

# Longevity Insurance Annuities in 401(k) Plans and IRAs

What role should longevity insurance annuities play in 401(k) plans? This article addresses the question of whether participants, and in particular men, should consider purchasing longevity insurance annuities through a 401(k) plan. It first describes what longevity insurance annuities are. It then discusses the proposed regulation and the Financial Engines product. With that background, it evaluates whether participants should purchase longevity insurance in 401(k) plans and, alternatively, in individual retirement accounts (IRAs).

by **John A. Turner, Ph.D.** | *Pension Policy Center* and **David D. McCarthy** | *Pension Policy Center*

**L**ongevity insurance annuities are deferred annuities that begin payment at an advanced age, such as 85. Because these annuities provide insurance against running out of money at advanced ages, they have attracted interest recently as an important innovation in the way retirement income is provided. To encourage their use, the Treasury Department in early 2012 released a proposed regulation<sup>1</sup> designed to encourage 401(k) plans and similar plans to offer a longevity insurance annuity as a form of benefit payout. The proposed regulation also applies to individual retirement accounts (IRAs). Also encouraging their use, early in 2012 the financial advisory company Financial Engines announced a new financial product for 401(k) plan participants for the payout period that includes longevity insurance annuities as an optional part of a complex package.

This article evaluates the possible role of longevity insurance annuities in 401(k) plans. It addresses the question of whether participants, and in particular men, should consider purchasing them through a 401(k) plan. It first describes what longevity insurance annuities are. It then discusses the proposed regulation and the Financial Engines product. With that background, it evaluates whether participants should purchase longevity insurance in 401(k) plans and, alternatively, in IRAs.

## What Are Longevity Insurance Annuities?

While all annuities provide retirees a degree of longevity insurance, in recent years the term *longevity insurance* has been used to refer to a particular type of deferred annuity, also known generically as *advanced life deferred annuities*

or *longevity annuity contracts*, as well as by product names used by life insurance companies providing them. Longevity insurance is a deferred annuity that starts at an advanced age, such as 85. This annuity is similar to buying car or home insurance with a large deductible, which optimally deals with catastrophic risk. By analogy, longevity insurance annuities provide insurance against outliving one's assets, but only when that risk becomes substantial at advanced ages (Milevsky 2005). The risk of people outliving their assets is increased when life expectancy is increasing, when people underestimate their life expectancies and when inflation-adjusted capital market returns are low.

Retirees face the risk of spending down their assets too quickly, especially if they live longer than expected. However, they also face the opposite risk of spending less than they otherwise could out of concern for having enough assets to pay for an unexpectedly long life. Unless they choose some type of annuity, retirees with 401(k) plans may face the difficult challenge of managing the spend-down of their assets over a retirement period of uncertain length.

With a longevity insurance annuity, the planning problem is simplified. Instead of planning for an uncertain period, participants can plan for a fixed period—from the date of their retirement to the date at which they start receiving the longevity insurance benefit. Longevity insurance thus reduces uncertainty in planning. It changes the planning problem from one with an uncertain end point (date of death) to one with a certain end point (the date at which longevity insurance begins providing benefits). An additional advantage of longevity insurance annuities is that they provide an (imperfect) alternative to long-term care insurance for those who are unable to qualify for that insurance. With the decline in defined benefit plans, they also serve as an alternative to the annuities provided by those plans.

Life annuities are both an investment product and a product that provides insurance against the risk of outliving one's assets. Given that, in the absence of an annuity, most retirees presumably would plan to draw down their assets at a rate intended to last until at least the age of 80, the longevity insurance value of benefits payments prior to that age is limited. Benefits provided by immediate annuities prior to the age of 80 are primarily return on an investment managed by the in-

surer. Longevity insurance provides an opportunity for retirees to retain control of their retirement assets for many more years without risk of outliving their assets because they would be substantially less expensive than traditional life annuities. Webb et al. (2007) estimate that retirees could maintain level income throughout retirement by purchasing at the age of 60 longevity insurance providing for payments beginning at the age of 85 for a relatively small amount—15% of pension wealth. Thus, a further advantage of a longevity insurance annuity is that it clarifies to the worker that he has the option to partially annuitize his account balance, rather than making an all-or-nothing decision. It allows individuals to purchase an annuity without needing to give up a relatively large sum of money, which many retirees are reluctant to do.

As an example, a longevity insurance annuity purchased with \$100,000 at the age of 70 would be expected to provide annual payments starting at the age of 85 of between \$26,000 and \$42,000, depending on the interest rate, whether a joint-and-survivor annuity was chosen and other factors. If the purchase was made at the age of 65, the \$42,000 figure would increase to \$51,000 (U.S. Treasury 2012). Alternative estimates indicate that an immediate annuity purchased with \$100,000 and starting at the age of 65 would provide \$6,950 a year for life, compared to the same purchase with benefits starting at the age of 85 yielding \$63,990 for life (Tergesen 2012). These benefits would be subject to inflation risk, but some policies allow for lower starting benefits with an automatic escalation. The amount of benefit depends on the interest rates prevailing at the time of purchase, with a risk associated with these annuities being that the purchase occurs at a time when interest rates are low. A strategy to deal with that risk would involve making smaller purchases of longevity insurance annuities over a period of several years.

While many life insurance companies do not currently offer this annuity, three that do are New York Life Insurance Company, Symetra Life Insurance Company and Northwestern Mutual Life Insurance Company (Tergesen 2012). New York Life is currently the largest seller of this type of annuity in the United States. However, only 4% of the purchasers of these annuities purchase an annuity that is solely a longevity insurance annuity. Most purchase such annuities that also provide death benefits (New York Life 2012).

### Recent Developments Encouraging Use of Longevity Insurance Annuities in 401(k) Plans

Two recent developments are designed to encourage the use of longevity insurance annuities in 401(k) plans and IRAs by accountholders. The proposed regulation by the Treasury Department in early 2012 deals with the issue of required minimum distributions (U.S. Treasury 2012). It clarifies that purchase of a qualified longevity insurance annuity would not be prohibited by the required minimum distribution rules. Under the proposed amendments to these rules, “prior to annuitization, the participant would be permitted to exclude the value of a longevity annuity contract that meets certain requirements from the account balance used to determine required minimum distributions.” The percentage of the participant’s account balance that could be used for this purpose would be limited to 25% of the account. In addition, a maximum dollar amount of \$100,000 would be set, which would be the maximum amount for all plans the participant had in which he purchased such an annuity.<sup>2</sup> The payment of the annuity must begin by the age of 85.<sup>3</sup> The annuity would be permitted to have some type of acceleration option so that payments increased over time to offset the effect of inflation. The requirements allow only a limited number of options to be available, in part to make it easier to compare products, such as annuities provided through IRAs. Other requirements would also apply in order for the annuity to be deemed to be a qualifying longevity annuity contract (QLAC).

The second development is the availability of financial products to help individuals manage investments up to the age at which the longevity annuities begin payment. Beginning in 2012, the financial advisory company Financial Engines provides a lifetime retirement income product called Income+ (Financial Engines 2012). It is a managed draw-down product combined with an optional longevity insurance annuity. It is managed within the 401(k) plan, so the participant does not need to roll over his account. Income+ provides retirees the option of choosing the timing and amount of monthly payments or suspending monthly payments within the framework of a managed account. It uses bonds and money market funds to provide a base of steady monthly payments, as well as equity funds to provide upside

potential. It also provides an optional longevity insurance annuity that starts payment as late as the age of 85 or, alternatively, an immediate annuity whose purchase is deferred up to the age of 85. The annuity generally is purchased outside the plan and thus is a gender-based annuity, but may be purchased within the plan, which would be a unisex annuity. In some cases it may be purchased from a defined benefit plan of the same plan sponsor.

### Evaluation of Longevity Insurance Annuities in 401(k) Plans

Annuities provided through employer-provided retirement plans in the United States must calculate benefits on a unisex basis because of a Supreme Court ruling that using gender-based mortality tables in employer-provided pension plans would constitute sex discrimination in compensation. In *Arizona Governing Committee for Tax Deferred Annuity & Deferred Compensation Plans v. Norris*, 463 U.S. 1073 (1983), the Supreme Court held that men and women were required to have the same level of annual benefits provided by the annuities from their employer-provided pension plan if they were the same age and had the same account balance.<sup>4</sup> Thus, employer-sponsored benefits are required to use the same mortality rates for men and women, despite the fact that women at typical retirement ages on average live about three years longer than men (Arias 2011). Annuities individuals purchase with nonpension funds and annuities purchased through IRAs do not have this requirement and are sold on a gender basis in nearly all states. Benefit levels provided by unisex single life annuities are favorable to women but adverse to men, compared to those provided by gender-based annuities.

In the annuities provided by 401(k) plans, the disadvantages to men of purchasing unisex single life annuities would be offset to some extent because group annuities offered through employers are priced cheaper than single annuities in the private market. The net effect on the cost of annuities within the plan versus outside the plan is an empirical question.

From the U.S. life tables for 2007 (Arias 2011), it can be calculated that women aged 62 are 35% more likely than men that age to survive to the age of 85. At 85, women’s life ex-

pectancy is 17% longer than that of men. Thus, when priced using gender-based mortality rates, women's single life longevity insurance annuities purchased at the age of 62 and beginning payments at the age of 85 would cost considerably more than those for men, perhaps as much as 50% more, depending in part on interest rates. For this reason, it is likely that men would be able to obtain longevity insurance annuities at substantially lower cost outside of a 401(k) plan than inside the plan.

With voluntary choice of annuities, problems of adverse selection arise, which further increase the disadvantage to men. With adverse selection, people with mortality rates above the group average are less likely to choose annuities than are people with mortality rates below the group average. In the case of unisex annuities, adverse selection results in women being more likely to choose single life annuities offered by 401(k) plans than are men. The outcome of voluntary choice and adverse selection is that the advantage that unisex pricing provides to women is reduced and the disadvantage to men increased compared to a situation where choice of annuities is mandatory. That occurs because the mortality rate assumed by the annuity provider presumably reflects the fact that men under these circumstances are less likely to choose annuities than women. The extent to which adverse selection reduces the advantage of unisex annuities to women and increases the disadvantage to men is also an empirical question.

A study by von Gaudecken and Weber (2006) has examined the effects of unisex pricing on single life annuity prices for annuities commencing payment at retirement in the context of the German requirement abolishing gender-based pricing for pension annuities starting in 2006. The study finds that German insurers expected few men to choose unisex annuities and consequently priced them at almost the level of female-only annuities. Thus, women were helped only marginally, with their mean benefits rising 1.2%, while men choosing the annuities would receive benefits 7% lower than before the requirement took effect. These magnitudes apply for an immediate annuity and would be considerably larger for deferred annuities. This study implies that, except for access to group rates, adverse selection leaves relatively little advantage to women to pur-

chasing a longevity insurance annuity through a 401(k) plan, as compared to outside the plan, and a sizable disadvantage to men.

The disadvantage to men of annuity purchases through 401(k) plans is reduced, or perhaps nearly eliminated, in some specific circumstances. In defined contribution plans for industries or occupations that predominantly employ men, unisex pricing would not be adverse to men since there would be few women in the annuity pool. The disadvantage is also reduced for men choosing annuities with survivor benefits, since those benefits combine both male and female mortality risks.

### **Longevity Insurance Annuities in IRAs**

The Treasury Department's proposed regulations facilitating the purchase of longevity insurance also apply to IRAs. However, the unisex requirement does not. For this reason, it may be advisable for men to roll over their 401(k) plan assets to an IRA or to use assets already in an IRA if they wish to purchase an annuity. A problem with the proposed regulations is that the 25% limit applies separately for IRA and 401(k) account balances (American Benefits Council 2012). A possible resolution of this problem is to aggregate IRA and 401(k) account balances in determining the dollar value associated with the 25% limit. Alternatively, as already generally occurs, the individual can roll over the entire 401(k) account balance to an IRA.

Individuals purchasing longevity insurance annuities within an IRA plan would face the disadvantage of needing to make the purchase without benefit of an employer having a fiduciary duty to screen annuity providers. They may have difficulty finding a longevity insurance annuity, since many insurance companies do not offer them. If they seek financial advice outside of the plan, they may encounter an insurance salesperson without a fiduciary duty to them.

If the annuity were to be purchased outside a 401(k) plan or IRA through the cash out of a portion of plan assets, the participant would incur tax liability at that point. For that reason, a preferable strategy would be for men to roll over sufficient assets to purchase longevity insurance via an IRA and to make the purchase from that account.

## Conclusions

Men generally face a considerable disadvantage, compared to women, in purchasing longevity insurance annuities through a 401(k) plan due to the requirement of unisex pricing. Men generally would be much better off making such a purchase through a rollover to an IRA. To the extent that such adverse selection occurs, the longevity insurance annuities obtained through 401(k) plans would be priced based mainly on women's life expectancy. Thus, adverse selection would reduce the advantage to women of purchasing through a 401(k) plan, compared to purchasing through an IRA, though presumably some advantage would remain due to the cost-reducing effect of group pricing through the 401(k) plan. These effects would be smaller in industries where the plan participants were primarily male, and for retirees who choose survivor annuities. While encouraging participants in 401(k) plans to consider purchasing longevity insurance annuities has some merit, generally males would be well-advised not to make such a purchase within the plan but instead to do it via rollover to an IRA. 

## Endnotes

1. Longevity Annuity Contracts, 77 Fed. Reg. 5,443 (proposed February 3, 2012); Modifications to the Minimum Present Value Requirements for Partial Annuity Distribution Options Under Defined Benefit Pension Plans, 77 Fed. Reg. 5,454 (proposed Feb. 3, 2012). Available at [www.gpo.gov/fdsys/pkg/FR-2012-02-03/pdf/2012-2340.pdf](http://www.gpo.gov/fdsys/pkg/FR-2012-02-03/pdf/2012-2340.pdf).
2. The maximum dollar amount would be adjusted with respect to increases in the price level, in increments of \$25,000.
3. The maximum age can be adjusted by the commissioner of the Internal Revenue Service, for example, through Revenue Rulings, to take into account improvements in life expectancy.
4. See McCarthy and Turner (1993) for an analysis of the impact of this ruling on sex discrimination in compensation. Starting in December 2012, the European Union will require unisex pricing of annuities, which implies that the analysis contained in that paper and this article will apply there.

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## AUTHORS

**John A. Turner, Ph.D.**, is director of the Pension Policy Center in Washington, D.C., where he provides consulting and research on pension policy. He has published 12 books on pension policy; two have been translated into Japanese and two are



required reading for Society of Actuaries examinations. He has published more than 100 articles. Turner has advised on pension policy in Tajikistan, Tanzania, Albania, Macedonia, Indonesia and other countries. He has a Ph.D. degree in economics from the University of Chicago.

**David D. McCarthy** is a consultant to the Pension Policy Center. During a 35-year career with the Department of Labor's Employee Benefits Service Administration, he received numerous awards for his work on employee benefit research, regulatory analysis and program evaluation and was a co-recipient of a Feature Article of the Year award from the *Journal of Risk and Insurance*.



After his retirement in 2011, he received the department's Distinguished Career Service Award. He holds a B.A. degree from Amherst College and an M.S. degree in operations research from George Washington University.