Will Boomers Pony Up for these Riders?

By Editor Test *Tue, Aug 18, 2009*

Deferred annuities have lapse rates as high as 40% to 70%, but the lapse rates of LTCI/annuity hybrids could shrink to as low as one or two percent—the rates associated with LTCI policies.

By attaching long-term care insurance (LTCI) riders to deferred annuities, insurers could solve three chronic conditions: the high cost of stand-alone LTCI products, the high surrender rate of deferred annuity contracts, and Baby Boomers' fear of potentially monumental nursing home expenses.

That's one of many insights in the July 2009 research report, "Annuity and Long-Term Care Insurance Combination Products," from analysts Carl Friedrich and Sue Saip at Milliman, the Seattle-based global consulting firm.

"It's reasonable to expect that the lapse rates on LTCI annuities would be substantially lower than lapse rates on deferred annuities," Friedrich said.

"People who buy this kind of coverage are very aware of the LTC insurance element. They know that the cost long-term care insurance goes up substantially as they age, and that the likelihood of being able to clear underwriting goes down. So they are reluctant to give it up."

Where deferred annuities have lapse rates as high as 40% to 70%, he said, the lapse rates of LTCI/annuity hybrids could shrink to as low as one or two percent—the rates associated with LTCI policies. As a result, he added, "There's a tremendous pricing benefit to making these riders available to existing annuity owners."

The Pension Protection Act of 2006 included a provision stating that, starting Jan. 1, 2010, payouts from non-qualified LTCI/annuity hybrid products can be distributed tax-free when used to pay long-term care medical expenses. (The effective date of the provision was delayed in order to control the long-term cost of the subsidy to the U.S. Treasury.)

Significantly, the law allows for 1035 transfers into these products from existing non-qualified annuities. Just as guaranteed lifetime withdrawal benefits churned up the annuity market, the availability of the LTCI riders could inspire producers and annuity owners to move hundreds of billions of dollars from old contracts into hybrid contracts in coming years.

So far, only about 10 insurance companies have issued LTCI/annuity hybrids. But Milliman expects that number to double during 2010. "Some of the major companies are waiting to see if these products take off in the marketplace. Some have held off because the law doesn't go into effect until 2010," Friedrich said.

“Another reason for holding off is that they know they’ve got a lot of training to go through,” he added. “On the other hand, if we begin to see a lot of replacement activity, with people exchanging annuities without LTC rider for annuities with riders, companies would be forced to develop combination products for their own portfolios.”

The Milliman report describes three basic product designs under scrutiny by carriers. In the so-called “tail design,” a contract owner would exhaust his or her own annuity assets before claiming benefits. In the second, or “co-insurance design,” every payment would blend client and carrier money. In the third, or “pool design,” a maximum benefit would be agreed upon in advance, and payments would continue until the pool amount was exhausted.

The co-insurance design appeals to consumers and the IRS. Consumers like to feel that they’re receiving assistance from the insurance company as soon as care begins. The IRS doesn’t like the scenario, possible under the tail design, where the client could die before the insurance company pays anything.

Under the co-insurance method, “the insurance company always has a meaningful amount of risk,” Friedrich said. That’s what the government wants to see. “The IRS did in fact issue a private letter ruling about three months ago for a company that used the co-insurance method. The IRS didn’t disclose the percentages”—that is, the exact balance of contributions—“but it said that design did include meaningful risk.”

Regulators can be expected to frown on LTCI/annuity hybrids that reduce carrier risk by insisting on long waiting periods before coverage begins, and by stopping eligibility for coverage at advanced ages-which are likely to be the ages when clients are most likely to need the benefits.