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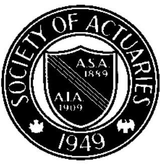

PENSION SECTION NEWS

NUMBER 45 FEBRUARY 2001

From the Pension Section Council Chairperson

by Bruce Cadenhead

This is my first column as Chair of the Pension Section Council, so of course I looked at past issues of Pension Section News to see how previous Chairs have handled this golden opportunity. Two related themes that have recurred involve communications with our members:

- Ensuring that the Council is responsive to the needs of Section members
- Keeping members informed of our current projects

Since we have some new developments in both areas, I think I'll focus on these topics in this column.

First, however, I would like to thank the outgoing members of the Council

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Lump Sums and Benefit Adequacy

by Anna M. Rappaport

There is a wide disparity in the use of lump sums as a form of pension benefit payment. Lump sums are used nearly all of the time for defined contribution plans and cash balance plans in the United States, and they are the usual method of payment in Australia. In the United Kingdom, most of the retirement benefit, about 75%, must be paid as a life annuity. They are offered more often by defined benefit plan sponsors than in the past in the United States, and when offered, the offer is usually accepted. In the United Kingdom, there are efforts underway to get the requirements liberalized.

Are lump sums a good thing? It depends on your point of view. They are great for some people, and a disaster for others. The benefits of lump sums are that they:

- Allow individuals control over assets and flexibility in planning for personal retirement
- In times of good investment performance, allow those who invest well to make their funds grow more rapidly
- Allow individuals to leave any funds not used for retirement to their heirs, but depending on who the heir is, a surviving spouse could be left without resources
- Allow individuals with considerable retirement assets to use some of the money to support frailty, to buy a retirement home, etc.

But, this is a story with down sides as well. Some of the down sides include:

- Money can be spent for non-retirement purposes, and research, in fact, shows that many people do spend all or part of their lump sums for non-retirement purposes

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Lump Sums and Benefit Adequacy
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- The retiree and/or the spouse of the retiree may outlive assets. Depending on whether governmental programs are available and adequate, this can be a disaster.
- Some retirees will spend their assets too fast, and have a great retirement early, only to find a big decline in living standards as the years go by.
- The retiree may not have good investment results. Those who choose to take more risk may get more rewards on average, but some of them will lose. People investing in equities at the wrong time can do poorly. Besides investing poorly, some retirees may be victims of fraud.
- Some retirees will be afraid to spend their principal and may live at too low a level rather than enjoying their retirement resources.

From an employer's point of view, it is a mixed story as well. If the plan's objective is to provide retirement income, lump sums don't work well. But, if the company is working to instill more individual responsibility, it does not make sense not to permit lump sums. For employees who work at several different jobs that build retirement assets, lump sums are more logical. Furthermore, one of the key reasons for providing pensions and other benefits is to win employee appreciation, and employees prefer lump sums.

The bottom line is that lump sums produce a great result for some people, and they are a disaster for others. Where lump sums are used, it is important for employees to have access to good information and products to help them plan for the post employment period. Some of the risks of the post employment period include outliving assets, becoming frail, losing a spouse, inflation, unexpected medical costs, investment risks, and unexpected needs on the part of other family members. Many retirees are not well positioned to deal with these risks.

Uses of lump sums when they are paid

EBRI did an analysis of the 1993 CPS. They looked at how lump sums were used by 12,361 recipients and found the uses as shown on the following table.

Use of all or part of lump sum	% of Receipients
Tax qualified savings	41.5%
Non-tax qualified savings	17.0%
Home, business, pay off debt	30.5%
Education	2.9%
Consumption	38.3%

Numbers add to more than 100% since some individuals used their lump sums for multiple purposes. EBRI also asked about use of lump sum distributions in the 1996 Retirement Confidence Survey, and found that:

Use of all or part of lump sum	% of Receipients
Spent it	50%
Rolled over at least a part into	46%
another retirement plan	
Put it into other savings	27%
None of these	3%

EBRI continues to monitor this issue. These studies show that leakage is an issue; many people spend part or all of their lump sums for non-retirement purposes. One can view this as a problem in different ways. People will not have enough assets to retire. Alternatively, it can be viewed as a problem because funds were allowed to accumulate on a tax-deferred basis in order to support retirement and they are not being used for retirement.

Where Do Immediate Annuities Fit In?

Immediate annuities are not very popular in the United States, and not very many are sold. The September *Actuary* includes a panel discussion on matters relating to the sale of annuities. It is unlikely that many of the people who choose lump sums will then buy annuities. These products convert assets to income that can not be outlived, but may not be inflation protected.

Why are few sold? There is relatively little focus on outliving assets and on post-retirement risks. People working with U.S. retirement systems need to encourage such a focus. To date, too much of the focus has been on the pre-retirement period. Maybe annuities are too expensive. Views differ on this topic, but in any case, it seems likely that many of the people who buy annuities do not appreciate the cost and value of investment and mortality guarantees. Few offer inflation protection. As was discussed in the *Actuary*, design enhancements might make annuities more attractive. Financial planners and advisors generally recommend against annuities — they see maintaining control of assets as a greater priority.

Is this a problem? There is a decline in economic status at time of widowhood. While many retirees are well off, others are struggling.

Benefit Adequacy Today

The traditional definition of benefit adequacy called for focusing on income at retirement age based on the assumption that at retirement, the retiree would leave the workforce by moving from a full time job to retirement. In fact, today retirement has become much more of a process. Many people will leave the workforce in a series of steps, phasing out by taking one or more bridge jobs after they leave a long service or career job.

In this framework, we need to rethink adequacy and what it means. Is it an amount built by each person based on their budget, or is it an amount linked to the poverty level or some multiple of it? In many organizations, considerations of adequacy have shifted from the employer to the employee, but the problem does not go away.

So, Where Does This Leave Us?

There are strong pros and cons of lump sums — it is not a one-way story. As the baby boom is aging, we have a lot of questions to think through at all levels — from a policy perspective, as employers, and as individuals. While we are thinking through questions in the United States, those working in other countries also have issues to think through.

My questions and challenges for U.S. public policy makers are as follows:

- How do we support appropriate retirement income levels? What do we mean by appropriate?
- Will lump sums in private plans be good or bad and for whom? Should they be allowed in tax favored plans? Should they be extended to Social Security benefits?
- What is the safety net for those who are in poverty or near poverty?
- Are we concerned about the needs of groups who are less well off including widows and divorced persons?

The challenges I see for employers are as follows:

- How can we compete for the right people?
- How can we enhance satisfaction through our retirement programs? Can they become more meaningful in the competition for people?
- How do lump sums affect retirement behavior?
- How can we balance the interests and needs of employees who leave early with those who stay for a career? What should be our priorities in this regard?
- How do we enhance retention?

The challenges for individuals are many and include the following:

- How can I understand post employment risks?
- How does my family plan for retirement on both a family and individual basis? How can each family be assured that the program will work in the event of a divorce or a premature death of a spouse?
- What are the options to not outlive assets?
- What is the best way to invest my money?

All of these are touchy questions, and there are a lot of trade-offs in any approach to their solution. What works for one individual, or family, may be inappropriate for another. This leaves actuaries with many opportunities. I will close with a few suggestions about them. We should get employers, the public, and policymakers to focus more on post employment risks and how to manage them. We need to improve the products that are available for their management. It is a big issue to help all of us use our retirement assets effectively. As actuaries, we can make a difference in these big issues.

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