



## THE CHALLENGES OF ENSURING RETIREMENT INCOME

*The risk of outliving retirement income is a growing challenge without easy solutions.*

If there's one topic on which there's general agreement it's that many people face the prospect of having less income than they will need to live comfortably — or even get by — after they retire. It's also a topic that has been studied extensively, sometimes with a focus on the root causes of the problem and sometimes with an eye to potential solutions.

For a straightforward overview of the available solutions and an analysis of those that people are selecting, you need look no further than a report from the US Government Accountability Office (GAO) titled "Retirement Income: Challenges for Ensuring Income throughout Retirement."

The report identifies three broad sources of potential retirement income in addition to Social Security. They are assets in defined benefit (DB) and defined contribution (DC) plans, private savings including IRAs and taxable accounts, and nonfinancial assets. To highlight why long-term income is a problem, the report points out that in 2007 half the households with someone between 55 and 64 had financial assets worth less than \$72,400, which is less than \$20,000 higher than the median annual earned income.

## USING LUMP SUM WITHDRAWALS

About half the private sector workforce participates in an employer plan. Roughly 30% are part of a DB and 70% part of a DC plan. All DC participants and an increasing percentage of DB participants can choose to take a lump sum withdrawal of their plan assets at retirement. They can roll the lump sum into an IRA or other self-directed plan or use it to purchase an income annuity.

### → A QUICK LOOK

- Just 6% of US households own annuities.
- A representative lifetime income annuity would have provided 25% more income than a bond in 2010.
- About half all recipients begin taking Social Security at 62.
- Postponing Social Security benefits from 62 to 70 would increase the average annual benefit by \$7,700.

Despite the assurance that they won't outlive annuity income, most people do not elect the annuity option. Only 6% of US households had annuities in 2007, and just 3% of the annuities sold in 2008 were fixed immediate annuities designed to provide lifetime income. In addition, just 1% of deferred annuities were annuitized, or converted to a stream of income, that year.

This is particularly surprising, given the GAO finding that annuities provide retirees more income than they would receive from conservative investments such as bonds or a US Treasury Inflation Protected Security (TIPS). In fact, based on April 2010 data from the Vanguard Group and the US Treasury, the annuity income was 25% higher than the bond income and 50% higher than a TIPS in representative cases.

One compelling explanation appears to be people's unwillingness to lose control over investment principal. Most lifetime annuities provide a fixed monthly income but no access to the principal. In contrast, with a long-term bond, the principal is returned at maturity even if neither the original buyer nor spouse is still alive. And, if the bond owner needs cash, the bond can be sold, even though the market price could be lower (or higher) than the purchase price.

Another factor is that most potential customers for annuities simply don't have enough money from cashing out of their DB or DC plans to buy an annuity that will provide enough income to live on. In addition, fixed immediate annuities lack inflation protection or provide it only in conjunction with reduced initial income. Variable immediate annuities, which address the inflation issue, are much more expensive to own than mutual funds purchased through an IRA.

Though this GAO study doesn't focus on the role that financial literacy could play in changing what appears to be a widespread rejection of annuities, it clearly suggests that education is part of the equation.

## DELAYING SOCIAL SECURITY

Another approach for providing adequate lifetime income is to delay taking Social Security benefits until age 70. At this age, the base amount a person is eligible to receive is fixed and no longer increases. Delaying payments doesn't work for everyone, of course. People who can't work and need the money probably have no choice but to start taking payments earlier. And waiting might not make sense for someone in ill health who might not live long enough to realize the fuller benefit.

But the difference in waiting eight years — from initial eligibility at 62 to maximum benefit at 70 — is eye-opening. Specifically, postponing payments for these years increases an average annual benefit from \$11,786 at 62 to \$19,487 at 70. Yet this approach to meeting retirement income shortfall is not particularly popular either. About half of the people eligible for Social Security benefits begin taking them at 62.

## USING PERSONAL ASSETS

When retirees have personal investment assets, whether in IRAs or taxable accounts, they are less likely to seek another source of lifetime income, such as an annuity. Rather, they use dividends, interest, and distributions to create an income stream and begin a gradual liquidation of principal if the income alone isn't adequate for their needs.

They are in no rush to take distributions from tax-deferred IRAs, though. Responses to an Investment Company Institute survey in 2008 showed that 64% of respondents were not planning to begin taking money out until they were compelled to do so, after they turned 70½. The wisdom of preserving tax-deferred growth has clearly gotten through to this group.

Retirees without personal investment assets, and those with savings of less than \$100,000, on the other hand, have limited options. That may help explain the Social Security Administration finding that, after Social Security, employment earnings are the second largest source of retirement income.

## WHAT IT ALL MEANS

In concluding, the GAO study highlights the importance of accumulating assets to provide adequate retirement income, and, for those people who prefer to keep assets in self-directed accounts, learning more about managing those assets to have adequate lifetime income.

Investment decisions are likely to mean the difference between a secure retirement and poverty, so increasing financial literacy is imperative.

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*The report "Retirement Income: Challenges for Ensuring Income throughout Retirement" was included in a document addressed to The Honorable Herb Kohn, Chairman of the Special Committee on Aging of the United States Senate on April 28, 2010 and signed by Charles Jeszeck, Acting Director for Education, Workforce, and Income Security Issues.*