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## The Annuity That Pays for Itself

By Kerry Pechter     Sat, Oct 15, 2016

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On the other hand, there's one income-generating annuity whose usage the Feds actively encourage: the qualified longevity annuity contract, or QLAC. It lets retirees buy an income annuity at say, age 65, with up to a quarter of their IRA (<\$125,000) and defer income (and the federal tax on that income) until as late as age 85 without violating the rules that require IRA withdrawals to begin at age 70½.

You may be thinking: The deferred income annuity already has three strikes against it. As a simple spread product, it's not profitable enough for publicly held insurers; by reducing assets under management, it reduces the income of fee-based advisors; and, because of its illiquidity, it's not even popular with retirees. Indeed, few people probably know it exists.

But QLACs have a couple of admirable, and timely, characteristics. Except for clients who have too little money or are in poor health, QLACs are likely to be in a retiree's "best interest," and therefore compliant with the new DOL rule. And, as academics have been saying for several years, they allow retirees to spend their non-annuitized money a little more freely.

To understand the logic of QLACs, consider a new academic paper from the National Bureau of Economic Research. Written by Olivia Mitchell of the Wharton School and Raimond Maurer and Vanya Horneff of Goethe University in Frankfurt, Germany, it demonstrates that longevity insurance, as QLACs are also known, can, when used strategically, almost pay for itself. (The authors present the QLAC as a distribution option in a 401(k) plan, but their findings are valid for IRA owners.)

The three economists, who have studied the use of QLACs in Germany and Singapore, where retirees are required to purchase them with part of their tax-deferred savings,

described two hypothetical college-educated women, one who bought a QLAC with 15% of her qualified savings at retirement and one who did not.

They found that the woman with the QLAC could afford to save a bit less before retirement, spend between five percent and 20% more during retirement, and probably have much more spending power after age 85 than the person without access to a QLAC.

“Introducing a longevity income annuity to the plan menu is attractive for most DC plan participants who optimally commit 8-15% of their plan balances at age 65 to a LIA that starts paying out at age 85. Optimal annuitization boosts welfare by 5-20% of average retirement plan accruals at age 66 (assuming average mortality rates), compared to not having access to the LIA,” the authors write.

Maurer, in an email exchange with RIJ, acknowledged that the following scenario would provide an approximation of what he and Mitchell found. For example, a single man with a more typical \$120,000 IRA could, under the QLAC rules, allocate \$30,000 at age 65 to a life-only QLAC paying about \$1,200 per month starting at age 85.

Alternately, the same man, seeking the same level of longevity risk protection, could wait until age 85 to buy an immediate annuity. But a life-only annuity paying \$1,200 per month for life, purchased at that age, would cost \$100,000. The man would have to create a side fund of about \$55,000 at age 65 to accumulate \$100,000 by age 85, assuming a 3% growth rate.

In other words, the QLAC gives this hypothetical client \$25,000 more spending power in retirement (by spending \$30,000 on an annuity at age 65 instead of putting \$55,000 in a side or “granny” fund). While \$25,000 over 20 years might not sound like much—it’s an average of only about \$100 per month—it’s enough to finance a fair amount of vacation travel during the so-called “go-go” years (ages 65 to 75).

So, counter-intuitively, the longevity insurance gives the retiree more liquidity in retirement rather than less. Of course, the same individual could simply ignore longevity risk, not set aside any side fund at all and assume that he will die by age 85. But advisors who specialize in retirement income might tend to advise against that.

“This is a nice example which is easy to understand,” Maurer wrote in an email to RIJ this week. The QLAC strategy, the paper notes, works best on average for people with substantial qualified savings, which in many but not all cases means people with higher educational attainment, higher incomes and longer life expectancies.

Maurer, Horneff and Mitchell aren't the first to observe that by relieving retirees of the duty to hoard their savings against the possibility of living past age 85 and by unlocking the "mortality credits" that accrue to owners of life-only annuities as a result of risk-pooling, deferred income annuities can make retirement more financially comfortable for many people.

To name just a few: Jason Scott of Financial Engines, Wade Pfau of The American College, David Blanchett of Morningstar, Moshe Milevsky of York University, and Jeffrey Brown of the University of Illinois-Chicago, have all contributed to the literature in this area over the past decade.

QLACs have another big advantage that isn't mentioned in the new paper. By reducing a retiree's longevity risk, these contracts arguably create more capacity for taking on equity risk with non-annuitized assets. Owning more stocks can protect clients against inflation risk and arguably raises the likelihood of producing a larger legacy.

To be sure, the pros and cons of longevity insurance have been known for some time. But what's new are the Treasury Department's exemption of QLACs from RMDs at age 70½ and the DOL's "best interest" requirement for retirement advisors. Advising clients to allocate part of their IRAs to longevity insurance might be a smart way for advisors and clients to take advantage of one and satisfy the demands of the other.

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