

Universal Life – LTC Combinations & Annuity - LTC Combinations

Product Design, Distribution,
Underwriting, and Marketing
Considerations



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II. Life/LTC Combination Products

Background – Hybrid Life/LTC Plans

- Hybrid plans generally have a component that accelerates, or draws down, remaining base plan values (death benefits and cash values) to pay for a first tier of LTC coverage
 - Represents a form of self-insurance, and results in lower rates than independent LTC benefits
- Hybrid life/LTC coverages beginning a period of expansion
 - Shrinking number of insurers selling stand-alone LTC
 - Increased rates for new LTC sales
 - Companies willing to gain experience through reduced risk plans
 - Significant product development activity in the works
- Interesting new annuity/LTC combinations appearing, with more in development due to new tax law changes

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UL LTC Accelerated Benefit and Extension of Benefit design considerations

- Product Rationale
 - LTCI need is increasingly apparent
 - 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
 - LTC, with inherent “self-insurance” of first tier of benefits
 - Combination plans pay whether LTC needed, LTC not needed and death occurs, or LTC not needed and policy is surrendered
 - LTC extension of benefits (EOB) complements accelerated benefits, rounding out the coverage

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Life/LTC Product Basics

- Various base plans including single premium universal life, flexible premium UL, WL, and VUL
- Accelerated Death Benefit LTC rider (ADB)
 - Pays out a specified portion of DB per month with a proportionate reduction to CV's
 - Charge structure typically YRT per thousand of NAR
- First generation
 - ADB only
 - Low cost
 - Self Insurance
 - Protect the producer

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Life/LTC Product Basics

- Second generation
 - Adds EOB
 - Asset re-positioning: Return assets, a multiple of assets (DB), or a multiple of DB (EOB)
 - Inflation option rounds out the coverage and addresses the comprehensive LTC needs

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Regulatory Requirements

- ADB not subject to a series of LTC requirements
 - Suitability and Shopper's guide
 - Loss ratio
 - Inflation Option
 - Nonforfeiture option if charges are YRT
 - Other LTC Model Reg requirements are generally assumed to apply to ADB, including agent licensing requirements
- Common view is that EOB benefits subject to all LTC regulatory requirements

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2006 Pension Protection Act (PPA) Changes

- "Separate Contract" treatment is clear
 - Charges are distributions
 - Technical correction to HIPAA – applies retroactively
- Charges for TQ riders reduce basis
 - Non-taxable when deducted
 - Increase gain in contract
 - Effective 1/1/2010
- Still not a QAB
- 1035 Exchanges

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PPA Impact on Life/LTC Combo

	Current Law	Under PPA
Benefits	<i>LTC benefits are tax-free if they qualify under 7702B or 101(g)</i>	<i>Same</i>
Tax Treatment of charges	<i>The LTC rider charges are treated as distributions. MEC contracts treated as gain first.</i>	<i>The LTC rider charges still distributions, but not taxable; however, they reduce basis in the life contract</i>
1035 Exchanges	<i>Tax treatment of transaction unclear</i>	<i>Allowed</i>

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Commissions

- Single Premium (industry estimates)
 - 8%+
 - 3.0 to 4.0% GA Override

- Level Premium
 - More reflective of stand-alone life commission schedules

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Market Positioning

■ Price Point

- Single Premium: \$40K – \$60K
- Level Premium: Varies by Age
- Target \$3,000/month Benefit
- Target \$100K Face Amount

■ Literature

- Emphasis on:
 - Simple “asset repositioning” sales track
 - Control of assets
 - LTC coverage / flexibility
 - Live, die or run with the money – you’re still OK

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UL LTC Claims Considerations

■ Product design will drive many aspects of claims management

- An expense reimbursement model caps benefits equal to expenses
 - *Requires not only monitoring of claimants, but tracking of bills and bill amounts*
- An indemnity model requires formal care but pays a predefined amount
 - *Still need proof of care for every period*
- A disability model is based on disability only, with a fixed benefit but no formal care requirement
- TQ status requires certification by a health care professional that disability is expected to last at least 90 days, and annual re-certification thereafter

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III. Annuity/LTC Combination Products

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Annuity/LTC Product Variations

- **Deferred annuities**

- Design one: Withdrawal of AV without SC during first 2 or 3 years of LTC (Accelerated benefit, or ADB), 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**

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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

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Consumer and Company Benefits

■ **Deferred annuity, second design:**

- No “self insurance” as in first design, but cost of LTC benefits can be kept down through extended waiting period such as the first six or seven policy years
- The biggest benefit to waiting period is to reduce anti-selection with limited underwriting

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Regulatory Environment

- Ancillary riders not uncommon on annuities, some that look much like limited forms of LTC
 - Some are not to be filed as health insurance
 - May arguably avoid marketing, licensing, and design requirements of LTC
 - May not have optimal tax positioning
- 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, the inflation protection offer requirement 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

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Policyholder Taxation

- **Treatment of charges**
 - Several companies have assumed that LTC charges are to be treated as a distribution for tax purposes
 - PLR request to that effect was withdrawn in 2005 when the IRS expressed concern about whether then current tax code allowed for annuity/LTC combos
 - Led in part to PPA 2006 provisions that provide clarification
- **Treatment of LTC benefits**
 - Some companies have filed their riders as “intended to be TQ”, and have designed their plans to meet all of the normal TQ requirements
 - Most ADB type provisions have not been structured as TQ

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Company Taxation

■ DAC taxes

- Currently 1.75%
- Change as a result of PPA, beginning after 12/31/2009
- Treated as LTC, with DAC tax rates of 7.7%

■ Premium taxes

- Not clearly addressed in regulations, but no separable consideration for the portion needed to fund the LTC rider

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PPA Changes

- Favored tax treatment for non-qualified annuity combos if LTC rider meets TQ requirements beginning after 12/31/2009
 - “Separate Contract” treatment
 - Charges not taxable, but reduce basis
 - Benefits not taxable
 - Language in Act says that this treatment applies regardless of whether benefits paid serve to reduce remaining base plan values
 - Note: Need to meet the test of providing insurance, which requires some meaningful amount at risk to the insurance company
- 1035 Exchanges allowed beginning after 12/31/2009
- DAC tax rate for annuity/LTC combos changed to 7.7% LTC rate beginning after 12/31/2009

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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%

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Market Positioning

- Lincoln, Genworth, John Hancock, Guaranty Income, Allianz, Great American, and more
- Several major carriers in development
- Distribution
 - Annuity producers
 - Banks
 - Financial planners

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Underwriting/Claims

- More challenging to impose traditional LTC underwriting on annuities than on life
- Distribution outlets
 - Differing acceptance levels for complex underwriting
 - Teleunderwriting emerging
- Claims issues similar to those for life combos

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Pricing Assumptions

- **LTC claim costs**
 - Utilization of independent benefits similar to stand-alone LTC
 - Incidence of claim
 - Claim termination rates
- **Reserves**
 - Statutory: ADB at $\frac{1}{2}$ cx, EOB and IPR a classic active life reserve calculation per LTC standards, claim reserves for expected run-off of claims
 - GAAP: May need SOP03-1 calculations for EOB/IPR

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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

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Pricing and Distribution of Business

- By sex (sex distinct or unisex rates)
- By age
- By LTC benefit

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Economics of ADB/EOB

- Incremental underwriting/issuance costs for riders over annuity only costs are usually modest
- Commissions on ADB same as annuity rate
- Reserves on ADB usually modest
- Charges for ADB flat as basis points on AV, so pre-funding involved
- EOB economic characteristics more in line with stand-alone LTC, but with lower compensation, and returns in the combo market are often 15-20%

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Economics of ADB/EOB

<i>Product</i>	<i>IRR</i>	<i>PV Profits</i>	<i>ROA</i>	<i>Break-even year</i>
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

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Risk Assessment and Risk Management

■ ADB

- True costs of most designs are very modest, as the only real benefit is waiver of SC
- Future designs may feature reductions to account values that are less than the dollars of benefits being paid (see PPA), so risk may increase somewhat

■ EOB/IPR

- Best viewed as layers of LTC benefits being purchased based on account value
 - As account values grow/decline, new layers of LTC coverage are added/subtracted
 - Charges are level basis points on AV
 - Charges for new layers are based on original age cost structure, so an added risk
- Persistency based pricing synergies as noted earlier

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Future Considerations

■ Market evolution

- More variations inevitable
- New structures for ADB to meet the test of insurance and thus assure that pay-outs are tax-free
- **Provide the only mechanism that allows gain in an annuity contract to be paid out on a tax-free basis**

■ Window of opportunity for annuity/LTC combos with lower DAC tax rate effective until 2010?

■ Upgrades and exchanges to add LTC to inforce annuity policyholders

- Enhance persistency
- Protect inforce business
- **Provide the only mechanism that allows gain in an annuity contract to be paid out on a tax-free basis**

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