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Taking a closer look at SeLFIES: Added thoughts, clarifications

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A reaction to a recent *P&I* editorial about the Standard-of-Living indexed, Forward-starting, Income-only Securities) proposal.

We read your editorial, "Tackling the issue of lifetime income" (May 13) and have some additional thoughts and clarifications about our SeLFIES (Standard-of-Living indexed, Forward-starting, Income-only Securities) proposal.

People have a preference for pensions that provide retirement benefit payments for life and never outlive their assets. In contrast, globally, individuals are being called upon to take greater responsibility for their own retirement, as employer defined benefits and government pension plans are either capped at levels well below a good retirement or completely replaced by defined contribution plans. Moreover, in many countries including the United States, a significant proportion of the population do not belong to any retirement plan, but they still need to save for retirement. SeLFIES are designed specifically to address the challenges of this new responsibility faced by working- and middle-class individuals worldwide, the majority of whom are totally unprepared to do so, and do not have access to good quality financial advice.

SeLFIES are designed to mimic pension payments and can be purchased directly by anyone (to create a type of "individual DB"). To address widespread financial illiteracy, SeLFIES require only the most basic information and offer choices for buyers of any educational strata. The two required inputs are anticipated date of retirement (i.e., the SeLFIES payment start date) and target income goal for a good retirement, which determines the number of SeLFIES needed to reach this goal.

How would this work? The federal government would issue a special bond that would pay a standard-of-living-adjusted coupon of $5 per year at retirement age for a period close to the average life expectancy of the economy, currently 20 years. Workers would fund their desired retirement income by buying a target number of SeLFIES, which would be determined by dividing the desired income by $5.

A commonly accepted retirement goal for a healthy pension is to be able to sustain the standard-of-living enjoyed in the latter part of working life, during retirement. Since SeLFIES payments are indexed to per capita consumption, they protect against future inflation and standard-of-living uncertainties. The buyer must simply set their goal at the level they currently live on, a number they already know and relate to in their everyday decisions. Since SeLFIES do not make payments until the retirement date, the buyer does not need to make any further transactions or decisions to reinvest coupon or principal payments during the entire accumulation period. One transaction, one time, for each SeLFIES purchased minimizes costs, decision effort and errors.

For SeLFIES to provide the same pattern of payments as a pension, they must address the lifetime payment feature and protect against longevity risk as the editorial notes. Working- and middle-class citizens who reach retirement age (e.g., age 65) are a diverse group: Some have economic responsibilities for several people and need to bequeath money to take care of their heirs. Others have no one else for whom they are responsible and, hence, have no motive to bequeath assets. For the latter, the annuity or a life pension is ideal because they maximize the benefit payment with no risk of running out and leave no "wasted" assets when they no longer need money. When the person reaches retirement, they have the best information as to their health (such as personal life expectancy vs. the population), they will know who they are responsible for besides themselves, and what other assets and commitments they have. With this information, they are best positioned to make an informed decision on how much to annuitize or not, and thereby implement a personalized plan for decumulation. Few people would commit to a deferred annuity during their work life because they do not know what their situation and needs will actually be when they get to retirement.

SeLFIES do not directly provide an embedded annuity feature of payments for life as they offer a fixed set of payments. But they do contribute to longevity risk protection for those who do eventually select full or partial annuitization at retirement, while providing decision flexibility to those who do not want to annuitize.

The design calls for the number of years of payout to equal a period somewhat longer than the life expectancy for the cohort population at retirement. For example, if life expectancy at age 65 is 20 years (age 85), then the specified-payment period on the SeLFIES might be set at 22 years (age 87). A well-run insurance company should be willing to exchange a life annuity with the same $5 indexed real payment for the specified term of $5 real payments on the SeLFIES. If so, then the retiree can simply exchange their SeLFIES for a life annuity with no extra payment and no reduction of retirement income level. Those retirees in different circumstances can adjust accordingly and potentially enjoy the built-in decumulation payments in SeLFIES with no further transactions.

Why would a well-diversified insurance company be willing to exchange one SeLFIES for a life annuity that pays $5 real/year until death (ignoring profit and cost considerations)? If the insurance company has insured a large group of diverse individuals in one cohort, then its net longevity realization should be close to the economy average of that cohort, with relatively low risk. SeLFIES delivered in the exchange is the perfect hedging instrument for the insurance company's aggregate liabilities of this cohort. The somewhat longer payments on the SeLFIES than expected (22 vs. 20 years) provide compensation to the insurance company for cost and profit. It becomes more interesting if the insurance company is also diversified across multiple cohorts. Hence, SeLFIES with a maturity a touch above the economy average could facilitate a much more efficient annuity market to ensure individual longevity risk mitigation. Both insurance companies and pension funds would be natural institutional buyers of large denomination SeLFIES and create price discovery through their auction.

SeLFIES could also serve a key role in implementing Professor Richard Thaler's recent proposal for using Social Security to provide annuity-like benefits as it will offer a liquid benchmark price for any real annuity offering, including one from Social Security. Furthermore, for retirement funding strategies that engage in risk-taking, one can easily see how a well-run asset management company can use a dynamic allocation strategy between risky assets and SeLFIES, with SeLFIES as the "risk-free" asset that locks in guaranteed retirement income — a highly desirable result. Current products today, including those with legal "safe harbor," offer no guarantee of achieving either a target wealth at retirement or a target retirement income. So, SeLFIES can greatly improve retirement funding security by completing the market. SeLFIES need to be created.

This leads to another clarification: SeLFIES can be issued by entities other than the federal government. For example, many states are launching so-called Secure Choice retirement plans for private-sector workers who don't have access to such plans through their employer — these states and municipalities could easily issue SeLFIES as part of their debt refunding or expansion, and we have discussed this with one state. SeLFIES offer synergistic cash flows to fund infrastructure — a challenge for most states — thereby allowing state and local governments to address two challenges with one innovation. The federal and state tax exemption would make their issuance for retirement funding in personal taxable accounts. We envision other (lower credit) issuers of SeLFIES, but the benefit of government issuance of SeLFIES is that credit risk is mitigated. With our aging population and "50 States of Gray," maybe this innovation emanates from one of these forward-thinking states, as opposed to "Waiting for DC." SeLFIES are designed to work in any country with a bond market.

The time to act is now — the longer the delay, the higher the cost of ensuring retirement security for future generations. SeLFIES are the new and improved "a-new-ity."

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Inline Play

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