the immediate annuity option being elected by young folks.

The good news is that participants with higher lump sum amounts that elected a distribution tended to rollover their distribution into an IRA or another qualified retirement plan (e.g., a 401(k) plan). The bigger the lump sum the more likely participants are to rollover their money. Interestingly, the likelihood of doing nothing is only slightly higher with larger lump sums than smaller lump sums, indicating that inertia is an issue regardless of lump sum amount. The chart below shows the comparison of those participants that took their distribution in cash versus a qualified plan rollover by lump sum amount.

There is a somewhat alarming pattern when we look at the election patterns by the age of the VTs. While the older VTs are more likely to rollover their lump sums than younger VTs, there is still a fairly high percentage (25%) of near retirees (in their 50s) who take the money. The average distribution of the VTs between ages 50-54 who took cash was $22,000. This amount could easily grow beyond $50,000 by age
67 (Social Security normal retirement age) which would provide a nice supplement to the VT’s Social Security benefits. We expand on this important concern below.

We analyzed the data and found no difference in election patterns for gender. These cashout amounts must be determined using unisex mortality tables and uniform interest rates. Since women have longer life expectancies than men they should be more cautious about taking lump sums.

Cash Versus a Rollover Distribution?
Participants that elect to take a lump sum distribution have two options: take the amount in cash or roll it over to an IRA or other qualified retirement plan. What’s the difference? Taxes. Money that is rolled over is not taxed and can continue to build up earnings that are tax free. If a participant takes his retirement money in cash, that money gets taxed immediately at whatever tax bracket the participant is currently in plus a 10% excise tax if they have not reached age 59.5. If they continue to invest it (rather than buy a boat), those earnings are taxable as well.

The chart below shows the difference in the eventual money available at retirement if the lump sum is taken as cash versus rolled over. We have assumed a 50 year-old with a lump sum of $22,000 and an annual return on investment of 5%. We have also assumed a 20% tax rate at age 50 and a 10% tax rate
at age 67.

What this chart shows is that all else equal, rolling over the lump sum into a qualified retirement plan versus taking the distribution in cash produces more retirement income, even for a distribution of $22,000.

Implications
Even small lump sums at early ages can grow to something significant in retirement. Those participants that cash out their pension benefit and don’t invest it for the future and instead “buy the boat” are giving away part of their retirement security. While some participants may not “buy the boat” but instead pay down debts, etc. the tax implications to holding on to those dollars in an IRA or qualified plan should sway individuals to at least consider keeping their money in a qualified retirement plan.

These outcomes are partly what prompted a February 2015 Government Accountability Office (GAO) report that recommended more information be given to participants that are allowed to elect a lump sum benefit. It is easy to see how additional disclosures could help participants make informed decisions about the ultimate value of their retirement money.

Plan sponsors considering lump sum cashout windows this year or in future years will want to enhance their participant communications strategy to help participants understand the full effect of their decision to:

1. Take a lump sum now, and
2. Understand the retirement savings consequences to taking the distribution in cash or rolling it over.

Ultimately it's not the plan sponsor’s role to provide financial advice but providing information that could urge participants to seek out the advice should surely be considered.

Conclusion

These lump sum campaigns for vested terminated participants are generally quite successful. They result in reduced risk for plan sponsors, just as intended. About half of the participants elect a single lump sum, erasing any future obligation for the plan. At the same time, many participants are happy to have been given the option, resulting in good news on both sides. But the results also indicate that the GAO’s concern is valid. In general, older participants with higher lump sum values do the “right thing” and opt to rollover their lump sum to an IRA thus preserving their retirement dollars and deferring taxation. However, 25% of those age 50-59 are taking the cash, oftentimes substantially reducing their chances of financial security in their retirement years. These participants need information to fully understand the advantages and disadvantages of their decision to “take the money and run.” The question remains, do these participants properly understand the cost of this choice?

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