Trilogy
Actuarial Solutions

Options for Providing Life Insurance Accelerated Death Benefits

Douglas Brown, ASA, MAAA

Trilogy Actuarial Solutions LLC

October 26, 2020

Disclosure

This paper was developed to provide a general overview of the issues related to its subject matter. While this paper contains specific suggestions and recommendations based on my experience with these benefits, the comments and recommendations contained in this paper are not intended to provide specific consulting advice or a statement of actuarial opinion. The unique situation of an individual company should always be considered in determining an appropriate response.

Introduction

The paper provides an overview of the design solutions available for providing accelerated benefits. This overview is intended to assist companies in the development of a high-level strategy for expanding their product portfolio to include accelerated benefit riders for terminal, chronic, and critical illness. This document identifies several of the design considerations related to these riders and provides a discussion of the options that are available, including an evaluation of the pros and cons of each approach. Additional detail will be required to develop complete product specifications, the necessary policy forms, and operational procedures.

Benefit Triggers

There are three common benefit triggers available in the marketplace today. The popularity of these specific triggers is based on a combination of favorable tax treatment and the appeal of living benefits. Additional tax considerations are discussed in the Tax Treatment section.

Terminal and chronic illness benefits are practically ubiquitous in the marketplace today. Critical illness benefits are less common, but widely available.

Terminal Illness: Terminal illness is typically defined as a medical condition that is expected to result in the death of the insured during a specified period (12 to 24 months). Provided that the period is no longer than 24 months, accelerated benefits for terminal illness are expected to qualify for favorable tax treatment. I generally suggest limiting the period to 12 months to reduce the pricing impact and increase the likelihood of an accurate diagnosis.

Chronic Illness: Chronic illness riders may be offered as qualified long-term care insurance riders or chronic illness accelerated benefit riders. This is a very consequential distinction which is discussed more thoroughly later in this document. Regardless of the form used, benefits are expected to qualify for favorable tax treatment provided that the benefit amount is within the limits specified by the tax code.

Chronic illness is typically defined as the inability to perform (without substantial assistance from another individual) at least two of six activities of daily living (ADL) for a period of at least 90 days due to a loss of functional capacity or requiring substantial supervision to protect oneself from threats to health and safety due to severe cognitive impairment. A common variation is to require an expectation of permanence with respect to the impairment.

Qualified long-term insurance care riders further condition the availability of benefits on the receipt of qualified long-term care expenses, including home health care, provided pursuant to a plan of care.

Critical Illness: Critical illness is typically defined as a list of specific conditions that are expected to result in a drastically limited life span (e.g., heart attack, stroke, life threatening cancer, end stage renal failure, amyotrophic lateral sclerosis (ALS), or major organ transplant). Benefits provided for critical illness are not generally expected to qualify for favorable tax treatment.

Benefit Structure and Cost

There are two general approaches to funding benefits: actuarial equivalence or a separate premium.

Outstanding policy debt is deducted from accelerated benefit proceeds regardless of the method used, similar to the payment of death or surrender benefits.

Actuarial Equivalence

The first approach is to charge no premium for the rider and pay an actuarially equivalent (reduced) benefit for approved claims. Under this approach, the cost is paid on the back end and the cost is only incurred by policyholders who utilize the benefit. Additional underwriting is typically not required, but the availability of chronic or critical illness benefits are typically limited to policies rated four tables or less. The actuarial equivalency method is very popular because it does not increase the premium for the policy, and it is commonly used with all three benefit triggers.

Under the actuarial equivalency approach, there will be a varying degree of uncertainty at the point of sale about the amount of future accelerated benefits that will be available depending on the specific method used. This is addressed more thoroughly in the descriptions of the different methods and in the Illustrations section of this document.

Since the accelerated benefit is designed to be actuarially equivalent to paying the death benefit, additional reserves are not typically established (neither active life nor claim reserves) and these benefits are not typically considered in the cash flow testing supporting the company's annual asset adequacy opinion.

Multiple claims can be permitted if needed to remain within benefit limits for tax qualification.

There are two distinct methods that fall under this approach: discounted benefit and lien.

Discounted Benefit: Under this method, the benefit is determined at the time a claim is approved based on an actuarial calculation of the present value of future benefits, including dividends, less the present value of future premiums and an administrative charge ($100 to $250).

If the policy is not fully accelerated, policy values, including future premiums, are adjusted on a pro rata basis. There is a residual death benefit only if the policyholder does not elect to accelerate the full death benefit.

The interest rate used is capped by state law (maximum variable loan rate), but the mortality assumption is determined solely by the company. In general, it should be possible to achieve the goal of providing an actuarially equivalent benefit, provided that an appropriate mortality assumption can be developed. Adjustments can be made for any material difference between the maximum interest rate and the current net earned rate in the calculation of the actuarial discount for products with interest sensitive non-guarantee elements.

There are two common approaches to developing the mortality assumption. The first is to develop a mortality assumption for each claim by putting the insured through an underwriting process to determine their expected longevity. The second is to develop a common mortality assumption that will be used for all claims for a particular trigger. In the second case, the mortality assumption could be guaranteed by the company depending on the level of certainty desired when presenting future accelerated benefits at the point of sale. In my experience, the first method is commonly used for chronic and critical illness triggers, where the mortality expectation for different individuals is less homogenous and pricing to the average could lead to adverse selection in the election of benefits; and the second method is commonly used for terminal illness where very little variation is expected in future longevity. This choice affects the way that potential accelerated benefit amounts are presented at the point of sale, the effort required to adjudicate claims, and the pricing risk assumed by the company.

Claim adjudication involves verifying that the insured qualifies for benefits and calculating the discounted benefit (this process can be automated). Depending on how the mortality assumption is developed, it can also involve underwriting the insured.

Unless the company is willing to guarantee the interest and mortality basis used to calculate discounted accelerated benefits, accurate projections of future accelerated benefits cannot be provided at the point of sale. In general, I do not recommend guaranteeing the basis of values unless the target market will permit a very conservative basis.

<u>Lien Method</u>: Under the lien method, the benefit amount is determined at the point of claim based on a formula determined by the company. A common approach is to define the maximum benefit as 100% of the cash value plus a specified percentage of the net amount at risk that varies based on the qualifying condition (triggers with shorter longevity expectations, such as terminal illness, will specify a relatively high percentage of the net amount at risk and triggers with longer longevity expectations, such as critical illness, will specify a lower percentage of the net amount at risk).

The accelerated benefit is treated as a lien against the policy. An administrative charge ($100 to $250) is typically added to the initial lien. The maximum interest rate for accelerated benefit liens is governed by state law (maximum variable loan rate). Lien based riders typically contain an automatic premium loan provision that allows the policyholder to borrow future premiums.

The residual death benefit is equal to the death benefit of policy less the outstanding lien balance on the date of the insured's death. This generally results in a more favorable residual benefit relative to the discounted benefit approach, but the accelerated benefit amount under the lien

method is typically lower to compensate for this difference. Greater residual benefits can be realized if the policyholder continues to pay premium and/or interest on the lien.

Claim adjudication is limited to verifying that the insured qualifies for benefits and applying the benefit formula to determine the benefit amount.

Given the benefit formula, it is possible to provide accurate projections of future accelerated benefits at the point of sale.

While additional reserves are not typically held for benefits offered using this approach, the portion of the lien in excess of the reserve will be considered a non-admitted asset.

Separate Premium

The second approach is to charge a separate premium for the rider and provide an accelerated benefit equal to the total death benefit of the policy. This method is typically used only with the chronic illness trigger. In general, a separate premium schedule is required for each product with which the rider is available. Under this approach, there should be no ambiguity at the point of sale regarding the amount of future accelerated benefits. Additional reserves (both active life and claim reserves) are typically held under this approach. Depending on the volume of business in force with this type of rider, it might be prudent to include this benefit in the cash flow testing supporting the company's annual asset adequacy opinion.

This approach typically involves additional underwriting that consists primarily of a supplemental application with questions related to ADL deficiency and cognitive impairment.

The separate premium approach generally involves more pricing risk relative to the actuarial equivalence approach as the company will need to lock in an interest rate assumption and make a specific morbidity assumption in addition to a disabled lives mortality assumption. While it is not necessary to guarantee the premium rates (for payment periods other than single premium), adjusting indeterminate premiums or non-guaranteed cost of insurance rates can be difficult without sufficient credible experience data.

Claim adjudication varies greatly depending on whether benefits are conditioned on receiving qualified services and whether benefits are paid as a reimbursement for qualified expenses. In the case where benefits are not conditioned on receiving qualified services, adjudication consists solely of verifying that the insured qualifies for benefits. Otherwise, claim adjudication will also involve verifying services and/or expenses.

Trilogy Actuarial Solutions

Comparison Chart

	Discounted Benefit	Lien Method	Separate Premium
Triggers Covered	Any	Any	Chronic Only
Additional Premium	No	No	Yes
Underwriting	None, Limit Availability (≤T4)	None, Limit Availability (≤T4)	Supplemental Application
Pricing Timing	Time of Claim	Product Development (Benefit Factors)	Product Development (Premium Rates)
Benefit Determination	Lump sum benefit based on actuarial valuation made at time of claim. Cannot be projected accurately without significant contract guarantees.	Lump sum benefit based on specified percentage of cash value and net amount at risk. Can be projected accurately.	Monthly or annual benefit based on specified percentage of death benefit. Can be projected accurately.
Residual Death Benefit	Any death benefit not accelerated.	Death benefit less lien balance. More equitable than discounted benefit.	Any death benefit not accelerated.
Claim Adjudication	Verification that insured meets qualifying conditions. May include assessing expected longevity of based on the severity of the underlying condition.	Verification that insured meets qualifying conditions.	Verification that insured meets qualifying conditions. May also include verifying that qualified services have been received and/or expenses depending on the rider design.
Additional Reserves	None, typically excluded from cash flow testing.	None, typically excluded from cash flow testing.	Additional active life and claim reserves. May include in cash flow testing if volume is sufficient.
Other Capital Considerations	None	Lien balances in excess of the reserve are a non-admitted asset.	None
Equity	Cost paid only by those who elect benefits.	Cost paid only by those who elect benefits.	Cost paid by everyone who elects the rider.

Qualified Long-Term Care Insurance Rider vs. Chronic Illness Accelerated Benefit Rider

The most important and consequential issue related to offering chronic illness benefits is determining whether benefits will be offered via a qualified long-term care insurance rider under IRC §7702B or a chronic illness accelerated benefit rider under IRC §101(g).

Offering this benefit as a qualified long-term care rider offers some pricing and marketing advantages, but these advantages come with a significant cost. This section will present the framework for a cost/benefit analysis of the two approaches. For this section, I will consider only riders with a separate premium as this is typically the only approach used for qualified long-term care insurance riders.

Advantages of Qualified Long-Term Care Insurance Riders

Marketing: These products can be marketed as long-term care insurance; whereas chronic illness accelerated benefit riders cannot.

Availability of Extended Benefits: These products can be combined with an extended benefit rider that provides benefits for a specified period (typically 2 to 5 years) after the death benefit of the original policy has been accelerated. The extended benefit rider is essentially a limited benefit long-term care insurance policy with a long elimination period that is tied to the amount of time that is required to fully accelerate the base policy. Extended benefit riders are subject to all the requirements of long-term care insurance, including the requirement to offer an inflation protection option and an optional nonforfeiture benefit.

Pricing: Premium rates for qualified long-term care insurance riders can be lower than otherwise comparable chronic illness accelerated benefit riders due to two factors. First, the availability of benefits under a qualified long-term care insurance rider is conditioned on receiving qualified services, not just meeting the definition of chronically ill. Second, qualified long-term care insurance riders are permitted to offer benefits on a reimbursement basis, resulting in some salvage value if the benefit limit is high enough to exceed the cost of care in at least some instances. These pricing advantages are coupled with increased claim adjudication requirements.

Monthly Benefits: Qualified long-term care insurance riders can be offered with a monthly benefit schedule (like traditional long-term care insurance policies); unlike chronic illness accelerated benefit riders, which typically require annual benefits.

Limitations of Qualified Long-Term Care Insurance Riders

HIPPA Compliance: Qualified long-term care insurance riders require compliance with HIPPA. I am not an expert on HIPPA, but I understand that HIPPA compliance can require substantial modifications to systems and procedures that are not limited to policies with a qualified long-term care insurance rider.

Pricing Risk: The pricing of qualified long-term care insurance riders, particularly the extension of benefit coverage, contains many of the same risks that have plagued traditional long-term care

insurance pricing. Of particular note is the dependency of pricing on the lapse and benefit utilization assumptions. Both have proved notoriously difficult to predict.

Administrative/Filing Requirements: There are several administrative and filing requirements associated with qualified long-term care insurance riders, including, but not limited to:

- Agent health licensing
- Agent training
- Replacement & lapse reporting
- Claim denial reporting
- Rescission reporting
- Rate filing
- Filing of advertising
- Suitability standards

If a company does not already have a high level of familiarity with long-term care insurance regulation, introducing a qualified long-term care insurance rider could require significant companywide investment in developing this expertise.

Tax Treatment

Accelerated benefits can qualify for favorable tax treatment (i.e., treated as the payment of a death benefit) under IRC §101(g) or §7702B.

Terminal illness benefits can be offered with a very high degree of confidence that benefits will qualify for favorable tax treatment. Nevertheless, it is still prudent for life insurance companies to encourage their policyholders to seek independent tax advice.

The qualification of chronic illness benefit for favorable tax treatment depends on a combination of the qualifying condition and the amount of benefits paid during a tax year. Chronic illness benefit riders can be designed with appropriate benefit triggers; however, since the benefit limits apply across all eligible policies covering the insured, an individual company will not be able to verify compliance with the benefit limits with confidence. As a result, policyholders should always be referred to their personal tax advisor.

In general, critical illness benefits are not expected to qualify for favorable tax treatment.

Illustrations

Many companies provide illustrations of future accelerated benefits as part of their point of sales illustration for the underlying product. This is frequently done via a supplemental illustration that shows illustrated accelerated benefit values on a discrete number of future policy anniversaries. Frequently, the agent can configure the specific anniversaries that are shown in the supplemental illustration.

The nature of the illustration varies based on the benefit structure. In the case of a rider with a separate premium that provides a dollar-for-dollar benefit, the illustrated accelerated benefit is a very simple function of the illustrated death benefit (e.g., annual or monthly benefit equal to a specified percentage of the illustrated death benefit).

In the case of riders that use the lien method, the illustrated accelerated benefit is a simple function of the illustrated cash value and death benefit (e.g., a lump sum benefit equal to 100% of the cash value plus a specified percentage of the net amount at risk).

In the case of riders that use a discounted benefit, the illustrated benefit will depend on whether the accelerated benefit basis has been guaranteed. In the case that the basis has been guaranteed, the illustrated accelerated benefit can be calculated based on the illustrated values and the guaranteed basis. In the case where only the mortality basis has been guaranteed, the illustrated accelerated benefit can be calculated based on illustrated values, the guaranteed mortality basis, and an assumed interest rate (e.g., current maximum loan rate). In the case where the accelerated benefit basis is not guaranteed, illustrated accelerated benefits can be shown for a range of different illness severities from minor (minimum reduction in expected longevity) to severe (significant reduction in expected longevity). Frequently, the minor condition is calibrated so that the illustrated benefit is equal to the cash value and the severe condition is calibrated such that it illustrates a lower benefit than the terminal illness benefit.

Product Chassis

Riders using the actuarial equivalence approach (discounted benefit and lien) are available on the full gamut of life insurance products. The benefit amount, particularly under the chronic and critical illness triggers, can vary significantly based on the underlying product. For example, the accelerated benefit available for a given insured that qualifies for chronic illness benefits will be much lower on a term product compared to a whole life insurance product.

Riders with an additional premium are typically limited to permanent products (traditional and universal life insurance chassis) and are commonly associated with single premium products.

Reinsurance

Before filing and issuing new accelerated benefit riders, companies should notify their current reinsurance partners and seek to have the accelerated benefits covered under the current treaties. Ideally, reinsurance claims will be paid contemporaneous with any accelerated benefit claims. The reinsurer will expect to participate in an equitable sharing of any discounting inherent in an actuarial equivalency approach or any premium charged.

Form Filing

The Interstate Insurance Product Regulation Commission has uniform standards for both accelerated benefit riders and qualified long-term care insurance; however, not all member states have accepted the uniform standards for qualified long-term care insurance.

Conclusion

Companies that are not currently offering accelerated benefits or are interested in expanding the range of accelerated benefits that they offer might consider the following approach.

Start by developing a series of riders using either a discounted or lien-based approach that provide benefits for terminal, chronic, and critical illness. I suggest developing separate riders for each benefit trigger so that the company can control the availability of benefits over time. The initial rollout could be limited to a subset of the currently marketed products (e.g., permanent products with a face amount above a particular threshold) to incentivize specific product sales. The company can expand the availably of the riders to additional plans in the future or attach them to in force life insurance plans as a gesture of good will. Ideally, the attachment of the new riders to in force policies would be done in conjunction with a marketing campaign developed to encourage in force policyholders to increase their life insurance coverage.

Given the significant effort associated with developing a qualified long-term insurance rider, I think that companies without significant long-term care experience are well advised to start with a chronic illness accelerated illness benefit rider. Companies that sell a significant volume of single premium whole life insurance with issue ages between 50 and 75, might consider developing a premium based chronic illness accelerated benefit rider to pair with this product. This approach can provide a low risk case study for ability of the company's distribution systems to sell an accelerated benefit rider with an additional premium. The single premium product is a good choice because it has a lower risk profile due to the lower net amount at risk relative to other products. It may also present the easiest sales proposal. Since many single premium life insurance sales at these issue ages are money purchase sales (i.e., the applicant has a specific amount of money that they would like to transfer from an existing asset such as an annuity, CD, or other life insurance policy), the additional premium for the rider may not be a significant factor. The presentation might be as simple as "here is the death benefit that your premium can purchase with a chronic illness accelerated benefit and here is the death benefit that your premium can purchase without a chronic illness accelerated benefit". If there is a significant election rate of the chronic illness accelerated benefit rider with the single premium whole life, consideration might be given to extending this benefit to other products. If the trend continues, you might even consider offering qualified long-term care insurance riders.

Trilogy Actuarial Solutions

Trilogy Actuarial Solutions LLC

Let us help you expand your portfolio of accelerated benefit riders by contacting us for a free initial consultation. You may contact us by phone, email, or through our website. We would be happy to schedule a time to review your situation and collect the information that we need to develop a specific proposal at no expense or obligation to you.

Email: douglas.brown@trilogyactuarial.com

Telephone: (346) 348-2757

Website: www.trilogyactuarial.com

LinkedIn: www.linkedin.com/in/douglas-brown-93725311