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Combination Annuities—A Market to Get Into?

By Cary Lakenbach

Just like the month of June in the renowned musical, "Carousel," combination annuities are "bustin' out all over." The impending effective date (Jan. 1, 2010) of the Pension Protection Act has insurers actively researching and/or developing such products for introduction next year.

Whether companies choose to enter this business or not, the dramatically large size of the potential market suggests that companies ought to research at least the appropriateness of the offering for their business. This article provides a road map of the issues a company will need to address to enter the combination long-term care (LTC) market. Following is a list of key issues:

1. Government Tax Policy
    - The impact of the Pension Protection Act
2. Markets and Customer Need
    - The case for long-term care generally, and for annuity combinations specifically
3. Distribution
    - What issues must be addressed to get transactionally oriented distribution to embrace this new business?
4. Insurers
    - What are the product implications of this business, with respect to risk and business management?
5. Product
    - What are the components of a successful product design?
6. Financial Environment
    - What might be the implications of the recent volatile financial environment on product, and on the prospects for the offering generally?
    - Implications for smaller insurers

Government Tax Policy

Just as HIPAA, which became effective in 1997, enabled standalone long-term care and combination life and long-term care products to be sold on a tax-favored basis, the Pension Protection ACT (PPA) similarly enables combination annuity and LTC contracts to be sold with similar tax benefits.

Actuarial Strategies, Inc. and others have previously written extensively on the tax treatment of combination annuities, so the following is a high-level summary of tax considerations (where all comments refer to tax treatment beginning in 2010, the effective date of PPA):

1. **Income Tax Free Benefits:** Benefits received under Qualified Long-Term Care Insurance (QLTCI) riders to annuities are received income tax free.
2. **QLTCI Requirements:** To be considered QLTCI LTC riders must meet the appropriate requirements of Section 7702B of the Internal Revenue Code (IRC).
3. **Nonqualified Retirement Annuities Only:** QLTCI riders may only be written in nontax qualified retirement annuities.
4. **Construction of Combination Annuities:** Combination annuities invariably include account value as part of the LTC benefit, although there must be some additional LTC risk coverage as well. Policies need not return account value and the additional LTC risk coverage at the same time. (As we do with clients, one must caution that the author is not a tax attorney, and neither he nor his firm provides tax advice.) In other words, one can design products that return account value first, as sort of an extended elimination period, and then pay out the pure risk amount.

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5. **Favorable Treatment of Gain:** Thus, when annuity gain is paid as part of an LTC benefit, the gain escapes income taxation. That is one of the key advantages of combination annuity products.
    a. What this says is that a tax-deferred annuity essentially becomes a tax-free annuity when the account values are paid out as qualified long-term care benefits.
6. **Treatment of Exchanges:** The PPA provides that one can make IRC Section 1035 exchanges from existing annuity contracts (written 1/1/97 and later) to combination annuity contracts.
    a. Because existing contracts can have significant gain locked up within them, the favorable treatment of gain within combination annuities makes them extremely attractive as an exchange vehicle.
    b. This has implications for companies in two different ways. A company must be extremely cognizant of the potential for dislocation of its in force. And, conversely, a company should be aware of the potential to attract existing annuity business with an attractive combination offering.
7. **Charges:** Charges to pay for QLTCI are not taxable, ever.
8. **Dac Tax:** The DAC tax rate for combination annuities is 7.70 percent, the same as for standalone LTC coverage. Note that nonqualified retirement annuities have a DAC tax rate of 1.75 percent.

Markets

That there is a need for long-term care services is incontrovertible. By 2010, the number of Americans 55 and over will be over 55 million, and by 2020, the number will be over 71 million. These Americans are living longer and incurring more claims, which of course are claims of infirmity and old age. The cost of claims is going up too. In 2007, the national average cost of a semi-private room was approximately $6,000 per month with enormous geographical variations, especially in urban regions of the country. Yet, if the number of Americans needing long-term care is so great, why aren't the sales of standalone LTC more robust? That they are not robust is clear.

Sales have fallen from the 2002 level of 725,000 policies to just fewer than 300,000 for the last two years (2006 and 2007). These sales barely begin to address the potential market demographic and customer need. Several reasons have been postulated by industry observers for the relatively poor and declining sales volume. These include:

1. Poor publicity on existing standalone business.
2. Rate increases on existing policy holders.
3. Relatively high prices of existing standalone products: A typical standalone policy with a 4-year benefit period at age 65 for $200 a day (without inflation) can cost $2,500 or more.
4. Major resistance on the part of many to the use it or lose it phenomenon. (If a buyer owns the LTC and dies without incurring LTC expenses, the total premiums will have been "lost").
5. Limited distribution: Today the LTC policy is sold largely through specialists. Huge numbers of distributors do not participate.
6. Underwriting is difficult and takes a long time.

Hence, the need is great, but existing solutions have not been terribly successful. Are there solutions that achieve the goal of covering the LTC need, and which overcome these objections? We do not know the answer for sure, and we won't until we are into next year, but the combination annuity story is a compelling one.

What makes it so appealing?

1. **Much Lower Cost:** The cost is significantly less than a standalone providing a similar benefit stream, primarily because the combination product owner will be using his own money as a copay, so to speak. There are other compelling reasons.
2. **No More "Use It Or Lose It"**: If the owner does not become chronically ill, he gets to keep his annuity dollars. A properly designed annuity ought to be able to provide for living benefits without jeopardizing LTC benefit levels, so that some values can be used to provide income. Remaining values can be passed along as a death benefit. In other words, no more "use it or lose it," which is bound to appeal to investment-oriented advisors.
3. **Gains Avoid Tax:** As noted, annuity gains will avoid tax. This is especially valuable if gains exist due to exchanges.
4. **Simplified Issue and Underwriting Process:** A simplified yet still rigorous underwriting can be designed that is both protective and enables the transaction-oriented annuity producer to sell this product.

Distribution

The real opportunity, as viewed by most observers known to the author, exists with annuity producers. Most annuity producers are transaction-oriented, so that maintaining the transactional nature of the sale is viewed as essential. The key to achieving this objective is the contract issue and underwriting process. Market research carried out by the author's firm in partnership with a major market research firm strongly suggests that producers from various distribution segments, including wirehouse and regional broker dealers, are comfortable with simplified underwriting if the underwriting process meets certain criteria, such as limited time until decision and minimal producer involvement in the underwriting process.

Also very important is how the sale can be positioned in a manner that is consistent with the overall business of the producer. Educating the producer on the type of customer that would be suitable for the LTC combination annuity is viewed as very positive. Because annuity producers are not so familiar with LTC products and related considerations, proper training and attractive tools are essential. If the insurer is larger, training wholesalers to educate their advisors properly is essential. Smaller insurers may want to sponsor schools, develop training disks and sponsor training webinars.

Market feedback to date suggests that illustrations that illuminate the design, and which are accompanied by attractive professional looking written material, will be viewed very favorably.

Insurer Considerations

Okay, how many insurers are in the LTC business? Not too many. That means most of you are not in the LTC business. Whether you are or not, you still need to understand what is involved in getting into the combination annuity business:

1. **Do You Want To Dance?** A key question to ask is, why get into the LTC business? Most executives view the opportunity to expand annuity sales as the key reason for market entry. For their companies, two major considerations are the minimization of risk and the limited involvement in LTC claims management.
2. **Minimization of Risk By Product Design:** For many, product design alone may address this objective. Many potential designs limit LTC risk inherently by delaying the payout of the pure risk elements until account values are paid out. Of course, the fact that the policyholder has relatively sizable amounts of account value at play is inherently limiting as well. (Not all designs may work from a tax perspective, however. While the tax code doesn't specify rules for the minimum amount of risk that a product needs to have, a number of prominent legal and actuarial advisors believe there are limitations that must be met. That topic is, however, outside the scope of this article.).
3. **Minimization of Risk By Reinsurance:** Several reinsurers are actively soliciting combination business. Therefore, it is possible to further limit a company's LTC risk exposure. Some degree of participation by direct writers, at least 20 percent, is essential. In light of market conditions, reinsurance will be easier to procure for nonvariable offerings.
4. **Claims Management:** Companies generally do not want to build their own LTC claims units. There is a great deal of overhead involved in building expertise unlikely to be used in any great measure for several years. It is much better to rent it by working with knowledgeable Third Party Administrators (TPAs) active in the LTC marketplace. There are several good ones.
5. **Other Considerations:** We have already addressed some of these previously. To summarize,
   a. Sound, protective underwriting that is sensitive to the culture of the annuity distributor is essential.
   b. Solid execution—this involves sales training and top-quality marketing materials, among other factors.
   c. Planning for in force challenges and opportunities.

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Product

In our world, product means more than the precise product-specific components. One must get product to the consumer, through the distributor, and whatever it takes to accomplish this objective may be considered "product." Here are some of the key combination annuity considerations:

1. **Defining Product Based On Need:** Today's combination annuity products, most of which are nonPPA compliant, do not directly determine the LTC product parameters based on the consumer's assessment of their LTC need. Yes, there is an outcome (e.g., the product provides $200 per day for a minimum period), but that is not necessarily great if the buyer needed $300 per day. It is better to start with the need, the way a prospect would be likely to look at the situation, and build the product up that way. This may lead to different designs, or at least to illustration systems that translate

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current designs into the structure most likely to be useful to a prospect.

2. **Provide Product Flexibility:** This is a tough one, because while training is essential, as noted, the reality is that most annuity distributors will not have much experience with LTC concepts, and too much flexibility may result in confusion and consequently, lack of sales. An answer to this dilemma lies in the illustration tool. How much deposit, how much desired benefit (and for how long), desire to take some income within specified parameters, and desire to leave money for heirs, will be the key parameters.
3. **Limit Early Claims:** A waiting period, two years for example, specifies that no claims will be payable within the specified period from issue. This complements the simplified underwriting. (Waiting period is to be distinguished from elimination period, which specifies how long an individual must be disabled before the company will start paying benefits.)
4. **Indemnity Or Expense Reimbursement:** These terms have to do with whether the daily or monthly benefit is a function of actual claims or not. Indemnity is simpler and easier to administer, but potentially more costly. Further, the tax rules limit the maximum tax-free payment under indemnity contracts. The limit, which varies year to year as a function of living indices, is $280 per day in 2009. For expense reimbursement contracts, all legitimate benefit payments are tax free.
5. **Simplified Issue and Underwriting:** While this topic has already been dealt with elsewhere, some additional comments are in order. Simplified does not necessarily mean a few (e.g., four) yes/no questions with accept/reject underwriting. It could, but rather it refers to a spectrum of noninvasive underwriting, and so it might also be more robust, and include elements such as tele-underwriting follow-ups and cognitive screens.

Financial Environment

We are not in any financial environment that most of us have previously been exposed to, and what company strategies and plans were in place as recently as a year ago have been in many instances dramatically altered.

Interestingly enough, some of these changes play favorably for the smaller insurers of this country. Not having delved into variable annuities, not having purchased asset-backed securities (hopefully), many insurers found their fixed annuity business growing rapidly at the expense of variable business, and in fact, noninsurance held assets such as individual securities and mutual funds.

Not surprisingly then, major combination annuity activity is therefore taking place in fixed annuity companies and business segments, and many larger companies are deemphasizing variable business and focusing on fixed. By reputation, smaller companies may have a competitive advantage currently, and many are capitalizing on it.

We have reviewed and discussed a variety of issues that need to be addressed by a company considering entry into the combination annuity business. The issues any specific insurer needs to address will no doubt not be precisely the same as these, but a well-prepared company will much more likely be a successful company.

Cary Lakenbach, FSA, MAAA, is president of Actuarial Strategies in Bloomfield, Conn. He can be contacted at caryl@actstrat.com.