Is There Life in Longevity Insurance?

THERE HAVE BEEN MANY ARTICLES written about the demise of traditional pension plans, long appreciated for the lifetime guaranteed annuity income they provide. Some pension professionals remain steadfast in their belief that these plans not only can be saved but that they must be preserved for the security of future retirees. However, many others believe that our leadership in Washington is unlikely to pass the legislation necessary to encourage employer sponsorship of traditional defined benefit plans. Consequently, the vast majority of future retirees must plan on a retirement with Social Security as their sole guaranteed lifetime income (this in spite of the fact that there are some distant dark clouds hovering over the financial future of our beloved Social Security system). To supplement Social Security, most future retirees will turn to employer-provided retirement nest eggs in the form of IRA rollovers. These rollover accounts will be composed of distributions from the various qualified employer-sponsored plans—including 401(k) plans—that they have participated in during their working lifetimes.

The planning issues that the next generation of retirees must face in structuring a financially solid retirement are numerous. But if there is one key element that causes more heartburn than any other, it's the impossibility of projecting longevity. The financial retirement planning process would be greatly simplified if each of us knew just how long we and our significant others will live. We could then calculate, based on our budgetary needs, inflation, investment return assumptions, and other pertinent factors, our financial ability to retire at our chosen standard of living. Unfortunately (from a planning perspective only, of course), we don't know whether we will survive five or 40 years in retirement. If we act conservatively and assume a greater longevity, we reduce our expendable annual income allotment and lifestyle options or, in some cases, significantly defer our retirement.

Insuring a Long Life

This brings me to my point, which is to make the case for what is currently referred to as longevity insurance. In its purest form, such insurance would be purchased with a single premium payment at the time of retirement. This is what actuaries refer to as a single-premium non-refund deferred annuity (different from what are now marketed as deferred annuities). The insurance would pay lifetime annuity benefits only to those who survive to a predetermined age. In essence, you are insuring yourself against the risk of living too long. This would permit you to project an age to which you expect to survive and then determine if you have sufficient funds to provide your desired standard of living to that age.

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Should you be fortunate enough to survive and essentially exhaust your nest egg, the longevity insurance, in the form of an annuity payable for the remainder of your life, would kick in. Another attractive aspect of longevity insurance would apply to those retirees who want to make sure that a portion of their nest egg is left to their heirs. The use of longevity insurance can mitigate the danger of living too long, exhausting all savings, and having no funds available for inheritance.

As an estimate of the level of benefits available under a pure longevity insurance policy, one major insurance company is offering the following to 65-year-old males: For a single $10,000 premium, payable at age 65, a $665-per-month life annuity beginning at age 85. The probability of a healthy 65-year-old male attaining age 85 is approximately 45 percent, and the estimated life expectancy at age 85 is 69 months (see table reference below). Thus, a male who survives to 85 can expect to receive a total of $45,885 (future-value dollars) for his premium payment of $10,000. Of course, many who purchase the insurance will receive

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less (or no benefits at all), and some will receive more. As insurers enter this field in greater numbers, we would expect to see much more favorable benefit payouts relative to premiums paid. Based on projected life expectancy (using the RP 2000 healthy male annuitant with 10-year projection) and a 5 percent guaranteed interest rate, a monthly benefit of $1,037 is actuarially available prior to administrative and other associated expenses, with a $10,000 single premium. This is for a 65-year-old male purchasing insurance with an annuity commencement age of 85. Of course, each insurance company will cost out its products based upon tables it feels provide appropriate underwriting standards.

Investment or Insurance?

The initial reaction of most retirees toward such a product might be less than enthusiastic. The prospect of paying a lump sum today for a possible future annuity payment does not seem to be a good investment. However, these products are not investments. They are insurance, and the essence of insurance involves risk of premium forfeiture. We buy auto, life, health, and many other insurance products on which we never see a return. We don't expect a premium refund if the insured event never occurs. What makes longevity insurance more difficult to accept is that with more traditional types of insurance, we are protecting ourselves and loved ones from unwanted occurrences.

However, longevity insurance is the opposite—we really do want to collect on this insurance. This unusual feature creates discomfort on the part of some consumers. But it's precisely the fact that only some of us will collect (and most for short durations) and not till many years in the future that allows us the leverage to buy a significant amount of pure longevity insurance for a relatively modest amount of premium. Nevertheless, older people are reluctant to buy products that they understand have a limited opportunity for any return. I would suggest that for these products to be readily accepted, optional features must be offered, even though these features will affect the premium-to-benefit leverage relative to a pure single-premium non-refund deferred annuity product.

The insurance industry is starting to address the need for products that can provide this type of deferred contingent income. The products that are currently available, with some limited exceptions, cannot be customized to individual requirements. Designing flexibility into longevity products and offering retirees more choice in product features would lead to more acceptances in the market. Possible features that should be made available include contingent annuitants, alternative financing options to the single premium, premature cash refund and cancellation options, cost-of-living adjustments, and alternative benefit commencement ages.

But how will retirees determine the optional features and level of insurance they should purchase? These products may not be simple for a retiree to evaluate, especially when considering that their purpose is to complement an overall retirement plan. In addition, those selling the products will need training so that they can assist consumers in making well-thought-out decisions in the selection process. This complexity will lead to an overall distribution challenge that may impede success in selling these products, regardless of their potential value to many retirees. A diligent effort must be made to educate the retiring public of the availability, the cost, and the advantages associated with longevity insurance. This could be done through employer human resource departments, retiree organizations, and advertising by insurance companies committed to this product line. The actual sale of the products should be done by specialists trained to work with retirees to ensure that each client receives a proper assessment of product feature options that best suit his or her needs on an individual basis.

Hedging Retirement

Some financial planners will suggest that new retirees should seriously consider converting a substantial portion of their nest egg into an immediate life annuity upon retirement. Though this may appear to be a safe and prudent course of action, very few retirees will want to take this approach, for psychological as well as economic reasons. From the psychological perspective, an enormous amount of comfort is provided to a retiree knowing that he or she has a significant nest egg under his or her control. From an economic point of view, the guaranteed returns on annuity contracts don't offer the inflation protection that is available through alternative investments. Longevity products allow retirees to use a small percentage of their overall nest egg to provide a hedge against the danger of their retirement savings not being sufficient to support a longer-than-expected retirement period.

The effects of the demise of the traditional pension, concerns regarding future Social Security levels, more active (and expensive) lifestyles for baby-boom retirees, and increasing life expectancy will converge to create opportunities for new products and ideas in the financial markets. The next generation of retirees is more financially sophisticated and will expect more customized solutions to personal financial challenges. The creation of longevity insurance products may help to satisfy a critical need that many retirees may soon be facing. As with all financial products, some of us will find that such insurance can fill a key hole in our retiree plans, and others will find that it is of limited or no value. The creation of these products must be accompanied by not only a general education process as to their value but also a distribution channel that will allow individuals to properly assess their particular need for such a product. ●

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