An Innovative Solution to Retirement Income
By Joe Tomlinson
February 7, 2012

Generating lifetime income is the ultimate goal of retirement planning. Why is it, then, that two of the most compelling mechanisms for doing just that are shunned by the investing public, despite overwhelming support from experts? I’m talking about immediate annuities and delayed claiming of Social Security, both of which are remarkably effective at securing retirement needs.

Why these options are so often overlooked – and how the government might steer investors toward better outcomes – will be the subject of this article.

Immediate annuities

The immediate annuity is the simplest of retirement products: Pay a fixed amount up front and receive a fixed monthly payment for life. A 66-year-old male could pay $100,000 and receive a lifetime income of $598.22 per month. One can also buy the product in a form that provides inflation protection. An up-front payment of $100,000 buys an initial monthly income of $446.95 that will increase each year based on the CPI, just like Social Security. (These rates come from Income Solutions®, a program offered by Hueler Companies, which sells annuities through Vanguard and other outlets.)

Both fixed and inflation-adjusted immediate annuities are well-suited to meet retirement income needs. Most individuals or couples planning for retirement find that Social Security will not provide enough to cover basic living expenses. Unless they also have a defined-benefit pension, they will need to use retirement savings to fill the gap between income and expenses. Buying an immediate annuity provides a way to fill the gap with guaranteed income. Buying the inflation-adjusted version is essentially like buying a larger Social Security benefit.

Immediate annuities have been endorsed by the experts. Last summer, the General Accounting Office (GAO) did a study on retirement income, including input from economists and retirement planning specialists, and one of the headline recommendations was that retirees "convert a portion of their savings into an income annuity to cover necessary expenses."

But the reality is different – few retirees purchase these products. Annual sales of immediate annuities total only about $7.5 billion, a level that the GAO estimated would support only about 0.25% of Americans’ retirement income needs.

There is a huge gap between what the experts recommend and what retirees actually do.

© Copyright 2012, Advisor Perspectives, Inc. All rights reserved.
Economists have dubbed this state of affairs "the annuity puzzle." Numerous articles and papers have examined buyer behavior in an effort to identify the roadblocks to wider adoption of annuities. I have weighed in myself, arguing in a prior Advisor Perspectives article that the puzzle cannot be explained by examining buyer behavior alone. Seller incentives may be even more important, and immediate annuities pay lower commissions than other annuity products.

**Delayed Social Security**

Besides immediate annuities, another way to generate additional retirement income is by delaying the start of Social Security benefits. For those who defer the start of their Social Security worker benefits beyond the full retirement age of 66, there is an 8% increase in benefits for each year of delay. This strategy was also endorsed in the GAO report.

Delaying Social Security is mathematically equivalent to purchasing an inflation-adjusted immediate annuity. If we think of a 66-year-old delaying Social Security to age 70, the Social Security benefits foregone between age 66 and 70 can be thought of as the purchase price of an annuity, and the additional Social Security income (compared to starting payments at 66) is analogous to annuity income. It turns out that delaying Social Security is even more cost-effective than immediate annuities offered by insurance companies, an advantage that is even greater for couples than for single individuals.

The following example provides a demonstration. It's based on an individual who can generate Social Security benefits of $20,000 per year (plus annual CPI adjustments) beginning at age 66, but could raise his or her inflation-adjusted income level to $26,400 – a 32% increase – by delaying to age 70.

We'll assume this individual would like to find a way to raise the $20,000 to $26,400, but also begin receiving benefits immediately. One way to do this would be to delay Social Security until age 70 and use a portion of retirement savings to provide four years of retirement withdrawals until Social Security begins. If we assume that short-term funds earn a zero interest rate, this individual would need to set aside $109,000 of savings to provide for the four years of withdrawals, starting at $26,400 in the first year and increasing at an assumed 2% annual inflation rate.

Another way to raise the income level to $26,400 would be to begin Social Security of $20,000 at age 66 and buy an inflation-adjusted immediate annuity to generate the additional $6,400. Evaluating this option involves comparing annuity prices to the $109,000 that would be needed for systematic withdrawals if the investor delays social security. The comparison is shown below based on rates from Income Solutions.® Private-market annuity rates differ for males and females, and, in both cases, the private-market annuities turn out to be more expensive than delaying Social Security and taking systematic withdrawals for the interim period.
Comparison of Funds Needed to Top Up Social Security

<table>
<thead>
<tr>
<th>To support SS delay strategy</th>
<th>Funds needed</th>
</tr>
</thead>
<tbody>
<tr>
<td>For M age 66 annuity</td>
<td>$109,000</td>
</tr>
<tr>
<td>For F age 66 annuity</td>
<td>$120,000</td>
</tr>
<tr>
<td>For Joint M 66 &amp; F 64 annuity</td>
<td>$135,000</td>
</tr>
<tr>
<td></td>
<td>$162,000</td>
</tr>
</tbody>
</table>

I also show figures for purchasing a joint annuity, which naturally is more expensive than the single-life version, since payments continue until the second spouse dies. Because Social Security provides a continuation of benefits to the surviving spouse, delayed claiming effectively provides the same joint-life benefit for couples as the single-life benefit for individuals. It's like being able to buy a joint-life annuity at single-life rates, in this case costing $109,000 for an annuity that would cost $162,000 in the private market. It is clear that there are great deals on offer here, especially for married couples.

One might expect, given these great deals, that delayed claiming of Social Security might be in vogue. Not so. Figures compiled for the GAO report showed only 2.8% taking benefits after the 66th birthday.

So we have a "Social Security puzzle" in addition to the "annuity puzzle," which naturally leads to the question, "What's to be done?"

Certainly, advisors need to become more aware of the benefits of delaying Social Security, and they also need to develop a better understanding of how to use products like immediate annuities. That said, advisor education alone is unlikely to make a huge difference. From a policy standpoint, if we want to encourage a major shift toward secure lifetime income, we need to develop new ways of reaching buyers. Fortunately, one new approach is already on the drawing board.

The Security-Plus Annuity

The Security-Plus Annuity is a proposed program developed by Pamela Perun and her associates at the Initiative on Financial Security at the Aspen Institute in Washington, DC. Under Perun’s proposal, Social Security offices would be set up to offer inflation-adjusted immediate annuities to individuals at the time they sign up for Social Security. These would be annuities from private insurance companies that bid to be included in the program, but the Social Security Administration (SSA) would deliver annuity payments as part of monthly benefit checks.

Products would include both individual annuities and joint-and-survivor annuities for couples. A centralized call center and online support would assist with financial planning questions like determining the amount of annuity to purchase. Such a program would allow applicants to purchase annuities in a convenient manner from a well-known and trusted source, and at a time when they are thinking about retirement income.
There are some complexities to be managed. As shown earlier, delaying Social Security offers greater economic benefits than purchasing private-market annuities, particularly for couples. One solution would be for the Social Security offices to be more proactive in promoting delayed claiming. Better yet, however, would be to tie delayed claiming into the Security Plus Annuity program. The program could work with insurance companies to provide short-term immediate annuities or funding contracts that would transition into the delayed Social Security benefits. An individual or couple could walk into a Social Security office and walk out with a guaranteed lifetime income beginning immediately, rather than being encouraged to delay claiming and somehow use savings for interim funding.

The key would be to provide one-stop shopping from a trusted provider and combine the interim funding, Social Security, and the annuities. If such a system were adopted, private-market annuities would be used for additional income needs greater than those that can be met with delay credits ($6,400 in the example above). Recipients would see this as purchasing a single package of additional income, rather than as a bunch of bits and pieces.

This program would not be for everyone. It wouldn't help low-income families who have little saved for retirement, and it probably wouldn't interest the super-wealthy. But for middle-income Americans who have some savings, most of whom face significant financial risks in retirement, this would be a very helpful program.

Easily accessible automated tools that the public could use to show how much income their savings can generate would be key to such a program, and arrangements would need to be made with insurers to provide both interim funding arrangements and immediate annuities. Rollout would require a major publicity campaign, and promotion of the program would need to continue on an ongoing basis once it was established. Tax and regulatory effects would also need to be examined carefully, in order to address any unintended consequences.

New legislation would be needed to define which regulator would be in charge – the SSA, the new Office of National Insurance at Treasury, or Treasury itself – and what standards would be used to design and operate the program. The government already runs a similar program, the Thrift Savings Plan for federal government employees, so there is a precedent and established practices that could be adopted.

The SSA would have to re-tool some of its accounting and payment functions to handle additional forms and sources of payment in monthly checks, but the Social Security Administration already does some of that today, albeit on a modest scale. By adapting the practices of existing federal programs and scaling up its administrative functions, the Social Security Administration could have such improvements up and running quickly.
This program would make a real difference. Just think of it – walk into a Social Security office and walk out with a complete retirement income package. This is such a great idea that it might create a Washington first – Republicans and Democrats actually agreeing on something.

www.advisorperspectives.com

For a free subscription to the Advisor Perspectives newsletter, visit:
http://www.advisorperspectives.com/subscribers/subscribe.php