Combo LTC annuities: Here they come

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The Pension Protection Act of 2006 included some key provisions that addressed for the first time the taxation of combination annuity plans featuring long-term care insurance (LTCI). The rules apply only to nonqualified annuities coupled with tax-qualified long-term care riders. The Act clarified that, effective Jan. 1, 2010, long-term care insurance benefits paid out of these plans (even if a portion of those serves to reduce account values in the underlying annuity) are paid as tax-free long-term care insurance benefits. This is unprecedented in the annuity world; prior to that date there was no mechanism that allowed for gains in a contract to be paid out on a tax-free basis. In addition, the law also allows for 1035 exchanges into combination plans. This is noteworthy in light of the many trillions of dollars deposited in existing annuities.

Given this new tax advantage, and the compelling need for long-term care insurance that is not being sufficiently met by standalone products, we are seeing significant activity by carriers who are developing combination annuities for introduction on or after Jan. 1, 2010. Carriers also see the opportunity to enhance persistency to levels much higher than those seen with standalone annuities, which is expected to boost profitability on new combo business as well for any existing annuity contracts to which long-term care benefits are added.

Early indications are that many consumers are intrigued by the concept of an insurance vehicle that can provide protection against the risk of long-term care, but that can also provide cash values even in the event that no long-term care services are ever needed. This overcomes one of the major concerns of consumers regarding standalone LTCI, the fear of a "use-it-or-lose-it" proposition.

Only a few companies have introduced such products to date. Actual sales results have been ramping up gradually by some accounts, although 2008 first-year premium on combination plans has been estimated at $650 million (primarily single premium), exceeding first-year standalone LTCI premium (primarily annual premium) of roughly $600 million. We believe that the industry will address the challenges of rolling out

these cutting-edge products over the next few years.

Clearing potential hurdles

To date, there are several key obstacles to success. Simplifying the underwriting process to protect the company, yet not burden the producer, is one challenge. Agent training and licensing issues need to be addressed to enable the sales process. Sufficient compensation needs to be provided to incent producers to market these products. In addition, there is agent confusion regarding the fact that properly structured plans that were sold prior to Jan. 1, 2010, will receive the same favorable tax treatment as plans sold after Jan. 1, 2010, once that date has passed. That problem goes away at the end of 2009.

Solutions are on the way. Education of producers will be a critical issue, and companies as well as wholesalers are targeting these products and markets and preparing for that effort. Underwriting standards are evolving and tele-underwriting techniques are being developed to reduce the burden on annuity producers or financial planners not familiar with LTCI underwriting. Commission structures are being developed to reward producers for their efforts in selling these plans, not only at issue but in some cases through trail commissions that can be lucrative over time because of the long-term persistency expected on these plans.

Unique product design

The benefit payout structure under these plans is typically defined as an accelerated benefit, whereby LTCI benefit payments are made from the annuity account value while waiving surrender charges. This is usually combined with some form of tail benefit payable after account values are depleted. The benefit is paid monthly and is usually expressed as a percent of the annuity account value at the time of initial claim. For example, 1/24 of the lifetime LTC benefit limit may be payable for 24 or more months from the account value, with a 12-, 24-, or 48-month extension of benefit "tail" as selected by the client. This creates the opportunity to convert what would have been partially taxable account values from the annuity into tax-free payouts that range from 150% to 300% of the account value as LTCI benefits.

There are several alternative structures, all of which combine accelerated benefits and independent benefits, but under different configurations. We think certain segments of the market will find these new designs even more interesting than the tail design described above. There are also various ways to provide protection against the risk of LTC cost inflation. Those designs that tie LTC benefit amounts to account values inherently provide a form of inflation protection, in that account value growth would naturally occur within the annuity.

Consider a 60-year-old annuity purchaser depositing $100,000 ($100K), who at age 80 needs 24 months of accelerated LTC benefits and another 24 months of tail benefits. Assuming an annuity purchase without the LTC rider, she cashes out $219K (4% annual growth) and pays $36K of taxes on gain (assuming a 30% tax rate), with a net of $183K after tax. In contrast, with an LTC rider attached that pays out up to 200% of account value, with a cost of 65 basis points per year assessed against the account value, the annuity grows to $193K, so the contract pays out $386K tax-free. Note that this ignores potential tax benefits of itemized deductions for unreimbursed LTC medical expenses, which might dampen some of the differentials above for many insureds.

Next, consider a second scenario, where the same client eventually needs six years of

care after the purchase of a more expensive 24 month accelerated benefit plus 48-month extension of benefit tail, effectively creating a total potential benefit of three times the account value. With the LTC rider featuring a cost of 90 basis points per year, the annuity funded with $100K grows to $184K, so the contract pays out $552K tax-free, versus the $183K without the rider.

These examples highlight the combination of tax benefits and insurance benefits that can leverage accumulation values within annuities. Admittedly, not all consumers will actually utilize long-term care services. But the risk of long-term care utilization is sufficiently high (50% or more at ages 65 and above), and the cost versus potential benefits sufficiently compelling, that we expect producers and companies will appreciate the power of these combination plans.

Getting combo products in the hands of consumers

In terms of distribution outlets, interest levels are expected to grow among LTCI producers who are familiar with LTCI underwriting and who are seeking lower-cost products to address the long-term care insurance need. Banks and annuity producers are close to customers with funds available, and repositioning of these assets into these new tax-effective protection plans is expected. Financial planners are yet another likely source of this business. Perhaps the most effective distribution mechanisms will evolve from a collaborative effort between different types of distribution systems.

With the new tax law reforms coming into place in 2010, this is a story that will be brought to the market. It should be fascinating over the next few years to see which product designs, which distribution mechanisms, and which companies most effectively address the needs of the consumer with these new products.