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Longevity Insurance in DC Plans—Paving the Way for QLACs

A Roadmap to the 2014 Regulations on Qualifying Longevity Annuity Contracts and Plan Sponsor Considerations

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Introducing the QLAC

In July 2014, the Treasury Department issued final regulations on Qualifying Longevity Annuity Contracts (QLACs). The regulations facilitate the purchase of deferred income annuities with assets in defined contribution (DC) plans—including tax-qualified plans, 403(b) plans, and eligible governmental plans under Code section 457(b)—and traditional IRAs.

As DC plans have become the primary (and often the only) source of retirement savings for today's workforce, employees face many new challenges in preparing for retirement. An Aon Hewitt study shows that the savings gap for those participating only in DC plans is large. At age 65, the average full-career participant will fall short of his or her retirement income needs by 3.8 times pay[1], creating a situation ripe for outliving one's retirement savings.

Helping participants save for retirement provides a partial solution, but cannot completely shield them from the risk of outliving their assets. Deferred income annuities, better known as "longevity insurance," are another way to help individuals address this worrisome risk. Yet this type of deferred annuity generally has not been prevalent in DC plans and IRAs for a number of reasons, including the complex required minimum distribution (RMD) rules. Per the final regulations, a participant's retirement account balance now excludes the QLAC for purposes of RMD calculations.

Treasury's QLAC regulations are a step in the right direction toward helping individuals better manage longevity risk. Deferred income annuities like the QLAC offer an efficient way to target longevity exposure by guaranteeing income in the later years of an individual's life. Plan sponsors may want to consider QLACs as an option when they review available retirement income solutions. In the long term, these regulations likely will spur innovation and potentially may create a more diverse marketplace with broader solutions for plan sponsor consideration. In the short term, sponsors will need to carefully review alternatives and may have limited available choices.

Required Minimum Distribution Requirement Relief

The required minimum distribution (RMD) rules generally require individuals to begin receiving distributions from their accounts the year for which they turn age 70½. Prior to the final QLAC regulations, the participant's account balance included the value of an in-plan longevity annuity contract when calculating the RMD each year. This created two issues:

- First, the value of the contracts needed to be calculated and added to the account balance.
- Second, the RMD payment was potentially problematic, especially for annuities where distributions began after age 70½.

The final QLAC regulations resolve these issues by excluding the value of the QLAC from the account balance when calculating the RMD payment. An annuity contract must meet certain criteria (discussed in

[1] Aon Hewitt's report, *The Real Deal: 2012 Retirement Income Adequacy at Large Companies,* looks at retirement income adequacy at retirement. For plan participants whose only employer-sponsored plan is a defined contribution plan, who are saving in the plan, *and* could have a full 30-year or more career with their employer, the average projected savings needed at age 65 to maintain their standard of living is 16.6 times their pay at retirement. Social Security's value is 5.5 times pay and the defined contribution plan is projected to provide 7.6 times pay, leaving a gap of 3.8 times pay in savings at age 65.

more detail below) to “qualify” as a QLAC. Modifying the RMD rules for QLACs may open the door for their greater use in DC plans and traditional IRAs.

Features of the QLAC

To qualify as a QLAC, and thus receive relief from the RMD rules, longevity annuities must satisfy the following requirements:

- **Cap on Amounts Used to Purchase QLACs.** Aggregate premiums paid over a participant’s lifetime for the QLAC in a DC plan cannot exceed the lesser of:
  - $125,000 (increased for cost-of-living adjustments in $10,000 increments); or
  - 25% of the individual’s account balance as of the last valuation date prior to purchase.
- **Maximum Commencement Age.** The deferred commencement age can be no later than age 85.
- **Types of Contracts.** The QLAC cannot be a variable annuity contract or an equity-indexed contract, but it can provide for cost-of-living adjustments.
- **No Commutation Benefits.** The QLAC cannot offer the insured the option to cash out the benefit or in other ways accelerate payments.
- **Other RMD Requirements Must Be Met.** All RMD requirements must be met except for the timing of the commencement.
- **Annual Disclosure Requirement.** Each year, the insurer must provide:
  - The IRS with information about the annuity contract, including the fair market value of the contract.
  - The participant with an annual statement that includes the value of his or her QLAC.
- **Taxation Not Addressed.** The QLAC regulations do not address taxation, either at the time of the investment in the QLAC or at the distribution of QLAC proceeds. It is our understanding that the taxation rules for contributions and distributions that would typically apply to a tax-qualified retirement vehicle would also apply for participants who are, or have, invested in a QLAC.

Despite the requirements outlined above, plan sponsors can structure the QLAC in a variety of ways to provide asset protection upon death through either a continuation of payments for beneficiaries and/or a return-of-premium feature.

New Opportunities for Plan Sponsors

The QLAC may be an attractive option in a DC plan because it provides longevity protection as part of a participant’s investment portfolio. Not surprisingly, adoption is likely to occur slowly, as we’ve seen with other “new” DC plan features. Initially, we expect to see opportunistic implementations by some plan sponsors that are ready to take advantage of QLACs, while others may move with some reticence as they wait for further market developments.

Despite anticipated slower initial broad-based adoption, the QLAC does allow sponsors to give participants an opportunity to achieve improved drawdown outcomes. Whether or not QLACs become viable for broader adoption will depend on how the markets, products, and thought leadership evolve over time. For sponsors that are early adopters, their decisions about both the plan and product structures will influence the QLAC marketplace development and what options eventually become available to plan participants.

Plan Considerations

Choosing a QLAC is a fiduciary decision, so plan sponsors will need to weigh their options carefully. They will also need to consider a multitude of factors including the plan design, communication, and administration when deciding whether and how to implement a QLAC.

Fiduciary Implications

Consistent with fiduciary expectations, plan sponsors will need to assess the creditworthiness of the underlying insurer or insurers of the plan's QLACs. This analysis is similar to what one would expect of a fiduciary in assessing any investment option offered under the plan. Sponsors should expect to conduct periodic reviews and complete ongoing analysis of the insurer(s).

Please note: The Department of Labor (DOL) is targeting January 2015 to amend its current rules regarding fiduciary considerations for annuities available as distribution options in DC plans.

Plan Design

Plan sponsors should view the full range of retirement income solutions and consider the pros and cons of the QLAC relative to other available options. This should be a plan design decision rather than a response to a product offering. Design characteristics include:

- Offering an in-plan QLAC or an out-of-plan purchase of a longevity contract;
- Providing the opportunity to buy the QLAC over time in order to dollar-cost average, or offering a point-in-time purchase at retirement; and
- Incorporating the QLAC into specific investment strategies like target-date investments or as a separate core investment option.

With each plan design decision, plan sponsors also need to consider how to help participants understand their options and how they can use the retirement income solution to optimize benefit outcomes.

Communication

Offering a QLAC is only the first step—having appropriate participant utilization is the long-term measure of success. That's why effective QLAC communication is critical. The most successful outcomes include active communication strategies and recordkeeping plan integration, regardless of the retirement income solution offered to participants. Based on industry experience, those plans that adopt retirement income solutions without adequate communication to participants tend to experience lower participant adoption and acceptance.

Administration

As with any new product, plan sponsors will need to work with their recordkeeper and their selected insurer(s) to implement a QLAC. The providers' capabilities may influence decisions about design and timing. The degree of integration between the insurer(s) and recordkeeper will also influence the participant experience at several points in time as plan sponsors consider factors like: 1) evaluating the QLAC as a viable option; 2) purchasing the QLAC; and 3) determining retirement readiness.

Product Considerations

While a plan sponsor should consider what type of retirement income strategy best meets desired outcomes, product availability and features may influence the implementation strategy and timing.

QLAC Features

To the extent there is plan sponsor interest, insurance companies are likely to develop a variety of QLAC offerings. Sponsors will need to understand these differences and do a thorough product comparison before choosing the appropriate QLAC for their plan. Factors in the selection process may include the QLAC design, the portability, and how easily it can be supported by various recordkeeping platforms.

Structure

When considering a QLAC, one option for plan sponsors is multiple-insurer strategies, which in essence mitigate risk through broad insurer diversification. However, this option could add significant complexity and perhaps additional cost compared to single-insurer strategies. As with any other decision, sponsors will need to consider the cost and benefit tradeoffs.

Timing

Initially, we expect the marketplace to focus attention on IRA QLACs because an outside-of-the-plan offering will be easier to implement than in-plan QLACs. Recordkeepers that are also insurance companies may have the highest incentive to develop in-plan solutions, and therefore may do so sooner. A catalyst for broader and faster adoption may depend on the emergence of third-party middleware providers that have the ability to establish open architecture solutions to connect recordkeepers with various insurers.

Putting It in Perspective

The risk of outliving retirement assets is a very real and important consideration for many workers. Access to retirement income solutions is a meaningful way plan sponsors can help participants protect themselves and draw down their retirement assets prudently. From an income receipt perspective, the final QLAC regulations provided an example that showed that a person purchasing a QLAC for $100,000 at age 70 and commencing payments at age 85 might receive $26,000 to $42,000 annually, depending on the chosen form of annuity.[2, 3]

These regulations open the door to longevity insurance solutions and market innovations that were incomplete in the past. Increased focus on the distribution phase may allow plan sponsors to offer a more complete retirement program and achieve better participant outcomes.

[2] Source: Department of Treasury, Internal Revenue Service 26 CFR Parts 1 and 602. According to the final regulations, the illustrations assume a 3% interest rate, no pre-annuity starting date death benefit, use of the Annuity 2000 Mortality Table for males and females, no indexation of the annuity stream for inflation, and no load for expenses

[3] Aon Hewitt is developing an upcoming paper to discuss the QLACs' quantitative aspects. The paper will include a focus on the economic tradeoffs of using QLACs in participant portfolios and other quantitative considerations.

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