Baby Boomer Women:
Secure Futures or Not?

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A collaboration of the
Global Generations Policy Institute
Harvard Generations Policy Journal
and Harvard Generations Policy Program

www.genpolicy.com

Baby Boomer Women: Secure Futures or Not? is published by the Baby Boomer Media Group LLC. All inquiries should be directed to the Baby Boomer Media Group, 124 Mount Auburn Street, Suite 200N, Cambridge, MA 02138, tel: 617-491-1171, fax: 617-547-1431, e-mail: *genpolicy@aol.com*, website: *www.genpolicy.com*.

ISBN 0-9778688-0-X

Baby Boomer Women: Secure Futures or Not? is a *pro bono* public service publication whose mission is to develop and implement national policies that will ensure a dignified, sustainable quality of life for our nation's aging baby boomer women.

Turning Personal Accounts into Secure Retirement Income: A Challenging Proposition for Boomer Women

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Much research has focused on whether baby boomers are saving enough for retirement. Largely neglected are questions about how boomers will turn whatever retirement savings they have into a secure stream of retirement income. This article draws on a study by an expert panel of the National Academy of Social Insurance (NASI) that identified payout issues that must be addressed if individual accounts are carved out of Social Security funds, as proposed by President George W. Bush, or are created outside of Social Security. Similar issues arise with private pensions as firms shift away from making guaranteed monthly payments. With the shift to 401(k) plans and growing use of cash-outs in defined benefit plans, many more retirees will face the challenge of turning

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* *This paper draws on findings in the National Academy of Social Insurance 2005 report,* Uncharted Waters: Paying Benefits from Individual Accounts in Federal Retirement Policy. *The academy is a nonprofit, nonpartisan organization devoted to research and education on social insurance. It does not take positions on legislative policy. Any views expressed are those of the author and do not reflect an official position of the academy, its board, or its funders.*

lump-sum distributions into a secure retirement income. Making retirement money last for life is particularly important to women because, on average, their retirement savings are smaller than men's, and they have longer life spans over which to make the money last.[1]

Transforming Social Security or pensions into personal accounts gives workers a new sense of ownership, but the change also exposes them to new responsibilities and risks. During the work life, they must decide whether and how much to contribute, how to invest the money, and how to resist pressure to spend it. At retirement, workers face new risks that the money in their accounts will decline in value or run out before the end of their lives. Social Security already covers these risks, but individual savings accounts don't. Life annuities are insurance products that can turn personal accounts back into insurance against outliving one's income, but requiring retirees to buy life annuities raises new questions that have not been sufficiently answered.

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Financial Risks Retirees Face

At retirement, women and men face at least four kinds of financial risks. Secure retirement income needs to cover each of them.

Longevity Risk is not knowing how long one will live. The average American woman at 65 has a life expectancy of about 20 years, while her male counterpart is expected to live about 17 years. But no one knows if she or he will be average. About 11 percent of women at age 65 will die before the age of 70, while about 14 percent will live another 30 years to age 95. Not knowing whether one will live less than 5 years, or more than 30 years, makes it difficult to allocate money wisely throughout retirement.

Survivorship Risk is not knowing how long one's spouse will live. Because wives are typically younger than their husbands and live to more advanced ages, they are likely to spend a substantial part of their retirement as widows. Widows face at least two financial setbacks: first is the loss of the husband's income. For widows (or widowers) to maintain their prior standards of living requires anywhere from just over half to about four-fifths of the couples' prior income.[2] Thus, the loss of more than 20 to 45 percent of the couple's prior income would bring a reduced standard of living. Second, paying the bills of a husband's final illness can siphon away financial assets that the couple had planned for their later years, leaving a widow with depleted assets as well as reduced income.[3]

Inflation Risk is not knowing how prices will rise in the future. Even a moderate rate of inflation can significantly erode the long-term purchasing power of a fixed income. Annual inflation of just 3 percent will make $100 today worth only about $74 in 10 years, and after 30 years, the value would drop by more than half to about $40. High and unexpected levels of inflation are particularly problematic. Over the past 30 years, annual price increases ranged from a low of 1.3 percent to a high of 14.3 percent. A few years of double-digit inflation could turn to shambles a retirement plan based on fixed income.

Investment Risk is not knowing what investment returns will be in the future. While savers of all ages face this risk, retirees at advanced ages generally lack options available to younger persons to work or save more in order to compensate for financial setbacks. Social Security protects against each of these risks: It pays benefits for as long as retirees live; the benefits are indexed for inflation; individuals do not bear investment risk; and survivor benefits for widowed spouses are automatic.[4]

Private Plans and Retirement Risks

Private retirement plans cover these financial risks to different degrees. Traditional defined benefit pensions protect retirees against longevity and investment risks; the employer covers these risks by promising to pay retirees monthly benefits for life. But private defined benefit pensions rarely keep pace with inflation. Survivor protection for widowed spouses is a default in private pensions; that is, John's pension is reduced in order to ensure 50 percent of that benefit for his widow, Mary, unless she had consented in writing to forgo that protection.

Typically, 401(k) plans do not protect against the four financial risks. Funds are generally paid as a lump sum that the retiree can use as she or he chooses. The retiree bears longevity, inflation, and investment risk, and spouses have only limited survivor protection. As long as the money remains in the employer-sponsored plan, it would go to a widowed spouse unless she or he had consented in writing to have it go to someone else. Once the 401(k) funds are withdrawn or rolled over into a tax-favored individual retirement account (IRA), the spouse has no automatic right to the funds under federal law. Neither do individual savings accounts, in and of themselves, cover the four financial risks retirees face. Proposals for individual accounts in Social Security generally assume that retirees will buy life annuities to cover these risks.

What Are Life Annuities?

Proposals for individual accounts in Social Security generally assume that retirees will buy life annuities to cover these risks.

A life annuity is an insurance product that turns accumulated savings into a stream of income that will last for life. The retiree pays a lump-sum premium, and in return, the insurance company has a contractual obligation to pay the annuitant a guaranteed income for the rest of her or his life. The insurance company bears both investment risk and longevity risk. By pooling longevity risk among a large group of annuitants, the insurer can use the money from people who die early to cover the payments to annuitants who live a long time. To date, the life annuity market in the United States is very small. Individuals do not seem eager to buy life annuities, and insurers do not seem to actively market them.[5]

Why Don't More People Buy Life Annuities?

Scholars suggest various reasons why life annuities are not more popular.[6] It could be that retirees who have enough savings to buy a life annuity already have enough of their finances in the form of monthly income from pensions and Social Security. If this explains the lack of interest in life annuities, then the products might become more popular as retirees have less of their retirement resources in the form of guaranteed monthly income.

Other explanations point to basic features of the annuity transaction itself; that is, the full purchase price of a life annuity is paid up front, and that payment may look large in relation to the monthly income it buys. For example, at age 65 Jane could pay a premium of $100,000 for a life annuity that pays $620 a month. “Wealth illusion”—the common tendency to value a lump sum much more highly than a stream of future income of equal or greater value—would lead retirees to prefer to keep the $100,000 and forgo the life annuity.[7]

The purchase of a life annuity is also irrevocable. All the money used to buy an annuity is no longer available to leave to heirs. This is a fundamental feature of annuities because the insurer uses the funds from annuitants who die early to pay for those who live a long time. Consequently, if Jane died shortly after paying $100,000 for a life annuity, the money would be gone. A life annuity, in effect, requires workers to give up ownership and bequests in return for insurance against outliving their income.[8]

Will Women Pay More for Annuities?

In the private market for individual life annuities, women receive smaller annuities than men for a given premium because women live longer. A $100,000 premium would buy a monthly annuity of $650 for a man, but only $620 for a woman at age 65, according to an annuity pricing Web site (www.annuityshopper.com). This distinction is not permitted in employee benefits. The U.S. Supreme Court ruled in 1978 that Title VII of the Civil Rights Act of 1964 forbids differentiation in employee benefits, even if it is justified on actuarial (or life-expectancy) grounds.[9] If insurance companies in the individual annuity market were required to price annuities the same for women and men, then companies would have an incentive to sell disproportionately to men because men would be more profitable customers. If price discrimination is banned, it may be necessary to also regulate marketing and risk-pooling techniques in order to avoid discrimination against women in the sale of life annuities.

How Do Annuities Protect Widows?

While single-life annuities guarantee payments for the life of the retiree, joint-life annuities guarantee payments for the lives of a primary annuitant and a secondary annuitant—usually the annuitant’s spouse. Annuities can be designed and priced to pay the widowed spouse the full prior amount (100 percent survivor payment) or to reduce the survivor payment to 75 percent, 67 percent, 50 percent, or any other fraction of the amount paid to the primary annuitant. In general, a larger payment to the survivor brings a smaller initial payment to the retiree.

Whether joint-life annuities are *symmetric* or *contingent* is a subtle but important difference in the nature of protection for widowed spouses. When John buys a *contingent* joint and two-thirds annuity, the payment to his widow, Mary, will shift to two-thirds of what he had been receiving. But if Mary dies, John will continue to receive the full amount. The reduction is *contingent* on whether the primary or secondary annuitant is widowed.

On the other hand, if John buys a *symmetric* joint and two-thirds annuity, the payment will drop to two-thirds of the original amount when either Mary or John is widowed. So if Mary died, John's annuity would fall by one-third.

Most proposals for individual accounts in Social Security assume that all married retirees will buy symmetric joint and two-thirds survivor annuities. If they did, then widows and widowers would generally receive annuities equal to two-thirds of the couples' prior annuity income. The symmetry of this outcome has analytic appeal, but it is different from the rules that apply in private pensions, where John's own pension is not reduced if his wife dies. Survivor protection in life annuities also differs from how Social Security protects widows. The cost of paying Social Security to widows and widowers is shared among all contributors to Social Security. Consequently, individual retirees do not have to accept a reduced benefit in order to ensure continued payments to their widowed spouses.

How Much Do Inflation and Survivor Protections Cost?

If John wanted his annuity to increase by 3 percent per year as a partial hedge against inflation, his initial payment would start out lower—about 78 percent as much as if he had bought a fixed annuity that did not increase over time. If John added survivor protection so that the payments would last as long as either he or his 65-year-old wife, Mary, lived, his initial payment would start out lower still, about 63 percent of the fixed, single-life annuity (see Table 1, column 2). If instead, John opted for a symmetric, two-thirds joint-life annuity, his initial payment would not be reduced as much (72 percent instead of 63 percent of a fixed, single-life annuity), but he would have to accept a drop in his payment if Mary died, and he was the surviving annuitant.

Table 1: Effect on Annuity of Partial Inflation Adjustment and Two Examples of Survivor Protection—Retiree and Spouse Age 65

Type of Annuity (1)	% of fixed, single-life annunity (2)	% of single-life annunity with 3% increase (3)
Single-life annuity		
Fixed amount	100	– – –
With 3% annual increase	78	100
Joint-life with 100% for widowed spouse—3% annual increase		
Initial payment to retiree	63	81
Payment to widow(er)—100% of initial amount	63	81
Symmetric joint and two-thirds life annuity—3% annual increase		
Initial payment to retiree	72	93
Payment to widow(er)—two-thirds of initial payment	48	62

Note: Based on calculations provided by the Office of the Chief Actuary, Social Security Administration, to the National Academy of Social Insurance.

The last column of Table 1 shows the added cost of survivor protection compared with a single-life annuity that rises by 3 percent a year. If John wanted that partial inflation protection, but was unsure about whether to buy survivor protection, the added cost of continuing a full payment to his widow would reduce his initial payment to 81 percent of a single-life annuity. The cost of a two-thirds survivor annuity option would bring a smaller cut in his initial benefit (to 93 percent of a single-life annuity), but if his wife died his payment would drop to two-thirds of that amount, or about 62 percent of what a single-life annuity would have paid him.

Mary's age will also affect the size of the joint-life annuity that John can buy. In general, a younger spouse will lower the annuity payment because she or he is likely to receive survivor payments over more years. If Mary was only 53 years old when John bought a symmetric joint and two-thirds life annuity at age 65, his initial payment would start out lower (72 percent instead of 93 percent as much as a single-life annuity with the 3 percent annual increase) and would drop to two-thirds of that amount (about 52 percent of a single retiree's indexed annuity) if Mary died leaving him widowed, or if he died leaving Mary widowed.

Should Joint-Life Annuities Be Required?

There is no easy answer about whether to require married retirees to buy joint-life annuities. The reason for requiring survivor protection is to ensure that widows will have income for as long as they live. Without such a requirement, some retirees would forgo the survivor protection in order to have higher immediate income.

Social Security's financial shortfall is not large, and it can be fixed by increasing revenues, gradually scaling back benefits, or a combination of both.

Yet, requiring retirees to buy survivor protection could prove unpopular or seem unfair in some cases. For example, if 53-year-old Mary was terminally ill when John reached age 65, she would be unlikely to need or benefit from the survivor protection. Yet, if John was required to buy symmetric joint and two-thirds survivor protection, the couple would have 22 percent less income than if he had bought a single-life annuity. And after Mary died, John's annuity would amount to just 52 percent of what he could have had from a single-life annuity.

In other cases, the purchase of joint-life annuities could leave a widow feeling that the purchase was an unfortunate decision. For example, if John and Mary both bought symmetric joint and two-thirds life annuities at age 65 and John died shortly thereafter, Mary would end up with considerably less income than if they had delayed the annuity purchase. If they had not yet bought annuities when John died, Mary could inherit his entire account, combine it with her own, and buy a single-life annuity. Her survivor annuities would amount to about 62 percent of what the single-life annuity would pay her (see Table 1, column 3).

Conclusion

Social Security protects against each of the four financial risks retirees face: It pays benefits for as long as retirees live; the benefits are indexed for inflation; individuals do not bear investment risk; and survivor benefits for widowed spouses are automatic. These protections are particularly important for women because they live longer than men. Individual savings accounts, in and of themselves, do not cover these risks. Most proposals for shifting Social Security funds to personal accounts would require that retirees use their accounts to buy inflation-indexed life annuities and that married retirees buy annuities that continue to pay a reduced amount to widowed spouses. While some private annuities rise by a predictable amount each year, few (if any) are now indexed to keep pace with inflation. Many questions remain about how annuities in a revamped Social Security system would be designed, marketed, regulated, and insured.

Many options exist to balance Social Security's finances without shifting funds to personal accounts.[10] Social Security's financial shortfall is not large, and it can be fixed by increasing revenues, gradually scaling back benefits, or a combination of both. As private pensions shift away from providing defined benefits, it is important to keep Social Security's traditional protections intact.

NOTES

1. Butrica, Barbara A. and Cori E. Uccello. 2005. "How Will Boomer Women Fare at Retirement?" Washington, DC: The Urban Institute.

2. Citro, Constance F. and Robert T. Michael. 1995. *Measuring Poverty: A New Approach.* Washington, DC: National Academies Press.

3. McGarry, Kathleen and Robert F. Schoeni. 2005. "Medicare Gaps and Widow Poverty," *Social Security Bulletin*, Vol. 66, No. 1, Washington, DC: U.S. Social Security Administration, Office of Policy.

4. Spousal benefits are paid to widowers on the same terms as to widows. Such benefits are paid only to the extent they exceed the recipient's own benefit as a retired worker. Because wives generally earn less than husbands, recipients of spousal benefits are overwhelmingly women.

5. More actively marketed are *deferred annuities,* which are quite different. Deferred annuities are tax-favored investment products that do not protect against longevity risk. Deferred annuities can be converted to life annuities, but relatively few people do so. Of the $300 billion in new product sales by life insurance companies, only about 1.5 percent was direct sale of life annuities and another 3.5 percent involved conversion of deferred annuities to life annuities (LIMRA International, 2004).

6. Brown, Jeffery R. and Mark J. Warshawsky. 2001. "Longevity-Insured Retirement Distributions from Pension Plans: Market and Regulatory Issues," NBER Working Paper No. 8064. Cambridge, MA. National Bureau of Economic Research; Mackenzie, G.A. 2002. *The Distribution Phase of an Individual Accounts Reform of Social Security: The Potential Role for Private Sector Annuities, Working Paper*, March 19. Washington, DC: The Urban Institute.

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8. Some annuities are designed to pay a specified amount to heirs if the annuitant dies shortly after purchasing an annuity. These guarantee features lower the monthly amount that the annuitant receives.

9. *City of Los Angeles Department of Water & Power v. Manhart*, 435 U.S. 702 (1978).

10. Altman, Nancy J. 2005. *The Battle for Social Security*, Hoboken, NJ: John Wiley & Sons, Inc.; Diamond, Peter A. and Peter R. Orszag. 2003. *Saving Social Security: A Balanced Approach,* Washington, DC: The Brookings Institution Press; Reno, Virginia P. and Joni Lavery. 2005. *Options to Balance Social Security Funds Over the Next 75 Years*, Social Security Brief No. 18. Washington, DC: National Academy of Social Insurance, February.