SOCIETY OF ACTUARIES

Article from:

Pension Section News

January 1998 – Issue 35

PENSION SECTION NEWS

NUMBER 35 JANUARY 1998

Chairperson's Corner

Carol E. Zimmerman

First, let me extend a hearty "thank you" to the members of the Pension Section Council who have just completed their terms. Dick Joss, Joan Weiss, and especially James Kenney, our departing chairperson, have each contributed a great deal of time and effort to the Pension Section Council and they will be missed.

We also welcome our new members, Lindsay Malkiewich, Lee Trad, and Colin England. Congratulations on being elected to the Pension Section Council!

I especially appreciated Jim Kenney's challenge to the Pension Section Council—what can we do to increase the value of the Pension Section to our members? During the coming year we, as your council, will be taking up that challenge and looking for new ways to help pension actuaries.

I am excited about some of the ideas that came out of our brainstorming sessions. Some of these include developing a training "bootcamp" for entry-level actuaries, continued improvement in the content of SOA Spring Meetings, and focus on sponsoring

continued on page 2, column 2

LIMRA Study

A Guide to Helping Employees Preserve Their Pension Benefits

Each year millions of employees change jobs, leave the workforce, or retire and become eligible for a lump-sum payment from their employer's retirement plan. These employees have the task of deciding whether or not to take a lump-sum payment and, if they do take it, where to invest it. For many of these employees, this money is the largest financial asset they own and may be their only private source of retirement income— income that must last the rest of their lives. Many will need assistance in understanding their options and selecting the best option for their circumstances. Their ultimate goal should be preservation of their retirement benefits in order to ensure a secure retirement for themselves and their families.

LIMRA conducted a study of employees retiring, changing jobs, or leaving the workforce and eligible for a lump-sum payment from their pension plans. The study's purpose was to assist pension companies with developing products and services that will help employees preserve their pension benefits.

The study included information on 1,763 employees eligible for a lump-sum payment from their employer's retirement plan: 684 employees who had retired in the past three years, and 1,079 employees who had changed jobs or left the workforce in the past three years.

Size and Growth of the Market

Persons eligible for a lump-sump payment from their employer-sponsored retirement plan include those who are:

- Retiring
- Disabled
- Changing jobs or leaving the workforce
- Losing their jobs due to layoffs or corporate downsizing
- Participating in a pension plan that is being terminated

continued on page 8, column 1

In This Issue

LIMRA Study
continued from page 1

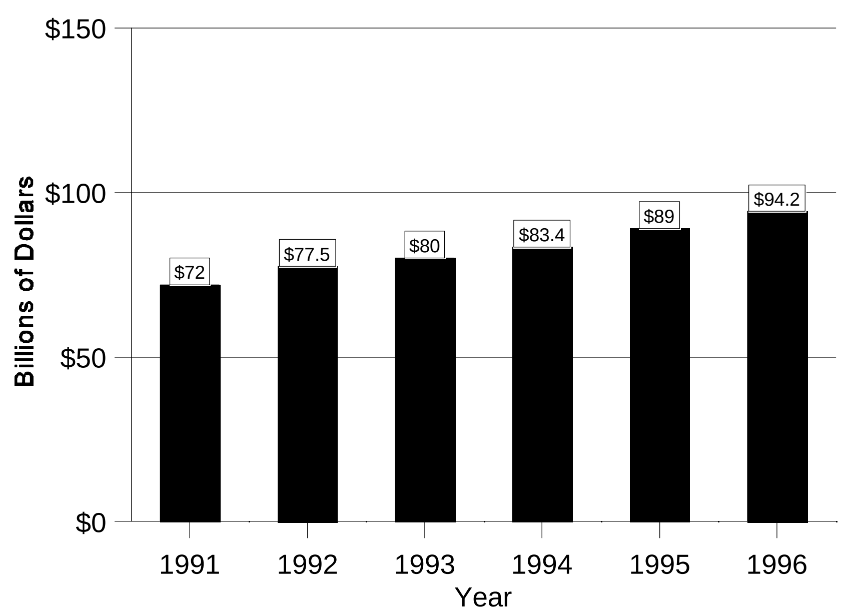
- Beneficiaries of a deceased participant in a pension plan.

No accurate measures of the number of these persons exist. Only estimates are available and they vary considerably. In 1996 employer-sponsored pension plans made benefit payments of $336 billion—an increase of 6% from 1995 and 31% from 1991 (Figure 1). Of that amount, an estimated 28% [1] or $94 billion was in lump-sum payments. This amount does not include more than $20 billion that plan participants choose to leave in their plans [2]. A major study conducted by the U.S. Department of Labor found that from January 1993 to September 1994, 940,430 workers aged 40 and older received a lump-sum payment [3]. Subsequent analysis indicates that this study underestimates the number of people receiving a payment and that it does not include those who were offered a payment but who left the money in the plan. It does show that a large number of workers representing billions of dollars have the task of deciding what to do with this money.

The number of employees faced with this decision as well as the amount of money involved not only is large but also is increasing rapidly. Three factors contributing to this rapid increase are:

- The growth of defined-contribution plans, particularly 401(k) plans
- The growth of participant account balances in defined-contribution plans
- The increasing number of persons reaching retirement age early in the next century.

FIGURE 1
Estimated Lump-Sum Payments from Qualified Pension Plan Assets



Need for Assistance

Selecting the right option for their circumstances will be one of the most important financial decisions these employees must make. Persons eligible for a lump-sum payment may have a choice of as many as six options. Their choices will include at least one or more of the following options:

- Take the money in one lump-sum cash payment
- Leave the money in the previous employer's plan
- Transfer the money to the new employer's plan
- Transfer the money directly to an IRA
- Take a cash payment and transfer it to an IRA within 60 days
- Take the money in installments or purchase an immediate annuity.

Each option has advantages and disadvantages (see Exhibit 1 on page 11). The options have differing effects on household income, tax liabilities, and preserving pension benefits. Not all options create the same estate value or survivor benefits for beneficiaries. Some options create maximum current income but not estate value. Other options create no current income but preserve estate value and spacial benefits.

Employees are strongly discouraged from taking a cash distribution. If they do, they will have a 20% withholding tax deducted from the payment and may incur a 10% penalty. The employee has 60 days to place this money into an IRA or qualified pension plan to avoid income and penalty taxes. However, the employee will not receive the 20% refund until income taxes are filed for that year, and to avoid the taxes and penalty on the amount withheld, the individual must put, within the same 60 days, the equivalent of the 20% withheld into an IRA or qualified pension plan [4]. The 10% penalty is not imposed if the employee died, became disabled, reached age 59½, or reached age 55 in the year his or her employment was terminated. If the employee has a loan from the plan, it will have to be repaid.

Size of Payment

The average lump-sum payment offered to a job changer is $22,230, with more than half offered $10,000 or more. This payment represents approximately 6% of household assets. For retirees, the average lump-sum payment offered is $119,200 with more than half offered $55,000—this payment represents 23% of their household assets. In addition, nearly 15% of retirees have lump-sum payments valued at $250,000 or more and one in three retirees have values exceeding $100,000.

When eligible for a lump-sum payment, the most popular option selected is to transfer the money to an IRA—two in five employees choose this option. Approximately one in five employees leave the money in the employer's pension plan. Also popular among retirees is taking the money in installments or as a series of annuity payments. A cash payment is popular among job changers. Of those taking a cash payment, 45

continued on page 9, column 1

LIMRA Study
continued from page 8

people saved some or all of the money (see Table 1).

Where Do They Invest or Save the Money?

Of those transferring the money to an IRA or taking a cash payment, the majority invested the money in mutual funds. Other savings and investment products include money market funds, savings accounts, annuities, stocks, and bonds (Table 2). The competition for these investment dollars is high. No one company has a dominant market share. The five companies with the largest market share have a combined market share of less than 25% (Table 3).

Those placing the money in an IRA show no clear preference for the type of company chosen to service the account. Banks and credit unions are the most popular among retirees, with 27% opening their IRA with this type of institution. Mutual fund companies are more popular with job changers—one in three job changers placed their IRA with a mutual fund company (Table 4).

Leaving the money in the employer-provided pension plan is the easiest option for an employee to choose and one of the reasons that they do so. Other reasons include:

- The plan offers good service
- They want to avoid taxes and penalties
- The plan has good investment performance
- They liked the investment choices
- They would have a larger amount of money.

Sources of Assistance

The employer plays a critical role of providing information to employees on their options. More than 90% of employees thought they received adequate information from their employer. In addition, among the most useful sources for information, three of the four mentioned by employees involved the employer. This information includes employer-written materials, employer seminars, and face-to-face meetings with the employer's staff. The other most useful source of information mentioned frequently is commercially available written material from bookstores.

TABLE 1
What Employees Did with the Offer of Lump-Sum Payment
(Percentage of Respondents)

Options Selected	Retiree	Job Changer
Transfer money to an IRA	41%	39%
Leave the money in the pension plan	21	24
Take a cash payment	16	28
Take the money in installments	21	1
Transfer money to new employer's pension plan	1	8
Total	100%	100%

TABLE 2
Where Did They Invest Most of Their Money?
(Percentage of Respondents)

Investment/Savings Product	Retiree	Job Changer
Mutual fund	46%	52%
Savings of money market	7	16
Certificate of deposit	14	8
Stocks and bonds	15	8
Annuity	10	8
Other	8	8
Total	100%	100%

TABLE 3
Companies with the Largest Market Share

Company	Market Share
Retirees	
Merrill Lynch	5%
Dean Witter	5
American Express/IDS	4
Fidelity	4
Smith Barney	3
Total	21%
Job Changers	
Fidelity	6%
Schwab	4
Dean Witter	3
Merrill Lynch	3
Prudential	3
Total	20%

Most do not seek the advice of a professional. They rely on either their own analysis or the help of family and friends. When they turn to a professional, they choose a financial planner, independent investment advisor, or full-service stockbroker (Table 5).

Conclusion

Pension companies and employers are only in the early stages of understanding the needs of employees eligible for a lump-sum payment from their pension plan and designing products and services to help these employees. They can play a vital role in assisting employees in preserving their retirement benefits. Pension companies need to be

continued on page 10, column 1

LIMRA Study
continued from page 9

more proactive in providing plan sponsors with necessary tools. One example is a service plan in which the company assumes many of the administrative procedures performed by the employer. This service offers the employer the pension company's expertise in advising employers and cost savings. It offers employees access to a full-time retirement specialist who works daily with employees in similar situations. In addition, the employer can tailor the services to meet the special needs of its employees (see Exhibit 2 on page 12).

TABLE 4
Type of Company Servicing the Rollover IRA
(Percentage of Respondents)

Type of Company	Retiree	Job Changer
Bank or credit union	27%	26%
Mutual fund company	25	33
Full-service stockbroker	24	21
Insurance company	11	13
Discount stockbroker	6	4
Respondent not sure	7	2
Total	100%	100%

TABLE 5
Where Do They Turn for Advice?
(Percentage of Respondents)

Advisor	Retiree	Job Changer
Family or friends	24%	37%
No one	19	22
Financial planner	14	7
Independent investment	8	7
advisor	8	5
Full-service stockbroker	5	2
Accountant	22	20
Other		
Total	100%	100%

END NOTES

1. Woods, John R., "Pension Benefits Among the Aged: Conflicting Measures, Unequal Distributions," *Social Security Bulletin*, Volume 59, No. 3, Fall 1996.
2. LIMRA estimates approximately 23% of persons eligible for a lump-sum distribution leave this money in the employer's plan.
3. *Retirement Benefits of American Workers: New Findings from the September 1994 Current Population Survey*, U.S. Department of Labor Pension and Welfare Benefits Administration Office of Research and Economic Analysis, September 1995.
4. Participants in 457 plans are not allowed to transfer their distribution to an IRA and cash distributions are only allowed after retirement.
5. Stable value investments—a type of investment that is only offered within pension plans. Stable value investments—also commonly referred to a guaranteed interest contracts (GICs)—are a popular investment option for participants in defined-contribution plans. A stable value investment option offers a return of money invested at a predetermined interest rate.

For more information regarding this report, contact Lucian Lombardi, assistant vice president, LIMRA International, at (860) 285–7845.

John Hanson Memorial Prize

The John Hanson Memorial Prize is given on a regular basis for the best paper on an employee benefits topic published in the *Proceedings of the Conference of Consulting Actuaries*. The author must write a paper but need not apply or be a member of the Conference to be considered for the prize. The winning paper will be selected by an employee benefit subcommittee of the Committee on Papers. Papers are judged on appropriateness of subject material, timeliness of topic, originality and practical application to employee benefits.

Due to lack of appropriate papers in the past year, the CCA Board of Directors has decided that the prize for 1997 will be $2,000 and the CCA will waive its Annual Meeting fee for next year to the recipient. Thereafter, until further notice, the prize will be $1,000 a year, and the CCA will waive its Annual Meeting fee for that year to the recipient.

LIMRA Study
continued from page 10

EXHIBIT 1
Each Option Has Advantages and Disadvantages

Option	Advantages	Disadvantages
Take the money in one cash payment	• Provides immediate access to some of the money to meet immediate financial needs or unexpected expenses • Provides estate value • Greater flexibility in use of money	• Entire amount subject to 20% tax withholding • Must pay federal, state, and local income taxes • Possible penalty for early withdrawal • Loss of tax-deferred growth • Loans must be repaid immediately • May make inappropriate investments • May not have adequate retirement savings
Leave money in plan	• Simple to implement • No mandatory 20% tax withholding • Avoids 10% early withdrawal penalty • Money grows tax-deferred • Can transfer the money to another plan or rollover IRA at a later date • Can maintain same investment options • Loans can be maintained • Choice of stable value [5] option typically available • Has estate value	• Limited investment options • Less flexibility • May incur record keeping charges • Access to money may be restricted
Transfer the money to a new employer's plan	• No mandatory 20% tax withholding • Avoids 10% early withdrawal penalty • Money grows tax-deferred • Choice of stable value option typically available • Has estate value • Loans may be transferred	• Limited investment options • Less flexibility • Access to money may be restricted • Must select new investment options • May have to repay loans
Transfer money to a rollover IRA	• No mandatory 20% tax withholding • Avoids 10% early withdrawal penalty • Money grows tax-deferred • Can transfer the money to another plan at a later date • Wider selection of investment options • Has estate value	• Loans must be repaid immediately • Must select new investment options • No stable value option available • May make inappropriate investments • May need an account that can handle employer stock
Purchase an immediate annuity	• No mandatory 20% tax withholding • Avoids 10% early withdrawal penalty • Offers guaranteed income for life • Taxes spread over a number of years • Provides immediate access to some of the money to meet immediate financial needs or unexpected expenses	• Loans must be repaid immediately • Payments are subject to income taxes • Limited or no flexibility on investment options • Limited or no estate value • No liquidity
Take the money in installments	• Avoids 10% early withdrawal penalty • Taxes spread over a number of years • Provides immediate access to some of the money to meet immediate financial needs or unexpected expenses • Has estate value	• Must structure correctly to avoid early withdrawal penalty • Income taxes on payments

continued on page 12

LIMRA Study
continued from page 11

EXHIBIT 2
Example of a Servicing Plan that Companies Can Offer to Employers

1. Servicing company provides a toll-free number to the employee—it could be the same number that the employee uses to call for other participant services.
2. Servicing company provides a special toll-free number for employees and beneficiaries.
3. Employer gives employees an instruction sheet directing them to the toll-free number.
4. The toll-free number offers the employee the assistance of a retirement specialist to explain the process, help the employee complete the necessary forms, and answer questions.
5. Servicing company mails necessary forms and supporting communication material.
6. The company may also answer questions about the investment options available to the employees and provide material or assistance on selecting investment options.
7. Employees are notified of the time limits and what will happen if they make no election.
8. The company provides a compliance monitoring system that tracks when the notice of employees' rights, the spousal consent form, and tax-withholding notice are mailed.
9. The company can answer questions on how to handle outstanding loans.
10. For vested amounts less than $5,000, the company can follow the special procedures it develops with the employer.

Study Note Corner

Securing Supplemental Retirement Arrangements (Course P–361C Study Note)

by C. Ian Genno

The incidence of Supplemental Retirement Arrangements (SRAs) in Canada has grown dramatically over the last two decades. This has been spurred by several factors, including:

- Minimal movement, since the 1970s, in the maximum pension limit which the Income Tax Act imposes on benefits paid from Registered Pension Plans (RPPs); in the absence of some form of arrangement to provide supplemental pension benefits, this would result in many executives, senior middle management employees, and highly paid professionals receiving inadequate pension at retirement.
- Increasing mobility in the workforce, resulting (among other things) in a need to provide greater pension benefits to executives hired mid-career than the Income Tax Act limits permit.
- An increase in the frequency of mergers, takeovers, and bankruptcies, resulting in some companies reneging on unfunded supplemental pension promises to certain employees.

In many organizations, SRAs have become a significant long-term element to the total compensation package for executives and other highly paid employees. And the security of the benefits promises by these SRAs has become a more prominent issue.

This study note deals with how security can be provided for members of SRAs in Canada—in other words, what mechanisms can be used to ensure that, under appropriate circumstances, SRA members will receive the supplemental pension benefits which they have been promised.

To order Study Notes, please contact Aleshia Zionce, Study Note Coordinator, at 847–706–3525. The price for Study Note 361–74–97 is $8. An up-to-date list of Study Notes and prices is available on the SOA website at http://www.soa.org in the Education and Exams area.