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Deferred Annuities Getting Some Traction

More investors are buying deferred income annuities in their 50s with income starting earlier in retirement, but longevity insurance is still a tough sell.

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You've probably seen this attention-grabbing advertising message on television or on a billboard: "The First Person To Live To 150 Is Alive Today." Not surprisingly, the ad comes from an insurance company—Prudential—and the pitch is for annuities.

You may find the message optimistic, unsettling, or just plain disturbing—but it does highlight the insurance industry's core value proposition for annuities: Even the best retirement plan can't precisely account for how long you'll live—so use insurance to hedge your risk.

It's been slow going. Annuity sales have mostly bumped along as a small fraction of the overall retirement market, the result of complex product offerings, high fees in the variable annuity segment, and buyer resistance to locking up their money with an uncertain future total return.

But that may be changing. One annuity category, in particular, is starting to show impressive growth: the deferred income annuity (DIA). These income annuities typically let buyers set a future date to start receiving income. Buyers pay an initial premium and then continue making additional premium contributions along the way.

Industrywide sales doubled in 2013 to roughly $2 billion, according to LIMRA, the insurance industry research and consulting group. And the number of insurance companies offering DIAs is growing fast. Just five companies offered them in 2012; another five came into the market in 2013, and several more are expected to launch products early this year, LIMRA reports.

The media has tended to focus on one variation of the deferred income annuity—the so-called longevity policy. These policies are designed for purchase at retirement or later, and payouts don't begin until—and unless—you reach an advanced age, say 85 or 90. The idea is to hedge the risk of exhausting funds in very old age. But longevity policies make up no more than 20% of the market currently, industry experts say.

"Going back a few years, these policies were known as longevity insurance," says Phil Michalowski, vice president of retirement income at MassMutual. "Just in the last year or two, they've started to be seen as an integral part of retirement income."

The sweet spot now is pre-retirees looking for ways to generate retirement income five to 10 years in the future. People are buying DIAs in their 50s or early 60s, and starting income in the younger portion of their retirement, perhaps at 65 or 70. Examples of products seeing strong growth include MassMutual's RetireEase Choice and New York Life's Guaranteed Future Income Annuity.

"Longevity insurance was the original concept, but a lot of the success has come from people who know they'll need money in retirement and want to reduce investment and sequence of return risk, and buy a guaranteed stream of income they can start when they retire," says Mark Paracer, senior analyst at the LIMRA Secure Retirement Institute.

In part, the gains are due to simple demographics. As the baby boom wave hits retirement age, the market opportunity for insurance companies gets bigger. About 75% of sales occur inside IRAs, LIMRA says; you pay ordinary income tax rates as funds come out. For DIAs purchased outside an IRA, the interest portion of distributions is taxed as ordinary income; returned principal is not taxed.

Expect insurance pitches for IRA dollars to intensify as more boomers retire and rollover funds from workplace retirement plans. In 2010, households transferred $288 billion from workplace plans to IRAs, according to the most recent data from the Investment Company Institute (ICI).

More Certainty and Mortality Credits

The DIA pitch has two key components. One is to give retirees more certainty about income, allowing them to feel better about spending, especially in the early years of retirement. "Our research shows that retirees put a lot of focus on protecting against bad things that might happen if they live to 85," says Matt Grove, senior managing director at New York Life. "What really happens is they pull back spending when they hit that age, and match their consumption to income."

Grove cites research from the University of Michigan Health and Retirement study, which shows that two-thirds of affluent retirees actually are net savers over the course of retirement, rather than net spenders. The implication is that retirees spend more conservatively than necessary due to fears about running out of money to meet essential expenses.

The income annuity can be used to guarantee funding for non-discretionary spending needs. "It's a simple equation," Michalowski argues. "Start by estimating the necessary expenses, then line them up against your expected guaranteed income sources—Social Security, and a defined benefit pension, if you have one. If there's a gap, you can annuitize the difference."

The second pitch is that income annuities—immediate or deferred—offer the potential of higher returns via mortality credits (see table below). "As an individual, you can buy a bond portfolio and take interest or principal from it, but you can't have other people's money," Grove says. "An insurance company can do that. If I'm planning my spend-down period in retirement, the only responsible thing for me to do is assume I'll live longer than average. The insurance company can just assume everyone will live 20 years, and the ones who die early will subsidize the ones who live longer."

Deferred Income Scenarios (Assuming $100,000 Premium)

	Gender	Purchase Age	Income Start Age	Monthly Payout	Annual Payout	Annual Payout Rate
Life w/Cash Refund	Male	55	65	$904.14	$10,849.68	10.85%
Life w/ No Refund	Male	55	65	$934.31	$11,211.72	11.21%
Life w/Cash Refund	Male	55	70	$1,349.43	$16,193.16	16.19%
Life w/ No Refund	Male	55	70	$1,385.52	$16,626.24	16.63%
Life w/No Death Benefit	Male	55	70	$1,469.70	$17,636.40	17.64%
Life w/No Death Benefit	Male	65	85	$4,664.90	$55,978.80	55.98%

Source: MassMutual
Notes: All rates based on quotations January 14, 2014.
Life w/Cash Refund: Upon death provides guarantee return of principal in deferral and return of principal less income payments made in income phase.
Life w/No Death Benefit: provides no death benefit in deferral; or in income phase and minimum 10-year deferral is required to select this option.
Annual payouts include interest earned, return of premium and mortality credits.

Longevity Is a Tough Sell

The concept of a pure longevity policy—with benefits commencing at a very advanced age—appeals to policy experts, who like its pure-play hedge against the risk of outliving assets. The U.S. Treasury Department has even proposed guidelines that would make it easier to use policies of this type within 401(k) retirement plans or IRAs. The idea is to encourage people to buy longevity plans within tax qualified accounts by relaxing required minimum distribution rules; the proposal would allow savers to exempt the value of their longevity policy from assets used to calculate those mandatory withdrawals.

"I think they are terrific," says Don Ezra, director emeritus of global investment strategy for Russell Investments. "It has all the characteristics of what you want insurance for—something that has a low chance of happening, but has a large impact if it does occur."

But pure longevity policies are a tough sell for most consumers, who tend not to think about the out-year longevity risks, and prefer income in the near term to an uncertain payout down the road. That same behavior can be seen in Social Security filing decisions: Roughly 40% of Americans file for benefits as soon as they are available, at age 62, with another 40% filing by their full retirement age (66). Just 3% take benefits at age 67 or later, although delayed filing will generate thousands of dollars in additional payouts at an advanced age.

"It's an interesting product to academics, because the payouts are high and there is lots of mortality credit," says Grove of longevity policies. "But real consumers don't buy it."

My next column will investigate some of the pros and cons of using DIAs as part of a retirement portfolio plan, including the swing factors that might argue for more or less allocation to these type of products.

Retirement columnist Mark Miller writes about trends in retirement, aging, and the economy. He is the author of The Hard Times Guide to Retirement Security: Practical Strategies for Money, Work and Living, and writes a syndicated column for Reuters. Mark blogs at RetirementRevised.com Twitter: @retirerevised.

Life w/No Refund: Upon death, the contract provides guaranteed return of principal in deferral and provides no death benefit once income payments begin. (Refers to chart on page 2)

MassMutual RetireEase Choice does not provide liquidity; there is no contract value or withdrawal provision. The only time that distributions are made from a contract is when annuity payments are made or a death benefit is paid.

During the deferral period on all annuity options except Single Life with No Death Benefit, a return of purchase payment(s) is included if the owner dies (or the annuitant if the owner is an entity such as a trust). On or after the annuity date, any death benefit will depend on the annuity option selected.

MassMutual RetireEase Choice is not a Medicaid-friendly deferred annuity. The use of MassMutual RetireEase Choice in conjunction with Medicaid planning is prohibited.

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