

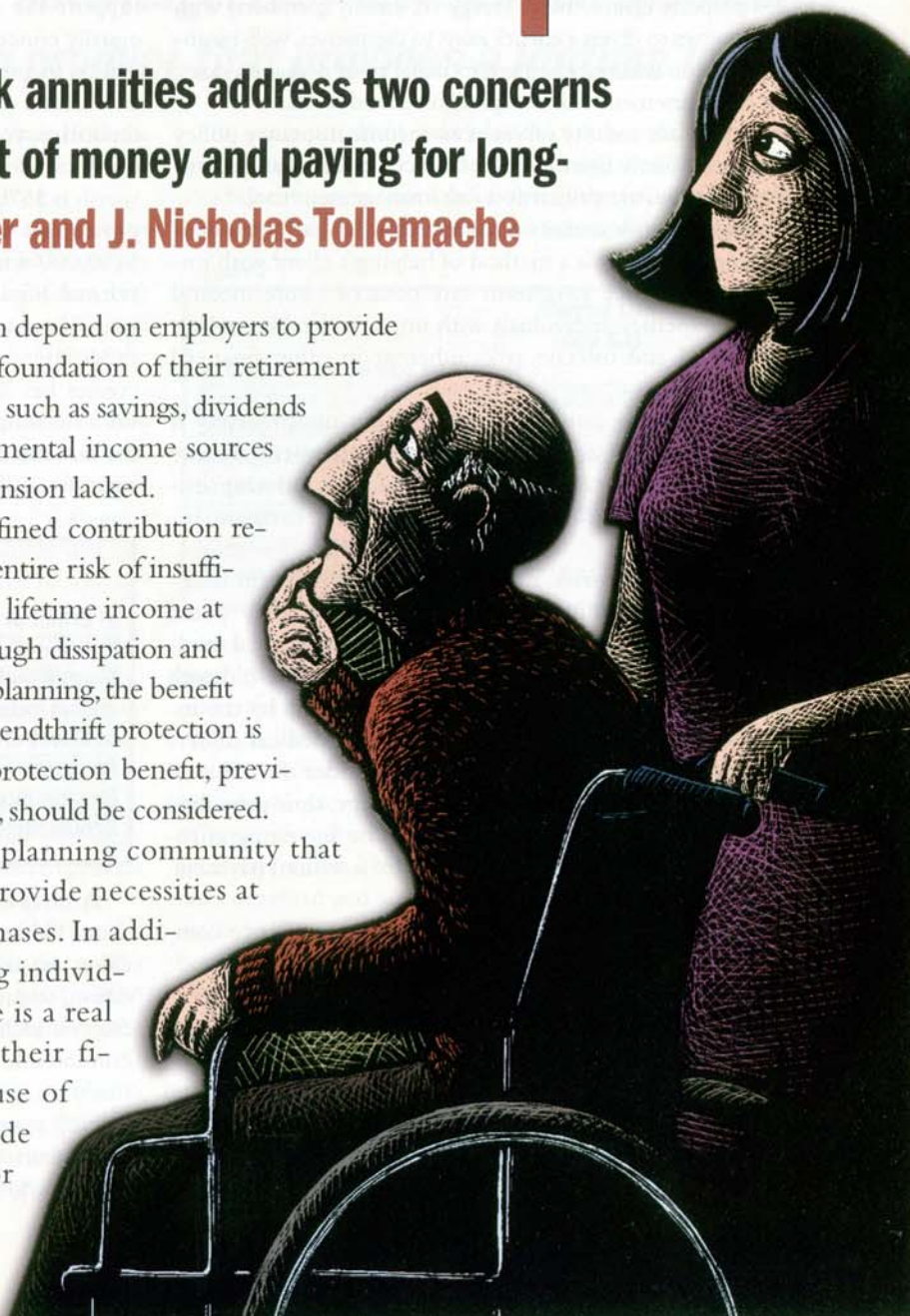
# Annuities: A Risk-Control Option

**Immediate and impaired-risk annuities address two concerns of aging clients: running out of money and paying for long-term care. By Gary S. Mettler and J. Nicholas Tollemache**

**T**he time is passing when retirees can depend on employers to provide defined benefit plans to form the foundation of their retirement income. Other retirement benefits such as savings, dividends and rents were considered supplemental income sources and provided flexibility that the pension lacked.

Many individuals now participate in defined contribution retirement plans, which means they bear the entire risk of insufficient asset accumulation needed to generate lifetime income at retirement and the possible loss of assets through dissipation and capital losses. When conducting retirement planning, the benefit of lifetime income may be addressed, but spendthrift protection is rarely discussed. The lack of a spendthrift protection benefit, previously provided by a defined benefit pension, should be considered.

It is widely believed by the financial planning community that many future retirees will be unable to provide necessities at retirement, let alone discretionary purchases. In addition, medical advancements are enabling individuals to live longer than ever. Thus, there is a real concern that individuals may outlive their financial resources. One solution is the use of immediate annuities, which can provide insured lifetime benefits and superior





spendthrift protection, filling the void many future retirees will experience. No other financial product, with the exception of a defined benefit retirement plan, can simultaneously accomplish these dual tasks.

Like a pension, the immediate annuity's entire income benefit is spendable without fear of future income erosion. The annuity owner incurs no reinvestment risk to maintain future spendable income levels, as the entire benefit will be paid for the annuitant's life. There is tremendous financial freedom in the annuity's lifetime benefit arrangement. In addition, the spendthrift protection of the annuity provides an anti-dissipation benefit, which assures the annuitant of future lifetime income.

Most planners understand the strong client attraction toward guarantees, particularly at retirement. The lifetime income benefits of an annuity are attractive in this regard when no defined benefit pension coverage exists. Spendthrift protection guards against risks not always considered at retirement: the depletion of assets due to lawsuit judgments, creditor's claims, con men and women, ex-spouse's property claims, future caregivers (family members) with ulterior motives to divert a client's assets to themselves, well-meaning friends who influence a client to make poor decisions, taxes, benefit reimbursement claims, capital losses, and so on.

An immediate annuity serves as an income insurance policy that protects clients from adverse financial circumstances. Immediate annuities are primarily a risk-management tool.

An impaired-risk annuity is an annuity that has been medically underwritten. It is a method of helping a client with impaired health finance long-term care costs or future medical and living expenses. Individuals with impaired health are least able to afford and tolerate risks inherent in other financial products.

An impaired-risk annuity is not new, but until recently it was available exclusively in the structured settlement annuity market. Several insurance companies are now offering impaired-risk annuities for retirement and non-retirement income purposes.

With an impaired-risk annuity, the benefit payment is determined by the annuitant's adjusted life expectancy (rated age) and not by his or her chronological age. Individual medical conditions are considered. For instance, a 65-year-old with impaired health may be assigned a rated age of 75 by the insurance underwriters of the annuity policy. Medical underwriting by the insurance company will consider the effect of impaired health and determine the rated age, thus providing the individual with a pricing advantage. The age rating effectively increases the monthly benefit or, for a desired payment, reduces the purchase cost.

The medical information submitted to the insurance company will include some or all of the following:

- physician's report at time of diagnosis;
- hospital discharge summaries;
- recent medical examinations by a physician;
- records of previous medical problems from physicians and hospitals. These records will help to determine the overall physiological condition of the annuitant. The insurance company will not send a health examiner to interview or gather medical

specimens from the annuitant, as is the current practice in life insurance underwriting.

Here are some of the ways in which impaired-risk annuities can be used. Please note: All annuity benefit payment quotes are valid as of the date of this writing.

■ **Adult disability/illness.** You have a 68-year-old client with impaired health. She is recently widowed and has several adult children and grandchildren who cannot be counted on to fully protect her financial interests. Several recently matured certificates of deposit with significantly reduced balances reflect title changes and now solely bear her adult children's names. Your client, while mentally alert, cannot fully account for the withdrawn funds but believes her children are in possession of her money. You client allowed the title changes as she is 100% dependent on her children for her care and did not want to upset them when they demanded title to these accounts.

She is rightfully concerned about the long-term level of support she can expect to receive from her family. She is equally concerned about the safety of her funds and her future ability to purchase necessities in light of any further illness and/or loss of cognitive ability. After analyzing her financial information you determine she has \$400,000 that could be utilized for a long-term financial commitment and her total net worth is \$570,000. After considering the benefits of insuring a portion of her future income, an annuity is purchased for \$150,000 with an installment refund of premium option. The normal lifetime monthly benefit is \$1,084, or \$13,008 per year. However, the insurance company, after reviewing her medical condition, issues her an age rating of 75, which increases her lifetime monthly benefit to \$1,261. This medical underwriting now produces an annual income of \$15,132 for life and the annuity insures this benefit against any future dissipation (see Figure 1).

Figure 1

	Normal Life (age 68)	Rated Life (age 75)
<b>a) Effect of rated age on income:</b>		
Premium	\$150,000	\$150,000
Monthly Income	\$1,084	\$1,261
Annual Income	\$13,008	\$15,132
<b>b) Effect of rated age on premium:</b>		
Premium	\$174,491	\$150,000
Monthly Income	\$1,261	\$1,261
Annual Income	\$15,132	\$15,132

A brief consideration is given to a \$400,000 annuity purchase. However, the annuity policy offers no liquidity and your client may need to make future unscheduled withdrawals. In addition, consideration was given to the risk of annuity carrier default on such a large portion of her assets. Your client states she is comfortable with the \$150,000 annuity policy purchase, particularly since favorable pricing has been obtained. Under normal pricing assumptions, a premium of \$174,493 would be needed to produce a monthly benefit payment of \$1,261, a savings of \$24,493 (\$174,493 minus \$150,000).



The remaining \$250,000 of the original \$400,000 portfolio can provide her with liquidity and sufficient funds to generate \$15,000 in interest income, assuming a 6% fixed-interest rate portfolio return. In lieu of a fixed-rate portfolio, a balanced portfolio of securities and/or other investments may provide capital growth and income. A total annual return of 10% could support a \$15,000 annual income withdrawal with an annual withdrawal growth rate of 5% for 30 years, until her age 97. She has a 1.37% probability of survival at age 97, according to the Individual Annuity Mortality Table as proposed by the Society of Actuaries Committee to Recommend New Mortality. These results assume there are no other withdrawals and funds are not dissipated or subject to capital loss. The annuity benefits and income withdrawals combine to gradually increase her total income each year beginning at a 2.489% rate.

## ***Impaired-risk annuities increase the benefit by giving those with impaired health a pricing advantage. They also provide spendthrift protection coupled with a product that provides a lifetime income.***

This helps to offset the effects of inflation in future years. Both the annuity and the securities portfolio in this example are employed in conjunction, providing joint protection for the client.

Her "total spendable income" annuity benefits and income withdrawals are \$30,132 per year, of which \$15,132 is annuity benefits that may be spent without reinvestment concerns. Her total taxable income is \$22,112 for the first year, because 53% of the annuity benefit is non-taxable due to the tax benefit of the annuity premium cost recovery.

She feels that her own financial needs are paramount, and any assets that remain in her estate after absorbing future expenses should be paid to selected children after allocating small stipends to the grandchildren. Your client is pleased with your assessment of the overall risks and is relieved to know that annuity benefit payments will continue even if she has to shift responsibility for her financial affairs to another.

■ **Child disability/illness.** Your second client is a high-net-worth senior. He seeks your services in establishing and funding a special needs trust for a grandchild with a disability. The grandparent wants to insure a lifetime income for the child to be coordinated with government benefits, adjusted for inflation, without making a direct gift to the child or to the child's parents, who have a history of marital difficulties. Family members' financial skill levels are low and none can be expected to provide adequate physical care for the child after your client's death.

The child is a male with a chronological age of 13, but the insurance company has issued an age rating of 60 due to the child's disability. The grandparent can contribute \$400,000 to the trust. He is in favor of the insurance benefits, particularly the spendthrift protection offered by an annuity.

An immediate annuity is purchased for \$200,000 with a 4% annual compounded cost of living adjustment on a "straight life" basis, as heavy future Medicaid liens are anticipated. The monthly benefit begins at \$967. If the annuity were priced at the

normal life expectancy of the child, the monthly benefit would begin at \$472. Therefore, the increased benefit from the impaired-risk annuity underwriting is \$495 per month, or approximately 105% increase in the monthly benefit. (see Figure 2).

Under normal pricing assumptions a premium of \$409,746 would be needed to produce a monthly benefit of \$967, a savings of \$209,746 (\$409,746 minus \$200,000). This client is relieved to know that these benefits will be paid to the trust even after he is deceased or can no longer direct the trust because of his own impaired health.

■ **Taxes and other considerations.** There may be state and/or gift tax considerations depending on how these policies are funded and how policy title is held. However, such considerations are outside the scope of this article.

In previous client examples the tax benefit of the annuity premium cost recovery was mentioned. One way of viewing this benefit is in its literal definition in the tax code. It cannot be a return of principal as there is no principal to return. The pre-

Figure 2

	Normal Life (age 13)	Rated Life (age 60)
<b>a) Effect of rated age on income:</b>		
Premium	\$200,000	\$200,000
Monthly Income	\$472	\$967
Annual Income	\$5,664	\$11,604
<b>b) Effect of rated age on premium:</b>		
Premium	\$409,764	\$200,000
Monthly Income	\$967	\$967
Annual Income	\$11,604	\$11,604

mium has been spent for—as opposed to invested in—the immediate annuity policy. In the same manner one spends the premium for an auto liability or fire insurance policy.

Immediate annuity premiums should be considered an expense and, like other insurance premiums, are a cost of doing business. However, some annuity premiums may be returned if the annuitant dies and had elected an installment or refund-of-premium option. The insurance company's investment portfolio rates of return and actuarial data are reviewed and a payment is made to the annuitant from the general fund. Like a pension benefit, no separate account is established for the annuitant. The tax benefit, commonly referred to as the "exclusion ratio," is merely contrived by the tax code (IRC Section 72). This tax benefit, like any other, is subject to change.

The majority of annuity benefit payments can be designed for payment in later policy years. This may be desired to provide additional future funds to combat potential inflation or simply because the need for greater benefits in later years is anticipated.



ed. This can be accomplished through cost of living adjustments, varying and/or stepped-up benefit payments and lump-sum payments.

Of course, an accurate assessment of the insurance need is critical. The client could suffer due to the lack of annuity policy liquidity as benefits may not be commuted or altered. The annuity's greatest strengths, spendthrift protection and lifetime benefits, may also be its greatest weaknesses should a liquidity need arise.

But liquidity is also a two-edged sword. It provides the portfolio owner with the ability to make changes such as repositioning funds, meeting unexpected expenses and making gifts, but subjects the liquid funds to capital loss and/or other dissipation problems. A prudent course of action may be to combine the benefits of an impaired risk annuity with those of a liquid portfolio in providing a balanced approach to protecting

a client's future income.

Impaired-risk annuities increase the benefit by giving those with impaired health a pricing advantage. They also provide spendthrift protection coupled with a product that provides a lifetime income, paid in the amount stated, to the person named, and on the dates promised. The next time a client compares immediate annuities to mutual funds or other investments, remind him or her that they are not investments, they are a risk management tool and, when medically underwritten, can be a powerful source of future income.

**FP**

*Gary S. Mettler, CFP, is a registered investment adviser in Dix Hills, N.Y., who works as a litigation economist and structured settlement specialist. J. Nicholas Tollemache is president of Legal Economic Evaluations Inc. in Palo Alto, Calif., the nation's largest consulting firm specializing in litigation economics.*

Figure 3

## Risk-Management Tools

### A \$250,000 Securities Portfolio Coupled With An Immediate Annuity

Age	Year	Begin Year	5% Growth Rate Withdrawal	10% Total Return End Year	Annuity Benefit	Total Spendable Income	Estimated Total Tax Income	Growth Rate of Spendable Income	Female Rated Age 75**
68	1998	250,000	15,000	258,500	15,132	30,132	22,112	0	0.9799
69	1999	258,500	15,750	267,025	15,132	30,882	22,862	0.02489	0.9577
70	2000	267,025	16,538	275,536	15,132	31,670	23,650	0.02550	0.9332
71	2001	275,536	17,364	283,989	15,132	32,496	24,476	0.02611	0.9064
72	2002	283,989	18,233	292,332	15,132	33,365	25,345	0.02672	0.8771
73	2003	292,332	19,144	300,507	15,132	34,276	26,356	0.02732	0.8106
74	2004	300,507	20,101	300,446	15,132	35,233	27,213	0.02793	0.8106
75	2005	308,446	21,107	316,073	15,132	36,239	28,219	0.02853	0.7732
76	2006	316,073	22,162	323,302	15,132	37,294	29,274	0.02912	0.7331
77	2007	323,302	23,270	330,036	15,132	38,402	30,382	0.02971	0.6903
78	2008	330,036	24,433	336,163	15,132	39,565	31,545	0.03030	0.6451
79	2009	336,163	25,655	341,558	15,132	40,787	32,767	0.03088	0.5977
80	2010	341,558	26,938	346,083	15,132	42,070	34,050	0.03145	0.5485
81	2011	346,083	28,285	349,578	15,132	43,417	35,397	0.03202	0.498
82	2012	349,578	29,699	351,866	15,132	44,831	36,811	0.03257	0.447
83	2013	351,866	31,184	352,751	15,132	46,316	38,296	0.03312	0.3962
84	2014	352,751	32,743	352,008	15,132	47,875	39,855	0.03366	0.3466
85	2015	352,008	34,380	349,391	15,132	49,512	41,492	0.03420	0.299
86	2016	349,391	36,099	344,621	15,132	51,231	51,231*	0.03472	0.2543
87	2017	344,621	37,904	337,388	15,132	53,036	53,036	0.03523	0.2132
88	2018	337,388	39,799	327,348	15,132	54,931	54,931	0.03573	0.176
89	2019	327,348	41,789	314,114	15,132	56,921	56,921	0.03623	0.1432
90	2020	314,114	43,879	297,259	15,132	59,011	59,011	0.03671	0.1147
91	2021	297,259	46,073	276,304	15,132	61,205	61,205	0.03718	0.0905
92	2022	276,304	48,376	250,721	15,132	63,508	63,508	0.03764	0.0702
93	2023	250,721	50,795	219,918	15,132	65,927	35,132	0.03809	0.0534
94	2024	219,918	53,335	183,241	15,132	68,467	31,132	0.03852	0.0397
95	2025	183,241	56,002	139,963	15,132	71,134	28,132	0.03895	0.0397
96	2026	139,963	58,802	89,277	15,132	73,934	23,132	0.03936	0.0202
97	2027	89,277	61,742	30,289	15,132	76,874	18,132	0.03977	0.0137

\* Exclusion ratio approximate end

\*\*Probability of survival, according to the 1983 Individual Annuity Mortality table age nearest birthday, as proposed by the Society of Actuaries Committee to Recommend New Mortality.