TEXAS PENSION REVIEW BOARD

Guidance for Calculating and Administering Lump Sums

Adopted July 25, 2024

Overview

A pension system may offer its members a choice among various optional forms of payment including the option of taking a full or partial lump sum. When providing optional forms of payment, the system should include plan provisions and administrative practices that help members and their spouses recognize the differences in these optional forms of payment. An optional form of payment can have a significant impact on the ultimate level of benefits received by members and their spouses. An effort should be made to help members make a fully informed decision, especially regarding lump sum benefits.

The following guidance provides more detail on these administrative practices and plan provisions, which can become outdated if not reviewed regularly. This guidance applies to all optional forms of payment but is especially important for lump sums, **where a single payment is traded for a lifetime of payments.**

Lump sums work best for both the plan sponsor and plan members when pension systems periodically revisit the intent of their lump sum option and regularly review and update the definition of actuarial equivalence and administrative practices. [1]

Components of Actuarial Equivalence

The pension plan document specifies how to convert the normal form annuity into other optional forms of payment. The specifications will include **an interest rate and mortality table, which together are used to determine actuarial equivalent forms of payment**. Some systems use a table of factors for actuarial equivalence, though the factors were usually determined originally as a simplified version of an interest rate and mortality table. To the extent that the conversion uses reasonable assumptions:

- the pension system will not be expected to incur significant gains or losses regardless of the form of payment chosen by the member and
- the member will receive a benefit that is arguably equal in value to the value of the normal form of payment.

Actuarial equivalence assumptions that approximate the system's future experience will help ensure that a member's choice of one optional form over another will not cause losses for the system. Additionally, actuarial equivalence assumptions that approximate the member's future experience will help ensure that a member's choice of one optional form over another will not cause losses for the member.

At this time there is no agreed-upon definition of "reasonable" actuarial equivalence, or even whether public pension systems must be expected to use a "reasonable" definition; however, the sections below

[1] For example, the lawsuit *Whetstone v. Howard University et al* filed in August 2023 alleges the use of "outdated actuarial assumptions" used to calculate optional payment forms.

offer potential definitions of a reasonable interest rate and reasonable mortality table for plan sponsors that desire a lump sum option that is expected to be of equal value to the other available payment forms.

I. Interest Rate

Because it is not reasonable to expect the member to achieve an investment return after retirement that exceeds the return of the pension system's professionally managed portfolio, **a reasonable interest rate will be no higher than the system's best estimate of future investment returns that is used in the actuarial valuation**.

When a pension system uses an interest rate higher than their best estimate of the system's future investment returns, the plan sponsor benefits financially to the member's detriment when the member chooses a lump sum option. Conversely, should the system choose an interest rate below the system's best estimate of future returns, the system should take steps to understand the cost to the system of lump sum payments. When interest rates that are different from the system's best estimate of future investment returns are used to determine other actuarial equivalent forms of payment, the system should understand if these assumptions are expected to generate gains or losses.

II. Mortality Table

Because retiree expected lifetimes have grown over time, an outdated mortality table will generally underestimate the number of monthly pension payments expected to be paid to a member under the normal form annuity, causing lump sums to be smaller than they would if calculated with updated expected retiree lifetimes. When systems use outdated mortality tables, the system benefits financially to the average member's detriment when the member chooses a lump sum option.

New widely adopted mortality tables typically come out approximately every 10 years. **Pension systems should review and consider updating this plan provision at least once per decade to align with typical timeframes for mortality table updates.**

III. Automatic Updates

Automatic updates to the interest rate and/or mortality table may be written into the plan to ensure timely updates. For example, the interest rate could be set to change periodically based on an index or the plan's funding assumptions. The mortality table could be set to change annually based on the IRS "applicable mortality table."[2] Such automatic updates should still be reviewed regularly to ensure they are achieving the desired result.

Administrative Practices: Disclosures and Transparency

Two administrative practices that are required by the Internal Revenue Service for private pensions but are not required for all Texas public pension systems include relative value statements and spousal consent requirements. [3,4]

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[2] (Internal Revenue Code) 26 U.S.C. Section 417(e)(3)
[3] 26 C.F.R. Section 1.417(a)(3)-1(c)(2)
[4] (Internal Revenue Code) 26 U.S.C. Section 417(a)(2)

The system should consider including statements regarding the relative value of each option and requiring spouses to approve any optional form that does not include payments continuing after the prospective retiree's death.

Prospective retirees presented with various optional forms of payment face a difficult decision that requires a substantial amount of information. Should the prospective retiree choose an optional form of payment that does not include payments continuing to the spouse after the member's death, the spouse will also be greatly affected by the decision.

IV. Relative Values

When presenting the prospective retiree with the optional forms of payment, the system should consider including some or all of the following in the benefit election paperwork:

- The interest rate and mortality assumptions used to calculate the options
- A statement that the various options may not all be of equal value
- The relative value of each option on the basis for comparison selected by the system, as described below.
    - For example, the lump sum may be worth 75 percent of the normal form annuity. The system's actuary can calculate these percentages.
    - The comparative value of the normal form annuity can be determined using the pension system's funding assumptions or a more conservative set of assumptions such as the IRS "applicable interest rate" and "applicable mortality table" or other more conservative alternatives developed by the pension system under consultation with its actuary. [5]

V. Spouse Approval

For annuity and lump sum optional forms of payment that do not include payments that continue to the spouse after the death of the member, the best practice is to require the spouse's signature for acknowledgement and approval of the member's choice. For example, by rule the Employees Retirement System of Texas requires spousal consent for such payment forms.[6]

If the spouse's signature is not required for approval, the spouse may not ever be informed that they are not covered after the member's death.

[5] (Internal Revenue Code) 26 U.S.C. Section 417(e)(3)
[6] 34 T.A.C. Section 73.29