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# Making the Money Last: The Case for Offering Pure Longevity Insurance to Retiring Canadians

*Many retirees are concerned about outliving their savings, and as a consequence they live a lower retirement lifestyle than may be feasible. They could be better off pooling the risk of outliving their savings with other retirees through longevity insurance.*

*First, government regulations need to change.*

David Don Ezra

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## THE STUDY IN BRIEF

With a large swath of babyboomers recently retired or set to retire, and many of them having accumulated retirement wealth in capital accumulation plans, the time has come for governments to shift their attention to policies facilitating the efficient and economical decumulation of retirement capital. The provision of longevity insurance is an essential component for making this happen. Yet little policy research exists on why and how to make this a reality.

This paper briefly explains longevity insurance and its value for retirees. It reviews the current Canadian and international environments, the obstacles for the development of pure longevity insurance in Canada, and what governments can do. Tax rules hindering stand-alone longevity insurance offerings need reform. Public education on the value of longevity risk protection at the start of retirement, when it is cheap to purchase, would be helpful. Requiring capital accumulation plans to offer their members the option to buy longevity protection at set ages towards the end of the accumulation phase would also help.

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## When we retire from the workforce, we do not know how long we have left to live.

For a person or a couple relying primarily on a secure pension plan from a government employer, for example, this life span uncertainty may not matter much. For all others whose main sources of retirement income are not guaranteed for life, this life span uncertainty matters a lot. Many retirees are concerned about outliving their savings, and as a consequence they live a lower retirement lifestyle than may be feasible out of a sense of precaution.

Many of these retirees would be better off pooling the risk of outliving their savings with other retirees facing the same risk exposure, through an insurance product known as longevity insurance. The result: retirees more secure in their financial ability to finance a very long life span would be able to enjoy more of their retirement years when younger and healthier, and presumably be better able to cover expenses related to very long life spans, such as long-term care, should they need it.

Government policies should be geared towards encouraging the take-up of longevity insurance for those who might benefit from it. Population aging will put increasing pressures on governments' health budgets, and seniors financially well prepared to support end-of-life expenses would take some of that pressure off public finances. Individuals already co-operate, in that they increase their rate of savings as they get older.<sup>1</sup>

But instead of helping, government tax policies actually hinder the provision of longevity insurance. For reasons related to individual taxation, Canadian insurers do not currently offer pure longevity insurance contracts on a stand-alone basis. The longevity insurance they offer is bundled up with another product resembling either a term deposit or a term life insurance contract, both of which make the existing offerings expensive for consumers and largely unattractive. Unbundling the pure longevity insurance component from these financial products would make the stand-alone contract cheaper and likely more attractive.

Government policies need to change to make that happen. Tax rules hindering stand-alone longevity insurance offerings need reform. Public education on the value of longevity risk protection at the start of retirement, when it is cheap to purchase, would be helpful. Requiring capital accumulation plans like defined-contribution pension plans to offer their members the option to buy longevity protection at set ages toward the end of the accumulation phase would also help.

This paper briefly explains longevity insurance and its value for retirees. It reviews the current Canadian and international environments, the obstacles for the development of longevity insurance in Canada, and what governments can do.

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- 1 See for example Table 5 on page 7 of the C.D. Howe Institute E-Brief "The Overlooked Option for Boosting Retirement Savings: Higher Limits for RRSPs" by Alexandre Laurin, September 11, 2014. In turn, this table is derived from Statistics Canada's Social Policy Simulation Database and Model, version 21.0.

## THE VALUE OF INSURANCE POOLING

When is insurance potentially most valuable? It's when an event is unlikely to occur, but if it does, it has a large negative financial impact. The reason is not difficult to grasp.

If an event with financial consequences is likely to occur, the obvious way to cope is to budget for it. If it is unlikely to occur and would only have a small financial impact, then one is able to live with the small impact, if and when it occurs.

But if you can't afford to live with the consequences of an unlikely and undesirable event, then risk pooling may be sensible. The way it works is that many people with the same risk exposure each contribute a small amount to a pool. The pool is then available to compensate the few who suffer the drastic event.

Those who suffer the event therefore find a source of funds to help them cope. Those who do not suffer the event (the vast majority) find that they have lost the small premium they have paid, which is the price for peace of mind gained.

An everyday example is insurance against a house fire. It is unlikely to occur in any given year (less than a 1 percent chance, typically), but if it does, the financial cost can be large. The required premium is very small in relation to large potential losses and the amount of protection bought. It's a relief not to collect on the insurance.

### A LONGEVITY POOL IS SIMILAR, BUT NOT IDENTICAL

The most frequently cited financial fear among retirees is outliving one's money.<sup>2</sup> If you know how

long you are going to live, you can budget for it, and draw down an appropriate amount each year from your assets. But longevity is uncertain. And extreme longevity, though unlikely, could have large negative financial consequences.

A rational solution is therefore to pay a small premium into a longevity pool, which then becomes available to provide money to those who live to extreme old age. As in the case of fire insurance, those who do not experience the event (extreme longevity) would subsidize those who do.

Of course, there are a couple of big differences between this sort of longevity insurance and fire insurance, and they turn out to be significant psychological barriers to the provision of longevity insurance. One is that, while we don't want to collect on fire insurance, we really do want to collect on longevity insurance. In fact, we feel that we win twice: we live longer, and we collect other people's money. The other big difference is that, unlike the occurrence of a fire, the occurrence of longevity isn't a clearly defined event. Is living to 80 evidence of longevity? Or 85? Or 105? Each age I've cited is a more extreme case than the previous one, but there is no clear dividing line between living long and not living long.

### UNCERTAIN LONGEVITY POTENTIALLY HAS A NEGATIVE FINANCIAL IMPACT

Why is uncertain longevity a negative financial experience?

Consider a couple where the male partner is aged 65 and the female partner 60. Suppose they're non-smokers in average health. According to the US Social Security Administration's readily available

2 See for example Table 3 on page 7 of "Omni Report: Seniors and Money" published by the Financial Planning Standards Council and Canada Credit Debt Solutions on May 25, 2018. This echoes concerns in many countries. See for example *The Motley Fool* "3 biggest fears facing would-be retirees" on April 27, 2016, *USA Today* "Big retirement fear: outliving your savings" on September 24, 2014, *The Daily Telegraph* "How to build a pension pot that can outlive you" on March 4, 2016.

calculator (at [www.longevityillustrator.org](http://www.longevityillustrator.org)), if you were to consider a large number of such couples financing their retirement until the longer-lived partner passes away, half of them would need to finance spending for 31 years.

That would be a sensible initial planning period for determining how much to draw down from accumulated assets each year. But what if you live longer than the average couple? How much larger would your assets need to be, to finance the same level of spending?

Well, one-quarter of the group would need to have enough to last 36 years. And one-tenth of the group would need to have enough to last 40 years. In a world where prevailing interest rates are 2.5 percent, an estimated additional 10 percent or 17 percent would be required, respectively, relative to the amount required to last for the average life expectancy. And even then, ex-ante there is a 25 percent chance of living longer than 36 years, or a 10 percent chance of living longer than 40 years, in which case even the additional amounts quoted above would prove to be inadequate.

To reduce the chance of inadequacy below a 10 percent probability, one can increase the number of years over which the money is planned to last. But that increases the cost enormously. Reducing the chance of inadequacy to less than 1 percent (as with fire insurance) the money would need to last about 50 years. And that would require an additional 33 percent relative to the amount required to last for the average life expectancy.

That's what self-insurance requires (meaning, financing it yourself, with a very low chance of failure). Bring on the longevity pool!

The 65/60 couple could pay a small premium today into the pool, forfeit the premium if neither

lives to that 25 percent or 10 percent or 1 percent age (as chosen by the couple), and collect if either survives beyond that age.

Let us deal with two side issues here.

The first involves "adverse selection." Those who know (for whatever reason) that they are likely to live for a shorter period than average would logically not join a longevity pool. So those who would benefit from joining it are themselves likely to be those in more robust health, more likely to survive beyond the average expectancy. That does not affect the argument. The benefit of pooling comes from relieving the financial effect of the uncertainty of longevity, regardless of its average length.

The second relates to the reserving requirements for insurance company guaranteed lifetime income products, often mentioned as a barrier to the provision of such products. I do not delve into that issue here, but note that as a general statement of principle it is common sense that solvency rules for such products should be adequate to protect both consumers and the industry.

If such rules cannot be devised, an alternative solution is for pooling arrangements that avoid guarantees and their associated reserve requirements, such as one proposed by Bonnie-Jeanne MacDonald<sup>3</sup> or one available in Australia.<sup>4</sup> These are interesting avenues, but the analysis in this paper deals only with guarantees.

## WHERE CAN YOU BUY PURE LONGEVITY INSURANCE?

What I've described is pure longevity insurance. It doesn't work that way in most countries (Canada, for example), for both psychological and tax reasons.

3 In a C.D. Howe Institute *Commentary*, *Headed for the Poorhouse: How to Ensure Seniors don't Run Out of Cash before they Run Out of Time*, Bonnie-Jeanne MacDonald proposes a national, completely voluntary program that would give retiring Canadians the option to buy into a pooled fund that provides a stable income stream starting at age 85.

4 Mercer Lifetime Plus<sup>®</sup> 2.0.

There is at least one country, with perhaps a second country to follow suit, where a form of that insurance is available. The first one is the United States, where such a pure collect-insurance-or-lose-premium contract is permissible (and available) as a so-called QLAC, or “qualifying longevity annuity contract,” for tax-sheltered retirement assets. The highest age to which the collection of the insurance may be deferred is 85. (Of course, it is also available for purchase with non-sheltered assets).

The second is the UK, where a parliamentary committee has recommended that “a default decumulation pathway” be made available by the National Employment Savings Trust (NEST) to its members. A senior official at NEST has outlined one possible component of a sensible approach, involving longevity insurance. The premium would be payable, not as a single initial amount, but monthly at the rate of approximately 2 percent of the retiree’s assets every year, for 10 years.<sup>5</sup> These premiums would start at retirement and continue for 10 years, at which point a deferred annuity would be purchased which begins paying out a further 10 years later. For example, for someone retiring at 65, the monthly premiums would start at 65, the deferred annuity would be purchased at 75, and the lifetime annuity would start on survival from 85.<sup>6</sup>

In both cases, the form of this longevity insurance is exactly what has been described as pure longevity insurance. You collect if you survive to the advanced age specified; you lose your premium(s) if you do not.

## AN ODD CHARACTERISTIC, AND THE PSYCHOLOGY IT GENERATES

If there is no deferral period, the product becomes the more familiar immediate annuity: payments commence immediately and continue for life. This is a product that is available, but less widely purchased than economists suggest is rational. Indeed, the phenomenon of relatively few purchases has led to the phrase “the annuity puzzle” being applied to it.

It seems there’s actually a simple explanation for the puzzle. It’s not a rational explanation: it’s an emotional one. Early death causes a huge financial loss to the annuitant, and that is a big emotional barrier to purchase, because it feels like a gamble rather than security. And in that sense, it truly is a gamble: half of annuitants are likely to lose money on the deal (as explained earlier). That’s not insurance.

Behavioral economists have found that average workers are risk-averse, and are unwilling to take a financial gamble unless the odds are two-to-one in their favour. Average retirees, they find, are five times more risk-averse (there’s no further opportunity to add to savings), and so they want odds ten-to-one in their favour. No wonder they don’t like immediate annuities as much as economists say they should.<sup>7</sup>

With that as background, let’s think about deferred annuities, in which the premium is paid up-front and the annuity payments begin later, by say 15, 20 or 25 years. We know that the single premium is likely to be much lower than for an immediate annuity. That’s a good start. But what about the deferral age, at which the lifetime income starts?

5 The actual rate will depend on interest rates and hence the expected price of the deferred annuity. This will be recalculated at regular intervals.

6 No precise details are available.

7 See, for example Shlomo Benartzi, “Behavioral finance and the post-retirement crisis.” Allianz Global Investors Center for Behavioral Finance.

With the US QLAC, and also with the UK example, the lifetime income starts at age 85. This is actually a very odd characteristic. The reason is that, for a 65-year-old male (the typical case that is discussed), 85 is roughly equal to the future life expectancy. That implies that half the purchasers of this insurance would expect to collect on the insurance. That's more like good advance financial planning than a typical insurance contract where few expect to collect. It would fit the case for insurance much better if the probability of collecting were much lower, closer to only 10 percent. That would imply a higher starting age, at least 90, more like 95. And then the premium required would be much lower, because it would genuinely cover only the extreme cases.

What about Canada?

As in the US, the maximum permissible age to which the commencement of a deferred annuity (lifetime income) may be postponed, for tax-sheltered Canadian savings, has (until very recently) been 85. That makes the single premium very expensive. And so, the possibility of losing the premium on early death feels like – and in some ways is – a gamble. It feels more like tossing a coin than insurance: you have a 50/50 chance of collecting or losing.

The result is that no Canadian insurance company offers pure longevity insurance as a stand-alone product. Catering to the typical buyer's psychology, they add an element of security to pure longevity insurance, promising not only to pay as desired if we survive past the selected age, but also to make a payment if we don't survive to that age. That don't-survive payment is sometimes equal to the premium paid, and sometimes it's the premium plus interest from the date the premium was paid.

That is a wonderful addition to appease psychological fears of losing a large sum of money. In fact, it is asserted that focus groups suggest that most Canadians won't buy longevity insurance unless it has that return-of-premium feature. Of course – now we understand the psychology. But it is important

to note that bundling a return-of-premium feature (with or without interest) makes it more than a pure longevity insurance contract, and can be unnecessarily costly. Let's examine this aspect.

## THE ADDITIONAL FEATURE AND ITS ADDED COST

I'll use as an example, not you, but your 65-year-old male friend who wants pure longevity insurance that kicks in if he survives past age 85. He gets a quote from an insurance company, telling him how many dollars a year they'll pay him once he survives to 85, for an initial premium of \$100 (a number we use to keep the example simple). That's the end of the matter. We'll call it Example A. (It doesn't matter what the quoted income payment is.)

Now let's consider a variation. This is Example B. The friend says: "How much will I get after 85, if in addition you also guarantee to refund my \$100 if I die before 85?"

What our friend has asked for, in addition to the longevity insurance that kicks in on survival to age 85, is a 20-year term insurance policy that pays \$100 if he dies before 85, and nothing if he survives to 85.

A single premium 20-year term insurance policy, with a sum assured of \$100, would roughly cost \$45 for a 65-year-old male – a rough estimate since here the precise number is sensitive to assumptions that are irrelevant for the argument. That means that, of the aggregate \$100 that your friend is willing to pay, \$45 will go for the term policy, and the remaining \$55 will buy him pure longevity insurance.

Whatever quote he received in Example A, he will be quoted an income after age 85 of 55 percent of that amount, in Example B.

For the psychological satisfaction of "I can't lose, whether I live or die," he sacrifices 45 percent of his longevity insurance income. For whose benefit? There are two beneficiaries. One (the financial beneficiary) is whoever benefits from his estate if it collects on the term insurance. The other is



undoubtedly the person himself, an emotional beneficiary since he is now able to think: “I feel good about the arrangements I’ve made.”

But his personal retirement prospects after 85 have been greatly sacrificed. If that’s what he wants, then he is admitting that he has potentially two financial goals, a bequest as well as longevity insurance, and the bequest goal is significant enough that he’ll significantly compromise his own prospects after age 85. In other words, while a bequest motive is a logical consideration, the extent to which it compromises ongoing lifestyle income is typically not realized.

In fact, it may be possible to accommodate the bequest motive, if one exists, most efficiently by making the deferred annuity a “joint and last survivor” one, in which payments continue to a named second person if and only if the second person survives your friend.

Note also that it’s an odd use of term insurance. The standard use of term insurance is during one’s working lifetime, to make good a loss of earnings on early death while in the workforce. (Remember: small chance of occurrence, significant financial impact to the surviving family if it does occur.) Term insurance after retirement is much more difficult to justify.

Or, of course, this may not be what your friend wants. All of this may be far too complex and erudite for him. He may not realize that he has been sold two essentially separate contracts, bundled together, because nobody ever told him you could split them apart and buy just the one you want. If so, he now has an unwanted and unnecessary and expensive 20-year term insurance policy.

Finally, consider Example C.

Here your friend wants pure longevity insurance, plus a return of premium with interest if he dies before 85. This time, what is he actually doing? He’s

not actually buying longevity insurance at all. In effect, what he has done is that he has deposited \$100 with the insurance company, and it has a great similarity to a locked-in bank deposit earning interest. If he dies before 85, his estate will get the deposit plus accrued interest. If he survives to 85, the accrued amount will, in effect, buy him an immediate lifetime income annuity at that point.<sup>8</sup>

Essentially, he’s locking in his \$100, thus losing the flexibility to use it for other purposes before age 85, and it’s invested purely in a fixed-rate deposit account.

He could just as easily invest the \$100 in his own way, whether in a bank deposit or in fixed income or in growth-seeking assets – in other words, with total flexibility and control – and approach the insurance company if he survives to 85 and buy his lifetime income then. In fact, for the first 20 years there is no insurance element at all (other than a guaranteed conversion rate). Not unless your friend wants a pure fixed-income investment and believes that the insurance company is best qualified to deliver it, would this be a sensible retirement choice.

## TWO REASONS FOR THIS CANADIAN PRACTICE

It’s no wonder that Canadian insurance companies don’t offer Example A. Catering to the market’s psychology, it’s logical and rational for them to only offer Examples B and C. They do call B and C longevity insurance, even though from a purist’s perspective the pure longevity insurance element (which is A) may be much smaller than perceived (as in B), or non-existent (as in C). It’s not as if insurance companies don’t underwrite A. They do, routinely, because both B and C are sold in the belief that they include A.

Would the public buy pure longevity insurance? In the UK, NEST’s focus groups suggest that

8 For the more expert reader, yes, the purchase will be at a guaranteed conversion rate.

many people are willing to spend up to 20 percent of their retirement nest egg on longevity insurance.

In the US, the QLAC was introduced in 2014 as a new, desirable contract, there being no such feature permitted for tax-sheltered money before then. The amount that can be used for such a contract was limited to the lesser of \$125,000 and 25 percent of the tax-sheltered assets. In 2018, the absolute ceiling was raised to \$130,000.

It is very difficult to find data breaking out its popularity at this early stage. I doubt that it is hugely popular, particularly at this early stage of its existence; there is no anecdotal evidence of that. But its purpose is not to appease an impatient multitude, it is simply to make available a very useful contract.

Anecdotal evidence suggests that some non-sheltered money has moved into longevity insurance in the US, but not in significant amounts, though it has been available for many more years.

Apart from psychology, a second reason for the absence of longevity insurance in Canada is that Canadian individual income tax treatment of such non-sheltered contracts is unique, and a definite influence. Here's a summary of how it works.

Since the early 1980s, Canada has restricted the ability of savers in permanent life insurance contracts to earn a return via untaxed internal insurance company funds, and not have that return recognised and taxed as individual income as it was being earned. Tax law effectively capped such returns by permitting a maximum amount. That maximum amount is essentially the required return, year by year, on insurance company reserves set up to back an annual premium endowment policy maturing at age 85. Anything accruing value faster than that must be reported as taxpayer earnings in the relevant year. (That's the essence of the rule, which is more complicated in practice.)

That has effectively ruled out single premium policies as assets that are not tax sheltered. And in tax-sheltered retirement accounts, Canada has rules requiring some minimum amount to be distributed each year after age 71, which essentially rules out the provision of pure deferred annuities within

registered accounts. The US has similar rules (with age 70½), but exempts a QLAC from its rules.

The use of age 85, arising from the endowment age definition in the tax law cited, became the natural Canadian anchor for the deferral age used for bundled longevity insurance policies. However, post-2016, in recognition of improved longevity, the endowment age was increased to 90 for Canadian tax purposes.

### COULD EVERYONE BENEFIT FROM THE AVAILABILITY OF LONGEVITY INSURANCE?

No, not everyone could benefit. There are three categories of people for whom the availability of longevity insurance would achieve little.

One is those with life expectancies known in advance to be below average. By definition, insuring against living much longer than average is not an issue for them.

Another category is the very poor. If they have barely enough to live on, and require government support payments, those payments will continue for the rest of their lives anyway. Even just above this support level, there is probably no ability to set aside anything for longevity insurance.

Third, at the other extreme, those who have sufficient assets that they can live their desired lifestyle and not run out of money even if they survive to the end of the longevity table (120, for practical purposes) have no financial risk associated with longevity, and so have no need for longevity insurance. Included in this group are those who have generous "defined benefit" pension arrangements that are sufficient to support their post-retirement lifestyles.

Everyone in between has a potential need for it, or the vast majority of the population, since typically the biggest fear of retirees is that they will outlive their assets, as mentioned earlier. That doesn't mean they will all buy it: some will not be aware of their need, others may prefer to underspend and thereby self-insure. But having

the option can only be a positive feature in their lives. And education about the higher income that results from ownership of longevity insurance supplemented by savings drawn down to the deferral age, relative to pure self-insurance, will surely help too.

This educational effort would be helped if capital accumulation plans were required to offer longevity insurance as an option at retirement – not for a retiree’s entire accumulated assets, but potentially for a portion of them. Having the option available means that it will have to be explained; again, this can increase its use.<sup>9</sup> Let me add in passing that mortality rates are low, even for males aged 65, so there is only a tiny mortality premium available for discounting the purchase price if purchase is made before retirement. So, making purchase available before retirement has no practical value. This is not generally understood.

## SO WHAT’S FOR GOVERNMENTS TO DO?

Here are some policy ideas.

(1) Change the tax rules so that it becomes possible and practical for insurance companies to offer pure longevity insurance products, thereby promoting innovation.

- For registered annuities, change the rules so that single premium, stand-alone deferred annuities are not caught in the past-71 minimum withdrawal rules. This is the principle behind the US’s QLACs, which could become a model to be followed. It would be even better if deferral is permitted to a more advanced age – a practice that would have the effect of simultaneously reducing the size of the premium paid, and increasing the post-deferral income a specified capital value would secure (ACPM 2017).

- For non-registered products, allow stand-alone, deferred annuities to be prescribed annuities with the following characteristics.<sup>10</sup> (a) An individual would not pay tax unless there are actually annuity payments received – common sense, surely. (b) The annuity payment would be treated as income when received, except for a deemed return of capital each year equal to the original purchase price divided by the life expectancy at the deferral age. (See Neilson 2012.)

(2) Invest in retirement planning education with respect to longevity risk protection.

There are many aspects that can be invoked. A potentially powerful one is reframing the issue as one of enhanced consumption, since sustainable consumption for a group is higher with longevity insurance than if members seek individually to make their assets last to extreme old age.

(3) Once possible and practical, require capital accumulation plans like DC plans to offer partial stand-alone deferred annuities for voluntary member purchase at retirement.

(4) Work with insurance regulators to ensure that solvency rules for stand-alone, single premium deferred annuities are adequate to protect both consumers and the industry.

In other words, the rules should be such as to discourage over-aggressive pricing, but not so onerous that insurance companies face a greater burden than with their immediate annuities.

## CONCLUSION

With a large swath of babyboomers recently retired or set to retire, and many of them having accumulated retirement wealth in capital accumulation plans, the time has come for governments to shift their attention to

<sup>9</sup> As with any option, it can also be abused. No doubt the appropriate legal protections would be developed alongside.

<sup>10</sup> Income Tax Regulation 304 prescribes that certain annuity contracts be exempted from the accrual rules pertaining to income reporting. Accordingly, these are called prescribed annuities.



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policies facilitating the efficient and economical decumulation of retirement capital. The provision of longevity insurance is an essential component to making this happen. Policy needs to shift, and quickly, to make the development of a thriving stand-alone longevity insurance market a reality.

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