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An Overview of Life and Annuity Living-Benefit Riders

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The life insurance industry has expanded its product offerings significantly in the last few years. Some of the most innovative new coverages are provided by riders that can be attached to life insurance policies, and in some cases annuities. These "combination" plans allow base policy values, such as life insurance death benefits and cash values, to be accelerated to the policyholder prior to death in the event of a long-term care need or, under some policies, a chronic illness event. In addition, many of these plans will continue long-term care insurance (LTCi) benefit payments even after the base plan values are depleted. This provides a form of insurance leverage that can result in LTCi benefits that might be double or triple the life insurance death benefit. These riders make life insurance or annuities more useful to the policyholder, providing living benefits to address this under-insured need of our society. At the same time, contrasted with stand-alone LTCi policies, these policies reduce the risk to insurance companies. Policyholders of combination plans share in the LTC risk since they are using their own "assets" first (such as receiving "an advance" on their life insurance benefit) to pay for the first layer of coverage. This factor, and other by-products of these riders such as the reduction in lapse activity on the underlying base plans, make these products a win-win proposition for insurers and consumers alike.

A 2015 Society of Actuaries Report titled "Life and Annuity Living Benefit Riders: Considerations for Insurers and Reinsurers," available on the Society of Actuaries website (*www.soa.org*), covers a wide range of living benefit riders with medically related triggers on life or annuity products. This article will cover several of those.

CHRONIC ILLNESS ACCELERATED DEATH BENEFIT RIDERS

The first products covered are chronic illness riders attached to life insurance policies that provide for Accelerated Death Benefits (ADB) to be paid under conditions prescribed by the rider. Insurance laws and regulations and tax laws govern these plans. The purchase of accelerated benefit chronic illness riders, if structured properly, may allow chronic illness benefits to be free of federal income tax, subject to certain IRS rules and limits.

Most plans require that for benefits to be paid, the insured must be certified by a licensed health care practitioner to be chronically ill, which often starts with the requirement that the insured is unable to perform two or more activities of daily living (ADLs), or suffers from a severe cognitive impairment. State insurance laws require a series of provisions to be met under these chronic illness plans:

- A lump sum payout option is required, commonly but not always interpreted by regulators as annual lump sums (often spreading the pay-

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outs over two to four years). The SOA report included a survey of direct writers, and among 23 plans, 17 offer a single lump sum, and 20 offer periodic payouts (eight annual, 14 monthly, and other variations).

- The product may not be marketed as LTCi. This relates to the fact that although some chronic illness riders may pay benefits in largely the same situations as LTCi, they do not meet the consumer protection requirements to qualify as LTCi and do not provide the full range of benefits as LTCi. For example, chronic illness benefits are constrained to the life insurance death benefit, and inflation related benefit increases are not generally available on these plans.
- Allowable pricing methods include a dollar-for-dollar death benefit reduction approach with upfront charges, a discounted death benefit approach, and the lien approach, which will be explained below.
- Terminal illness benefits are included on most plans with chronic illness riders (and required under some regulations).

So how do these ADB riders work? Under the discounted death benefit design, the riders are "free" with no extra cost upfront, but when medical trigger requirements are met, a portion of the life death benefit is paid out. However, only a discounted portion of the reduction to the death benefit is paid to the policyholder. For example, if the policy has a two year annual lump sum ADB rider on a $250,000 life insurance policy, upon the first claim the death benefit would be reduced by $125,000 ($250,000/2 years), and upon the second claim if the insured is still chronically ill, the remainder of the life policy would be used up. The actual payments to the insured would each be less than the two $125,000 reductions to the death benefit, and those amounts will be dependent on the age of the insured and the mortality assumptions and factors in use by the insurance company at that time. At younger ages, the payout amounts may be fairly small percentages of the reductions to the life insurance face amounts. For example, the policyholder might only receive $100,000 in total as accelerated benefits over the two year period as opposed to the $250,000 they would have received if they kept their coverage (and paid premiums) until their death.

Under the lien approach, normally offered without an upfront charge, benefits are not discounted, but a lien is placed on the policy values and lien interest is normally charged to the policyholder, so this works essentially like a loan to the policyholder.

For riders with charges upfront, most notably the dollar-for-dollar death benefit reduction approach, a portion of the life death benefit is paid periodically, and the policyholder receives the full amount equal to the reduction in the death benefit. The charges for these riders are often only 10 percent to 15 percent of the cost of the base plan, which many might view as more attractive than dealing with the uncertainty of what benefits might be paid under the discounted death benefit approach.

The SOA survey of insurance companies issuing chronic illness riders revealed that these riders are attached to a variety of base plans, with the most common being universal life, whole life, and indexed universal life. As noted above, triggers usually require licensed health care practitioner certification, and the inability to perform two of six ADLs or cognitive impairment, but seven plans out of 23 also require permanent nursing home confinement. Fourteen of 23 require an expectation of permanence of the condition, which is more restrictive than most LTCi requirements.

The study also involved interviews with reinsurers. More reinsurers are moving to participate in full in these coverages, but various concerns were expressed. The biggest concern is with the discounted death benefit method. There were comments about low percentage payouts under certain circumstances, and whether insurers were able to provide enough information to consumers to avoid unrealistic policyholder expectations. It was noted that in the past, very few people have taken a discounted death benefit offer unless they were relatively healthy and the discount was not that substantial. Some reinsurers went so far as to question whether chronic illness discounted death benefits can work well without underwriting at the time of claim, which would allow companies to provide a payout appropriate to the insured's actual medical condition at that point.

LONG-TERM CARE INSURANCE ACCELERATED DEATH BENEFIT RIDERS

Another type of living benefit covered in the report was LTCi Riders that provide an acceleration of life insurance benefits. These are very similar to chronic illness riders, with a few key differences.

They are governed by LTCi laws and regulations, with some exemptions from normal LTCi rules. Most qualify as tax qualified LTC under IRC 7702B, so benefits are generally tax-free subject to some IRS limits.

Under an LTCi ABR, a specified portion of the death benefit is eligible to be paid each month on claim with a proportionate reduction to cash values when traditional LTCi triggers are met (two of six ADL's or cognitive impairment, **with no permanence requirement**). This difference in trigger requirements relates to different regulations that govern chronic illness ADB riders and LTCi ABR riders. Allowed benefit structures include the dollar-for-dollar death benefit reduction approach, or the lien approach, but the discounted death benefit approach is not allowed.

There are three potential types of payout structures. Expense reimbursement plans pay benefits that are capped at the lesser of the maximum payout specified in the rider, such as 2

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percent or 4 percent of the face amount every month, or at the level of LTC expenses actually incurred. Indemnity plans or disability plans pay an amount specified in the policy without regard to actual LTC expenses incurred. The indemnity design does require proof that formal care is being received (i.e., receipts from providers), while the disability model does not. Under the disability model, the insurance benefits are paid even if the only care is being provided by family members or other informal care providers.

Most LTCi riders are expense reimbursement or indemnity, which lowers the cost of coverage compared to a disability model. In contrast, all chronic illness riders are based on the disability model due to regulations.

The SOA survey on LTCi ABR riders indicated that universal life is the most common base plan. Five of eight companies use an indemnity structure and two use a disability model under plans where only an acceleration rider is included. However, this section of the survey does not include those products that also include an Extension of Benefit rider (EBR), which continues coverage after the full face amount is depleted and which may result in LTCi benefits that are double or triple the life insurance death benefit if catastrophic LTC expenses are incurred, which leads us to the next set of living benefits.

LIFE/LTCI LINKED BENEFIT PRODUCTS

The products that include both an accelerated LTCi benefit, as well as additional benefits (EBRs) that are payable without reducing the base plan values, are sometimes called "linked-benefit" products, and can feature a life insurance or an annuity base plan. All LTCi regulations apply to the EBR provisions/riders. From the SOA survey on life/LTC linked-benefits, four are attached to single premium products only, one is attached to both single and recurring premium plans, and two are attached to recurring premium products only. Five of seven use the expense reimbursement model, and two use an indemnity structure. They are all required to offer inflation benefits and nonforfeiture benefits to applicants. Reinsurers are increasingly providing support for LTCi accelerated death benefit riders, but there is still only limited support for the EBR and inflation benefit provisions that these plans offer.

> These riders make life insurance or annuities more useful to the policyholder, providing living benefits to address this underinsured need (coverage for long term care or chronic illness) of our society.

ANNUITY/LTCI LINKED BENEFIT PRODUCTS

The annuity linked-benefit plans work much like the life linked-benefit plans, but the amounts paid out during the accelerated benefit period under most designs are a percentage of the annuity cash value at the time of initial claim (with surrender charges being waived), as opposed to a percentage of a life insurance face amount. In contrast, some plans base the LTCi benefit on a multiple of the initial premium going into the policy. These policies include an extension of benefit feature, as do life linked-benefit plans. This feature continues the monthly LTCi benefits, after the account value is depleted, for an extension period specified in the policy so long as LTCi claim requirements are still met. Inflation benefits are also offered. Not all survey respondents answered the question of what design their policy used, but two indicated that benefits were based on account value at the time of claim, and two said that LTCi benefits were based on a multiple of initial premium. Essentially all of the annuity linked-benefits feature a single premium base plan. One is a variable annuity contract, and the other respondents reflected a mix of book value annuities or market value adjusted annuities. Three of five plans reported the use of an expense reimbursement structure, and two feature an indemnity design.

CONCLUSION

In summary, there is widespread interest and participation by both direct writers and reinsurers in living benefit riders. A wide variety of regulations apply, and favorable tax treatment of benefits can be realized by policyholders under several structures, subject to certain limitations. Behind the scenes, reinsurers are working more with direct writers to provide complete reinsurance mechanisms to support this business. Sales information gathered from the survey was somewhat fragmented. However, from data gathered in the survey for 2013, plus other sources, the authors estimate chronic illness sales (total policy premium) to be $1.2 billion in first year premium, sales with LTCi riders on life business to be over $2 billion in first year premium including base plan and rider totals, and annuity linked-benefit business to be over $300 million and climbing. In addition, a number of companies are reporting that a growing percentage of their life insurance sales include some form of living benefit rider. This is a very positive sign for the industry and consumers alike, and one that should continue as additional innovative solutions emerge to cover the risks of long-term care or chronic illness. ■

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