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Social Security: What Role for Life Annuities in Individual Accounts? Issues, Options, and Tradeoffs

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Summary

Life annuities are products sold by insurance companies to protect retirees against the risk of outliving their money. A life annuity is a once-in-a-lifetime purchase with lifelong consequences. Requiring retirees to buy life annuities with their individual accounts has advantages and disadvantages. Mandatory annuities cost less on average, while voluntary annuities cost more because short-lived people tend not to buy them. An inherent tension exists between the interests of heirs and the purchase of annuities because money used to buy a life annuity is no longer available to leave to heirs. The timing of annuity purchase can have an important impact on the amount of funds left for a widowed spouse or other heirs. Retirees may want help in understanding the impact of different decisions on their own financial security and that of their spouses, dependents, and other heirs.

This brief draws on analyses and findings in the study panel report, *Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy*, to highlight key points about the purchase of life annuities at retirement from the perspective of single and married retirees.

Retirees Face Varied Financial Risks

Retirees face a variety of financial risks: they don't know how long they will live or how long their spouses might live (longevity risk), how prices might rise in the future (inflation risk), nor what returns they will earn on their savings (investment risk).

Life expectancy estimates show averages, but do not provide certainty because averages hide a broad range of experiences. On the short-lived side, about 11 percent of men and 7 percent of women who live to age 65 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 hard to allocate money wisely throughout retirement.

Even modest price increases can erode the value of a fixed income over a long period of retirement. For example, price increases of just 3 percent per year will make $100 today worth only about $74 in 10 years; after 25 years the value would drop by more than half, to just $45. High and unexpected inflation can rapidly erode the buying power of a fixed income.

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Some retirees invest in financial markets in hopes of increasing their retirement savings. But such investments yield uncertain gains or losses, producing both year-to-year volatility in income and an unknown income stream over the entire retirement period. In general, higher risk investments offer a higher expected return as a way to compensate for greater risk of financial loss.

Social Security protects against many of these risks by paying benefits for life that are indexed for inflation and by providing automatic payments for spouses and widowed spouses. A spouse benefit is 50 percent of the retiree's full benefit and is paid only to the extent it exceeds what the spouse would receive from her or his own work record. Social Security pays widow(er)s up to 100 percent of the deceased worker's full benefit, but only to the extent that the benefit exceeds the widow(er)'s own benefit as a retired worker.

Life annuities are insurance products that convert accumulated savings into monthly payments that protect against some of the risks retirees face.

Life Annuities Protect Against Some Financial Risks

Life annuities are contracts offered by insurance companies that promise payments for as long as annuitants live. The purchase of a life annuity shifts an individual's longevity risk and investment risk to the insurance company. Because insurers pool longevity risk over a large group of annuitants, the extra funds from annuitants who die early are used to pay annuitants who live a long time.

Many products are called "annuities," but are not life annuities. It is important to distinguish life annuities from deferred and term annuities. Deferred annuities are tax-favored investment products that do not guarantee payments for life. Deferred annuities can be converted to life annuities, but relatively few owners of deferred annuities do so. Term annuities promise specified payments for a given term, say five or ten years and they, too, do not guarantee payments for life. Only life annuities pay guaranteed payments for the life of the annuitant. See Box 1 for a glossary of annuity features.

Life Annuities Have Many Different Features

Life annuities vary in how payments change over time, whether they insure one life or two, and the kinds of guarantees they provide (if any) when an annuitant dies shortly after buying the annuity. Each additional layer of annuity protection (such as inflation-indexing and automatic survivor benefits) lowers the size of the annuity one can buy with a given account balance. For instance, a 65-year-old retiree with $10,000 could buy a flat, single-life annuity of about $80 a month. If the annuity were indexed to keep pace with inflation at 3 percent a year, the monthly annuity payment would start out lower, about $62 a month. If the annuity would continue to pay the same inflation-indexed monthly amount for as long as either the annuitant or a 65-year-old spouse lived, the payment would start out lower still, at about $50 a month.

Some annuity contracts add "guarantee" features that promise a certain level of payout if the annuitant dies shortly after buying the annuity. A 10-year-certain life annuity, for example, guarantees payments for 10 years even if the annuitant dies in fewer than 10 years. A refund-of-premium life annuity guarantees that the annuity will pay out at least the nominal purchase price. For example, if the annuitant paid $10,000 and then died after receiving only $1,000, the annuity would pay $9,000 to the death beneficiary.

Guarantees lower the monthly annuity that a given premium will buy. For $10,000, a 65-year-old could buy a single-life, inflation-indexed annuity of $62 a month. Adding a 10-year certain feature would lower the monthly amount to about $58 a month, while a refund-of-premium annuity would lower the initial amount to about $55 a month. Many experts believe that guarantee features are not a wise buy on strictly economic grounds, yet annuity buyers often choose guarantees.

Box 1. Glossary of Annuity Terms

Different Products

Life annuities are contracts sold by insurance companies that obligate the insurer to make regular payments for as long as the annuitant lives. Typically, one buys a life annuity by paying a lump sum or "single premium" to the insurance company.

Deferred annuities are tax-favored investment products that do not provide payments for life, but that can be converted to life annuities. Deferred annuities are used mainly to defer taxes on money that accumulates in the fund.

Term annuities are contracts that promise specified payments for a given term of, say, five or ten years. Payments do not continue for life.

How Do Life Annuity Payments Change Over Time?

A fixed life annuity pays a flat dollar amount, usually monthly, for the life of the annuitant.

Rising life annuities pay amounts that rise at a prescribed rate, say 3 percent per year, for the life of the annuitant.

Inflation-indexed life annuities pay monthly amounts that are adjusted each year to keep pace with the consumer price index.

Variable life annuities pay benefits that vary from year to year depending on investment returns. Payments can go down as well as up. The annuitant bears all or part of the investment risk.

Participating variable life annuities are variable life annuities in which the risk of changes in life expectancy is shared between annuitants and the annuity provider.

How Many Lives Are Covered? What Does the Survivor Get?

Single-life annuities make payments only for the life of the individual annuitant.

Joint-life annuities make payments for the life of the primary annuitant and a secondary annuitant (typically the primary annuitant's spouse).

Symmetric joint-life annuities pay the same amount to a widowed primary annuitant as would be paid to a widowed secondary annuitant. The payment to the longer-lived person could be 100 percent, 75 percent, 67 percent, or any other fraction of the amount paid while both were alive.

Contingent joint-life annuities pay a lower amount to a widowed secondary annuitant than to a widowed primary annuitant. The primary annuitant's payment is not reduced if he or she is widowed. If the secondary annuitant is widowed, the payment could be 75 percent, 67 percent, 50 percent or any other fraction of the amount previously paid to the primary annuitant.

Guarantee Features

A *ten-year-certain* annuity will make payments for ten years, even if the annuitant dies within ten years. Period-certain annuities can guarantee five, ten, twenty, or other durations of payments.

A *refund-of-premium* annuity guarantees to pay until the sum of payments equals the nominal purchase price of the annuity. For example, if one paid $10,000 for a life annuity and died after receiving payments equal to $1,000, the heir (designated beneficiary) would receive $9,000.

Should Life Annuities Be Required?

Policymakers designing an individual account system would have to decide how much choice to allow account holders at retirement. That policy decision would likely be influenced by 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 contribute to accounts. If the purpose of the accounts is to provide basic income security, policymakers might want to require that retirees buy life annuities that have inflation protection and that automatically provide for widowed spouses. On the other hand, if the accounts are voluntary new savings on top of the traditional Social Security system, policymakers might favor granting people broad freedom to decide how to tap the accounts.

Requiring that retirees buy life annuities has both advantages and disadvantages. The requirement protects retirees from outliving the money in their accounts. If the purchase is required, life annuities will cost less, on average, because short-lived people are required to buy a product that might not be a good deal.

If the purchase of life annuities is optional, annuities cost more because people with short life expectancies tend not to buy them. Because longer-lived people are more likely to choose annuities when the purchase is optional, annuities have to be priced higher to cover the longer lives of willing buyers. In the insurance world, this is called "adverse selection" — the situation whereby those more likely to benefit from the insurance are more likely to buy it. In this case, buyers' self-selection is adverse to insurers.

Some individual account proposals would require the purchase of life annuities up to a specified threshold. For example, some have suggested requiring the purchase of inflation-indexed life annuities sufficient to keep retirees out of poverty when their annuities are combined with their remaining Social Security benefits. One advantage of this approach is that it could keep some retirees out of poverty. One downside is that, while high-earning retirees are likely to have account funds left for discretionary spending or bequests, many lower-income retirees would have to use their entire accounts to buy the required annuities.

Timing of Annuity Purchase and Heirs

The interests of heirs could influence the question of whether and when to buy a life annuity. From a strictly selfish perspective, a named beneficiary might want the account holder to delay buying a life annuity so that the money remains inheritable. An unmarried account holder, for example, might name an adult child, other relative or friend as a death beneficiary. If the account holder died before buying an annuity, the entire balance would go to the heir. But when the account is used to buy an annuity, the bequest is gone.

If account holders are required to buy life annuities, "boundary issues" might arise about when the required purchase must take place. Would a retiree with poor survival prospects be allowed to delay buying an annuity in order to keep the inheritance intact? Or would uniform rules and deadlines apply to all?

If purchase of life annuities were mandatory, terminally ill retirees would likely want to be excused from the annuity requirement. Should exceptions be granted? A strong case could be made for exempting the dying because forcing them to buy life annuities could be viewed as harsh and unfair. Yet, to exempt the ill or dying raises new questions of fairness and efficiency. In terms of fairness, the terminally ill are not the only group who could make a case for exiting the life annuity pool. Any retiree facing large, unexpected expenditures, such as medical bills for a sick family member, could argue for an exemption from the annuity mandate in order to use the money for immediate needs. And, defining terminal illness and deciding who would make that determination could become a matter of dispute. In terms of administrative efficiency, granting exceptions from an annuity requirement on a case-by-case basis would involve new adjudicative processes and appeal rights. It could even be argued that to allow any exceptions would ultimately unravel the mandate and forsake any advantage of universal life annuities.

How Big Might Life Annuities Be?

The size of life annuity payments produced by individual accounts will depend on how much workers put in, how long they contribute before retiring, and the investment returns the accounts earn.[1] We illustrate two investment scenarios, both of which assume that workers contribute 2 percent of their Social Security taxable earnings to individual accounts. In the first scenario, the worker invests half in stocks and half in corporate bonds, resulting in projected investment returns of 4.7 percent over inflation, as described in the note on Table 1. The pro-

Table 1. Size of Annuities with Equity Premium

Account Balance and Monthly Annuity at Age 65 by Earnings Level and Duration of 2 Percent Contributions

Workers invest half in stocks and half in corporate bonds for a combined real return of 4.7% over inflation.

Earnings Level	Account Balance	Monthly Annuity
At age 65 after 40 years, accounts are about 1.7 times annual earnings		
$34,700 (medium)	$59,400	$333
$15,600 (low)	$26,700	$150
$55,500 (high)	$94,900	$536
At age 65 after 20 years, accounts are about 0.60 times annual earnings		
$34,700 (medium)	$21,000	$125
$15,600 (low)	$ 9,400	$55
$55,500 (high)	$33,300	$195

NOTE: Assumes stocks yield 6.5 percent over inflation and corporate bonds yield 3.5 percent over inflation, which average out to 5.0 percent real return, minus 0.3 percent annual administrative costs, for a net real return of 4.7 percent. Monthly annuity is single-life annuity indexed to rise by inflation of 3.0 percent per year.

Source: U.S. Social Security Administration, 2004. Based on unpublished tables from the Office of the Chief Actuary.

1 For the purpose of illustrating the relative size of annuities, the estimates presented here assume that inflation-indexed annuities would be available on terms consistent with the intermediate assumptions used in the 2003 report of the Social Security Trustees. The illustrations also assume that all retirees would be required to buy annuities and that annuities would be priced the same for men and women.

jected dollar amounts for illustrative workers with scaled "medium," "low," and "high" earnings are shown in Table 1. After 40 years, a 65 year old would have an account equal to about 1.7 times his or her annual lifetime earnings; the monthly annuity would amount to about 7.4 percent of earnings. The medium earner, making $34,700 — about the average earnings of all workers covered by Social Security in 2003 — would have an account of about $59,400. The account would produce a single-life, inflation-indexed annuity of about $333 a month. The account balance and monthly annuity are proportionately smaller for a low earner, who makes about $15,600, and are proportionately larger for a high earner, who makes about $55,500.

Table 1 also shows results for workers who were age 45 when the system began and therefore had only 20 years to contribute before age 65. Using the same investment strategy, these retirees would have accounts equal to about 60 percent of annual earnings. The monthly annuity would equal about 4.2 of these workers' earnings. For the medium earner, the account balance would be about $21,000, which would produce an inflation-indexed single life annuity of about $125 a month.

Table 2 shows accounts for similar workers, but these workers realize lower investment returns consistent with those earned on U.S. Treasury securities.

Table 2. Size of Annuities with Low-Risk Investment

Account Balance and Monthly Annuity at Age 65
by Earnings Level and Duration of 2 Percent Contributions

Workers invest solely in U.S. Treasury securities with net real return of 2.7 percent over inflation.

Earnings Level	Account Balance	Monthly Annuity
At age 65 after 40 years, accounts are about 1.1 times annual earnings		
$34,700 (medium)	$38,200	$215
$15,600 (low)	$17,200	$ 97
$55,500 (high)	$61,000	$344
At age 65 after 20 years, accounts are about 0.48 times annual earnings		
$34,700 (medium)	$16,700	$ 99
$15,600 (low)	$ 7,400	$ 43
$55,500 (high)	$26,600	$158

NOTE: Assumes Treasury bonds yield 3.0 percent over inflation, minus 0.3 percent annual administrative costs, or 2.7 percent. Monthly annuity is single-life annuity indexed to rise by inflation of 3 percent per year.

Source: U.S. Social Security Administration, 2004. Based on unpublished tables from the Office of the Chief Actuary.

In this scenario, after 40 years of contributing 2 percent of earnings, a worker at age 65 would have an account equal to about 1.1 times his annual earnings. An inflation-indexed single life annuity from that account would replace between 5 and 6 percent of the worker's earnings. For a medium earner, the account would be about $38,200 and the annuity would be about $215 a month.

A 45-year-old worker who contributed 2 percent of earnings for 20 years would have an account at age 65 equal to just under half of her annual earnings. Her account could buy an annuity that replaced between 3 and 4 percent of her prior earnings. A medium earner's account would amount to about $16,700 and the annuity would be about $99 a month.

Should Joint-Life Annuities Be Required for Married Retirees?

Single-life annuities guarantee payments for life for individual annuitants, whereas joint-life annuities guarantee payments for the lives of a primary annuitant and a secondary annuitant, typically the primary annuitant's spouse. Whether joint-life annuities should be required is likely to depend on the purpose of the accounts and the level of remaining Social Security benefits. Many proposals for accounts that aim to replace part of traditional Social Security require that married retirees buy joint-life annuities in order to protect widowed spouses. Proposals for accounts that are discretionary savings on top of Social Security might allow married retirees the broader payout choices available to holders of Individual Retirement Accounts (IRAs), which have no special requirements for spousal protection.

Married Retirees — What Are the Annuity Choices?

Many choices are possible in joint-life annuities. Two key questions are: How much should a widowed spouse receive? Would the annuity be *symmetric* or *contingent*?

Annuities can be designed and priced to pay a widowed spouse the full payment (100 percent survivor payment), or to reduce the survivor payment to 75 percent, 67 percent, 50 percent, or any other fraction of the prior annuity payment. In general, a larger payment for the surviving partner means a smaller initial payment for the retiree.

The choice between joint-life annuities that are *symmetric* or *contingent* is a subtle, but important, distinction and policy question. If John buys a contingent joint and two-thirds life annuity, the payment to his widow will fall to two-thirds of the prior amount, but if he is widowed, his payment will not be reduced. In contrast, if John buys a *symmetric* joint and two-thirds life annuity, his payment will drop to two-thirds of the prior amount if his wife dies. The payment will also drop to two-thirds of the prior amount if he dies and the payment shifts to his widow. Symmetric joint-life annuities can produce a more predictable income for widowed spouses relative to the prior income of the couple.

Under the Employee Retirement Income Security Act (ERISA), the minimum federal requirement for spousal protection in private defined-benefit pension plans is contingent. The pensioner's spouse must be offered at least a 50 percent survivor benefit. The law does not call for the pensioner's benefit to be reduced if he or she is widowed.

How Does a Spouse's Age Affect Joint-Life Annuities?

In general, a younger spouse will lower a retiree's initial annuity amount, because the insurance company expects to pay a younger spouse over more years than an older spouse. If a 65-year-old retiree with a 65-year-old spouse were to buy a symmetric joint and two-thirds life annuity, it would start out at about 93 percent of the amount a single retiree would get. If the spouse were much younger, say only 53 years old, the retiree would get an annuity that is about 78 percent as much as a single retiree age 65 would receive. On the other hand, if the 65-year-old retiree had a 77-year-old spouse, the retiree's initial benefit would actually go up — it would be about 112 percent of what a single retiree would get at 65. While it might seem surprising that an annuity covering two lives would pay more than a single life annuity, this occurs because of the nature of a symmetric joint and two-thirds annuity. A 65-year-old retiree with a 77-year-old spouse has a high probably of outliving the older spouse and shifting to the two-thirds survivor payment. The main point is that age differences between husbands and wives will affect the size of joint-life annuities that each can buy.

When Spouses Make Different Choices to Participate

Many proposals require that married retirees buy joint-life annuities in order to ensure adequate spousal protection. And many proposals require (or assume) that married retirees will buy symmetric two-thirds life annuities in order to provide the same treatment between husbands and wives. At the same time, if workers have a choice whether or not to participate in an individual account plan, some couples could end up with one partner in and one partner outside the individual account plan. This situation could undermine any requirement about symmetric treatment and adequate spousal protections. For example, if Mary, but not John, decided to join an individual account plan, she would be required to buy a joint-life annuity to cover him, while he would not have an account or an annuity to provide survivor protection for her. In theory, rules could require that husbands and wives make the same choice, and, if they cannot agree, provide a default rule to determine their status. But, new marriages and remarriages over the work life would still create mismatches between spousal participation. In the end, it appears that the intended outcomes of requiring the purchase of joint-life annuities for married retirees would be achieved only if participation in the accounts was also mandatory.

Annuities and Changes in Marital Status

In general, life annuities cannot be rewritten to shift from a single-life to a joint-life annuity if one marries after retirement. Nor can one "undo" the purchase of a joint-life annuity and shift to a single life annuity if a marriage ends shortly after buying a joint-life annuity. This could affect married couples' decisions about whether and when to buy annuities.

Whether one is widowed right before or right after the purchase of annuities could make a big difference in what the widowed individual receives. Consider the case of John and Mary (illustrated in Table 3), who each have individual accounts, and who are approaching the time when they will be required to buy joint-life annuities. If John dies before they buy annuities, Mary could inherit his account, combine it with her own, and buy a single life annuity with the total amount. Similarly, if John is widowed before they buy annuities, John could inherit her account and buy a single life annuity with the proceeds of both accounts.

Table 3. Annuities for Widowed Spouses: Timing of Life Annuity Purchase and Widowhood Affect Survivor Payments

Sequence	Survivor Payment
Widowed before either buys annuities:	
Survivor buys single life annuity with both balances (baseline case)	100%
Widowhood after both buy annuities (percent of baseline payable):	
Each bought joint and two-thirds life annuity	62%
Each bought joint and 100 percent life annuity	81%

NOTE: Annuity estimates are based on assumptions that: purchase of life annuities is mandatory (reflecting total population life tables for individuals age 65 in 2005); annuities are priced the same for men and women of the same age; the annual inflation rate is 3.0 percent, the real annual interest rate is 3.0 percent, and the joint-life annuities are symmetric.

Source: U.S. Social Security Administration, unpublished calculations of illustrative annuities, August, 2003.

If “widowhood before annuity purchase” is considered a baseline, how different would the outcome be if John and Mary had just purchased joint-life annuities before one of them died? The results would depend on their ages and the kind of annuities they purchased. If both were age 65 and bought symmetric joint and two-thirds annuities, and then John died shortly thereafter, Mary’s combined annuities (from her own and John’s accounts) would amount to 62 percent of the baseline case. Similarly, if Mary died and John survived, he would get 62 percent as much as he would get in the baseline case. The payment is less because they both paid for annuities that cover two lives (reducing the initial payments to 93 percent of a single life annuity) and then shifted to the two-thirds survivor payment from each annuity (93 percent x 67 percent = 62 percent).

If John and Mary, both age 65, had instead bought joint-life annuities that paid the full amount to the survivor, each would start out with an annuity that is about 81 percent of what a single-life annuity would provide. When one died, the survivor would continue to receive 81 percent as much as the baseline case.

The key point is that the timing of annuity purchase interacts with the timing of widowhood to produce very different results for retirees who are otherwise in similar circumstances.

Recap of Annuity Choices

Policymakers designing individual account payout rules will confront inevitable tension between offering choice and ensuring retirement income for life. Hard and fast rules and mandates might ensure that the system meets certain high-priority goals, but those rules might also create pressure for exceptions. The following list summarizes issues that arise as account holders approach retirement. How many of these decisions would be left up to retirees and the kind of options that would be offered will depend upon the ultimate design of the payout rules:

(a) Whether to buy a life annuity at all;

(b) How much of one's account to spend on a life annuity;

(c) Whether the annuity would be indexed for inflation;

(d) When to buy a life annuity;

(e) Whether to buy a guarantee feature;

(f) If a guarantee is desired, whether to buy a period-certain (and for how long) or refund-of-premium annuity, and whether it would go to a named beneficiary or to the estate;

(g) If joint-life annuities are optional for unmarried retirees, whether to buy one and with whom;

(h) If joint-life annuities are offered or required for married retirees, whether to buy contingent or symmetric products;

(i) If joint-life annuities are offered or required, what level of benefit to provide for the secondary annuitant.

A life annuity is a once-in-a-lifetime purchase that has lifelong consequences. To the extent that retirees have choices, they may want advice and assistance in order to fully understand the consequences of different decisions for their own future financial well-being and the well-being of their spouses, dependents, and potential heirs. Organizing and paying for trustworthy advice could become an important issue in a new system that envisions widespread purchase of life annuities.

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U.S. Social Security Administration (2004). Unpublished tables from the Office of the Chief Actuary, January 27.

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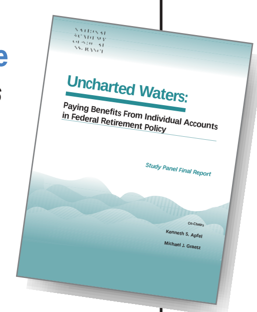

***Uncharted Waters: Paying Benefits From Individual Accounts in Federal Retirement Policy*, Study Panel Final Report, January 2005.** Michael J. Graetz, Kenneth S. Apfel, co-chairs. National Academy of Social Insurance, Washington, DC, January 2005. 225 pages, $29.99. To order call 202-452-8097 or email nasi@nasi.org.

This report considers some of the payout issues that might arise from implementing a system of individual accounts, if such accounts were to become a part of federal retirement policy. Why is it important to examine "payout" issues? Because a central goal of retirement security policy is to assure some level of adequate income, it is essential that any debate about creating individual accounts include a complete understanding of how the benefits will be received.

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