American Academy of Actuaries
Lifetime Income Initiative
ISSUE BRIEF

OCTOBER 2015

Risky Business: Living Longer Without Income for Life
Actuarial Considerations for Financial Advisers

The number of baby boomers retiring over the next 20 years will, as a matter of demographic reality, increase the nation's attention on the needs of seniors and their unique financial risks in retirement.

Professional financial advisers can play a critical role in promoting responsible, risk-intelligent financial solutions to generate lifetime income. The purpose of this brief is to provide actuarial insights regarding lifetime income planning, which includes identification of various financial products and strategies available to mitigate risks, and to highlight emerging issues relating to lifetime income planning.

Lifetime Income Planning: It's Not Just an Investment Issue

As the baby boom generation transitions from their working years, when they have accumulated assets for retirement (the "accumulation" or "savings" phase), into retirement, when they will be drawing upon various financial resources to generate income (the "decumulation" or "payout" phase), there are several important changes in their financial situation that should be realized:

- the value of one's "human capital" (value of future wages) will diminish; and
- the individual will therefore become more reliant upon accumulated savings and accrued lifetime income benefits to meet future income needs, and less reliant upon future wages

Further, for most of us, finite financial resources—including Social Security—accumulated during the working years must provide for lifetime income needs over a future that will pose uncertain financial needs affected by various life contingencies and other challenges, including:

- **Time horizon.** The longer an individual lives, the more income is needed to meet the living expenses in these later years.
- **Health.** Poor health often results in a need for higher income to provide for higher health care costs, potentially at a time when the individual is unable to generate that higher income.
- **Daily-living needs.** Long-term care needs require higher income to pay for the services and supports for the associated activities of daily living.
- **Health care costs.** As the cost of health care continues to increase, more income will be needed to meet these higher costs.
- **Inflation.** The inflation-adjusted cost of living can be significantly higher during retirement than during an individual's working years.
- **Investment returns.** These returns and the sequence of these returns realized during retirement can significantly impact available assets.
- **Tax rates.** The uncertainty of future income tax rates, property tax rates, and other taxes creates additional challenges.

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A well-designed financial strategy during retirement should identify and appropriately manage these risks.

Depending on an individual's circumstances, different financial strategies might be needed to manage these uncertainties. For example:

- Individuals who have accrued substantial lifetime income benefits under a retirement plan in addition to Social Security will likely require a different financial strategy than otherwise similar individuals who have not accrued any lifetime income benefits.
- Individuals with significant financial resources may have the ability to "absorb" potentially uncertain costs by drawing down savings, while individuals with fewer financial resources may not have sufficient funds to meet these needs in that way.
- Individuals who plan to make significant bequests may want greater assurance of preserving a minimum amount of assets, while individuals without significant bequest needs might be less concerned about asset preservation.
- Individuals with higher levels of financial risk aversion may require a different financial strategy than individuals with high risk tolerance.

While strong investment returns would certainly enhance one's ability to meet potentially higher income needs in the future and extend the longevity of an individual's savings, investment strategies that have the potential for generating high returns typically possess greater risk, which contributes to future economic uncertainty rather than reducing it.

Lifetime income planning will often benefit from the use of a diversified approach to risk mitigation, extending beyond the relatively narrow lens of investment risk. The use of risk-pooling mechanisms, including insurance-based solutions, can be a powerful tool.

- Risk-pooling mechanisms can help transform highly uncertain costs, such as long-term care, into more predictable costs, such as a premium for a long-term care policy.
- Risk pooling can be less expensive than self-insured strategies because it spreads the cost of the "worst-case scenario" over a broad population. For example, single premium immediate annuities (SPIA) or deferred income annuities (DIA) can provide more generous levels of lifetime income than a systematic withdrawal strategy from personal accounts. This is due to the SPIA's or DIA's mortality credits or risk pooling benefits made available by those who die before their life expectancy. Additionally, these annuities utilize the planned consumption of principal. Systematic withdrawal strategies require more savings to be set aside to allow for investment return uncertainties and to have enough assets to meet potential income needs beyond life expectancy.
- Risk pooling might allow a wider range of potential investment strategies with more asset categories than could otherwise be considered in the absence of risk pooling. For example, a DIA can be combined with a withdrawal strategy. Because pooling-based solutions can reduce risks, they can allow for higher risk in the remainder of a balanced portfolio.

Even when risk pooling is not appropriate for a given individual, lifetime income planning can still add value. For example, quantifying a sustainable level of systematic withdrawals and how this might need to be adjusted under different economic scenarios (e.g., inflation) is a useful way to assess exposure to risk and an individual's appetite to bear this risk.

A judicious use of pooling-based solutions, integrated with appropriate investment strategies, can often yield a more favorable financial result than one that fails to take pooling into appropriate consideration.

Lifetime Income Risks and How to Mitigate Them

There are certain risks associated with providing sufficient lifetime income, several of which can be mitigated through the use of specific financial approaches (and, in certain instances, different types of financial products. See table at the bottom of this page.)

While insurance-based solutions have their benefits, selection of the insurer and an understanding of the state guaranty associations should be considered.

In addition, the insurance marketplace often has a wide variety of products offered by many different insurance companies. As a result, the price and benefit features of products offered can vary considerably. Due diligence is therefore required to sort through the options available and determine whether a given solution is a good alternative.

Managed payout strategies, such as structured withdrawal programs and bond ladders, have their own issues that should be carefully examined during the lifetime income planning process, including:

- What factors can affect the level of payout realized?
- How likely is it that payouts will be adjusted because of investment returns, inflation, and other uncertainties, and by how much?
- How will the managed payout strategy perform if I live beyond my life expectancy?
- How can managed payout strategies be adjusted to mitigate this risk?

Financial Advisers – A Critical Role in Improving Lifetime Income Strategies

The additional considerations associated with the decumulation phase and the range of financial products available make lifetime income planning more complex than financial planning in and of itself during the accumulation or saving phase. Financial advisers can serve a critical role in helping individuals navigate through these complex issues and find a financial strategy that is well suited to their needs and objectives. In doing so, selected actuarial considerations that may be useful include:

- Reviewing important decisions such as the deferral of Social Security, lump-sum elections on defined benefit plans, and elections of single life vs. joint and survivor annuity income options.
- Assuring that a financial portfolio is comprehensive and appropriately integrated (e.g., asset allocation appropriately reflects the Social Security approach selected and the existence or absence of pension benefits or insurance-based solutions).

Lifetime Income Risk	Potential Risk Mitigants
Longevity risk	Social Security Pension benefit Single Premium Immediate Annuity (SPIA) Annuity with Guaranteed Lifetime Withdrawal Benefit (GLWB) Longevity insurance Reverse mortgage (with tenure option) Managed payout strategies
Long-term care costs	Long-term care insurance Life insurance or annuity with rider providing long-term care benefits
Health care costs	Medicare Medicare Supplement Insurance Health savings account
Inflation costs	Treasury Inflation-Protected Securities Annuity with inflation-adjusted income benefit Social Security
Investment volatility	Portfolio diversification Variable annuity with living benefit Derivatives such as put options and collars Reverse mortgage (relating to home equity)

- Assuring that recommended systematic withdrawal strategies meet client objectives and also appropriately reflect the existence or absence of pension benefits or insurance-based solutions that incorporate risk-pooling features.

Emerging Issues for Financial Planning

The American Academy of Actuaries' Lifetime Income Risk Joint Task Force's purpose is to objectively investigate lifetime income and longevity risk issues from an actuarial perspective and identify areas for public discourse.

In addition to the general considerations outlined in this brief, financial advisers should also be aware of other developing issues affecting lifetime income planning, including:

- a proposed requirement by the Department of Labor that defined contribution retirement plans provide estimates of lifetime income on statements to retirement plan participants, with the intention of better informing plan participants of how much income they might expect their accumulated savings to provide;
- any proposed changes to the tax code that may limit the tax deferral under retirement plans;
- the expansion of some defined contribution retirement plans to offer annuities and other lifetime income options; and
- possible changes to Social Security, for example the reduction of the cost-of-living adjustment.

Considerations such as those noted above arise from many perspectives spanning regulation, marketplace trends, product design and other aspects. They evolve over time in a dynamic fashion and therefore create dynamic challenges.

In conclusion, there are key strategic longevity risk-related considerations that may be useful to professional financial advisers as they assist their clients in retirement planning and achieving lifetime income. These considerations include the identification of the various financial products and strategies available to mitigate risks, as well as emerging issues relating to lifetime income planning. The prudent use of actuarially developed pooling-based solutions, integrated with appropriate investment strategies, can often yield a favorable financial result for professional financial advisers and their clients.

Members of the Academy's Lifetime Income Risk Joint Task Force who participated in drafting this issue brief include: Noel Abkemeier, MAAA, FSA – co-chairperson; Nancy Bennett, MAAA, FSA, CERA; Bruno Caron, MAAA, FSA; John Esch, MAAA, FSA; Andy Ferris, MAAA, FSA, FCA; Andrew Forgrave, MAAA, EA, FCA, MSPA; C. David Gustafson, MAAA, EA, FCA; Novian Junus, MAAA, FSA; Barbara Lautzenheiser, MAAA, FSA, FCA; Cynthia Levering, MAAA, ASA; Tonya Manning, MAAA, EA, FSA, FCA – co-chairperson; Mark Shemtob, MAAA, EA, ASA, MSPA; Kenneth Steiner, MAAA, FSA; Steven Vernon, MAAA, FSA; Zorast Wadia, MAAA, EA, FSA, FCA; Benjamin Yahr, MAAA, FSA