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DELAYING SOCIAL SECURITY RETIREMENT BENEFITS: THE BRIDGE TO BETTER OUTCOMES IN DEFINED CONTRIBUTION PLANS?

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As the retirement solutions provider of PGIM, we plan to deliver innovative defined contribution solutions founded on market-leading research and capabilities. Our highly-experienced team partners with clients on customized solutions that seek to solve for current challenges facing DC participants. As of 12/31/2024, PGIM has $170 billion[3] DC assets under management and PGIM DC Solutions AUM has $1.3 billion.

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Executive Summary

This piece summarizes recently released research[1] exploring the potential benefits of delayed claiming of Social Security retirement benefits from a defined contribution (DC) plan perspective.

Key Takeaways

- There are few strategies as widely touted among retirement academics as delayed claiming of Social Security benefits; however, the average Social Security claiming age today is only approximately 65. This means that many retirees are limiting their potential income in retirement.
- The breakeven return required to outperform delayed claiming varies by household, but the annual nominal lifetime geometric return is likely to be somewhere around 9-10% for most DC participants who would actively consider delaying, which is a relatively high hurdle.
- When focusing only on DC balances, less than 10% of participants are estimated to be able to delay claiming Social Security benefits to age 70 while maintaining a reasonable liquidity cushion. This is important for plan sponsors who are considering offering, or allocating to, longevity protected solutions, such as annuities, since participants are unlikely to have enough DC savings available to fund both (and delayed claiming of Social Security is currently more economically advantageous than purchasing an annuity, on average).
- Creating an explicit "delayed claiming account" sleeve within the default investment (e.g., a target date fund or managed account) could help precondition participants around the claiming decision (i.e., behaviorally prepare them for it), as well as create a relatively flexible account that could be used to fund delaying Social Security or to purchase an annuity depending on the participant's situation at retirement.
- Overall, delayed claiming of Social Security retirement benefits is a valuable strategy that should be more proactively considered among DC plan sponsors and participants, especially when considering adopting longevity solutions for a DC plan.

[1]https://papers.ssrn.com/sol3/papers.cfm?abstractid=4296321
[2]PGIM DC Solutions does not establish or operate pension plans.
[3]Reported data reflects the assets under management by PGIM and its investment adviser affiliates for defined contribution investment purposes only.

An individual who delays claiming Social Security benefits to age 70 would receive a benefit that is approximately 77% higher than if benefits are claimed at age 62, in today's dollars. Additionally, Social Security benefits are explicitly linked to inflation, tax advantaged, offer spousal survivor benefits, and are based on relatively dated pricing assumptions. The benefits of delayed claiming have been widely touted among retirement academics for decades; however, relatively few individuals delay claiming to age 70, with the average claiming age today at approximately 65.

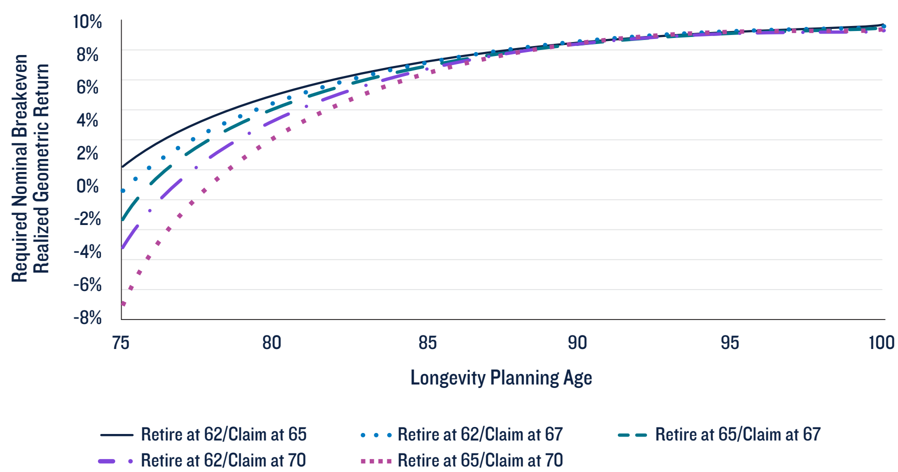
Delayed claiming is by no means a "free lunch," though, since the retiree must finance consumption from savings during the delay period, and if the individual were to die early in retirement the cost of delaying could be relatively high (ignoring any kind of spousal survivor benefit). Therefore, while delayed claiming is generally considered to be economically advantageous, the decision needs to be based on each person's unique situation.

While delayed claiming of Social Security benefits and purchasing an annuity are not mutually exclusive, relatively few participants have sufficient balances to both delay claiming and purchase an annuity. Therefore, the decision to include an annuity in a DC plan (e.g., as part of the default investment) needs to be considered to the extent it pulls savings away from monies that could be used to delay claiming, since delayed claiming of Social Security benefits is currently considered more economically advantageous than purchasing an annuity, on average.

Quantifying the Benefit of Delayed Claiming

The economic benefits of delayed claiming of Social Security retirement benefits are going to be driven primarily by how long the retiree lives (ignoring the spousal survivor benefit). One way to quantify how the expected value changes for different survival periods is to estimate breakeven returns. The breakeven return is the annual lifetime geometric nominal return required so that the individual would technically be indifferent between early and delayed claiming. If the realized return of the investor's portfolio exceeds the breakeven return, the individual would be better off claiming early, if the realized return is lower than the breakeven return, the individual would be better of delaying. Exhibit 1 includes the breakeven returns for various claiming scenarios and longevity ages.

Exhibit 1: Breakeven Returns for Delayed Claiming by Longevity Planning Age



Source: Research paper "Delaying Social Security Retirement Benefits: The Bridge to Better Outcomes in Defined Contribution Plans?" (Blanchett 2022).

The breakeven required returns clearly increase for higher longevity planning ages. This is expected and is based on the fact the individual would receive the higher (delayed) benefit the longer he or she lives. At age 85, the breakeven return averages about 7%. By age 90, the breakeven returns all exceed 8% and by age 95 they are all approximately 9%.

Note, the analysis in Exhibit 1 doesn't include spousal survivor benefits, which will only increase the potential expected breakeven return. While the actual rules are slightly more complicated, when one spouse of a married couple passes away the surviving spouses' total continued benefit will equal the larger of the two Social Security benefits being received. The presence of spousal survivor benefits can potentially affect the delay decision, since even someone who is relatively unhealthy may be better off delaying based on spousal life expectancies. Through an analysis we find that the presence of a spousal survivor benefit is likely to increase the breakeven return by 1% to 2% on average, with the greatest differences occurring when the spouse is relatively healthy.

Overall, the breakeven return analysis suggests the required return for most DC participants who would likely be actively considering delayed claiming (e.g., are relatively healthy with likely some potential spousal survivor benefit) is close to 10%, which is a relatively high hurdle that relatively few investment strategies could be expected to outperform.

Who Can Actually Afford to Delay (and for How Long)?

DC balances only represent a portion of total household financial assets. Data from the 2022 Survey of Consumer Finances (SCF) suggests that DC assets are typically less than one third of total household financial assets, and given the continued decline in job tenure , DC balances are likely to provide a decreasing window into overall participant retirement readiness in the future.

This lack of perspective is important when considering including longevity solutions in DC plans, such as annuities. The suitability of an annuity depends on a variety of factors, many of which the plan sponsor is unlikely to be aware, especially if the annuity is offered as part of a default investment (which requires no engagement on behalf of the participant).

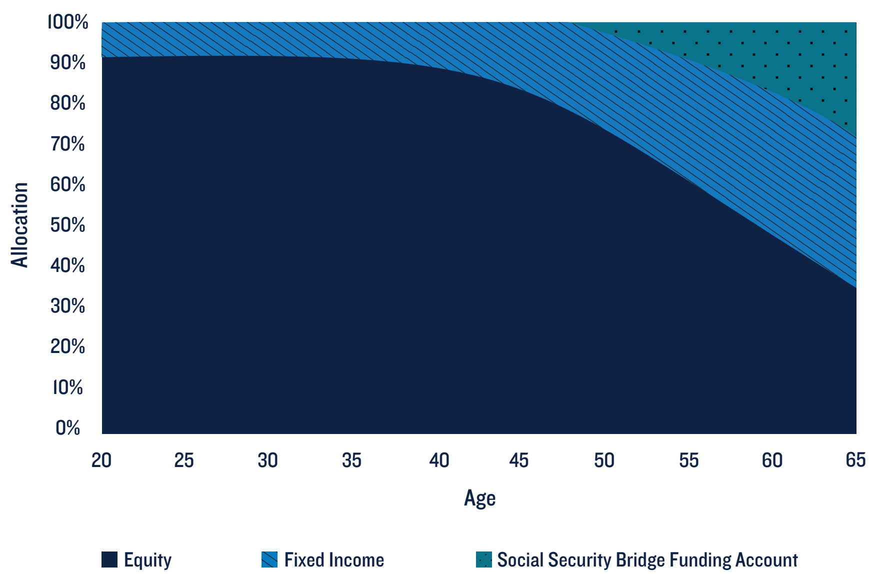
When looking at a dataset of 100,000 401(k) participants, we estimate only approximately 5% of participants who are age 55 currently have enough savings to delay to age 70 and only 10% of participants are expected to have the required savings assuming a retirement age of 65 and a liquidity target that is 2.5 times the after-tax income goal at the claiming age. However, roughly 20% of participants currently have enough savings to delay to age 67 and around 40% of participants are expected to have enough to delay to age 67, suggesting that an earlier delayed claiming age is likely a more realistic target for most DC participants (focusing on DC savings).

The fact that relatively few participants have, and are expected to have, sufficient balances to fully delay claiming Social Security benefits has implications around including an annuity in a DC plan, especially if those monies allocated to an annuity depletes the available funds to delay claiming Social Security benefits.

Funding the Bridge

One potential approach to encourage participants to delay claiming would be to create an explicit sleeve within the plan default investment, which is typically a target-date fund. We demonstrate an example of this in Exhibit 2, which includes specific allocations to equities, fixed income, and a Social Security bridge funding account. The monies allocated to the Social Security bridge funding account would likely mostly be fixed income, but could also include equities and alternatives as well.

Exhibit 2: Allocating Savings to Fund Delayed Claiming



Source: Research paper "Delaying Social Security Retirement Benefits: The Bridge to Better Outcomes in Defined Contribution Plans?" (Blanchett 2022).

If the bridge account is invested in relatively liquid securities the monies could also be used to purchase an annuity at retirement, or not annuitized at all. This creates a high level of flexibility for both the participant and the plan sponsor, especially compared to other longevity strategies (e.g., annuities) that have annual fees or may have certain access restrictions.

CONCLUSION

DC plan sponsors and consultants are increasingly considering various strategies to generate lifetime income (e.g., adding an annuity to DC plan). It is important that this is done in the correct context. Delayed claiming of Social Security benefits is currently one of the most economically advantageous ways a retiree can generate lifetime income. While an annuity may be attractive for certain participants given various preferences or situations, delayed claiming should economically dominate an annuity for most participants and is a more attractive starting place to look for lifetime income in the absence of complete participant information and an affirmative decision around preferences. Therefore, delayed claiming of Social Security retirement benefits should be more proactively considered by plan sponsors interested in getting participants to allocate savings to longevity protected income.

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