



Creating More Choices for Older Adults: Financing LTC Through an Integrated Income and Disability Annuity

Traditionally, health insurance and income security are not integrated in retirement. LTC insurance and life annuities do share common barriers, however, that limit their reach among retirees, including the potential for adverse selection, relatively high cost, and inflexible benefits.

The Proposed Approach

Concerned with such limitations, recent work (Spillman et al., 2003; Warshawsky et al., 2002; Murtaugh et al., 2001) examined the potential of an annuity that provides both income and disability payments. The approach provides a steady

Life Annuity - Receive payments throughout retirement; insurance against outliving resources.

Long-Term Care (LTC) Insurance – Pays LTC expenses due to chronic disability.

income throughout retirement and an increase in income at the onset of disability to cover the costs of LTC. By pooling disability and mortality risks into one annuity risk grouping, the opposing risks—long life versus short life with more immediate disability—would be balanced (see Figure 1).

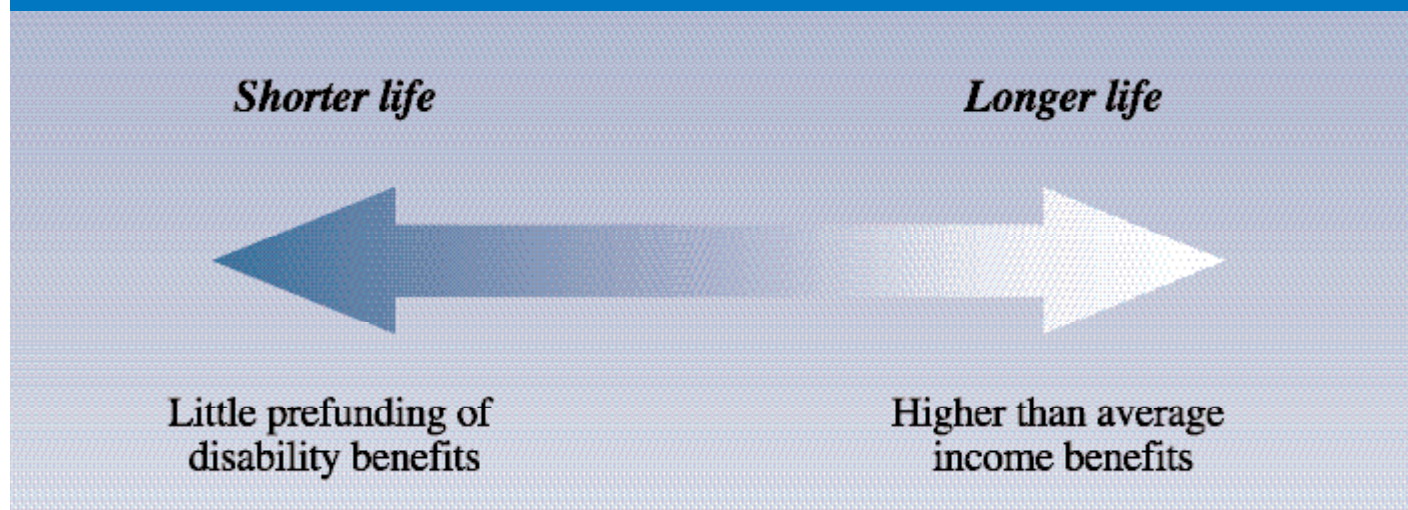
Goal: To reframe retirement planning to ensure an income stream is available to meet all the needs of older adults.

Theoretical Benefits

Theoretically, the combined annuity could:

- 1) Reduce adverse selection in the life annuity and the need for medical underwriting in LTC insurance;
- 2) Decrease premiums/costs;
- 3) Increase the number of people who would be eligible to purchase LTC insurance;
- 4) Integrate retirement planning; and,
- 5) Reduce the “illiquidity” of income annuities.

Figure 1. Balancing Insurance Risks



Study Results

The feasibility of a fixed immediate life annuity that increased payments with the onset of chronic disability was examined in a recent empirical study. The National Mortality Followback Survey was used to examine the difference between a combined income and disability annuity (assuming purchase at age 65) and traditional income annuities and LTC insurance purchased separately.

Study simulations showed that, when compared to separate purchase of an income annuity and LTC insurance, the combined annuity:

- **Increased eligibility** using minimal underwriting requirements: 98% of persons aged 65 would be medically eligible, compared to 77% under current LTC insurance underwriting; and,
- **Decreased the total premium** for income and disability insurance by three to five percent.

The decrease in total premium is due to potential purchasers dying 1.5 years earlier and having slightly lower disability years, on average, than those typically eligible to purchase private LTC insurance.

Combined Annuity Benefits

- \$1,000 per month for life, with a 10 year guaranteed payout (paid to estate in the event of early death)
- Additional \$2,000 per month for disability defined as two or more ADLs or cognitive impairment
- Additional \$1,000 per month for four or more ADLs

Direct benefits relative to premiums varied. The simulations showed that people with limitations in activities of daily living (those with more than one limitation would be excluded under minimal underwriting) and people with cognitive limitations (all of whom would be excluded under minimal underwriting) would receive direct benefits exceeding the premium. Others (e.g., individuals who have had a recent heart attack) would not. The perceived value of the annuity and disability benefits by persons in different states of health, therefore, will affect purchasing decisions and the success of risk pooling.

[Note: For further information on the study methodology see Murtaugh et al., 2001.]

Limitations

Some possible limitations of the use of a cash benefit in the combined annuity approach are identified below.

- **Moral hazard** is the tendency for service use to be greater with insurance than without. In the context of this project, it means the incentive to claim cash benefits before meeting the disability criteria of the joint annuity.
- **Fraud and abuse** would be easier with a cash benefit (e.g., by caregivers and family members of a cognitively impaired person receiving benefits).

Policy Implications

A combined income and disability annuity has the potential to expand the private market for LTC financing and to reduce the total cost of purchasing both an income annuity and disability insurance. The ability to realize pooling benefits—namely the reduction in adverse selection as a result of combining the income and disability products—is key to the success of the integrated annuity. If the combined benefit is not valuable enough to those currently medically ineligible for LTC insurance, the integrated product will not sufficiently pool the opposing risks and will not reduce premiums.

To predict the success of such a product in the marketplace, answers are needed to a number of questions:

- 1) What is the potential size of the market for such an integrated product?
 - How many older adults would find it affordable, and what assets would they use to pay for it?
- 2) What is the longevity and disability profile of likely purchasers?

- 3) How would the joint annuity fit together with current public benefits?
 - Is a state's Medicaid program likely to influence decision making?
- 4) Does tax policy distort choice?
 - What would current-law tax treatment be?
 - Are preferential tax benefits necessary/warranted?
 - If so, what would be the appropriate nature of those benefits?

References

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