

# HEDGING LONGEVITY

THE IMPORTANCE OF QLACS IN THE DISCUSSION ABOUT LIVING LONGER



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Last year's Treasury Department regulation set the stage for qualifying longevity annuity contracts (QLACs) being made available in defined contribution (DC) plans. This new rule impacts the options plan sponsors can offer participants and sparked many questions about longevity risk and longevity insurance. Roberta Rafaloff, vice president of Institutional Income Annuities at Metropolitan Life Insurance Company and Jack VanDerhei, Ph.D., research director at the Employee Benefit Research Institute (EBRI), provided PLANSPONSOR with more insights in a recent conversation.

## **PS: How does longevity insurance work?**

**Rafaloff:** Longevity insurance is a fixed deferred income annuity that protects individuals against outliving their income. For those nearing or even already in retirement, it provides a set amount of guaranteed income that begins later in life—say, when they're 80 or 85—and may be set up to coincide with the depletion of other income sources. Longevity insurance makes it easier for individuals to plan for retirement rather than self-insuring their retirement. And, of course, the longer they wait to start their income payments, the larger those payments will be.

## **PS: When was it first introduced in the qualified plan arena?**

**Rafaloff:** In 2004, Metropolitan Life Insurance Company was the first company to introduce longevity insurance, which evolved into a product category for the industry. And, to the best of our knowl-

edge, we are first to market again as the first insurance company to introduce a group QLAC this month. Americans buy life insurance, health insurance, insurance for cars, our homes, etc. We insure just about everything except our retirement income.

Yet during people's working lives, most make nearly all of their spending decisions based on their paycheck, so they'll likely make similar decisions later in life based on their retirement paycheck—whatever sources of lifetime income they have then.

## **PS: So what particular issues or challenges does longevity insurance solve for participants?**

**Rafaloff:** Longevity insurance solves for longevity risk—somebody outliving the average life expectancy, which is the greatest risk a retiree faces. Think of it this way: An individual will need to figure

out how to ensure his or her retirement income lasts 20, 30 years, maybe even longer if he surpasses the average life expectancy. In fact, a 65-year-old male has a 50% chance of living beyond age 85 and a 25% chance of reaching 92.

Unfortunately, we often see the "wealth effect." At retirement, people take a lump sum from their defined contribution plan because it's typically the most money they've ever saved and they want to hold onto it.

**PS: A lot of attention has been focused on raising awareness about longevity risk. Do you think those messages are resonating with defined contribution plan participants and that they understand the need to hedge that risk?**

**VanDerhei:** At EBRI, we just conducted our 25th annual Retirement Confidence Survey and wanted to get at exactly that issue. We asked 1,000 workers whether or not they would be interested in using a portion of their savings to purchase an insurance product that begins providing guaranteed monthly income in their future, such as at age 80 or 85. We said this monthly income would continue throughout their or their spouse's life, and this product is sometimes called longevity insurance. Among the workers we asked, the overall findings were that nearly four in 10 were interested, including 8% of workers who were very interested and 30% who were somewhat interested.

I went back and did some breakouts on those, and what I found is that a person's expectation of how long she's going to live affects how she answers the question. After combining some groupings because of the sample size, of those individuals who believe they are not at all or not too likely to reach 85, only 25% were interested in buying, in essence, a QLAC. Of those who believed they were somewhat likely to reach age 85, 41% were interested in a QLAC; and of those who felt they were very likely to reach age 85, the

number jumps to 47%.

One other quick break down: Among those with some form of retirement plan, 39% said they'd be interested in a QLAC, and 47% with no plan at all would be interested, regardless of age.

**Rafaloff:** We think this data is really encouraging and shows that workers are really starting to think about not just retirement savings, but how they turn that savings into guaranteed retirement income they can't outlive.

**PS: Would you address the new regulation and how much of plan participants' assets can be allocated to a QLAC, or how they can get access through the plan?**

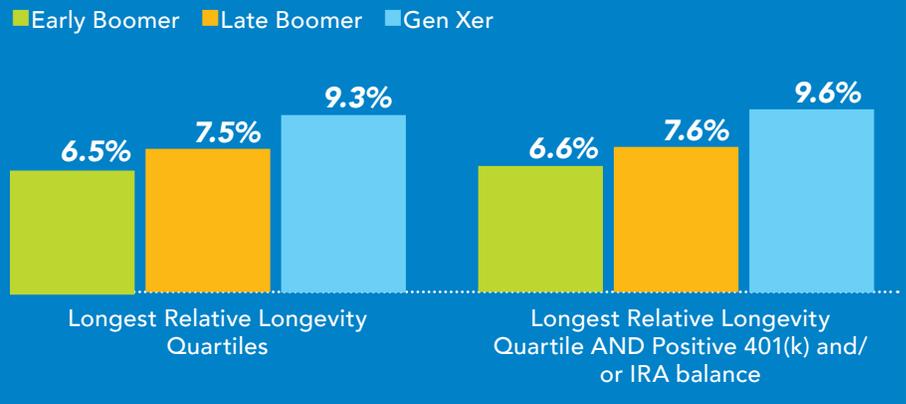
**Rafaloff:** Historically, longevity annuities haven't been a viable option for DC plans because participants couldn't defer their income start date beyond age 70.5, due to the required minimum distribution (RMD) rules. Last July, the U.S. Treasury issued final regulations that allow for a QLAC and let DC plan participants exclude what they allot toward a QLAC from their RMD calculation. So now they can have income through systematic withdrawals from the plan, as before, plus guaranteed income later.

To be excluded from the RMD rules, the funds used to purchase the QLAC must be from within the individual account's qualified plan—that is, the lesser of \$125,000 or 25% of the total account balance. The QLAC is very simple: It's deferred, so payments begin at later ages; it's a fixed annuity, not an investment product, so no variable annuity-type situation applies here; and it's available either with or without a return of premium feature or death benefit.

**PS: How else do plan participants benefit from allocating a portion of their DC assets through QLACs?**

**VanDerhei:** I did modeling on this to present to the Bipartisan Policy Center, last fall, for their Retirement Security and Personal Savings and Long-Term Care Initiative event on Threats to Retirement Security: Longevity, Long-Term Care and Leakage, and I obtained the pricing parameters from an insurance company that was selling QLACs at the time. I ran it through for all Baby Boomer and Gen Xer families to show the impact if individuals used the maximum amount—the lower of 25% of their projected defined contribution and individual retirement account (IRA) balances or \$125,000 indexed for inflation—and if they purchased that

## IMPACT OF A 25% QLAC ON 2014 RETIREMENT READINESS RATINGS™ FOR BOOMERS AND GEN XERS BY AGE COHORT (PERCENT CHANGE)



Source: Calculations based on EBRI Retirement Security Projection Model® versions 2195 and 2197.

product with a start date for income at age 85, to determine the effect it had on their overall probability of success in retirement. My basic definition of success was that the retiree's household does not run short of money in retirement.

I looked at it by three age cohorts: early Boomers, late Boomers and Gen Xers. And, as with any insurance policy, you focus on those who'll benefit most from the coverage. Here, for every household, Boomers and Gen Xers, I essentially did 1,000 simulated life paths, where sometimes they died early, sometimes late, and then broke them into various quartiles. Since the products are primarily for the longest-lived quartile, that's who I looked at. With the starting point that approximately 56% of the households will have a successful retirement, I wanted to see how much purchasing a QLAC—using the lower of 25% of their projected defined contribution and IRA balances or \$125,000 indexed for inflation—would enhance the probability of their success.

For the earliest Boomers, those on the verge of retirement, their overall probability would increase from 56% by 6.6%; for the late Boomers, it would be a 7.6% increase; and for the Gen Xers, a 9.6% increase in overall probability of success at age 85.

**PS: So how else can a participant maximize his remaining assets with a QLAC?**

**Rafaloff:** Participants can gain flexibility with the savings left after buying one because they've established a definite timeframe those savings need to last.

So, if they're 65 and buy a QLAC with the benefit beginning at 85, the defined period is now 20 years. Participants can determine the best way to invest and draw down those other assets, knowing they'll be protected later in life.

As an example, based on calculations done in January 2015 (actual income payments are determined when the QLAC is purchased and may vary), if someone purchased a QLAC at age 65 with \$125,000 and began income at 85, he would receive \$4,275 a month until death. So that deferral period allows for a significant income to start later in life.

**PS: If a plan sponsor is ready to take action and add a QLAC, what steps does he need to take?**

**Rafaloff:** It's like adding any investment option to a DC plan, and involves just five basic steps: 1) You have to select the insurance provider; 2) amend your plan to allow for the annuities, the distribution option; 3) notify all your participants and beneficiaries—DC plans do these things regularly; 4) modify your summary plan description (SPD) and the election form people fill out at retirement; and 5) establish procedures for administration of 5500 filing. None of this is difficult for the plan or recordkeeper; all major recordkeepers know how to handle annuities as a distribution option from a defined contribution plan.

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