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November 6, 2015

Mr. J. Mark Iwry
Senior Advisor to the Secretary and Deputy Assistant Secretary
for Retirement and Health Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3064
Washington, DC 20220

RE: Variable and Indexed Annuities in QLACs

Dear Mr. Iwry:

The American Academy of Actuaries¹ Pension Practice Council commends the Treasury Department and the Internal Revenue Service for its publication of final regulations concerning Qualified Longevity Annuity Contracts (QLACs) in 2014. Providing benefits through qualified retirement plans and individual retirement accounts will enhance the retirement security of many Americans.

QLACs can provide protection against individuals outliving their retirement savings by providing lifetime income that begins only after a certain age, which may be as late as age 85. This type of protection makes it much easier for individuals to ensure that retirement savings last for their lifetime without having to reduce their standard of living. The Council believes that significantly more Americans could benefit from such longevity annuities and these benefits could provide better longevity protection if variable annuities and indexed annuities could be provided in a QLAC. In this letter, we point out some of the advantages provided by these annuities and the form these annuities could take.

The preamble to the final regulations states “The Treasury Department and the IRS believe that because the purpose of a QLAC is to provide an employee with a predictable stream of lifetime income a contract should be eligible for QLAC treatment only if the income under the contract is primarily derived from contractual guarantees. Because variable annuities and indexed contracts provide a substantially unpredictable level of income to the employee, these contracts are inconsistent with the purpose of this regulation. This is true even if there is a minimum guaranteed income under those contracts. In addition, having a limited set of easy-to-understand QLAC options available for purchase enhances the ability of employees to compare the products of multiple providers. Moreover, exposure to equity-based returns is available through control over the remaining portion of the account balance.”

¹ The American Academy of Actuaries is an 18,500+ member professional association whose mission is to serve the public and the U.S. actuarial profession. The Academy assists public policymakers on all levels by providing leadership, objective expertise, and actuarial advice on risk and financial security issues. The Academy also sets qualification, practice, and professionalism standards for actuaries in the United States.

This letter first defines the type of variable and indexed QLACs that we believe would be in keeping with the purpose of these regulations and then discusses each of the concepts addressed in this part of the preamble. In the regulation, no distinction was made between variable annuities and indexed annuities; however, there are significant regulatory and structural differences. Consequently, our comments recognize the characteristics of each type of annuity.

Variable and Indexed QLACs

We appreciate that a typical IRC Section 817 variable annuity is not that different from retaining the funds in the account balance. A Section 817 variable annuity also typically would provide a death benefit no less than the account balance, which would not be allowed in a QLAC. Variable QLACs, however, could be designed differently so that the focus is on income protection. A variable QLAC should require that there is no surrender value after the time of purchase (the same as a fixed QLAC). Only annuity distributions should be available and death benefits should be subject to the same restrictions as other QLACs.

Variable QLACs can be designed to provide a participant with a stream of lifetime income and the potential of sustaining the desired level of purchasing power by using the same mechanism that applies to variable benefits in defined benefit plans (adjustment to payouts based on investment performance relative to a target or “hurdle” rate.) A variable QLAC design also would provide a greater incentive for individuals to purchase a QLAC at younger ages, when they might otherwise be concerned about the opportunity cost of not investing their savings in equity-linked investments. This greater utilization of QLACs would be consistent with the Treasury Department’s stated objective of enhancing the retirement security of American workers.

Indexed annuities are different from variable annuities insofar as the basis for interest credits is similar to that for traditional fixed annuities; however, in lieu of crediting fixed interest, the amount of the credit is used to purchase call options that support interest crediting that varies with the change in an index, most commonly an equity index. This means that the annual growth on an indexed annuity is less volatile than that of a variable annuity and more volatile than that of a traditional fixed annuity (which has no volatility).

Indexed QLACs could be designed to provide a participant with a stream of lifetime income calculated in relation to whether the interest credit, with a 0% floor, exceeded or fell below a hurdle rate. This would be the same mechanism as with a variable QLAC, except that the dispersion of results would be more limited, including both reduced annual upside potential and a limit on the maximum decrease in a given year. Another design could guarantee interest crediting at a level equal to the assumed discount rate in the annuity. This could guarantee that the lifetime income could never go down, but could increase. The upside potential is more limited than in other designs, but it would provide a guaranteed non-decreasing floor.

Purposes of QLACs

We respectfully submit that just providing predictable income should not be the only purpose of a QLAC and fixed predictable income may not provide adequate financial security. We believe that the main purpose of a QLAC should be to protect individuals against risks that they may not be able to effectively manage otherwise. Although individuals can, through their own investment

choices, reduce the volatility of investment returns, individuals cannot effectively manage the risk of outliving their assets without accepting a significant reduction in near-term spending. We believe the primary purpose of a QLAC should therefore be to guard against this longevity risk through pooling of mortality experience. Another purpose for some participants would be to protect against inflation risk, and for some participants the best way to do this may mean accepting some volatility in the resulting payment stream.

Inflation is an integral part of our economy and is especially difficult for a retiree to address. Over 20 years (which is likely to be a typical deferral period for a QLAC), even the current benign inflation rate of two percent would see an individual's purchasing power reduced by one third. And inflation is unlikely to be significantly less than this as the Board of Governors of the Federal Reserve System has continued to maintain a goal of two percent inflation.² Should inflation increase to the levels seen in the 1970s or 1980s, fixed QLACs would not accomplish their intended purpose.

The final regulations were helpful in that inflation-indexed annuities were explicitly allowed. But an inflation-indexed annuity costs significantly more than a level-payout fixed annuity. This may be exacerbated by the limited supply (and thus relatively high cost) of the investments that are adequate to hedge the risks, and perhaps because expense allocations and risk charges are greater when the insurer believes the market for these annuities to be small. Alternatives such as variable or equity indexed QLACs would help provide a large, less expensive market and would thus encourage more participants to take advantage of the ability to pool longevity that QLACs create.

The difficulty with investing for inflation-indexed annuities also applies, to some extent, to fixed QLACs, which are also not very attractively priced in the current environment. A traditional annuity includes payments over the same post-age 85 period covered by the QLAC, but most of the value is associated with near-term (pre-85) payments. These near-term payments are much easier to manage with existing investments, minimizing the reinvestment risk as a percentage of the total contract value. As a result, a smaller risk margin can be built into the cost structure than is the case for QLACs. Consultants specializing in DC plans have reported that very few DC plan sponsors have added QLACs thus far, and we have heard that QLAC purchases in IRAs have been similarly slow. The slow pace of adoption may be at least partially due to an unwillingness to incur the cost of the reinvestment risk. This outcome defeats the longevity protection objective that QLACs were designed to address.

A variable QLAC would eliminate the insurer's reinvestment risk, enabling the insurer to offer more attractive pricing. Underlying investment strategies can still be designed to reduce investment volatility as the insured reaches the target payout age (through strategies similar to those underlying target date funds). Indexed QLACs would not provide these additional advantages and so would be priced somewhat higher, but the upside potential will still be attractive to many individuals. In both cases the insurer bears additional mortality risk cost because of the potential of increasing annuity payments; however, this mortality risk is outweighed in variable QLACs by the lack of reinvestment risk.

² Board of Governors of the Federal Reserve System Press Release September 17, 2015.

Consistent With Purpose of Regulation

The mere fact that a variable or an indexed annuity is less predictable than a fixed annuity does not make it inconsistent with providing longevity protection. The purpose of the regulation should be to allow a mechanism that provides financial security to retirees who survive to an advanced age through pooling of longevity risk. A variable annuity is likely to be more successful at maintaining a particular level of purchasing power than a fixed annuity. This is also true of an indexed annuity, but to a lesser degree. We agree that a variable annuity may not provide as much guarantee of maintaining purchasing power as an inflation indexed annuity, but if guarantee of maintaining purchasing power were the only criterion, then fixed annuities would also fall short. Allowing QLACs to be paid as fixed annuities indicates an acceptance that other considerations, such as affordability, may outweigh guaranteed maintenance of purchasing power, as such variable annuities are at least as attractive as fixed annuities. Under the variable annuity approach, investment volatility can still be reasonably managed through control of the investments backing the annuity, or through management of an individual's remaining investments.

Sufficiently Easy-to-Understand Option

While variable and indexed annuities are more complex than fixed annuities, their relative complexity should not be an obstacle for most retirees. The concept can be explained relatively simply—the retiree receives a lifetime income that increases when investment returns exceed a benchmark and declines (except in certain equity-indexed QLAC designs) when investment returns fall short of the benchmark. A retiree with assets in a defined contribution plan will be familiar with the concept that income can increase when returns are good, but will decrease when returns are poor. The variable and indexed annuities operate the same way but in addition provide a guarantee that the income will never stop during a retiree's lifetime. It needs to be acknowledged that their complexity may make it difficult for some retirees to be comfortable with them. While some retirees find having to choose among any optional benefit forms to be challenging, other retirees appreciate the availability of sophisticated optional benefit forms that better address their retirement goals. Given that these are only additional options, we do not believe that all retirees should be precluded from the advantages of variable and indexed QLACs because they might not be appropriate for some retirees.

Appropriate Allocation of Equity Exposure

The concept behind longevity annuities is to provide financial security beyond the average life expectancy with the balance of the account providing financial security in the income deferral period. The Treasury and the IRS allow the participant to take significant equity risk with the account balance remaining after the insurance is purchased for multiple purposes including protection against inflation.

Conventional investment advice typically provides that more risk can be taken with assets that are not needed for many years. Current regulations require the opposite approach with respect to longevity annuities. The regulation has no influence on the individual's investment choices relating to the assets that will be used to meet expenses prior to the QLAC start date, allowing the retiree to take additional risk with assets needed in the next 15 to 20 years. However, individuals are not permitted to take any investment risk with the assets invested in a QLAC,

which provide income for the longer term. While not everyone agrees with such conventional advice, we are not aware of any investment theory that supports taking more risk with short term assets and no risk with long term assets.

Summary

The final regulations provide a welcome addition to the options available to retirees for providing financial security throughout their retirement years. We appreciate that the regulation allows the Commissioner to issue additional guidance that would allow variable annuities to be considered QLACs. We urge that such guidance be issued as we have described in this letter.

We appreciate the Treasury Department and the IRS giving consideration to these comments. Please contact Matthew Mulling, the Academy's pension policy analyst (202-785-7868, mulling@actuary.org) if you have any questions or would like to discuss these items further.

Respectfully submitted,

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