

Oh, No! Not Another Government Program

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Should any of the readers of this essay believe I have been living under a rock for the last decade, let me assure them I am very aware of the current trend to bash government programs. Such sentiment continues to thrive regardless of the fact that any attempt to curtail Medicare or Social Security is a career-limiting move for politicians. With that as a back drop, I want to outline some very basic ideas regarding a potential new government program.

Our profession is engaged in seeking actuarially based solutions that reduce financial risk. Few risks are more prominent today than the risk of retirees outliving their retirement nest eggs. This has become magnified by increasing lifespans and the demise of traditional pensions. Many approaches and solutions have been advanced over the years, ranging from encouraging changes in behavior such as delaying retirement, to the creation and refinement of insurance products designed to provide lifetime income such as longevity insurance and guaranteed minimum benefit products. Though these solutions have value, they are by no means adequate or appropriate for the vast majority of retirees. Not everyone wants to or can delay retirement. These newer insurance products come with costs, restrictions and risks and are often complex.

Thus there continues to be a need to provide solutions to the challenge to be faced by those seniors fortunate to live many years into retirement but who may not be fortunate enough to have sufficient financial resources. This challenge is generally referred to as longevity risk. However, longevity risk can be viewed differently from the perspectives of different stakeholders. For the retiree, it is the risk of running out of money on account of living longer than the money lasts and thus having

to lower one's lifestyle below a reasonable or desired level. From an institutional point of view, such as a pension plan or insurance company, longevity risk can be viewed as the risk that benefit claims on annuity products exceed what has been reserved on account of underestimating life expectancy, thus leading to negative financial consequences. A third take on longevity risk is from the societal point of view; that is the financial impact on all members of society being confronted with an aged population with insufficient financial resources. Supporting a high percentage of the elder population reduces funds available for other societal needs or desires.

Longevity risk at the individual level can be mitigated through the use of risk pooling. Though solutions exist, they are far from ideal (and often unattractive) for reasons including high cost and complexity. If, however, pricing came down and the solutions more heavily utilized an increase in the longevity risk borne by institutions that guarantee these benefits (pension plans and insurance companies) increased utilization could follow. Should those institutions fail, the onus would then fall upon society to act as the ultimate back stop. Thus the risk ultimately falls upon us all when all else fails. We generally look to government to deal with such large societal issues and challenges, thus the logic for considering another government financial security program.

Key Principles

Such a program, a longevity insurance fund (LIF), could be designed based upon the following six key principles.

- **Must be well understood.** Far too many individuals lack an adequate understanding of longevity risk. They often plan for retirement based upon their normal life expectancy. At least 50 percent of these individuals will live beyond that expected age and thus could be prone to outliving their assets. For a longevity insurance program to succeed, it is crucial individuals understand that the purpose of the program is one of insurance, in this particular case, insurance covering the risk of living too long and depleting one's nest egg. Too many individuals lack a proper understanding of how insurance works and that insurance is a most cost-effective way to limit personal risk.
- **Must be universally available and voluntary.** Having a program that is available to all individuals has the benefit of creating public interest and

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support as well as providing for lower expenses. The voluntary nature of a program is clearly a dual-edged sword. It is likely to be better received by citizens at large but may not be used by those who could most benefit from it.

- **Must be considered fair.** For citizens to support and participate in a voluntary program, they must perceive it as fair. Since fair has no universally accepted meaning, this creates a challenge. A majority of our citizens would agree that a program is fair if some are not favored over others. Unfortunately, this is not always possible. More to be said about this later on in the essay.
- **Must be cost efficient in respect to both administrative expenses and benefit level.** Among the negatives associated with current insurance products designed to provide lifetime income are high expenses. These expenses include administrative, marketing, sales, company profits and hedging (mortality and investment). For a longevity insurance product to be successful, it needs to be as actuarially fair as possible; that is a high percentage (as close to 100 percent as possible) of premiums paid (adjusted with investment earnings) should be paid as benefits. In addition, expenses to run the program must be very low.
- **Must provide for secure benefits.** Another drawback of current private market longevity type products is counterparty risk, the possibility that insurers will not make good on their promises. This concern becomes even more magnified when the benefits may not be payable for decades. Whether these concerns are legitimate or not when applied to private sector products is not as much an issue as the perception by the potential buyers of these products. For a longevity insurance program to be successful, there needs to be no doubt that benefits will be paid as promised. Having the backing of the U.S. federal government is the single most secure approach currently available.
- **Must provide for some flexibility to account for varying circumstances.** There are clearly individuals that will have no need for longevity insurance.

This could be a result of having very large nest eggs or somewhat certain short life expectancies. There are others that have very modest nest eggs. Varying circumstances dictate a need to provide for some accommodations. However, having too much flexibility will complicate the program, which diminishes its value. The creation of a program that can accommodate different circumstances is critical to its success but must be done judiciously.

Hypothetical Program

A program might work as follows:¹

- **Eligibility.** Upon attainment of age 65 (or some other age), an individual is offered the option to make a contribution into the longevity insurance fund (LIF).
- **Contribution details.** Single payment from an IRA, 401(k) or personal funds. An additional alternative could be provided that would allow reduction in Social Security benefits to be used to fund the LIF.
- **Benefit payout age.** 80 to 85 (or some other range) at the election of the individual to be made at the time of the contribution.
- **Benefit payout amount.** Accumulated value of contribution to benefit payout age converted to a life annuity based on then current life expectancy (with projections to the extent appropriate) and a market discount rate reflecting then current expected payout period.
- **Prepayout age death benefit.** Full refund upon death within the first two years of contribution funding. Thereafter several options available; must be elected at time of funding.
- **Accumulated value determination.** The contribution funded plus interest. The determination of the interest crediting rate should reflect expected returns on a long-term basis in accordance with the actual investment policy. Additional amounts to be credited based on mortality experience of individual's cohort based on death benefit option selected.
- **Longevity insurance fund.** Structured in a similar manner to the Social Security Trust

¹ Note that the purpose of laying out a hypothetical program is to add context to the general concepts outlined above and hopefully stimulate discussion and in no way should be considered the author's definitive thoughts on the matter. There are a variety of complications that would need to be considered including, though not limited to, taxation, unisex table challenges and investment policy.

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Fund, however, investments not restricted to government securities. To the extent that it is cost effective and appropriate, the federal government could outsource investment management responsibilities.

As noted earlier, one only needs to look to the popularity of Social Security and Medicare to appreciate how much our citizens rely on the safety nets provided. Criticisms of these programs center on their cost, not their value. The program as outlined above has been designed to limit (though not fully eliminate) the exposure to the federal government as well as to limit the extent of intergenerational wealth transfer. Establishing it as a voluntary program would clearly make it more palatable to many citizens. However, it would have the impact of potentially limiting its use by many who could most benefit from it. Thus its success would be contingent upon an appreciation of the value of protecting one's financial situation should they attain extreme old age. Those that may be reluctant to part with some of their nest egg in hopes of maximizing the amounts that might be available to their heirs must be made aware of the financial strain they will place on their heirs if they live beyond life expectancy and run short of funds. Those retirees without heirs or a desire to leave funds to heirs need to consider what their future would be like in 20 years if their nest egg is depleted. They need to answer the question: Is it not worth sacrificing a small bit of my early year retiree living standard to protect against old age poverty? Alternatives might be considered that would use a default strategy to get individuals automatically covered. This could be done by automatically using a portion of Social Security benefits to fund the longevity benefit. Of course, individuals could opt out if they wish.

Program Fairness

A couple of comments on the issue of fairness are in order. The program as outlined does offer a sense of fairness from a generational point of view since it is designed to not require future generations to pay for current generations. However, within a generation, the issue of fairness is more complicated. Even though each retiree is paying for his or her own benefit, not all retirees will have the funds available to divert to the purchase of longevity insurance. In addition, life

expectancy differs based upon a multitude of factors ranging from gender to race. Thus the program will have greater value for some than others. I believe the way to consider the merits of such a program is not that it be universally fair but that it improve on the status quo. Though it is true that the program described above will do little or nothing for those retirees who have not accumulated sufficient retirement funds, it does serve a valuable purpose. The program as outlined in this essay is aimed at a different group of retirees—those who have accumulated meaningful funds for retirement but potentially not enough as a result of an uncertain lifespan. Those who have not accumulated sufficient funds will either need to work longer, turn to family for help or seek assistance from government programs designed for the indigent.

Conclusion

Some may feel that the idea of a universal longevity insurance program is a solution looking for a problem. Whether there will be millions of elderly citizens faced with significant declines in their standards of living in the future is not possible to predict with any certainty. However, trends seem to indicate an increasing possibility. It is possible that longevity improvements could cease or that retirement nest eggs will last longer than expected due to proper financial management and cooperative financial markets. Whether we wish to leave this to chance or initiate a program focused on dealing with this likely (though not certain) problem is a fair question. Though even if a crisis does not materialize, there are clear benefits to such a program. These include peace of mind for those who utilize it. In addition, knowing that funds are available in the future should a retiree survive to an advanced age may allow for a greater consumption of funds in the earlier stages of retirement. This both improves the personal retirement experience as well as aids the overall economy.

Though Social Security does provide lifetime income, it is seldom on its own sufficient to provide a respectable living standard for our elderly. The majority of our citizens will also rely on nest eggs that cannot last for multiple decades. Thus we need to create additional income sources for the super elderly. Fortunately, we have not yet reached the level of demographic danger that Japan and certain European countries are facing

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and thus this issue may not seem pressing at the moment; however, waiting for a crisis to be upon us before we take action would be foolish. Whether our citizens would agree that the elderly financial challenge warrants a new government program would likely depend on how it is presented and structured. Whether

private industry on its own can deliver a cost-efficient universal solution to the prospect of insufficient financial resources for the very elderly is doubtful. The reality is that certain challenges are too large for any entity other than the federal government. This is likely one of them.

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