Fixing the Wealth Depletion Phase of the Private Retirement System

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Retirement planning has two phases: a wealth accumulation phase followed by a wealth depletion phase. Considerable attention currently is being paid to phase 1 issues, with a focus on developing methods to encourage retirees-to-be to accumulate greater wealth. This is an important issue that deserves the attention it is receiving. But phase 2 is equally important, and has been neglected. It is the subject of this article.

The wealth depletion segment of the retirement system has three components: financial asset management, annuities and HECM reverse mortgages. All three have important dysfunctional features. Because they operate independently of each other, furthermore, potential synergies between them that could benefit retirees do not exist.

This article describes each of the systemic dysfunctions that now characterize the phase 2 retirement system. In each case we describe the modifications of the system that are needed to eliminate the dysfunction, how the modified system would work, and how it would benefit retirees. We place special emphasis on the now-absent synergies that would arise between the different components of the system.

The modified system we describe would be of little interest to billionaires or street people. The target retirees have wealth but not enough to assure that they won't run out if they live long enough. The typical retiree we use in our simulations is 63, has $1 million of financial assets and a paid-for house worth $500,000.

Little Useful Information Now Available to Retirees

The questions below are a small sample of those to which a retiree cannot find reliable answers in the current market.

- Will I do better drawing funds 1) entirely from financial assets or 2) use part of those assets to purchase an annuity that is deferred for a period before payouts begin?
- If I use both approaches, how do I combine them to avoid disruption in the availability of spendable funds?
- If I select a HECM reverse mortgage, would a credit line, a term payment or a tenure payment fit best into the other features of my retirement plan?
- How do I assure myself that my estate will be at or above some specified level?

The problem for the retiree is that the three retirement components are unconnected, and their advisory functions are correspondingly parochial. Very few money managers, for example, will recommend an annuity which would reduce the volume of assets they manage. Most annuity providers only sell annuities. Some reverse mortgage lenders also offer forward mortgages but they don't manage assets or sell annuities.

Since there are no entities that pull it all together for retirees, we have created one that we call the Retirement Funds Integrator or RFI. We expect to deploy it in the marketplace shortly. (At the time of writing, it had not yet been deployed).

RFI Would Deploy Two Fund Sources

RFI would divide the retiree's financial assets into two blocks. The first block would be used to provide spendable funds monthly for an initial pre-set period called the "deferment period". The second block would be used to purchase an annuity from an insurance company which will make monthly payments beginning at the end of the deferment period, for as long as the retiree lives.

Why two sources? Retirees who depend entirely on draws from financial assets can run out, either because they live too long, or their assets don't earn as much as expected, or some combination of both. By limiting dependence on financial assets to the early part of their retirement, the chances of running out are minimized while the annuity payments that take their place are guaranteed for life. The length of the early period can be as long as the retiree wants to make it up to 25 years. Insurers don't offer annuities deferred more than 25 years.

Annuity payments are enhanced by mortality sharing. The longer the deferment period, the larger the segment of the payments still being made that is offset by the early deaths of others.

RFI Would Develop Alternative Scenarios For Each Retiree

A scenario is a pattern of monthly draw amounts over the retiree's life span that has a set of options that affect these amounts. Those options include:

- The annuity deferment period.
- An assumed rate of return used to determine the initial draw amounts from financial assets during the deferment period.
- A "worst case" rate of return during the deferment period, and how a shortfall in draw amounts would be handled.
    - Allow the decline in draw amounts.
    - Offset the decline by drawing on a HECM credit line.
    - Offset the decline by tapping a "Set Aside" otherwise reserved for the estate.
- Whether draw amounts should increase annually as an inflation adjustment, and if so, at what increase?
- Whether the retiree plans to have other special needs during the deferment period that are sufficiently well defined to include in the spendable funds projection.
- Whether there is a fund set-aside for the estate, and if so, whether it is available for an emergency?

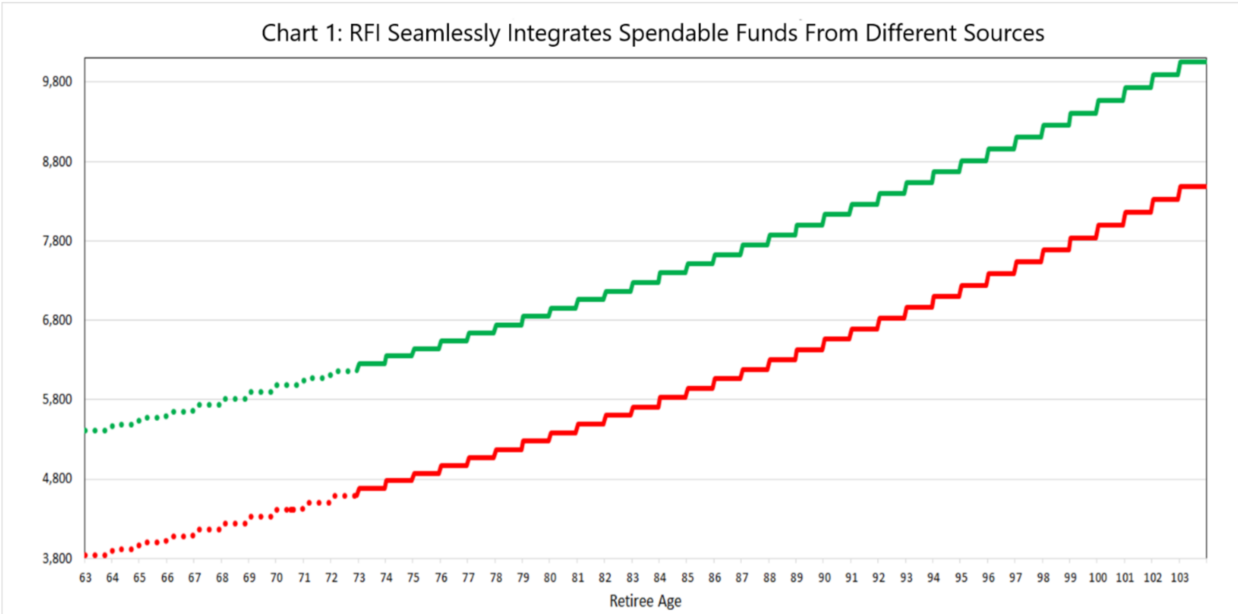
- Whether a HECM reverse mortgage is included in the plan as a supplementary source of spendable funds, a standby for emergencies, or both?

RFI would develop alternative scenarios that reflect the major issues faced by the retiree, for selection by the retiree.

RFI Would Seamlessly Integrate Funding From Different Sources

The two blocks of a phase 2 retirement plan must be seamlessly integrated. For example, the lower line on Chart 1 shows monthly draws from financial assets for 10 years, rising by 2% a year, followed by annuity payments that follow the same schedule. The chart distinguishes the fund source by showing the asset draws with a dotted line, and annuity payments with a solid line. The first annuity payment is 2% higher than the last draw from financial assets.

The higher line on Chart 1 integrates the funds shown on the lower line with the proceeds from a HECM term payment for 10 years. HECM term payments are seldom used because the payments suddenly stop at the end of the term, regardless of the needs of the retiree. But RFI would in effect convert the term payment into a larger annuity by using those payments to reduce draws from financial assets, which allows more of the assets to be used for annuity purchase.



RFI Would Solicit Competitive Prices of Annuities and HECMs

The absence of synergies between the components of phase 2 retirement plans is aggravated by the imperfect markets in which annuities and HECMs are delivered. In both cases, the product is extremely complicated, purchasers seldom transact more than once, they must do it at a time of life when they are no longer at their sharpest, with the result that sellers are transaction-oriented rather than relationship oriented.

To overcome these disadvantages to retirees, RFI would develop networks of annuity and HECM providers who would deliver their pricing structures to RFI. The best price in both markets would be deployed in developing scenarios for each retiree. An exception would be available for a retiree who prefers to select a provider by name.

Note that annuity and HECM providers would be the sources of revenue to RFI in the form of lead fees or commissions. These would be the quid quo for the delivery of qualified customers who understand their options and know exactly what they want.

RFI Would Substantially Enhance HECM Functionality

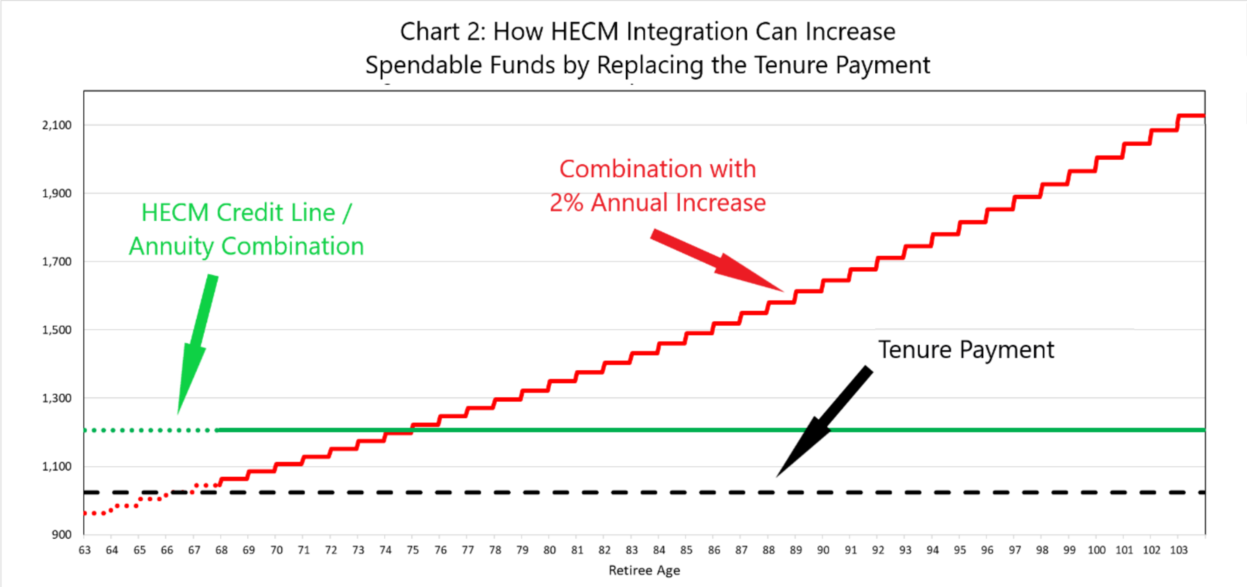
Reducing Losses on the HECM Program: The HECM reverse mortgage is an ingenious program that potentially meets a large variety of needs for the homeowning elderly that cannot be met in any other way. The problem is that most of the potential benefits arise from integration of HECMs into comprehensive retirement plans, which is barred by regulation. HUD has mandated that HECM lenders maintain "firewalls" to ensure that "individuals participating in the origination of a HECM mortgage have no involvement with any other financial or insurance product." (FHA Mortgagee Letter 2008-24).

While the rationale is not explicitly stated, it is clear from the context that HUD fears that complicated transactions expose older borrowers to increased vulnerability to abuse. HUD views annuities as especially troublesome for retirees. This rationale has no applicability to the competitive annuities provided in RFI retirement plans.

In addition to the loss of synergies, the stand-alone rule for HECMs has encouraged adverse selection of borrowers. The existing client pool is heavily weighted by those in desperate financial condition, who turn to a HECM as their last resort. Loss rates on such transactions are bound to be high.

A key to reducing losses is to make HECMs a mainstream program by integrating them into retirement plans. HECMs that are included in plans that fund retirees for life are less likely to cause loss to HUD than HECMs that provide temporary fund infusions.

Replacing the HECM Tenure Payment: A HECM tenure payment is a fixed amount paid monthly for as long as the retiree lives in the house. On September 9, 2019, the monthly tenure payment to a 63-year old with a house worth $500,000 was $1,024, shown as the lower horizontal line on Chart 2.



But RFI provides the retiree who owns this home with a better alternative. That is to take out the largest HECM credit line available, part of which is used to provide funds monthly for 5 years, and part to purchase an annuity that will provide funds beginning after 5 years. The horizontal line labeled "HECM Credit Line/Annuity Combination" in the chart is more than $200/month larger than the HECM tenure payment. Further, the larger payment terminates at life, rather than at the termination of the borrower's occupancy in the home. This option would be most attractive to retirees with little or no assets to commit to a retirement plan.

Why the 5-year annuity deferment? Only because that generated the largest payment. At different times or with different circumstances, a longer deferment might work better.

Another advantage of the HECM credit line/annuity combination is that it can be formulated into a rising payment with the rate of increase set by the retiree. The rising line on the chart grows at 2% a year. This valuable option is not available on a tenure payment.

There is one small drawback in this approach, and that is HUD's rule that no more than 60% of a credit line can be drawn in the first year.

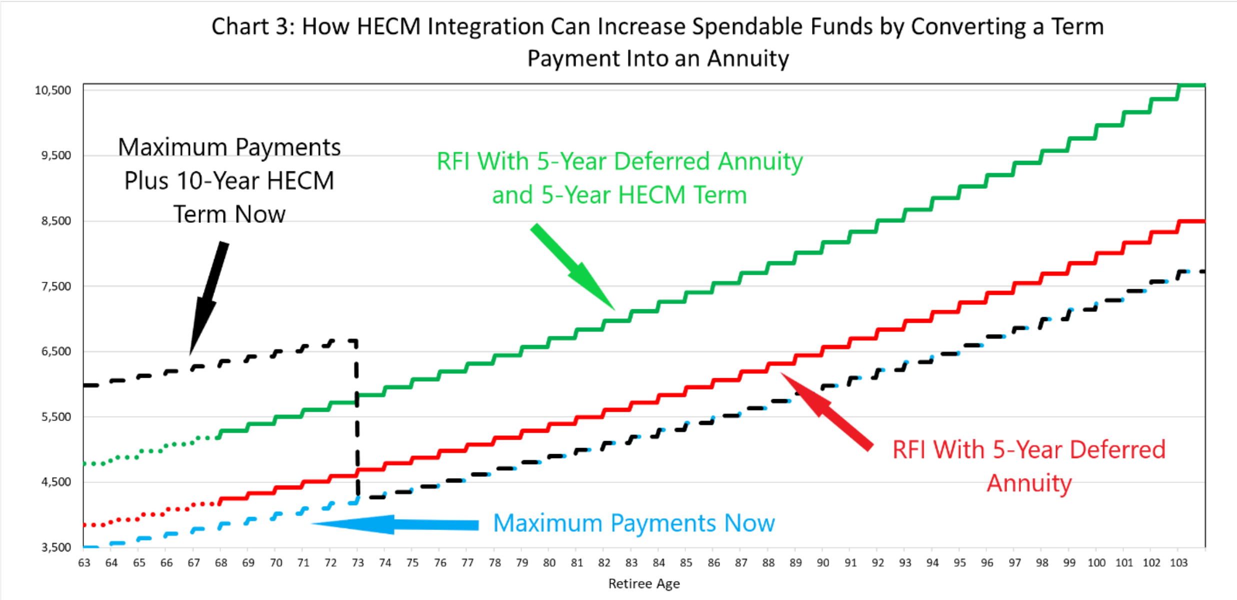
With a 5-year deferment, the annuity cost would exceed the limit. Since the purpose of the limit is to prevent borrowers from exhausting the entire credit line in the first year, logic would dictate that the limit be removed for this application. Until HUD makes this adjustment, retirees can use a deferment period of 9 years which will conform to the 60% rule, with only a very small decline in the spendable fund amount.

In sum, RFI would enable a cash-poor/house-rich retiree, looking for the largest possible safe monthly payment, to do better than the currently available option of a HECM monthly tenure payment. The better option is to draw the largest possible HECM credit line, use part of it to purchase a competitively-priced deferred annuity, and the balance to draw payments during the deferment period. The HECM credit line/annuity combination will be about 20% higher, and it runs for life rather than for the borrower's occupancy in the home.

Enhancing the HECM Term Payment: A HECM term payment is a fixed amount paid monthly for a specified period. It is little used because the payments stop abruptly regardless of need. Integrated with RFI, however, a term payment can be converted into a lifetime payment that is better than any option available to a retired homeowner with modest financial assets.

The lowest spendable funds line on Chart 3 is the best option now available to a retiree with $1 million of financial assets yielding 5% and a house worth $500,000, assuming a 2% per year inflation in spendable funds. The draw amount of 4.2% of the balance is the amount that exhausts the financial assets in year 104, given the 5% earnings rate. Call this the status quo pattern.

If the retiree then added a HECM term payment for 10 years to the status quo pattern, the spendable funds line would bulge for 10 years and then drop to the previous pattern. Few if any HECM borrowers would ever choose to do that.



With RFI, this retiree could use part of the financial assets to purchase an annuity deferred 5 years, with the remaining assets funding the payments for the first 5 years. The spendable funds line would be higher than the status quo pattern. The retiree might also opt to raise the spendable funds line by taking a 5-year term HECM. Instead of a 5-year bulge in payments, however, RFI would convert it into higher lifetime payments.

In sum, RFI would enable homeowner retirees with modest financial assets to obtain larger spendable funds over their lives by using a HECM term payment to enlarge an annuity. [1]

Using a HECM to Hedge Investment Risk: In the two cases discussed above, using RFI to integrate HECMs into retirement plans resulted in larger monthly draws to the retiree than would be possible with the

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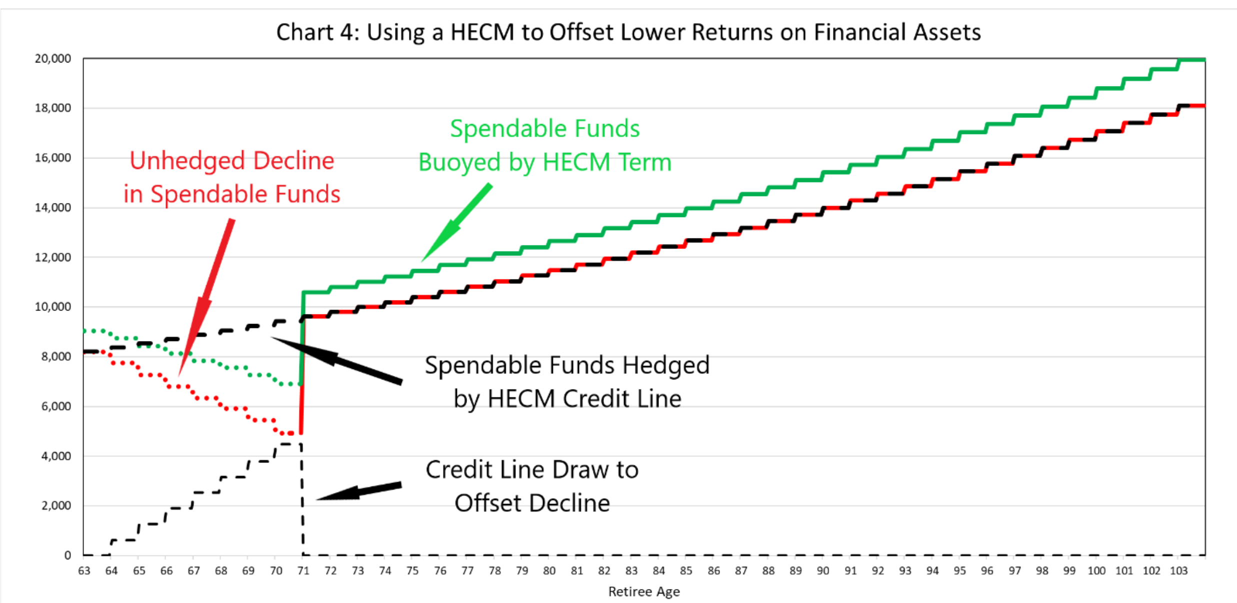
[1] Those curious as to how this alchemy works, the term payments are used to supplement draws from financial assets during the deferment period, which allows a larger portion of the assets to be used to purchase a larger annuity.

HECM as a stand-alone. Those applications would be particularly useful to retirees with very modest financial assets.

This application is directed to retirees with more assets (we assume $2 million) invested entirely in equities in order to generate a high rate of return. The problem with this policy is that the high expected return on equities has a high variance of returns. A prudent retiree needs to confront the possibility that the rate of return realized on the retiree's assets will be substantially less than expected.

The challenge is illustrated in Chart 4 which assumes an annuity deferment period of 8 years, an assumed rate of return of 10%, and a realized rate of 2%. There are two ways in which a HECM can offset the lower asset returns in order to stabilize fund flows to retirees. One way is to take a HECM term payment with a term equal to the annuity deferment period. This reduces but does not eliminate the payment shortfall during the deferment period, enhancing the return during the annuity period.



The second method of dealing with the shortfall in spendable funds is to draw a credit line as needed to offset it. In contrast to a term payment, which entails a full commitment at the outset, a credit line draw can be adjusted each year to the exact amount needed to offset a rate of return on financial assets that is lower than expected. If the line is large enough, as it is in Chart 4, spendable funds can be restored to what it would be if the assumed rate of return on assets remained unchanged. Any excess could be used in the future.

Retiree Discretion in Future Spending Patterns

RFI provides retirees with a variety of options regarding how they draw funds during the deferment period. Inflation adjustments can be combined with U-shaped and inverse U-shaped patterns that are adjustable. In addition, the retiree can specify additional amounts that will be needed in specific months. By defining alternative scenarios with and without such adjustments, the retiree sees at a glance how additional draws in the early years will affect available funds in later years.

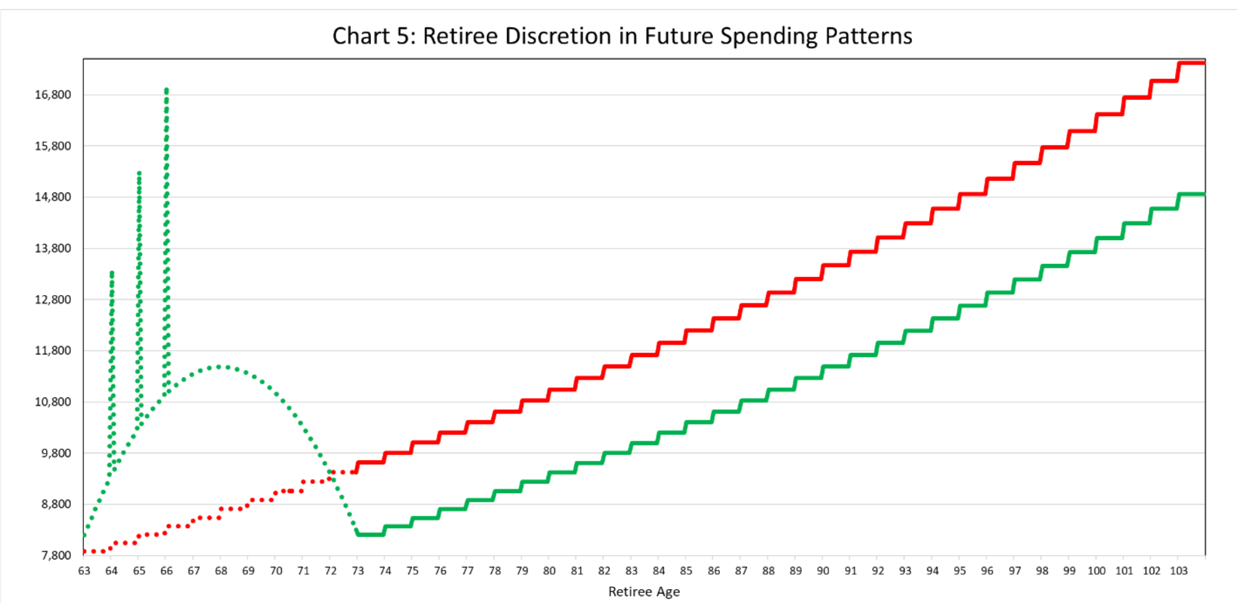


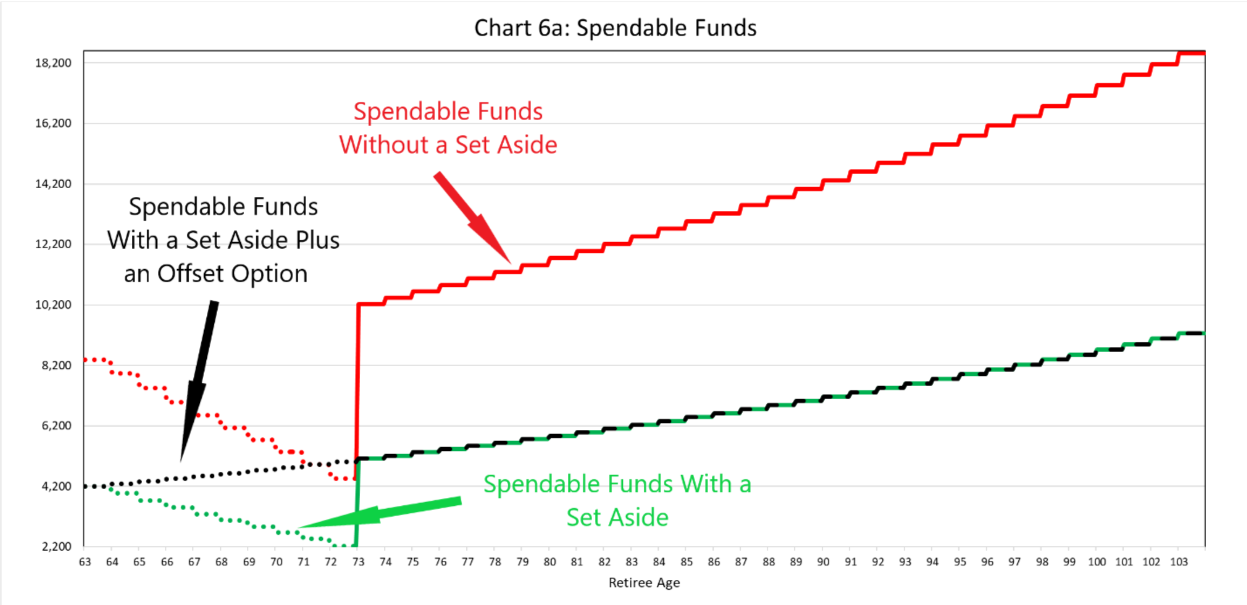
Chart 5 provides an example. The retiree plans a world-wide trip that will require rising payments for 5 years after which they will decline. In addition, the retiree plans additional spending of $4,000. $5,000 and

$6,000 in years 1, 2 and 3. The two lines show payments with and without the adjustments.

Planning an Estate

RFI will allow retirees to exercise discretion over the size of their estates, instead of leaving it strictly to chance. They exercise control by designating a specified portion of their assets as a "Set Aside" that will not be used to draw funds monthly or to purchase a deferred annuity. Depending on its size, the Set Aside will reduce available monthly payments and increase the estate value. However, the retiree can over-ride this option if needed to offset shortfalls in spendable funds.

This is illustrated by Chart 6a and 6b which assume that the retiree has $2 million of assets on which she expects to earn a return of 10%, and purchases an annuity with payment deferred 10 years. We assume that her timing was bad and her assets earned only 2% over that period. In the absence of a Set Aside, her estate value would be the lowest line on the lower chart while her spendable funds would be the highest line on the upper chart. If she had allocated $1 million to a Set Aside, her spendable funds would be lower and her estate value higher. And if she tapped the Set Aside to offset the rate decline, her spendable funds would be stabilized and her estate value would be a little lower.



Concluding Comment

Phase 1 of the retirement crisis, inadequate savings by retirees-to-be during working years, will require decades to change established habits. Phase 2, involving the best possible uses of the savings that exist, could be substantially improved in a very short time. This article shows how.