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Combination Products: An Accelerated Education

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Consumers and insurance companies have been challenged by traditional stand-alone long-term care insurance (LTCI) products for more than a decade. Consumers have felt the financial strain of rising premiums on a product they likely expected to have level premiums. Companies have responded to the challenging trends in economic and actuarial experience by strengthening reserves and filing for new premium rate increases. The turbulence has seeded the landscape for the growth of an increasingly popular idea: the combined life and health insurance product. In this context, the health insurance coverage is supplemental medical insurance, such as long-term care or critical illness coverage.

MARKET

The combination life and health product has grown more common in recent years. Consumers now increasingly choose these combination products (sometimes called "combo" or "hybrid" products) over stand-alone LTCI to protect against risks of long-term care (LTC) and chronic illness. In 2015, the sales of combination products more than doubled those of stand-alone LTCI in terms of new policy counts, and that trend continued through 2018. Many consumers dislike the "use it or lose it" nature of a stand-alone health product such as LTCI; in turn, they value the promise of receiving benefits from a combination product whether or not they use the health benefits. This effect is magnified by a tendency for consumers to underestimate the eventual need for long-term care services. Agents often find it easier to promote the advantage of adding long-term care coverage to products that consumers already feel they need (such as life insurance) rather than selling them stand-alone LTCI products that they may perceive as less critical.

A large portion of combination products are sold as single-premium policies. Although this does make it an unaffordable option for much of the middle market due to the high up-front price tag, those who can afford it benefit from the typical rate guarantees in the product. Even though current stand-alone LTCI products are less likely than ever to experience significant rate increases,[1] consumers still perceive these products as risky purchases subject to possibly large future premium rate increases. This perception fuels the attraction consumers feel toward combination products.

BENEFITS

Combination products provide valuable, and often substantial, health insurance coverage in the framework of a life insurance or annuity policy. Insurance companies offer many varieties of benefits in the market. This article addresses a range of combination life insurance and health products.

Consumers now increasingly choose these combination products over stand-alone LTCI.

Indemnity and Reimbursement Models

Similar to stand-alone LTCI products, benefits from combination products may indemnify policyholders a specific amount or may reimburse them for actual chronic illness or LTC costs. For instance, a combination life policy with LTC benefits might reimburse a policyholder for expenses up to $5,000 per month. A life insurance policy with chronic illness benefits might indemnify a policyholder by accelerating 4 percent of the available death benefit each month.

Acceleration, Restoration and Extension of Benefits

The most common combination products are accelerated benefit riders, which advance all or part of the policyholder's death benefit for a qualifying event, such as a chronic, critical or terminal illness. As a risk mitigation measure, companies may limit the acceleration amount to a maximum portion of the total face amount (e.g., 75 percent) or to a certain dollar amount (e.g., 50 percent of the face amount up to $250,000). Furthermore, companies may change the eligible acceleration amount by attained age or other factors.

Companies may also extend the health benefit beyond the acceleration and restoration of benefits amounts to longer benefit periods. These policies carry greater health risk than the acceleration-only riders. Policyholders purchasing a more robust health benefit on their life insurance policies may be more anti-selective in nature. In pricing these products, actuaries should consider the portion of overall benefits that the company expects to pay out for life insurance and for nonlife benefits as well as the profile of the purchaser the product will attract along that spectrum.

In-depth coverage of the tax implications for combination product policyholders can be found in the Society of Actuaries *Life Insurance & Modified Endowments* text.[2]

REGULATORY FRAMEWORK AND GUIDANCE

Companies developing combination products should review the applicable regulations in the jurisdictions they wish to have the products filed. For accelerated death benefits to life insurance policies, the following regulations commonly apply.

NAIC Accelerated Benefits Model Regulation (620)

The National Association of Insurance Commissioners (NAIC) first issued Model Regulation 620, better known as the Accelerated Benefits Model Regulation (AB Model Regulation), in April 1998. This regulation is the guidance that allows accelerated benefits, including benefits for chronic illness, to be added to life products, provided certain requirements are met. These requirements include:

- obtaining a signed acknowledgment of concurrence for payout;
- certain criteria for payment, including the requirement to provide a lump-sum settlement option; and
- general disclosures, such as the need for a descriptive title, a description of tax consequences and a disclosure of administrative expense charges.

The AB Model Regulation also offers guidance regarding actuarial standards, disclosure and reserves. Note that an actuarial memorandum describing the accelerated benefits, the associated risks, the expected costs and the calculation of statutory reserves should accompany each filing and should be made available to state insurance commissioners upon request. The AB Model Regulation does not govern any qualified long-term care accelerated benefits; these are subject to the NAIC Long-Term Care Model Regulation (640).

NAIC Long-Term Care Model Regulation (640)

The NAIC LTC Model Regulation applies to stand-alone LTC policies as well as to "life insurance policies that accelerate benefits for long-term care." Because the LTC Model Regulation was primarily written for stand-alone LTC policies, there are many notes and exceptions spelled out for LTC accelerated death benefits, including for the following areas:

- disclosure of tax consequences;
- requirement to offer inflation protection;
- reserve standards; and
- actuarial memoranda, found in the "Loss Ratio" section, 19.C.(5).

IIPRC Additional Standards for Accelerated Death Benefits

Adopted in August 2014 and effective four months later, the Interstate Insurance Product Regulation Commission (IIPRC) Additional Standards for Accelerated Death Benefits amended an earlier set of standards adopted in 2007. Riders filed under the Accelerated Death Benefits standard may not be marketed as LTC insurance. Similar to the NAIC model regulation framework, a separate IIPRC LTC standard applies to products marketed as long-term care offering qualified LTC benefits.

Consistent with its distinction from LTCI, the potential benefit triggers (i.e., the qualifying events) for an accelerated death benefit are more diverse than for a stand-alone LTCI product. Qualifying events under this standard could be based on the policyholder's inability to perform a specified number of activities of daily living or cognitive impairment, as is true for LTCI, or there may be qualifying events for terminal illness or various other condition-based diagnoses. Terminal illness benefits must always be included in riders filed under this standard, while other triggers may or may not be included.

The standards also provide guidance related to benefit amount, benefit design options, the effect of benefit payments on other benefit provisions, exclusions and restrictions, expense charges,

incontestability, payment options, payment procedures, qualifying events, reinstatement and termination.

Finally, the IIPRC requires that a qualified actuary certify that the present value of the benefits of the base and rider policy combined is not more than 10 percent of the value of the base policy alone. In other words, the rider shouldn't add more than 10 percent to the expected policy benefits. This test is referred to commonly as the "incidental value test." Similarly, the actuary must also certify that the premiums (or cost of insurance charges) for the rider are less than 10 percent of those of the base policy.

PRICING

This section discusses the pricing of accelerated death benefit riders to life insurance policies, unless otherwise stated. Accelerated death benefit riders are among the most popular forms of nonlife coverage within combination life and health policies currently sold on the market. Many of the concepts discussed here (e.g., modeling, mortality assumptions, expenses) may be extended to other combination product features, such as extension of benefits or inflation benefit riders. Reinsurance on combination products is common, but practices vary as to when reinsurers pay for accelerated benefits; those issues are not covered in this article. A discussion of reinsurance on these riders can be found in the *Report on Life and Annuity Living Benefit Riders: Considerations for Insurers and Reinsurers.*[3]

Policyholder Behavior

These combination products offer long-term care (or similar) benefits, but companies have reason to believe that purchasers of these products will not behave like purchasers of traditional stand-alone LTCI products. Traditional LTCI policies are health insurance, and they may not carry any cash value. As a result, traditional LTCI policyholders face a "use it or lose it" scenario; if they don't access their LTCI benefits, they will not get any money back from the policy (with some exceptions, such as return of premium riders). A combination product policyholder, however, is guaranteed the life insurance benefit as long as the premiums are paid. At the margin, this will impact the decision-making of combination product policyholders as they balance accelerating a benefit today with reducing or eliminating the life insurance death benefit that their beneficiaries would receive later.

The combination product accelerated benefit typically carries a small value relative to that of the base life policy, because a primary portion of the cost is the time value of money cost involved in paying out benefits on average two to three years prior to death. Moreover, policyholders under some designs will pay no explicit premium for the rider. As a result, the combination product policyholder likely does not view the chronic illness or long-term care benefit in the same light as the traditional LTCI policyholder who may pay $2,000 per year or more for the stand-alone LTCI policy.

Financing

Accelerated death benefit riders are typically financed in one of three ways per NAIC Model Regulation 620: charging an explicit premium, discounting the benefit using a present value approach or establishing a lien on the base policy.

Explicit Premium

Companies that charge an explicit premium will develop premium rates per unit of face amount, or cost of insurance charges, to apply to the net amount at risk. This approach to financing is often referred to as the "dollar for dollar" method, as the policyholder receives 100 percent of the accelerated benefit elected and the death benefit is reduced by the same dollar amount. To file these rates in many jurisdictions, including the IIPRC, the actuary must certify that rider premiums overall are less than 10 percent of the value of the base policy premiums. Companies that charge a separate premium for the rider will also need to reserve for this benefit.

Actuarial Present Value Method

Instead of charging an explicit premium for the accelerated death benefit, companies may instead discount the accelerated benefit

payment. This "actuarial present value method" accounts for the time value of money that the company has forgone by providing the death benefit early. The pricing actuary will determine a set of actuarial discount factors to apply to the accelerated amount. These factors may vary by age at claim, sex, smoking status and so on. Some companies analyze the condition of the policyholder at the time of claim (referred to as underwriting at the time of claim) and determine the discount factor based on the policyholder's life expectancy at that point. The actuarial present value method of pricing accelerated benefit riders may be appealing for its zero-dollar premium, but the company faces the risk of confusing the policyholder at the time of acceleration. If the rider benefits were not explained clearly at the point of sale, some policyholders may mistakenly assume that they will receive the entire accelerated amount request when in actuality they will receive that amount with a discount applied, which may significantly reduce their benefit.

Lien Method

Finally, companies may offer an accelerated benefit rider by assessing a lien on the policy at the time of claim. Similar to other policy loans, the policyholder pays interest on the lien subject to a maximum interest rate determined by regulation.

Impact on Policy Values

Accelerating a portion of the face amount affects the base life insurance policy. The policy form and the actuarial memo will specify the impact of the acceleration to the base policy cash value, policy loans, remaining face amount, net amount at risk and other factors. Typically the policy values are reduced in a pro rata fashion with the amount of the acceleration. For instance, if the policyholder elects to accelerate 25 percent of the face amount of a policy, the policy's cash value will decrease by 25 percent. A portion of the acceleration may be used to pay back an outstanding loan—for instance, in this case paying back 25 percent of the outstanding loan. The base policy premium may also be reduced in a similar fashion, but this is required only when using the actuarial present value method. Accelerated benefits from products financed using the lien approach do not impact policy values. Instead, the lien amount, up to cash values, is booked as an admitted asset. However, gross policy values are reduced by the lien amount to determine net amounts payable to the insured.

Modeling

The pricing actuary will ideally price combination products using the same model as the base life insurance policy. The health benefit (e.g., chronic illness, LTC, critical illness) cash flows should be included in the calculation of net income. If the company must establish reserves for the health benefit, such as for an explicit premium rider, those reserves may be modeled alongside the life insurance reserves. The change in total reserves will then be included in the calculation of net income.

Mortality

With the addition of the health benefit to the life insurance policy, the pricing actuary must estimate mortality separately for active and disabled lives. This estimate of mortality is a critical consideration when pricing a combination life and health product. The actuary should make explicit assumptions around the following items:

- If the actuary believes that including the health benefit with the life insurance policy will not materially impact the estimate of future overall mortality rates per life on the policy, a "conservation of mortality" may be assumed. This is a common approach used in pricing combination products. Under this approach, the actuary first estimates mortality for the disabled lives. Then, by estimating the future mix of active and disabled lives, the actuary can calculate the resulting active life mortality such that the total mortality of the base policy is conserved.

- If the actuary believes that including the health benefit with the life insurance policy impacts the total mortality, an adjustment to total mortality may be assumed. This adjustment could take the form of a scalar applied to the base policy mortality estimate, where the actuary can use the same balancing approach as described earlier to determine active life mortality.

- The disabled life mortality may be measured using data appropriate to the health benefit. For instance, the disabled life mortality for an LTC accelerated benefit rider to a whole life policy may be estimated by using LTCI continuance tables as a starting point. Typical LTCI continuance tables include terminations from death and recovery, and they are based on data from traditional LTCI policies. The pricing actuary should make adjustments to those continuance tables to reflect expectations of the future mortality of the combination product policyholder.

- The mix of active and disabled lives will be determined by the actuary's estimate of the incidence of the policyholder triggering the health benefit. Once the policyholder triggers the health benefit, that person moves into the disabled life pool. For benefits that are paid over longer periods of time—say, a monthly acceleration for chronic illness—the actuary may assume that some disabled lives recover and move them back to the active life pool. This multistate modeling is complex, and the actuary should consider the impact of simplifying assumptions, such as modeling no recoveries when the claim terminates.

- Accelerated death benefits are typically offered as lump-sum accelerations to the base life insurance policy face amount. The company may allow part or all of the face amount to be accelerated. If only a portion of the face amount is accelerated, the actuary will want to consider the entire life to be disabled for the purpose of modeling mortality.

Expenses

Combination product riders are usually ancillary to the sale of the base life insurance products and therefore carry with them mostly marginal expenses. These marginal expenses may be expressed as a portion of premium for those riders that charge explicit premium. Companies may also charge an acquisition cost, typically a one-time expense per policy.

Most combination product issuers are life insurance companies that may not have experience handling complex health-type benefits. Claim expenses for rider benefits, particularly those benefits that reimburse actual costs, may therefore be high relative to expenses for riders paying a single lump sum, multiple lump sums or a stream of indemnity payments.

Companies may charge an administrative fee that can be deducted from the acceleration amount paid to the policyholder. States and other jurisdictions typically limit this fee, capping it at $250 or in some cases $100.

Premiums

For companies that charge an explicit premium for combination products, the actuary will target the company's internal profit metric—for example, statutory internal rate of return, profit margin as a percentage of premium or other internal hurdle rates. Companies that file combination products as individual non-LTC accident and health benefits, as opposed to filing them only as accelerated death benefits, will develop premiums that meet the minimum-loss ratio requirements in their jurisdictions. Companies filing acceleration riders that qualify as LTCI coverage are subject only to the LTC Model Regulation, including provisions on rate stability.

Synergies and Natural Hedges

For traditional stand-alone LTCI policies, claims paid in the later durations for a few policyholders are supported by premiums paid early on by many policyholders. The "lapse-supported" nature of this product means that higher-than-expected policy termination is financially favorable to insurers after expenses are recouped. For level premium combination life and health products, health claims may be substantially higher at older ages. If mortality and voluntary lapse are higher than expected on a base life policy, lifetime LTC or chronic illness morbidity experience will be more favorable, all else equal, because fewer insureds will persist into the later durations when most claims occur. This phenomenon is a natural hedge between the life and health benefits offered in combination products.

There is also a hedge in the inverse scenario, when persistency is greater than anticipated, and this contributes to an increase in earnings on the underlying life policy unless the life policy is also lapse supported. Each of these hedges reduces the volatility of earnings across a range of adverse scenarios in the combination product relative to a stand-alone life policy or stand-alone LTCI policy. The volatility of combination product earnings is muted when considering fluctuation in other assumptions as well,[4] such as investment earnings, LTC claim termination rates and persistency.

> Each of these hedges reduces the volatility of earnings across a range of adverse scenarios.

UNDERWRITING

Companies issuing life insurance products need to address the additional risks of adding health riders to their policies. For companies conducting full underwriting on their base life insurance policies, additional application questions and a detailed medical history can help classify the riskiness of a combination product applicant. The larger the health benefit in relation to the life benefit, in general, the stronger the health underwriting should be to mitigate the risk of anti-selection.

For companies offering relatively small health riders to base life insurance policies, a more limited underwriting approach may be appropriate. The carrier will also want to consider who is making the benefit election and what choices they face.

For instance, some companies selling voluntary life insurance policies through the work-site market allow the employer to elect the combination rider. In this case, where the employee has little to no say in the election of the rider, and where risk is spread across all employees purchasing coverage, the insurer may elect to ask only one or two "knockout" questions in a simplified underwriting application. In cases where the carrier is charging a zero-dollar premium, financing the rider through the lien or actuarial present value methods, there may be lower risk of anti-selection, as the decision to purchase the policy and rider carries with it no additional marginal cost. Although this may be counterintuitive, think of the example of a combination life and health product with a health-benefit premium that is twice that of the base life policy. Purchasers of that product likely perceive a greater future need for using the health benefit than if the product had minimal health coverage.

RESERVING

The reserves requirements for combination products will depend on how the product is financed and whether the benefit is more substantial than accelerating the death benefit.

Active Life Reserves

The active life reserves required for the accelerated benefit portion of a combination product depend largely on the extent to which the benefit is prefunded. Many accelerated death benefits do not have an accompanying level premium or charge to prefund the benefit, so companies typically hold a minimal explicit active life reserve. The opposite is true for an independent extension of benefits rider, which does have a prefunding component and thus would require an active life reserve.

Claim Reserves

Once a policyholder goes on claim for an acceleration benefit, a claim reserve needs to be established. The mechanics for such a reserve are generally similar to a claim reserve held for a traditional long-term care policy. In theory, this claim reserve may be offset by a reduction in the expected value of future death benefits. Companies will reduce the claim reserve by the life policy account value.

MARKETING

Many companies now offer a combination product rider with their base life or annuity policies in order to stay competitive. Although a health rider is not usually the tipping point in a policyholder's decision to buy a life product, companies without combination products may not even be presented to the customer at the time of sale.

Companies developing combination products with a long-term care or chronic illness benefit will need to make the decision to offer the benefit as tax-qualified long-term care or as "chronic illness." Companies that wish to market their combination products as long-term care coverage must comply with the LTC Model Regulation.[5]

The LTC Model Regulation includes certain exceptions for accelerated benefit LTCI riders to life products—for example, not requiring that the rider have an inflation protection option. If the company has not offered an LTCI product before, it may find it cumbersome to comply with certain elements of the Model Regulation, such as licensing agents or requiring an inflation protection option.

CONCLUSION

Life and health insurance combination products have been sold for many years and in some cases, such as terminal illness riders, are ubiquitous in today's market. Dwindling sales in the stand-alone LTCI market have prompted more life insurance companies to offer an LTC-like benefit. In this regard, the combination life and health product market may still be in its infancy, as substantial sales and experience continue to emerge. The coming decades could see increasing sales of combination products as insurance companies acclimate to these new risks and develop new benefits. Demography and economics point to a greater demand for solutions to financing LTC costs in retirement. Combination life and health products are paving the way for an expanding insurance market to meet that demand. ■

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ENDNOTES

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4 Chow, Linda, Carl Friedrich, and Dawn Helwig; Milliman. 2012. *Quantification of the Natural Hedge Characteristics of Combination Life or Annuity Products Linked to Long-Term Care Insurance*. Schaumburg, IL: Society of Actuaries. *https://www.soa.org/research-reports/2012/research-2012-03-quant-nat-hedge/* (accessed March 28, 2019).

5 The full text of the NAIC Long-Term Care Insurance Model Regulation is available at *https://www.naic.org/store/free/MDL-641.pdf*.