

## BENEFITS INFORMATION BULLETIN - EXECUTIVE SUMMARY

December 20, 2007

BIB 07-01

## Lump-Sum Pension Payments: 2008 and Beyond

### Executive Summary

This executive summary of the Milliman *Benefits Information Bulletin 07-01* presents an overview of the new rules that ERISA-covered defined benefit (DB) plans must follow when calculating lump-sum payments. (The rules do not apply to governmental plans and plans not covered by ERISA.)

The new rules are the result of the Pension Protection Act of 2006 (PPA) and recent guidance from the IRS (*Revenue Ruling 2007-67* and *Notice 2007-81*). This summary also includes graphs that demonstrate the potential effects the new rules may have on lump sums that are slated to be paid out between 2008 and 2012.

### Overview

In general, the PPA's biggest changes affecting DB lump-sum calculations involve interest rates and mortality tables. The PPA amended the tax code and ERISA to change the interest-rate standard that applies, as well as mandated the use of an updated mortality table; these are two of the main factors used to determine the minimum value of a participant's accrued benefit, and therefore, the lump-sum payment to a participant.

By changing the interest-rate standard from 30-year U.S. Treasury bonds (i.e., the "GATT" rate) to three interest-rate segments based on high quality corporate bonds, the new requirements generally will produce higher interest rates, which in turn will result in lump sums that will be smaller. (The higher the applicable interest rate, the lower the resulting lump sum, and vice-versa.)

The new mortality table, which assumes that people will live longer, offsets this to some degree. It will increase the value of the annuity option, since the mortality table predicts people will receive their annuity for a longer time. As a result, it will increase the value of the equivalent lump-sum payment alternative. Still, the higher interest rates will have a greater effect than the increased longevity in the new mortality table, as shown in the charts following this summary. Lump-sum payouts will generally be smaller than they were pre-PPA.

### New IRS Guidance

The IRS's recent guidance (*Revenue Ruling 2007-67*, regarding the mortality table and timing rules for the interest-rate snapshot, and *Notice 2007-81*, regarding the yield curve and derivation of the applicable interest rates) provides the basic rules necessary for plan sponsors to determine lump-sum distributions starting in plan years beginning in 2008.

Under the guidance, the time for determining the interest rate does not change. The measurement date for the interest rate is the plan-defined "lookback period" of one to five full months prior to the plan-specified "stability period" (e.g., monthly, calendar quarter, or plan year). The stability period, which determines how often a plan will update the interest rate it will use, typically is the plan year.

The transition to the new interest-rate standard will occur over the next five years in 20% increments (with the remaining balance of the percentages applying the GATT rate). In the 2012 plan year, the interest

rate for determining the present value of a participant's lump sum will be based exclusively on the three corporate segment rates.

## Effects and Implications

Plan sponsors may want to consider developing communications describing the impact of the new lump-sum standards to participants. The primary determinant of the effect of PPA on lump sums will be dictated by the changing interest-rate structure. For plans with a November lookback period, the changes for 2008 should not be significant relative to the lump-sum factors in 2007. However, the longer-term effects on lump-sum calculations will generally result in lower lump-sum values than before PPA, provided that interest rates remain at their current levels.

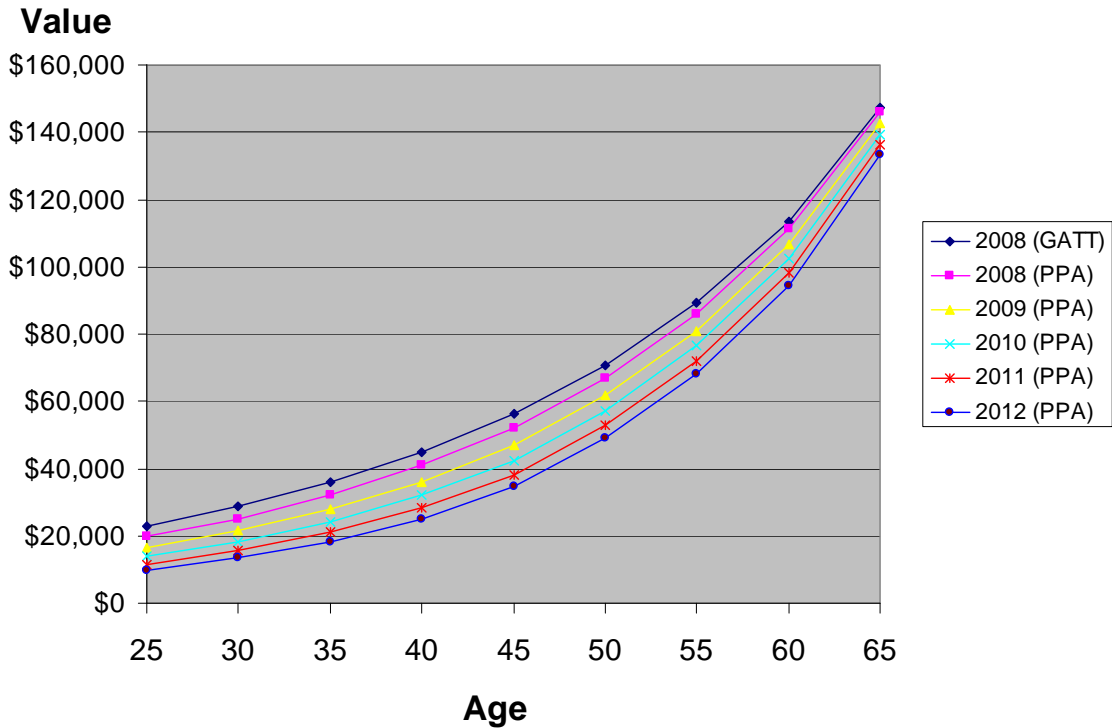
For plans currently relying on the 30-year Treasury rate, the PPA will closer align a plan's termination liability basis with the plan's funding target (developed with the annual actuarial valuation) by 2012. In the future, actuarial valuation funding reports are less likely to indicate that the plan is "fully funded," but "severely underfunded" on a plan termination basis.

For plans with a lookback period that could present more significant lump-sum changes for the 2008 plan year (i.e., a lookback period other than November, which is used in the *Benefits Information Bulletin* and the charts that follow), sponsors might consider preserving the 30-year Treasury rate (if this is the plan's current prevailing interest-rate standard for determining lump sums). However, without immediate further IRS guidance on any long-term consequences of preserving the 30-year Treasury standard, the logistics of adopting anything that deviates from the new PPA lump-sum basis may be too risky.

## Charts Illustrating How Lump-Sum Valuations Could Change

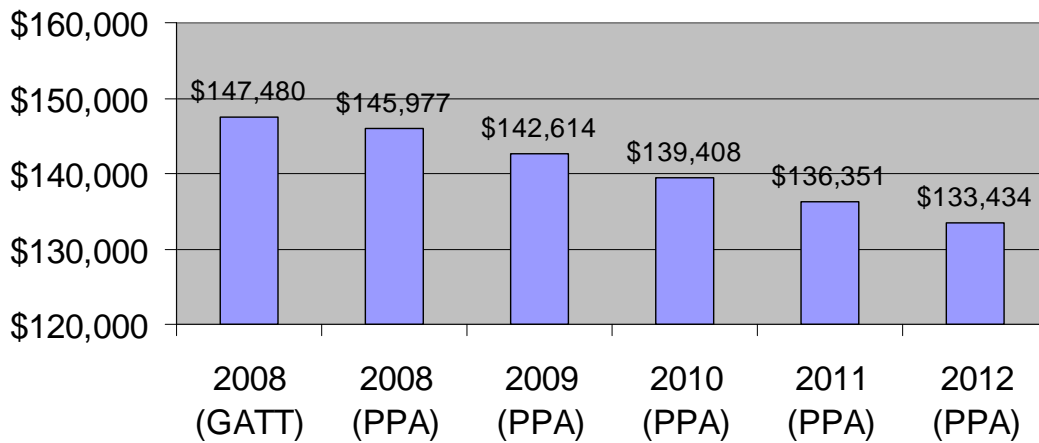
- Chart 1 shows the general erosion of lump-sum values by plan year as the lump sum interest rate migrates to the corporate bond standard. This chart assumes the plan uses a November 2007 lookback period and that the interest rates for future years remain at the levels existing at November 2007. Age-specific lump-sum values were calculated assuming a \$1,000 monthly annuity commencing at age 65.
- Chart 2 provides more details of the assessed lump-sum value for a 65 year-old with a \$1,000 per month benefit if the pre-PPA standard (or GATT basis) had remained in effect in 2008 and then the emerging lump-sum value by year if the November 2007 interest-rate structure remains unchanged over time.
- Charts 3 and 4 illustrate the pronounced erosion of lump-sum values from the effects of steadily rising interest rates during the lump-sum transition period under PPA (increase of 0.25%/year from November 2008 through November 2011).
- Charts 5 and 6 show the offsetting effects of a steady decline in the interest-rate structure (decrease of 0.25%/year) during the migration to the PPA's corporate bond rate basis; lump-sum values remain closer at older ages and still decrease (though by a smaller proportion) at younger ages.

**Chart 1: Lump-sum Values by Age as the PPA Standard Emerges under a Stationary Interest Rate Structure Scenario**



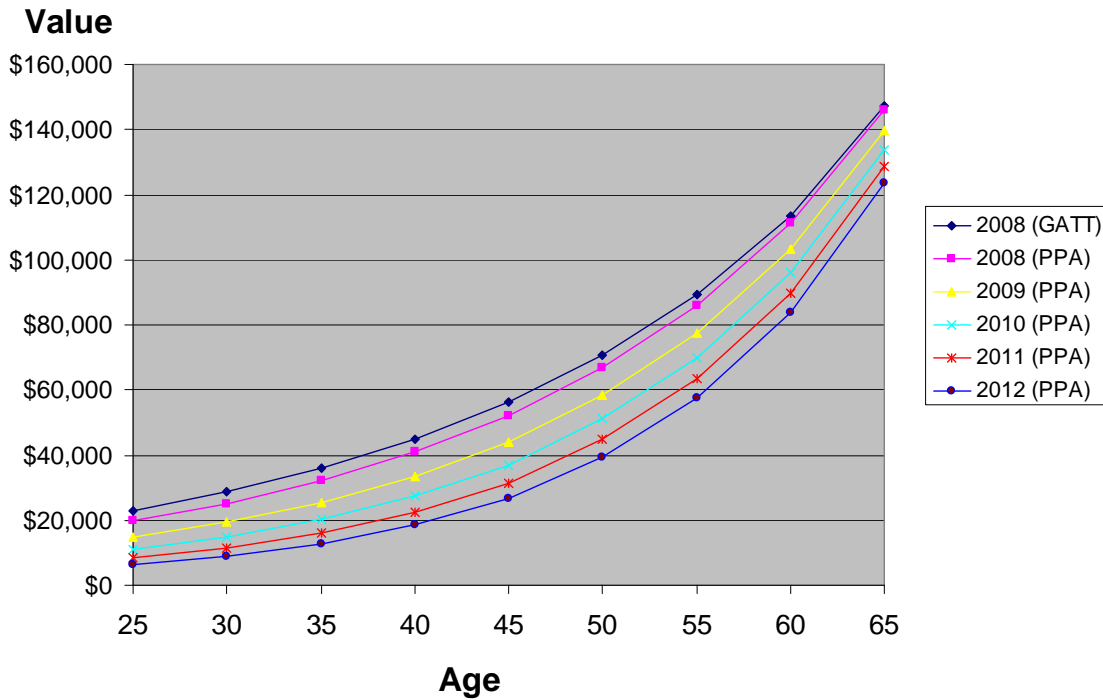
Lump-sum values are based on an annuity of \$1,000/month payable at age 65 under an unchanging interest rate structure.

**Chart 2: Lump-sum Values for 65 Year-old as the PPA Standard Emerges under Stationary Interest Rate Scenario**



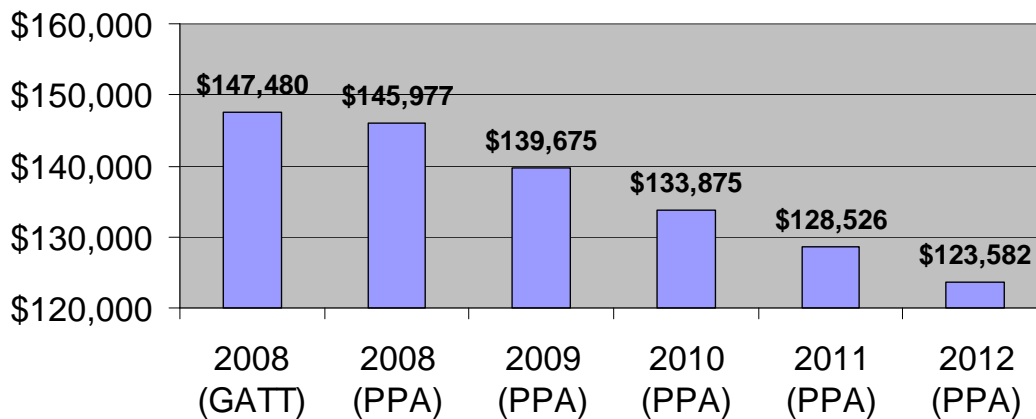
Lump-sum values are based on an annuity of \$1,000/month.

**Chart 3: Lump-sum Values by Age as the PPA Standard Emerges under a Rising Interest Rate Scenario (+0.25%/year)**



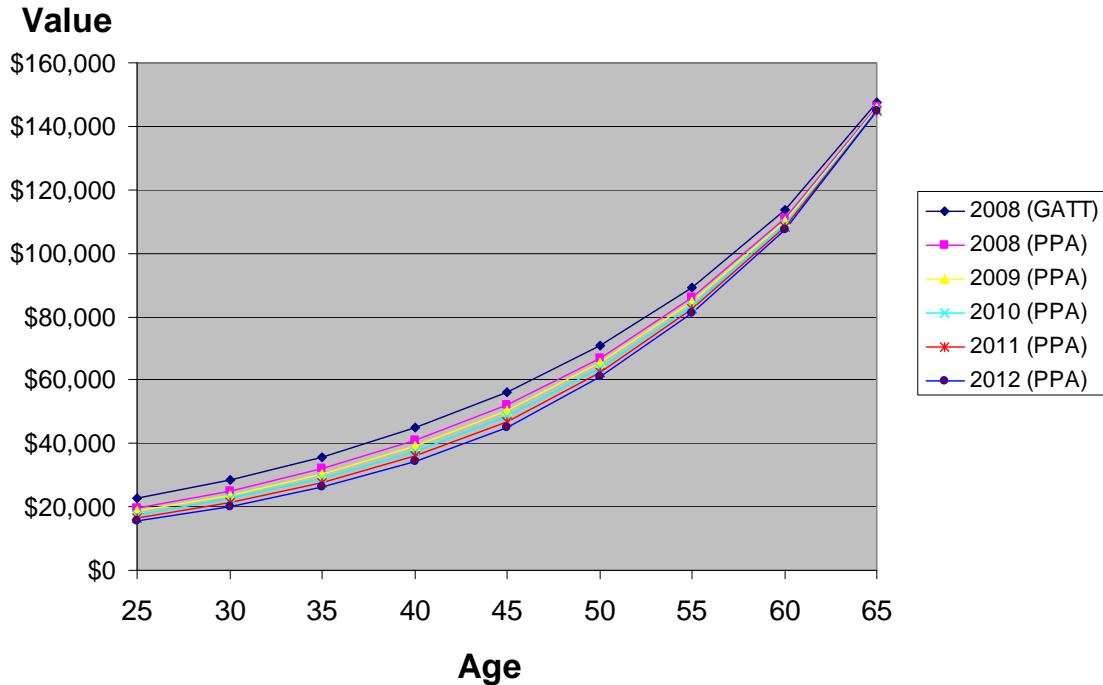
Lump-sum values are based on an annuity of \$1,000/month payable at age 65 under a rising interest rate structure (+0.25%/year).

**Chart 4: Lump-sum Values for 65 Year-old as the PPA Standard Emerges under Rising Interest Rate Scenario (+0.25%/year)**



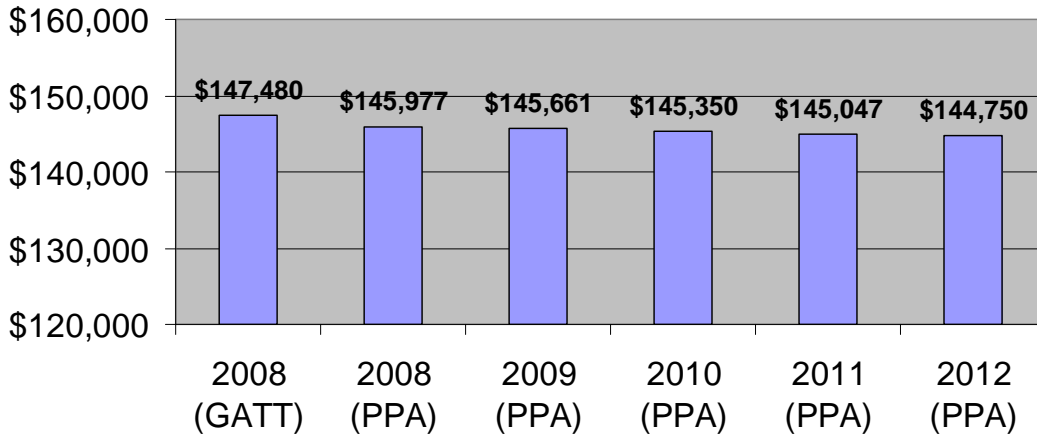
Lump-sum values are based on an annuity of \$1,000/month.

**Chart 5: Lump-sum Values by Age as the PPA Standard Emerges under a Decreasing Interest Rate Scenario (-0.25%/year)**



Lump-sum values are based on an annuity of \$1,000/month payable at age 65 under a decreasing interest rate structure (-0.25%/year).

**Chart 6: Lump-sum Values for 65 Year-old as the PPA Standard Emerges under Decreasing Interest Rate Scenario (-0.25%/year)**



Lump-sum values are based on an annuity of \$1,000/month.

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