NATIONAL ACADEMY OF•SOCIAL INSURANCE

UNCHARTED WATERS: PAYING BENEFITS FROM INDIVIDUAL ACCOUNTS IN FEDERAL RETIREMENT POLICY

NASI press contact is Jill Braunstein (202-452-8097 or jillbraun@nasi.org)

Fact Sheet #4: Tapping the Money: Free Choice or Limits?

Social Security provides monthly benefits to a retired worker and, when he or she dies, to a qualified widowed spouse for life. Benefits are adjusted each year for inflation.

Financial Risks in Retirement: When retirees have decisions to make about taking money from retirement accounts, they face four kinds of financial risk: they don't know how long they will live, how long their spouse might live, how prices might rise in the future, nor what returns they will earn on their savings.

Life expectancy figures provide estimates, but not certainty. No one knows if her or she will be average. Women at age 65 have a life expectancy of 20 years; men who reach 65 have a life expectancy of 17 years. Those figures disguise a wide range of longevity for those who make it to age 65. About 11 percent of men and 7 percent of women will die before their 70th birthday. On the long-lived side, 6 percent of men and 14 percent women will live to their 95th birthday, and beyond.

This uncertainty makes it difficult to allocate money wisely throughout retirement. If retirees live longer than they planned for, they risk running out of funds. If they try to avoid that problem by spending conservatively, they may have a lower standard of living than they could otherwise afford.

Account Withdrawal Policy Options: Policymakers designing a personal account system would have to decide how much freedom to allow personal account holders at retirement. The purpose of the accounts, the level of Social Security benefits that go side-by-side with the accounts, and whether workers are required to have accounts may influence this decision. If the accounts are supposed to provide basic income security, policymakers might want mandatory, inflation-indexed annuities with spousal protections as the payout option. On the other hand, if the accounts are voluntary savings on top of the traditional Social Security system, policymakers might favor granting people broad freedom to decide how to tap the accounts.

At one end of the choice spectrum is completely unfettered access. At retirement age, the individual can withdraw as much as he or she chooses from the account. This would be similar to the federal Thrift Savings Program; the money can be tapped with few, if any, restrictions.

The other end of the spectrum would be a requirement that personal account holders annuitize all the money in their accounts when they retire. When you buy a life annuity, the insurance company has a contractual obligation to pay you a guaranteed income for life. The annuity shifts your longevity risk and investment risk to the insurance company. Because the insurer pools many annuitants, the extra funds from those who die early are used to cover the annuity costs of those who live a long time.

A basic life annuity covers the risk of outliving one's income, but additional annuity features can help mitigate other retirement risks such as loss of purchasing power and the loss of a spouse's income.

From the buyer's perspective, the downside of purchasing a life annuity is that you pay the full price up front and you can't undo the purchase later. However, other strategies to spread your money over the rest of your life – such as taking phased withdrawals – do not guarantee the money will last as long as you live.

How Annuities Work: Assume a worker shifted 2 percentage points of Social Security taxes into a personal account and, at retirement, purchased an inflation-indexed lifetime annuity:

- A "low earner" (as defined by the Social Security Administration) making $15,600 a year, would have a personal account with a balance at age 65 (after 20 years of work) of $9,400. An annuity purchased with the $9,400 would yield an income of $660 a year for life. Someone contributing to an account for 40 years at the low-wage level would have $26,700 for purchase of an annuity, producing $150 a month.

- A medium earner (as defined by the Social Security Administration) with average lifetime earnings of $34,700 a year would have a balance of $21,000 in a personal account after 20 years. At age 65, the individual could purchase an annuity that provided an income of $125 a month. If the individual contributed to an account for 40 years, the account balance would be $59,400, producing an income of $333 a month.

- The Social Security Administration's high earner, making $55,500 a year and contributing two percentage points of Social Security tax to a personal account, would have a balance of about $33,300 after 20 years. This could buy an annuity producing income of $195 a month; contributing to an account for 40 years would produce a personal account balance of $94,900, sufficient for an annuity of $536 a month.[1]

Current Annuities Market: Insurance companies, whose solvency is under the jurisdiction of state regulatory authorities, sell annuities. The market is limited, and a comparatively small percentage of retiring workers decide to convert their 401(k) accounts into annuities. Increasingly, workers prefer to take lump sum payments.

Policy Questions: If policymakers decide they want to promote the purchase of annuities for personal accounts, they will face important issues:

Should the federal government regulate annuities for personal accounts created as part of the Social Security system?

Should additional financial institutions be allowed to market annuities?

Should there be a government guarantee if a vendor of annuities goes out of business and retirement payments cannot be paid to the buyers of that firm's annuities?

See Uncharted Waters Chapter 2 for the assumptions used in these examples.

Source: Reno, Virginia P., Michael J. Graetz, Kenneth S. Apfel, Joni Lavery, and Catherine Hill (eds.), (2005). *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy,* Study Panel Final Report, Washington, DC: National Academy of Social Insurance, January.

NATIONAL ACADEMY OF SOCIAL INSURANCE—1776 Massachusetts Avenue NW, Suite 615, Washington, DC 20036 (202-452-8097) (www.nasi.org)