Fiduciary Commentary

Winter 2015/2016

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By: Brant Griffin - February 10, 2016

QLAC Market Update

Today's retirement challenges are vast, and support the need for products to help investors better manage income during retirement. There is no shortage of statistics to illustrate the risks retirees face of outliving their assets; life expectancy today, exceeding 78 years, magnifies these challenges as savers struggle to produce income in preparation for a longer retirement. A survey conducted by the American Institute of CPAs found the major concern of their clients to be insufficient savings to meet the needs of a prolonged life expectancy. Herein lies the clear appeal of longevity annuities – lifetime income that is guaranteed regardless of market conditions or unforeseen events.

In July 2014, the Treasury and IRS issued final regulations on the treatment of qualified longevity annuity contracts or QLACs. The regulations provide an exception to the required minimum distribution rules (RMDs) that permit investors to use a portion of their retirement accounts to purchase a deferred income annuity.

QLAC Basics

QLACs are deferred income annuity contracts that permit individuals in defined contribution plans or IRAs to manage retirement income by deferring benefit payments until an advanced age (but not later than 85). The contract serves as longevity insurance, assuring that there will be income through the end of life. Contributions to the contracts cannot exceed the lesser of $125,000 or 25% of the employee's retirement account balance (aggregated among all defined contribution plans and IRAs), and must provide guaranteed monthly payments. The products may also be designed to offer a return of premium feature to a beneficiary.

Where are They?

Despite the attractiveness of these products, there have only been a small handful of insurers that have developed QLAC products. With the ink still drying from the regulations, the investments are still considered a new creation in the insurance and retirement industries.

Currently, there are no longevity annuities available for defined contribution plans (although there are other plan-level annuities available). To date, the only products developed have been for the more adaptable retail IRA marketplace, where logistical challenges are less daunting than they are in the defined contribution environment. The obstacles for the insurance industry in launching a plan-level product involve a host of efforts that are distinct from the IRA marketplace. Additional distribution and administration costs effectively make a retirement plan product a new offering with little, if any, economies of scale with retail distribution.

Obstacles to Adoption

From a fiduciary perspective, the adoption of a QLAC is a decision involving considerable nuances. As with any plan investment, a fiduciary must evaluate the annuity's appropriateness for its participants. However, the responsibility in prudently selecting the product involves a variety of factors that are not typically present with other investments. The due diligence process would include not only an evaluation of the adequacy of the product's annuity payments, but an assessment of the insurance carrier's financial strength including an examination its credit rating and the investment quality of its general account – on an ongoing basis! According to the *Towers Watson 2014 Defined Contribution Survey*, the liability associated with insurer selection process is one of the primary reasons employers do not offer lifetime income products.

Additionally, significant administrative obstacles exist for annuity investments to be integrated into defined contribution plans. Today's plan recordkeeping systems were designed to track participant purchases of shares of investments, not an annuity's mortality credits. Consequently, all plan providers do not maintain the technology to track participants' annuity contributions. Not only does this hinder the availability of QLACs, but also the portability of any QLAC selected if the plan migrates to another recordkeeping provider. Thus, the fiduciary risk of the early adopter is real.

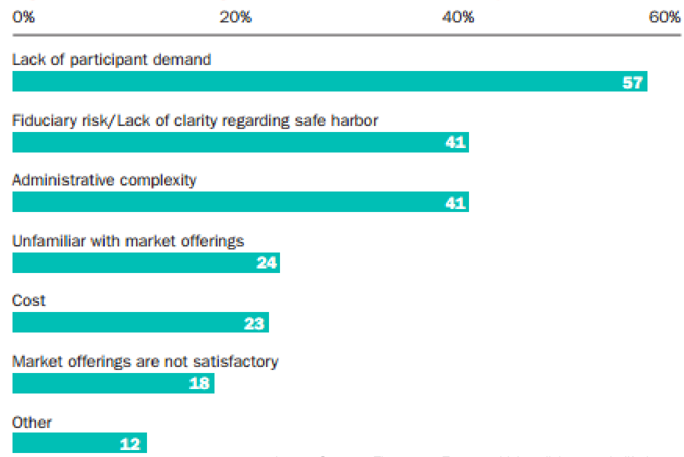

Image Source: Figure 11. Factors driving disinterest in lifetime income options from "Towers Watson North American Defi ned Contribution Plan Sponsor Survey Report" (2014)

Due to the challenges facing QLACs in adapting to defined contribution plans, many believe deferred annuities are more likely to find traction in target date funds. After the final QLAC regulations, separate guidance permitted the use of deferred annuities in a sleeve of a target date fund's fixed income allocation (and offered as a plan's QDIA). The appeal of this solution is that the annuity is then part of a cohesive investment offering where the responsibility for the selection and monitoring of the annuity would reside with the TDF's investment manager.

Conclusion

The regulations permitting the development of longevity annuities in defined contribution and IRA accounts highlight the cross-agency efforts, and the broader public policy goal to encourage the use of tools to manage retirement income. Despite these attempts, in the year and a half since the final QLAC regulations became final, the product development train is moving at a snail's pace.

Over the years, the retirement plan industry has proven adept to change. The industry has integrated major policy shifts with the introduction of legislative initiatives such as plan automation features, the introduction of target-date funds and qualified default investment alternatives. Overtime, I foresee QLACs gaining momentum once investors comprehend the unique value of guaranteed lifetime income in providing an effective answer to address longevity risk. Then, investor demand should finally spur the development of more diverse products to create a more competitive marketplace for plan sponsors.

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