LTCi Summit

LTC Combo Products: What's Coming Because of New Tax Laws

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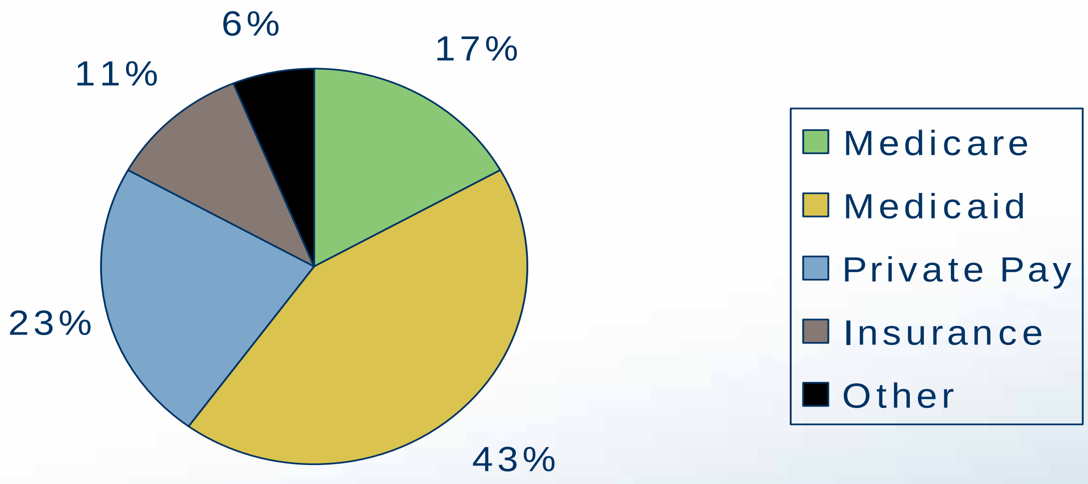
Long-Term Care Insurance

- Lessons from the past: Stand-alone plans
  - Tremendous market need
  - Stand-alone product configurations mandated by regulations that create paths to failure
  - Pricing challenges with level unisex premiums that contrast with steep claim cost curves that vary by sex, low lapses, and low interest rate environment

Long-Term Care Insurance

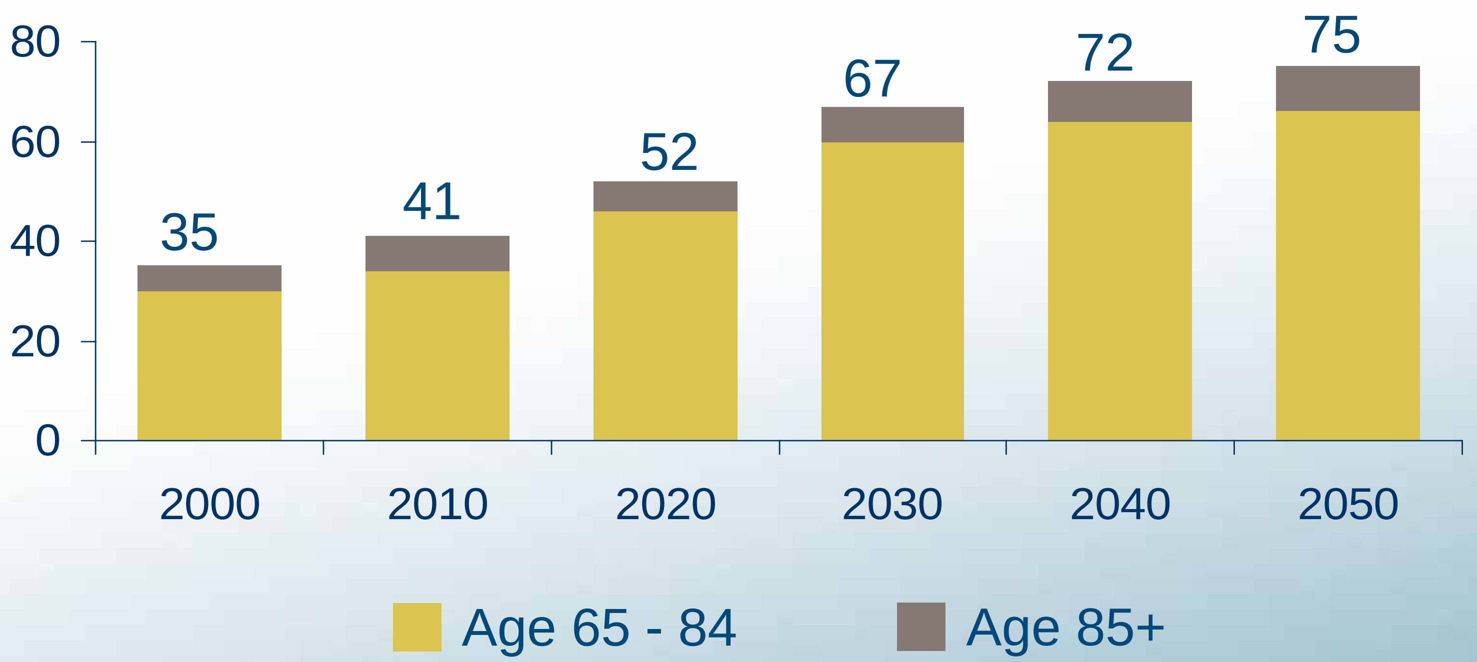
- A change for the future: Combination plans
  - Many flavors of benefits
  - Marketing synergies in coupling base plan cash values with LTC riders
  - Pricing synergies in coupling lapse supported products with persistency supported products
  - Pension Protection Act of 2006 and new incentives for Combo plans
  - Life/LTC combos expected to grow substantially
  - Annuity/LTC combos expected to be even bigger

LTC Market Needs



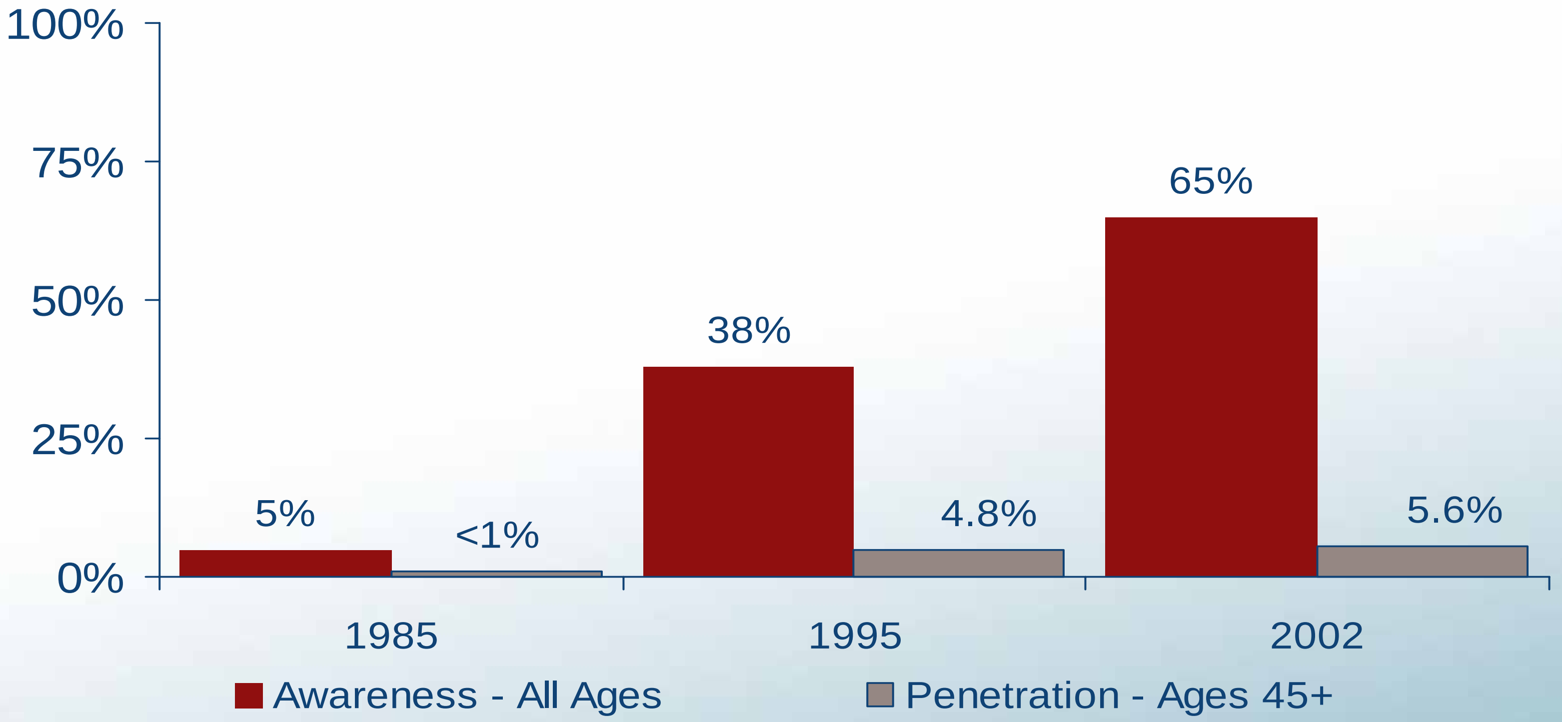
Average 2006 semi-private nursing home room costs - $183 per day
Average 2006 private nursing home room costs - $206 per day
(per 2006 Met Life survey)

The Opportunity
Compelling Demographics



Source: Bureau of the Census, Elderly Population Will More Than Double by 2040, January 2000.
Source: Long-Term Care. AHRQ Focus on Research. AHRQ Pub. No. 02-M028, March 2002. Agency for Healthcare.
Research and Quality, Rockville, MD. Graph

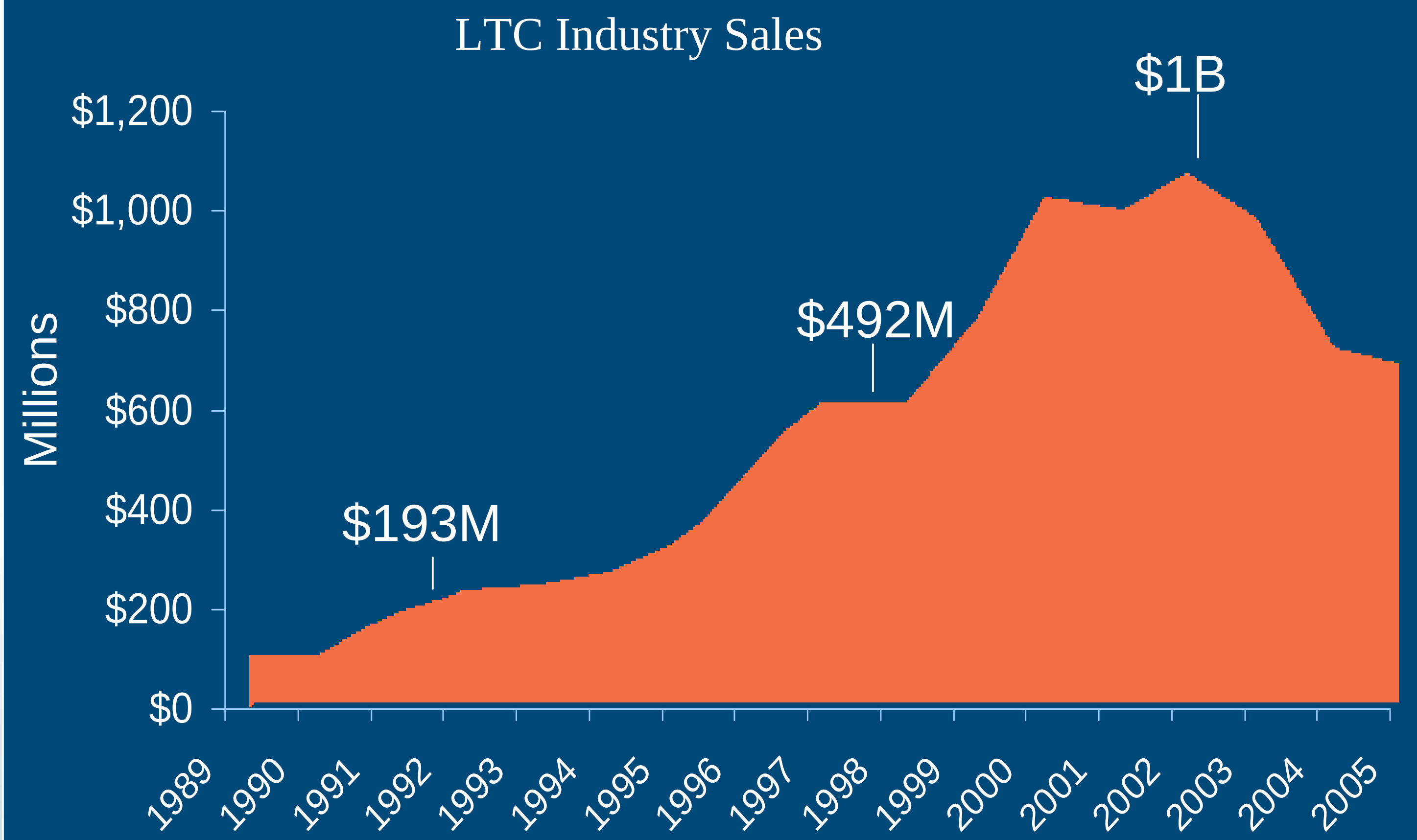
The Opportunity
Low Market Penetration for LTCI



Source: Statistical Abstract of the U.S., U.S. Census Bureau, ACLI, HIAA, Life Plans, Inc., JH Analysis.

What's Happened to Sales?

Industry sales peak at $1 Billion in 2002 and drop to $661 in 2005.



Source: LIMRA

2006 Sales Characteristics

2007 Broker World Survey

- Sales: $565 Million (2006) Vs. $611 Million (2005) – 7.5% Decrease
- Comprehensive Coverage (91.9%)
- Tax-Qualified (98.2%)
- Average Issue Age 58.0 (vs. 58.6 in 2005)
- 47.6% Compound Inflation Protection, 19.4% Simple Inflation, 12.6% Future Purchase Option, 14.3% no inflation
- 19.8% Lifetime Benefit Period (down from 33.2% in 2004)
- 76.4% 90+ Day Elimination Periods (up from 70.6% in 2004)
- 12.6% of sales in multi-life situations

Why the Turmoil?

- Companies leaving the market
  - Lapse rates - very low - <2%
  - Interest rates - dropped - <6%
  - Mortality - extremely low
  - Morbidity - claims quite close
- Producer dissatisfaction
  - Rate increase activity
  - Fewer company choices
  - Product complexity
  - Rates on new products 25% to 40% above levels available five years ago
- Consumers “put off by the price tag of stand-alone LTC product” (2007 LIMRA survey)

Background – Hybrid Life/LTC Plans

- Hybrid plans generally have a component that draws down remaining base plan values (death benefits and cash values) to pay for Accelerated Death Benefit (ADB) LTC coverage
  - Represents a form of self-insurance
  - Can be complemented with Extension of Benefit (EOB) that extends the period of coverage
  - Inflation Benefit provisions can add additional layers of independent LTC coverage

Background – Hybrid Life/LTC Plans

- Hybrid life/LTC coverages beginning a period of expansion
  - Companies willing to gain experience through reduced risk plans
  - Companies see the market opportunity
  - Significant product development activity in the works
- Interesting new annuity/LTC combinations appearing, with more in development due to new tax law changes

UL LTC Accelerated Benefit and Extension of Benefit Design Considerations

- Product Rationale
  - LTCI needs tend to rise as need for life protection is diminishing
  - Cost of LTC accelerated death benefits (ADB) is greatly reduced from cost of stand-alone LTCI
  - Combination plans pay whether LTC needed, LTC not needed and death occurs, or LTC not needed and policy is surrendered
    - Asset re-positioning theme: Return assets, a multiple of assets (DB), or a multiple of DB (EOB)
    - LIMRA focus groups in 2007 highlighted attractiveness of combos that “get consumers something for their premiums”

UL LTC Accelerated Benefit and Extension of Benefit Design Considerations

- Product Rationale
  - ADB charge structure typically YRT per thousand of NAR, and may be sex-distinct, so reduced risk to company
  - Inflation option rounds out the coverage and addresses the comprehensive LTC needs
  - Producer without an LTC policy in his portfolio can protect his clients by offering a hybrid product solution, even if only ADB

Who Buys Combo Life Plans

- Client Profile
  - Age 55-80, retired or close to retirement
  - Generally optimistic about the future
    - Doesn’t think long term care will be needed
  - Recognizes that long term care (LTC) should be included in financial and retirement planning
    - Need for long term care is too great and the cost is too high to ignore
    - Medicare and Medicaid are not suitable options
    - Likes the idea of LTC in insurance package where, if LTC not needed, cash values are provided

Who Buys Combo Life Plans

- Client Assets
  - Invested assets ≥ $300,000
    - Not including home and qualified plan assets
  - Currently self-insuring the risk of long term care
  - Asset-based LTC solution is attractive alternative
    - Covers the need for LTC benefits
    - If LTC benefits are not needed, a death benefit amount is available for beneficiaries
    - Surrender value available

UL LTC Accelerated Benefit and Extension of Benefit Design Considerations

- Tax considerations
  - To date, most companies assumed that LTC charges were treated as distributions from the life policy
    - Private letter ruling by IRS determined as such on one design over ten years ago
    - “Separate contract” argument
    - Potentially taxable
    - 1099’s
    - But no cash being sent to the insured
  - Some companies argued that these were not distributions under certain designs

UL LTC Accelerated Benefit and Extension of Benefit Design Considerations

- Tax considerations
  - Treatment of LTC "portion" as a separate contract allows Code Section 7702B qualification rules to apply to LTC rider
    - Thus cash value under life insurance contract, as well as the "pure" LTC insurance benefits, can be paid as tax-free QLTC benefits if the rider meets TQ requirements
  - Alternatively, LTC accelerated benefits may be deemed to be tax-free death benefits per Code Section 101(g) if payable for chronically insureds and meeting other regulatory requirements
  - LTC riders are not listed as Qualified Additional Benefits (QAB's) under 7702
    - Thus not considered in calculation of Guideline premiums, 7 pay, or Cash Value Tests

UL LTC Accelerated Benefit and Extension of Benefit Design Considerations

- Implications of no increase to Guideline Single Premiums
  - Maximum single premium allowed is enough to cover the cost of life insurance, usually with some margin due to current interest and COI’s
  - May not be enough to fund LTC for richer LTC designs
  - Alternative is CVAT test, which force up DB’s even more than GPT tests
- Implications of no increase to Guideline Level Premiums
  - Generally this washes out as the charge for LTC serves as a reduction to the paid premiums which are measured against guideline premium limits
  - Some timing issues may cause minor problems
- Much of the business is single premium sales

Minimum Ratios of DB to CV (80 CSO 3%)

CVAT Test				
Age	*Female Non-smoker*	*Female Smoker*	*Male Non-smoker*	*Male Smoker*
50	2.34	2.17	2.13	1.88
60	1.85	1.76	1.70	1.55
70	1.49	1.45	1.40	1.32
80	1.26	1.23	1.21	1.19
90	1.12	1.12	1.11	1.11
GPT Test				
Age	*Female Non-smoker*	*Female Smoker*	*Male Non-smoker*	*Male Smoker*
50	1.85	1.85	1.85	1.85
60	1.30	1.30	1.30	1.30
70	1.15	1.15	1.15	1.15
80	1.05	1.05	1.05	1.05
90	1.05	1.05	1.05	1.05

Minimum Ratios of DB to CV (2001 CSO 3%)

CVAT Test				
Age	*Female Non-smoker*	*Female Smoker*	*Male Non-smoker*	*Male Smoker*
50	2.54	2.19	2.33	2.06
60	2.00	1.77	1.83	1.67
70	1.61	1.48	1.49	1.40
80	1.35	1.28	1.26	1.23
90	1.18	1.16	1.14	1.12
GPT Test				
Age	*Female Non-smoker*	*Female Smoker*	*Male Non-smoker*	*Male Smoker*
50	1.85	1.85	1.85	1.85
60	1.30	1.30	1.30	1.30
70	1.15	1.15	1.15	1.15
80	1.05	1.05	1.05	1.05
90	1.05	1.05	1.05	1.05

New Legislation: Overview

- Pension Protection Act of 2006
- Amends some rules for LTC / life insurance combination products
- Amends rules for tax-free exchanges
- Allows LTC / annuity combination products
- Amends “DAC tax” rules
- Imposes reporting requirements
- Delayed effective date for most of the new rules

2006 Pension Protection Act (PPA) Changes: Impact on Life/LTC Combos

	Prior Law	Under PPA
Benefits	*LTC benefits tax-free if they qualify under 7702B or 101(g)*	*Same*
Tax Treatment of charges	*LTC rider charges treated as distributions. MEC contracts treated as gain first (Retro to 1996). Rider not a QAB.*	*LTC rider charges still distributions, but not taxable; however, they reduce basis in the life contract. Rider not a QAB.*
1035 Exchanges	*Tax treatment of transaction unclear*	*Allowed*

- Annuity/LTC Combination Products

Annuity/LTC Product Variations

- Deferred annuities
  - Design one: Payout of Account Value without Surrender Charge during first 2 to 5 years of LTC, with extension of benefits after that
  - Design two: Independent payment of benefits into AV
  - Either features monthly pay-outs tied to the account value at the time of initial claim
- Immediate annuities
  - Enhanced pay-outs when LTC trigger met
- All feature charge structures that are typically level amounts, in basis points, against account values

Consumer and Company Benefits

- Deferred annuity, first design:
  - Waiver of SC modest cost to company
  - Extension of coverage addresses full LTC need, with a long elimination period
  - Package still less risky than stand-alone LTC
  - Cost of LTC benefits still less expensive than stand-alone coverage
  - Pricing synergies between annuity and LTC
- Deferred annuity, second design:
  - No “self insurance” as in first design, but cost of LTC benefits can be kept down through extended waiting period
  - The biggest benefit to waiting period is to reduce anti-selection with limited underwriting

Regulatory Environment

- Requirements for riders that are clearly intended as LTC are less clear than in the life combo arena, but generally similar treatment as for life-based ADB and EOB provisions

- Since annuity-based benefits are based on account values, inflation protection is sometimes addressed in annuity combos by an offer to allow the policyholder to pour in more premium on an annual basis such that cash values increase by 5% or more

Underwriting/Marketing Challenges

- More challenging to impose traditional LTC underwriting on annuities than on life
- Distribution outlets
  - Differing acceptance levels for complex underwriting
  - Teleunderwriting emerging
- Simplicity may be very important in early sales, per LIMRA survey
  - Simplified sales concepts and presentations
  - Carrier reputation important
  - Suitability
  - Training and home office support

Who Buys Combo Annuity Plans

- Client Profile
  - Age 55-80, retired or close to retirement
  - Generally optimistic about the future
    - Doesn’t think long term care will be needed
  - Recognizes that long term care (LTC) should be included in financial and retirement planning
    - Need for long term care is too great and the cost is too high to ignore
    - Because Medicare and Medicaid are not suitable options
    - Likes the idea of LTC in insurance package where, if LTC not needed, cash values are provided
  - Likes the idea of the potential to not just defer taxes on gains in the contract, but potentially eliminate such taxes in some cases

Tax Considerations prior to PPA

- LTC / Annuity Combinations
  - Not expressly addressed by Code under law prior to PPA of 2006
  - Uncertain tax treatment due to “separate contract” issue
- Tax-Free Exchanges
  - Code Section 1035 did not address exchanges of QLTCI contracts under prior law
  - Also did not address exchanges of life insurance, annuity, or endowment contracts for QLTCI contracts

PPA: Annuity Combos

- Separate contract treatment
  - Follows prior law rules for LTC / life insurance combinations by treating LTC “portion” and annuity “portion” as separate contracts
    - “Portion” defined
  - Facilitates compliance with QLTCI rules under Code Section 7702B and annuity rules under Code Section 72
  - Does not apply to certain retirement plan or employer-related annuities

PPA: Annuity Combos

- Tax-free benefits
  - Amounts received under the contract as provided by the QLTCI rider are treated as QLTCI benefits
  - This treatment applies whether or not the payment causes a reduction in the annuity contract's cash value
    - Deferred annuities
    - Immediate annuities
  - Same rule applies to LTC / life insurance combinations (as was true under prior law)

PPA: Annuity Combos

- Treatment of charges
  - Generally treated as distributions
  - But not includible in income
    - This rule applies even if a distribution from the contract otherwise would be taxable under Code Section 72
  - And reduce after-tax basis or “investment in the contract” (but not below zero)
  - And not deductible as an LTCi premium under section 213(a) for either life or annuities (generally same as prior law)

PPA Changes

- Favored tax treatment for non-qualified annuity combos if LTC rider meets TQ requirements beginning after 12/31/2009
  - Benefits not taxable
  - Language in Act says that this treatment applies regardless of whether benefits paid serve to reduce remaining base plan values
    - From Joint Committee on Taxation report: “Amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract’s death benefit or cash surrender value.”
    - Note: Need to meet the test of providing insurance, which requires some meaningful amount at risk to the insurance company
    - **Success in meeting this test may provide the only mechanism that allows gain in an annuity contract to be paid out on a tax-free basis**

PPA: Tax-Free Exchanges

- Amends Code Section 1035 to allow tax-free exchanges of QLTCI contract for another QLTCI contract
- Also allows tax-free exchange of life, annuity, or endowment contract for QLTCI contract
- Clarifies that combination products can be exchanged for other combination products or stand-alone contracts

PPA: DAC Tax Rules

- Code Section 848 requires capitalization of “specified policy acquisition costs”
  - Annuities = 1.75%
  - Other individual insurance contracts = 7.7%
- New rules treat LTC combination products as “other” insurance contracts
- Thus, annuity portion of LTC / annuity product will be subject to 7.7% rate rather 1.75% rate
  - *See*, however, Code Section 848(e)(3)

PPA: Reporting Rules

- Issuers required to annually report:
  - Aggregate charges against the contract to fund QLTCI coverage;
  - The amount of the reduction in the investment in the contract resulting from the imposition of such charges; and
  - The name, address, and TIN of each contract owner
- Payee statements also required

PPA: Effective Date

- New rules apply to contracts issued after 1996, but only with respect to taxable years beginning after 2009
  - Treatment of products issued prior to 2010?
- Tax-free exchange rules apply only to exchanges occurring after 2009
  - Treatment of exchanges prior to 2010?

PPA: Effective Date

- New DAC tax rules apply to specified policy acquisition expenses determined for taxable years beginning after 2009
  - Re-application of DAC tax in 2010?
- Reporting rules apply to charges made after 2009
- Clarification that separate contract treatment applies for entire Code applies retroactively to 1996 for life or annuity combos

PPA Impact on Annuity/LTC Combos

	Current Law	Under PPA
Benefits	*Not clearly defined. Most companies take the position that the LTC payments are taxable, with some exceptions*	*Favorable tax treatment of benefits if riders designed as TQ, on non-qualified annuities only* *Portions (or all?) of AV currently taxable may be paid out tax-free*
Tax Treatment of charges	*Not clearly defined*	*The LTC rider charges are distributions but not taxable, however they reduce basis. No 213(b) deduction of premium allowed.*
1035 Exchanges	*Tax treatment of transaction unclear*	*Allowed*
DAC taxes	*1.75%, but consider IRC 848(e)(3)*	*7.70%*

Pricing Assumptions

- **Lapses**
  - Deferred annuities are persistency supported
  - Stand-alone LTC lapses in ultimate durations 1-2%
  - Combo plan lapses could approach these levels in ultimate durations with richer LTC designs
  - Tremendous pricing synergies with many designs
    - If benefits of higher persistency on the base plan are attributed to LTC rider, the cost of the rider can be reduced to as low as 60-70% of that of stand-alone LTC
    - Conversely, if lapse rates are higher, ala traditional SPDA lapse rates, the LTC will still be self-supporting

Economics of ADB/EOB

Product	*IRR*	*PV Profits*	*ROA*	*Break-even year*
Annuity only, std lapses	10.9%	$611	17 bp	7
Annuity only, low lapses	11.4%	$1093	25 bp	6.5
Annuity plus LTC, low lapses	12.9%	$1094	30 bp	6

Future Considerations

- Window of opportunity for annuity/LTC combos with lower DAC tax rate effective until 2010?
- Market evolution
  - More variations inevitable
  - New structures for ADB to meet the test of insurance
  - **Provide the only mechanism that allows gain in an annuity contract to be paid out on a tax-free basis**
  - Consider 60 year old annuity purchaser depositing $100K who needs 25 months of LTC at age 80
    - Without LTC rider, she cashes out $265K (5% annual growth) and pays $50K of taxes on gain (30% tax rate), with a net of $215K after tax
    - With an LTC rider that pays out up to 150% of AV, with a cost of 50bp per year, the annuity grows to $240K so the contract pays out $360K **tax-free**

Future Considerations

- Design considerations for LTC annuities after effective date of legislation
  - Annuitization requirements
  - Consumer protection requirements, such as inflation protection and in-kind non-forfeiture benefits
  - Integration with other living benefits
- Design considerations before the effective date – what can be done?
- Upgrades and exchanges to add LTC to inforce annuity policyholders
  - Enhance persistency and enhance returns on inforce business

Combo Plan Product Development – Who Will Lead the Way?

- Distribution often has the best feel for the market and customer
- Distribution often not involved in the product development process early enough
- Too many agents are frustrated when ideas are not considered
  - Insurance company has to balance idea consideration vs. resources

Distribution Based Product Development

- Alternative model case study
- Large IMO establishes relationship with consultant
  - Consultant meets with IMO to discuss market trends
  - IMO brings agents' ideas to consultants for discussion
- Consultant produces pricing results based on industry typical assumptions
  - IMO firms up marketing story
- Presentations given to potential partner companies
  - If companies interested, additional pricing done
  - IMO may secure a marketing allowance

Distribution Based Product Development

- Why is this a Win – Win?
- Insurance Company
  - Innovative product design with less upfront cost
  - Distribution buy-in
  - Only viable products are being considered
- Distribution
  - Ability to create what the market really wants
  - Additional income if successful
  - Nurture a relationship of innovation with agents
- Do you have a Combo idea you want to pursue?