Consider Lump-Sum Payouts Amid Higher Interest Rates

Posted June 1, 2023
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Recently, many defined benefit plan sponsors have opted for various de-risking strategies, including buy-outs, buy-ins, and liability-driven investing. Today, there is an increased focus on the segment rates used to determine lump-sum payouts for retiring or terminated participants.

Here we explain segment rates and the impact they have on lump-sum payments. Now is an opportune time to consider lump-sum payouts, as the current high-rate environment may help plan sponsors cash-out participants at a lower cost.

How segment rates affect lump-sum payouts

Most traditional defined benefit plans offer two types of payouts: annuities for life or a one-time lump sum. The Internal Revenue Service (IRS) releases monthly Minimum Present Value Segment Rates. Plan sponsors identify which IRS segment rates to use for their lump sums by defining a stability period and a lookback period in their plan documents. These rates are then used for lump sums over a set period of time (typically each plan year).

The interest rates set by the IRS are based on the value of corporate bond yields, which have increased considerably over the past year. According to Pitasky, many plan documents determine lump sums for the full 2023 Plan Year using IRS rates between August and December 2022. Those rates increased from 1.8% to as much as 2.8% as compared to the prior year.

Rising interest rates can markedly affect lump-sum payouts in both directions: When rates are low, lump-sum payouts are high and vice versa. In a pension, where expected annuity payouts occur over a long period of time, a change in rates can have a significant effect on lump sum determinations. For example, a 2.5% increase in rates could lower lump sums by 30%–40%.

High interest rate triggers

Plan sponsors who have a high interest rate in place for valuing lump-sum payments should be focused on the following:

- **Participant reaction:** Many participants may not be paying attention to the effects of interest rate changes on their pension payout. It isn't unusual for a participant to think their lump sum will not change from statement to statement, so it is important to help them understand the difference between their accrued benefit and other forms of payments, like lump sums.
- **Auto cash-outs:** It isn't uncommon for a plan to have auto cash-out provisions, which allow plan sponsors to cash out participants whose balances fall below $5,000. As a result of the high interest rate environment, many participants' balances may be under this threshold, allowing plan sponsors to cash them out involuntarily.
- **PBGC premiums**: All plans are required to pay insurance premiums based on funding status to the Pension Benefit Guaranty Corporation (PBGC). PBGC premiums have increased to a flat rate of $96 per participant plus a variable rate of $52 for each $1,000 of unfunded vested benefits (capped at

$652 per participant). These premiums are significantly higher than ten years ago, when they were $42 per participant plus $9 for each $1,000 of unfunded vested benefits. Plan funding status and premium payments could be reduced significantly as a result of cashing out participants. Volatility in the plan may also be lowered with fewer participants in the plan.

- **Cash balance plans:** It should be noted that interest rate fluctuations do not affect many cash balance plans as significantly. Cash balance plans act like 401(k)s, so the amount in each account is the actual payout.

Insight: Time to terminate your plan?
Many factors play into the decision to terminate a plan. Even though lump sums may have decreased, plan assets may have also decreased, which could affect the ability of a plan to afford a termination. In addition, the process to terminate may take a year or more, so the rates used to calculate lump-sum payments in 2024 may not be what the plan applies in 2023. Therefore, higher payouts may result. Finally, even though participants can be offered lump sums in a plan termination, they always must be offered annuity payments from an insurance company, which usually come at higher costs to the plan when compared to lump sums.

One way to shore up a plan's volatility and remain active is to review the plan documents and see how the lump sum cash-out rate may help. While annuities may be a good option, plan sponsors will need to pay a premium for insurers to take on participant pension liabilities. In a high interest rate environment, lump sums could reduce the number of participants in the plan with payouts that are lower than what was previously expected.

Contact our Retirement Plan Administration team to discuss what's best for your plan.