

A Review of Qualifying Longevity Annuity Contracts

AUGUST 2022

Key Points

- Qualifying Longevity Annuity Contracts (QLACs) are insured annuities paid out one or more years after purchase, possibly starting at an advanced age. A QLAC is less expensive than an immediate annuity because it covers a deferred and shorter time frame.
- QLACs have a great amount of potential benefit to retirees who have insufficient assets to provide immediate lifetime income above what is provided by Social Security but would be at financial risk if they lived to an advanced age.
- Insurers, plan sponsors, advisers, and retirees could all potentially benefit from a better understanding of QLACs.

Introduction

Americans who have saved for retirement are entering their retirement years with assets in tax-qualified retirement accounts, such as 401(k)s or other defined contribution (DC) plans and individual retirement accounts (IRAs). Those Americans now face equally important challenges of how to meet financial needs in retirement by converting retirement savings into income. The decrease in the number of individuals who will have guaranteed lifetime income through a defined benefit plan adds to this challenge. Producing lifetime income in retirement from a pool of assets is a difficult task even for experienced financial professionals, and many retirees struggle to find an effective strategy that balances lifestyle needs with ensuring that retirement assets last for the remainder of their lives.

The risk of running out of retirement money prior to death is called longevity risk and is common among retirees. Some retirees might fully exhaust their retirement assets and subsequently be forced to accept a lower standard of living and/or need to rely on some form of assistance, such as support from their family, charities, or government programs. Alternatively, some retirees may be so concerned about the possibility of outliving their savings that they are reluctant to draw retirement income, and as a result maintain a standard of living below what their resources could provide.

Longevity risk pertaining to retirement account(s) may not always be problematic. This is true if retirees have sufficient financial resources (including Social Security) to provide safely for a standard of living that meets their needs regardless of how long they may live. For retirees with less significant balances, the depletion of assets could be financially devastating.



AMERICAN ACADEMY
of ACTUARIES

1850 M Street NW, Suite 300
Washington, DC 20036
202-223-8196 | www.actuary.org

Craig Hanna, Director of Public Policy
Linda K. Stone, Senior Pension Fellow

As with other risks—including risks from death, auto accidents, hospitalization, etc.—insurance may be used to manage longevity risk. Insurance policies spread the cost of these risks across a group of similarly situated people, so that no individual is forced to bear the entire burden of an adverse outcome. One insurance product that manages longevity risk is called a fixed lifetime-income annuity.

A fixed lifetime-income annuity can provide retirees with a guaranteed stream of income that continues to the end of life. Immediate annuities convert a single sum of money into a guaranteed lifetime income stream commencing within one year of purchase. In contrast, deferred fixed income annuities provide lifetime income that begins more than one year after the premium payment, and perhaps as late as age 85. A deferred income annuity that is offered within a tax-qualified retirement account is called a Qualifying Longevity Annuity Contract (“QLAC”).

This issue brief discusses how QLACs can help address some of the challenges associated with converting a retirement account into lifetime income, important factors for consideration when deciding whether to purchase a QLAC, barriers for widespread adoption of QLACs, and approaches to improving the efficiency of the market for these annuities.

How QLACs Can Help Address Retirement Challenges

Challenge of Budgeting for Retirement

While it is possible to predict the average lifespan across a large group of people with relative accuracy, a specific longevity prediction for an individual person is not possible. The [Actuaries Longevity Illustrator](#)¹ indicates that a male nonsmoker in average health retiring at age 65 in 2022 has a median expected future lifetime of 21 years, with a 29% chance that retirement will last 15 years or less, and a 15% chance that retirement will

¹ The Actuaries Longevity Illustrator was jointly developed by the American Academy of Actuaries and the Society of Actuaries.

Members of the Lifetime Income Risk Joint Committee, which authored this issue brief, include Noel Abkemeier, MAAA, FSA; Michael Bain, MAAA, FCA, FSPA, ASA, EA; Nancy Bennett, MAAA, FSA, CERA; C. David Gustafson, MAAA, FCA, EA; Andrew Huh, MAAA, FSA; Scott Japko, MAAA, FSA, EA; Cynthia Levering, MAAA, ASA; Spencer Look, MAAA, ASA; Steven Mendelsohn, MAAA, FCA, EA; James Ritchie, MAAA, FCA, ASA, EA; Michael Schmidt, MAAA, FSA; Mark Shemtob, MAAA, FSA, FCA, EA, MSPA—*Co-Chairperson*; Mary Stone, MAAA, FSA, FCA, EA; Ricardo Trachtman, MAAA, FSA—*Co-Chairperson*; Amy Trainor, MAAA, FSA; Shuhan Wang, MAAA, FSA; and Benjamin Yahr, MAAA, FSA.

last 30 years or more—i.e., to age 95 or beyond. Even if investment returns and annual spending needs were predictable, the high degree of life uncertainty makes it difficult for a retiree to develop a budget for drawing income from a retirement account.

If this retiree were to develop a retirement income budget based on the median expected lifetime of 21 years, there would be a 50% chance of outliving the saved retirement assets. In order to reduce the risk of outliving the retirement account, the retiree should budget retirement income over a period that is substantially longer than 21 years. For example, to achieve 85% certainty of not outliving retirement assets, the retiree would need to develop a spending budget based on 30 years.

Drawing retirement income from an account balance based on the high end of longevity expectations largely solves the problem of potentially outliving the retirement savings; however, budgeting for an exceptionally long retirement period may not produce sufficient income for retirees to maintain a desired lifestyle and may force individuals to work longer than they wish. As a strategy for providing lifetime income, it is also inefficient in that, on the average (based on typical lifespans), this method will use only about 70% of the retirement account toward retirement income, with 30% remaining at death.

Potential Role of Annuities

Annuities provide an approach for converting retirement accounts into lifetime income vs. a drawdown of balances over time or alternative strategies. Through the pooling of longevity risks, annuities can provide retirees with income that is guaranteed to last until death. While the cost of an immediate lifetime annuity will vary based on many factors, it generally produces a higher level of income than would be obtained by an individual planning to use withdrawals from a retirement account to last until the 85th percentile or more of expected longevity, as noted above. While an annuity provides lifetime income, it typically doesn't leave balances for an estate, unless otherwise specified.² On the other hand, a spending approach that does not rely on an annuity could leave remaining balances to the estate's beneficiaries in the event of an early death.

The benefits of pooling longevity risks through annuities may be offset by several potential disadvantages, including, as previously noted, the potential impact on the estate. An in-depth discussion of this issue is beyond the scope of this issue brief. Other disadvantages include the loss of access to the full retirement account balance, impact of anti-selection resulting in increased pricing (i.e., annuities are commonly purchased by

² Many annuities have refund features if the individual dies before lifetime income payments total the original premium. However, this type of feature can be costly as it diverts some of the original investment away from the purpose of ensuring lifetime income.

individuals who are in above-average health), potential low rate of investment return on the assets backing the policies, lack of inflation protection, and costs and profits of the insurer that are embedded in the pricing.

An immediate annuity provides benefit payments immediately, including at ages that are not typically associated with longevity risk. Retirees may worry only about having sufficient retirement assets left to provide income at advanced ages, not 5 or 10 years into retirement. In this sense, an immediate annuity sacrifices near-term financial flexibility and liquidity in exchange for protection against longevity risk during years when longevity is not likely to be a significant risk factor. Alternatively, QLACs are structured so that benefits are paid out only from an advanced age as specified in the contract, such as age 80 or 85. A QLAC is less expensive than an immediate annuity, because it covers a deferred and shorter time frame. Thus, retirees who face a significant unexpected expense shortly after retiring may have sufficient resources even after purchasing a QLAC, which would leave them with more remaining assets available, than after purchasing an immediate annuity.

As noted above, because a QLAC provides retirement income for a shorter period of time than an immediate annuity, the QLAC can guarantee a specified amount of later lifetime income at a lower cost. For example, the cost of a Single Premium Immediate Annuity (SPIA) providing \$1,000 per month for a male age 65 is approximately \$191,000, while the comparable cost for a QLAC is \$60,000 for income beginning at age 80 and \$36,000 for income from age 85.³ Limiting the scope of the annuity to just those years where longevity insurance is most critical preserves a large portion of the retirement account that could be managed flexibly while providing pre-QLAC income and preserving account funds. The downside of the QLAC is that purchasers who die prior to benefit commencement date receive no benefits, or a return of premium if an extra premium is paid.

A QLAC that provides an adequate benefit level to supplement Social Security late in life can take much of the guesswork out of choosing an income-planning horizon. Retirees purchasing a QLAC can budget a structured withdrawal-based retirement spending from invested assets over the known period of time prior to the QLAC income commencement date, as opposed to budgeting retirement spending over a conservatively long retirement horizon, which as noted can be a decade or more beyond an expected average lifetime. Retirees concerned about outliving their savings may choose a very conservative strategy for deriving income from their retirement accounts, such as spending only the investment returns and not drawing down the principal. A QLAC could allow for significantly higher

³ Quotes from immediateannuity.com March 20, 2022.

retirement spending than the investment return-only approach because retirees could draw down the principal over a known time horizon before QLAC income begins, while guaranteeing an additional source of income in old age.

Factors to Consider Concerning the Purchase of a QLAC

There are many factors that retirees and financial advisers might consider when evaluating whether to utilize a QLAC as part of a retirement strategy. Retirees with large account balances or substantial financial resources from other sources may be able to maintain a desired standard of living in retirement with negligible risk of outliving the retirement income. On the other hand, retirees with less money saved may not have sufficient retirement income from personal savings to materially affect the standard of living, and thus might expect to live off external retirement income—in most cases primarily from Social Security. QLACs have the greatest amount of potential benefit to the retiree between these extremes, where individuals have sufficient assets to provide lifetime income above what is provided by Social Security but would be at financial risk if they lived to an advanced age.

QLACs will ultimately pay greater benefits to individuals who live long lives and will pay smaller amounts (and potentially nothing) to individuals who die before benefit amounts are paid. In deciding whether to purchase a QLAC as a retirement planning tool, retirees would weigh how factors such as family longevity history, lifestyle, and medical history affect whether they expect to live longer or shorter than average. There are several ancillary features that could be added to a QLAC to mitigate concerns about the financial impact of an early death, such as a return of premium death benefit or joint and survivor coverage. It is also possible for the QLAC to begin payments at an earlier age, such as 70 or 75. Each of these options, however, would either increase the cost of the purchase or lower the benefit level.

Another important consideration is how aggressively retirees plan to invest the retirement assets. Some retirees who consider purchasing a QLAC may be more comfortable investing in other retirement assets with higher potential returns and risks, because a QLAC will provide a guaranteed source of income in later years. However, some retirees would consider the risk of not having sufficient income in the pre-QLAC period should the more aggressive investments lose value. At the same time, the money spent on a QLAC is likely to earn a very conservative rate of return (reflected in the pricing of the contract, which is tied to the investments that the insurer would use to back the guarantee), which may be an undesirable feature for retirees with a higher risk tolerance.⁴

⁴ Purchasing a QLAC will help boost the overall growth of the funds as a result of longevity pooling that adds to the conservative rate of return.

Risk-averse retirees might see less downside in the investment returns implicit in the QLAC pricing, because those returns may not differ substantially from the returns that are expected from the assets that remain under their control. Additionally, retirees may place more value on the lifetime income guarantee that a QLAC is designed to provide.

Different retirees have different financial priorities. Some retirees may place a relatively high value on passing assets to their children or other beneficiaries. Retirees with this priority might not be interested in converting a retirement account into income through the purchase of an annuity, but instead would be more likely to limit spending to preserve their assets for this purpose. Other retirees may prioritize having a desired lifestyle in retirement, while also minimizing the likelihood of needing to rely on charitable or family support at later ages. A QLAC may be an effective part of a retirement income strategy in this case. Use of annuities in general has been demonstrated to improve retirement financial outcomes.⁵ It should be noted that the purchase of annuities (immediate or QLAC) generally results in lower bequests only if the payments actually received in return are small relative to the purchase price—i.e., primarily for individuals who die at younger ages. Individuals who live well beyond average life expectancy, and thus receive a substantial number of annuity payments, are likely to end up with greater bequests than they otherwise might have.

Barriers That May Discourage or Limit the Use of QLACs

Retirement savings in tax-qualified retirement accounts are subject to the required minimum distribution rules under Section 401(a)(9) of the Internal Revenue Code, which generally require that distributions begin by April 1 of the year after participants attain age 72. Historically these rules had been an impediment to QLACs, but in July 2014, the IRS modified the regulations to generally exempt the premiums paid for QLACs that defer income payments to no later than age 85 from the required minimum distribution rules.⁶ While this change was an important step toward making it feasible for retirees to purchase QLACs through retirement plans or IRAs, other potential regulatory barriers remain.

The 1983 Supreme Court *Norris* case (463 U.S. 1073) concluded that annuities sold within tax-qualified retirement plans (as opposed to those bought with IRA funds) must be priced the same for male and female retirees. Because females live longer than males on average, the cost of an annuity is generally higher for females than it is for males. Males, therefore, have a disincentive to purchase an annuity in a qualified retirement plan, as the

⁵ “A Broader Framework for Determining an Efficient Frontier for Retirement Income”; *Journal of Financial Planning*; February 2013.

⁶ Prior to this change, the minimum distribution rules applied separately to each annuity contract held within a qualified plan. Therefore, required minimum distributions would have been required on the value of the QLAC prior to the beginning of income payments.

purchase price would include a cost for the greater longevity exhibited by females. Due to the deferral of income to later ages, this effect is more pronounced for QLACs than it is for immediate annuities. This limitation may mean that in-plan, single-life QLACs may be more appealing to female participants, while males could find it more favorable to purchase QLACs through an IRA rollover.⁷ Purchasing QLACs within plans may offer better pricing through reduced commissions and/or fees.

The IRS regulations on QLACs⁸ currently restrict purchases to 25% of the balance as of the end of the prior year in each retirement plan and 25% of the aggregated balance of all traditional IRAs, subject to a cap of \$145,000 for all QLACs⁹. Additionally, when one or more retirement accounts are rolled into an IRA, the end-of-the-prior-year measurement date makes it necessary to wait until the following year before those retirement assets can be considered for purposes of the 25% limit if the purchase is made through an IRA. If the rollover coincides with retirement, the inertia created by this delay may lessen the chance of the purchase ever happening.

The special provisions for QLACs under the required minimum distribution rules, however, only apply to defined contribution plans and IRAs. Currently, defined benefit plans are precluded from offering any portion of the benefit in the form of a QLAC. In 2015, the Academy's Pension Practice Council wrote a [letter in support of permitting defined benefit plans to offer a QLAC](#) along with a partial lump sum payment as an alternative to a full lump sum. This approach could work for any defined benefit plan that offers lump sums, but it might be of particular interest for cash balance plans, which comprise an increasing share of defined benefit plans. These plans express the income benefit as an account balance and therefore share some characteristics with defined contribution plans such as 401(k) plans, which are currently permitted to offer QLACs. Under current law, defined benefit plan participants can access QLACs by taking a lump sum distribution and then rolling that payment into an IRA. Allowing defined benefit plans to provide QLACs directly as a form of payment would streamline the process, potentially increasing the likelihood that participants would consider this option.

Aside from the regulatory barriers, insurance companies have generally been reluctant to develop and market QLAC products. There are several possible causes of this reluctance. Developing and marketing new products requires an investment of capital, and companies may be concerned that the long-term volume of sales will be insufficient to justify this upfront cost. QLACs concentrate annuity payments many years into the

⁷ A QLAC on a joint-life with an opposite-sex partner and 100% survivor benefit would not be negatively affected by the requirement to use unisex mortality because both sexes would be implicitly included in the pricing. Smaller survivorship levels would reduce but not eliminate the impact of unisex pricing.

⁸ Treas. Reg. 1.401(a)(9)-5.

⁹ Indexed for inflation. The proposed [Retirement Security and Savings Act of 2021](#) includes an increase in the limit to \$200,000.

future, which exposes insurers to greater longevity risks in relation to premium paid than traditional immediate annuities. This concern may be magnified by the currently small market for QLACs, where there is a danger of anti-selection. Further compounding this issue is the lack of reliable data on the degree of anti-selection that insurers can expect.

Few defined contribution retirement plans offer QLACs, which is part of a broader reluctance by plan sponsors to use insurance-backed products in their qualified plans. Some concerns why plans sponsors may be reluctant to offer insured solutions within their plans include:

- Fiduciary risks, particularly related to the selection of insurers and products¹⁰
- High product cost
- Market offerings are not satisfactory and/or too new
- A single solution will not meet the needs of all participants
- Administrative complexities associated with offering a new type of asset within the plan

There are several reasons why retirees might be disinclined to consider a QLAC, or financial advisers might be reluctant to suggest them to their clients. Many may simply be unaware of insured products such as longevity annuities. Retirees may not appreciate the longevity risks that QLACs are designed to mitigate, and advisers might not have access to the analytical tools needed to evaluate whether a QLAC makes sense in a particular circumstance. Some retirees and advisers may consider the cost of these products to be high compared to alternative approaches, or they may believe that relying on a stream of income payable decades in the future that is supported by an insurer's general assets and state guaranty associations is too risky. Retirees might be concerned about ceding control of a nontrivial portion of their savings to an institution, particularly in light of the possibility of unexpected emergency expenses, and they might also worry about a potential loss of the premiums they paid in the event of an early death, unless a death benefit is purchased. Both retirees and advisers may have expectations of superior investment returns from retirement accounts. Lastly, fee-based advisers without insurance licenses may not have access to annuity products, and some advisers may prefer to be compensated via the ongoing income stream derived from managing a portfolio of assets over many years, as opposed to the one-time commission associated with a longevity annuity.

¹⁰ The SECURE Act of 2019 contains safe harbor provisions related to the selection of insurers that may mitigate this concern.

Potential Approaches to Improving the QLAC Market

There are many possible changes to the QLAC market that could help ensure that these tools are both available and properly considered in situations where they could be a beneficial retirement planning tool.

Certain statutory and regulatory changes might remove some of the artificial barriers to the use of QLACs. Congress could address the difference between the value of QLACs for male and female retirees by permitting sex-distinct pricing for insurance products purchased through employer-sponsored defined contribution plans.¹¹ Congress could raise the current \$145,000 limit. The IRS could issue regulations permitting QLAC to either aggregate all accounts (plans and IRAs) for the purpose of the 25% test or allow the test to be performed as of the date of the QLAC purchase rather than as of the end of the previous year. The IRS could also modify regulations to extend the ability to provide QLACs to defined benefit plans, as noted previously. Lastly, the IRS could permit variable or index-based returns in QLACs, allowing these annuities to compete more effectively with other retirement income options that are based on market rates of returns.¹²

Helping retirees understand the implications of the difference between their life expectancies and their potential life spans is challenging, as is the process of managing investments.¹³ Individuals who have financial advisers with expertise in retirement spending may receive relevant education from those advisers; however, access may be limited. Retirees would benefit from plan sponsor education efforts. The Department of Labor could survey plan sponsors implementing successful DC retirement strategies and produce model guidance that plan sponsors could adopt or modify to help inform active and retiring employees of the risks of underestimating life expectancy and the tools and strategies to mitigate the risk. The Social Security Administration (SSA) could also provide information on longevity risk when individuals apply for their benefits. The Government Accountability Office has recommended that the SSA take steps to ensure that the Social Security benefit claims process includes basic information on the potential impact of life expectancy and longevity risk on the decision to claim benefits.¹⁴

Insurers could advise policymakers about potential regulatory changes for annuities allowing for greater adoption and better pricing. Due to the limited market, insurers have invested few resources into developing materials that explain the potential value

¹¹ The Norris decision, mentioned previously, is an interpretation of federal statute. Congress has the authority to change the statute upon which the decision was based.

¹² See the [Nov. 6, 2015, letter](#) from the Academy's Pension Practice Council to the Department of Treasury discussing this concept.

¹³ Some older retirees may not want the burden of managing their assets but would prefer to receive a steady monthly payment from an insurance company.

¹⁴ "[Social Security—Providing More Information During Claims Process Would Help Individuals Making Decisions About Retirement Benefits](#)"; Testimony Before the Special Committee on Aging, U.S. Senate; Statement of Charles Jeszeck, Director, Education, Workforce, and Income Security Division, Government Accountability Office; Sept. 14, 2016.

proposition for their clients. Insurers already do this for other products, but few have done so for QLACs. In addition, insurers could improve the QLAC market by educating retirees about longevity risk and the strategies and tools that can be used in the conversion of retirement savings into income.

Financial advisers who have greater experience with asset management than with lifetime income generation might benefit from resources that explain how investments and insurance can be used together to achieve superior results for their retiree clients. Advisers who are well-educated about longevity risks and have the proper analytical tools can more confidently and competently evaluate whether QLACs are appropriate for their clients. Resources that distinguish QLACs from immediate annuities could be of particular value, because the amount of money needed to purchase a specified level of longevity-risk-mitigating benefits is significantly lower than the amount needed to purchase an immediate annuity.

Registered Investment Advisors (RIAs) generally do not receive commission income but are instead compensated on a fee-only basis. QLACs are currently sold on a commission basis, which deters RIAs from recommending them to retirees. One potential solution would be for insurers to create a commission-free QLAC product, which would be less expensive than current products and which retirees could purchase based on the recommendation of fee-based advisers. RIAs could then adjust their fees to either charge the retiree on a one-time basis for the associated work, or they could include the value of the QLAC in the assets under management in recognition that the QLAC is an integral part of the overall portfolio, complementing the investments being managed.

Conclusion

QLACs have the potential to help retirees manage their longevity risk by taking much of the guesswork out of how long retirement income needs to last. However, due to limited availability and statutory and regulatory barriers, QLACs currently receive very little consideration from retirees, financial advisers or plan sponsors. Insurers, plan sponsors, advisers, and retirees could all potentially benefit from a better understanding of QLACs and from the removal of barriers that have impeded the use of these products.

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