The Evolution of Living Benefits Riders

The concept of accelerated death benefits (ADB) for life insurance is not new. ADB riders have been available on the market since the late 1980s. However, the triggers for these benefits generally were very limited with early payout only available to insureds diagnosed with a terminal illness with no more than 12 months to live.

Now carriers are loosening the qualifications needed to receive accelerated benefit payouts. Benefit triggers are attached not only to imminent death but also to financial need due to chronic illness. This trend is driven in part by growing interest and demand among Baby Boomers for living benefits riders to provide financial protection against illness and the cost of care while surviving to an older age.

To address these needs more life insurers are adding riders to their existing products, usually permanent products. In previous issues of The Messenger we have discussed the evolution of life/long-term-care (LTC) “combo” products. In this article we examine two living benefits riders, particularly features of the chronic illness riders, and the role reinsurers can play in helping carriers manage the emerging risk.

Critical Illness Riders

Critical illness (CI) risk is familiar territory for many life insurers, though demand for standalone policies in the US remains low. Freestanding CI policies pay a stipulated benefit if the insured is diagnosed with a covered illness, such as stroke, cancer or heart attack. The risk of imminent death need not be present.

The critical illness rider behaves like a standalone CI product. If the insured is diagnosed with a covered ailment, they can claim a portion of the life insurance policy’s death benefits. The insured need not be diagnosed as terminal. Underwriting for such a rider follows similar processes and procedures as those used to assess risk for critical illness policies.

Filing a claim is fairly cut and dried: a licensed physician presents the diagnosis, which the insured then files with the insurer to claim the benefit. Risks of moral hazard or fraud are therefore controlled.

Chronic Illness Riders

We typically define “chronic illness” in terms of the insured’s inability to perform activities of daily living (ADLs). If the insured is unable to perform two or more ADLs, they are considered as chronically ill. In this sense, the chronic illness rider resembles an LTC rider.

However, prominent differences exist between chronic illness and LTC riders. LTC usually requires proof of assisted living care (inhouse or an institution). Chronic illness riders do not require any administration of care. Additionally, LTC
products and riders generally contain reimbursement provisions tied directly to care costs.

In contrast, once the insured satisfies the conditions of the chronic illness rider, they may claim the benefit. The rider benefit is not dependent on the cost of care, but rather is a stated amount up to the total death benefit. Even if the insured qualifies, they may choose not to receive the living benefit, especially if the death benefit is important in the insured's financial planning and they have other sources of funding.

Key Design Considerations
Companies are responding to consumer needs through these riders by offering features that provide consumer flexibility, while implementing tools to manage the risk.

Benefits structure. Carriers are structuring chronic illness living benefits in three ways:

- **Discounted death benefit.** The rider may stipulate that the chronic illness benefit is equal to the policy death benefit, discounted for time-value of money and forfeited future premiums.
- **Policy lien.** The insurer may treat the benefit paid as a loan against the policy’s underlying death benefit. In addition to paying premiums for the underlying policy, the insurer expects the insured to begin repayment of the loan similar to a standard policy loan provision. The carrier discounts any outstanding principal from the policy’s death benefits if the insured dies before the loan is repaid.
- **Rider premium.** The policyowner pays an additional premium for the chronic illness rider to accelerate the death benefits payment.

Figure 1 presents an example of a male policyowner-insured, aged 70, under each of the scenarios.

**Figure 1 - Benefits Structure**

<table>
<thead>
<tr>
<th>Premium</th>
<th>Discounted Death Benefit</th>
<th>Policy Lien</th>
<th>Rider Premium</th>
</tr>
</thead>
<tbody>
<tr>
<td>Rider Benefit at Time of Claim (Age 83)</td>
<td>Standard premium for underlying policy</td>
<td>Standard premium for underlying policy</td>
<td>Standard premium for underlying policy, plus premium for Chronic Illness Rider</td>
</tr>
<tr>
<td>$300,000/year ($1m <em>.025</em>12), until discounted death benefit is depleted</td>
<td>$300,000/year, until the death benefit is reached</td>
<td>$300,000/year or IRS maximum LTC per diem disbursement, whichever is less, until death benefit is depleted</td>
<td></td>
</tr>
<tr>
<td>Repayment schedule</td>
<td>Policies with such riders usually include a waiver-of-premium (WP) provision, triggered by the first disbursement; no repayment</td>
<td>Continued premium payment (unless WP provision, then zero). Will be required to repay loan according to repayment schedule</td>
<td>Policies with such riders usually include a WP provision, triggered by the first disbursement; no repayment</td>
</tr>
<tr>
<td>Resulting Death Benefits</td>
<td>Any remaining face amount available at time of death</td>
<td>The life insurance policy’s death benefit, less outstanding loan principal</td>
<td>Any remaining face amount available at time of death</td>
</tr>
</tbody>
</table>

**Tax Considerations for Benefits.** Living benefits from a chronic illness rider are tax-free, up to a limit stipulated by Internal Revenue Code (IRC) (Figure 2). Benefits in excess of this amount are treated as ordinary income. IRC 101(g) defines accelerated benefits for the purpose of favorable tax treatment. This section defers to IRC 7702B (which covers long-term care insurance) to determine events which may trigger a claim.

IRC 7702B(d)(4) stipulates the maximum per diem benefit payable from chronic illness riders without causing a taxable event. This maximum for 2013 is $320 a day, or $116,800 per year. This amount may be less than the benefit stated in the rider. As a result, many carriers allow insureds to claim the IRS maximum per diem to avoid income tax. This can be an important feature for estate-planning purposes.

**Controlling for Selection.** Product features that provide access to funds before death introduce the risk of adverse consumer behavior. Carriers can take steps in structuring the rider to help mitigate some of these risks. Some of these features include:

- Developing a separate application for the rider to address morbidity-related adverse selection
- Requiring documented proof from a licensed care practitioner before benefits will be paid
- Using the lien or rider premium versus discounted death benefit approach to delivering benefits
- Specifying maximum benefits and/or minimum age for benefits to be released
- Itemizing and disqualifying specific factors contributing to the impairment (e.g., self-inflicted injuries, alcohol/drug abuse, etc.)
- Requiring documentation that the inability to perform an ADL is deemed permanent
- Requiring annual recertification of impairment, possibly at the policyowner’s expense
The Role of Reinsurers

As primary life insurers continue to develop living benefit riders, reinsurers can be a valuable source of feedback in product design, pricing and ultimately participation on the risk.

At SCOR, we have conducted substantial research, on our own and with major actuarial consultants, to develop our understanding of these new accelerated death benefit riders. We have participated on the risk on a number of these products. We have reviewed policies from each of the funding methods (discounted death benefit, lien, rider). Depending on the client’s request, we reinsure the underlying policy death benefit, the rider benefit or both.

If you would like to know more about how to approach this growing market, please contact your account executive.

---

**Figure 2 - The Effects of IRS Maximum Per Diem Allowable (Illustrative)**

<table>
<thead>
<tr>
<th>Age</th>
<th>Stated Accelerated Benefit</th>
<th>IRC 7702B LTC Allowable Per Diem (Annualized)</th>
<th>Accelerated Benefit Paid</th>
<th>Face Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>83</td>
<td>$300,000</td>
<td>$116,800</td>
<td>$116,800</td>
<td>$883,200</td>
</tr>
<tr>
<td>84</td>
<td>$300,000</td>
<td>$116,800</td>
<td>$116,800</td>
<td>$766,400</td>
</tr>
<tr>
<td>85</td>
<td>$300,000</td>
<td>$116,800</td>
<td>$116,800</td>
<td>$649,600</td>
</tr>
<tr>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
<td>...</td>
</tr>
<tr>
<td>90</td>
<td>$300,000</td>
<td>$116,800</td>
<td>$116,800</td>
<td>$65,600</td>
</tr>
<tr>
<td>91</td>
<td>$65,600</td>
<td>$116,800</td>
<td>$65,600</td>
<td>-0-</td>
</tr>
</tbody>
</table>

The maximum tax-free benefit payable in this example is the lower of the accelerated benefit ($300,000) or the maximum LTC benefit per Internal Revenue Code for the benefit year ($320/day, or $116,800 annually for 2013). This amount is adjusted annually for inflation; we have assumed zero growth in this illustration.