Helping DC Plan Participants Hedge Longevity Risk

To help retirees turn savings into a steady, permanent income stream they won’t outlive, the U.S. Treasury Department has made it easier for defined contribution plans to offer qualifying longevity annuity contracts (QLACs). This article explains the features of QLACs and why both employees and employers are finding this type of insurance an attractive option, as it protects people against their greatest risk in retirement—longevity. The author provides five steps a plan sponsor needs to take to add a QLAC.

by Roberta Rafaloff | MetLife

Approximately four million Americans leave the workforce each year. Many will face significant challenges in managing their defined contribution (DC) plan assets and other savings throughout retirement. For many Americans, translating savings into a steady, permanent income stream will likely be their greatest obstacle—and biggest fear. For plan sponsors, industry practitioners and policymakers, it has become apparent that DC plans must provide better retirement outcomes for our country’s workforce—outcomes that include the promise of sustainable income that cannot be outlived.

One significant regulation that was designed to help facilitate better retirement outcomes and increase awareness of longevity risk focuses on making it easier to select longevity insurance as a DC plan distribution option. On July 1, 2014, the U.S. Treasury Department announced final regulations for qualifying longevity annuity contracts (QLACs). According to a press release issued by the Treasury Department, “the final rules make longevity annuities accessible to 401(k)s and other employer-sponsored individual account plans and individual retirement accounts (IRAs) by amending the required minimum distribution [RMD] regulations so that longevity annuity payments will not need to begin prematurely in order to comply with those regulations.”

Prior to the issuance of the final rules, a participant who purchased longevity insurance with DC plan assets needed to comply with the RMD rules, which require that distribution of a percentage of the participant’s entire balance generally begins by April 1 of the calendar year following the calendar year in which the participant attains the age of 70½ or, if later, the year in which the participant retires. Absent this regulation, longevity insurance products created challenges for DC plan participants since benefits typically are not payable until an advanced age, such as 85, yet the value of the annuity was still included in the calculation of the RMD. The final ruling, however, now provides a “safe haven” for amounts allocated to a QLAC.

The final QLAC ruling expands upon the 2012 proposed guidance issued by the Treasury Department as part of a
broader effort with the Department of Labor “to encourage lifetime income and enhance retirement security for American workers.” The ruling makes it easier for individuals in qualified DC plans to choose to receive their benefits as a stream of income in regular payments later in life for as long as they live.

What Is a QLAC?

A QLAC is a deferred income annuity (DIA) that provides guaranteed income for a retiree’s later years—when other income sources might run short. Essentially, it’s longevity insurance that delivers a fixed monthly paycheck later in life. It’s expected to be an attractive alternative to participants trying to rely on a dwindling savings balance to finance retirement income over an unpredictable period of time. While DIAs aren’t a new idea for guaranteeing lifelong income, their availability and application within the DC plan arena is relatively new.

QLAC Quick Facts:

- A QLAC is a distribution option for employees at the point of retirement. It generally is not an investment option.
- Assets allocated to a QLAC are not considered as part of the balance used to calculate RMDs imposed on qualified DC plan balances at the age of 70½.
- Participants may purchase a QLAC using up to $125,000 in qualified DC savings (which periodically will be indexed for inflation) or 25% of their account value, whichever is less. Individuals who inadvertently exceed these limits will be permitted to correct the excess without disqualifying the annuity purchase so long as excess contributions are returned to the non-QLAC portion of an individual’s account by the end of the calendar year following the calendar year of the excess contributions, either in cash or as a non-QLAC annuity.
- Income payments begin at an advanced age—typically 80 or 85.
- Payment options can include lifelong income guarantees covering an individual or an individual and a joint annuitant for as long as at least one of them lives.
- QLACs cannot be invested in variable or index annuities.
- The final regulation mandates that QLACs contain no cash surrender value, commutation benefit or other similar features.
- A QLAC may offer a return-of-premium death benefit (cash refund).

There are a number of features that can be added to a QLAC that are designed to address some of the concerns participants have expressed in deciding whether a fixed annuity is an appropriate approach for meeting their retirement income needs. For example, although there is no cash surrender value once purchased (i.e., it must be irrevocable and illiquid), a QLAC can have a return-of-premium death benefit payable to designated beneficiaries (also known as a cash refund). This is payable after the death of the individual or after the death of the participant and the participant’s joint annuitant. Should a participant die, the amount paid to purchase the annuity will be returned to a beneficiary, less any previously paid benefits.

A QLAC can also include inflation protection to help individuals ensure that their retirement income keeps pace with the rising cost of living by electing yearly payment increases (e.g., 1%, 2% or 3%), subject to limitation under tax laws. It is important to note, however, that QLACs generate the most amount of income with the fewer options participants elect.

Why QLAC Now?

Until recently, defined benefit (DB) plans played a bigger role than DC plans in most retirees’ strategies for guaranteed retirement income. DC plans initially were intended to serve as supplemental savings vehicles—complementing the guaranteed paychecks retirees received from Social Security and their DB plan.

With the gradual transformation of the U.S. retirement system to the DC model, there are over 52 million workers who will rely on their 401(k) plan to fund retirement—and many will be left on their own to figure out how to make their savings last a lifetime. As they plan their drawdown strategies, it’s likely we will see a greater emphasis on core concerns, such as having confidence that their income will last throughout retirement.
Outside of Social Security and a DB plan, only a fixed annuity can provide guaranteed income that individuals cannot outlive. In fact, a recent study by the Insured Retirement Institute (IRI) supports a high correlation between annuity ownership and positive retirement expectations. Of baby boomers who own annuities:

- Over 90% have retirement savings, versus less than 50% for nonowners.
- 80% expect their money to last throughout retirement, compared with less than 50% of nonowners.
- More than 60% have calculated the amount they need to save for retirement, versus less than 33% of nonowners.²

### Hedging Risk With a QLAC

Well-being in retirement encompasses an array of risks that make today’s workers uneasy about their ability to fund the future. Employers that offer a QLAC through their DC plans can facilitate greater financial certainty for employees as they retire and help make these risks more manageable.

Among the risks workers face are:

- **Longevity**, the greatest risk of all (Figure 1). One out of every four people turning aged 65 today is expected to live past the age of 90.³ MetLife research reveals that for 51% of older boomers (ages 65+) and 57% of younger boomers (ages 51-64), outliving their savings is the greatest financial concern.⁴

- **Inflation**. Income for retirees may need to double over a 20-year period just to stay even with average rates of inflation.

- **Market volatility**. Workers who are still saving for retirement have the benefit of time on their side. But for retirees, market downturns, especially early in their retirement years, can significantly and permanently reduce how long accumulated savings will last.

- **Cognitive decline** is also a consideration for retirees in their later years. The loss of mental acuity can reduce an individual’s ability to make sound financial decisions and is another reason for addressing these matters prior to retiring or in one’s early retirement years.

### Why Plan Participants Should Consider QLACs

By lowering the annual RMDs that participants must take in early stages of retirement, more money can remain in the participant’s DC plan with the potential to grow. Additionally, by deferring payments to a later age, the participant can increase the income amount that is possible when the QLAC’s guaranteed income payments begin.

This structure creates a best-of-both-worlds environment that can be most effective for plan participants when used in combination with a systematic withdrawal plan. DC plan participants can, for example, have both immediate access to their savings through systematic withdrawals for a portion of their balance and guaranteed income for the rest of their lives once the QLAC begins payment.

The Employee Benefit Research Institute (EBRI), which is known for its work in analyzing retirement income adequacy of various demographic

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**Figure 1**

**Longevity: The Greatest Retirement Risk**

If you don’t know how long you will live, how can you avoid outliving your savings?

- The average American spends approximately 20 years in retirement²
- 68% of people aged 62 will live to 82¹
- 30% of people aged 62 will live to 92²
- Average Retirement Age¹

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3. Society of Actuaries Annuity 2000 Mortality Table D (50% male and 50% female mortality blend).
groups, recently gauged participant interest in QLACs. Research conducted for its 2015 Retirement Confidence Survey found that interest in QLACs is a function of many factors—including age, life expectancy and the likelihood of guaranteed income from other sources, such as Social Security.

The study reveals that interest in QLACs increases with expected longevity. Specifically, participants were asked if they believe they will live to the age of 85 and the age of 95, respectively. Nearly half of individuals (47%) who believe they are very likely to live to the age of 85 are interested in QLACs, while 53% of individuals who believe they are very likely to live to the age of 95 are interested in the product (Figure 2).

In view of these findings, it is important to note, once again, that QLACs are intended as a distribution method for purchase at the point of retirement (aged 65), when an employee is exiting a 401(k), and provide income payments that begin later in life. As such, EBRI’s results showing highest interest among the younger demographic (<45) may be attributed to this group’s lack of confidence in the Social Security system as
a viable source of income when they reach retirement age.

Further insight into how participants might benefit from allocating a portion of their DC assets to a QLAC is offered through recent modeling by Jack VanDerhei, Ph.D., CEBS, research director at EBRI.

This study looked at baby boomer and Gen Xer families to more fully understand the impact of purchasing a QLAC with a start date of aged 85, using the maximum amount (the lower of 25% of their projected DC and IRA balances or $125,000 indexed for inflation). With a starting assumption that approximately 56% of these households will have a successful retirement, 1,000 simulated life paths for each household were performed to see how purchasing a QLAC would enhance their probability of success—or decrease their odds of running out of money—compared with a portfolio of stocks and bonds alone. Success in retirement is defined as having sufficient funds to meet average retirement expenses and uninsured health care costs for the remainder of the retiree’s life.

For the earliest boomers in the longest relative longevity quartile, those on the verge of retirement, putting 25% of their retirement savings in 401(k) plans and IRAs into a QLAC at retirement would increase their success by 6.6%; for the late boomers in the longest relative longevity quartile, it would be a 7.6% increase; and for Gen Xers in the longest relative longevity quartile, the overall probability of success would increase by 9.6% (Figure 4).

Considerations for Plan Sponsors

Given the clear link to a successful retirement for plan participants, employers are taking note. Income annuities are being given serious consideration by plan sponsors at Fortune 1000™ companies. Among plan sponsors that do not currently offer an income annuity from a DC plan, 70% have taken important preparatory steps for a future addition of guaranteed lifetime income to their plan’s distribution options, including 57% that have discussed options with their company’s DC plan recordkeeper, 34% that have explored the lifetime income solutions available in the marketplace and 11% that already have conducted due diligence about the providers of these solutions. Only 1% of plan sponsors have reviewed and decided against offering a lifetime income annuity option.6

Offering a guaranteed retirement income distribution option to enable plan participants’ retirement savings to last their lifetimes is easily accomplished, from an Employee Retirement Income Security Act (ERISA) plan amendment perspective, by adding an income annuity as a distribution option to the plan. When the plan fiduciary offers this option, the selection of the annuity provider is a fiduciary decision and subject to ERISA rules.

Five Simple Steps

If a plan sponsor is ready to take action, adding a QLAC is similar to add-
ing an investment option. These five basic steps should be taken:

1. Select the insurance provider.
2. Amend the plan to allow for the annuities, the distribution option.
3. Notify all participants and beneficiaries. DC plans do these things regularly.
4. Modify the summary plan description (SPD) and the election form people fill out at retirement.
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 DC plan.

Conclusion

With the discussion of longevity risk should come the recognition that retirement income—specifically, guaranteed retirement income that cannot be outlived—should be a critical component of how plan sponsors set up their plans and plan participants consider their retirement preparations. With the finalization of QLAC regulations, both employers and employees are likely to find longevity annuities to be an attractive option.

Endnotes

5. The longevity quartile is established relative to family status, gender and age cohort. For more detail, see Jack VanDerhei, "Why Does Retirement Readiness Vary: Results from EBRI's 2014 Retirement Security Projection Model?", The Journal of Retirement, Spring 2014.

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