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To Protect Pension Funds, Mix Lump Sum with Annuity: Hewitt

By Editor Test *Tue, Jun 1, 2010*

The United Kingdom, Germany, Belgium and Switzerland already offer their participants the option of a one-off payment as part of their pension rights at the retirement date.

Introducing a lump sum payment as part of pension benefits could decrease the risks for Dutch pension funds, Hewitt Associates suggests.

A lump sum of up to 50% of the benefits would raise pension funds' financial buffers and reduce the financial effects of increased longevity, Hewitt claimed in a response to the proposals of social affairs' minister Piet Hein Donner to increase both buffers and contributions.

"Pension funds don't need to keep extra financial reserves for the money they have already paid through a lump sum payment. This will increase their leeway for indexation as well as raise their cover ratio by some percentage points," argued Hewitt's Arnold Jager.

"In order to prevent participants from spending straight away, they should only be allowed to use a lump sum payment for paying off a mortgage, or use the capital within a set period of between five or ten years through a frozen account," he explained.

"Although this won't be a lifelong benefit, pensioners will have more money available when their spending is usually the highest. An additional advantage is that the lump sum payment becomes part of the inheritance if the pensioner dies." Lump sum payments will bring the Dutch pension system more in line with other capital-funded systems in the surrounding countries, according to Hewitt.

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In the Netherlands only pension rights that entitle members to yearly benefits of less than €400 ($600) can be bought off, because of the administrative burden of these small pensions to pension funds.

"Although a lump sum payment will probably have a limited effect on the buffers, it will certainly decrease the longevity risk," commented Lans Bovenberg, Professor at Tilburg University and Netspar, the platform for pensions, retirement and ageing.

"However, the advantage will increase if the longevity risk is born by pension funds' active participants, as the Goudswaard Committee has suggested," Bovenberg added. "It will increase schemes' stability by limiting risks and buffer requirements."

But in the economist's opinion, the lump sum should by capped at 20%. "If pensioners have spent most of their money early in retirement, they will become a financial burden for society when they require extra care later," he explained.