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Understanding Linked- Benefit and Hybrid Products And Their Role in Long-term Care Planning

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There is a growing discussion among long-term care professionals about the viability of so- called Hybrid plans and their appropriate use… if any. The advocates believe that there is a definable place for the concept and that the increase in use of these products is inevitable and in fact, quite appropriate. Some even say, they will take over the marketplace and the vast majority of insurance purchases to address the cost of long-term care will be life insurance based.

The following is my take on this product concept as we developed it in 1987 in association with the management of First Penn-Pacific Life, at the time a subsidiary of Lincoln Financial Group. It is written from the perspective of the salesman on the street responding to the needs and desires of a segment of the customer base. Fortunately, the leadership and the actuaries in the company were willing to listen and understand the "street's" perspective and develop a product concept based on what the consumer wanted to buy.

Some company people may disagree with my perception of the actions that have been taken during the development years of this product, or the reasons or motivations for certain modifications over time. But regardless of perspective, we are where we are today because of a continuous collaboration between home offices and the field; a rarity in our industry.

To understand this issue further it is important that we define our terms. The conventional policies are those that have grown up out of the health insurance or disability model. They are typical insurance polices that offer a basket of benefits and a criteria for how and when one can claim them. If the specified circumstances never occur, that is, the need for care under the policy definition never materializes, then no benefits will be paid and the premiums shall remain with the carrier.

The term Linked Benefit shall refer to life insurance policies qualified under IRS code section 7702(B) to provide actual long-term care insurance benefits as well as life insurance. Most of these are "packaged" to define the manner in which they are purchased, such as with a single premium deposit, or specified multiple premiums.

Often they have a money back guarantee when purchased with a single premium and typically, there is a rider available that extends the benefit (Extension of Benefits Rider) once all of the life insurance benefit has been distributed for long-term care cost reimbursement. These riders can double or triple the size of the death benefit available to pay long-term care costs. Even lifetime benefits are available, but as I write this, those are being severely modified or even withdrawn due the pricing challenges created by the high incidence of claims and the current low interest rate environment.

The term Hybrid plans refer to those life insurance products sold with accelerated benefit riders and qualified under section 101(g) of the code. These riders allow for the acceleration of the death benefit in the event of Critical Illness, Chronic Illness and Terminal Illness. Their indemnity benefits are paid from the death benefit in lump sum or in monthly payments. The Critical illness rider is triggered when a specific illness such as heart disease, kidney disease, cancer and other such condition has been diagnosed. Chronic Illness is triggered using the same ADL or cognitive impairment requirements as long-term care insurance policies. And, Terminal illness is usually defined as the insured being diagnosed with life expectancy of less than one or two years. These policies would pay all or a portion of the death benefit when a claim is approved but do not offer additional riders to extend the benefits payable past the life insurance face value.

The basic premise of this paper is that any and all of these products are legitimate responses to the risk of someday needing long-term care. For the sake of brevity this paper will not discuss specific benefits available with conventional policies as they are already the primary product that advisors and other readers know and understand. The purpose here is to put the linked benefit and Hybrid plans into context as to why they may be considered as a viable alternative to the conventional plans.

As with any financial product, one must evaluate traditional long term care products in the context of the issues they are intended to address. Long-term-care benefits more closely resemble disability income than they do medical insurance. Whether indemnity or reimbursement, the benefits are received in the form of tax free income payments designed to pay all or a portion of the monthly cost of nursing care. Unlike insuring a house for fire or a car for an accident or most other high-risk items, convalescent care is a much bigger unknown and sold differently. At least we know about how much it costs to replace a car or to rebuild a house from a fire and each year the insurance company reevaluates its risk and modifies your premium accordingly. However, in the case of convalescent care, the insurance company must determine the odds of you ever needing care in the future based on what it can find out about you today in a process called underwriting. Nobody really knows, where the care will take place, what kind of care or how long the care will be needed or when or if it will be needed at all. All we know is that if it is needed, your income needs will increase measurably. However, even with the substantial risk; most people choose to deny that it will ever be a problem to them or if it does become a problem, then they will just take care of it at the time. In addition, most people don't like to purchase insurance they cannot imagine ever needing to use.

So if we assume; 1) that a significant number of people reject the idea of needing insurance for this risk, or 2) they resist it by rationalizing that they can self-insure, and 3) that what we are really trying to accomplish is to assure that their income will rise significantly in the case of a long-term care event, then Linked-Benefit and Hybrid plans become a viable option for them. To "self-insure" assumes that one has money invested somewhere and assuming it will either be used to pay for care or, if not needed, eventually pass to the heirs. The Linked-Benefit life insurance policy is simply presented as a better place to store a portion of that same invested money safely, just like any other available "safe money" investment option.

Linked Benefit Policies

The original versions of the linked benefit concept were marketed as single premium life insurance policies with accelerated benefit riders that allowed the carrier to pay some portion of the death benefit each month to reimburse the cost for a nursing home stay. They had no legitimacy in the tax code and it was assumed that there was a 50/50 chance the benefits would be received tax-free. Money deposited into the policy created a cash value, but it would typically take 2-4 years before the client could surrender the contract for 100% of the deposit. Still, the product sold well as people with sufficient resources recognized that the strategy accomplished several objectives at once;

- It was a safe place to store some of their cash savings.
- It grew their savings somewhat after a couple years.
- It provided a logical solution to the long-term care concern.
- It paid their heirs a significant tax-free return if not needed for long-term care.
- Never a "use it or lose it" scenario

Once it was clear that the concept would sell, the carriers began to fine-tune it to remove as many objections as possible. Other forms of care were soon added to the benefit list; home care, assisted living and others.

Experience confirmed that money "deposited" into the cash value of these policies was idle and clients didn't withdraw or borrow it or ever cancel the policies. So it was determined that the surrender charges had limited utility and riders were created to provide a money-back guarantee. And when the HIPPA legislation passed that determined what would qualify an LTCi product to pay its benefit tax free, the Linked-Benefit carriers modified their products to comply and the legislation was written to include long-term care riders on life insurance policies as tax-free benefits.

Rather than embrace these products as viable additional tools to help clients deal with long-term care, LTCi specialists chose to compete against them claiming they did not have sufficient features and benefits. So instead of offering something that appealed to a segment of their market, they went away empty handed. They had no sale and the clients had no strategy to eventually pay for their care someday.

But the product was embraced by financial planners, stockbrokers and bank financial advisors. Their clients (many of them) had money they could allocate to these products, and they liked the idea that they could reallocate a portion of their assets by "depositing" cash with the insurance company and receiving a commitment for the LTCi benefits if needed. While the conventional industry flailed around trying to outdo one another with clever "bells and whistles" to differentiate their products, a couple of life carriers simply took a product they had been selling for decades and tweaked it slightly to pay some of their insureds a little sooner than normal…for long-term care. No rate increases and few (if any) denied claims…after all, why deny a claim today that will be paid later anyway when the insured dies?

After all, while conventional products were constantly being reviewed, re-priced and reconstructed to try to address the higher than expected claims rates, the simplicity of Linked-Benefit continued to prove it's viability for those who could see its value. After all, Life Insurance is the only insurance policy that is designed and priced to eventually pay a claim on every policy kept in force.

The key to the linked benefit product is the assumption under which it is applied.

- First, the issue being addressed: long-term care really means that the cost of living increases substantially when one requires someone to assist them with normal activities of daily living,
- Second, the action to be taken: even if you have sufficient resources to pay the bills yourself, the high incidence of usage simply makes it a wise idea to have a strategy in place to provide that extra income.

When a client can accept these two premises, we can get past the "I won't need care and even if I do, I have plenty of money to pay for it (and I know I won't need to)." Now we can get on with the strategy. Everyone will buy long-term care insurance if they don't have to pay for it.

1. For those who insist that they can self-insure, life insurance is a natural extension of that approach since the money to do so must reside somewhere.
2. Linked-Benefit policies paid with a single premium have a money back guarantee; so the client's premium "investment" never leaves the balance sheet.
    a. The client simply repositions some savings to the insurance contract and the carrier will credit sufficient interest to cover the mortality cost of the life insurance benefit and the morbidity cost of the income benefits if needed for long-term care.
    b. If never needed then the heirs will receive a tax-free lump sum death benefit representing a reasonable return on the money that has been "on deposit" in the insurance policy.
3. Life insurance contains cash value even when purchasing with annual premiums; so unlike conventional policies this cash value can be used to continue insurance in force for several years if paying premiums ever becomes a problem.
4. Life insurance will pay its benefits whether or not long-term care is ever needed or regardless of how short a claim may be; so the ultimate minimum benefit is always known from the outset.
5. Most Linked-Benefit policies acquired with a single premium are 100% guaranteed. The premiums will never increase, the benefits will never reduce and the customer can opt out and receive all of his money back at any time.
6. Linked benefit products allow for a variety of benefit options including the same cost-of-living increase options available in conventional products.
7. Life insurance is the only insurance product designed to pay benefits on each policy that is kept in force. Therefore, the pricing is more in line with the heavy claims that LTCi experiences.

This is all presented as a repositioning of some of the funds that currently reside in a bank, or bonds, or stocks or some other financial instrument.

It is simply being transferred into the insurance policy with a money back guarantee. Therefore it is not spent and its value remains on the balance sheet. At any time, the client can take their money back although historically they have chosen not to do so since the money in these policies typically earns higher interest than other safe money options. Currently it's earning 3% to 4% (without tax) and used to purchase potentially valuable LTC benefits that are also tax-free; and if not needed for LTCi, it will deliver a fair return, also tax-free, to the heirs.

Hybrid Policies

After almost 25 years of virtually no competition the handful of carriers selling Linked-Benefit products are finally facing some competition. And the sheer volume of new participants has finally garnered the attention of the life and LTCi sales force.

"Hybrid" policies are conventional Whole Life and Universal Life (fixed, variable and Index) that have accelerated benefit riders attached that allow the company to pay their death benefits early if the insured has a chronic condition that requires convalescent care. They generally use the same definitions (ADLs and Cognitive Impairment) as the conventional LTCi policies and Linked-Benefit products but qualify for tax-free treatment under the life/disability section of the IRS code.

These products are not constructed specifically as a long-term care strategy and cannot be referred to as long-term care policies. Rather, they are regular life insurance policies with the accelerated benefits added to increase salability. The riders accelerate the death benefit for Chronic Care and many include Critical Care and Terminal Illness. In some cases the entire benefit will be paid in lump sum and in others, a monthly, quarterly or semiannual income. But in all cases they pay an indemnity benefit; that is, "prove you have a legitimate claim and we will pay you cash benefits under the terms of the policy". No need to reimburse for expenses.

A word about the Indemnity approach to claims vs. reimbursement:

While anticipating a predetermined amount of money regardless of the claim sounds better than having to submit bills each month for qualified services, the extra cost probably is not worth it…especially when dealing with Linked-Benefit and hybrid policies.

It costs more (sometimes much more) to purchase an indemnity (cash) payment vs. reimbursement. You are paying for a "convenience factor" at time of claim and there is a 50/50 chance that the claim will last only a couple of months or not materialize at all. If that is the case, you have paid extra for little or no benefit. The real reason for doing this is that once a claim is filed, you will be paid the full benefit each month regardless of how much you spend on care. This is perceived as increasing the likelihood that the maximum possible benefit will be realized out of the policy. That is true but then, you paid more to begin with.

When dealing with a Hybrid or Linked-Benefit policy, the value of the indemnity payment almost becomes moot. Since we know at the outset that the policy will eventually pay out the total death benefit (assuming you selected wisely). All the indemnity approach accomplishes is to save someone some paperwork….and even then, only in about half the cases. Yet we might see as much as a 10% difference in the benefit, given a specific premium.

Some riders require that the chronic condition be permanent for payment.

These riders are constructed to pay benefits in several different ways and benefits vary greatly from product to product. Some make no additional charge for the rider, but the benefit will vary depending on the cause if the claim. In some cases the age of the insured at the time of claim will determine the percentage of the face value that may be accelerated. Some policies charge for the accelerated benefit at time of claim by reducing the ultimate death benefit and some charge an extra cost monthly from the cash value, but guarantee to accelerate the total death benefit.

These products are becoming favorites of some large sales forces that are replacing older life insurance policies with new ones that allow greater claimability for the insured. Why would anyone want to continue to pay for a life insurance policy that only pays when the insured dies, when they could have one that allows the insured to access some or all of the death benefit for money to pay for cancer treatment (Critical Care) or home care (Chronic Care) or receive the lion's share of the death benefit when they become terminally ill.

From the perspective of the long-term care professional looking to provide the best, most appealing solution to their LTCi prospects, the Hybrid has a great potential to significantly increase their success ratio. Consider the client who will not purchase a Linked-Benefit product with a lump sum but now we can offer alternatives that require only an annual premium.

In this scenario he has two options;

- The first is to "rent" a conventional long-term care policy by paying premiums each year; but he has no guarantee they will not increase over time. He knows he has secured LTCi benefits that will provide the greatest amount of benefit per dollar of premium if a serious long-term care event occurs; but that may never be needed at all. And even if he makes a claim, will it last long enough to recover the years of premium payments he has made?
- The second is to "invest" in a strategy to create a lump sum of money that will be significant enough to mitigate the financial impact of a long-term care event. If long-term care is needed, the "investment" is "self-completing" by making the death benefit available to apply to the cost of care. If LTC is never needed (or needed only briefly), the premiums invested in the contract will "self-complete" when the insured dies and pay the death benefit, tax-free to the heirs.

Clearly the "renting" of insurance in this context is preferable if the client can handle the rate increase risk, and particularly if an extended long-term care episode occurs. Unfortunately, many prospective purchasers cannot bring themselves to adopt that approach. But when the excuse of not needing care is taken away by the concept of always realizing a return on the premiums "invested", many otherwise recalcitrant prospects can be turned into clients and become much better prepared for a long-term care event.

There are many such Chronic Care riders available now and more on the way. You must be very careful to understand when and how their benefits are paid. We have found one or two carriers that consistently offer a competitive product and a couple Linked-Benefit products actually provide a true LTCi benefit with extension riders while offering annual premium funding options. These tend to have the best cost/benefit proposition.

In Conclusion:

Our firm, Westland Financial Services, is an insurance advisory that has specialized for over 30 years providing honest, unbiased information and advice to insurance agents, financial planners and other professionals charged with addressing these issues with their clients. We operate as a Brokerage General Agent for insurance but our approach is much different than many in our business. We focus on the issues to be addressed then, from top-tier carriers, we determine the very best quality products and most appropriate solutions. And when the appropriate product or solutions don't exist, we design and create our own, as in the case with the Linked-Benefit and Hybrid Life products over 25 years ago.

No one solution is best for all cases. When dealing with the LTCi issues, the objective is to provide a strategy that will advance the solution that works for the client. It is our opinion that no true financial professional should take a position that the Linked-Benefit or the conventional products are the best. They both have their place and there are copious ways to employ them to work best in the clients' circumstances. I trust this has provided the reader with a basic understanding of these issues as the products have been developed and successfully marketed for over 25 years.

We welcome inquiries about specific products as we are a premier source for almost all of them. If you would like a matrix of the top 20 products, illustrations for your clients, or be added to "Pearls" our periodic newsletter that keeps you current on all of the issues and concepts you need to know to be the best when recommending insurance, simply call Peggy at (800)238-8144 or email us at info@westlandinc.com.

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