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Pricing and Underwriting of New Combination Products—Will We Get It Right?

by Carl Friedrich

The Pension Protection Act of 2006 includes some important tax rules affecting combination plans that feature life or annuity plans coupled with long-term care insurance (LTCI). Many of these rules will become effective Jan. 1, 2010. In some cases, the rules will be applicable to policies on the books prior to that time. Among the benefits resulting from these new rules, the most notable would seem to be the clarification of tax treatment of annuity/LTCI combination products. Under certain product designs, distributions of annuity cash values—which in the past would have triggered a taxable event—may be payable on a tax- free basis as LTCI benefits. As a result of these factors and the huge untapped market for products that address long-term care needs, there are a significant number of companies developing combination plans in various forms.

Underwriting of Life/LTCI Combination Plans

The development of such products is a welcome new direction for the industry, but there are a number of challenges in designing and pricing these products successfully, in particular, for those companies who do not have prior experience in the LTCI arena. For example, life insurance providers may believe that they have a wealth of medical and non-medical information on life insurance applicants that should allow them to underwrite LTCI riders. Some even believe that the life insurance risk classification for a client should be applicable to the LTCI risk and charge structure. However, there are a number of considerations for the underwriting of LTCI that are quite different from those for life. In particular, this includes the importance of cognitive testing and activities of daily living assessments for long-term care.

The importance of these distinctions is dependent on the level of benefits provided by the LTCI rider. If the rider is purely an accelerated benefit rider that pre-pays life insurance benefits that would otherwise be paid upon death, the risk and cost of such coverage is greatly diminished and the need for additional underwriting is reduced. In contrast, the presence of independent benefits for LTCI that do not reduce the base plan coverage—particularly when inflation benefits are offered—increases the desirability of underwriting standards that are more closely aligned with the experiences and practices in the stand-alone LTCI market.

Underwriting of Annuity/LTCI Combination Plans

With respect to annuity/LTCI plans, there is an even greater challenge to define appropriate underwriting methods, as annuities typically require no medical underwriting, and producers have that engrained in many of their sales techniques. The introduction of a supplemental application with medical questions is one important step that companies can take to protect themselves against anti-selection by those in poor health. Designs with accept/reject questions need not cause any meaningful delay in the sales process. In contrast, the additional information needed to protect companies in the older age markets would commonly require personnel with some medical training to conduct assessments of applicants. This can delay the issuance of the policy and, of course, deny rider coverage to some applicants, which in turn could affect the underlying base plan sale.

The good news is that there are a number of vendors who have developed programs that allow for the screening of applicants through telephone interviews. These may include cognitive impairment tests that can be administered relatively simply and within short timeframes.

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Pricing Assumptions

Of equal importance to underwriting is the question of financial modeling and pricing of these products. The first unknown for most companies entering these markets is the claim cost to be expected for LTCI. Reliable industry data is difficult to secure. The Society of Actuaries has compiled some studies from industry data, but it is difficult to evaluate the impact of product definitions and underwriting approaches against the averages provided in the SOA studies. Nonetheless, there are companies and consultants in the market who do have data that is increasingly credible with respect to stand-alone LTCI. This information can be extended to values expected under combination products. In addition, there is some early emerging experience on combination plans indicating that for certain plan configurations reflecting accelerated benefit provisions, incidence rates for at least shorter term claims are lower than those for stand-alone LTCI plans.

Financial Model Considerations

Another factor in modeling is the question of how to quantify the cost of a combination product compared to the cost of the underlying base plan. Some might attempt to simply quantify the claim costs expected to be paid for LTCI benefits and add that to the base plan cost. There are a number of reasons this approach may not be appropriate:

- Most combination products feature acceleration of benefits paid for LTCI that would otherwise be paid as surrender benefits or death benefits under the base plan. Thus, an offset to those foregone benefits should be factored in.
- The charges for LTCI are often expressed in terms of base plan characteristics, such as the net amount at risk. As LTCI benefits are paid out, they affect future life insurance amounts at risk, so the reduction in charges for those clients needs to be considered.
- The payout of account values related to LTC charges or LTCI benefit payments reduces future net investment earnings to the company because the invested assets are reduced.
- There are reserving and required capital considerations, and related tax considerations that make the quantification of income even more complex. There are general provisions in the NAIC Long-Term Care Insurance Model Regulation that, for accelerated benefit plans, prescribe a multiple decrement model utilizing all relevant decrements except for voluntary termination rates, noting that some alternatives may be acceptable.
- The presence of a rider with meaningful benefits is likely to have an impact on policy persistency, which represents

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another incremental change to the cash flows expected under the policy. It should be noted that favorable policyholder persistency on deferred annuity plans with these riders could have tremendous positive implications for lifetime profitability on these plans.

- On a related note, partial withdrawal activity and other policyholder options may trigger very different policyholder behavior depending on whether a LTCI rider is part of the coverage.

Modeling of Cohorts

The complexity of all the elements above is compounded further when one considers that many LTCI claims are short term in nature. Those recovering from claim have policy values that are different from those who had no prior claims. Those clients who are actively on claim have very different mortality expectations from healthy lives, which also must be recognized. There is also the question of the appropriate mortality assumption for those who have recovered from claim. Some companies assume that they are still substandard risks, while others assume that they are healthy. It would appear that the most accurate financial models that capture these distinctions are based on various cohorts of lives reflecting these different characteristics, with results blended within the models to produce aggregated results. It would require an extremely complex model to capture all of these elements with total precision, but models have been built which do a very good job of addressing these factors.

Positions in the Market

Not surprisingly, at this point in the evolution of combination products, the range of charges being observed in the marketplace for these coverages suggests quite a wide variety of views on claims costs, appropriate underwriting levels, modeling approaches and pricing assumptions. In light of the new tax advantages being extended to these plans, and recognizing the pricing synergies of coupling LTCI riders with annuities in particular, it is expected that these plans will proliferate over the next few years. As sales increase, it will become increasingly important for companies to understand these issues and to model and price their business accurately. ◻

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