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Turning Savings into Security

Human nature makes most people spectacularly ill-equipped—intellectually, educationally, and emotionally—to prepare for a secure retirement. Yet, with private sector pension plan coverage vanishing, workers are responsible for saving adequately and investing prudently during their working lives—and then wisely spending in retirement to neither run out of money nor underspend, and leave more for their heirs than they intend.

Until recently, the focus has been on saving and investing (can't worry about spending until you have money to spend). Now, focus is expanding to the critical and daunting challenge of turning retirement savings into monthly income. Crafting the ideal retirement spending program requires an alchemistic blend of the retiree's life expectancy, future investment returns, inflation, emergency spending needs, bequest motives, and ever-changing tax law and Social Security benefits. Annuities would be an obvious solution for many, but few retirees are willing to turn over a large sum of money for a seemingly small monthly payment.

Fortunately, some very smart people have been searching for other attractive and creative approaches. There are three relatively new and promising ideas I'd like to highlight: a voluntary Social Security buy-in; tontine—a kind of mortality risk sharing pool; and a new kind of Treasury bond called a SeLFIE. (Other ideas are nicely set out in "From Saving to Spending," a draft white paper from John, Gale, Iwry, and Krupkin).

SOCIAL SECURITY BUY-IN

What if Social Security allowed people to voluntarily purchase a higher monthly benefit upon retirement? This idea was recently proposed by Richard Thaler, Nobel laureate and one of the minds behind the concept of automatic savings. As proposed, the cost of the Social Security buy-in would be actuarially sound and capped at around $100,000 so it doesn't function as just another financial planning tool for the wealthy. The extra payout, which could include a spousal survivor benefit, would be added to the participant's regular Social Security benefit and adjusted for inflation.

Social Security already is sending retirees monthly checks, has the infrastructure in place to manage the added payouts, and, because there is no profit motive, to minimize administrative costs. Moreover, the federal government can afford to assume the longevity "risk" that a future medical breakthrough will significantly boost average life expectancy. To be fair and ensure confidence in the program's viability, the buy-in would have to be guaranteed and unaffected by any future changes in Social Security or by the automatic 20-percent haircut in regular retirement benefits that would be triggered if the Social Security trust fund runs dry.

The big downside to this idea is adverse selection. Since people who expect to be on the winning side of the mortality curve would be more likely to buy in, actuaries would need to apply a more conservative and expensive (to the buyer) mortality charge. One proposed solution would allow workers to voluntarily increase their Social Security tax withholdings during their careers and thereby get a proportionally higher benefit at retirement. That way, participants would buy in gradually and without foreknowledge of their age-65 health status. A gradual buy-in also would have to be guaranteed, and I question whether many people would agree to a voluntary "tax" increase for higher benefits many years in the future. Still, using the existing Social Security infrastructure is an idea worth further consideration.

TONTINE

From the seventeenth century into the early 1900s, tontine was a popular and effective royal and, eventually, commercial financing tool. Let's say the king needed to raise 1,000 pounds. His minister would find 10 people willing to invest 100 pounds each in exchange for receiving annual payments during their lifetime of five pounds apiece. Once a year, the investors would meet with the minister to receive their annuity and, as participants died, the entire 50-pound total payout was

shared equally among the survivors. Investors accepted a lower initial return in the hopes outlasting some of their cohorts. From the king's perspective, the obligation to make annual payouts ended altogether once the last participant died.

Tontine eventually was adopted by nonroyals, to the point that by the early 1900s some form of the concept was behind roughly two-thirds of life insurance contracts in the United States. Ultimately, due to a wave of fraud, high commissions, and other abuses, Tontines were prohibited by New York and other states. However, as suggested by Professor Moshe Milevsky at York University and others, adopting the logic behind tontine on a larger scale could enable people today to share their mortality risks without paying insurance company charges. Imagine 10,000 65-year-olds buy into a tontine 2.0 fund that invests in a conservative bond portfolio or 2020 lifecycle fund. Income is shared pro rata (based on initial investment), and as folks pass on to the next world, the income pot is shared by fewer and fewer people. Presumably, the people who die early aren't harmed because they don't need the money, while the living benefit.

One downside to this approach is that most people spend less as they age until the very end, when they may need custodial or intensive medical care. Other concerns are its complexity, novelty, and the ghoulishness of benefiting from another person's death. Still, with some financial engineering, tontine could serve as a lower-cost mechanism for people to group-insure their longevity risk.

SELFIES

SeLFIES—Standard of Living Indexed, Forward-Starting, Income-Only Securities—are a very clever new type of proposed Treasury bond with aspects of a Social Security buy-in and tontine, but with fewer downsides. Proposed by economists Robert Merton (another Nobel laureate) and Dr. Arun Muralidhar, among others, SeLFIES would pay regular income (without a balloon payment at maturity) for a stated period based on average life expectancies at the time of issue. The payment starting date would vary by bond issue, so people could tailor income to their expected retirement date. Monthly payments would be adjusted for inflation or another cost of living factor, much like TIPS (Treasury Inflation-Protected Securities).

To make the idea attractive and understandable to noneconomists, the bonds would be sold in units of retirement income, for example having one unit pay $5 a month for 22 years (which is the current life expectancy for a 65-year-old). The cost of each SeLFIE unit would depend on the year payment would start (the further the time horizon, the lower the cost), current market interest rates and inflation expectations.

For example, a 55-year-old in 2019, planning to retire at age 65 in 2029, who wants a guaranteed monthly income of $500 a month could buy 100 SeLFIE 2029 units, guaranteeing her the desired monthly income (100 times 5), adjusted for inflation. The investor would have solved for her investment and inflation risk and guaranteed a steady income stream in retirement—and without needing a team of economic, finance, and actuarial advisors.

Unlike an annuity or tontine, SeLFIEs pay for the scheduled number of years; people who die prematurely pass the bonds to their heirs, while those who live longer than average will need to look to other resources when the SeLFIE payout ends. This lack of longevity protection actually makes SeLFIES fairer to lower-income people, who generally have shorter life expectancies, because they won't be subsidizing participants who are wealthier and longer-lived. The longevity risk can also be easily mitigated by buying a low-cost deferred annuity that begins paying out when the 22 years are up. Crucially, SeLFIES would be fully marketable, so investors could sell some bonds to cover an immediate and unexpected financial need or a change to their planned retirement date or investment strategy.

The simplicity of this idea, with no added cost to the Fed, makes it extremely appealing. Of the three ideas, I find SeLFIES the most encouraging.

The time is ripe for government leaders to fully explore these and other retirement spending alternatives. America's economic, financial, and retirement experts have built the foundation for a number of relatively simple, no-cost solutions. Government needs to examine these alternatives and enable one or more of these products to be brought to market. If not now, when?

The views set forth herein are the personal views of the author and do not necessarily reflect those of the law firm with which he is associated.

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