KIM: Could 'Tontines' from 1653 fix today's retirement savings crisis?

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Traditional corporate pension plans have all but vanished, replaced by 401(k) plans and IRAs. The results under our "do-it-yourself" retirement system are frightening.

According to "The State of American Retirement—How 401(k) s have failed most American workers http://www.epi.org/publication/retirement-in-america/" by the Economic Policy Institute, the median working-age American family (age 32-61) has a paltry $5,000 saved in retirement accounts (nearly half of families had $0). Even those fast approaching retirement (age 56-61) had only $17,000 saved. With the future solvency of Social Security questionable, it's clear we have a crisis.

Enter exiled Italian banker Lorenzo de Tonti, who first proposed a "tontine" to Louis XIV as a way for the French king to finance his wars. Louis XIV didn't go for the idea right away, but in the end both he and King William of England used tontines to finance wars—against each other.

In his book, "King William's Tontine: Why the Retirement Annuity of the Future Should Resemble Its Past," Professor Moshe Milevsky of Toronto's York University argues what was good for Louis XIV and King William could also be good for us.

A tontine is a pooled investment vehicle where each member contributes the same lump sum. In return, members receive ongoing payments or dividends. As with a single premium immediate annuity, a member receives payments as long as she lives (i.e. the payments cease at her death). However, with a tontine, ***the ongoing payments that would have gone to the deceased member are redistributed to the remaining living members.***

For example, assume ten members contribute $10,000 each ($100,000 total) and the tontine earns and distributes 8% each year ($8,000). Assuming all 10 members are still living at the end of Year 7, each would have received $800/year (8% on $10,000 investment). During Year 8, six members die. The tontine still pays out $8,000 at the end of Year 8, but it is split among the remaining four members ($2,000/each). This goes on until Year 11, during which three members die, leaving the sole survivor to collect the entire $8,000 (80% on $10,000 initial investment!) for Year 11 and ***every year until she dies***.

One of the key risks in retirement is outliving your money. Life expectancy in the U.S. is just under 80 years today, but what will it be in 20 years? Further, because that figure is just an average, by definition some folks will live longer, perhaps much longer. If you budget to spend your retirement savings down to $0 by a certain age and live longer, its "Houston, we have a problem."

Investing in a tontine mitigates this ***longevity risk*** because the longer you live, the greater your payouts (as other members die and their payments are redistributed). Just as traditional insurance enables risks to be spread among policyholders, a tontine spreads longevity risk among members.

European kings loved tontines because they could offer a lower interest rate, since every member assumed she would be among the last survivors and reap huge payments at the end. Here, Alexander Hamilton (of "Hamilton" fame) proposed a tontine to pay off Revolutionary War debts, but was rebuffed by Thomas Jefferson (huge surprise).

Tontines won't fix our retirement savings crisis, but it's high time for some "outside the box" thinking.
