

LONGEVITY INSURANCE: AN ANSWER TO A DIFFICULT RETIREMENT PLANNING QUESTION

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Retirement planning is enjoying renewed focus in the insurance industry. With the well-documented decline of defined benefit plans and questions regarding the long-term viability of Social Security, it is feared that most U.S. citizens are left with the responsibility of preparing for their own retirement. While defined contribution plans are a solid vehicle for retirement savings, they cannot single-handedly provide for the future income needs of many workers. Fortunately, there is no shortage of other vehicles offered by the financial services industry to help customers accumulate assets for retirement. While these products certainly aid in the savings aspect of retirement preparation, a different type of insurance product—longevity insurance—protects consumers at retirement in a completely different way.

THE QUESTION OF LONGEVITY

Many key assumptions go into the retirement planning process. Assumed age at retirement, desired income, inflation, future income tax rates, and assumed investment returns (before and after retirement) are just some of the pieces of information necessary to work on the retirement planning puzzle. While it may be hard for the average retiree to quantify these items, life expectancy or longevity is an additional input to the process that may prove particularly difficult to estimate. At issue is the question of how far into the future retirement income will be needed.

The question of longevity is moot if a consumer takes all accumulated assets at retirement and buys a large single-premium immediate annuity. This provides an income that one or more individuals can never outlive, transferring all the longevity risk to an insurance company. Slow growth in the immediate annuity market and results from several industry surveys, however, both point to consumers' reluctance to relinquish complete control over their assets by making such a purchase.

SOLUTIONS TO THE CONTROL DILEMMA

One solution to the control dilemma is the purchase of a smaller immediate annuity, one guaranteeing a floor income for life without requiring a retiree to hand over all accumulated assets. While this relieves the issue of control over assets, it still requires the consumer to provide for a portion of desired future income to an unknown age.

Longevity insurance offers an alternative solution. It allows a retiree to purchase income that doesn't commence payments until a future age. This is income insurance in the purest sense. Like term life insurance, which provides a death benefit only if the person dies during the coverage period, longevity insurance only provides an income to the annuitant during the coverage period. In this case, however, payments are made if the insured lives too long rather than dies too young.

Consider an example. A 60-year-old desires an \$8,000 per month retirement income. Purchase of a life-only immediate annuity would require accumulated assets of well over \$1 million. If the individual does not wish to part with that amount of money all at once, a different approach is to purchase an immediate annuity for a floor income of \$2,000 per month at 25% of the same sum. In these two circumstances (not the only choices available), the retiree either hands over all retirement savings (and buys a large immediate annuity) or must plan for additional income in excess of the purchased floor income for an unknown life expectancy.

Longevity insurance permits a completely different solution to this example. For as little as \$100,000 (based on a sample pricing model constructed by the author), our retiree could purchase an \$8,000 monthly income to begin at age 85. The remaining assets could then be used to structure income for a *known* period of time, the period from retirement to age 85. Longevity is effectively taken out of the equation.

The beauty of this type of coverage is how efficiently it leverages mortality. Individuals living to the income commencement age (age 85 in our example), receive needed income. Those who die prematurely have no need of the income and get nothing (thereby helping to fund benefits for those who live). These products have no death or surrender benefits. For all 60-year-olds purchasing income that begins at age 85, only a certain percentage of them will live to age 85. By not paying death or surrender benefits, the company offering the product is able to maximize the inherent insurance leveraging. Couple this with the time-value-of-money discount for deferring the start of income until age 85, and it is easy to see how longevity insurance can be purchased inexpensively with control of the remaining assets left in the hands of the retiree.

A DEVELOPING MARKET

Longevity insurance is a developing market. While products exist, the variety and features that would be expected in a robust market are not yet available. If the market takes off, longevity insurance could easily be offered in fixed and variable forms with a variety of inflation-adjusting income features. Should it really prosper, there would be little end to the features and options that could be included in innovative product designs. As with all other insurance products, however, additional features have additional costs (measured in reduction to deferred income per \$1,000 of premium).

But the main benefit is undeniable. Longevity insurance removes the “How long will I live?” question mark that plagues the retirement income planning process. By taking a fraction of accumulated assets at retirement and purchasing longevity insurance, consumers can protect themselves against outliving their means of providing a retirement income. The comfort provided by this protection could result in a much more enjoyable retirement.

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