INITIATIVE ON FINANCIAL SECURITY

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THE CASE FOR SECURITY PLUS ANNUITIES

ASPEN INSTITUTE INITIATIVE ON FINANCIAL SECURITY

PAMELA PERUN

As Americans live longer and increasingly rely on 401(k) plan savings as a prominent source of income in retirement, they will need to find ways to convert their savings into income that lasts a lifetime. Because the financial situations and goals of American savers are diverse, they will need a variety of products and services to secure their income. One future solution, if policy makers are successful, is to enable more savers to buy annuities and other lifetime income products through their 401(k) plans. Alternatively, savers, especially savers with large account balances, could be encouraged to purchase some of the longevity-protected products and services available through private insurance companies.

Another promising solution that could become operational quickly is a proposal called "Security Plus Annuities." Developed by the Aspen Institute Initiative on Financial Security (Aspen IFS), the proposal partners private industry with the Social Security Administration to offer low-cost, inflation-protected, "starter" life annuities. It enables new retirees to purchase another layer of Social Security-like income that lasts a lifetime. Security Plus Annuities would offer all Americans the ability to achieve greater financial security in retirement. Moreover, it would provide immediate assistance to two groups of Americans who have critical unmet needs for longevity-protected products: low- and moderate-income workers who frequently have not had access to a 401(k) plan at work, and near retirees whose work-based plans don't currently offer lifetime income products.

The Problem

The United States is beginning to recognize it has another gaping hole in its retirement system, just as over 35 million baby boomers transition into retirement over the next ten years. For years, policy makers have worried about Americans not being financially prepared for retirement because they have not saved enough. Now, they are also concerned that, even if savings rates increase significantly as they are expected to do, Americans will still be unprepared for retirement. The cause for this concern is twofold: the increase in life expectancies in retirement, and the lack of guidance Americans receive about managing their savings to last a lifetime.

Americans who retire today at age 65 can expect to live, on average, to be 83 years old.[1] That means that retirement savings must be stretched over substantial periods of time, often over many decades. Social Security does provide retirement income for life but it is meant to provide only a base level of retirement income. An average 65 year old earner retiring in 2010 will receive an inflation-indexed Social Security benefit that replaces 41 percent of pre-retirement income.[2] Because the age for full retirement benefits for Social Security is increasing, that worker's benefit is likely to replace only 36% of income in 2030, and that is *before* deductions for Medicare premiums and federal taxes.[3]

For a comfortable retirement, many financial planners suggest that an individual's total savings—pensions and personal savings—plus Social Security income should replace at least 70 percent of pre-retirement income.[4] For decades, the United States has relied on the private pension system to deliver plans in the workplace that boost retirement income. Historically, many employers who sponsored work-based savings plans offered defined benefit pension plans to their employees. Defined benefit pension plans provide workers with a steady stream of income in retirement, usually payable for life, based on employees' levels of compensation and years of service. But defined benefit plans no longer dominate the private pension system. Over the last twenty years, the number of employers offering these plans and the number of employees covered by them have fallen drastically.

Most Americans today save for retirement through defined contribution plans, popularly known as 401(k) plans.[5] These plans are saving, not retirement, plans so they do not automatically generate a stream of income in retirement. Instead, 401(k) plans enable savers to accumulate a pool of financial assets in their accounts based on their own contributions and often their employers' contributions as well. But, for a variety of primarily legal reasons, 401(k) plans currently do not offer savers a vehicle for converting their account balances into retirement income.[6] Instead, employees usually must choose between lump-sum or installment distributions, and they bear the risk of outliving their savings if their plans for managing their assets fail.

The Search for Solutions

One accepted tool for transforming savings into lifelong income is a life annuity. Similar to Social Security payments or pensions paid by defined benefit plans, annuities pay guaranteed income for a set period of time, usually for life. An annuity is available for purchase through an insurance company. In the traditional and most basic form of an annuity, an immediate, fixed annuity, a purchaser transfers all or a portion of his or her savings, usually in a single payment, to an insurance company, which then assumes responsibility for paying the purchaser a guaranteed income for life.

1 Life expectancy statistics available at: http://www.ssa.gov/pressoffice/basicfact.htm

2 "The 2010 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Federal Disability Insurance Trust Funds" August 9, 2010. Available at: http://www.socialsecurity.gov/OACT/TR/2010/tr2010.pdf

3 Alicia H. Munnell, "The Financial Crisis and Restoring Retirement Security," Testimony before the Committee on Education and Labor, U.S. House of Representatives, February 24, 2009. Available at: http://edlabor.house.gov/documents/111/pdf/testimony/20090224AliciaMunnellTestimony.pdf

4 Selena Caldera. "Social Security: Who's Counting on it?" Fact Sheet 178, AARP Public Policy Institute, April 2010. Available at: http://assets.aarp.org/rgcenter/ppi/econ-sec/fs178-socsec.pdf

5 "Retirement Trends in the United States Over the Past Quarter-Century," Facts From EBRI, June 2007. Available at: http://www.ebri.org/pdf/publications/facts/0607fact.pdf

6 Pamela Perun, "Retirement Savings: Confronting the Challenge of Longevity," Initiative on Financial Security, the Aspen Institute, 2010.

Because annuities (and related longevity-protected products) are virtually absent today from 401(k) plans, the roughly 60 million Americans who participate in 401(k) plans do not have an opportunity to learn about these products in the workplace or to buy one from their plans.[7] In addition, there are about 78 million Americans who lack access to a plan at work. Life annuities are available for purchase from private sector insurance companies but the market is small and under-developed.[8] The result is that most Americans must solve the riddle of transforming their account balances into income that lasts throughout retirement by themselves.

Federal policy makers are beginning to tackle the problem by launching an initiative on lifelong income products. Recently, the Department of Labor, the Internal Revenue Service, and the Department of the Treasury spearheaded a project to gather information and expertise on how products designed to provide a lifetime stream of income might be made available in 401(k) plans and IRAs.[9] The agencies' initiative will build momentum towards structuring a national policy on transforming savings into income that lasts throughout retirement.

This initiative, however, has already revealed that there are difficult legal, policy and implementation issues to be resolved and a wide variety of opinions on the best way forward. Realistically speaking, it will take years of building a consensus, crafting and passing legislation, and issuing regulations before lifelong income products become routinely available in 401(k) plans and IRAs. Even then, such a policy is unlikely to benefit the millions of Americans who do not have access to a plan at work but do have other financial assets that could provide income in retirement.

Security Plus Annuities

Aspen IFS believes there is one potential solution already close at hand. It proposes to leverage the resources and goodwill associated with Social Security to offer new retirees the opportunity to secure more of their retirement income through the purchase of "Security Plus Annuities."[10] Aspen IFS developed this proposal in conjunction with the financial services industry and policy experts, as part of four years of research and design in developing a new, lifespan savings system for the United States. Its program of four, inter-related proposals for lifelong financial security, described in *Savings for Life: A Pathway to Financial Security for All Americans,* has been endorsed by leading CEOs from every corner of the financial services industry, economic development specialists and policy analysts.

7 In the Profit Sharing/401k Council of America's 53rd Annual Survey of 2009 plan year experience, only 19% of DC plans offered an annuity distribution option. Testimony of David L. Wray before the Departments of Labor and the Treasury Joint Hearing on Lifetime Income Products, September 14, 2010. Available at: http://www.dol.gov/ebsa/pdf/PSCA091510.pdf. The estimates of current participation in the 401(k) plan system reflect Department of Labor statistics in 2006 and are available at: http://www.dol.gov/ebsa/pdg/1975-2006historicaltables.pdf

8 In 2008, the market for sales of immediate fixed annuities was $8 billion versus about $156 billion for variable annuity products. See Anthony Webb, "The United States Longevity Insurance Market," Pension Research Council Working Paper 2010-17, The Wharton School, University of Pennsylvania, September 2010.

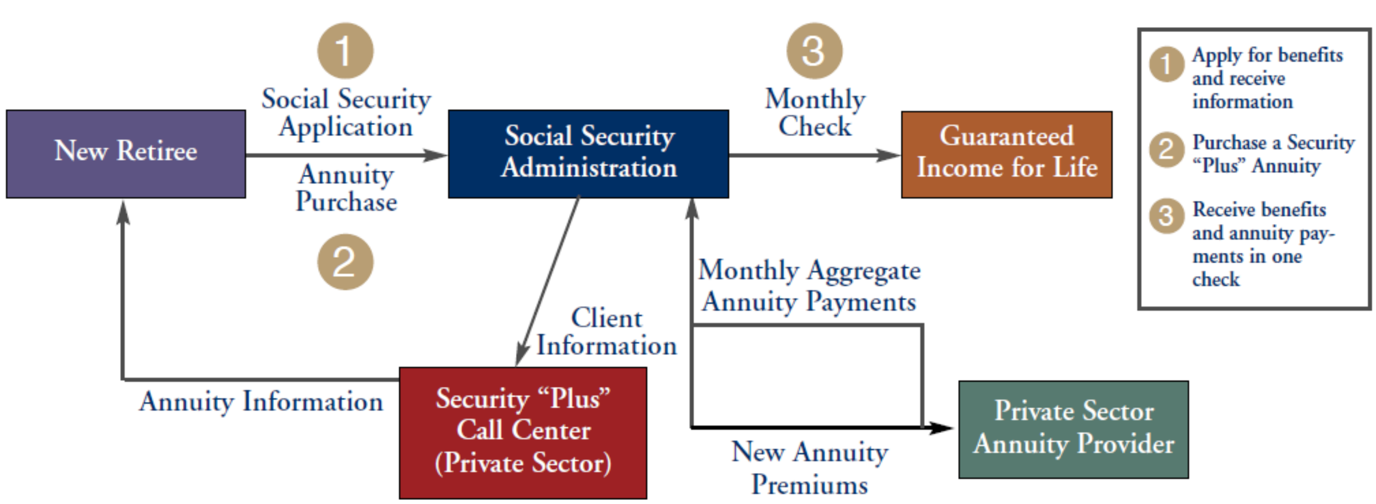
9 On February 2, 2010, the agencies published a request for information soliciting public comments that suggested what steps the agencies should take to enhance retirement security through lifetime income streams for workers in employer-sponsored plans. The agencies received almost 800 public submissions, and followed up with a two-day public hearing at the Department of Labor on September 14-15 about lifetime income options for retirement plans.

10 More information about Security Plus Annuities is available in *Savings for Life: A Pathway to Financial Security for All Americans*, available at: http://www.aspeninstitute.org/publications/savings-life-pathway-financial-security-all-americanshttp://www.aspeninstitute.org/publications/savings-life-pathway-financial-security-all-americans

A Security Plus Annuity is a "starter" annuity that retirees could buy through the Social Security Administration. As shown in Figure 1 below, the Security Plus Annuities program has these basic features:

- A Security Plus annuity is an immediate, inflation-adjusted life annuity designed to provide retirees with an additional layer of Social Security-like income.
- Retirees have a one-time opportunity in their first year of receiving Social Security benefits to buy a Security Plus Annuity, capped at $100,000 in purchase amount).
- For married retirees, Security Plus Annuities offers spousal benefits.
- Security Plus Annuity payments are automatically added to monthly Social Security checks.
- A private call center under contract to Social Security is available to explain the program, provide individualized cost estimates and purchase assistance and remind retirees when their eligibility will end.
- Through a competitive bidding process, the federal government pre-selects a private market annuity provider or providers (depending on the volume of purchases) to underwrite Security Plus Annuities on a group basis.
- The federal government provides record-keeping, marketing, distribution and other administrative services, keeping Security Plus Annuities low-cost and a good value.

Figure 1. Security Plus Annuity Proposal Diagram



Security Plus Annuities solves the immediate needs of retirees today for a basic level of longevity-protected income on top of Social Security. It offers a basic life annuity, priced on a group basis, which is low-cost, simple, widely-available, and easy to understand and purchase. It also offers important consumer protections against the risks of market downturns, erosions of purchasing power through inflation and insurance company insolvency. The program uses the federal government as an intermediary to market and distribute annuities, provide supportive administrative services and select annuity providers. But it also assigns to the private sector the critical role of underwriting group annuities on a large scale.

The Security Plus Annuities program offers the following additional benefits.

- Security Plus Annuities will simplify the annuity purchase decision for the two to four million baby boomers expected to retire each year between now and 2030 and the 90% of Americans eligible for Social Security, whether or not they participate in a 401(k) plan at work or have an IRA.

- Security Plus Annuities will minimize the risk that retirees will outlive or lose their savings. If just 10 percent buy a Security Plus Annuity, that means that 200,000-400,000 Americans each year will increase their financial security in retirement.

- As life expectancy increases and the baby boom generation retires, the aging of America will increase the fiscal pressures on the federal government. Security Plus annuities will enlist the help of the private sector in providing some additional, secure lifetime income for retirees.

- Security Plus Annuities will educate millions of American families about the benefits of annuities and other lifelong income products and should increase take-up rates in 401(k) plans and IRAs, once a new national income policy for the private pension system is in place.

Using the annuity estimator of the federal Thrift Savings Plan to project benefits, a Security Plus Annuity bought today might look like this.[11] As of October 22, 2010 a single retiree at age 67 could purchase $242 of additional monthly income for life for $40,000, replacing about 10% of pre-retirement income for a worker earning $30,000 a year. A $60,000 investment would produce $362 of additional monthly income, replacing almost 15% of pre-retirement income for a worker earning $30,000 a year and over 6% for a worker earning $70,000 a year.[12] Interest rates today, however, are at historic lows. As interest rates rise with the economic recovery, payout amounts from Security Plus Annuities will increase and replace a greater proportion of pre-retirement income.

11 Because the Thrift Savings Plan does not offer a fully inflation-protected annuity, the figures cited above are only rough estimates of the monthly payout amounts obtainable through a Security Plus Annuity.

12 As of October, 2010, the TSP calculator uses an annuity interest rate index of 2.750% and calculates estimated monthly payments for a single life annuity with no additional features. The TSP calculator is available at: https://www.tsp.gov/planningtools/annuities/annuityCalc_input.shtml

Aspen IFS projects that, with an average purchase amount of just $20,000, Security Plus Annuities would generate $3.5 billion each year in new annuity purchases at a 5% take-up rate and $6.9 billion at a 10% take-up rate. An average purchase amount of $50,000 would generate $8.6 billion each year in new annuity purchases at a 5% take-up rate while a 10% take-up rate would generate $17.2 billion. These figures indicate that the Security Plus Annuities program could increase the size of the private life annuities market substantially in just a few years while it insures millions of Americans, a large proportion of whom could be low- and moderate-income Americans, from the risk of outliving their savings.

Conclusion

A dignified and fulfilling life in retirement rests on financial security—financial security that matches longevity and enables seniors to enjoy the last stage of their lives without burdening their families financially. While policy makers craft a national policy on lifelong income for 401(k) plans and IRAs that will assist future Americans in achieving this financial security in the long-term, the Security Plus Annuities program can immediately help America's millions of baby boomers make their savings last a lifetime.

Questions and Answers about Security Plus Annuities

What types of annuities will be available?

Security Plus Annuities are intended to be simple, low-cost and inflation-protected. The basic annuity will be a single life annuity for single retirees and a joint-and-survivor annuity for married retirees. Additional options could include an annuity with a cash refund of premium feature and an annuity with a 10-year certain feature.

Will Security Plus Annuities protect against inflation like Social Security benefits?

Yes. Social Security benefits currently have a built-in adjustment for inflation, and Security Plus Annuities will be adjusted for inflation using the same method.

Is the Social Security Administration the most federal appropriate agency for Security Plus Annuities?

Yes. Social Security is the agency currently in charge of the primary retirement income of millions of Americans. It touches the lives of almost all Americans today, not just in retirement but throughout their lives. The Social Security Administration receives high scores of satisfaction from Americans in terms of the services it provides, and its online services have been rated the best in government and receive higher scores than top private sector sites in customer satisfaction.[13]

Using the Social Security Administration is appropriate because it already has the necessary personal data, such as ages and addresses, to assist with annuity purchases and payouts. It is also the most logical marketing point. Americans will learn about annuities when they sign up for Social Security benefits — a moment when a decision to purchase an annuity is highly relevant. Finally, this agency can make annuity payments efficiently by adding them to monthly benefit checks.

Why is there a 12-month time window and $100,000 limit on annuity purchases?

Security Plus Annuities are not intended to turn the Social Security Administration into an insurance company or to supplant the private insurance industry. Savers who wish to purchase larger annuities when Social Security benefits begin or additional annuities later in life can always obtain them from the private sector.

What role would private-sector insurance companies play in Security Plus Annuities?

The federal government provides the marketing, administration, payment and customer service functions that a private insurance company usually performs. The insurance company would be asked to do just what it does best: invest funds in order to provide a guarantee of lifelong payments.

13 *See* http://seniorjournal.com/NEWS/SocialSecurity/2010/20100504-SocialSecruitysOnlineServices.htm and http://www.theacsi.org/index.php?option=com_content&task=view&id=200&Itemid=212

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Initiative on Financial Security | One Dupont Circle, NW | Washington, D.C. 20036 | 202.736.2910 | ifsinfo@aspeninstitute.org| www.aspenifs.org