Who Should Read This Insight:
Annuity manufacturers, employer sponsors of defined-benefit pension plans and their third-party administrators, workers, retirees, consumer advocates, policymakers

Institute Research Agenda Topic:
New takes on the annuity puzzle

Definitions of **bold key terms** are at the end of this article.

JASON J. FICHTNER
Ph.D., Alliance Research Fellow, is a Senior Lecturer in the Department of Economics and Finance, and Associate Director of the Master of International Economics and Finance program at the Johns Hopkins University School of Advanced International Studies and a Research Fellow with both the Alliance for Lifetime Income and the Retirement Income Institute.

KAITLYN O'NEILL
is a student at the Johns Hopkins School of Advanced International Studies working toward a Master of Arts degree in international economics and finance. She also holds a Bachelor of Commerce degree in economics and management science.

Author and Title of the Article(s) Addressed in this Insight
Banerjee, Sudipto. 2013. "Annuity and Lump-Sum Decisions in Defined Benefit Plans: The Role of Plan Rules." Issue Brief 381, Employee Benefit Research Institute, Washington, DC.

Insight: THE IMPACT OF DEFINED-BENEFIT PENSION PLAN FEATURES ON THE ANNUITIZATION DECISION, AND IMPLICATIONS FOR DEFINED-CONTRIBUTION BENEFIT PLAN DESIGN

IDEAS IN THIS INSIGHT YOU CAN PUT INTO ACTION

Sudipto Banerjee finds that employers' retirement plan rules can drive **annuitization** decisions and that the participant's age and account balance are also important factors affecting annuitization decisions. Changing pension payout rules can therefore change annuitization behavior.

Based on our review of the author's research findings, we suggest pursuing the following ideas: (1) encourage **defined-benefit pension plan** administrators to establish plan rules that encourage annuitization and restrict lump-sum offerings; (2) with the passage of the SECURE Act, and the continued trend away from defined-benefit plans to **defined-contribution plans,** encourage defined-contribution plan administrators to offer more options for full or partial annuitization and restrict full or partial lump sum options; (3) change pension plan rules to restrict the lump-sum payout option, which can positively impact annuitization rates; and (4) lowering plan account balance requirements for annuitization, or lowering the involuntary cash-out threshold, could positively impact annuitization rates among workers under 40 who change jobs frequently.

PRINCIPAL INSIGHTS

The overall objective of the study is to understand the impact of pension plan design features on plan participants' annuitization decisions. The author finds that the annuitization decision may be driven more by plan rules than by individual choice, and that the annuitization rate may also be driven by employee age, account balance, and job tenure.

Today, private-sector defined-benefit (DB) pension plans are required to provide a **lifetime annuity** option (a stream of income throughout retirement). However, many plans also offer a lump-sum payout option (i.e., a retirement benefit in the form of a single payment) in lieu of, or in addition to, an annuity. Motivated by the growing concern surrounding retirees outliving their lifetime savings, this study analyzes how the decision to **annuitize** varies across different types of pension plans. The study makes use of annuitization decision data between the years 2005 and 2010, examining 84 pension plans that were classified into five different categories: (1) traditional DB pension plans without a lump-sum payout option, (2) traditional DB pension plans with strong restrictions on the lump-sum payout option, (3) traditional DB pension plans or cash balance plans with weak restrictions on the lump-sum payout option,

(4) traditional DB pension plans without restrictions on the lump-sum payout option, and finally, (5) cash balance plans without restrictions on the lump-sum payout option.

The author finds that the annuitization rate increases with the degree of restrictions imposed on receiving the retirement benefit in the form of a lump-sum payout. For example, between 2005 and 2010, DB plans without a lump-sum payout option consistently had the highest annuitization rate, while DB and cash balance plans without restrictions on lump-sum payouts had the lowest annuitization rate.

Additionally, the author finds that, across all plan types studied, the annuitization rate increases with age, up until age 70, when the annuitization rate begins to decline. The annuitization rate is found to be very low for workers under the age of 40. In fact, the author finds that, for workers under age 40, the annuitization rate is close to zero for all plan types except DB pension plans that do not have a lump-sum payout option. For workers beyond the age of 40, annuitization rates increase for all plan types. Furthermore, annuitization rates peak for workers between the ages of 65 and 69, and then begin to fall sharply for workers between the ages of 70 and 75. A possible explanation for the low annuitization rate among younger workers is that, if they frequently change jobs, they might not meet the account balance requirements for annuitization, and their employers may force low-account balance pension participants to take a lump-sum payout. Federal law permits plan rules that force a cash payout for account balances less than $5,000.

Moreover, the author finds that, for workers ages 50 to 75, annuitization rates increase with account balance for almost all plan types. However, the study does not find this to be the case for younger workers. For workers below the age of 40, the author finds that, for accounts with balances of less than $25,000, annuitization rates are very close to zero across all plan types, while accounts with balances greater than $25,000 have annuitization rates that vary positively with the degree of restriction imposed on lump-sum payouts.

Finally, the study finds that the annuitization rate increases with employee tenure (i.e., the duration of employment with a particular employer). However, the study finds that tenure makes more of a difference among older workers (ages 50–75) than younger workers (ages 20–50). For younger workers with low tenure (i.e., tenure of less than 10 years) annuitization rates are very low, while older workers have higher annuitization rates, even when tenure is short.

To learn more, visit the Retirement Income Institute at
www.allianceforlifetimeincome.org/retirement-income-institute

KEY TERMS ARE SOURCED FROM THE ALLIANCE FOR LIFETIME INCOME'S ANNUITIES LANGUAGE GLOSSARY AND INVESTOPEDIA

Annuitize: *When you turn your current account balance into a series of periodic income payments, either for a specific period of time or for your whole life.*

Annuitization: *When you turn your current account balance into a series of periodic income payments, either for a specific period of time or for your whole life.*

Defined-benefit pension plan: *An employer-based program that pays benefits based on factors such as length of employment and salary history.*

Defined-contribution plan: *Plans that allow employees to invest pre-tax dollars in the capital markets where they can grow tax-deferred until retirement.*

Lifetime annuity: *A financial product that features a predetermined periodic payout amount until the death of the annuitant.*

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