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Session 13PD
Life/LTC Blends: The Best Of Both Worlds

Track: Product Development/Long-Term Care

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Summary: Industry representatives address the market need for and acceptance of life and long-term care (LTC) combination products and the issues for carriers to consider regarding developing, marketing, and distributing this emerging product.

MS. MARY J. BAHNA-NOLAN: This session will not be covering stand-alone LTC. Rather, we will be covering the blended or combination products that are in the industry, including recent developments in the marketplace, product designs, and some issues to consider in the development of these products. A major area to consider in developing those products and also a complicating factor is taxation. We will be covering this issue at a fairly high level.

Our first presenter is Cary Lakenbach. Cary is an FSA, MAAA, CLU, and is president of Actuarial Strategies. Prior to founding the firm in 1991, Cary created and developed the actuarial consulting practice of American Financial Systems.

MR. CARY O. LAKENBACH: I'm going to be talking to you today about providing LTC benefits through life insurance contracts. These benefits are most likely to be used by individuals over the age of 50. I'd like to provide you with an overview of issues that are important to the design of integrated life and LTC products. These considerations include a high-level overview of market need, and we'll also focus on designs and critical issues.

Although it isn't the only available design, what we're talking about here is a so-called acceleration rider which starts paying off a life insurance policy's death

benefit when the insured becomes chronically ill, and that's a term that we'll define momentarily. Why use acceleration riders? Wealthy individuals with life insurance needs can add riders that pay off at the earlier morbidity contingency for a very modest incremental cost. For many it makes sense to pre-fund the coverage. By pre-funding, one can more effectively maintain assets when a chronic illness strikes. The avoidance of forced sales at such times should be a critical objective. Such forced sales will lead to increased gross income, which offsets the impact of the deductibility of the LTC expense. In some states, like Connecticut, the state tax is based on adjusted gross income, not federal income—net income after deductions, so that forced sales can actually result in state tax costs rivaling the federal tax charged.

Paying for the LTC premium from C-corporation coffers is a tax-deductible expense, and that's a reason you could fund LTC products from C-corps. By the way, these can be done on a fully discriminatory basis. A major benefit of LTC insurance is that it provides buyers with ready access to expertise. Companies utilize licensed care coordinators that can guide insureds to the right service providers. It is very stressful to try to do that when the need arises. Concerns such as forced sales can thus be avoided. Many buyers of riders dislike paying for coverages when it is possible no benefit will ever be received. That's a distinguishing feature between stand-alone and rider coverages. You're always going to get a benefit if you have this rider. Insurers can structure contracts owned outside the estates to have LTC riders. Note that the trust, which is typically the vehicle outside the estate holding the life insurance policy, need not actually pay for the LTC services. We will discuss tax considerations later, but a key issue is that LTC riders to life contracts can be structured so that the LTC payments are received income tax free.

The simplest view is that the rider to a life policy provides benefits for a contingency other than death or chronic illness. The benefit level is expressed as a monthly limit, typically two or four percent of the death benefit at the time of initial claim. So, if a policy was issued at $100,000 face and grew to $110,000, most companies will pay out $110,000 as an LTC benefit. Most designs will pay out any additional growth that may well occur after the point of initial claim. If the insured is chronically ill, then most policies will waive charges or premiums. So you have a policy that prepays perhaps some part of the life insurance benefit when a person is chronically ill, and the remaining death benefit is paid out at death, just like in any life insurance contract. The design is available on any chassis because the LTC payment is a prepayment of the death benefit and not an additional payment. The cost is a modest one. On single premium sales the extra cost may be around four percent of the guideline single premium.

Let's go through an example together. We have a $200,000 death benefit at the time of initial claim and a $20,000 account value. The key observation is that virtually all integrated life and LTC contracts operate by reducing contract values proportionately to the reduction in death benefit. Our example assumes that the acceleration operates under the reimbursement model approach. Therefore, the monthly payment is limited to the smaller of qualified LTC charges incurred and the

monthly limit. What this means is that the life and LTC model effectively operate under a pool-of-money approach, just as the stand-alone contract does.

In our example, the monthly limit is determined using a two-percent payout rate. Thus, in the first month, the actual allowable payment is not the $5,000 in actual charges but the $4,000 monthly limit. In the first month the ratio of payment to death benefit before payout is easy. It's two percent. So the reduction factor applied to all other values is also two percent. The reduction in account value is, therefore, $400 ($20,000 x .02). In the next month the actual expenses are $3,000, which is less than the limit of $4,000. The reduction ratio, if you will, is $3,000 over $196,000, which is 1.53 percent. So all values would be reduced by 1.53 percent at that point.

What's the benefit here? Most LTC contracts are qualified contracts. That is, they meet the requirements of Section 7702(b) of the Internal Revenue Code (IRC). You first have to be eligible for benefits by being certified as chronically ill. In order to be considered chronically ill, an individual must essentially satisfy one of two qualifying requirements: (1) he or she must be unable to perform two out of six activities of daily living (ADLs) without substantial assistance and be expected to do so for a period of at least 90 days, or (2) he or she must suffer from a severe cognitive impairment and require substantial supervision to protect himself or herself from threats to health and safety. These conditions must be certified by a licensed health care practitioner. There are terms used here that need some discussion. A licensed health care practitioner is defined in the IRC and includes physicians, registered nurses, and licensed social workers.

One of the things about LTC is you have a cognitive impairment screen sometimes or very frequently. I always worry if I am going to get the six ADLs correct, so I have a mnemonic device, BCDETT. B is bathing. C is continence. D is dressing. E is eating, and the two T's are transferring and toileting. Those are the six ADLs specified in Section 7702(b). Severe cognitive impairment includes Alzheimer's.

What's covered under LTC rider designs? If you meet the eligibility requirements, then the company will pay benefits for qualified LTC services. What are they? I'm reading from the code—they are necessary, diagnostic, preventive, therapeutic, curing, treating, mitigating, and rehabilitative services and maintenance or personal care services. These must be required and provided pursuant to a plan of care—that's a critical requirement that has been prescribed by a licensed health care practitioner.

Here are key designs of riders; however, you'll recognize that these are key designs of virtually all stand-alone contracts as well. LTC products, including riders to life policies, provide a reasonably standardized set of benefits. These include benefit periods. While a benefit period is typically stated in terms of years in a stand-alone contract, (such as three years, five years, or lifetime) what is really being defined is a pool of money. A three-year benefit period which promises up to $100 a day provides for a pool of $109,500 three times 365 times 100. Thus, if not all the

benefits are utilized at the maximum rate of a $100 in this example, the benefits would be paid out over longer than a three-year period. It works similarly in a life contract. If you don't pay out the entire two or four percent a month—let's say two percent would go 50 months at a minimum—then the coverage will last longer than 50 months.

The elimination period is the initial period when insurers will not provide benefit coverage, typically 60 or 90 days. Most stand-alone coverages are guaranteed renewable which allows an insurer to raise premiums for classes of coverage. Note that there are some riders to life coverages that are noncancelable. Stand-alone coverages must offer inflation protection options that provide for increasing benefit limits. Acceleration riders, such as the ones we're talking about here, need not do so. All contracts offer waiver protection so that premiums or charges cease when an insured is chronically ill. Besides covering nursing homes and skilled facilities, modern LTC coverages provide coverage in the home. The next two coverages, adult day care and respite care, are reasonably self-explanatory. The bed reservation benefit provides reimbursement for a nursing home charge, even if the insured has had to go to a hospital for some reason.

Let's discuss key rider design considerations. As I've noted, the typical payout is two to four percent of the death benefit. Although the rider doesn't include an inflation provision, death benefit growth from superior general account or separate account performance will lead to growth in available dollars for LTC expenses. Please remember that the growth is ratcheted up by corridor factors. Most contracts are structured so that the entire amount can be paid out. That is not always possible, however. For example, suppose a policy has a $1 million death benefit with a four percent payout rate. That translates to $40,000 a month. That four percent may be greater than an insurer might be willing to cover. Thus a structure can be set up so that four percent is paid out, let's say, on half the benefit.

Some companies have reduced payout rates. For example, instead of having four percent, they might limit it to a lower rate, such as one percent, for very high face amounts so that they can provide some coverage on these large contracts. Most contracts follow the reimbursement model. As we've noted earlier, the monthly payment is limited to the smaller of qualified LTC charges incurred and the monthly limit. What this means is that the life and LTC model operates under the pool-of-money approach, just as the stand-alone contract does.

Section 7702(b) also provides for a per diem approach. When the law was enacted, the limit was $175 a day. Under this model, the insured has to be chronically ill but doesn't have to submit charges to the insurer. The current limit is $200. Suppose an individual bought a $100,000 contract and became chronically ill when the benefit was still $100,000. If the payout rate was four percent, the insured could receive a minimum of 25 months of coverage. Well, what happens if the limit is paid out and the insured is still alive? It is for such situations that the so-called extended benefit rider (EBR) exists. It is, in effect, a stand-alone LTC rider with a deductible equal to the policy's death benefit. Thus it takes over when the policy

payout is exhausted. As a stand-alone LTC rider, it is subject to the requirements of the LTC Model Act, which includes providing for inflation protection, for example. Furthermore, most companies offer either an extension for the same minimum payout period as the base policy or lifetime coverage.

So, if you have a four percent contract, you could have an EBR that provides for an extra 25 months, or you could have an EBR that lasts for life. Suppose a policy has exhausted benefits, and the EBR is still active. Under the EBR no death benefit is payable when the insured dies. Because the insured may incur some significant final expenses, a so-called residual death benefit is sometimes available. Under this rider the company pays a death benefit of some minimum amount, say, 10 percent of the initial face amount. Most contracts issued today are qualified under Section 7702(b). Such contracts can provide only qualified LTC benefits. Note that the residual death benefit is life insurance, not LTC. So care must be taken in constructing the rider form so that you don't taint it with any kind of nonqualified LTC coverage.

There are some critical issues that are worth raising. First, let's observe how a payout affects policy values. Under today's contracts, payouts reduce the values proportionately to the drop in death benefits. Those key relationships, for example, the relationship of a loan to a cash value, are maintained. Here are some issues to note. Most universal life (UL) and variable universal life (VULs) take corridor growth into account when determining LTC benefits. And, by the way, with a traditional contract, if you have dividends that are used to buy paid-up additions, those paid-up additions will also be reflected in additional payouts. There could be some limits, but they are typically reflected in payouts.

What happens in a variable contract that has grown significantly and is in the corridor? After all, such growth could evaporate instantly, and we've seen that happen. Most companies have devised policy provisions to protect the growth previously incurred or built. Most companies also waive charges during chronic illness. This limits any pressure on the account value. By the way, some single premium contracts where the charge is taken out of the cash value do not always waive the charge in case of chronic illness. As noted earlier, some contracts provide for acceleration of only part of the death benefit. Also noted earlier is the existence of noncancelable product designs. As far as compensation is concerned, generally the same compensation rate is paid on the rider as on the base. Some companies increment targets and others do not.

Let's discuss cost considerations. In this kind of product design, a company pays out death benefit dollars early. Thus, it's losing interest on assets for a period of time, and it's losing cost of insurance (COI) charges or premium for the period of prepayment. Pricing is structured to pre-fund for these "losses". There's a cost consideration vis-à-vis stand-alone products. Stand-alone vehicles rely heavily on early lapses for profit contributions. In contrast, life vehicles, including their riders, are not lapse-supported. One does not anticipate higher utilization in life vehicles as one sees in a stand-alone product where an insured is faced with use it or lose it

situations, therefore, lapses are naturally expected to be lower in the life environment.

Earlier we discussed costs for single premium offerings. Costs are typically contrasted to premium levels. I've mentioned that for a single premium the cost is typically four percent of a guideline single premium, but when you have a flexible premium product and you contrast it to a scheduled premium or a target premium, the denominator is an important consideration. If the premium is low, as it can be in death benefit protection vehicles, the cost can be upwards of eight percent of such premiums.

Let's highlight some of the operational issues faced by life carriers. As far as illustration systems are concerned, most simply show the cost of the rider deductions and do not attempt to demonstrate hypothetical payouts. That's also true for in-force projections. It's one person's view, by not showing the effect of payout you're missing a market opportunity to provide valuable information to clients, especially when they have become chronically ill. We'll cover claims administration and administrative issues separately, but you typically have a life administration environment in which you're trying to modify the policy when a claims payment is made, and you have a claims operation that needs to determine the eligibility for the claim and the amount of the claim.

There are some comments worth making on marketing and training. In our experience with such products, marketing and agent training are particularly critical contributors to a successful introduction. Maybe that's not surprising. Most successful LTC riders have specialists focusing on that business. Even life producers with LTC units have had specialists in their organization to focus on LTC sales to the organization's customers. If the life producer does not have such specialists on staff, the life producer's marketing now has to incorporate an entirely different business concept, and help from the company to make the learning curve short is vital. We found that the producers with LTC specialists have been best able to build their integrated business using the expertise of their specialist colleagues. We'll talk about underwriting and taxes separately, given the importance of taxes.

Reinsurance can complicate matters, especially when the life reinsurer and the LTC reinsurer are different. There are some technical challenges in dealing with the reinsurance charges that must be addressed. Companies constantly try to use one reinsurer for both coverages. EBRs are essentially similar to stand-alone vehicles, and LTC reinsurers are very well equipped to provide coverage on them.

Let's discuss systems issues. Life carriers considering integrated products have to make a decision regarding claims handling. Will they build such an operation? The financials don't make sense if there's no underlying stand-alone business. For companies in the stand-alone business, the existing ability to handle claims administration is a major plus. The blended product is usually under the aegis of the life line. Sometimes coordination between the life and LTC business units can be a challenge, such as when the LTC unit doesn't feel it can get sufficient credit for

providing services. We know from existing situations that developmental activity can be roadblocked unless both units report to a single, actionable individual.

As far as claims administration is concerned, the reality is that underwritten business will generate few early claims. Consequently, most companies have utilized claims providers or LTC TPAs for that purpose. They will provide all necessary claims support, including determining eligibility, identifying resource providers, and determining claims payments. Charges are generally very modest and are on a per-payment and per-claims basis. We've actually seen that some companies have had a setup charge, from the time they set up the relationship to the time they start getting income, because there are claims that can be somewhat lengthy. Some TPAs also provide reinsurance, which, for many direct writers, is desirable, especially when the company has recently exited other health businesses and is leery of new health exposure.

The key requirement for administration systems is to reflect the changes in policy values when acceleration occurs. As it is, some companies are still working with ancient systems for their basic life vehicles, and trying to modify them for acceleration will truly be the final straw. This has led to the development of modules by external software providers to handle the processing once an insured has become chronically ill. The administration system has to receive the payment information from the claims TPA in order to reflect it in the policy. The claims TPA has to be aware that the policy is in force.

Let's discuss the vital issue of tax considerations. It's a big deal for this product. We'll cover a few highlights. First of all, we are talking about qualified LTC riders, and these riders will not incur any income taxes on benefit prepayments. The treatment of charges is a bit more problematic. Section 7702(b) effectively tells you to treat the LTC coverage as a separate contract for tax considerations Any of you who are familiar with Section 7702 will recognize that this is similar to the treatment of nonqualified additional benefits (NQABs).

As I mentioned before, one needs to be careful that the contractual rider does not contain ANY non-LTC features that may taint the qualified treatment for the rider. For premium-paying riders, premiums paid by employers for LTC coverages on their employees are tax- deductible, even in a program limited to senior executives. Premiums paid by individuals are severely limited as far as deductibility is concerned. You're subject to the requirements of Schedule A of Form 1040, which means that LTC expenses, in conjunction with other medical expenses defined in that section, are only deductible to the extent they exceed 7.5 percent of adjusted gross income. That's a pretty high threshold. The LTC rider is a nonqualified LTC benefit in terms of Section 7702, and consequently, the use of any policy values to pay a premium would be considered distributions. These distributions would be taxable to the extent the distributions reflect any contract gain.

There are legal chasms as far as Section 7702(a) is concerned. Although it makes sense that a reduction in a policy during a seven-pay period would reduce the

policy's face amount, its gross premium, and its seven-pay test premium, the law really is silent on how this works with acceleration vehicles. Consequently, there is some uncertainty on the impact of payments on things such as the seven-pay test. Legal counsel at our clients, in conjunction with very respected Washington counsel, have, however, viewed the product treatment as logically as it would suggest it be treated. What does that mean? That means a modified endowment contract (MEC) would not be created by the benefit prepayment. In other words there's a distinction being made between a benefit reduction, which, within the first seven years of issue or from a material change would have to be reflected in a new seven-pay-test calculation, and the type of benefit prepayment like we're talking about here.

With respect to UL and VUL contracts where the LTC charge is made against the cash value, a fluke in the tax law (that's the way our attorneys describe it) only allows deductibility of charges in MEC contracts and only to the extent of gain reflected in the distribution. Because of the view of LTC as a separate contract, payments made for LTC charges are considered distributions, a particular problem in MECs. As NQABs, the LTC riders may not be pre-funded. You cannot build an extra increment in guidelines. The same 7702 considerations apply to the charge-based rider as with premium-based riders.

And now a brief word about underwriting. Specifically, LTC issues must be addressed in the underwriting process. These issues are different from the life issues. Certain offending conditions and illnesses would affect the insurability for LTC that would not affect the insurability for life. Consequently, many of the underwriting techniques used in stand-alone offerings are incorporated into the underwriting of riders. A supplemental application is typically designed for the rider that inquires about conditions affecting morbidity: and face-to-face interviews, especially at higher ages, are used to probe for emerging cognitive impairment conditions. The latter is especially important, as improvements in cognitive screenings have been instrumental in limiting claims rates.

MS. BAHNA-NOLAN: Our next presenter is Michael Barsky. Michael is a pricing actuary with the Guardian Life Insurance Company in New York where he's responsible for the development of traditional and variable individual life products. Michael will address chronic illness accelerated benefits and some of the issues that he faced when he was developing products for his company.

MR. MICHAEL L. BARSKY: My presentation is going to overlap a bit with Cary's, but I'm going to be speaking mostly from the perspective of positioning the chronic illness benefit as an accelerated benefit (ABR), rider as opposed to an LTC rider. These riders, which were first introduced in the U.S. over a decade ago, allow policyholders to access some or all of their life insurance death benefit in the event of certain conditions. My company has recently launched a new ABR that includes a chronic illness trigger, as well as terminal illness, to help give extra protection to our whole life policyholders against the costs associated with chronic illness. We've also tried to simplify the rider as much as possible in order to get it to market as

quickly as possible.

The issues I will be addressing today include a brief market overview of ABRs, the reason your company might want to consider such a rider and the potential obstacles, the federal tax treatment in the aftermath of the Health Insurance Portability and Accountability Act of 1996 (HIPAA), how states regulate these riders, and different ways of constructing and financing the benefits.

In 1998, Life Insurance Marketing and Research Association (LIMRA) and the ACLI completed an excellent study on the availability and design of ABRs. Previous LIMRA studies were done in the early 1990s, but the 1998 study noted a significant increase in the availability subsequent to clarification of the federal tax status in HIPAA. The 1998 study identified 245 companies offering ABRs, and this was a 14 percent increase over their previous study and represented over 80 percent of the life insurance in force in the U.S.

Most of the current ABRs allow for some or all of the death benefit to be triggered in the event of terminal illness. This means that a doctor certifies that the insured has a severe medical condition that's expected to result in death in a specified timeframe, which is typically between six and 24 months. The most common period is 12 months. However, some ABRs also allow the death benefit to be accelerated for other conditions, including permanent confinement to a nursing home, the need for LTC, or specified dread diseases, such as heart attack, cancer, and stroke. Most of the recent activity in these riders has been in these conditions.

There are several variations in the methods that companies use to charge for these benefits. For ABRs that use a terminal illness trigger, only two percent of companies assess a premium or COI charge. The rest either have no charge or charge only upon acceleration. LIMRA notes that this is down significantly from the first generation of ABRs a decade ago when 90 percent of companies had a charge for their ABR. However, for those riders that use LTC, dread disease, or permanent confinement triggers, most companies do assess some sort of charge. This is understandable considering that the benefit is being accelerated at dates that may significantly precede the ultimate date of actual death.

Some of the other highlights of the ACLI/LIMRA study include the number of companies that offer ABRs by rider as opposed to policy provision or non-contractual provision; how prevalent ABRs are on various types of life products, VUL, UL, and whole life; limitations on amounts that could be accelerated; how many companies use lump-sum versus periodic payments, and similar data on group insurance.

The remainder of my presentation will now focus on ABRs with chronic illness triggers. One of the reasons for offering this rider is to differentiate your company by offering an extra option for accessing benefits during an insured's lifetime. The industry sales of individual life insurance have been fairly flat, whereas LTC sales have been on the rise. It's becoming increasingly important to have features that

set your company apart from the competition in order to gain market share and have owners hold onto their policies. Some companies with experience in stand-alone LTC may see this as a way to leverage that expertise in a combination product. Whether a company has LTC expertise may influence the design of the ABR, and whether it looks and is marketed more as an LTC rider or a life insurance rider. Finally, in my company over the past few years, agents have been hearing about these riders in industry publications, and they've asked us to develop one.

However, there are several obstacles you're going to need to overcome to develop this rider. First, you'll need to gain proficiency in LTC underwriting and claims payment. Not all applicants who are acceptable life insurance risks are acceptable chronic illness risks. Again, if your company chooses to promote this as a life insurance rider instead of LTC, you may position the rider differently. For example, my company chose to use tighter requirements for chronic illness by requiring that conditions be permanent. We've also, at least at the outset, chosen to limit this to non-substandard or nonrated cases.

Your field force will need to get educated in things such as how the triggering conditions work and the tax treatment of these benefits. They'll have to understand the similarities and differences of the rider compared to stand-alone policies and the impact of electing acceleration. The actuary faces challenges in pricing these riders. The LTC industry is still fairly young, and there's a lack of historical data corresponding to the triggering conditions that are used in today's riders. The manner in which benefits are paid and financed will influence the type of data you require. For example, one of the key assumptions you will need is the life expectancy for insureds who satisfy one of the triggers. And, as I will discuss in a few minutes, states vary on how they regulate these riders. I think it's fair to say that the state regulations have not kept pace with the federal tax definitions. So you shouldn't go into this expecting you're going to have an easy 50-state approval.

Although I'm optimistic that consumers will view these benefits positively, this assumption still needs to be validated. My company has conducted focus groups with policyholders and has found significant interest, particularly for insureds in their 40s and 50s, where more people have had to cope with a relative who's needed LTC services.

As I've mentioned earlier, the federal tax treatment of these riders was clarified in the 1996 HIPAA legislation, and this act added several new provisions to the tax law, including Sections 101(g) and 7702(b). Section 101(g) states clearly that amounts paid to a terminally or a chronically ill insured are treated as if the insured had died. A person is considered terminally ill if he or she has been certified by a licensed health care practitioner as having an illness that can reasonably be expected to result in death within 24 months. Cary mentioned earlier the corresponding definitions for chronic illness—being unable to perform without substantial assistance at least two out of six ADLs, or requiring substantial supervision to protect from threats to health and safety due to a severe cognitive

impairment. There's also a third qualifying condition in the tax law, which I don't expect companies will use in their riders, that gives discretion to the Department of Health and Human Services—or to the IRS in consultation with the Department of Health and Human Services in setting up a similar level of disability.

Two different payment approaches can be used by a company in paying benefits to a chronically ill individual—an indemnity approach or a per diem approach. Under the indemnity approach, the payment must be for actual costs incurred by the payee that are not compensated for by insurance for qualified LTC services. Also, under the terms of the contract, the payment must not be for expenses that are reimbursable under Medicare. Alternatively, payments can qualify for exclusion if they are made on a per diem or other periodic basis without regard to the expenses incurred. However, unlike the indemnity approach, such amounts are subject to a dollar limit, currently $200 per day in 2001, and that amount is indexed for inflation. Actual incurred expenses can be used instead of the $200 a day if they are higher. This limit is reduced for payments received as reimbursement, though, for qualified LTC services.

In our rider my company chose to use the per diem approach, feeling that it would be overly cumbersome to identify and reimburse qualified LTC services. We felt it also fits in better with our field force's view that the company should not get involved in policing qualified expenses.

There are a few other federal tax requirements. The insurer must meet those requirements under Section 7702(b)(g) and 49(a)(d)(c) which the secretary specifies as applying. These sections pertain to consumer protection provisions and reference certain sections of the NAIC LTC model regulation and model act. However, I'm not aware that the Secretary of the Treasury has actually made the specification yet as to which sections apply. Therefore, I suggest that any of you who are considering such a rider carefully review these sections of the law and form a company opinion as to which provisions reasonably apply to an ABR as opposed to a stand-alone LTC contract. For an insured to claim an exclusion for accelerated benefits made on a per diem basis, he or she needs to complete an IRS Form 8853 and attach it to the tax return. To do this, the insured will need information from a Form 1099 LTC that the insurer must send for any accelerated benefits paid.

The state regulation of ABRs is still evolving. There's an NAIC model regulation for accelerated benefits that was adopted around 1991. This regulation is useful to get a general sense of how states treat this rider, but there are some limitations. First, the model has only been adopted in about 15 states, and some of those that adopted it had material differences from the model regulation. Second, the model regulation was written before HIPAA and, therefore, contains different triggers than in the federal tax law. I guess you could say that our company has been learning by doing. For our new ABR, we've obtained 33 state approvals within three months from the original filing date. We feel we'll eventually be able to get about half of the remaining states, and the other half are probably not going to approve our design.

New York has its own regulation, Regulation 143, on accelerated benefits, and it addresses advertising, disclosure, benefit levels, payment criteria, policy provisions, benefit eligibility, actuarial standards, and additional policy standards. The New York legislature passed a law that allows the federal conditions, the chronic illness triggers, to be used, and now Regulation 143 needs to be updated for those new triggers. So we've been working with the Life Insurance Council of New York to update their regulation.

I'm going to review three possible financing options for an ABR. These methods are outlined in the NAIC Model Act, and they are assessing a premium or COI charge, using a present value approach, or having a lien approach.

The premium/COI charge method, particularly for an extension rider, is comparable to pricing a stand-alone LTC contract where the actuary needs assumptions as to the incidence and continuance rates of LTC. The basic idea, of course, is to collect enough in COI or premium charges to compensate for the early, undiscounted payment of the death benefit. Despite the extra charge, consumers in our focus groups said they would be willing to pay a reasonable extra premium in order to be able to receive their entire death benefit unreduced. However, the disadvantage of this approach is that it's more likely going to put you in the arena of health regulation with the associated requirements from the states for acceptable loss ratios.

Under a present value approach, no premium or COI charge is assessed prior to the rider being exercised. Instead, the death benefit is reduced for the time value of money between the date of payment and the assumed date of death. Subsequent premiums and policy values reflect only the remaining face amount after the acceleration. This method has been widely used for terminal illness ABRs due to the short (less than two-year) discounting period. However, it may be less suitable for chronic illness because the time between the onset of the illness and the date of death may be many years. Also, it may be difficult to pinpoint the precise life expectancy for a chronically ill insured and awkward to communicate that period to the insured. Finally, this method has a disadvantage in that the insured explicitly sees he or she is giving up a certain face amount for a reduced accelerated benefit.

Finally, the last approach to consider is the lien method. Liens may be either interest bearing or non-interest bearing. If there is no interest, the lien would commonly be used with a premium or COI charge, but if the lien is interest-bearing, there likely wouldn't be a premium charge. The model regulation specifies what interest rates may be charged on the lien. Now a lien has a similar impact as a policy loan on the policy's values. Specifically, the death benefit and cash value are reduced by the lien, but the premium and face amount don't change. My company chose to use this method on our ABR, and we allow an amount between the cash value and the full face amount to be liened out. The older the insured is at the onset of chronic illness, the greater the amount of the net amount at risk that we will allow to be accelerated.

MS. BAHNA-NOLAN: Our next presenter is Keith Dall. Keith is an actuarial consultant with the Indianapolis office of Milliman USA. He's been with the firm since 1998 and has been working in the actuarial profession for 15 years. Keith is going to address some of the other types of blended products that we're seeing in the marketplace or can expect to see in the near future.

MR. KEITH A. DALL: As Mary stated, Michael and Cary talked about the most common form of LTC rider, and I'm going to talk about a couple of riders that are coming out in the marketplace. One is a rider, and one is an annuity product that I think we'll start to see more and more of in the future. The first one is an LTC guaranteed purchase option rider, and the second one is an LTC coverage using a single premium immediate annuity. After these, I'll talk very briefly about some of the annuity LTC riders that are out there, that have been out there for quite a while and actually are fairly common. I will also have a few comments about LTC surveys that were done both formally and informally.

The LTC guaranteed purchase option is from MetLife, and it was actually in the *National Underwriter* not too long ago. It's very similar to a life guaranteed purchase option. In fact, the only real difference is that it's giving you a guarantee to purchase an LTC stand-alone product rather than purchasing additional death benefits without any underwriting. It can be sold on a number of different insurance policies. This particular one was sold on a variable life, a whole life, and a term life product, and it has already been approved in a majority of the states.

The LTC guaranteed purchase option allows the insured to choose to purchase a stand-alone LTC product every five years, and the insured can do this all the way up to age 60. Now there are two keys here. First of all, when you're pricing this product you don't want to set up those intervals in too short of a time period. You're going to end up with antiselection because people are going to wait until their health begins to fail to pick up the LTC coverage. The other thing is you don't want to go too far beyond age 60 because, again, the same thing will happen. People will go ahead and wait and anti-select against you. So you have to be careful of those two numbers in your design of this particular rider.

Again, there is no new underwriting when they choose the LTC policy. The premiums for the rider itself can be guaranteed renewable and are attained-age rates. If you're adding it to a level term period or a level whole life premium, then you're going to want to price it so that the premiums on the rider are also level. You can choose to have a current rate that would be somewhat less than the guaranteed rate if it's on a UL- or a VUL-type product. For this product the minimum face amount is $100,000, and the real need for this product is that it hits the marketplace that everybody wants to sell to, the younger insureds. Everyone's trying to sell their LTC coverage to the younger marketplace, and this allows the agent to go in to talk to the insured with a fairly small premium amount and try to get them to commit to purchasing this rider, first of all, and then hopefully down the road to purchase the LTC stand-alone product itself. There seems to be a need for this product in the marketplace. So try to get the younger insureds to

understand that the cost of LTC is expensive, and the sooner you can purchase LTC, the cheaper the premiums are.

The underwriting for this guaranteed purchase option is fairly limited, simply because you're selling to the younger insureds. The issue ages are typically 18 to 55. MetLife has added three yes-or-no questions to its application to cover this particular LTC rider. Again, the cutoff point is only up to age 60. The underwriting is limited because if you're going to be insurable from a life insurance standpoint for these ages, then you're also insurable for LTC coverage.

Table 1

BENEFIT **PREMIUM**

●$110 or $200 per day ●1-3% of WL

●Max 3 years ●10% of 20 YT

EXAMPLE: VUL, Pref NS, $250,000 F.A., Minimum Prem $1,800

Benefits	$110	$200
GPO Premium	64	116

This is a specific example of, again, the LTC stand-alone product that offered a benefit period—benefit amount of $110 per day or $200 per day for a maximum of three years. So when you purchased the guaranteed purchase option rider, at that point in time you had to decide if you wanted the $110 benefit amount or the $200 benefit amount. The relative cost for the rider premium is about one to three percent of a whole life base policy premium, and it's about ten percent of the 20-year term base policy premium. The specific example that is listed in Table 1 is a VUL product in which the minimum premium is $1,800, but if you look at the guaranteed purchase option rider premium for the $110 benefit, it's only a $64 rider charge. For the $200 benefit, it's a $116 rider charge. So you can see the relative difference between the rider and the base cost premium is so large that it makes it a lot easier for the agent to get the insured interested in this particular rider and talking about LTC coverage. So, the real key to this is trying to sell to the younger marketplace.

The second product is a single premium immediate annuity which is being done currently by Golden Rule, and, again, it is very similar to a standard single premium immediate annuity. The only difference really is that it's underwritten, and it's underwritten because it's best for the people that may already be receiving care or are on their way to receiving that care. The unhealthier they are, the smaller the initial deposit is going to be to cover that monthly benefit that they're incurring in an LTC facility. This marketplace now is really on the other end of the spectrum of the GPO rider that I was talking about earlier. This is trying to hit the older people who wished at this point that they had bought LTC coverage, but they didn't, and now they're in a situation where they're looking at having to go to a facility, and they're worried about trying to cover the costs. Everyone expects to live for 10, 15, or 20 more years, even if they are in an LTC facility. So when they start adding up those monthly $3,000 bills it can get quite expensive.

The underwriting for this product is really the key part of the profitability of the product. Golden Rule does it in two phases. The first phase happens in a one- to two-day turnaround; that's where they just pick up general information. They want to get enough general information to be able to get the deposit amount that is going to be expected of the insured back to the insured so they can make a choice because this is going to be an expensive premium. The average premium may be around $100,000. So they don't want to do a lot of extensive underwriting because it can be quite expensive if these people may just be kicking the tires trying to understand what the cost of this benefit really is. So they split up their underwriting into two phases.

The second phase is a more detailed underwriting; looking at the medical records, and, sometimes they go so far as to have a geriatric care manager on site to review the insured. After this stage they would actually go back to the agent and give him or her the set deposit amount that they would expect for this particular coverage. An example of this is an 85-year-old man with Alzheimer's disease. He needs $3,000 a month for life because he's entered an LTC facility. The standard single premium immediate annuity would cost him $216,000, but because he's being underwritten, and the realization is that his life expectancy is going to be shorter than the average insured, the LTC single premium amount is $111,000. So you can see that the cost of this coverage was cut in half because of the underwriting.

Some general information about the LTC single premium immediate annuity (SPIA). Again, the issue ages are 60 to 95, so you're targeting a much different age bracket for this particular product. The minimum premium is $25,000, and the average premium, as I said, is $100,000. Commission is 3.5 percent on this particular policy, and the riders are key here as they allow the insured some flexibility. You can choose an inflation option that increases between one and 10percent. Obviously, the higher the inflation rate that you choose, the more money that you're going to deposit initially. Likewise, another risk that the insured is looking at is putting down the $100,000 payment for this particular coverage and maybe not living beyond a three-year or a three-month period, and the insured would be out the full $100,000. So there are riders that would give a cash refund option where they would refund 25 percent, 50 percent, 75 percent, or even 100 percent of the premium less any payments that had been made up to that point in time, at time of death. Again, that's going to increase the initial deposit.

The deferred annuity products with LTC riders have actually been out there for quite a while, at least the first one, which is the waiver of surrender charges. This is a very common provision, and when I say it has limited sales appeal I am talking about limited sales appeal as far as covering the LTC costs themselves. It's really just another bell and whistle for the agent to have to be able to throw out at the possible candidate for insurance. The other rider would be an additional benefit on the deferred annuity. These riders typically have a charge, and experience at this point is pretty limited. It's a fairly new rider that's coming out.

An example of one of these new riders with additional benefits is one that offers

one percent of the initial investment for three years, and then those benefits become available after seven years, along with the account value as the surrender charge has worn off. There is no underwriting for this typical deferred annuity, but in order to get the additional benefits, you have to go into an LTC facility and have two of the six ADLs. The charge for this is about 30 basis points, but this is going to vary. The additional benefits and the charges vary from company to company.

As I was going through this, I was trying to think of the benefits these riders should be covering. What are the insureds trying to cover for this LTC rider? I gathered some information from an Eastern Research Associates survey that discussed the benefits. If you look at the percentages, each of these benefits, whether the waiting period or the benefit amount itself, had an average industry premium associated with it. The person filling out the survey actually had to make a choice between the cost of the premium versus the additional benefits that they would receive. The waiting periods were split fairly evenly—180 days, 90 days, 30 days, and then the zero days. For the benefits, on the other hand, the largest vote-getter was the $150 per day coverage at 51 percent. And then the $75 per day coverage was next at 28 percent, followed by the $300 per day coverage at 22 percent.

For the benefit period, the winner was the unlimited benefit period at 57 percent, followed by the five-year 21 percent, and then there was an even split between the two-year and the ten-year. This is interesting because if you look at the accelerated death benefit LTC riders that currently exist, the most common form has a cap on it, maybe a 24-month or a 36-month benefit coverage or maybe up to the death benefit itself. So it is not an unlimited coverage. The more recent designs that Cary and Michael mentioned add on some additional benefits to be able to cover, to extend the benefit coverage. Regarding inflation protection, the winner was the guaranteed purchase option every five years, receiving 49 percent of the votes. This is obviously prior to receiving the benefits. The simple interest inflationary coverage was 35 percent, followed by the compound interest of 16 percent. When you're trying to develop your own LTC riders, you should try to keep in mind that there is definitely interest, and the one thing that stands out in my mind is the unlimited benefit period.

Now for the informal LTC survey. I sent an e-mail to 35 companies. I got 22 responses. Of those, six had an LTC rider in the marketplace. All of them were the accelerated death benefit variety. And of those, two had additional benefits. The more interesting side for me, is that of the 16 that said they did not have an LTC rider, half of them said that they plan to incorporate an LTC rider in the next two years. I think that was similar to the hand count that we got here. The concerns, again from this informal survey of in-house actuaries, was that the LTC riders had inadequate benefits, again this comes from the most common riders that are out there typically for a 24-month or a 36-month period as they accelerate the death benefit, and there's also a belief that there's a lack of sales appeal. That probably goes hand-in-hand with the inadequate benefit concern. Next was the higher-than-expected claims, obviously from a pricing standpoint, not being quite sure what the expected claims would be. There was one other issue—somebody said they thought

there would be a misunderstanding of the taxes.

MS. ANNA M. RAPPAPORT: I want to ask all of the panelists if they've seen any combination products used successfully in the employee benefit market, and how.

MR. LAKENBACH: I've seen some companies try to focus their combination sales to employers. The advantage is that if you sell a product, let's say, a blended life product that complies with 7702(b), the premiums that an employer pays will be fully tax deductible under current law, and that applies to the blended offer—to the LTC premium only. I'm not really sure about the success of this. It's pretty new, but these are upscale companies. It remains to be seen.

MR. BARSKY: I'm on the individual side. We don't get involved in employee benefits. I know that our group operation came out with a different approach on the group term where they're assessing an additional charge but paying an additional benefit. So it's not really an acceleration. I think you have to meet a waiver definition, a very strict waiver definition, in addition to a chronic illness definition, and then they pay an additional monthly benefit. I think they are using that in employee benefits.

MR. GREGORY A. GURLIK: Keith, I want to ask you about a couple of additional concerns with the guaranteed purchase option for the life policies. At the end you discussed the survey results, and you talked about the lifetime benefits being the most popular—especially among those at younger ages, which is the target market. They generally buy very rich plans. Here you have a guaranteed purchase option, and that's providing a three-year benefit with no inflation protection. How did you address suitability issues in going to that target market? It seems like this is a tool that could make it awfully easy for the field representatives to say, "Well, I'm glad I took care of that LTC problem for my client." But he or she may not have taken care of anything if the client doesn't purchase that coverage, and even if he or she does, it might be pretty limited.

MR. DALL: On the first question, this particular rider was set up for the LTC coverage that this particular company had, which was just a three-year benefit, and the rider itself is fairly new. So I think that we will see some additional riders in the marketplace that will be able to cover some richer benefits. You have to be very, very careful when you're pricing this because there's not a lot of experience out there, and the anti-selection is a big question mark. So, for the first product that's out there and being discussed, to have limited benefits, maybe it makes sense to pick up some experience at this point. As far as the second question, getting the agents to say that they've taken care of the LTC problem, I think you have to start somewhere. This particular rider has the ability to at least get the agents talking to the insureds about LTC coverage and give them the opportunity then to either purchase it at that point in time or to purchase it down the road in five-year intervals.

MR. THOMAS A. CAMPBELL: Mike, just a question on your lien approach. Did you consider any taxation that the company would incur by actually owning a piece of the death benefit once you take the lien?

MR. BARSKY: I'm not sure I understand.

MR. CAMPBELL: If I understand the lien approach, the company has now become an owner of a portion of the death benefit and the receipt of death benefits are an income benefit to the company, kind of like split dollar.

MR. BARSKY: Why do you say the company has become an owner of the death benefit?

MR. CAMPBELL: I thought that's how the lien worked. You actually liened a portion of the death benefit, as well as a portion of the cash value.

MR. BARSKY: Again, I think we're viewing the liens, like I said, much like a policy loan. So, when you take out a lien it reduces dollar for dollar the cash value and the death benefit. Normally you can only borrow your cash value with a policy loan. Now we are allowing amounts greater than the cash value to be liened. But we're only doing this on whole life policies. It's still a requirement that the person has to pay premiums to keep the policy in force, and the policy will continue to remain in force as long as the lien and the carrying charges, on the lien stay less than the full death benefit.

MR. EDWARD P. MOHORIC: You mentioned the use of an additional rider to extend the benefit once a fronting of the death benefit is used up after three or four years, and there's no life insurance left, that you could have a rider to extend the LTC for another three years or something. There are mostly regulatory questions around that. It would seem to me that since it's a separate rider, it would need to meet loss ratio standards. It's a health rider, not a life rider.

MR. LAKENBACH: It's an LTC product. That's absolutely correct.

MR. MOHORIC: Also, it would seem that, while it's a great idea and fits in well with a high deductible for the life insurance, state regulators, within some of the rules that they have defined, might have a hard time approving it since they typically do not like products with more than a six-month elimination period. You would need to get around that somehow. While it makes sense, I could see a lot of regulators just denying it because it doesn't fit the rules. How have you dealt with that?

MR. LAKENBACH: You are right. There are a few states that object to this vehicle for any number of reasons. I'd say, speaking population-wise of the states that will approve an acceleration vehicle, probably 80 percent or so, if not greater, will approve this rider as part of the life contract.

MR. JACK BRAGG: I have a couple of comments and then a question. Around age

55 the incidence rate for critical illness is quite a bit higher than the mortality rate, and so it would also be true for chronic illness. It's amazing when you actually look at these things and compare your incidence rates. This seems to me to have an implication on the salability of the product to people in their mid-50s. It was very interesting to hear about the single premium disabled life annuities. There is a lot of information, obscure actuarial knowledge, about morbidity ratios for sick people, and most of it is quite obscure, but to come up with these single premium annuities you're looking for a mortality ratio on these people, and there is a tremendous amount of work that can be found. I like the stand-alone. I think that quite a bit of work has taken place that says if you're taking away the death benefit, the public doesn't like it. The public doesn't like the stand-alone benefits, whether they're in a separate policy or a stand-alone type rider. What do you think the impact of all of this is going to be on the executive market, the large amount market? Typically the executives are in their 50s, and you're talking large policies. Are these riders going to be attractive to beef up that market?

MR. LAKENBACH: I think the example that I gave in my talk about the use of riders outside the estate is an example of market applications such as you're just inquiring about, Jack. Let's review that a little bit. We're talking about wealthy individuals who are buying insurance and where the insurance resides outside the estate. They buy an LTC rider with the life policy. It's not necessarily meant to be in an islet that is used for, say, second-to-die tax liquidity applications, but it is outside the estate. When an individual becomes chronically ill, a claim will be made to the insurance company, and that money will be received by the estate. That's a nontaxable receipt, if everything else is done correctly. On the other hand, the payment for the benefit—the payment for the LTC services is done from the estate. You're reducing the estate and, therefore, eliminating potential tax costs. It's a very efficient sale that's turned out to be reasonably attractive over time.

FROM THE FLOOR: I'll make it specific. On the life LTC products you mentioned reinsurance. Do the reinsurance companies that are assuming the risk tend to be those that normally have a life reinsurance business or an LTC reinsurance business, or is it restricted to those who have dealt with both?

MR. LAKENBACH: First of all, there have been some situations where companies, very prominent companies in terms of the market share, initially decided they didn't want to be providing coverage. And then when other reinsurers started offering coverage, it turned out that market forces changed their mind. The best outcome is if you have the same reinsurer providing LTC and life reinsurance. It's just a much cleaner transaction.