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Longevity Insurance: **Defining your own defined benefit**

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If the media is to be believed, most retirement aged individuals are either sitting around their kitchen table worriedly discussing their retirement plans or walking around with a confident smile knowing the exact dollar amount of savings they require. Those I know who fit this demographic do neither of these things, but perhaps it is because they spend their time riding tandem bicycles and sailing in other commercials.

For the purposes of this article, I set out to paint a more realistic picture of retirement through an informal survey of friends, family, and colleagues. I had three very simple questions:

1. How much money do you need to have saved in order to retire?
2. How much monthly income do you need in retirement?
3. What do you know about longevity insurance?

Answers to the first question were large and round, such as $1 million or $500,000, and typically based on advice from a financial advisor years ago or an equally outdated newspaper article. Answers to the second question were much more suited to their own lifestyles: take current expenses, factor in increased medical bills, consider your hobbies, and arrive at $2,000 - $3,000 per month.

The third question was answered with "nothing," which is discouraging but not surprising. By the time you finish reading this, I hope your response would be different.

Product Overview

Longevity insurance, often referred to as a Deferred Income Annuity (DIA), comes in two basic forms: (1) "pure" longevity insurance and (2) pension replacement vehicles. Though both rely on the same principle—providing guaranteed income streams for the life of an annuitant beginning at some point in the future—the two forms are quite distinct.

The first form, pure longevity insurance, is the most commonly considered product from an actuary's point of view. A customer pays a premium to purchase a future income stream and must survive to the start date to receive the benefit. If the annuitant does not, no benefits are paid and the premium is forfeited. As a result of the deferral period and mortality leverage, payouts for this product may be very high: a $100,000 single premium could buy as much as $60,000 of annual income, depending on age and deferral period. This product is typically marketed to those near retirement age as a way to eliminate the tail risk of outliving their retirement income. Because customers receive no benefits in the event of an early death, the product has been viewed as a gamble, and the high payouts have not been enough incentive to create strong demand.

The second form of longevity insurance is a pension replacement vehicle and represents the majority of policies that have been placed in the market to date. With the decline in the prevalence of defined benefit pension plans, a need exists for middle-aged employees to fund their retirement in a more accessible way than simply accumulating vast amounts of money. This product can be positioned as a personal pension funded through weekly payroll contributions. The main difference between this product and pure longevity insurance is the presence of a death benefit (typically a return of premiums paid) during the deferral period. From a consumer standpoint, the death benefit lowers the product risk (and thus payout), but this design has seen market appeal due to customers' aversion to losing all their money in the case of an early death.

Product Design Issues

While the basic design of most longevity insurance products is very similar, and the market has developed to compete directly on price quotes, there are still a number of design issues that companies have handled in different ways.

Income benefits – The Interstate Compact requires that all income streams on longevity products contain some life dependency, eliminating the option for a deferred period certain annuity. There has been some desire for period certain options as a way for customer's to bridge the gap between retirement and Social Security, and as

CONTINUED ON **PAGE 12**

a way to defer the start date of Social Security payments for a higher benefit. Note that this may be possible in most states, if filed individually.

The product may be sold with single or joint life income streams. Period certain with life thereafter payouts are still possible, and most products sold do contain some amount of guaranteed payments. Increasing Payment Options (IPOs) are also prevalent as inflation protection, and may range from 1-5 percent increases annually.

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Commutation and accelerated payouts – One of the major sticking points for consumers is an inability to remove what they view as their own money from the product. No partial withdrawals are allowed during the deferral period. Historically, many products allowed full commutation of the income stream once the deferral period ended. The exposure to mortality anti-selection, and the Interstate Compact prohibiting commutation features on new filings, has made this feature much rarer today. Note that Cash Refund and Installment Refund payout types do not count as commutation benefits and are still allowed.

While the Compact prohibits full commutation, it has approved products that feature payment acceleration. As an example, customers may receive six months of payments in a lump sum, with the next five payments skipped. This may be marketed as an emergency method to tap into your savings for medical bills or other unexpected costs. One design issue to consider is whether life contingent payments may be accelerated, and if so, whether they may be recaptured in the event of a death before the lump sum has been fully earned.

Death benefit – The most common form of death benefit for the pension replacement variation is a return of premiums paid, though other payouts are possible. These include an accumulation of premiums at a defined interest rate or receiving only a portion of premiums paid. Note that potential death benefits affect the pricing of the income benefit amount to varying degrees, depending on the age of the annuitant. The richer the death benefit feature, the lower the income payout.

Beyond the amount of the payout, one of the major design issues for this product involves the death of an annuitant during the deferral period for a joint life policy. Current tax rules require payouts of a death benefit to begin within five years of a death, even if the second annuitant is still living, which conflicts with the purpose of most longevity products. Joint annuitants must be structured as married, opposite-sex spouses with each spouse being the sole beneficiary of the other in order for the product to continue as planned under spousal continuation after a death.

Payout start date – Most products offer deferral periods of between 2-40 years, with minimum purchase ages and maximum annuitization ages. The income start date is chosen when the product is issued, but most contracts allow some amount of flexibility to change the commencement date. Any date change is accompanied by a corresponding change in payout amount, based on the new age and typically an adjustment for interest rate differences.

Anti-selection can occur from customers extending their deferral period (and thus increasing their payout) with knowledge of their health and an expectation of living longer than average. As a result, most companies place limits on the extra deferral allowed. Accelerating the start date is generally allowed with more freedom, under the assumption that the customer choice is driven by poor health and thus the company will profit.

Tax-qualified contracts must still comply with Required Minimum Distribution (RMD) rules, which generally limits the deferral by forcing payments to begin at age 70 ½. However, while an RMD must be calculated on each contract, the actual distribution in total may be withdrawn from any combination of ac-

counts. With the right disclosures and enough other assets from which to withdraw funds, deferral need not be limited by this age.

Update from the Hill

In February 2012, the Treasury Department released a set of proposals designed to ease reliance on Social Security, which triggered a flurry of activity in the longevity insurance world. These regulations would theoretically open up the market for longevity products to tax-qualified money in a number of ways:

1. Simplifying partial annuity options in 401(k) accounts, making it easier for retirees to split their account between annuities and a lump sum
2. Eliminating RMDs on Qualifying Longevity Annuity Contracts (QLACs), which facilitates deferrals beyond age 70
3. Easing the administrative requirements on plan sponsors of offering annuities in their 401(k) plans

To be considered a QLAC, the longevity contract must be purchased with the lesser of $100,000 or 25 percent of the retirement account's value and commence payments by age 85. No commutation or lump sum death benefits are permitted. The majority of products on the market should satisfy the requirements with minor changes and limitations.

While the Treasury's proposals are attractive on an individual customer level, they also hint at institutional possibilities. A partnership between insurance companies and retirement plan sponsors to offer longevity products through 401(k) plans could dramatically increase customer knowledge and exposure with limited marketing costs. At the time of writing, these proposals have not been finalized or approved.

Conclusion

The first two questions in my informal survey focus on what I consider to be a silently significant problem with retirement services: too much emphasis on accumulating wealth without a plan for decumulation. It is both unintuitive and intimidating to target a generic savings amount most middle class people are unable to achieve. By concentrating on paycheck contributions, with a specific benefit in mind, retirement goals become more definitive and attainable.

Longevity insurance is perfectly positioned to lead this pivot in retirement understanding, and we as actuaries are perfectly positioned to give it the right push. With Social Security's uncertain future, arming customers with the knowledge and products to take control of their own retirement should be a top priority. ◻