Pensions - Financing.

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The Contribution of Private Insurance to the Security of the Aged

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The warm human side of gerontology is high-lighted by such things as a recent news item describing the New Hampshire grandmother of 89 who won a "glamorous grandmother" contest, or even by my own mother who recently made her first airplane flight at 84 and told me afterward that she would never again travel any other way. But, in order that these older people may lead reasonably happy and somewhat useful lives, it is necessary that the cold financial facts of life after retirement be made known. Here are some of those facts.

The era, when the small group of aged individuals in the population could be supported at home by its children, is gone. The day of big houses, where grandpa or grandma could be given an extra room, is gone. The day of small farms and small enterprises where grandpa and grandma could lend a helping hand and thus pay for their "keep", is also gone. In our present increasingly urban civilization, where cash money is essential for existence, there are basically just two ways of supporting the aged:

1. By their own individual savings, in the form of investments, insurance, or private pension plans.

2. By contributions from the general working population in the form of Social Security benefits or other similar devices.

With the increasing percentage of aged persons in the population, any form of complete and enforced support by the producing groups might become such a burden on production that youth would rebel and refuse to maintain a governmental pension or social security system. For example, in the United States in 1900 only 1 person out of every 25 was age 65 or over; in 1950 1 person out of every 12 was age 65 or over; some estimates by the Social Security Board anticipate that in the year 2000 1 person out of every 6 will be age 65 or over.

Practically all forms of government aid are based on a pay-as-you-go philosophy. (Social Security (O.A.S.I.) as presently constituted claims to be on an actuarial-reserve basis, but I cannot feel that that claim is justified.) A pay-as-you-go system uses current income to pay current benefits; it does not save up in advance for benefit payments. Basically, therefore, it redistributes production by withholding from the producer and giving to the non-producer; it does not add to the total production.

Private insurance plans, on the contrary, provide in advance for benefit payments. The person who will ultimately receive the benefits, pays for them.

He foregoes temporarily some of the results of his own production so that he or his beneficiary may receive them later. The savings element inherent in private insurance increases the net productivity of the nation because the savings are invested in whole or in part in capital goods which are tools of production.

It behooves each working generation, therefore, in its own enlightened self-interest, to provide as much as possible for its own old age. By providing in advance, it helps build up the productive capacity of the nation. Thus, as the percentage of non-workers to workers increases, production does not decrease but is shifted from worker to machine and remains at a level sufficient for the wants of all.

Under present conditions, it is probably a Utopian dream to think of complete self-sufficiency for the aged through their own savings. However, a floor of protection such as is provided by the present level of Social Security benefits might well be maintained without becoming too great a tax burden, and this together with private savings should permit of supporting the aged in reasonable comfort.

Private insurance and private pension plans can provide a sufficient supplement to Social Security without too great a present cost and without wrecking the economy through pyramiding savings to an amount in excess of investment outlets. They can do it, that is, if each worker realizes early enough in life that it is his own responsibility to help provide for himself and if he thereupon enters upon a reasonable savings program and one which does not contemplate too early a retirement.

That problem of when a person is "old", when he is ready for retirement, is one of the hardest ones facing pension planners and insurance experts. The problem should be faced in advance of retirement, because the amount of money necessary to be saved to provide a specified pension varies very greatly with the age at which the pension is to be granted. The Social Security Act infers that age 65 is the threshold of old age and hence the "normal" age for retirement. A lot of private pension plans and insurance programs have gone along with the concept as being the easiest way out. However, the armed services of our government and many fire and police pension plans provide for at least optional retirement after 20 years' service. Thus we may find an ex-sailor of 37 who has completed his life's work and has been retired by a grateful government. Retirement at 37 or 40 seems silly to most of us, but actually some employees do need to be retired by 50. Most, however, still produce excellent work at 70.

Many employees come up to retirement age psychologically unprepared to stop work; they have developed no avocations, no hobbies, and no outside interests. The recent motion picture, "As Young as You Feel", is based on the rather startling method by which the "hero", a 65 year old printer, goes about getting his job back after his compulsory retirement. Nowadays the loss of production caused by premature retirement of skilled employees may be a serious blow to the defense effort of the country. Many older employees are in jobs where they can do as good and as rapid work as they would if they were 20 years younger.

In direct contradistinction to the situation where an insurance program or a pension plan contemplates earlier retirement than is necessary or desirable, there is the situation where the individual himself wants to retire long before his productive capacities should be lost by society. The "20 year retirement", already described, is a result of a combination of demands by the individual coupled with what appears to be a mistaken idea of the armed services that they can't use many people over 40.

But, assuming the "age-at-retirement" problem can be settled, let us examine the insurance methods for providing financial security for old age. Basically there are 2 approaches:

(1) The "rugged-individualist" approach, where the individual purchases an annuity contract from a life insurance company.

(2) The group approach, where an employer cooperates with his employees in establishing a pension plan. The employer contributes a substantial portion of the cost and thus helps guarantee the permanency of the plan; however, the employer's contributions must come from the income of the business which might otherwise be available to pay higher wages.

Under the individual-contract approach private insurance offers a variety of annuity plans, often ornamented with sales features providing supplemental insurance before retirement and "refunds" to a beneficiary or survivor after retirement. However, whatever they are called, these contracts are essentially annual premium deferred annuities whereby the annuitant pays a level periodic payment, or premium, to the insurance company during his working years and then collects a life annuity starting at some predetermined retirement age.

The simplest form of such a contract might, for example, be entered into by a young man of 30. He might decide that he would like to try to retire at 65. He would, therefore, have to pay a typical insurance company a premium of approximately $24 a month from age 30 to age 65 for each $100 a month of life income starting at age 65. The company would provide for the refund of premiums paid, to a beneficiary, in the event of the annuitant's premature death before retirement. Basically, however, the contract would be an exchange of $24 a month to age 65 for $100 a month for life after 65. Total premiums paid from ages 30 to 65 would amount to about $10,000. Even this substantial sum alone would not equal the single premium needed to provide a life annuity during the average expectation of life after age 65. The difference would be made up from interest earnings which the insurance company would receive on the accumulated premiums prior to the time they were needed to meet the annuity payments.

Actually the single one-time premium necessary to be paid an insurance company by a man of age 65 to permit the company to guarantee him a monthly life annuity of $100, starting immediately, would amount to about $15,900. This is a large amount of money; but $100 payable each month ($1200 a year) is no picayunish thing. The average male life expectancy at age 65, according to one of our most-used annuitant mortality tables, is 14.4 years. The product of 14.4 times $1200 gives a total average expected annuity payment of $17,280. So you can see that provisions for old-age cash income run into substantial amounts of money.

We are here dealing with sums of money equivalent to $15,900 just to provide $100 a month retirement income to one individual, through an insurance company. Surely, you may ask, our Social Security Act does not contemplate any such vast sums of money as would be indicated by the product of $15,900 times the working population of the United States. But that is exactly what Social Security will be faced with. It will not have such enormous sums on hand at any one time but it will have moral obligations equivalent to those amounts and its eventual annual pension outlay on a pay-as-you-go basis may be in the neighborhood of 10 billions of dollars. There is nothing magic about any form of pension system. If a certain amount of money has to be paid out to pensioners, that same amount of money must be collected somewhere. In private insurance the money is collected in advance in the form of premiums and interest earnings. In Social Security the money is collected in the form of taxes with relatively little interest available. There may be some difference in expense charges between private insurance and Social Security, but the main item of cost in the two systems is identical; it is the basic cost of providing cash monthly incomes to old people.

To return to the example of our illustrative strong-willed individualist of 30! If he were willing to postpone his proposed retirement age to 70, it would only cost him a premium of perhaps $17 a month from age 30 to age 70 to pay for a $100 a month annuity starting at 70. The five-year longer premium paying period, coupled with the shorter life expectancy at 70, results in the reduction in premiums from $24 to $17; this is a reduction of about 30%. The financial effect of delayed retirement is very great.

Not only is it psychologically desirable to keep our older citizens at work as long as they are physically able, but such a program reduces enormously the strain on our economy. Many insurance contracts are flexible enough so that, even if they originally contemplated a pre-determined retirement age, premiums may later be continued beyond that age in order to provide a larger income at a later retirement age.

A popular variation, of the insurance industry's deferred annuity, is a contract which provides for life insurance prior to retirement with automatic conversion to an annuity at retirement age. The amount of insurance is normally in the ratio of $1000 to each eventual $10 unit of monthly retirement income. Such a contract meets the dual objectives of protection for a wage-earner's family during his working years and retirement income thereafter. Similar objectives can be met, perhaps a little more haphazardly but still quite effectively, by applying the cash value of any life insurance policy at retirement under one of the annuity settlement provisions in the policy. Almost any life insurance policy with a reasonable amount of cash value can thus be easily converted into an annuity when the need arises.

Any retirement program must be meshed with the individual's need for protection for his family. Normally the need for such protection decreases with advancing age, hence the conversion of some life insurance into an annuity is a logical step and is not unfair to the family. A certain amount of protection for the family can even be continued under an annuity. By means of a refund or survivorship feature, provision may be made for the annuity continuing to a beneficiary after the death of the original annuitant. Such a refund or survivorship feature results in a somewhat smaller original annuity than would be the case if a "life-only" annuity were used, but it does permit of provision for dependents.

We have had to admit that an illustrative $24 a month premium payment program, between ages 30 and 65, presupposes a strong-willed individual who lets neither the desire for a new automobile, nor for a new 20" television set, interfere with his annuity savings. A more indirect and more painless method of providing for the future, still through private channels, has been developed primarily in the last 20 years. This is through private pension plans which cover groups of individuals.

The most usual form of such a pension plan covers employees of one employer. The employer normally pays from 50% to 100% of the cost. When employees do contribute, it is on a salary-deduction basis and hence relatively painless and yet quite hard to avoid. Such pension plans are embodied in formal documents setting out in detail conditions of employee eligibility, formulas for pensions and other benefits, and provisions for funding. Annuity payments are usually determined by a formula based on both years of service with the employer and amount of salary; thus the employer pays most with respect to his longer-service and presumably more valuable employees.

A sociological aim in pension planning is to provide sufficient retirement income to maintain a decent standard of living. This can usually be well below the income prior to retirement because of the reduced needs and expenses of non-working people and their larger income-tax exemptions. An overall retirement income of 50% to 60%, of income prior to retirement, is usually considered adequate. This includes both Social Security and private pension income. Thus, for a $300 a month employee, a private pension plan may aim at a $75 to $100 a month retirement annuity upon the assumption that an additional $75 a month will be payable as the primary Social Security benefit.

A private pension plan usually contemplates paying for each employee's pension during that employee's working life. This entails the building-up of a trust fund, on a so-called actuarial-reserve basis, so that when the employee is ready to retire there is sufficient money in the fund to guarantee his pension regardless even of the continued existence of the employer. Payments are made into the trust fund in level installments over the working lifetime of the employee.

Such a pension fund requires the services of a trustee and a technical expert to supervise the rate of contribution to, and growth of, the invested fund. These services may be supplied either by an insurance company or, as in a self-administered pension plan, by a trust company and an independent actuary. Regardless of the method of administration, the basic operating principles of most actuarial-reserve pension plans are very similar.

It is difficult to get accurate statistics as to the extent of private pension coverage in this country. There is also a probability of some duplication of coverage in the statistics. Nevertheless, it does appear that 7,000,000 American workers are at present covered by funded pension plans recognized for tax purposes by the Bureau of Internal Revenue. In addition millions of other employees are covered by pay-as-you-go and discretionary pension plans.

At the end of 1950 there were 1,235,000 individual annuity contracts in force in the United States. In addition there were 217,000 annuities in force as supplementary agreements to life insurance policies.

To sum up, the cost of providing a cash retirement income to our aged citizens is very large. There is, however, no other satisfactory means of caring for them. There is relatively little difference in cost as between private insurance methods and Federal Social Security, granted that identical benefits are provided by each. The incidence of cost does vary, however. Private insurance saves up in advance and makes its savings available for investment in the tools of production, thereby increasing the productive capacity of the country. Government benefits normally are paid from current income on a pay-as-you-go basis and hence simply redistribute available production without adding to it.

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October 2, 1951

Miss Gwendolyn Lloyd
Industrial Relations Librarian
University of California
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Dear Miss Lloyd:

Enclosed is a copy of my paper on "Contribution of Private Insurance to the Security of the Aged" requested in your letter of September 25.

The statistics relative to the aging population are best obtained from the pamphlets "Actuarial Cost Studies" prepared by the Actuary for the Social Security Administration. Many statistics relative to life insurance coverage may be obtained from the 1951 Life Insurance Fact Book obtainable from Institute of Life Insurance, 488 Madison Avenue, New York 22, New York. I assume that you are familiar with the Monthly Statistical Bulletins, prepared by the Metropolitan Life Insurance Company, which contain a wealth of information on mortality and mortality rates.

Sincerely yours,

Donald B Warren

Donald B. Warren

DBW:mh

Enclosure