American Academy of Actuaries

# Issue Brief

# Public Pension Plans: Helping Members Evaluate Buyout Programs and Other Lump Sums

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## Key Points

- In recent years, it has become more common for public pension plans to offer buyout programs in which plan members are offered a lump sum payment in exchange for some or all of their pension benefits.
- This issue brief suggests critical information that would help members compare the value of the lifetime benefits to the buyout amount offered.
- Members should always receive an explanation of how the buyout amount is calculated, showing, if applicable, the present value calculated by the plan and the percentage of that present value used to determine the buyout amount. In addition, members also would be helped by: an estimate of the cost to replace the benefits otherwise payable in the private market; and the approximate annual investment return on the buyout amount required to replace the forgone benefits, assuming an average life expectancy.

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## Introduction

In recent years, it has become more common for public pension plans to offer buyout programs in which plan members are offered a lump sum payment in exchange for some or all of their pension benefits. To implement these programs, plan administrators should provide eligible members with information to make an informed choice to accept or reject the offer.

This issue brief suggests critical information that would help members compare the value of the lifetime benefits to the buyout amount offered. Other aspects of the communication to plan members, including explanations of other optional forms of payment, a discussion of longevity risk, administrative procedures to select the lump sum benefit, and tax considerations, are beyond the scope of this issue brief.[1,2]

A typical program offers a buyout amount equal to a percentage of the present value of an annuity benefit based on the assumptions used to fund the plan. These buyout programs often reduce the expected costs of the public pension plan by offering members a buyout that is less than the expected cost of providing the pension benefits. The Academy does not endorse this practice, but when any lump sum is offered in exchange for lifetime benefits, it is essential that plan members fully understand the offer so they can make an informed choice.

1 Disclosure practices and requirements for public pension plans vary by jurisdiction. SECURE 2.0 established new requirements for private sector plans that offer a lump sum, which may also serve as a useful reference for public plans. See 29 USC 1032.

2 The Academy has published several papers related to lump sums and lifetime income in the context of private sector pension plans. Many of those recommendations are reflected here, but others are not applicable to public sector pension plans.

## Informed Choice

Comparing the value of a current lump sum payment to a series of future payments is difficult, especially when the series of payments extends for an unknown length of time (e.g., a lifetime) or increases for cost-of-living adjustments (COLAs) are based on an uncertain index (e.g., CPI-U).

Member choices are likely to be influenced by factors such as:

- Immediate needs for cash (e.g., credit card bills);
- Knowledge of personal life expectancy;
- Confidence the pension plan can pay promised benefits; and
- Financial literacy.

Members with an immediate need for cash may be more likely to accept a smaller buyout due to the additional value of satisfying that cash need. Members who expect to live a long time may be less likely to accept a buyout than those who do not expect to live very long. Members who believe the pension plan may not be able to pay all future promised benefits may be more likely to accept an immediate, lower buyout amount to ensure they receive as much of their pension as possible. Finally, members with less financial literacy may be willing to accept a smaller buyout amount simply because they do not understand the value of periodic payments over many years.

While the plan cannot control the influence of personal circumstances on a member's decision, clear communications can mitigate a lack of financial literacy.

The information appropriate to provide members varies based on the features of the buyout program. Members should always receive an explanation of how the buyout amount is calculated, showing, if applicable, the present value calculated by the plan and the percentage of that present value used to determine the buyout amount. In addition, the following benchmarks would help members understand the financial impact of accepting the buyout offer:

- An estimate of the cost to replace the benefits otherwise payable in the private market; and
- The approximate annual investment return on the buyout amount required to replace the forgone benefits, assuming an average life expectancy.

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**The committee extends special thanks to Bill Hallmark for his role as lead author for this issue brief.**

These amounts provide the member with easily understood reference points. Members can then compare the offer with the reference points and make a more informed choice than they would without such information.

If the buyout offered is less than the cost to replace the benefits in the private market, the member can see approximately how much they would need to make up on their own to ensure that they receive the forgone benefits. In most cases, an individual annuity would be required to replicate the benefit.[3]

Instead of purchasing an individual annuity, the member may believe they can invest the proceeds of the buyout to replace the forgone benefits. Disclosing the annual investment return the member would need to earn on the buyout amount to replace the benefits for an individual with an average life expectancy provides the member with some of the information necessary to assess whether it is realistic to replace the forgone benefits by investing the buyout amount.

Finally, members will likely need some assistance assessing the value of the buyout amount for their situation. A fiduciary financial adviser is obligated to act in their client's best interest and can help make this assessment for the member. Members should be encouraged to engage a fiduciary financial adviser before making a significant irrevocable decision on a buyout offer.

**Illustration 1**

### Retirement Buyout

**Buyout Amount = $293,000**

*Buyout Election: One-time lump sum distribution equal to 70% of the present value of future benefit payments.*

| | |
|---|---|
| Member Age: | 62 |
| Monthly Benefit | $2,500 |
| Benefit Form: | Life Annuity |
| COLA: | 2.0% |

*To assist the member in evaluating the buyout offer, consider providing some explanation and comparisons such as the following.*

| **Suggested Comparisons** | |
|---|---|
| Plan's Present Value | $419,000 |
| Buyout Amount (70%) | $293,000 |
| Annuity Cost Estimate | $621,000 |
| Annual Investment Return Needed on Buyout Amount | 11.1% |

You are entitled to $2,500 per month payable for your lifetime with an annual cost-of-living increase of 2% per year. The plan expects this benefit to cost $419,000, and the buyout is 70% of that amount.

The cost to purchase this guaranteed benefit from an insurance company is estimated to be approximately $621,000. The plan is offering you an option to forgo the annuity and receive a single lump sum benefit of $293,000.

Based on an average life expectancy, you would need to earn an 11.1% annual rate of return on the buyout amount to replace the annuity payments you are forgoing.

There may be circumstances in which you may wish to select the lump sum even though it appears to be of less value than the annuity. You may wish to consult a fiduciary financial adviser before electing the lump sum option.

## Key Assumptions

In addition to providing the benchmarks described above, the critical assumptions used to develop the buyout option should be disclosed. By identifying these assumptions and communicating how they impact the amount of the buyout offer, plan administrators can better support members in making informed elections.

3 Public pension plans may offer some optional forms of payment not available in the annuity market.

Four primary assumptions affect the calculation of the buyout amount:

- Discount rate;
- Cost-of-living adjustment (COLA);
- Mortality; and
- Factor or adjustment applied.

**Illustration 2**

## Vested Buyout

**Buyout Amount = $35,000**

*Buyout Election: One-time lump sum distribution equal to 60% of the present value of future benefit payments.*

| | |
|---|---|
| Member Age: | 45 |
| Retirement Age: | 62 |
| Monthly Benefit | $1,000 |
| Benefit Form: | Life Annuity |
| COLA: | 3.0% |

*To assist the member in comparing the buyout amount to the monthly benefit they are relinquishing, consider providing some comparisons such as the following.*

| Suggested Comparisons | |
|---|---|
| Plan's Present Value | $58,000 |
| Buyout Amount (60%) | $35,000 |
| Annuity Cost Estimate | $158,000 |
| Annual Investment Return Needed on Buyout Amount | 9.0% |

You are entitled to $1,000 per month commencing at age 62 and payable for your lifetime with an annual cost-of-living increase of 3% per year. The plan expects this benefit to cost $58,000, and the buyout is 60% of that amount.

The cost to purchase this guaranteed benefit from an insurance company is estimated to be approximately $158,000. The plan is offering you an option to forgo the annuity and receive a single lump sum benefit of $35,000.

Based on an average life expectancy, you would need to earn a 9.0% annual rate of return on the buyout amount to replace the annuity payments you are forgoing.

There may be circumstances in which you may wish to select the lump sum even though it appears to be of less value than the annuity. You may wish to consult a fiduciary financial adviser before electing the lump sum option.

**Higher discount rates produce smaller lump sums**. The discount rate for public pension plans is usually based on the expected return on plan assets, which generally includes significant investment risk. A lump sum calculated on this basis would only replicate the plan benefit if the member could invest the assets themselves and achieve the plan's assumed return. However, lump sums from private sector plans must be calculated using a discount rate derived from a hypothetical reference bond portfolio. This discount rate is typically significantly lower than the expected investment return, producing a larger lump sum. Such a lump sum approximates the cost of purchasing an annuity, which is implicitly invested in a similar bond portfolio.

**Lower assumed COLAs produce smaller lump sums**. Sometimes, lump sums may be offered with no assumed COLA, even though the plan benefits include a COLA. In other cases, lump sums may be offered in exchange for a reduced COLA. Members may not realize the COLA assumption's significant impact on the buyout amount. For example, ignoring the COLA in the vested buyout illustration (Illustration 2) would reduce the buyout amount by over 25%.

**Mortality assumptions can also significantly affect the size of the calculated lump sum.** Plan members (along with the general population) have a long history of mortality improvement, so it is important that the assumptions used to compare the value of the buyout offer reflect current mortality rates and anticipate future mortality improvement. While the individual member may not understand whether the mortality table used is appropriate, a fiduciary financial adviser could provide some assessment if the mortality table is disclosed.

### Illustration 3

## COLA Buyout

**Buyout Amount = $54,500**

*Buyout Election: One-time lump sum equal to 50% of the present value of the reduction in future benefits due to reducing the COLA from 3.0% to 1.5%.*

| | |
|---|---|
| Member Age: | 62 |
| Monthly Benefit | $4,000 |
| Benefit Form: | Life Annuity |
| COLA: | 3.0% |
| Reduced COLA: | 1.5% |

*To assist the member in comparing the buyout amount to the COLA they are relinquishing, consider providing some comparisons such as the following.*

**Suggested Comparisons**

| | |
|---|---|
| Plan's Present Value of COLA Reduction | $109,000 |
| Buyout Amount (50%) | $54,500 |
| Annuity Cost Estimate | $201,000 |
| Annual Investment Return Needed on Buyout Amount | 11.9% |

You are entitled to $4,000 per month payable for your lifetime with an annual cost-of-living adjustment (COLA) of 3% per year. Under the buyout, the COLA would be reduced to 1.5%. The plan expects the 3% COLA to cost $109,000 more than the 1.5% COLA, and the buyout is 50% of that amount.

While an annuity replicating the forgone portion of the COLA is not likely to be available, theoretically it would cost about $201,000. The plan is offering you an option to forgo the higher COLA and receive a single lump sum benefit of $54,500.

Based on an average life expectancy, you would need to earn an 11.9% annual rate of return on the buyout amount to replace the higher COLA you are forgoing.

There may be circumstances in which you may wish to select the lump sum even though it appears to be of less value than the annuity. You may wish to consult a fiduciary financial adviser before electing the lump sum option.

By law, the mortality assumption used to calculate a lump sum must be the same for everyone, regardless of gender or health. Generally, females live longer than males, and healthy people live longer than unhealthy people. So, depending on these factors, accepting a buyout offer may be advantageous or disadvantageous for a specific individual.

**In addition to these assumptions, most buyout programs apply other factors or adjustments to the lump sum calculation.** For example, they may apply a factor approximating the current funded ratio for the plan (e.g., 70%). The rationale for such factors may be that the plan currently has only 70% of the assets expected to be needed to pay all benefits. However, if such a factor is applied, plan communications should explain that the plan's current funded ratio does not imply that members would receive less than their full promised benefits if they were to remain in the plan and not take a lump sum.

Short of getting actual quotes on annuities, assumptions can be selected to approximate the current prices of annuities. In particular, the discount rate would be similar to the yield on high-quality corporate bonds, and other assumptions may be more conservative than the plan's valuation assumptions. Rather than develop specific assumptions to estimate the cost of an annuity, it also may be reasonable to use current assumptions that corporate pension plans use for a similar purpose.[4] These assumptions provide a rough approximation of the cost of purchasing an annuity in the private market.

4 Possible references include the interest rates published by the Pension Benefit Guaranty Corporation under ERISA 4044 or the required interest rates for corporate plan lump sums under Internal Revenue Code 417(e).

# Conclusions

When a lump sum is offered in exchange for lifetime benefits, it is essential to provide sufficient information for the plan members to make an informed choice. To make that informed choice, members offered buyout options may need assistance understanding the value of the benefits they relinquish. It is difficult to compare a single buyout amount to periodic payments that extend over a lifetime. While the specific calculations will vary depending on the plan terms and the buyout offer, members may find the following reference amounts particularly helpful:

- An estimate of the cost to replace any benefits otherwise payable in the private market; and
- The approximate annual investment return on the buyout amount required to replace the forgone benefits, assuming an average life expectancy.

These amounts would allow members to better understand the value of the monthly benefits they would give up by accepting the buyout offer. In addition, by clearly identifying the key assumptions used in developing the buyout amounts as well as the implications if actual individual member experience deviates from these assumptions, plan administrators can better enable members to make informed decisions regarding such buyout offers.

Members should also be encouraged to obtain professional fiduciary advice so the information related to the buyout option can be considered in their individual circumstances.

The American Academy of Actuaries is a 20,000-member professional association whose mission is to serve the public and the U.S. actuarial profession. For more than 50 years, the Academy has assisted public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.