

Better conversations. **Better outcomes.**

# Pension lump sums: Thoughtful considerations for plan sponsors and retirees



The IRS recently altered course and announced that it will no longer stop employers from offering retirees a lump sum payment in exchange for their pensions. Initial reactions have been that this is very bad—comparing lump sum cash-outs to cigarettes—legal, liked and bad for you. The irony of that argument is that if the retiree is a smoker, taking a lump sum may be a really good idea, given the reduced life expectancy.

No matter which side you align with in the argument, it is important to take into consideration what this means for plan sponsors and retirees..



## **FOR PLAN SPONSORS:** Five things to think about before paying a retiree lump sum

**The savings vs. buying an annuity isn't as great as non-retiree lump sums.** Buying an annuity to settle a DB liability generally costs more than simply paying out the lump value. Annuity carriers have regulatory (and business) overhead, profit margin, and generally use more conservative valuation and risk assumptions than an ongoing plan would. Very roughly, all of these requirements can add between 15%-35% or more for non-retirees; because of the shorter time period for payments (among other things), they only add roughly 5%-10% for current retirees.

**There's a hidden adverse selection cost.** Settling benefits by providing an annuity with a lump sum option is considerably more expensive than only providing an annuity. That is because individuals who believe they are likely to die before reaching the group's average life expectancy will take lump sums, and the remaining group's average life expectancy—and annuity payout period—will go up. In a lump sum window program, the sponsor will have to finance the obligation with respect to this now longer-lived group that does not take the lump sum, and the cost of settling liabilities with respect to that group will go up, by perhaps as much as 5%-10%. That additional cost may be more than the savings from those participants who take lump sums.

**Unisex tables exacerbate the adverse selection problem.** Because plans must use the same life expectancy tables for both males and females, often referred to as unisex tables, which in effect overstate life expectancy for males and understate it for females, lump sums will appear to be a relatively "good" deal for males and a "bad" deal for females.





**Offering lump sums to some older annuitants may present consent/fiduciary issues.** Whether an older annuitant's cognition is compromised, whether she is able to adequately consider a lump sum option, may (perhaps with some frequency) be disputed—perhaps years after the lump sum election and after all the money has been spent.

**Given press coverage, retiree lump sums may become an enforcement target.** Experience has taught us that, with enough publicity and controversy, rules that were considered non-problematic can become problematic.

“ ”

Initial reactions have been that this is very bad—comparing lump sum cash-outs to cigarettes—legal, liked and bad for you.

## Contact us

-  1-844-BMO-Fund (266-3863)
-  [bmo-global-asset-management](https://www.linkedin.com/company/bmo-global-asset-management)
-  [bmogamviewpoints.com](https://www.bmogamviewpoints.com)
-  [bmogam.com/betterconversations](https://www.bmogam.com/betterconversations)



**FOR PARTICIPANTS:**  
**Should a retiree take a lump sum in exchange for their pension?**

What should a retiree do if they have received one of these offers? We thought it would be useful to run down some questions to have your clients consider:

**Realistically, how long do you expect to live?** If you expect to live an “average” number of years, or more than average, you are going to need a regular income for the whole period. And the pension you’re getting is probably one of the best lifetime income deals going. On the other hand, if you have a good reason to believe your life will be shorter than average, then a lump sum may be the better choice. For married couples this calculation is more complicated. One of you is likely to live longer (perhaps a lot longer), but the one who dies first can pass along what he didn’t spend.

We cannot emphasize this enough—the risk that you might outlive your assets, called “longevity risk,” trumps everything else. An annuity can mitigate “longevity risk” and help to ensure your assets will last. And your employer’s pension is one of the best lifetime income deals out there. If you take a lump sum, you must be comfortable that you can live on whatever other lifetime retirement income resources you have, like Social Security.

**Should you spend the lump sum to delay Social Security?** Right now, the other really good deal you can get on guaranteed retirement income is delaying the start of Social Security, which increases the benefit you ultimately get, each year you delay until you reach age 70. If taking a lump sum will allow you to do this, you might want to consider it.

**Do you have another source of retirement income?** Social Security replaces a significant amount of lower-income individuals’ pre-retirement income. And you may have other sources of income.

**Do you have other personal objectives?** What is “adequate” is different for different individuals. You may want to live on less so that you can pass something on to your heirs as a legacy. There may be a trip you’ve waited your whole life to take. Just remember what we said at the top—you are going to need income for the rest of your life. If you have no good Plan B, like going back to work, then your assets are going to have last.

**Should you put your money in the market?** You may want to invest some of your money in the market. The only way you can do that is by taking a lump sum. There are arguments on both sides here with two things to consider. First, even the best investors can lose money (sometimes, a lot of it) in the market. You should not take more risk than you can afford. Second, you shouldn’t do this unless you realistically think you know what you’re doing.

**Do you want spending flexibility?** The typical pension provides a fixed amount per month for however long you live (a “life annuity”). Spending in retirement isn’t always that smooth. You may experience spending “shocks”—like a health crisis. You may want to spend more in a particular year—say to help your children with a big expense. A lump sum will give you more spending flexibility.

**BOTTOM LINE:**

**There are a number of factors that require thoughtful consideration for both plan sponsors and retirees regarding lump sum payments. There are no right or wrong answers in general but with better conversations better outcomes can be achieved for sponsors and retirees around these important decisions.**

**Continue the conversation**

BMO Global Asset Management’s Better Conversation Guides provide insights into some of the biggest challenges to your success.

Visit [bmogamviewpoints.com](http://bmogamviewpoints.com) for additional resources and information to help make your next client conversation a better conversation.

BMO Global Asset Management provides this material for informational purposes and does not intend for it to substitute for professional advice regarding your particular financial position. The information contained herein is based on sources that we believe reliable, at the time of publication, but is not guaranteed by us and may be incomplete. The information contained herein is subject to change in the time following publication.

BMO Global Asset Management is the brand name for various affiliated entities of BMO Financial Group that provide investment management and trust and custody services. Certain of the products and services offered under the brand name BMO Global Asset Management are designed specifically for various categories of investors in a number of different countries and regions and may not be available to all investors. Those products and services are only offered to such investors in those countries and regions in accordance with applicable laws and regulations. BMO Financial Group is a service mark of Bank of Montreal (BMO).

BMO Asset Management Corp. is the investment advisor to the BMO Funds. **BMO Investment Distributors, LLC is the distributor.** Member FINRA/SIPC.

Securities, investment advisory and insurance products are: **NOT A DEPOSIT — NOT FDIC INSURED — NOT BANK GUARANTEED — MAY LOSE VALUE.**

© 2019 BMO Financial Corp. (8535314, 5/19)

“ ”

We cannot emphasize this enough—the risk that you might outlive your assets, called “longevity risk,” trumps everything else.