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Helping Participants Manage "Longevity Risk": New Rules on Qualifying Longevity Annuity Contracts Are Only a First Step and Plan Sponsors Should Proceed with Caution

On average, more than 10,000 baby boomers — those born between 1946 and 1964 — will retire in the U.S. every day between now and 2030, when the youngest of this post-World War II generation will have turned 65.[1] While Social Security and, to a lesser extent, private defined benefit (DB) pension plan payments will provide some portion of a retiree's income in retirement, individual retirement savings — including from an employer's defined contribution (DC) retirement plan and an individual retirement account (IRA) — play a significant role. There is virtually universal acknowledgement that the U.S. has a retirement-income-adequacy problem, stemming from the fact that, for an increasing stream of retiring employees, less of their retirement income is coming in the form of guaranteed payments over their lifetime and more from the drawdown of their DC accounts or IRAs. This is, of course, not only an employee problem but also an employer problem because employees' inability to retire can thwart talent management and succession-planning objectives, as well as diminish workforce productivity.

One sign that the government is taking steps to address the problem is the publication by the Department of the Treasury and the Internal Revenue Service (IRS) of final rules for a certain type of annuity, called a qualifying longevity annuity contract or QLAC. Under this form of annuity, payments are scheduled to begin sometime after the participant's retirement and continue for life, thereafter. The rules allow a DC plan participant to purchase a QLAC with a portion of his or her account balance without the amount of the purchase being included in the total that determines the amount of his or her minimum required distribution (RMD) each year from the DC account. That will ensure that there will be enough cash in the DC account to actually fund the required RMD payment. Otherwise it would be possible for the account to run out of cash because of the annuity purchase and then have the participant charged with an RMD requiring the participant to pay tax on an amount not yet actually received in cash. The rules also prescribe that in order to be a QLAC the following requirements must be met:

- The annuity must be sold by an insurance company.
- The annuity must have a premium value of no more than $125,000 (indexed), or if less, 25 percent of the participant's account balance.
- The annuity must be distributed to the participant in a fixed monthly amount beginning no later than the month following the participant's 85th birthday.[2]

Although these regulations remove a small impediment to lessening longevity risk within employer-sponsored DC plans and IRAs and may help plans offer solutions to participants concerned about "outliving their money," they are not a panacea. As discussed in this *Spotlight*, these new rules are just one step and should be considered in the context of all the issues sponsors face in helping their employees attain retirement income adequacy.

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[1] The Social Security Administration's Fiscal Year (FY) 2012 Annual Performance Plan (APP) and Revised Final Plan for FY 2011: http://ssa.gov/agency/performance/2012/

[2] The final rules on QLACs, which took effect immediately and apply to contracts purchased on or after July 2, 2014, were published in the July 2, 2014 *Federal Register*: http://www.gpo.gov/fdsys/pkg/FR-2014-07-02/pdf/2014-15524.pdf. For a detailed summary of the rules, see Sibson's August 7, 2014 *Compliance Alert*, "Guidance on Offering Longevity Annuities in DC Plans": http://www.sibson.com/publications-and-resources/compliance-alert/archives/?id=2609.

Longevity and Other Risks

Designing a plan for drawing down retirement savings requires an astonishingly complex financial analysis. For example, when drawing down retirement accounts, participants typically underestimate their "inflation risk" — that is, their exposure to loss of purchasing power due to inflation. They also tend to either overestimate the potential returns generated on their assets or invest too aggressively in order to "make the plan work." Many do not sufficiently understand investment risk and the need for an appropriate asset mix or the need to re-balance it from time to time; fail to evaluate the possibility of delaying Social Security to maximize potential income; and diminish their future income by taking unplanned withdrawals. Finally, they underestimate their possible life expectancy. And even if they prudently plan for having their assets last for their life expectancy, this means that 50 percent of the individuals will run out of money because 50 percent of individuals live beyond their life expectancy.

Probabilities of a 65-Year-Old Living to Age 90 and 95

	Probability	
Age	Male	Female
90	32%	41%
95	13%	20%

Source: SOA proposed RP-2014 Mortality Tables

In fact, more than 40 percent of women and more than 30 percent of men who reach 65 can expect to live into their nineties, according to the Society of Actuaries (SOA). The table above shows the probabilities of a 65-year-old surviving to 90 and 95. Planning for the retirement-income needs of couples is even more difficult, given that nearly 1 out of every 10 couples age 65 will have at least one person surviving to age 100.[3] Most retirees do not understand the risk that their potential longevity presents. Whether planned or not, every retiree spends down his or her retirement savings. Being able to lessen investment and longevity risks through annuity contracts (whether immediate or deferred) should be considered as part of any drawdown strategy.

Many DC plan participants do not have the option of purchasing any type of annuity coverage through their DC plans[4] and may not have adequate (or any) guaranteed lifetime income available from a DB plan. If employers include QLACs as a plan investment option, participants may be interested in them as a way to supplement other sources of guaranteed income they might have (*e.g.*, Social Security). There are, however, other significant issues, generally not in the jurisdiction of the IRS, that must still be resolved before it can be determined if these contracts will be successful as DC plan investment/distribution options.

Prudent Selection Process

For plans subject to Employee Retirement Income Security Act (ERISA), a QLAC is an investment within the plan and subject to a prudent selection process. When selecting annuity providers, a plan fiduciary must evaluate each provider's claims-paying abilities and creditworthiness. Further, this evaluation must be conducted periodically, as the suitability of insurance carriers evolves over time. Given the long-term nature of annuity contracts in general and longevity annuities in particular, additional guidance from the DOL or a safe harbor for their selection would certainly be helpful.

Plan Impact

When adding any investment or plan feature, sponsors must consider all plan participants. Adding new features or services has an impact on the plan operations and administration — and often the overall plan cost. Prudence dictates that evaluating a new service or feature includes a cost/benefit analysis to ensure that the effort and cost of adding the feature provides a commensurate benefit to plan participants as a whole.

[3] SOA proposed RP-2014 Mortality Tables

[4] According to the Plan Sponsor Council of America's *56th Annual Survey of Profit Sharing and 401(k) Plans*, which reflects 2012 experience, 17.1 percent of DC plans offer annuities as a retirement distribution option.

There is also the possibility that use of QLACs would be low. People are reluctant to lay out a large lump sum in exchange for an uncertain payment. The issue is magnified with QLACs because a participant may not live to receive any payments. Return-of-premium features alleviate this concern, which is the reason the insurance industry lobbied hard to have that feature included in the final rules. The trade-off for that feature is higher purchase rates. Experience with immediate annuities within the retirement plan environment shows that only about 6 percent of participants purchase annuities when leaving their DC plans.[5]

Administrative Complexities

To offer QLACs, the sponsor must set up procedures to purchase the contracts, including determining that the purchase amount does not exceed the IRS allowable limits.[6] Although now exempt from the minimum withdrawal requirements, the contract appears to be considered part of the value of the participant's account and it may be appropriate to include it on the account balance statement that the participant receives from the defined contribution plan's recordkeeper. There is also the risk that the IRS requirements may change requiring modifications by early adopters or that the products initially available will be improved or enhanced as the market matures. Additional complications will arise when plans change QLAC provider(s) and contracts issued by multiple insurance companies must be tracked.

Pricing Considerations

One of the key advantages of an employer-sponsored retirement plan is the benefit of group purchasing power, frequently referred to as institutional pricing. Unfortunately, in this case, the advantage is lost because annuities purchased within qualified plans must use unisex mortality tables whereas annuities purchased through IRAs may use gender-based tables. Due to their longer life expectancy, female annuity rates exceed male purchase rates by approximately 6 to 8 percent. Group rates are usually lower than individual rates; however, preliminary analysis indicates this may not be enough to outweigh the benefit of male individual purchase rates available on a retail basis. A likely outcome is that women would purchase QLACs within the plan and men would purchase them within IRAs.

What Should DC Plan Sponsors Do?

The issuance of the final rules warrant DC plan sponsors revisiting their plan's role in helping participants manage the future drawdown of their accumulated DC savings and the associated longevity risk. A review should start with measuring how well the plan supports the participant drawdown process today. Specifically, if a participant wanted to set up a drawdown plan, could she assemble an appropriate strategy using the educational tools and support services in the plan?

Typically, these services are provided by the DC plan's recordkeeper, and include not only written materials and online tools but also phone and in-person support. The sponsor should evaluate how the plan's recordkeeper handles terminating or retiring participants and whether that is consistent with its philosophy. It is also important to consider questions like the following:

- Should participants be encouraged to remain in the plan or to rollover their assets to the plan recordkeeper's IRA product?
- How is the potential future income that a participant's account balance might generate communicated: is it included on participant statements or is there a calculator that must be used?
- Are participants educated on important considerations such as the appropriate Social Security start date?

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[5] June 2011 Government Accountability Office report Ensuring Income throughout Retirement Requires Difficult Choices (GAO-11-400 page 28).

[6] As noted on page 1, the IRS places dual limits on premium value: the lesser of $125,000 or 25 percent of a participant's account balance.

- What investment funds and information are provided to participants in drawdown that address their unique considerations, especially for the target-date funds?

In addition, employers should reevaluate or consider these products or services that aid in managing the drawdown process:

- Participant advisory and managed-account services provide assistance although the level of services varies considerably including how customized the advice is to the participant's circumstances and how longevity risk is handled.
- Guaranteed products, such as guaranteed minimum withdrawal benefits, immediate annuities and QLACs, all provide some form of income guarantee. The products are complex and vary considerably. Each can play a role in managing the drawdown process and hedging longevity risk.
- Existing plan-distribution options may or may not support the drawdown process. For example, having only a lump-sum distribution feature is obviously not compatible with drawing down assets within the plan; however, having an annuity as the default distribution option would automatically provide lifetime retirement income for participants who do not make an affirmative election to manage the drawdown of their account.

Employers that offer a DB plan and a DC plan should explore options that involve both plans.[7]

Conclusion

In conclusion, these final rules do not solve all the problems or answer all the questions related to QLACs. In addition, the bigger issue of simple retirement income adequacy, including maximizing retirement income and managing it during retirement, is a major challenge for DC plan participants that requires a cohesive solution involving participants, employers and government. These regulations may be a first step along the road to helping participants manage the risk of outliving their retirement income — but plan sponsors should proceed with caution.

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To discuss the advantages and disadvantages of offering QLACs through your DC plan, contact your Sibson consultant or the nearest Sibson office. (For a list of Sibson offices, click on the second link in the box with the red border below.)

[7] For example, employers may want to allow DC to DB rollovers. That option was discussed in Sibson's June 2012 *Spotlight*, "Advantages and Disadvantages of DC to DB Rollovers" (http://www.sibson.com/publications/spotlight/june2012roll.pdf). Earlier this year, the Pension Benefit Guarantee Corporation (PBGC) issued proposed rules to encourage DC to DB rollovers. Those rules were published in the April 2, 2014 *Federal Register*: http://www.gpo.gov/fdsys/pkg/FR-2014-04-02/pdf/2014-07323.pdf