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All This Talk About QLAC….What Does It Really Mean?

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The U.S. Treasury has been making news over the last several months with rule changes that expand the use of Deferred Income Annuities (DIA) inside retirement plans. The first to hit was in July of this year and allows for the deferral of income from a qualified DIA to extend past the mandatory RMD age of 70½ (however, with a cap on how much you can put into the contract). The second came about recently in October which allows for a Target Date Fund, made available within a 401(k) plan, to hold a DIA as an asset. Whether you call it a DIA, a QLAC (Qualified Longevity Annuity Contract), or Longevity Insurance, it all basically involves the same type of product.

These rulings have come about as a result of lobbying efforts by insurers to break down certain operational and regulatory barriers to help make annuities more accessible to a wider segment of the market – basically the working middle class where most, if not all, of their savings sit within qualified accounts at the workplace. Firms that support the Defined Contribution market continue to lobby hard for rule changes with the DOL to allow for programs that provide an incentive for increased savings behavior such as automatic enrollment. Many of these programs have been successful and the government is now starting to take a more active role in making sure those savings are less at risk when the average employee leaves the worksite and enters retirement.

So, the first announcement, referred to as "The QLAC Ruling" around the industry, addressed a conflict between the basic value of a DIA product and the existing tax code which prevented its complete and intended use. The second addresses just one of many possibilities of how a DIA can be deployed to help increase adoption among those who may need it most. To support this point, a statement provided with the second ruling mentions that *"Treasury is working to expand the availability of retirement income options for working families. By encouraging the use of income annuities, today's guidance can help retirees protect themselves from outliving their savings."*

So why is the Government initiating these changes with a relatively "niche" DIA product and not including other insured retirement vehicles like a deferred annuity with GLWB?

Over the last several years, most of the dialogue with regard to retirement solutions around Washington has essentially centered on solving mass market issues through employer sponsored plans. In other words, with the current administration it isn't a retail advisor serving the High Net Worth client discussion. In fact, there are some in DC who feel that retail rollover campaigns and programs that move the investor from a low cost 401(k) account into a new retail account or product is predatory. This description may be an extreme view by a few, however, it does provide a general sense as to the current environment. If there is one consistent standard that has been applied over the last several years in DC - whether its plan rules, investment choices, guidance, and now annuities – is that any action has involved a simple and low cost result for the plan participant. Although some large annuity manufacturers have been very focused on growing the in-plan market for group variable annuities with GLWBs held in 401(k)'s, both plan sponsors and regulators still seem very cautious with adoption given the complexities that exist with bringing these structured products into a mass market environment.

In the case with QLAC, Treasury understands what the actuaries across our industry also understand. A DIA represents the most efficient, transparent, and least expensive use of an annuity (or any product for that matter) to address Longevity Risk. In fact, the most efficient deployment of a DIA would have the retiree place a portion of their nest egg into a "longevity insurance contract" and defer the income start date until their early to mid 80's. In the meantime, the retiree would have the control and flexibility to live off the income/withdrawals from investments while there was a greater likelihood of not running out of assets. Once the risk of depleting assets increases in retirement, the longevity contract would kick in and maintain a level of floor income for the remainder of life. Of course this is exactly how the first DIA contracts were initially sold some years ago. Unfortunately, as a retail product sale, this translated horribly across the kitchen table and became a behavioral finance nightmare.

But a VA or FIA with a GLWB can provide the benefits of the same approach, right? It can, but the various rules and options within these contracts do come with an additional cost and requires continuous support in providing investors with the appropriate guidance to trigger certain options at the appropriate times. In other words, income annuities (SPIA or DIA) are "set it and forget it" types of contracts compared to bundled products with options. Thus, a better fit for the institutional plan environment where the focus is more process centric versus product focused.

In fact, the second ruling validates this process focus by positioning the DIA in a product allocation construct. Details within that ruling also state that *"some of the fixed income exposure in the TDFs (Target Date Funds) for older age groups results from the purchase of deferred annuities, which will be distributed to participants when the TDF is dissolved at its target date. As each group's age advances, an increasing portion of the portfolio is applied to the purchase of deferred annuities."* In this scenario, the mutual fund manufacturer is managing a glide path to a target date that includes a DIA as a fixed income holding. It's "allocation in a box" and managed automatically for the mass market investor.

Given these institutional movements, there is still opportunity for the retail advisor, especially with regard to the first ruling which is applicable to any qualified contract be it a 401(k) or an IRA. The biggest impact is that "the QLAC" ruling put both qualified and non-qualified DIAs on a level playing field where the income start date can be deferred way past age 70½ regardless of the type of asset. Granted that in today's market, the average age of an investor purchasing a DIA is in their late 50's with deferral period between 7 to 10 years…nowhere near the RMD horizon. However, there are some advisors and retirement income planning specialist that have been embracing longer deferral periods as part of certain financial planning processes where significant tax benefits and income optimization can be achieved. Some of these concepts are available through the American College with their RICP program in partnership with Curtis Cloke's Thrive University. In a retail environment, a longer deferral period probably correlates with more of a High Net Worth investor when supported by an established financial planning and allocation process. Shorter deferrals seem to align with a different sales approach by marketing a DIA to the investor who not only can make "catch up contributions" in their 401(k) to increase savings in pre-retirement, but also catch up their contributions to build their own pension plan by the time they're ready to retire in their mid to late 60's.

Going forward we will continue to see rulings coming out of Washington that help better facilitate the integration of annuities alongside investments. For the Defined Contribution market, this will result in "institutional strength" and "low fiduciary risk" processes that utilize low cost and "transparent" products applicable for any 401(k) plan. Again, the question remains whether or not a deferred annuity with a GLWB will ever (or need to) meet that criteria over time. Ultimately, the retail advisor can provide significant value by managing planning concepts tailored specifically to their client's needs regardless of the type of annuity deployed. In some cases, the impact of institutional focused rulings will also align with the interests and growth of the retail advisor market.