

# Income Flooring: Is Annuitization the Right Strategy?

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Managing the post-retirement payout period is a major topic today. Professionals generally agree on the importance of long-term planning and having an income plan, but not on the specifics of how to get there. “Income flooring”<sup>1</sup> and annuitization are two common topics in the discussions. There were recent discussions of income flooring and annuitization among retirement experts on the Society of Actuaries Post-Retirement Needs and Risks listserv. This essay reflects a compilation of issues raised during the discussion together with SOA research on related topics and my additions to the discussion based on more than twenty years of work focusing on these issues. An extensive discussion was started after a blog post<sup>2</sup> written by an individual was cited. That individual developed a comprehensive retirement income plan which included an income floor created by buying single premium immediate annuities (SPIAs) with about 1/3 of his assets and combining those with his Social Security benefits.

## Big Picture of Findings

Income flooring is a good idea. It is particularly important for middle income people. However, many people do not have an adequate emergency fund or much in the way of financial assets. As we have seen with COVID-19 in the first part of 2020, emergency funds are critical and many Americans do not have adequate funds. The first priority for financial assets is to have an emergency fund and then the establishment of an income floor should be considered.

The discussants had different opinions on most points. They generally seemed to accept the desirability of income flooring, but they did not agree on implementation. They also seemed to agree that for most people, deferring Social Security claiming is a good way to increase guaranteed lifetime income. They definitely had different perspectives on the advisability of buying annuities, on how much annuity was the right amount, and on whether there was a general solution that works for most people.

Some of the themes that generated considerable discussion or are important based on prior research are:

- Different financial products and approaches can be used for income flooring.
- There is a need for inflation protection and there are different methods of inflation protection.
- There are pros and cons of annuities.
- One must acknowledge consumer preferences and knowledge.
- It is important to link other risks and assets to the income flooring discussion.
- Social Security issues and claiming are complicated and important to understand.
- There is a role for employee benefit plans and plan sponsors.

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<sup>1</sup> Income flooring is establishing a lifetime income stream to cover a floor of minimum required expenses.

<sup>2</sup> <https://www.newretirement.com/retirement/establishing-retirement-income-using-an-income-floor/>

## Different Financial Products and Approaches that Can Be Used for Income Flooring

A variety of approaches can be used in a flooring strategy:

- Deferral of Social Security commencement
- Election of income options in defined benefit plans
- Use of withdrawals from defined contribution plans, IRAs and other personal savings accounts
- Immediate life annuities, possibly with fixed rate increases as a partial cost-of-living adjustment
- Longevity insurance or advanced life deferred annuities (QLACs)
- Bond or annuity ladders
- Treasury inflation-protected securities (TIPS) or I Bonds
- Cutting expenses to reduce the income floor needed

The Society of Actuaries offers a [Decision Brief](#) and a series of research which helps the reader understand the trade-offs between different income options.

Deferring Social Security is the first strategy that would usually be recommended because of the favorable provisions for deferred Social Security payments. This is discussed further below.

Single premium immediate annuities (SPIAs) provide a guaranteed lifetime income starting at the time of purchase, and they are the easiest type of annuity to compare. They can be provided on a joint life basis and can include a death benefit in the form of payments guaranteed for a minimum period of years. A SPIA without a minimum death benefit provides for the most longevity protection yet surrenders liquidity. The discussion pointed out that SPIAs can be purchased through the use of a bidding service which often enables the purchaser to get a more advantageous price.

Variable annuities sold at earlier ages may include guaranteed minimum payments in the form of income. These are commonly referred to as Guaranteed Life Withdrawal Benefits (GLWBs), and they provide some longevity protection and some liquidity, and may have substantial fees. These annuities have more market acceptance than SPIAs due to their flexibility. GLWB provisions can be built into investment options for employer-sponsored defined contribution plans offering a way to buy longevity protection while still working. These products offer a variety of investments and floor guarantees on returns for a price.<sup>3</sup>

Advanced life deferred annuities (QLACs), also called longevity insurance, are deferred annuities purchased at an earlier age and making payments starting at a high age such as 80 or 85. They have a lot of theoretical appeal. One discussant pointed out that they are an efficient way to ensure retirement income lasts into the tail of the survival curve. They can also be helpful in providing some funds for long-term care. They have not had much market acceptance even though they cost considerably less than SPIAs for a given amount of income.

Bond ladders are an approach where bonds maturing at different times are used to create an income payout over time with little market risk. Returns on bonds are based on the market when the arrangement

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<sup>3</sup> In the SOA online discussion, one discussant mentioned that his company sold about \$20 billion of GLWB annuities and \$20 million of SPIAs in the same time period.

is set up. They offer income but not longevity protection. They can be combined with a QLAC for longevity protection. Professional help would be needed by most individuals to set up such an arrangement and it would not be suitable for the average person with a modest amount of assets.

A very common method of withdrawing money from Individual Retirement Accounts and defined contribution plans is the Required Minimum Distribution. This does not directly address income flooring, but it provides an income in addition to Social Security although it is not guaranteed.

## The Need for Inflation Protection and Different Methods of Inflation Protection

Inflation protection is an important issue. Social Security includes built-in lifetime inflation protection. The amount of initial Social Security monthly income can be increased by claiming it later. It is unclear whether inflation protection is necessary for the entire amount of minimum income covered by flooring since many households reduce expenses during retirement.

There are currently no (or almost no) inflation-protected SPIAs on the market. TIPS, I Bonds, and longevity insurance in combination are an option for someone who wants inflation protection.

SPIAs can be laddered for inflation protection and QLACs can be used for partial inflation protection. (Laddering of SPIAs would not be practical unless there are significant assets and a knowledgeable buyer.)

Inflation risk can also be managed by spending less. SOA and other research show that household spending (other than health care) tends to drop with increasing age.

## Pros and Cons of Annuities

SPIAs provide good longevity protection and have a valuable place in establishing an income floor, but people's views of them vary greatly. The online discussion brought out some advantages and some of the reasons for reluctance to buy annuities. Some of the advantages in addition to longevity protection are:

- Protection against bad decisions due to cognitive decline later in retirement.
- A way of ensuring regular income to a surviving spouse who may not have the background or interest to make financial decisions.
- A way of providing an inheritance to a spendthrift heir.
- Protection from creditors, since only the income can be attached.
- Protection from fraud and scammers targeting large pools of assets.

Annuities include guarantees that are not available in arrangements that pay out investment funds over time. It is very likely that many people do not understand the guarantees and their value.

There are very rational reasons why people would prefer not to buy an annuity and not to make an irrevocable decision:

- A preference to keep funds in a liquid form so that they can be used earlier if needed. For people who do not have adequate emergency funds and long-term care insurance or another funding source for long-term care, this availability is very important.
- A preference to keep funds in a form so that the remainder will not be lost on early death.

- An opinion that the buyer can earn a better return on their money by investing it differently. This may or may not work out and it involves risk.
- Exchanging an asset for a guaranteed monthly income stream may make the buyer feel less wealthy. Behavioral finance tells us that this can be a big influence in decision making.
- There are few marketplace options that offer inflation protection, so the longevity protection provided is incomplete.
- Financial products are often hard to understand and compare.
- Annuity products may be viewed as expensive.

## Consumer Preferences and Knowledge

Retirement savings plans can be positioned primarily as asset accumulation or income replacement plans. This positioning is a critical issue for the future since it helps to shape participant expectations for the spenddown period.

There are many gaps in consumer knowledge and decisions are often driven by behavioral preferences rather than rational economic analysis. Consumer preferences often do not match what economists and actuaries think is the ideal strategy. The ideal strategy for income flooring is often set forth based on the assumption that the retiree wants to maintain pre-retirement living standards without recognizing actual spending patterns and retiree preferences with regard to asset spend down. However, many retirees have reduced expenses and are quite resilient. (Average household expenses, except health care, tend to go down with increasing age.) Retirees have repeatedly told the Society of Actuaries in various research studies that they prefer not to spend down their assets. Turning over assets to an insurance company to buy an annuity does not match what many consumers say they prefer.

Consumers often do not have a long-term planning horizon or much understanding of the value of guarantees. Without a long-term planning horizon, it seems unlikely that they will do much to develop a long-term income floor.

## Linking Other Risks and Assets to the Income Flooring Discussion

People are subject to a wide variety of retirement risks. Products that offer risk protection may cover one or more risks, but they generally do not cover a wide range of risks. What looks good when you look at a part of the picture may not work so well when looking at the total picture. SOA focus groups indicated that many people want to hold on to assets and deal with risks as they occur – this enables them to allocate the asset to the risk that occurs first.

The income flooring discussion may be part of a holistic discussion about retirement security or it may take place in a narrow context, focusing on income only and not on the broad range of retirement risks.<sup>4</sup> Risks include outliving assets, unexpected long-term care expenses, unexpected health expenses and many more. Adequate liquidity partly depends on what financial products are available to provide coverage for a variety of risks.

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<sup>4</sup> For an overall overview of retirement risks and their management, see Society of Actuaries, *Managing Post-Retirement Risks, Strategies for a Secure Retirement*, 2020. <https://www.soa.org/resources/research-reports/2020/post-retirement-strategies-secure-chart/>

Society of Actuaries' research has shown that many Americans at all ages are financially fragile and lack adequate emergency funds.<sup>5</sup> The first step is to have an adequate emergency fund. Recent thinking is that this might be enough liquid assets to cover expenses for six to 12 months.

For many, probably the majority of the retired population if we exclude the top quintile, the value of their house exceeds the value of other financial assets at retirement. A house that is paid for is also a possible resource to help fund retirement. Home equity can be used by downsizing to a smaller house, or taking a reverse mortgage, or refinancing. A reverse mortgage can be arranged so that funds are available if needed. This could be used to supplement income flooring.

My view is that it is advisable to consider the entire picture when deciding how much income floor is needed and how to achieve it.

## Social Security Issues

For the average person, Social Security represents the majority of the lifetime retirement income they will receive. Social Security monthly income benefits are inflation-adjusted annuities. They are paid for life and increase each year for the cost-of-living. The benefits are calculated based on the age at which a person retires, their work history and, if they are married, the benefit situation of their spouse.

Benefits are calculated at "full retirement age." The benefits are increased for each month after that until age 70 at about 8% per year. Benefits are reduced for each month payment starts before full retirement age. The increase from delaying retirement is greater than what would be produced by current market rates for annuities. The reduction for retirement before full retirement age is also greater than what would be produced by current market rates. The increases and reductions are set by law. (The magnitude of the adjustment factors is in part due to the economic environment when the Social Security legislation was passed that set the current benefit structure.) The online discussion repeatedly focused on delaying Social Security benefits as a way to get a larger benefit that will increase with inflation. This was one of the few points on which there was general agreement.

## Role of Employee Benefit Plans and Plan Sponsors

Income from a defined benefit plan can be a valuable part of an income floor. Some plans offer a lump sum option instead of income. Caution is urged in selecting the lump sum. The Society of Actuaries has a [Decision Brief](#) enabling the reader to understand some of the trade-offs involved in the choice.

The discussion suggested that actuaries should be more involved in defined contribution plans, and their design. Employees have been accustomed to the strong promotion of default options in 401(k) and other employer-sponsored retirement savings programs. Default options commonly used include auto-enrollment, auto-escalation, and investment defaults, but not defaults for income creation during the payout period. More attention is needed on plan structures and the payout period. Some financial products offer the potential to build an income option with a guarantee into a target date fund and allow

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<sup>5</sup> Society of Actuaries, *Financial Perspectives on Aging and Retirement Across the Generations*, 2018, <https://www.soa.org/resources/research-reports/2018/financial-perspectives-aging-retirement/>

the plan participant in a 401(k) to buy deferred income, which can be activated at different times. This is an interesting design for promoting income as an option in a 401(k).

## Conclusion

Having a plan that will provide lifetime income to cover minimum expenses is a very good idea. Social Security does much of this for many people. More work is needed to understand all of the issues this goal entails and how to help consumers develop and implement such plans. The SOA discussion indicated acceptance of the idea of income flooring but some disagreement about how to get there. And consumers often don't plan and may not prefer longer term solutions, particularly in light of the many risks they face and a desire to hold on to assets. This essay does not focus on policy changes that can promote more income options in retirement, but this is also an important topic moving forward. Policy influences the way employee benefit plans and financial products are structured and information is provided to plan participants and consumers.

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