Longevity Annuities in DC Plans: New Regulations Pave the Way

By Charlie Cahill & Michael Clark - P-Solve

New regulations make it easier for Plan Sponsors to help their participants have a secure, long-term retirement. Fiduciaries of 401(k) plans have always had the responsibility to ensure that their plan’s fund line up is diverse, well-performing and maintains competitive fees. One item that has never been on the fiduciaries’ plate is ensuring that participants are saving enough to have an adequate income stream that lasts through retirement. On July 1, the Department of the Treasury and the IRS issued regulations aimed at addressing the longevity issue of retirement income by making it easier for workers to buy protection against outliving their retirement savings.

These new regulations clear previous barriers so sponsors can give 401(k) plan participants the ability to purchase a deferred annuity (aka “longevity annuity”) within the confines of their qualified plan. The regulations allow workers to purchase an annuity that starts as late as age 85. This allows workers the ability to more effectively plan their retirement spending since they will ensure that they will never run out of a regular income stream. There are limits as to how big of an annuity a person can purchase depending on whether there are spouse protections built into the annuity. The limits are between $26,000 and $42,000 per year based on the estimates disclosed in the regulations. Under the regulations the purchase price of the longevity annuity is deducted from the account balance in determining the mandatory 70½ payouts – a huge step forward for helping retirees in retirement!

J. Mark Iwry, Senior Advisor to the Secretary of the Treasury and Deputy Assistant Secretary for Retirement and Health Policy said in the bulletin issued with the new regulations:
“All Americans deserve security in their later years and need effective tools to make the most of their hard-earned savings. As boomers approach retirement and life expectancies increase, longevity income annuities can be an important option to help Americans plan for retirement and ensure they have a regular stream of income for as long as they live.”

Plan sponsors should begin discussing in-plan, longevity annuity contracts with their 401(k) plan providers to ensure that their employees have access to this important vehicle.

More Thoughts and Details

This concept of longevity protection in retirement is something that we have been focused on for a number of years. Click here to read an article featured in the Financial Analysts Journal (volume 68 number 1) entitled “Making Retirement Income Last a Lifetime” that was co-authored by one of P-Solve’s managing directors, Dan Cassidy. Strategies involving longevity annuities can be compared against the Defined Contribution Decumulation Benchmark (DCDB), a benchmark of longevity risk during retirement that we helped create in order to gauge their effectiveness. The benchmark can be accessed at www.dcdbbenchmark.com.

Outliving retirement savings is one of the biggest challenges facing the American worker today. 30 years ago, many workers were covered by traditional pensions that provide a lifetime income during retirement. Now traditional pensions have been largely phased-out and 401(k) style retirement plans have phased-in. The retirement benefits from these plans depend on the amount of money that an individual saves, plus (if they are lucky) employer contributions, plus investment returns over their career. A big concern is whether these workers will have accumulated enough to maintain their pre-retirement lifestyle once they retire and whether those funds will last through their golden years. These new regulations address the longevity issue of retirement income by making it easier for workers to get protection against outliving their retirement funds.
Mr. Iwry’s comments about increased life-expectancy are amplified by recent mortality studies by the Society of Actuaries (SOA). The SOA’s study revealed that today’s workers are living longer and that life expectancy continues to increase. The SOA tables estimate that a 65 year old today has a life expectancy of almost 23 years (Age 88!). A 2012 SOA report found an almost 50% chance that at least one survivor of a married couple would live to at least age 90.

To illustrate the value in a longevity annuity, let’s look at an example. Suppose a married retiree has approximately $650,000 at age 65. Assuming a conservative investment allocation, the account balance earns 4% each year and the retiree draws a flat $38,450 each year. By age 93 they will have run out of money (see Chart 1).

Compare that with a retiree that buys a joint and survivor longevity annuity at age 65 that will begin payment at age 85 and will continue payment for as long as either the retiree or spouse are alive*. We’ve assumed that the retiree purchases the annuity for $125,000 (see Chart 2). Here the account balance only lasts until age 85 but payments from the annuity will continue until both retiree and spouse have passed away. The trade-off here is the outlay of capital at the beginning of retirement for predictable income that will never run out during retirement.
Some retirees may look at the prospect of buying an annuity that doesn’t payout until the latter end of their retirement as a risky investment since they might see little or no payout if they do not live long. This could be a deterrent to many retirees to buying a longevity annuity. Treasury and the IRS addressed this concern by allowing these longevity annuities to offer a return of premium allowance that pays a single-sum death benefit to a beneficiary equal to the excess of the annuity premium paid over actual annuity payments made. This should make in-plan deferred annuities much more attractive to retirees since there is no real risk of losing out on their savings (despite the additional cost with the return of premium feature).

While these regulations have taken a giant leap in addressing the longevity issue in 401(k) style plans, one shortfall of the regulations is the inability to purchase a variable annuity or an indexed annuity. These types of annuities could be extremely helpful to retirees to combat inflation during their retirement years. However, Treasury and the IRS did leave room to incorporate these types of longevity annuities into a plan saying, “that the Commissioner may provide an exception to this rule in revenue rulings, notices, or other guidance.” Adding inflation protection on top of longevity protection would go a long way in protecting retirees during retirement.

With these new regulations, retirees (and those approaching retirement) have an additional tool to work with to ensure a secure retirement. The ability to purchase longevity annuities within a 401(k) style plan should help to reduce the possibility of a retiree outliving their retirement savings. Plan sponsors should begin discussions with their 401(k) providers immediately to discuss what options they have for getting longevity annuities introduced into their plans.

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*Annuity based on 2000 Mortality Table for males and females and a 3% interest rate